

BARNETT & COMPANY

INVESTMENT COUNSEL

Quarterly Review and Outlook

2nd Quarter 2010

One Dip or Two?

Any self-respecting contrarian must question his premises once the consensus moves over to his side of the fence. Last fall, when the bulls were rampaging, we highlighted some of the obvious impediments to a robust economic recovery, and suggested that the pace of expansion would be more bridled than the groupthink scenario. Now in light of the recent market correction and a helping of disappointing data, the punditocracy is obsessed with speculation about the odds of persistent deflation and a double dip recession. The mood, it seems, has swung too far toward the dark side. We believe that a healthy (and expected) correction is under way, and our original outlook remains intact: no double dip back into recession, but subnormal growth, stubbornly high unemployment, low interest rates and volatile markets well into next year.

A meaningful pullback was long overdue, and finally materialized in May, wiping out first quarter gains and leaving every equity index in the red for the year to date. The Dow Jones Industrials fell 10% in the second quarter and finished below 10,000. The S&P 500 lost 11.4% for the quarter and 6.7% for the year to date, revisiting a level last seen in early October of 2009. The tech-heavy NASDAQ Composite index dropped 12%, and the Russell 2000 small cap benchmark gave up 9.9%. Foreign stock



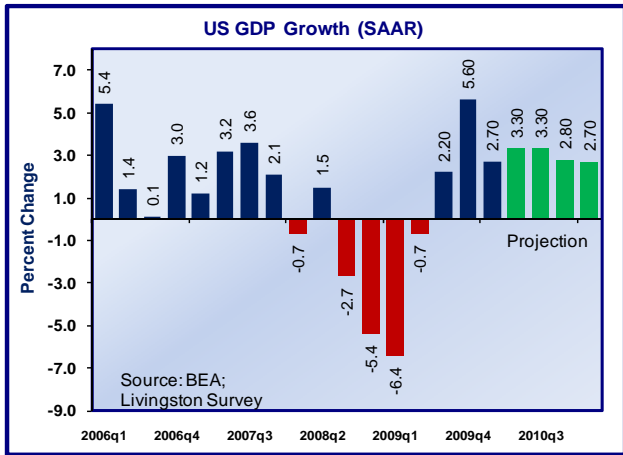
markets continued their slide as well, with the MSCI EAFE international index falling 14%, and the MSCI Emerging Markets bogey coughing up a loss of 8.4% for the quarter. Only the bond market prospered, as frightened investors once again plunged into the perceived safety of fixed income. The Barclays Aggregate Bond index gained 3.5%, while the price of a 30 year US Treasury bond gained an incredible 12% and drove the yield to a pathetic 3.9% in a classic flight to safety in response to the heightened fears of another global slowdown.

Not much to cheer about this quarter

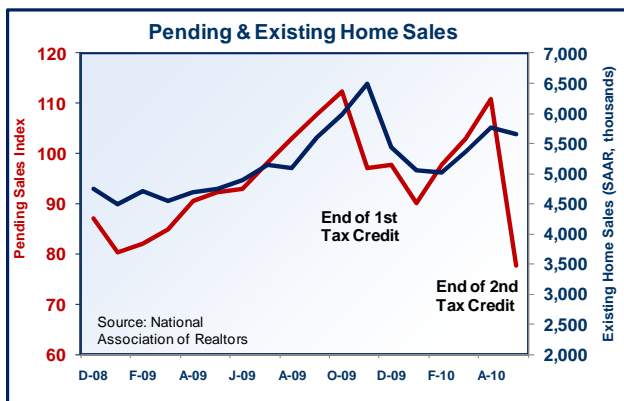
Most of the economic data disappointed investors, as the fragility of the recovery reasserted itself. Economic growth is proving to be about half as strong as one would normally expect following such a painful recession. First quarter GDP

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growth, originally estimated at 3.2%, was revised down to 2.7% at an annualized rate. Although this was the third straight quarterly uptick, about half of the rise was accounted for by inventory replenishment, not final demand for goods and services. Economists are currently recalibrating their forecasts for the next four quarters downward from the 3.2% mean growth rate they had predicted earlier.

