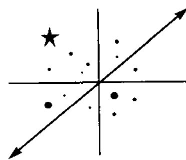


CHARTWELL REVIEW

July 2010 | SECOND QUARTER 2010 | Volume XVII, Issue No.2

A GREEK TRAGEDY

The second quarter was nominally dominated by two sets of images. The first was of Greek citizens rioting in the streets of Athens in protest of their "easy" way of life coming to a foreseeable end, as an economic collapse, the biggest bailout in EU history, a mark down of the country's credit rating to junk bond status, and sweeping government reforms shocked the country. The second image was that of oil spilling into the Gulf of Mexico at heretofore unimagined volumes, at a depth below the surface that few of us can conceive of. While the BP oil spill is a huge deal to be sure, and should help trigger (IMHO) a re-think of our country's energy production and consumption paradigm, it was the events in Greece which fundamentally re-directed investor attitudes in the second quarter. This led to the sharply negative results for equity markets you see at right, and to similar sharply positive returns you'll see on Table 4 for long-term US Treasuries.

How do the government finances of one of Europe's smallest countries, with total sovereign debt of less than $300bn, lead to the world's equity markets shedding nearly $3 trillion of mark-to-market value, despite robust corporate profit growth, generally declining interest rates, and an EU support package of shock and awe proportions ($900bn)? In a word – extrapolation. The investment environment abruptly shifted from "risk-on" to "risk-off" mode, because investors didn't just see Athens in those images. They saw Madrid, Lisbon, Rome, Dublin, London, Sacramento, Chicago, Trenton, and perhaps even New York. Greece's fiscal and debt problems are feared by many to be like the proverbial dead canary in the coal mine. If you think this is all a bit overblown, you have another opportunity to re-direct some monies to global risk assets.

Table 1: Index Benchmarks

Market Index	Trailing Returns *				
	Q2 10	1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	(11.4)	14.4	(9.8)	(0.8)	(1.6)
U.S. Large-cap Stocks	(12.1)	11.6	(10.0)	(1.2)	(3.0)
U.S. Mid-cap Stocks	(9.9)	25.1	(8.2)	1.2	4.2
U.S. Small-cap Stocks	(9.9)	21.5	(8.6)	0.4	3.0
Foreign Stocks (**devel**)	(13.7)	6.4	(12.9)	1.4	0.6
Foreign Stocks (**emerg**)	(8.3)	23.5	(2.2)	13.1	10.3
3 mo. LIBOR	0.0	0.4	2.6	3.5	3.2
U.S. Aggregate Bonds	3.5	9.5	7.6	5.5	6.5
High Yield Bonds	(0.1)	27.5	6.4	7.1	7.1
Global Bonds, unhedged	0.3	3.0	7.8	5.1	6.5
CPI, annualized	***0.6***	***1.0***	***1.1***	***2.1***	***2.3***
Dow UBS Commodity	(4.8)	2.7	(8.4)	(1.3)	4.4
Chartwell Global 65/35	(6.6)	13.2	(2.3)	4.3	4.5

Table 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	Q2 10	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	(11.8)	13.6	(9.4)	(0.4)	(0.5)
U.S. Mid-cap	(9.9)	21.3	(7.8)	1.5	3.0
U.S. Small-cap	(9.2)	21.8	(8.0)	1.0	4.1
International Lg. Cap	(13.2)	7.6	(12.3)	1.9	1.4
International Sm. Cap	(10.0)	16.7	(11.8)	4.3	4.4
Emerg. Mkt. Equity	(8.7)	22.1	(4.2)	11.6	9.9
Balanced/Hybrid	(5.7)	12.9	(3.1)	2.0	2.8
General Bonds	2.7	14.3	6.8	5.2	6.3
Government Bonds	5.4	9.0	7.9	5.4	6.2
High Yield Bonds	(0.5)	22.7	3.9	5.3	5.5

* Annualized trailing returns for periods ending 6/30/10.

