

DOUBLE, DOUBLE, TOIL AND TROUBLE; FIRE BURN AND CALDRON BUBBLE?

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Act IV of Shakespeare's *Macbeth* opens with three witches stirring a boiling caldron, in a dark cave with thunder. They are throwing all kinds of nasty things into the pot, serving up a vile broth, making dark predictions. Scary thing is, their prior two prophecies were fulfilled.

It wouldn't be a far stretch to draw some tempting economic analogies here. Like the return of the witches, several pessimistic economists are on center stage again, often with good reason. The nasty, structural economic challenges of debt, deficits, and nagging unemployment, which had settled to the bottom of the economic crock pot during the market rally, have not gone away and could get worse with anemic growth.

In the past month, fears of contagion from Greece, slower growth in China, and possible "double dip recession" brought these challenges back to the surface, spoiling the appetizing flavors borne by stimulus and improved corporate earnings.

If the witches have their way, their spells will be twice the toil and double the trouble for Macbeth, who will sacrifice anything to become king. Will investors suffer the same fate as we desperately seek economic stability?

THIS QUARTER'S UNSAVORY BREW

We'll recap our own take on these economic challenges in a moment, but we'd first like to reiterate what is hopefully obvious by now: this harrowing uncertainty will take time to address, during which we are likely to see perhaps dramatic swings in asset prices as the market reacts to headlines.

As you know, our goal is not to forecast the nearer term swings in the market. Instead, it is to structure portfolios to meet our clients' long term goals in these



tumultuous times. More specifically, we must objectively assess how these unprecedented economic challenges might affect asset allocation, investment decisions, client cash flows, and investor psychology.

This quarter, in contrast to the euphoric rally of 2009, domestic and international stocks posted double-digit losses, commodities once again took a hit on fears about economic growth, and "flight to safety" investments like Treasury bills, gold and the US dollar were up 5%-10% for the quarter. It sounds like a glimpse of what we saw when the caldron was boiling hot 18 months ago.

Some "witches" are saying the recovery can continue, while others say the recent burst of activity was only temporary. Adhering to outcomes on the extreme offers high reward but also intolerably high risk for most investors. Hold on to your broom sticks.

AS FOR OUR OWN CRYSTAL BALL

To recap what we've been saying about the challenging economic picture:

- The era of incredibly cheap debt will likely reverse at some point, with wide implications for everything we do, from consumption, to investing, to economic and social policies. For the past 20 years, it has driven above-average consumption, high standards of living, and low savings rates. More expensive debt will bring new constraints on what had been relatively easy choices.

- Housing and credit are the keys to recovery, and their current state implies lower-than-expected economic growth for the foreseeable future. Government intervention can amplify activity in these two areas (both positively and negatively), but it cannot override their fundamental equilibrium.
- Currently, even accounting for second-quarter performance, the corporate bond market remains priced for optimism, the Treasury bond market is priced for extreme fear (a 34x earnings multiple on 3% yield!), and stocks are somewhere in between (with the S&P 500 trading at 13X earnings).

What do we do with this outlook? Our starting point is that we set a long term allocation plan based on our clients' specific risk tolerances and financial goals, and we stick to it. That said, we seek to understand how future events present changing opportunities and risks for portfolios today.

We are mindful that deflation may persist near-term but that the probability of inflation (or, at minimum, higher rates) increases in four or five years, which influences our fixed income strategy. In stock selection, we continue to follow our disciplined process based on Fundametrics® research and use our understanding of the credit and housing markets to stress-test investments for cushion to manage debt and support dividends. See our prior commentaries at www.cornercap.com for more details.

Adhering to a bearish or bullish prediction on the economy or markets misses the inevitable opportunities and risks that are unfolding in unpredictable ways, and leads to "market timing," with its dismal record. Our disciplined research and rebalancing continues to balance risk/reward with fundamentals and probable outcomes to help our clients meet their long term financial objectives in an uncertain time.