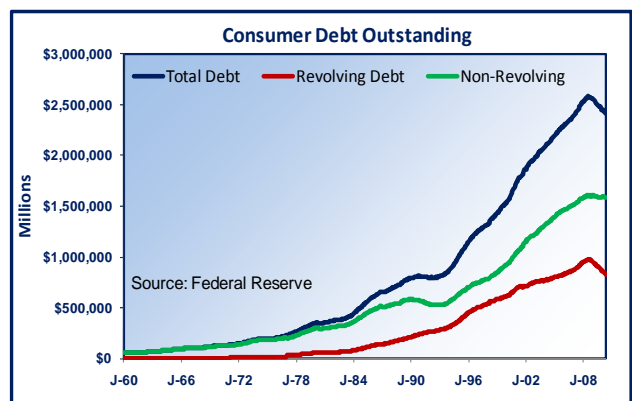


Perhaps of most concern is the execrable state of the US housing market, which continues to languish despite record-low mortgage interest rates. New single family home sales descended to a new post-war low in May, 18.3% below the previous bottom of one year ago. Meanwhile, the Pending Home Sales index maintained by the National Association of Realtors plummeted in May following the expiration of the extended home buyer tax credit. This



index tracks the execution of sales contracts and tends to adumbrate the eventual number of existing home sales reported (actual closings at which time the buyer gets the keys). Residential real estate is still sick and probably will get sicker for a while, as foreclosures increase and some homeowners walk away from mortgages that are hopelessly underwater. This is part of the explanation for the exceptionally weak labor picture, inasmuch as the home building and real estate sectors had been the leading engines of new job creation in the decade of the 2000s.

Credit continues to be a topic of concern at many levels. Obviously the amount of debt at the federal, state and local levels is a topic that will be discussed in many upcoming editions. What is relevant in the shorter term is the ongoing deleveraging of the consumer, upon whose back (and pocketbook) the lion's share of economic activity depends. Household indebtedness ballooned virtually unabated in the post-war period, fueled by the expansion of mortgage lending and by a veritable explosion in revolving credit (credit cards, personal loans, etc.) made possible by the invention of securitization. Now the worm has turned, and consumers are unwinding some of this borrowing (some voluntarily and some involuntarily). The ultimate extent of improvement to household

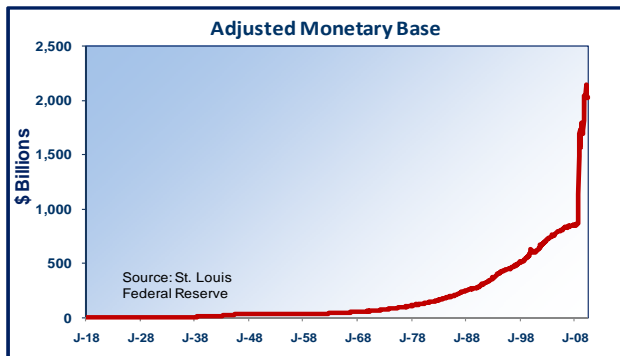


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balance sheets remains unknown, and the longer-term impact will be positive for families and for business capital formation, but the immediate effect is less spending and slower growth.

Plusses that make the double dip unlikely

Just as the struthious bulls ignored or minimized the potential dangers last year, so now the pessimists are overemphasizing the obstacles and gainsaying the positives. Federal Reserve policy remains extraordinarily accommodative (Fed-speak for “easy”). Interest rates remain at historically low levels and are likely to remain there for quite some time, given the excess capacity in the economy and the absence of inflationary stirrings, at least for now. Furthermore, in an effort to offset the dearth of lending by banks, the central bank has injected an unprecedented amount of liquidity (i.e. money) into the system, as seen in the chart of the monetary base since 1918.



Large non-financial businesses in the US are reaping the rewards of a rapid adjustment to the financial crisis of 2008, having aggressively reduced headcount and slashed expenses. Corporate earnings growth has been impressive over the past three quarters and is expected to make a repeat performance this time around. Furthermore, cash balances on corporate

balance sheets are approaching all-time highs; these cash stashes will eventually be deployed into productive investments in capital goods or returned to investors in the form of dividends or stock buybacks, either of which will help support the fragile recovery.

Another motivation for corporate caution had been uncertainty regarding the political and regulatory climate; financial regulatory reform and implementation of the health care reform bill are still incomplete and their ultimate costs to business uncertain. As these initiatives play themselves out and businesses adjust to the new realities once they are known, they are more likely to proceed with planned investment and expansion. The upcoming election in November will also provide some additional clarity once the new balance of power in Washington and in state governments is known with more certainty.

One notable bright spot in the slow-motion recovery has been the US manufacturing sector, one of the few parts of the economy to have consistently added jobs for several months now. Given the expectation for continuing (or growing) global uncertainty, the US dollar is likely to maintain its relative strength for the present time, making exports from American manufacturers more competitive and prolonging the expansion in production jobs here at home.

On balance, we believe the positives outweigh the negatives for the time being, and that the recovery is sustainable for at least the next few quarters. No double dip.

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