Slower Growth

The Bureau of Economic Analysis just released its advance estimate of *2nd* quarter GDP. The headline estimate is that GDP grew at a 2.4% annualized rate. The consensus expectation had been 2.5-3.0%. The BEA also revised the prior three years' reports. In essence, the economy sank further during the 2007-09 recession (down 4.1%) than previously thought, had a less robust initial recovery phase in late 2009, but that means 2010's slowdown hasn't been as sharp.

A summary of recent GDP components is contained in **Table 3**. Growth has slowed from the 4th quarter's +5.0% rate because the "pop" from re-building business inventories isn't being sustained, and net imports have risen sharply. Also, consumer demand has been tepid. Looking at Final Sales (GDP before inventory changes), we see a very weak trend during this recovery.

Our rebound has slowed to a pace not considered high enough to meaningfully raise employment, and certainly not fast enough to put much of a dent in our record unemployment. Yet, the broad concern *has shifted* from direction (the US economy is no longer seen as declining), to magnitude and sustainability. Now, we just need faster growth in order to productively increase domestic employment, and thereby help ensure continuation of that growth. Given the current economic balance, too slow growth is seen as being unsustainable, thus risking that we will shortly fall back into recession.

Table 3: Breaking Down Real GDP

Factor	2Q '10	1Q '10	2009	2008
	% Change from Preceding Period *(seasonally adjusted)*			
Real GDP Growth	**2.4**	**3.7**	**(2.6)**	**0.0**
Nominal GDP Growth	**4.3**	**4.8**	**(1.7)**	**2.2**
Final Sales	**1.3**	**1.1**	**(2.1)**	**0.5**
Personal Consumption	1.6	1.9	(1.2)	(0.3)
Private Investment	28.8	29.1	(22.6)	(9.5)
- Businesses	*17.0*	*7.8*	*(17.1)*	*0.3*
- Residential	*27.9*	*(12.3)*	*(22.9)*	*(24.0)*
*Chg. In Inventories **($Bn)***	*$74*	*$41*	*$(51)*	*$(143)*
Exports	10.3	11.4	(9.5)	6.0
Imports	28.8	11.2	(13.8)	(2.6)
Government Spending	4.4	(1.6)	1.6	2.8

The US employment situation disappointed many during the second quarter, although it was improved from the first. Non-farm payrolls rose by 599,000, compared to +162,000 in the Q1. Over 40% of the net new jobs were in the Federal government (many census takers), while private sector employment rose by just 341,000 persons.

Obviously we are not yet seeing the 350,000 new jobs we need *each month* in order to bring down our >9% unemployment rate. Further, the pace weakened as we progressed though the quarter. At this point, the employment trend is decidedly not our friend.

Before seasonal adjustments, general consumer prices rose very modestly in the 2nd quarter, increasing at just a 0.6% annualized rate. Adjusted for seasonality factors, general CPI *declined* in each month of the quarter, shifting the media's concern from inflation to deflation. Perhaps a better gauge of price trends is year-over-year change. This was just +1.1% for All-items through June. The ex-food & energy index rose 0.9% during the past year. Housing costs (42% of CPI) are estimated to have fallen by 0.6% since June 2009, while overall transportation costs (17% of CPI) were up 4.9%, and medical care costs rose 3.5%.

Producer Prices for Finished Goods declined at a 3.5% annualized rate during the 2nd quarter. They are up just 2.8% over the past 12 months. Producer Prices for Crude and Intermediate goods have declined 2.4% and 0.9%, respectively, over the past year.

There were many signs that domestic manufacturing and industrial production activity slowed during the quarter, but the direction remained upward. Broadly, the survey of Purchasing Managers intentions registered a reading of 56.2% for June, down 4% from April's 60.4 reading (a reading above 50% indicates the manufacturing economy is still generally expanding). Both the New Orders and Production indices dipped 5-7% in June compared to April, closing the quarter with little momentum. The Inventories Index, which had surprised to the upside in Q1, contracted in every month of the 2nd quarter. It has declined in 45 of 48 months.

