Growth | Preservation | Partnership
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"The Frog in the Well Problem"

A frog is at the bottom of a 30 meter well. Each day he summons enough energy for one 3 meter leap up the well. Exhausted, he then hangs there for the rest of the day. At night, while he is asleep, he slips 2 meters backwards. How many days does it take him to escape from the well?

Have we slipped back enough? We have often described this recovery as a two-step forward, one-step back process; a back and forth between stimulus and austerity. Our belief last quarter was that we were near the beginning of a step back. The negatives to growth had been growing, but the stock market was climbing the wall of worry. We decided to raise cash. Then came weak job market numbers. Domestic GDP estimates came down to the 2.5% range (after starting the year closer to 3.5%), and several companies have reduced their earnings outlook for the second quarter. The stock market peaked at the end of April, and then began an 8-week decline, correcting 7% below the recent peak. Many great companies with strong long-term growth prospects were down 15-30%. At that time we felt that we had rested enough for the next leap forward, and decided to put some of the cash back to work. But still we wrestle with several questions. Are the problems that we are facing temporary in nature? Or are they long-term and are we doing more than just kicking the can further down the road?

We believe that several of the issues that we are facing today are transitory in nature, and as a result there is the potential for near-term positive catalysts in the second half of 2011. First, while supply chain disruptions caused by the earthquake in Japan have negatively impacted many economic sectors during the second quarter, there are signs that this is reversing. For example, there is an expected 20% increase in US vehicle production for Q3 2011, and business conditions as measured by the ESRI have recently surged. Second, the US was hit by severe weather in the second quarter, and we can only hope that this will not be repeated to the same extent in Q3. Third, and most importantly, inflation appears to be cooling which should reduce pressure on central banks around the world to raise rates, and provide consumers with a bit more buying power. While broad based among commodities, this reduction in inflation is most readily seen in the price of oil, which has declined approximately 15% from recent peaks.

But there remain many problems that are more long-term in nature. First, the geopolitical unrest in Middle East North Africa is unlikely to go away soon, and could have a destabilizing effect on global sentiment for some time to come. Second, is the magnitude of sovereign debt. The world only has to look to Greece to see what happens when a country ignores its balance sheet, and keeps kicking the can down the road. While nobody can be sure of the global impact of a potential PIIGS country default (Greece first, then who?), we take some comfort in the fact that credit risk indicators (TED and LIBOR-OIS spreads) reside near historic averages, and still sit at 50% of the levels of last summer and at only 4% of the levels during the height of the credit crisis in 2008. Countries around the world will have to face up to their debts, and the sooner the better. Austerity budgets will be in vogue, and the consequence to this will be slower growth unless corporate growth can pick up the slack.

Bernanke says it best "If the nation is to have a healthy economic future, policymakers urgently need to put the federal government's finances on a sustainable trajectory…by enacting a credible, long-term plan for fiscal consolidation." The hope would be that such action would lead to lower long term interest rates and increased confidence for both consumers and corporations. Currently lawmakers are considering options to both raise the debt ceiling and enact $2 billion of spending cuts by August 4. Both low rates and higher confidence are needed to help support corporate growth that is so necessary.

As a nation we can't rely on tax increases and spending cuts to pay off our $14 trillion in government debt. We need growth. The Federal Reserve has the money spigots wide open, but businesses have been slow to line up. The good news is that loan growth has finally begun to show signs of life (a mere 2 years into the recovery), and is up over the past 2 months. But, we need more. We need animal spirits, and we need confidence to take some risk. It's possible that we're slowly on our way. According to ISI's semi-annual survey of CFOs, hiring plans are up in 2011 at 61% of the companies surveyed, and capital spending plans also increased. This was the highest reading since they began the survey in 2003. Hopefully corporations will continue to have the confidence to follow through with their plans, although the most recent weak employment reports indicate hesitancy here.

We have not changed our view that the economy is in recovery, it's just slow and bumpy. We believe that the barbell strategy that we have been following continues to be relevant. We hold GARP (growth-at-a-reasonable-price) stocks for the two steps forward part, and we hold high dividend yielding defensive stocks to help support the portfolio during the one step back timeframe.

Based upon the risk tolerance for each client, we are balancing our stock investments with fixed income, MLPs, REITs, and preferred stock. We were active in the bond market, both corporate and municipals, in January and February when 10-year Treasury yields reached over 3.5%. However, yields have since reversed back down under 3%, and we are being deliberately slow in reinvesting maturing bonds, hoping for higher yields to come in the upcoming few quarters as QE2 comes to an end.

We look forward to speaking with you soon and thank you for entrusting us with the management of your money.

Sincerely,

John A. Zaro III, CFA	Laura K. Drynan, CFA
Managing Partner	Partner