

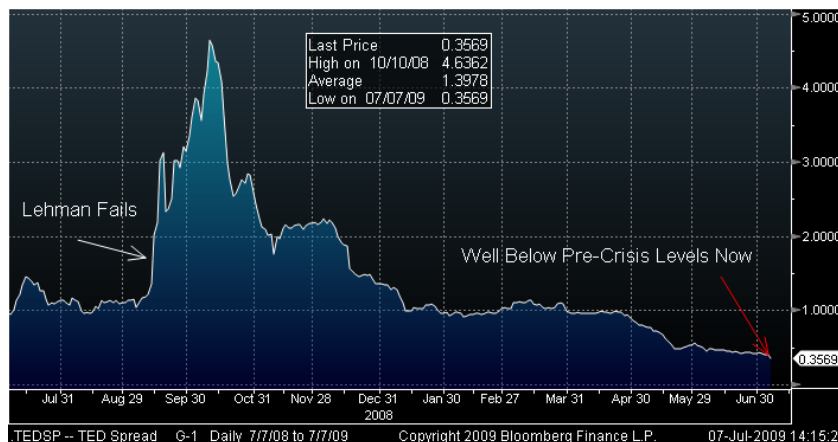
What a rally! As the specter of a collapsed financial system faded, the stock market staged the third largest rally in a hundred years, rising nearly forty percent in just over three months. Following the historic policy response by the world's central banks and governments there are signs the global economic system is healing. Until very recently much of the improvement has been in the form of "not as bad as expected" declines, but now we are beginning to see actual positive improvement in some places. Recent industrial production numbers from Germany, Japan, and South Korea are up. The Purchasing Managers Index (PMI) for manufacturing in China, India, the UK, and Singapore all suggest positive growth. Possibly confirming this, positive foreign data US exports are now growing as well. Domestically we are also seeing improvement in home and car sales, albeit from very low levels.

In the past few weeks stock markets around the world have been correcting. This is not unusual after such heady advances. The equity markets seem to be particularly linked to releases of new economic data. The markets have reacted negatively to poor payroll employment numbers. Conversely, as I write this, an IMF announcement that it is increasing its forecast for global growth next year reversed a decline in the stock market. It seems that getting the outlook on the big picture right will be even more critical than usual for our investments.

To be sure, this is not a time to be Polyanna-ish. There are still a lot of areas in the economy that have yet to see improvement. For instance, the latest Industrial Production numbers are still declining. Some areas that have been improving fell back recently. The payroll employment figure mentioned above posted its first month over month decline in four months. Likewise, vehicle sales, which had been slowly increasing since February retreated marginally in June. In general, demand remains weak in most sectors of the economy.

So what is giving us optimism that the economy is on the mend? First, the worst of the financial crisis seems to be over. Please see Chart One. This is a chart of the TED spread which is an

**CHART ONE. TED Spread**



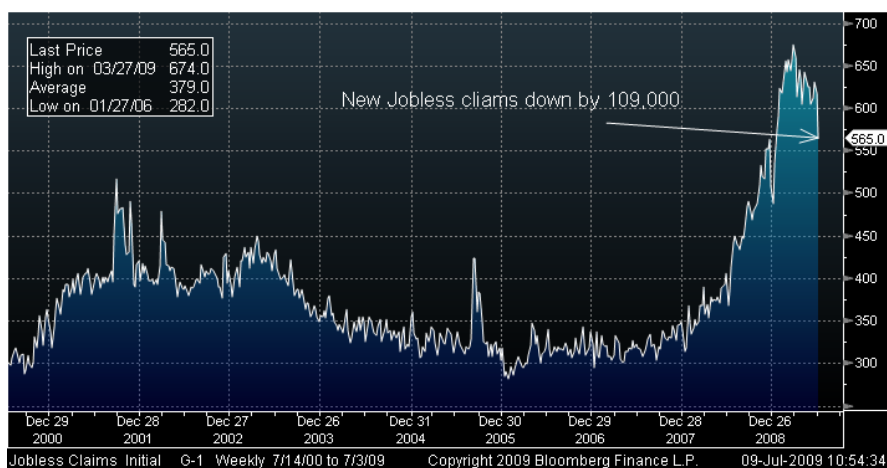
indicator of perceived risk in the financial system. (It's the difference between yields on Treasury securities and Euro dollar deposits). You may recall I included this chart in my January letter to show what happened after the Lehman debacle. After Lehman, the already elevated spread rocketed to over four percent, showing that the financial system was under severe stress. It now stands

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at less than four-tenths of one percent, a level usually indicative of stable economic times. The banking system is slowly healing. We are now “only” facing the fallout of the most severe recession in decades.

While the worse than expected payroll employment numbers recently caused a sell off in stocks, the overall employment data is mixed. Certainly the loss of jobs during this recession is the worst in decades. But even the payroll employment figure is well off its worst levels. The PMI for manufacturing employment has also improved. Layoff announcements and new unemployment claims have both been declining. Chart Two shows new unemployment claims. While elevated, recent figures are 109,000 less than the March peak, an amount that coincided with the end of past recessions.

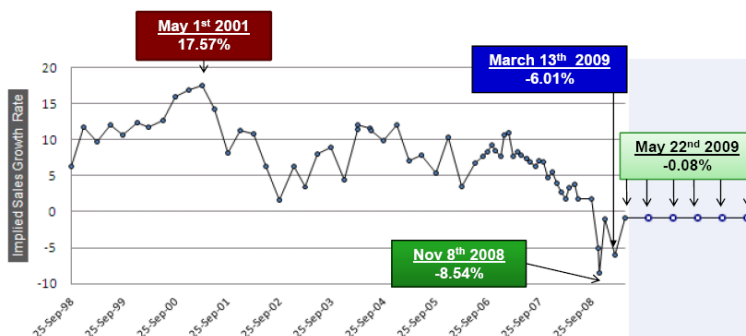
**CHART TWO. Unemployment Claims**



Some other recent positive news: Restarting of automobile production which is expected to increase by 67% versus just last month; New home sales up 4%; Consumer spending is expected to fall only -.5% rather than the previously expected -1.5%; Durable goods orders have begun to increase; Company earnings in the first quarter were not as bad as expected and estimates for the second quarter are being revised upward.

Stocks look to be of good value too. Many advisors use PE (price to earnings) ratios to gauge the value of stocks. The problem with trying to do that in times like these are that earnings are probably abnormally low which then makes the market look expensive even though it is still down more than 40% from its 2007 peak. Chart Three is courtesy of the Applied Finance Group (AFG). AFG calculated the future sales growth for the companies of the S&P 500 implied by market prices. (For comparison note that corporate sales growth was about 6% for the past several years.)

**CHART THREE. Future Sales Growth of the S&P**



When the market was peaking in 2000, implied sales growth was in the high teens, a highly unlikely outcome. In November of last year, when most stocks were at their lowest levels, the implied sales growth rate was a negative -8%, also highly unlikely. In May, when the market was at a level very

