

## Investment Strategy and the Financial Market Decline

The 13% S&P 500 decline since August 1st puts that index's total return for the past year back to approximately +8% as I write this comment and is a decline of 17% from the late July level. The benchmark ten year US Treasury Note yield to maturity has declined to 2.33% from 3.30% at the beginning of this year, reflecting concerns about continued economic expansion, but apparently not about the August 5 Standard & Poor's downgrade in the rating of US Treasury debt securities or the ultimate, potentially inflationary impact of the significant money creation by the Federal Reserve Bank in the past year with its quantitative easing program. Indeed, the US Treasury market appears to continue to be regarded as a safe haven in tumultuous financial markets.

Our lengthy quarterly commentary addresses the shorter and longer term implications of a slowing in economic growth given the clearly anemic 0.8% annualized growth in the year's first half. The financial market reaction to the slowing economy was exacerbated in July by the tenor of the deliberations in Washington regarding the debt ceiling legislation and by similar intransigence of the European monetary authorities to credibly address the peripheral countries' financial distress. We note that this weekend's announcement of the European Central Bank's plan to buy Italian and Spanish debt has at least temporarily stabilized conditions somewhat in those markets.

Memories of the financial market meltdown of just three years ago are fresh. Investors remember that selling into the precipitous decline of the autumn of 2008 was the correct course of action, as the market continued down and did not bottom until early March 2009. However, selling into steep equity market declines does not always insure success or the propensity to buy back at levels at or below those prevailing at the time of selling. Events that influence the market are unfolding rapidly and no one can predict the very short term outcome. It is possible that this episode will be similar to the last, but markets rarely accommodate simple solutions.

It is very important to remember that the economic backdrop is not that of 2008. Consumers and businesses have deleveraged since 2008, although governments have materially increased debt, yet have the potential to honor those debts. Yes, most analysts have very recently lowered their earnings forecasts for this year and next, but to levels that are still positive and that reflect historically attractive valuation levels. The same analysts have persistently underestimated the earnings potential of companies since early 2009 as they recovered to record levels. The source of much of this earnings growth has been demand from emerging market countries, as about half of domestic company earnings of constituents of the S&P 500 are from abroad with the fastest growing segments from emerging market countries. While those engines of economic growth are likely to provide important support to global economies, the US, Eurozone and Japan comprise over half of global GDP and are likely to grow much more slowly or lapse into recession. However, corporations in the US, are, on balance, well financed and able to sustain themselves to capitalize on opportunities, as they have amply demonstrated in the past two years.

Our assessment is that sharp market movements tend to overshoot, both positively and, in this interval negatively and that equilibrium ultimately prevails. The short term may well bring further declines, which will compel us to rebalance portfolios by selling those assets that performed best and adding to those down the most, but with promising fundamental prospects. In addition to fixed income allocations, hedged strategies that are part of all of our portfolios should provide a cushion to overall portfolio value decline. We will continue to adhere to the principles that guided us through the last market decline and recovery and invite any questions that you may have during this unsettling interval.