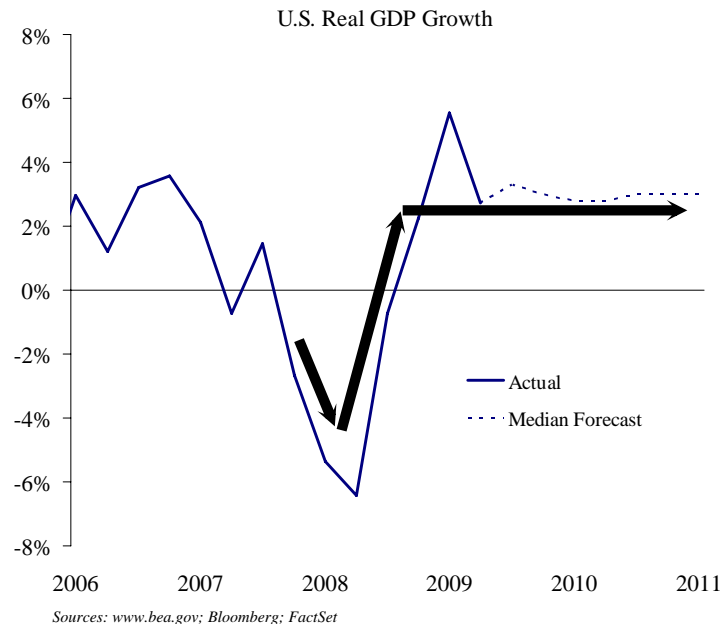


**JULY 2010**

**REVISITING THE SQUARE ROOT RECOVERY**



In the September 2009 *The Stratton Letter* we highlighted our expectation of a sharp economic recovery through the first half of 2010 driven by enormous amounts of government stimulus and inventory restocking, followed by slower growth thereafter. The shape of this recovery resembles a square root sign. Fast forward to the present and so far this has largely been the case, as illustrated above. Recent commentary from the Federal Reserve following its June meeting indicated that while the economic recovery is proceeding, the pace of the recovery is likely to be less than robust. The reason is largely due to the fading effects of government stimulus implemented during the recession as well as fallout from the European debt crisis.

✧ FROM KEYNESIAN STIMULUS TO FISCAL AUSTERITY

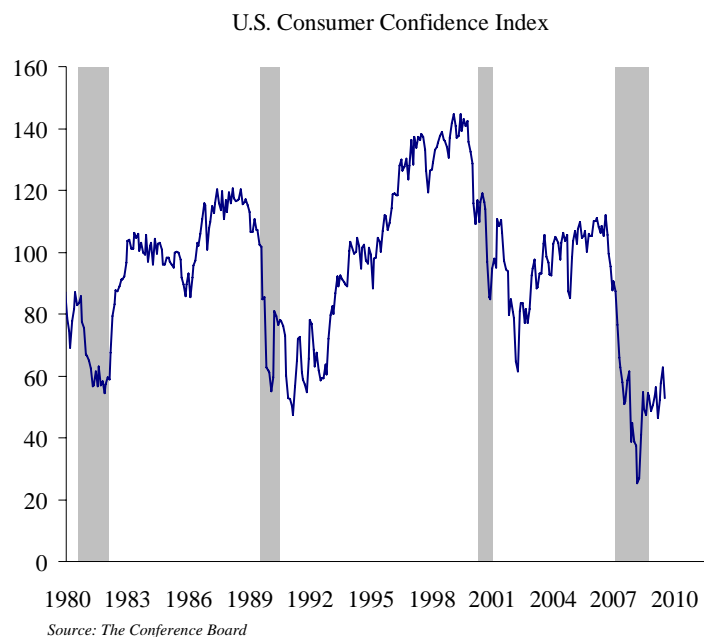
With the bulk of the stimulus in the rear view mirror, policy makers of the world's largest developed economies face significant challenges, most notably large budget deficits and stubbornly high unemployment rates. Doubts surrounding sovereign credit in Europe have driven many countries, Germany being the most prominent, to embrace an agenda of "fiscal austerity" to reduce budget deficits and secure credit ratings. Throughout the Eurozone, governments have unveiled plans to slash government spending while increasing taxes (or, more affectionately, "tax and axe"). While the reduction of government deficits is a positive over the long term, the near term risk is that simultaneous fiscal tightening across economies could undermine an already fragile recovery.

