

# The Fairlead Quarterly

Second Quarter of 2010



215 Reed Boulevard

Mill Valley, California 94941

[www.fairlead-fa.com](http://www.fairlead-fa.com)

415-381-6890

## Quarterly Overview

The equity market's meteoric bounce off of its March 2009 lows has finally abated. This past quarter witnessed a broad-based period of correction with all market segments posting losses. Large Cap (Russell 1000) posted a -11.44% loss, Mid Cap posted a -9.88% loss and Small Cap (Russell 2000) a -9.92% loss. Emerging Markets were down -8.29% which was slightly less than the US markets for the quarter. The big loser for the quarter was the EAFE index which was down -13.75% most of which occurred in April and May as investors lightened up on their holdings of European stocks in the face of the European Debt Crisis scare. Through June 30<sup>th</sup> almost every major equity (stock) index is negative year to date. In contrast, the bond markets generally performed well during the quarter as investors shunned risk and embraced safety.

There is a silver lining to this recent correction trend - valuations are becoming more attractive and more accurately reflect the uncertainty of earnings and the global recovery going forward.

We have shared our concern that the numbers coming out on employment, housing, and the consumer were painting a picture that was brighter and more optimistic than the underlying reality. Everyone knew that the numbers were being impacted by various stimulus packages (cash for clunkers, home buyer tax

### INSIDE THIS ISSUE

Quarterly Overview	1
The Backdrop	1,2
Going Forward	3
Summary of Index Returns	4

credits, census workers) but no one really knows how the dust will settle now that the programs have been removed.

## The Backdrop

**Global Sovereign Debt:** in last quarter's newsletter we directly addressed the threat posed by the global sovereign debt situation and our concern that this issue, while being addressed in the press, was not being properly acknowledged by the market. Unfortunately, there is a massive Global Macroeconomic challenge posed by the balance sheets of the Developed Western Nations. Their enormous and ever increasing indebtedness, now brought to the fore, is impacting policy decisions - and make no mistake, these policy decisions will have a real world impact on the global economy. The problem is that all of these decisions will be subject to "the law of unintended consequences" - no one really knows exactly how the ripple effect of their decisions will play out. There has never been a more interesting time to be a student of macroeconomic policy because the stakes are high and the "experts" do not agree.

At the heart of the debate rests the fundamental disagreement about how to “save” the economy from recession. For simplicity’s sake we will separate the world into Keynesian economists and non-Keynesian economists.

“Keynesian economics advocates a mixed economy—predominantly private sector, but with a large role of government and public sector... Keynesian economics argues that private sector decisions sometimes lead to inefficient macroeconomic outcomes and therefore, advocates active policy responses by the public sector, including monetary policy actions by the central bank and fiscal policy actions by the government to stabilize output over the business cycle...The former British Prime Minister Gordon Brown, President of the United States Barack Obama, and other world leaders have used Keynesian economics to justify government stimulus programs for their economies...Keynes argued that the solution to the Great Depression was to stimulate the economy (“inducement to invest”) through some combination of two approaches: a reduction in interest rates and government investment in infrastructure.”(Wikipedia)

Opponents of Keynesian theory would suggest that the end result of reduced interest rates is asset price inflation, and after 30 years of stimulating ourselves through each economic downturn by lowering rates we have exhausted this option. They would further argue that government investment gets hijacked in the political process leading to an inefficient allocation of capital which both weakens the Government balance sheet and fails to achieve its objective of meaningfully stimulating the economy.

In any event, policy makers across the globe will be debating whether or not to increase

spending to stimulate the economy or decrease spending to help the balance sheet. Should they raise taxes to close the deficit gap or lower taxes to stimulate the economy with the hope that this increased activity will lead to greater tax revenues? Should they hire government workers to decrease unemployment or fire workers to balance the budget?

This dichotomy was evident in the most recent G-20 meeting in Toronto in June, where Obama went “to promote government spending and stimulus-style policies to his global counterparts, who these days are more worried about their growing debts” (WSJ Online, June 25, 2010)

**Inflation:** Remains very low with a *decrease* in the CPI over the past three months of 0.03% or 0.87% over the past year. With continued high unemployment, low factory utilization and fears of a double dip recession increasing daily, inflation should remain in check.

**Bond Credit Spreads:** Bond credit spreads continued to increase this past quarter. As the fear of a renewed global recession grew investors sought to reduce risk – driving up demand (higher prices, lower yields) for low risk treasuries and high grade corporate and dampening demand for high yield bonds (lower prices, higher yields) which have performed so well over the past year.

**The US Dollar:** The dollar which had strengthened considerably against the Euro when the “Debt Crisis” first became headline news, has now given back much of that ground.

**Government Stimulus:** Over the next two quarters we will begin to see economic numbers with less “stimulus” behind them. Housing and employment, both crucial to a sustained recovery, will be of particular interest.

