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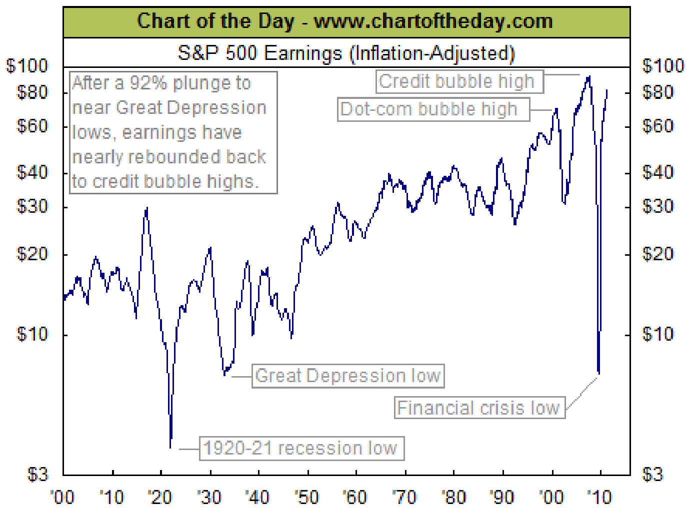
Mid-Year 2011 Market & Economic Update

The Greek crisis could cause some U.S. money market funds to "break the buck." Investors are scrambling for the safety of U.S. debt and dollar. S&P500[1] valuations are at lowest level in 26 years. There are always risks so caution and selective investing is critical using prudent **"Participate yet Protect"** strategies we recommend based on managers with a long history of outperformance (Alpha) vs. risk (Beta).

S&P 500 Stocks Cheapest in 26 Years - For the second time since the bull market began, profits are surging and stocks are falling. In mid-2010 the S&P500 lost 16% before a rebound of 32%. We are down about 7% in the May-June 2011 decline.

Chart below is as of 1st quarter but most companies with fiscal quarters ending in May have reported better than expected earnings growth.



S&P500 companies will earn 18% more this year than in 2010, according to the average estimate of 9,000+ analysts. Higher profits haven't stopped the index from falling to the cheapest levels in 26 years. Even if companies posted no growth, price-earnings ratios would be lower than on 96 percent of days in the past two decades. (Bloomberg 6/20/2011)

Since its 2009 low, S&P500 earnings have surged (up over eleven-fold). When 2nd quarter earnings reports are in, earnings should exceed their pre-recession peak even after inflation.

For example on 6/22/11 FedEx reported a 33% profit gain for the fiscal quarter ended May 31, boosted by exports from Asia and a surge in business use of its U.S shipping services.

It expects the strong results to continue, driven by emergence of a vast middle class in India and China and rebounding U.S. industrial production. China is trying to slow growth to about 8% to reduce inflation.

Non-financial U.S. companies hold $1.84 trillion in cash - 27% more than before the recession – probably more after 2nd quarter results are reported.

Leading indicators indicate surprise for second half of year - Vital signs are improving, and the economy is expected to pick up in the third quarter.

The index of U.S. leading indicators rose more than forecast in May, after declining for the first time in almost a year. The Conference Board's gauge of the outlook for the next three to six months rose 0.8 percent after a revised 0.4 percent drop in April, the New York-based research group reported 6/17/11.

Declining fuel costs and an easing of supply bottlenecks stemming from the earthquake in Japan may help strengthen consumer spending and manufacturing in the third quarter.

Consumers' outlook - The University of Michigan index of consumer sentiment decreased to 71.8 in June from 74.3 in May, led down by households making from $15,000 to $40,000 a year and older Americans. The outlook was positive for the most wealthy who are on a spending spree as executive pay overall is at all-time highs.

Low Interest Rate Money Available to large corporations and U.S. Treasury - With interest rates so low, Google sold its first-ever bond offering of $3 billion. Why take on debt despite an already huge cash pile? Because investors snapped up 3-yr notes from Google, IBM and Colgate-Palmolive, even though all were at a low 1.25% rate.

With inflation at 2-3%, debts are repaid with cheaper dollars - virtually free if the interest rate is less than the inflation rate. Google can use the money to grow, further increase profits and hire more workers.

Treasury debt is also low interest money with a huge demand for the safety of U.S. debt. Long-term the deficit has to be addressed, but today creating jobs and faster economic growth is much more a real "crisis" than debt at today's historic low rates for

Treasury borrowing - with 2-3 times more demand at most auctions than debt available for investors. Yields went negative by 0.2% on some short term Treasures due to desire for safety (WSJ 6/26/11).