One example that highlights the high costs of austerity is Ireland. Two years ago, a weakening of its economy prompted leaders to engage in significant public spending cuts and raise taxes to maintain its credit status. The argument at the time was analogous to ripping off a band aid – feel the pain now but get it over with quickly. Currently the nation remains mired in recession with a 13% unemployment rate and an economy that contracted 7.1% last year. So far its efforts have failed to reduce government borrowings and unfortunately at this time there is no financial capacity for stimulus.

We are witnessing a rapid shift of the global economic mindset from Keynesian economics, which generally espouses the use of government spending to stimulate demand, to fiscal austerity. This was underscored at the recent G-20 Summit in Toronto where leaders of the member nations pledged to reduce their respective budget deficits by 50% within the next three years. While the U.S. stance on rapid deficit reduction has been less sanguine than its European counterparts for fear of hampering the recovery, the broader dilemma facing all policy makers is striking a balance in creating “growth-friendly” yet “deficit-fighting” policies.

#### ✧ THE U.S. ECONOMY

The Bureau of Economic Analysis recently released its final estimate of first quarter gross domestic product, and the result was a +2.7% annualized growth rate from the previous quarter. This was slightly lower than previous estimates and marked a deceleration from the +5.6% rate in the fourth quarter of 2009. A slower economic growth rate, combined with a multitude of other factors caused consumer confidence to fall in June, after three straight months of gains. Issues that have cast a gloomier mood on the market and the consumer include the stock market correction since late April, an anemic housing market, persistently high unemployment, and continued ineffectiveness in containment of the Gulf oil spill.

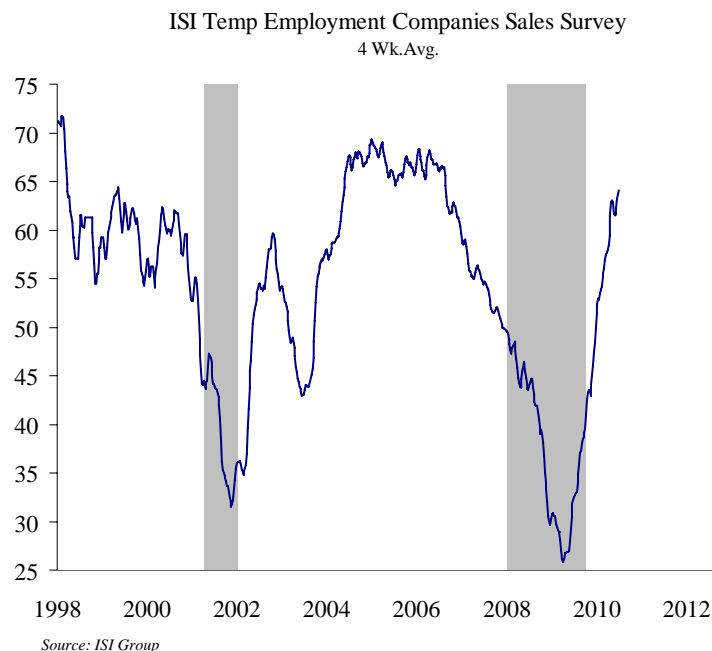


While recent signs imply a slowing of the recovery, many measures of activity are significantly above their levels at this time last year. Durable goods orders are more than 19% above their recession low. Corporate profits are up 41% from their recession low and should continue to be very strong for the next few quarters. The result is that companies now have greater ability and incentive to increase capital investment. ISI Group recently conducted a broad survey of Chief Financial Officers of U.S. companies regarding their capital spending plans for 2010. The results showed that 49% of CFOs surveyed are planning on increasing capital expenditures this year over last year. Importantly, this is up from just 29% of CFOs this past November and is a positive indicator for future employment prospects and economic activity.