Economic activity in the non-manufacturing sector grew in June for the sixth consecutive month, but also at a slowing pace. The NMI (Non-Manufacturing Index) registered 53.8% in June, or 2.0% lower than in May. Fourteen of sixteen industries reported growth. Still positive, only less so.

On the global front, the IMF now forecasts the world's economic activity will be slightly *better* for 2010 than it expected just a few months ago. The IMF projects global growth of 4.6% in 2010, 0.7% faster than its January forecast. The US economy is expected to expand by 3.3% in 2010 (versus 2.7% in the January forecast), Emerging and Developing Economies by 6.8% (vs. 6.0%), with Developing Asia at +9.2% (vs. 8.7%). Benefiting from Asian growth, Japan is expected to advance 2.4%. Conversely, the Euro Area economies may grow by only 1% in 2010 (unchanged), and the UK by 1.3%. Some economists think the new IMF forecast is too optimistic, and perhaps politically motivated.

Bonds: The "Risk Off" Trade Dominates

Sometimes, it's a take more risk and get more reward kind of world. Bond markets were in that comfortable space for nearly all of the prior 15 months through March. But, the 2nd quarter of 2010 wasn't like that. A flight to safety occurred, favoring the reserve currency (US$) and "risk-free" bonds (US and Germany).

Three worries occupied markets: 1) contagion risk from the Greek crisis; 2) financial regulatory uncertainty, and; 3) the health of the global economy. Markets retreated and the conversation shifted quickly and dramatically from fears of inflation to fears of deflation as investors grappled with an ugly reality: intense deleveraging by highly indebted countries may be necessary to sustain market confidence in their solvency.

As a bleaker picture of US and European growth emerged over the quarter, anxious investors bid up the price of bonds. The drop in yields dominated any spread widening and resulted in the BarCap US Aggregate bond index returning 3.49% (**Table 4**). Every domestic bond sector except high yield produced strong total returns in the quarter. Excess returns versus Treasuries were decidedly negative, however, with the exception of mortgage-backed securities. In contrast to the first quarter (and, to nearly all of 2009), when high yield and emerging markets debt were the best-performing sectors, these higher-risk sectors were among the worst performers in the second quarter as spreads versus Treasuries widened (**Table 5**).

In the US Credit sector, lower risk provided favorable results. AAA's outperformed BBB's by 35 basis points. The US Credit index yields just 4.04%, but this compares favorably to the US Government sector's 1.74% yield. Overall, the yield-to-maturity of the BarCap Aggregate is an anemic 2.84%. Yield on the 10-year Treasury, which had been in the 3.5-3.9% range, shot down to 2.93%. The yield curve flattened a bit, with the "10-2" spread dipping to +233bps, after reaching a twenty year high of +283bps late in the 1st quarter.

Fiscal woes seem like they will be the next chapter in the financial crises of 2008, with Europe at the center of the plot. But, it's easy to overreact. European policy-makers have already done a lot, adding approximately €200bn in liquidity through monetary measures, and a total of €860bn through two EU/IMF rescue packages. Many countries, including Greece, Spain, Italy, France, Germany, and the UK, have announced plans to cut their fiscal deficits. Sovereign debt yields, while higher in some cases than at the end of March, have not spiraled out of control, except in Greece (**Table 6**).

What has occurred is a decided tiering of country risk, with investors clearly favoring large countries over small, regardless of 2010 budget deficits. It's good to be the reserve currency (US$), Germany or China.

Conversely, the bonds of small countries with sound budget controls, like Poland, Australia, and South Korea, look undervalued.

