

July 2011

3rd Quarter Outlook

DETOUR ON THE ROAD TO RECOVERY

As we enter the 3rd quarter of 2011, it seems like we have hit a bump in the road in our attempt to get the domestic economy back on track. Housing news continues to be difficult, the employment picture remains cloudy at best, auto sales (hurt by Japan supply limitations) have lagged, industrial production numbers are slipping, and the retail environment is mixed at best. Consumer confidence numbers are low and not getting much better and this, combined with global pressures, has led to what will likely be a meager 1-2% GDP number for the 2nd quarter. (News did improve slightly as the 3rd quarter began, as we got surprisingly good news in manufacturing the first week of July).

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Speaking of global pressures, the situation in Greece continues to fester as the inevitable continues to be delayed as politicians look for a way to prevent the dreaded "contagion" that is likely to occur. Few doubt that the Greeks' most probable outcome is some sort of default. No one knows what the ripple effects will be if and when the day of reckoning comes. A "Lehman Brothers" form of contagion is a nightmare type of scenario that no central bank or politician (let alone simple investment advisors located in The Woodlands, Texas) wants to even envision. Unfortunately, this contagion is exactly what needs to be understood when political decisions are made. Who owns the Greek debt? Who will have to take the haircuts and what does this do to their capital requirements? Well we know, for instance, that many European banks own a good portion of this debt, and that banks around the world deal with these European



banks. I think you know where I am going with this.

This leads us to our domestic politics here in the United States. The showdown over the debt ceiling and budget deficit is a very dangerous game of chicken. Should the U.S. "default" on its debt or miss an interest payment, even for a very brief period of time, we don't know what the ramifications would be. The rating agencies would surely have to act and commence downgrades of U.S. Treasury securities to something less than the AAA rating it presently holds. The "Gold Standard" that the U. S. has provided for generations would be in jeopardy and quite frankly none of us can predict what the consequences would look like. Again, those simple money managers in The Woodlands, Texas would rather not find out. It's time that politicians take this very seriously, get the job done and stop playing games with our reputation and good name.

As for the markets, our second quarter theme of liquidity vs. reality has also seen a bump in the road. After the Japan incident, and the early spring rise in oil prices, the economy, as stated earlier, has definitely seen a slowdown. Only time will tell whether this slowdown is temporary or not, but the effect on minds of investors was evident. Stock mutual funds which had finally seen several months of cash inflows saw just the opposite happen in May, as wary investors began to take money back out of these funds. Investors seem to have very little tolerance these days which is not surprising after a lost decade of price performance. It is a shoot first and ask questions later type of mentality. To say that individual investors have a case of the jitters is putting it mildly. Nothing like a couple of 50% drops in the last ten years to leave an indelible imprint on the minds of investors.

THE ECONOMY

The end of June marks the end of what the market

referred to as QE2. We have known for some time that the Federal Reserve had intended to stop their asset purchases by the end of the 2nd quarter of this year, and they have indicated that they will follow through with that intention. So where does this leave us? We have a slowing economy and a Central Bank that is backing away from the punch bowl. Quite frankly, the Fed has provided plenty of liquidity. Some would say the liquidity is overflowing. The problem is that the money is sitting on the balance sheets of corporate America and U. S. banks. The banks continue to hoard money to maintain their capital requirements as more and more loans on the books become questionably valued. As we have known for some time, U.S. corporations are flush with cash as they too protect against future uncertainty and potential downturns in their business.

Economists have reduced their forecasts for the 2nd quarter GDP, but the real dilemma is whether this slowdown is temporary or the beginning of a new leg down. Early July economic numbers were encouraging (indicating that perhaps the “temporary” camp may be proven correct) until the miserable employment report. The Japan crisis and higher energy prices definitely provided headwinds for the economy in the second quarter, but oil prices have come down in the past few weeks and word out of Japan is that by the second half of the year, many of the disruptions should be behind them. Indeed, Japan could turn out to be a driving global economic force over the next 12 months as the rebuilding begins.

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Housing continues to be a drag on the economy and it appears that this will be the case for some time to come. Working off the inventory of excess homes will simply take time as we had discussed in the past. Until then, we don’t expect housing to have any positive effects on the economy for years. On the employment front, the second quarter produced disappointing results as the unemployment rate remains above 9% (the first report of the third quarter was also dismal). As we have said for some time now, without job creation, it will be very difficult to improve consumer confidence, and with GDP numbers under 3%, it will be very difficult to create jobs. Without a pro-growth agenda coming from Washington,

corporations will not hire and will instead continue to sit on their mountains of cash.

Economic forecasts for the second half of the year have been reduced recently, but short of a total disaster in Greece and a complete slowdown in China, we think that the U.S. economy will get on a better track in the second half of the year, especially if oil prices continue to slide. What we really want to see is the budget situation addressed in a serious manner and some better job growth in the second half of the year.