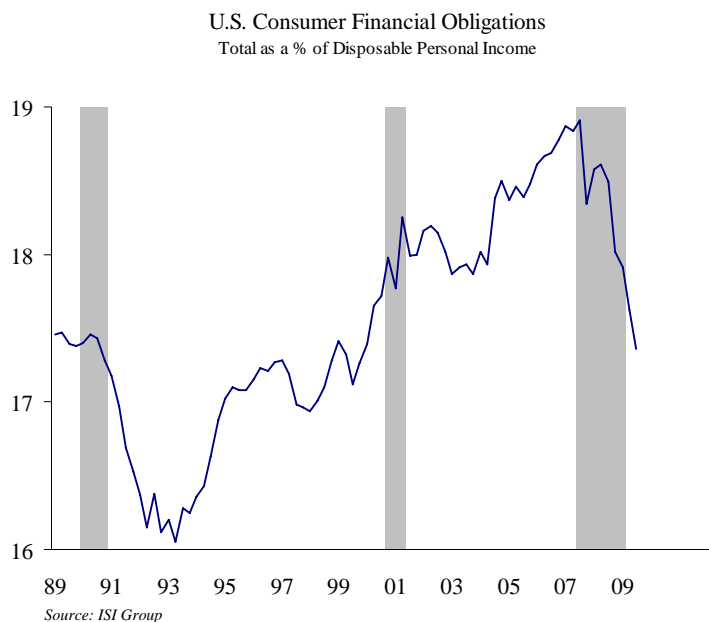
While fears and false signals of an economic “double dip” are common during recoveries, justifiably stoked by recent memories of recession, we feel that Europe is more at risk of a “W” type recovery than the United States. Over the past two quarters, U.S. nominal GDP growth has been +5.0% annually versus just +1.5% in Europe, where the bulk of the negative impact from significant spending cuts and tax increases has yet to be felt. While we feel that the austerity measures taken in Europe will likely be more dramatic than in the U.S., we expect that many of these ideas will migrate across the Atlantic and will be up for debate in solving our own unsustainable deficit situation.

❖ EMPLOYMENT, THE CONSUMER, AND HOUSING

It’s widely accepted that the health of the American consumer and the state of the U.S. housing market are highly dependent on the job market. We don’t believe we will see sustained strength in consumer spending or house prices until the employment situation improves. There currently are several signs that point to future improvement in job market fundamentals. The June Business Roundtable survey of the employment outlook by U.S. CEOs showed its best reading since 2006, while layoff announcements are back down to pre-recession levels. Apartment rents and renewals are showing signs of improvement nationally, which supports the argument that employment is increasing. Temporary employment, a strong leading indicator of permanent employment, has continued its positive trend.



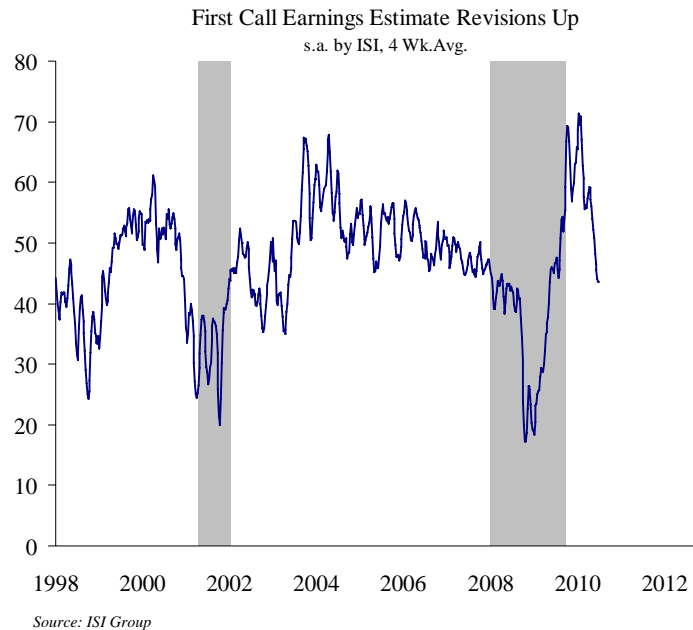
Since the beginning of the recession, the consumer has been in the process of deleveraging, as shown in the chart below. The savings rate went as high as 6% at this time last year and currently stands at 4%. This is above the 2.7% average savings rate over the past decade and we expect it to remain elevated. While a higher savings rate is a short term negative for economic growth, improvement of the consumer's balance sheet is a longer term and very necessary positive. Also, over the past several months we've observed a meaningful decline in credit card delinquencies which is another supporting factor for consumer fundamentals.