Bond investors suffer losses in value when interest rates climb, but corporations and governments lock in today's historic low rates on debts.

Investors may realize we have a low tax burden (both individual and corporate) compared to the rest of the world. Taxes could increase to more reasonable levels on corporations and the wealthiest to help solve the debt issue. The greater risk is spending cuts too soon, which could result in more job losses and slow the recovery.

Few loans for homeowners or small businesses Flush with cash, banks are mostly holding it as reserves at the Fed, not making loans to small businesses or homeowners. They make huge profits from foreclosing - not loan modifications - and taxpayers take most of the foreclosure losses.

Grumpy Spell from Mother Nature - Floods, tornados and tsunamis aren't permanent but brought down global growth. If nature doesn't go wild again, the rebuilding should start adding to global and U.S. growth.

Jobs Crisis is partly education related – Many available jobs do not have qualified applicants. PIMCO's Bill Gross says, "Our labor force is too expensive and poorly educated. If we are to compete globally while maintaining a higher wage base, we must train for 'middle' in addition to 'high tech.' Philosophy, sociology and liberal arts agendas will no longer suffice. Skill-based education is a must, as is science and math. The private sector is the source of long-term job creation, but in the short-term, no rational observer can believe that global or even small businesses will invest here when the (skilled) labor over 'there' is so much cheaper." (Government Should Do More to Foster Job Growth 6/21/11)

Gas "Dirt Cheap" in U.S. compared to most of the world - CNNMoney points out, "Most Europeans pay at least double what Americans do."

For example as of 6/27/11 unleaded gas in the U.K sells on average for £1.361/Liter or $8.28/gal. European countries pay even more. Much of the higher price is due to higher taxes (VAT).

U.S. Income Tax Rates also "Dirt Cheap" - The current top rate, with lots of deductions available, of 35% of taxable income over $379,150 compares to pre-Bush rate of 39.6%, and before that a whopping 70% for many years with a still-thriving economy.

Of the 32 wealthy nations that make up the Organization for Economic Cooperation and Development, U.S. corporations enjoy the lowest tax burden at only 1.8% of GDP - due to many deductions - so few pay stated top rates.. Revenue Statistics of O.E.C.D. Member Countries, 2010

U.S. tax revenue as a percentage of GDP is at the lowest level in 60 years. Chief executives at 300 large U.S. companies earned an average $11.4 million each last year - about 343 times average worker pay – the largest gap in U.S. history and by far the widest gap in the world. (AZ Republic 6/5/11)

In the U.K as an example, their top rate is 50% on income over £150,000 ($238,907). They have a personal allowance similar to the U.S. but phased out based on income, and no itemized deductions. In addition Brits have a value added tax of 20% on most goods and services.

U.K. inheritance tax is 40% on estates with a £325,000 exemption ($517,633) vs. the U.S. exemption of $5 million and top rate of only 35%.

Brits also pay a National Insurance Tax (somewhat like Social Security) of about 20% of income split between worker and employer (vs. 10.4% combined in the U.S. up to $106,800 and then zero, plus 2,9% for Medicare with no cap.)

British taxes also pay for a medical care system based on the idea that good healthcare should be available to all, regardless of wealth. Medical care in their view is too important to be profit centered. The U.K. system has no $million executive bonuses or the goal to maximize profits for shareholders. However, like in Canada a Brit may have to wait for certain procedures and may not get expensive treatments for marginal improvements in life quality. The United States health system despite being the most expensive in the world has not resulted in superior care by most heath studies.

Greece is a wreck – 3 years of recession and heading for a likely default. If Greece defaults, many French and German banks probably would have to be bailed out. How this would be done is critical. In the U.S., TARP worked well and has been mostly repaid with big profits to Treasury. If Greece defaults, some U.S money market funds hold French and German commercial paper which could result in losses and "breaking the buck". Some U. S. banks may hold credit default swaps which guarantee payments on Greek debts. If they default the U.S. banks may have to pay any losses.

[1]Investors cannot directly invest in indices. Currency conversions are as of 6/27/11. Additional risks are associated with international investing (especially in developing countries), such as currency fluctuations, political and economic stability, and differences in accounting standards. Past performance does not guarantee future results.