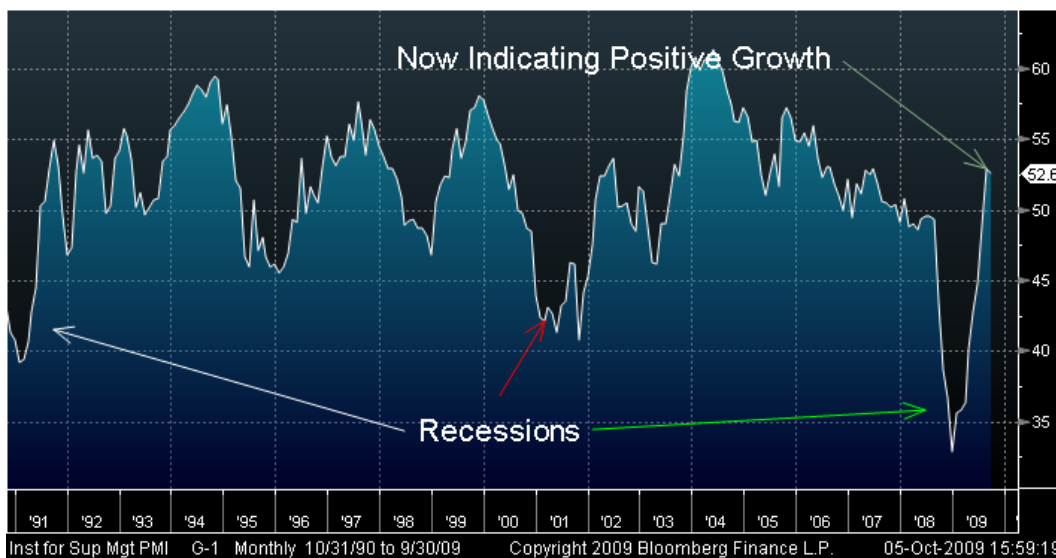


Another great quarter for financial assets! When we guessed that the worst was over for the bear market in our April letter little did we know that one of the most powerful rallies ever for stocks and bonds would be in the offing over the next six months. Markets are supposed to “climb a wall of worry” and they are certainly doing just that. Despite what appears to be the beginning of a rare synchronous worldwide economic recovery, I am still seeing prophecies of coming crashes in the markets and economy. The funny thing is that many of the reasons for negativity cited by the doomsayers are somewhat correct. There are lots of problems with which we will need to contend. For now, and probably the next few quarters, I think the cyclical forces supporting the economic recovery will out-weigh longer term secular problems.

Over the course of the past year global governments and central banks have made over 700 separate fiscal and monetary policy moves to stimulate the various economies. It typically takes time for measures such as these to take effect and the current environment has been no exception. But we can see they are starting to take hold. Chart 1 shows The Purchasing Managers’ Index (PMI) for manufactured goods for the US. The PMI is the result of a survey taken by companies who report on specific economic measures for their companies.

Chart 1. Purchasing Manager’s Index for Manufacturing.

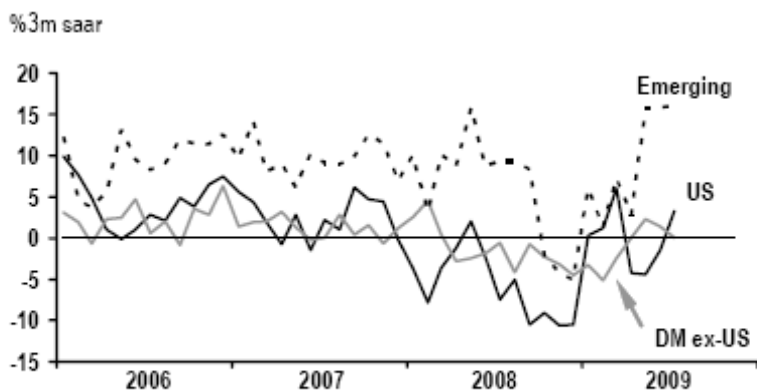


It is widely used as it has a good track record of marking turns in manufacturing activity. A number in the upper 40’s, or higher, indicates positive economic growth. As you can see, since the beginning of the year, when the index bottomed, it has progressed steadily and is now in “positive” territory.

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Something that is very different about this recovery as compared to those in the past is that the US is not looking like the engine for world growth. It has often been said that when the US sneezed the world caught a cold. This is because the sheer size of our economy dwarfs other regions of the world. But there was a change during the last expansion that seems to have continued into the recovery. Rather than the US, it was emerging economies who were producing the incremental growth in the world economy. Now we see that emerging economies, especially in Asia, are leading the way out of recession as well. Chart 2, from JP Morgan, shows