Housing had been artificially strong through April, helped largely by the homebuyer tax credit. While acting as a temporary tool to prop up the market, the tax credit has served to pull demand forward. Now, with its expiration, we anticipate weaker housing data for the next few months. One factor helping to mitigate this expected softness is that mortgage rates are back near their lows, helping to drive housing affordability to record highs.

#### ✧ THE STOCK MARKET AND THE STATE OF U.S. CORPORATIONS

After turning in a dramatic +68% return from the low in March 2009 through the end of the year and a +84% return through the recent high on April 23<sup>rd</sup>, the S&P 500 has declined by approximately 12%. Better-than-expected earnings in the fourth quarter of 2009, followed by very strong results in the first quarter of 2010 led analysts to repeatedly revise their earnings estimates higher for companies. In mid-April, with 70% of earnings estimate revisions for 2010 having been upward, expectations were high and arguably analysts had gotten ahead of themselves. This highly optimistic environment, combined with slowing economic momentum and negative news flow was a perfect recipe for a stock market correction.



Despite the recent stock market weakness, U.S. corporations as a whole are in a decidedly better financial position now compared to one year ago. Earlier this month the Federal Reserve reported that through March, cash and equivalents on the balance sheets of nonfinancial companies were up 26% from the previous year and totaled \$1.84 trillion. This represents 7% of company assets and is the highest level since 1963. Corporations, similar to consumers, have taken steps to improve their balance sheets. Through March, S&P 500 companies had reduced their net-debt as a percentage of total capital to approximately 25%, which is near historical lows. Moreover, credit spreads have declined substantially and combined with the historically low interest rate environment, companies have been taking steps to refinance debt at attractive terms. Cost cutting efforts in recent years have led to significant profit margin improvements as streamlined companies have demonstrated significant operating leverage. This is expected to continue going forward, with S&P 500 earnings per share estimated to increase by double digits in both 2010 and 2011.

From a valuation perspective, one can make the case that stocks are inexpensive. The S&P trades at 13x the 2010 earnings estimate, hardly a rich valuation. At 15x trailing earnings, the S&P 500 P/E ratio is below the 20 year median multiple of 19x.

With companies' cash coffers full and their cost of capital reduced due to the recovery in the credit markets, we are hopeful that we will soon see a resulting increase in new capital investment through projects that were previously put off due to economic uncertainty. History shows that there is typically a nine month lag between changes in credit conditions and capital investment. While memories of the near collapse of the global financial system are fresh in the minds of company managers, earning a 0% return on large sums of cash cannot be justified to shareholders for very long.

## ✧ INVESTMENT POLICY

In this low rate environment we find that the corporate financial manager and the individual investor face a similar tug-of-war: holding cash for safety versus investing for growth and to preserve purchasing power in the future. Given the large deficit and a good chance of higher interest rates in the future, it is difficult to recommend an investment in long term bonds. Although inflation remains tame, we believe that longer term it will be an obstacle that investors will have to face. With precious metals such as gold nearing all-time highs, and accompanied by very bullish public sentiment, we also find it difficult to recommend investment in this asset class.

Given the recent market correction, a drop in consumer confidence, the slowing of the global economic recovery and the subsequent trimming of analysts' estimates, it is safe to assume that investing in stocks right now is not popular. This is a good thing from a contrarian perspective. In previous periods following a broad, high-beta stock market rally like the one that began in March of 2009, equity traits that subsequently outperformed in the following periods were those of Value and Quality. Going forward, in a slowing economic environment, success in equities is likely to be determined by stock selection. We think that our bottom-up, valuation-based process has our portfolios well positioned for this type of a market. In addition, we continue to believe that companies with exposure to faster growing emerging markets economies will outperform.

It is understandable that the memories of the 2008 financial crisis are fresh and events like the "flash crash" of May 6<sup>th</sup> make investing in equities seem quite daunting. By observing the day-to-day volatility of the stock market, it is easy to see that the markets are dominated by traders, not investors. We learned from the flash crash that often 50% or more of daily stock market volume is driven by "high frequency traders". It is our belief that in this environment, a successful market participant is likely to be either a highly skilled professional trader or a long-term investor with a diversified portfolio of the right stocks. To maximize chances of success, we recommend that investors take the latter position.