INVERNESS
INVESTMENT COUNSEL & WEALTH ADVISORY

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State of the Markets

The Good, the Bad and the Uncertain

August 18, 2011

"The reason people find it so hard to be happy is that they always see the past better than it was, the present worse than it is, and the future less resolved than it will be."

-- Marcel Pagnol

<u>The Good:</u>

- *Beware the crowd during extremes*. The crowd is very pessimistic and extremely "oversold" conditions exist. These extremes were last seen during March 2009 and October 2002, previous market lows.

- Price-to-Earnings (P/E) ratios are the lowest in many years-lower than at the market panic of March 2009 and the lowest in 20 years. Current P/E is 1/3 that of 1999.

- Dividend yield on the S&P 500 is now greater than the yield on the 10-year Treasury Note for only the second time in 50 years, last occurring in March 2009.

- Corporate cash is very high and balance sheets are fortress-like.

- Insider buying at the highest level since March 2009. Stock buybacks continue.

- Federal Reserve policy is very supportive with a 2.1% yield on the 10-year Treasury Note. *Don't fight the Fed.*

- In Europe, banks are priced at lowest level to book value ever. US banks are no longer overleveraged as reserves have been boosted and bad loans written off.

- Economically:
  - ✓ Exports Strong. Energy costs have fallen.
  - ✓ Housing still weak but showing some signs of bottoming and stabilizing.
  - ✓ Retail sales better than expected for school buying season.

- Sentiment indicators are very low and retail investors pulling money from stock mutual funds are typically good contrarian buy signals.

- "Year-end rally" – The approaching November-December period is historically the strongest market period each year.

- The best investment opportunities often come amidst great fear and uncertainty.

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The Bad:

- Global economic malaise. Too much debt and poor demographics in the developed markets countered by hyper-growth and inflation in emerging markets.
- Politics, Politics, Politics. Lack of political will to fix problems that have only unpleasant solutions. Lack of confidence in our leaders and political system.
- Investors are uncertain about where to put their capital. Mistrust of government and the financial system.
- Standard & Poor's downgrades the United States credit rating.
- Will the European sovereign crisis spread to Spain and Italy?
- There are growing concerns about the possibility of a Lehman Brothers style banking / liquidity crisis in Europe.
- High volatility in the markets reflects high uncertainty among market participants. Why deal with this?
- Business investment and consumer spending remains on strike. Business and consumer uncertainty about regulation, taxation, and the "rules of the game".
- Weakest economic recovery on record. Slowing economies worldwide. "Double-Dip" recession fears.
- Super-bubble conditions in sovereign debt, especially US Treasuries, pushing interest rates to record low levels, punishing savers.
- Despite record low interest rates, some borrowers remain unable to access the credit markets.
- Housing has been weak and unemployment remains very high.
- We are likely to retest the lows of recent weeks before an eventual rebound.

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<u>The Uncertain:</u>

- America's Dog Days: Will there be a silver lining in the downgrade crisis? Certainly this is a "wake-up call" to our leaders at all levels of government, but will there be solutions forthcoming?
- Can government function effectively and solve problems?
- Can Europe and the European Union financial system remain intact?
- Will high government debt and weak demographics in the developed economies globally restrain growth?
- What is the future of our entitlement programs? How will Social Security and Medicare be reformed? Means-testing looks to be an inevitable eventuality.
- The November 2012 elections will largely be a referendum on the future direction of America. What will be the outcome(s)?
- Will a balanced budget amendment be enacted? What about broad-based tax reform? Tax reform would dramatically alter the investing landscape.
- Weak dollar and low interest rates. Can we continue funding our debt?
- Future inflation is likely a threat. Or is it? Or are we instead headed for deflation?
- How long will the US Dollar continue to be the world's reserve currency?
- When will housing recover? How will jobs be created? Are we facing structural unemployment? Recession or no recession?
- Known-unknowns and unknown-unknowns: What other events may surprise, positively or negatively?
- Will America again follow its longstanding habit of surprising everyone by emerging stronger and more resilient than ever in the coming years?

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Our Position:

- We expect weaker GDP numbers of 0-2% growth through year-end, but do not expect a double-dip recession.
- Although currently volatile, stocks clearly look to be the asset class of choice relative to bonds and cash.
- After being cautious for much of the year we are taking advantage of the recent panic. For long-term investors we are net buyers of stocks.
- Today we are buying great companies at historically low valuations, particularly in the energy, industrial, and technology sectors.
- We are focusing our equity selections on global companies with strong competitive advantages and a history of rewarding shareholdings with growing dividend payments. These “global champions” have good downside protection with the ability to surprise on the upside relative to presently depressed expectations.
- As for the Treasury market, we feel there are bubble conditions and have been net sellers. We expect greater inflation and to eventually see 5%-6% yields on the 10 year Treasury Note within 5 years.
- Our income investments are concentrated on shorter-term corporate bonds, selected preferred stocks, floating rate instruments and convertible preferred stocks. We prefer to take a small measure of credit risk rather than high levels of interest rate risk that come with longer-term debt instruments.

As always, please call anytime to discuss the markets, investments, and your specific portfolio and investment strategy. Thank you for the trust and confidence you have placed with us.

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