Table 4: Primary Bond Sector Returns

Bond Index	**2Q '10**	**1 year**	**3 years**
US Aggregate Bonds	**3.5%**	**9.5%**	**7.6%**
3-mo. T-bills	0.0	0.4	2.4
US Treasuries, long	12.2	12.0	10.7
U.S. TIPS (1-10)	2.3	8.5	7.0
Mortgages	3.3	8.0	8.5
CMBS	2.9	30.1	5.0
ABS	2.5	12.9	4.7
Inv. Grade Credit	3.3	14.7	7.4
High Yield Credit	(0.1)	27.5	6.4
Non-US Global, Hedged	2.3	5.7	6.3
Non-US Global, Unhedged	0.0	3.0	8.5
Emerging Mkts Bonds	1.4	17.4	8.2

Table 5: Spread Bonds Gave Back in the 2nd Quarter

***Excess Returns** versus Treasuries, duration-adjusted (%)*			
Bond Sector	**2Q '10**	**1Q '10**	**2009**
Aggregate Bonds	(0.5)	0.8	7.5
US Agencies	0.0	0.3	2.9
Agency MBS	0.0	0.7	5.0
Comm'l MBS	(0.7)	8.0	29.6
Asset-Backed bonds	(0.1)	1.3	25.0
Invest. Grade Credit	(2.2)	1.1	19.9
High Yield Credit	(3.9)	3.5	59.6
Primary Non-U.S.	(4.3)	0.1	7.3
Emerging Markets	(5.2)	3.1	38.0
AAA Subprime	5.7	5.2	18.0

Table 6: Sovereign Bond Trends in 2010

10-Year Government Bond Yields (%), as of			
2010 estimated budget deficits in parens	**Mar 30th**	**June 9th**	**July 23rd**
United States (-8.8)	**3.62**	**3.18**	**2.89**
Germany (-5.2)	3.11	2.56	2.63
Britain (-10.3)	4.02	3.52	3.34
Poland (-3.0)	5.50	5.82	5.85
Spain (-9.9)	3.81	4.57	4.22
Greece (-9.9)	6.37	8.15	10.48
China (-2.6)	3.36	3.01	2.92
Australia (-2.9)	5.80	5.31	5.18
South Korea (-2.0)	4.91	4.81	4.74

Domestic Equities Change Course

The rally that began on March 9, 2009, took the S&P 500 index up 84% by April 23rd of this year. From there it corrected 15% to quarter's end. Modestly positive April returns, followed by significant weakness in both May and June, resulted in domestic stock prices registering sharp declines for the second quarter. The Dow Jones Industrials declined -9.4%, the S&P 500 fell -11.4%, and the Russell 2000 index lost -9.9%. In late April, at what proved to be the market's 2010 peak so far, we suggested that nervous investors might be "dancing by the door," looking for an exit. Seems like many of them found it, all at the same time.

The poor performance generated by stocks in the 2nd quarter more than reversed the first quarter's gains, leading to year-to-date losses of 6.7% for large-cap stocks and 2% for small-caps. Furthering the general trend that started when the bull market began in March 2009, the size effect (*smaller > larger*) was once again consistently evident in the quarter, across both value and growth styles (**Table 7**). After outperforming in April, small-cap stocks matched losses in May and modestly underperformed in June. During the past twelve months, the size effect has been robust, accounting for a 10% differential return between Top-cap (+11.6%) and Small-cap (+21.5%) stocks.

From a style perspective, the value effect (*value>growth*) was evident during the quarter for large and mid-cap stocks, but not small and micro-caps. However, over the past year value stocks returned more than growth across all capitalization ranges (**Table 7**). This is a bit surprising for those who equate value portfolios with low beta portfolios. But, the prior two downmarket years had seen value portfolios sharply underperform, since financial services stocks make up 25+% of the value benchmarks.

Looking at the economic sectors, we see the more pro-cyclical areas of the market underperformed in the quarter, in direct opposition to the 1st quarter (**Table 8**). Materials, Energy and Financial Services stocks (which together make up 30% of the S&P) lagged for the quarter. Less economically sensitive Telecom, Utilities and Consumer Staples firms outperformed on a relative basis.

Small-cap sector performance in the quarter was not fully consistent with the large-caps. The small Utilities sector did outperform in relative terms, and energy stocks were weak. But, the biggest contributor to losses was the large Consumer Discretionary sector (14% of overall market cap). During the past year, the biggest contributor to gains has been the Tech sector, which accounts for the outperformance of growth portfolios.