PROTECTION

FIXED INCOME

We’re kind of like a broken record here. We still remain short and defensive when it comes to our fixed income holdings. On the protection side of the ledger, we want to remain diligent in choosing quality and we remain convinced that this is not time to lengthen maturities. The Fed’s QE2 program has ended and we want to see who is going to fill the void and buy all of those treasury securities that the Fed was absorbing.

So far, the predicted collapse of municipal financing has not occurred and we continue to be comfortable in good quality (especially Texas) municipal bonds with short durations. We do not believe that a collapse is imminent, nevertheless we will continue to own only what we consider the best of credits.

CASH

We have raised our cash position towards the end of the 2nd quarter and now sit with an ample supply of liquid assets. Considering our concerns about domestic and global economic forces, we are comfortable with our position. We believe that cheaper prices for stocks, and possibly bonds, may lie ahead, and feel that we are in a good position to take advantage of any price weakness, the first days of July’s rally notwithstanding.

GROWTH

STOCKS

After a very good first quarter, stocks struggled in Q2. The S&P 500 ended the quarter virtually unchanged when adding in dividends. The average would have been down had it not been for a

remarkable four day rally to end the quarter. The economic and global issues that we discussed earlier were simply too much for stocks to overcome for the majority of the quarter. Indeed, reality finally overcame liquidity. Money flows into stocks reversed in May as nervous investors headed to the sidelines again. We preached for the last two years not to fight the Fed. If Dr. Bernanke was going to provide the liquidity, then stocks had quite a tailwind at their back. With QE2 ending, it seems likely that the Fed will no longer be a tailwind. We don't believe they've become a headwind just yet, but we must acknowledge that the Fed part of the equation has lessened. This led to us lightening up as the quarter came to an end. We are curious if the economy can now stand on its own two feet, without additional stimulus from the Federal Reserve.

Earnings season, which begins on July 11th with earnings from Alcoa, will be the next major catalyst for stocks. To date, corporate executives have been somewhat positive with their views of the future, so it will be important to see if results can continue to impress. In addition, major corporate executives' views for the remainder of the year will dictate the tone of the stocks.

As we have pointed out in our updates, the S&P broke some important support levels in June which led to a new trading range of 1250 to 1300. As July began, stocks broke back through the 1300 resistance level and charged ahead past 1350. With Friday's disappointing employment report, stocks find themselves moving back into what might be a new range of 1300 to 1350. Aside from the technical considerations, stocks still look like a good relative value compared to other asset classes. Indeed, when we factor in the dividends that many of these stocks provide, we conclude that stocks are a superior asset if purchased at the right price (that's always the challenge, isn't it?). At roughly \$95 a share of earnings for the S&P 500, we still feel that on a fundamental basis stocks are a fairly good value. An S&P 500 at around 1300 puts stocks at about 13.68 times earnings, which again, are historically reasonable.

As we have pointed out, large U.S. corporations are flush with cash and we expect to see more dividend increases, stock buybacks and mergers and acquisitions as the second half of the year unfolds. We continue to prefer stocks that pay dividends and have a history of increasing those dividends. We will search for opportunities to add to quality names as the third quarter unfolds. We

feel that we have an ample supply of cash to put to work when prices dictate.

OIL AND GOLD

After the coordinated effort to drive oil prices down by announcing the intention to increase supplies by releasing strategic reserves, oil has risen to over \$95 a barrel once again. So much for trying to affect oil prices by using what are supposed to be emergency-only reserves. As we go forward in the third quarter, energy prices seem to be firmly entrenched at these levels. A break below \$90 could drive oil prices back toward the \$80 to \$85 for WTI, but seems likely to only be temporary.

As for gold, after falling back below the \$1500 level with the help of Greece and domestic debt headlines, the yellow metal is firmly back above \$1550 and seems like it wants to move higher as the third quarter unfolds. A miraculous outcome from the U. S. Congress could take the wind out of the sails of the gold trade, but that remains to be seen.

SUMMARY

With the game of chicken going on in Washington over the debt ceiling, we remain cautious despite the tremendous move for stocks in the last days of June and the first few days of July. European debt problems seem to never go away and, domestically, the lack of job creation continues to be a major concern for the economy going forward. We like the total return prospects of owning major U. S. corporations and will look for opportunities in the 3rd quarter to accumulate great companies at good prices. We spent much of the second quarter tending to our protection bucket, making sure it was sufficiently filled, and having done so, we expect to be able to attend to the accumulation of items for our growth bucket as the 3rd quarter unfolds.

FINALLY

We appreciate any feedback we can get on our communications with you. Let us know what you like or dislike, and better yet what else you would like to receive from us. We continue to strive to deliver the most comprehensive communication to you possible. Thank you in advance for your thoughts.