

The Summer of Our Discontent: Doldrums or Disaster for the Markets?

With apologies to William Shakespeare (and his Richard III), we couldn't resist tweaking his classic phrase as we offer our thoughts on what lies ahead for the markets. No doubt, the economy and its markets have come a long way since March of 2009 but not without a substantial assist from the Treasury and the Fed in the form of TARP, record low interest rates, and Quantitative Easing. This stimulus must, at some point, come to an end and that day is fast-approaching. Combine that with the sovereign debt crisis in the Eurozone and the rise of inflation in the Emerging markets and you have the makings for a drama that promises a variety of outcomes for the Global Economy: A "soft patch", double-dip recession, Great Stagnation? We think the result could be "all of the above" depending on where you live. That's why we'd rather turn our focus to the stock market and how it might react to the ensuing denouement. We expect a lot to happen this summer that could rattle investors and give the media plenty to talk about. Despite all this, we see a continuation of what is likely to be a less-than-raging bull market. Our advice? Stay cool and stay invested.

A Little Perspective

This past month some investors have been asking: "What's wrong with the stock market"? Of course the simplest answer is "Nothing" (it's the economy) but that simple answer requires some explanation. We'll begin with a reminder that the stock market is an extremely efficient processor of information about the Global Economy *in the long term* but has a pretty shoddy track record in the short-term. Remember March 9, 2009 when the market priced in the apocalypse? Unfortunately, the financial media is in the business of telling investors why the market is moving *today* rather than framing the events du jour within a broader context. We'll attempt to do that here.

Last year at this time we were on the cusp of completing a nearly 16% correction that set the stage for the significant advance we have enjoyed this past year. As of today the market has declined a little more than 5% from the year's closing high we saw on April 29th. In our March Outlook we outlined the challenges to the economy that lay ahead and advised that we could see a pullback of an over-heated market somewhere between 4-6% and that what would follow would depend on the fiscal policy initiatives undertaken by Congress and the Euro central banks this summer. Since then, the deadline for raising the debt ceiling has passed, Greece is hurtling toward a default on its debt, and China has tightened credit to deflate a real estate bubble. How all of that translates to an effect on corporate profits is the challenge for us in determining whether to alter our stock market expectations for 2011.

The Global Economy: A Grand Stage with Three Sub-Plots:

Eurozone: The Great Default - Hamstrung by massive debt and on the brink of impending default, Greece, Portugal, Spain, Italy, and other profligate spenders seek salvation from their more prudent and thrifty counterparts in the European Union. Will the "Haves" choose to save the "Have-Nots" and preserve the Union? **Biggest Challenge: Insolvency and Dissolution of the Union.**

US: The Great Stagnation - An aging empire in denial, unwilling to see itself on the same path as the Eurozone. Disaster looms ahead in a fog of partisanship and ideological conflict. But, it's not too late for redemption. Will we have the fortitude to come together, save the empire, and retain leadership of the Global Economy? **Biggest Challenge: Stagflation and resisting the temptation of more deficit spending.**

Emerging Markets: The Great Expansion - The next generation, hungry for the title held by the US. Aggressive and sometimes reckless, they outnumber the developed economies and often prey on their complacency. Will they gain

wisdom and work with others to revitalize and bridge the Global Economy through this challenging period? **Biggest Challenge: Inflation.**

As investors, we have our opinions about what should happen in each of these sub-plots and what will foster stable, long-term growth. Unfortunately, fiscal policy decisions emanate from a political process that is rife with avarice, corruption, and a lust for power. It's where the protagonists are seemingly outnumbered and without a voice. That said, the final re-write of any economic drama is left to the stock and bond markets. Over the course of the next few years they'll tell us who "gets it right" and who doesn't.

Coming Attractions

Here's our preview of the months ahead. First up is the Eurozone and what to do about Greece, arguably the prettiest setting for a welfare state you could imagine. Germany is the largest holder of Greece's debt and culturally the least disposed to throw good money after bad. However, this problem has spread virally to other needy vacation spots and now weighs heavily on the balance sheets of the ECB and every large bank in Europe. The choice? (A) Let Greece go and pray that there is no Domino Effect that will collapse the banking system OR (B) Craft a "soft default" by restructuring the terms of their debt. This would avoid another banking crisis and provide a model for other Euro-members headed for the same fate. **Bet on (B) Coupled with an austerity program and take-backs from public employees, this averts a market implosion and buys time for the economy to assist in the resuscitation of the banks' balance sheets.**

The US is at a crossroads. Never one to be preemptive with policy, it's a good bet that something will have to break before we get serious about addressing the deficits. And it will have to be done without choking off the economy. This is where the Eurozone finds itself today. At the risk of sounding heretical, we actually believe Chairman Bernanke is on the right track. We see the need to withdraw stimulus with surgical precision while keeping interest rates low. As we've said before, this is a process and not an event. It will take time. The risk in the interim is that the brain-trust in Washington drives us into the ditch by failing to reconcile their ideological divide. Neither spending cuts nor taxes alone will solve the problem to the markets' satisfaction. Both will be required. However, this is not a chicken and egg question for us. Spending cuts must come first. If not, it's time to break something and then fix it. Otherwise, we find ourselves in the same spot as the southern Eurozone, absent the scenery and cuisine of course. **Our bet: A last minute compromise that touts more style than substance and kicks the can a little further down the road into the election year. Then we do it all over again.**

As for the Emerging Markets ("EM"), their problems are of a different kind. The big players are of course China and India. We've heard it said that the first succeeds because of its government while the other does so in spite of it. Regardless, they are headed in the same direction and are moving to join the US at the center of an evolving economic universe. While the developed world struggles against stagnation at home as it imports inflation from abroad, the EM fights inflation and struggles to manage an expansion of a size not seen since the Industrial Revolution in the US. They've become the growth engine of the Global Economy. They find themselves with a hefty surplus of capital, and are uniquely positioned to ride to the rescue of the developed economies. They could also turn their back and deploy that capital internally to subsidize consumers and support asset prices. **Our bet: the EM will rein in credit to moderate inflationary excesses at home while remaining the world's banker. Fortunately, we're still their biggest customers.**

Doldrums for the Economy, Something Better for the Stock Market

Should our bets prove correct, we would expect the tailwinds from the Emerging Markets to translate to improving corporate profits through the remainder of next year. We would also expect that tailwind to more than offset the uncertainty arising from the political machinations underway here and in Europe. In these perilous times, it seems there are some advantages to having a centrally managed economy such as China's. We expect the volatility of events to be matched by that of the markets in the short-term so it's possible that this pullback could exceed our expectations. That hinges on what the US does in the current session of Congress. Deferring action on the budget now might be embraced by the market in the short-term but there would be a severe price to pay later.

As we see it today, the market's efficiency in the long-term should reflect not only the continued growth in the Emerging Markets but slow improvement in the developed economies. With the outlook for corporate profits **intact** and stocks still presenting a compelling value proposition relative to bonds and cash, we believe this Bull market is likely to persist into next year, though at a slower, uneven pace that could see stocks slightly under-performing their historical average.