In **Table 9**, we see that over the past twelve months the S&P 500 companies have reported consistently rising earnings that have also increasingly exceeded analysts' expectations of one year ago. During that timeframe the index rose from 976 to 1070, or just under 10% before dividends. In the process, the market has gone from trading at a current PE of 17.6x to 13.0x.

Table 7: U.S. Equity Market Size/Style Returns

		Trailing Periods		
	2Q '10	1-Year	3-Years	5-Years
Growth				
Top Cap	(12.3)	10.9	(6.6)	0.1
Mid Cap	(10.2)	21.3	(7.5)	1.4
Small Cap	(9.2)	18.0	(7.5)	1.1
Micro Cap	(7.9)	15.2	(11.3)	(2.2)
Value				
Top Cap	(11.8)	12.4	(13.4)	(2.5)
Mid Cap	(9.6)	28.9	(9.4)	0.7
Small Cap	(10.6)	25.1	(9.8)	(0.5)
Micro Cap	(9.6)	25.2	(13.1)	(2.7)

Table 8: U.S. Equity Sector Returns

	Large-cap Returns *(%)*		Small-cap Returns *(%)*	
Sector	2Q '10	1-Year	2Q '10	1-Year
Consumer Disc.	(10.6)	29.1	(13.1)	31.1
Industrials	(12.1)	26.8	(9.5)	18.9
Financials	(13.3)	17.8	(9.3)	25.6
Info Technology	(12.4)	15.3	(8.5)	26.9
Materials	(16.3)	14.0	(10.3)	34.0
Consumer Staples	(8.2)	13.4	(10.2)	17.6
Health Care	(11.8)	8.5	(8.6)	22.4
Telecom Svcs	(4.6)	7.9	(13.0)	1.8
Utilities	(3.8)	5.4	(3.6)	13.7
Energy	(12.7)	2.8	(11.0)	26.7

Table 9: Company Earnings are Beating Expectations

S&P 500 Operating Earnings per Share

	Actual @7/23/10	Estimated @7/21/09	% diff.
2Q 2010	$20.03	$17.89	+12%
1Q 2010	19.38	16.40	+18%
4Q 2009	17.16	16.09	+7%
3Q 2009	15.78	15.00	+5%
Total	$72.35	$65.38	+11%
FY 2009	$56.86 A	$55.42 E	+3%
FY 2010	$82.15 E	$74.01 E	+11%

International Markets: the Tempo Shifts (again)

In late April, global stock markets took a dramatic turn. Concerns over European sovereign debt and tighter funding markets, less-positive economic data in developed countries, policy tightening in key emerging markets, and financial regulatory reform served to shift investor sentiment from optimistic to cautious, and markets shrugged off a continuing stream of better than expected corporate earnings.

In this environment, international equity markets retraced all of the positive returns achieved in the first quarter, and ended the second quarter in negative territory for the year-to-date. The EAFE+Canada index fell -13.4% in the quarter. The World ex-US index dropped slightly less (-12.3%), bolstered by relatively better performing emerging markets (-8.3%). Local market returns were less negative (**Table 10**), but a weighted basket of currencies declined 3.2% relative to the US dollar during the quarter. The British pound fell by 1.4%, while the Japanese yen gained 5.6%. The worst performing currency was the Euro, which lost 9.5% relative to the US Dollar (it rose 9% in July).

Every market sector posted negative returns, with the defensive consumer staples, telecom and healthcare sectors limiting their losses to single digits. Energy was the worst performing sector (-19.5%), plummeting on fears of slowing economic momentum, specifically in China (**Table 11**). The Gulf disaster trimmed BP's market value nearly in half and accounted for 92 bps of the overall drop in the MSCI EAFE index. Fears of slower growth also drove material stocks down -15%. Worries over the financially stressed southern European countries pulled the financial sector down to a -16% loss. Small cap stocks continued to outperform large caps, dropping less during the quarter (-11%). Value stocks (-15%) lagged growth stocks (-12%).