**Housing:** According to Robert Schiller, co-founder of the S&P/Case-Schiller Housing Index, housing and construction expenditures have typically been about 4-6% of GDP. In April he indicated he “did not trust the trend that we have” and was worried that “it might get reversed” once the various stimulus measures (tax credits, Fed’s purchase of mortgage-backed securities) come to an end. As if to punctuate his concern, new home sales declined by 33%(!) from April to May.

**Unemployment:** Unemployment continues to plague the economy and we aren’t hearing anyone suggest the number might drop below 9% any time over the next year. May was particularly disappointing; employment increased by 431,000 but 390,000 of those were temporary census workers, which means only 41,000 came from the private sector, far below the consensus expectation of 180,000.

According to the June ADP National Employment Report, nonfarm private employment increased 13,000 from May to June. But a peak behind the curtain shows disturbing weakness – construction dropped 35,000 (good news is that’s the smallest drop since July 2008) and the financial sector dropped 10,000 giving both sectors 3 years of consecutive monthly declines.

We are concerned that as State’s begin to grapple with their own fiscal challenges (they can’t print money like the Federal Gov’t) we will begin to see accelerating layoffs from state and local governments that will only exacerbate the situation.

**Oil & Commodities:** Commodities on the whole were down another -4.81% on top of the -5.03% (as measured by the DJ UBS Commodity Index) they were down in the first quarter. These prices reflect decreased de-

mand and concerns about future demand. China has been a huge consumer of commodities and they are clearly trying to control their rate of growth which could translate into lower demand for commodities.

Gold continued its move to new highs closing up 11.52% for the quarter – more fear and fiscal concern.

Crude Oil was down -9.71% for the quarter reflecting slackening global demand. This sector will also be interesting to follow as the BP Gulf Oil Spill approaches its fourth month. What will the near-term costs be for the companies involved? What impact will the moratorium have? What restrictive regulations will result to increase the cost of extraction?

## Going Forward

We continue to prefer balanced portfolios that are well diversified with high quality global franchises. As we have previously stated we believe that we are in a secular bear market for equities that has the potential for a pull-back even without a “double-dip recession”. We believe higher taxes, high unemployment and a heightened desire to save on the part of those who are working will keep the US consumer on the sidelines. We believe the high wire government balancing act between a desire to stimulate our way out of recession and a realization that we must address a fiscal policy that has spiraled out of control will continue to weigh on the markets for some time to come leading to greater market cyclicality.

As always I am available to discuss the markets, the economy, your portfolio and your concerns.

JOHN VREELAND

## SUMMARY OF INDEX RETURNS

Global Markets Year to Date				
INDEX	2nd QTR of 2010	Calendar Year 2009	Calendar Year 2008	UNMANAGED INDEX DESCRIPTION
Russell 1000	-11.44%	28.43%	-37.6%	<i>US Large-cap Stocks</i>
Russell 1000 – Growth	-11.75%	37.21%	-38.44%	
Russell 1000 – Value	-11.14%	19.69%	-36.85%	
Dow Jones Industrials – Total Return	-9.36%	22.68%	-35.65%	
S&P 500 – Total Return	-11.42%	26.46%	-37.00%	
NASDAQ Composite	-12.04%	43.89%	-40.54%	
NASDAQ – 100	-11.19%	53.54%	-41.89%	
Russell Mid-Cap	-9.88%	40.48%	-41.46%	<i>US Mid-cap Stocks</i>
Russell Mid-Cap – Growth	-10.20%	46.29%	-44.32%	
Russell Mid-Cap – Value	-9.57%	34.21%	-38.44%	
Russell 2000	-9.92%	27.17%	-33.79%	<i>US Small-cap Stocks</i>
Russell 2000 – Growth	-9.22%	34.47%	-38.54%	
Russell 2000 – Value	-10.60%	20.58%	-28.92%	
MSCI World ex USA	-13.41%	34.39%	-43.23%	<i>Morgan Stanley World ex USA (US\$)</i>
MSCI Emerging Markets	-8.29%	79.02%	-53.18%	<i>Morgan Stanley Emerging Mkts (US\$)</i>
30 Day Money Market – All Taxable	0.0%	0.16%	2.03%	<i>Cash</i>
Consumer Price Index – US	-0.03%	2.9%	4.31%	<i>Measure of Inflation</i>
Barclays US Corp. High Yield Index	-0.11%	58.21%	-26.15%	<i>High Yield (Junk) Bonds</i>
Barclays US Aggregate Bond Index	3.49%	5.93%	5.24%	<i>General US Bond Index</i>
FTSE NAREIT REIT: All	-3.66%	27.45%	-37.34%	<i>Real Estate Investment Trusts</i>
Dow Jones – UBS Commodity Index Tot Ret	-4.81%	18.91%	-35.65%	<i>Basket of Commodities</i>
Crude Oil – Arab Light Crude	-9.71%	77.94%	-49.94%	<i>Price of Arab Light Crude</i>
Gold – London PM	11.52%	25.04%	4.91%	<i>London Spot Price</i>

Source – Thomson Financial Company