



INVESTMENT STRATEGY UPDATE

June 29, 2009

UNINTENDED CONSEQUENCES

There has been a significant stock market rebound since the trough in early March. In hindsight, the signs of a bottom were classic. The substantial negativity and bearishness of early 2009 culminated in masses of investors finally throwing in the towel (capitulation). To be sure, there was a lot to be worried about back then. However, the decisive actions of governments and central banks around the world gained traction. Huge amounts of liquidity were injected into the global economy, while fiscal authorities announced major economic stimulus projects and undertook the necessary moves to stabilize their banking systems.

From an investment standpoint, the flirtation with disaster had driven stock valuations to very attractive levels. In addition, there was a tremendous amount of cash on the sidelines that was earning very little interest. As the second quarter progressed, numerous early signs of economic stabilization began to appear – a.k.a. “green shoots.” Suddenly, it seemed, the fear of losing money in stocks gave way to the fear of being left behind during a rally phase. So despite an economy still mired in recession, money flowed into the stock and commodities markets. The move up in equity prices was by no means unusual, as history has often demonstrated that the stock market is anticipatory. In fact, a major portion of most post-recession stock market advances have occurred prior to the actual economic upturns.

So now what? Has the stock market moved too far, too fast? Equities prices have risen a long way and the coming economic advance seems almost certain to be less than robust. Also, while valuations can still be considered reasonable, they are no longer cheap. Furthermore, the enormous and still growing size of our government’s fiscal and monetary stimulus programs has lead many investors to voice concern about the potential for significant inflation down the road.

Economic Expectations

The consensus expectation is that the U.S. economy will begin to grow again later this year. We agree. Rising energy and commodity prices seem to indicate a firming global economy. The U.S. housing market is showing signs of stabilization. And, it appears that recession-related inventory destocking across large segments of our economy went too far, such that even a marginal pickup in end-market demand will inevitably lead to an increase in output. Furthermore, the ramp-up in U.S. government stimulus spending is still mostly ahead of us. It is also noteworthy that the recent surge of debt and equity offerings provides Corporate America with ample liquidity to support growth, without government assistance.

On the other hand, banks are still curtailing loans, the commercial real estate environment seems to be worsening, unemployment is likely to remain too high, and it will take a long time for consumers to rebuild their balance sheets following the tremendous destruction of real estate- and stock market-related personal wealth. Years may pass before we see a full return to pre-recession levels of consumer spending.

In addition, we expect a prolonged period of substantive economic headwinds, even after the recovery begins, primarily as a result of the need for post-stimulus actions to rein in the deficit and reduce excess liquidity. We also believe that rising global demand for economically sensitive commodities, such as oil and industrial metals, will keep their prices high. That would be restrictive as well, as it increases costs to both domestic industry and consumers. In such an environment, economic and corporate earnings growth is likely to be materially slower than has been typical of previous post-recessionary periods.

Future Inflation?

The single topic most addressed by clients in recent weeks has been the risk of future inflation. The Federal Reserve Board's response to the financial crisis has led to what is, by far, the largest percentage increase in the U.S. monetary base in the past fifty years. Also, the fiscal stimulus measures enacted, and proposed to be enacted, will leave our government with huge borrowing requirements. Not since WWII has the federal deficit been this large as a percentage of GDP. The inflation concern is understandable but, we believe, premature.

Nobel-winning economist Milton Friedman would tell us that inflation is primarily a monetary phenomenon – too much money chasing too few goods. So, is there too much money? Yes and no. Even though there has been a huge increase in the monetary base, the money multiplier and the velocity of money have both dropped. In other words, the monetary stimulus is not being utilized as intended – lenders are not lending and consumers are not spending. The Fed can create substantial sums of money, but if no one spends it, economic growth will stagnate and prices will not rise. So the amount of money in the system is not currently inflationary. Then, are there too few goods? No, not by a long shot. There is substantial manufacturing capacity around the globe, the utilization of which currently stands at near-record low levels. So, we think it will take both time and a firm global economy before capacity limitations put any meaningful pressure on pricing. From a monetarist's standpoint, inflation is not a near-term risk.