No country in developed Europe posted positive returns during the quarter, as the region dropped -14.8%. Uncertainty regarding the sustainability of government finances and the ability of the EMU to deal with a de facto default by one of the fiscally weaker countries drove large stock market losses in Spain (-20%), Greece (-40%), Italy (-21%) and Portugal (-17%). Core Euro countries like Germany (-12%), France (-18%) and the Netherlands (-13%) did not escape investors' wrath.

Pacific ex-Japan markets held up slightly better in the second quarter, falling -14.2%. Singapore was the only developed country to post a positive return for the quarter (+0.2%). Hong Kong posted a single-digit loss (-6%) and the Japanese market declined "just" -10% due to currency strength. The commodity-driven Australian market was the weak link in the region, dropping -19%, amid concerns about its mining sector.

The economic recovery in emerging economies has been progressing well, evidenced by continued robust GDP growth in China, South Korea, India, Brazil, South Africa and Russia. Despite this, policy tightening measures in China and slowing growth in the US and Europe (prime end-markets) pressured emerging markets, pulling them down -8.3%. Asian emerging markets held up best (-5.1%). China and India, two of the largest components, posted low single-digit losses. Korea and Taiwan were the weaker performers in the region, falling -7% and -9%, respectively. Select small Asian markets posted positive returns; Indonesia +4% and the Philippines +3%. Emerging Europe (-15%) and Latin America (-12%) pulled down the broad index. As with Australia, commodity-rich Russia (-15%) and Brazil (-15%) were among the weakest performing countries in the EM index.

Table 10: International Markets Returns

	U.S. Dollar Return %		Local Currency Return %	
	2Q '10	**1-Year**	**2Q '10**	**1-Year**
EAFE+Canada	**(13.4)**	**7.5**	**(10.4)**	**10.3**
- MSCI Growth	*(12.0)*	*9.1*	*(9.3)*	*11.1*
- MSCI Value	*(14.8)*	*5.9*	*(11.5)*	*9.4*
- Europe	(14.8)	6.3	(9.5)	17.3
- Pacific, ex-Japan	(14.2)	18.6	(9.3)	14.7
- Japan	(10.1)	0.9	(14.8)	(7.5)
- United Kingdom	(13.8)	8.6	(12.6)	19.6
Int'l Small Cap	**(11.0)**	**16.1**	**(8.4)**	**17.5**
Emerging Mkts	**(8.3)**	**23.5**	**(5.5)**	**20.1**
- EM Ásia	*(5.1)*	*23.0*	*(2.7)*	*19.9*
- EM Europe & ME	*(15.1)*	*25.0*	*(9.3)*	*27.3*
- EM Latin América	*(11.9)*	*25.7*	*(10.3)*	*18.3*
- EM BRIC	*(9.2)*	*19.8*	*(7.7)*	*16.2*

Table 11: Global ex-US Sector Returns *(% in US$ terms)*

thru June 30, 2010	Large/Mid-cap Returns *(%)*		Small-cap Returns *(%)*	
(GICS Sector)	**2Q '10**	**1 Year**	**2Q '10**	**1 year**
Cons. Staples	(7.2)	19.4	(6.5)	14.6
Materials	(15.3)	17.3	(7.5)	30.7
Industrials	(10.3)	16.7	(11.3)	14.5
Cons. Discretionary	(8.4)	13.3	(11.2)	16.1
Health Care	(9.0)	13.0	(10.4)	5.7
Info Technology	(14.0)	11.6	(9.2)	17.5
Telecom Services	(8.7)	6.1	(6.3)	23.8
Financials	(16.3)	3.8	(11.8)	5.2
Utilities	(12.9)	(3.6)	(15.3)	(0.2)
Energy	(19.5)	(4.8)	(16.3)	16.7

The Back Page

Inflation looks like a secondary issue for some time.

