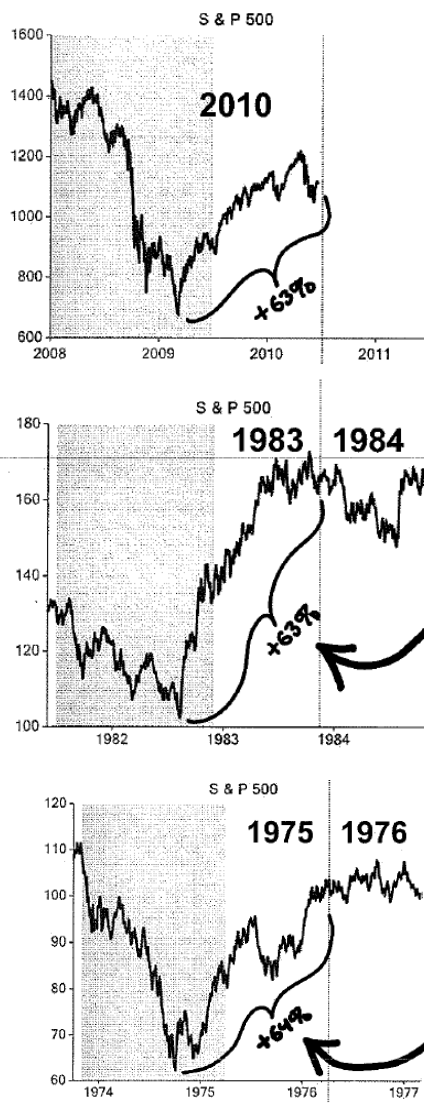


The past quarter saw was a sudden change of heart for the financial markets. From March of last year right through April of this year the stock and bond markets rallied in response to signs the global economy had seen its worst and was recovering. Then, in early May, the optimism quickly faded. Although the stock market had peaked a week or so before, the change seemed to be in response to the “Flash Crash” of May 6. In a matter of minutes the stock market lost nearly ten percent of its value. We found out later that the problem was mainly due to the modern computer centric markets and a huge, but incorrect, order. But even though the market came right back and many of the craziest trades were canceled, investor complacency was dashed.



Suddenly, problems like Greek solvency took on a new urgency. And it wasn't just Greece. Potential problems with the sovereign debt from Portugal, Italy, Ireland and Spain also came into focus and with it the realization that Europe is probably going to fall back into recession. To make matters worse, China, the engine of global growth, began to slow more than was expected. Our economy hasn't helped either as much of the data coming in has been less than robust.

Chart One shows graphs of the S&P 500 index one year into the economic recoveries following the recessions of the 1970s, 1980s, and now. These are the three deepest recessions in the post-WWII era and all show comparable, robust, stock market rallies. We can see that the timing and extent of the current correction should not be looked at as unusual. We can also see that the second year of economic recovery has not been very profitable for the stock market. After that the examples diverge. In the case of the 1970s, the stock market remained mired around the 100 level for years. In the case of the 1980s, the stock market exploded with one of the strongest bull markets in our history. Our big question is which, if either, example most closely resembles where we are headed?

Chart One. S&P 500 Index

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Given the severity of the recession we should have expected a more robust recovery in the economy. The first year following the recessions noted above both saw seven percent. growth in the economy.

The past year's recovery grew four percent. Chart two shows how sales during this recovery are growing at half the rate of previous recessions.

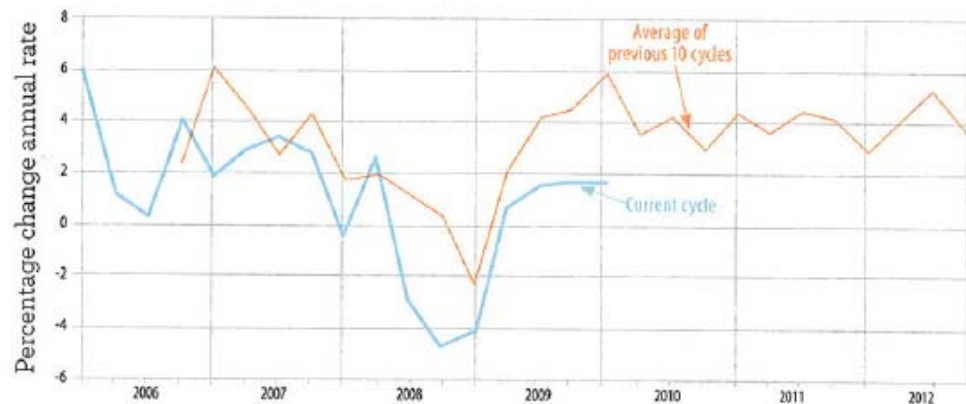


Chart Two. Growth Rate of Inflation Adjusted Final Sales
Current Cycle vs. average of previous 10 cycles

Source: Haver Analytics, Wells Fargo Advisors

Employment growth has also been anemic. Within two to

three quarters the two past recessions saw private employment growth between 200,000 to 400,000 per month, with the lower number representing the 1970s. This time we did get one month over 200,000 but then job growth dropped dramatically to only 33,000. It seems we are already facing a more problematic future. The kind of fiscal response by the government might be another clue. Unfortunately, today's response much more closely follows the 1970s' model.

Nobel laureate Paul Krugman says our current economic recovery is in trouble because the trillions of dollars spent as "stimulus" just wasn't enough; the government needs to spend more and more. Krugman's is a Keynesian-like economic theory that doesn't distinguish between a fiscal policy that keeps government workers employed and a policy which promotes private sector endeavors. The problem is that this program hasn't promoted economic growth. It didn't work in the 1930s when the government increased taxes and regulation in favor of an increase in government spending and a devalued currency. It didn't work in the 1970s either. That was another period of higher government spending and taxes coupled with a weaker currency. Recently announced government spending illustrates why this kind of policy doesn't work.

In a Saturday radio address in early July the President announced that \$2 billion was going to be given to two private companies involved in the solar power industry. About 1,585 permanent jobs are expected to be created. That's about \$1.26 million per job! There should be 3,600 temporary construction jobs created as well. That brings the amount to be spend for both permanent and temporary jobs to about \$385,000 each, about 7.4 times the national median income. Almost certainly that capital would have been spent in a more efficient and productive manner by creating more jobs in the private sector. The opportunity cost is substantial.

Contrast the Keynesian-type policy with a policy that lowers taxes, cuts or restrains government spending, and promotes a stable currency. These measures were used in the 1920s, 1960s and 1980s and all led to above-trend growth. In a recent article on RealClearMarkets.com John Tamny discussed post WWII West Germany. "West Germany defied the Keynesian consensus, and moved in favor of real stimulus through tax cuts which stimulated the supply side of its economy, along with a stable mark...Within a few short years this formerly decimated country

was the most prosperous in all of Europe”. Japan’s response was similar. With similar results as well.

At this point we don’t know what will happen to fiscal policy in the upcoming months. It does seem evident that the Keynesian-type model is still in favor. As such it appears that a 1970s-like outcome is more likely. For equities we will be lessening exposure to companies and sectors that require robust economic growth in favor of those which require less macro-economic support. For fixed income portfolios we will be buying bonds with longer maturities.