There are other factors, as well, indicating that inflation is not a current problem, and perhaps even suggesting some continuing deflation risk. With high unemployment, for instance, wage growth is anemic both here and abroad. In some industries, compensation is actually declining. Also of note is that many state and local governments in this country must, by law, balance their budgets, necessitating outright cuts in personnel and, in many cases, reduced wages for those remaining. If people earn less, they spend less. That is not a recipe for inflation.

But what about the fiscal situation? Isn't that inflationary? The projected federal deficit for 2009 will approach \$2 trillion, and it is estimated that the government will need to borrow at least \$5 trillion cumulatively over the next three to four years. Who is going to lend us that money, and what interest rates will they demand? What if investors (either domestic or foreign) believe that our government's policies are so irresponsible that they will ultimately get paid back with "cheap" dollars? If there are not enough buyers of all the debt, the only option will be for the Fed to step in and monetize the deficit by buying U.S. Treasury obligations. Taking such action would no doubt be inflationary, causing interest rates to rise and the dollar to decline.

For the moment, however, we do not see a lack of lenders willing to finance our deficit; Foreign central banks currently own more than 20% of U.S. Treasuries outstanding. While it is not unreasonable for creditor nations to want to diversify their reserves, there are only a few countries whose currencies have enough transaction volume to provide meaningful liquidity. And currently, most of those nations' economies and government debt levels are in worse shape than ours. Furthermore, it would not be in the interest of creditor nations to drive down the value of the dollar. China, for instance, would have no incentive to raise the relative value of the Yuan, thereby undermining the competitive position of its exports.

Thus we do not see inflation as a likely current problem but, in time, the global economy will start to gather steam, the velocity of money will increase, and excess manufacturing and human resources will become more fully utilized. At that point, the Federal Reserve Board will need to move quickly to unwind its balance sheet expansion, or inflation will become a problem. In like manner, the federal government will need to move aggressively to scale back spending and rein in the massive budget deficit. Unfortunately, entitlement programs are politically quite difficult to unwind. The path forward is fraught with risk, and the prospect of insufficient efforts in this regard is worrisome. Again though, these are longer-term issues.

Financial Market Outlook

Regarding the fixed-income markets, we believe it is important to differentiate between Treasury obligations and corporate and municipal bonds. Over the past nine months, yields on Treasury bonds fell dramatically, reflecting a combination of the Federal Reserve Board's liquidity injections and the mass flight to safety by fixed-income investors. However, yields on corporate and municipal bonds moved higher and their spreads over the yields on Treasuries rose to record levels. This increase has resulted in attractive investment opportunities in corporate and municipal bonds. Within those sectors, we strongly favor investments with short- and intermediate-term maturities, recognizing the risks of higher inflation and interest rates, longer term.

As far as the stock market is concerned, equity prices and valuations have risen strongly in recent months, reflecting both relief that the financial crisis has passed and anticipation of the coming economic recovery. Nonetheless, we do not think it will be that difficult for stocks to continue beating the returns from cash and most other asset classes in the months

ahead. The economic recovery is still ahead of us, and there remains a very large number of under-invested individual and professional investors. Money market assets currently total 47% of the market value of the S&P 500, a number well above the 20% average of the last twenty years. The yield on those money funds is miniscule, and most of the alternatives to stocks do not seem very attractive at this time. Consequently, we believe that still-sidelined investors will feel an increasing pressure to invest in stocks – particularly institutional investors, who are judged by their quarterly performance results. We sense a growing “buy-on-weakness” camp. As such, we think that any near-term stock market setbacks are not likely to be all that substantial.

Further out in time, the uncertainties increase. That our monetary and fiscal authorities adopted extreme measures to deal with the financial crisis is understandable. They had little choice. However, history has shown that massive policy interventions usually yield unintended consequences. For instance, the reflationary effort following the bursting of the dot-com bubble in early 2000 unquestionably enabled the housing bubble which followed. That bubble has now burst, as well, and the current efforts to reflate the economy pose a serious risk of creating an even larger bubble of government borrowing and spending. The massive distortions created as a result of the financial crisis will have to be unwound. The exit strategy will be hugely challenging, presenting risks and uncertainties to both the economy and financial markets. Investors must pay attention. The bottom line is that we expect stocks to move higher in coming months, but given the uncertain outlook, we will stay conservative in our asset allocation and overall portfolio composition. And as ever, we will remain focused on the preservation of capital.

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- 4 -

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- 4 -