- From a wage-pull perspective, our 9.5% unemployment rate, Europe's >10% rates, and China/India/Mexico's increasingly accessible labor forces will keep the lid on wage growth. Real average weekly earnings were up only 1.5% year/year through June 2010. Combined with overleveraged personal balance sheets and "sticky" credit conditions, consumer demand remains weak;
- From a cost-push perspective, domestic businesses have considerable excess capacity to absorb, relative to both three years ago and long term averages. Capacity has been increased since June 2007, while output is still down over 8%. It remains very difficult to pass costs up the supply/distribution chain. The only caveat here is with critical global commodities that we must import a lot of. With those goods, marginal demand growth elsewhere is driving the price, and the US has become more price-taker than price-maker. Think copper, light sweet crude, and aluminium, rather than corn, soybeans, and wheat.
- For those who think inflation is "always and everywhere a monetary phenomenon," the M2 money stock is up only 1.6% in 2010 and 1.8% since June 2009. M3, which is a broader concept that includes institutional money funds, is down more than 6% year/year. That's **de**flationary.

So, we think hard commodities inflation is the concern for investors, if any. But, in more of an offensive sense. That is, should you try to profit from getting long key natural resources, because they are quite apt to rise in real dollars terms over a medium timeframe.

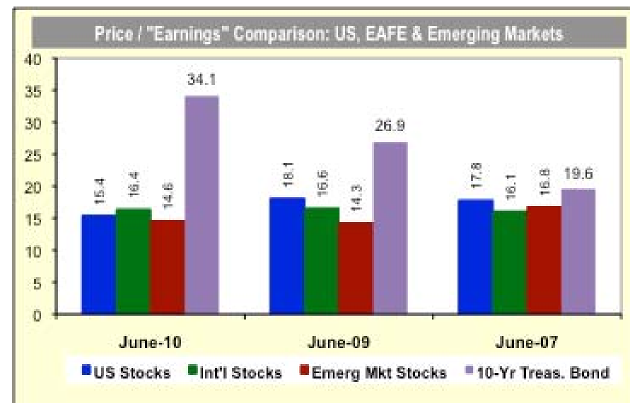
Many see the major developed countries of the world de-basing their currencies through overly accommodative fiscal and monetary policy, with the US ultimately leading the beggar's race. This adds further luster to real assets allocations, and detracts from fixed return financial assets. But, it doesn't directly relate to a rise in CPI. Rather, the question here is how much will real interest rates need to rise in order that each sovereign borrower can refinance its debt? Greece has given us a glimpse into this dynamic. That said, the storyline will play out differently and over a much longer time horizon for US$-based investors. This is because foreign creditors, who now hold a rather astounding 48% of our outstanding sovereign debt (thirty years ago it was 0%), face something of a prisoners' dilemma. They'll have to gradually dig their way out of our credit.

Most investors will not want to wait around for an answer to that question, preferring to consider how to invest *around* the issue. We think the primary "play" is still to aggressively diversify one's US$ holdings, despite its recent rally, specifically in the direction of emerging country currency and securities exposures (stocks and bonds). The second quarter re-priced many of those markets, providing some better entry points.

For US bond investors, credit spreads backed up a little in the 2nd quarter. Valuations of risk assets became a bit more attractive, with spreads having widened 20-170 bps since mid-April. A number of sectors were nearly back to late-2009 spread levels, notably financial sector corporates, high yield, and emerging markets bonds. Spreads are only one component of total return, but who wants to talk about the other, when the full curve Treasury index yields just 1.75%?

Which brings us to the next potential asset bubble – US Treasury bonds. As Figure 1 reflects, the "P/E" of term Treasury-bonds (which is the inverse of their yield), has left the gravitational pull of competing investments. It reminds us of tech stocks in late 1999.

Figure 1. PE Ratios of Regional Stock Markets



The rationale for this disconnect is the questionable sustainability of the global economic recovery, concern over which has certainly been heightened by the recent barrage of negative economic news emanating from the US, Europe and China. The "Greek Tragedy", writ large. Thus, *relative* equity valuations are now quite low in many regional markets. Opportunities may exist for investors willing to look beyond the near term uncertainty.

Sell high, buy low. See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

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