Chart 2. Goods Consumption Growth



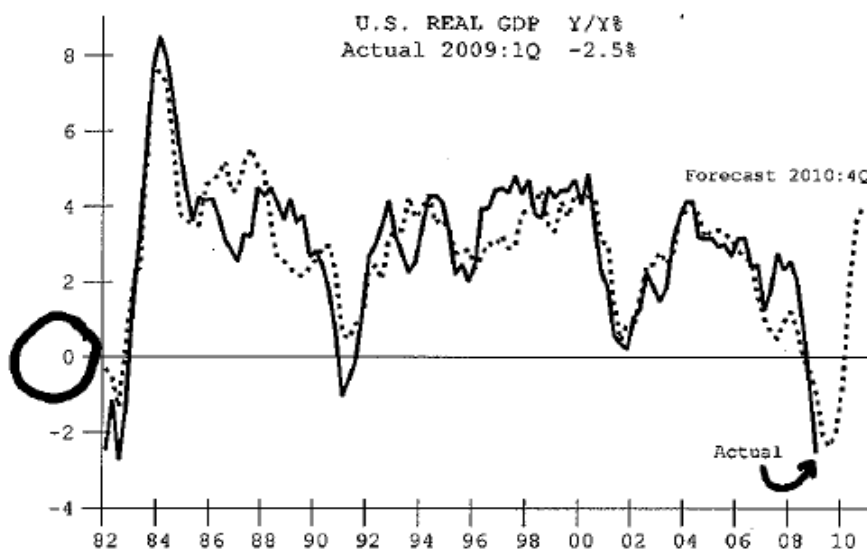
goods consumption growth by the US, the emerging economies, and developed economies excluding the US. We can see that emerging economy consumption held up longer and has come back stronger than other parts of the world.

That a recovery appears to be upon us should not be a surprise. While nothing in economics is as precise as math or science, there is a

history of cause and effect for policy initiatives. Chart 3 shows a chart of ISI's economic forecast model. This model is heavily dependent on monetary variables. Happily, this model is predicting decent economic growth for the next year which should provide a good background for the markets.

One might conclude that if a firm like ISI can create a forecasting model that, while certainly not perfect, can catch the major effects of policy decisions, our policy makers would understand what works and investors would act more logically. Yet for some reason we have days like two Fridays ago when poor employment figures, a lagging indicator, led to a large sell off in the stock market. Why such an interest in a lagging indicator?

Chart 3. ISI Economic Forecast Model



Likewise, some fiscal policies have been shown to have long term affect while others are short lived. The recent cash for clunkers program is a good example. Auto sales were running at

about a 9 million annual rate prior to the clunker program, rose to 14 million, then immediately crashed back to the 9 million rate when the program stopped. One-time income tax credits have been shown to act similarly. Things that affect growth in the economy and thus the returns of our investments are those that affect the long term cost of capital for investors, both companies doing business and investors in the markets.

It doesn't matter whether we are talking about business managers deciding to introduce a new product or an investor looking to buy a stock or bond, the same finance theory holds; the higher the cost of capital, the less valuable your asset. Chart 4, from AFG, shows the math. We see that the required rate of return for our investment is 3% with no inflation or taxes. If 4% inflation is introduced we need to earn 7.12% before inflation in order to still make our original 3%. The amount is 4.62% if taxes are introduced and 10.95% if we have both taxes and inflation. For businesses, this means that they look at selling a certain product or service and choose those that will make at least the cost of capital. It is easy to conclude that there are probably a lot more things out there that could make 3% than there are that can make 10.95%. In the lower cost environment more products are made and sold. More people are employed. The economy grows faster. At the higher rates fewer products will be found that can make the higher profit. Fewer people are employed. The economy grows slower. Note that the economy can still grow, just at a slower rate.

Chart 4. Cost of Capital with Inflation and Taxes

		No Inflation/ No Taxes	No Taxes	No Inflation	Taxes & Inflation
a	Real After Tax Return	3.00%	3.00%	3.00%	3.00%
b	Inflation	0.00%	4.00%	0.00%	4.00%
$c = (1+a)*(1+b)-1$	Nominal After-tax	3.00%	7.12%	3.00%	7.12%
d	Investor Tax Rate	0.00%	0.00%	35.00%	35.00%
$e = c/(1-d)$	Nominal Before-tax	3.00%	7.12%	4.62%	10.95%

Our friends at AFG have shown how this works in reality. From 1968 to 2008, periods with increasing inflation and/or taxes realized real GDP grew about .4% less than periods of decreasing taxes and/or inflation. This may not seem like much, but when compounded it makes a huge difference. If our economy had grown .4% less during the life of the USA our GDP right now would be 61% less than it is today. That would bring us back to about 1976.

Let's use a bond example to show how the cost of capital effects our investments. Going back to the example in Chart 4, we need a 3% rate of return. If there are no taxes or inflation our bond is worth \$1000. Add inflation into the mix and the price drops to \$492. We have lost more than

half of our investment! If we have both taxes and inflation the price drops to \$303. Clearly, these are important issues in regard to our investments.

Tax increases and inflation are two of the biggest potential secular problems I see on the horizon. Inflation is not a problem right now as there is ample spare manufacturing capacity and demand is tepid. As the economy recovers and those become less true the Fed will need to take away some of the huge capital reserves we have discussed in the past. If they act too slowly, being afraid they could weaken the economy, inflation could become a problem.

There is no shortage of talk about raising all sorts of taxes. Value added taxes, cap and trade, healthcare, and income tax increases are all being discussed. Raising taxes in a nascent recovery is unusual. For cap and trade we have a White House estimate of tax increases of \$1,761 per family, about a 15% increase in tax burden according to *Investor's Business Daily*. The White House continued: "Economic costs will likely be on the order of 1% of GDP, making them equal in scale to all existing environmental regulation." Most of the other measures have estimates that are all over the board and, of course, nothing has been passed into law yet. Be sure that we will be keeping a close eye on the magnitude of any increases.

We are investing in order to take advantage of what appears to be a global recovery. We are looking for companies with higher sensitivity to the (positive) changes in the economy. We had been fairly heavy in consumer cyclicals, which are considered an "early" cyclical. We are now putting more focus on later-stage cyclicals like commodity based and industrial businesses. We had been focused on mostly corporate bonds for fixed income investments but spreads have quickly contracted in recent weeks leaving yields very low. We are looking for opportunities but are being cautious in regard to bonds.