

A Special Report **July 28, 2011**

The Muddy Middle

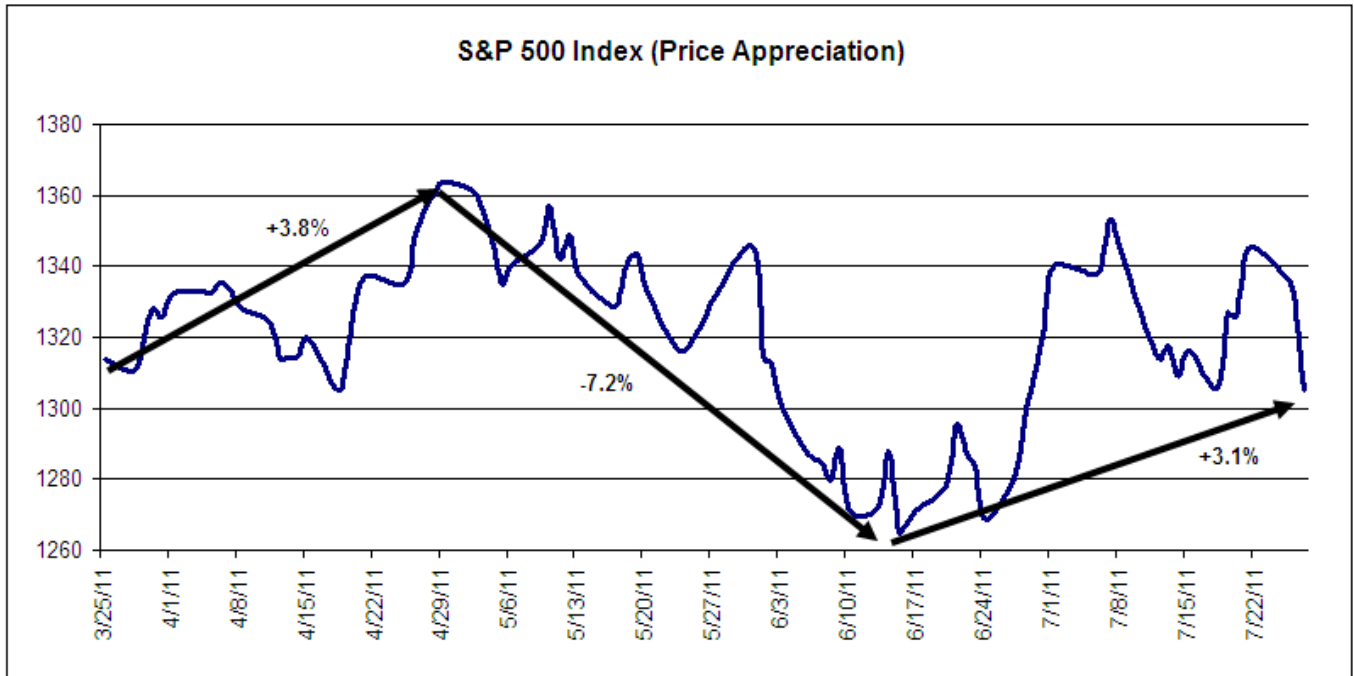
When last we left our friends at the soap opera – turned reality show, “*The Days of Our (Washington) Lives*”, we saw our leading man, President Barack Obama, looking for love from all the wrong places, namely, Congressional leadership. His closed-door meetings in the Cabinet Room with politicians from both parties always start with cameras televising what appears to be an amiable group of smiling colleagues gathering to work together for the country’s benefit, but one can only imagine the level of pleading, promises, threats, and Presidential pressure that is being applied as soon as the cameras are turned off and reporters are shown the door.

From his ever-present podium in the Briefing Room, the President daily appeals to voters in televised addresses to inundate Congressional offices with calls and e-mails demanding that they back his “balanced plan” for deficit reduction. According to reports, the calls and e-mails are flooding Congressional offices’ switchboards, but to no apparent avail. His leading protagonists (i.e. Reid and Pelosi) and antagonists (Boehner and McConnell) each hold their own press conferences several times per day, with disparaging claims of bad faith, and vocal complaints that “*The President moved the goal posts*”, and the “*The Republicans are unwilling to say ‘Yes’ to anything*”, adding to the drama.

Meanwhile, both sides have proposed, and in some cases, passed their own versions of deficit reduction plans, all of which, when actually “scored” by the Congressional Budget Office (CBO), provide less deficit reduction than their sponsors initially claim, and all of which cut very little actual spending in the early years. This should be no surprise, since politicians like to talk about spending cuts, but love to push those cuts to years down the road, where the “pain” can be blamed on the opposition by politicians who hope the electorate has a short memory.

In very recent days the equity markets have been expressing their discontent at the apparent stalemate. Daily volatility is up in recent months, with competing earnings and economic data buffeting investors back and forth. But when one looks at the net impact on the markets’ performance this cacophony of data and speculation has wrought the past several months, ***it’s surprising how little prices have actually changed.***

Much Ado About Nothing



Source: Yahoo! Finance

Date	Closing Value	% Change (Daily)	Date	Closing Value	% Change (Daily)	Date	Closing Value	% Change (Daily)
3/28/11	1310.19	-0.27%	5/9/11	1346.29	0.45%	6/20/11	1278.36	0.54%
3/29/11	1319.44	0.71%	5/10/11	1357.16	0.81%	6/21/11	1295.52	1.34%
3/30/11	1328.26	0.67%	5/11/11	1342.08	-1.11%	6/22/11	1287.14	-0.65%
3/31/11	1325.83	-0.18%	5/12/11	1348.65	0.49%	6/23/11	1283.50	-0.28%
4/1/11	1332.41	0.50%	5/13/11	1337.77	-0.81%	6/24/11	1268.45	-1.17%
4/4/11	1332.87	0.03%	5/16/11	1329.47	-0.62%	6/27/11	1280.10	0.92%
4/5/11	1332.63	-0.02%	5/17/11	1328.98	-0.04%	6/28/11	1296.67	1.29%
4/6/11	1335.54	0.22%	5/18/11	1340.68	0.88%	6/29/11	1307.41	0.83%
4/7/11	1333.51	-0.15%	5/19/11	1343.60	0.22%	6/30/11	1320.64	1.01%
4/8/11	1328.17	-0.40%	5/20/11	1333.27	-0.77%	7/1/11	1339.67	1.44%
4/11/11	1324.46	-0.28%	5/23/11	1317.37	-1.19%	7/5/11	1337.88	-0.13%
4/12/11	1314.16	-0.78%	5/24/11	1316.28	-0.08%	7/6/11	1339.22	0.10%
4/13/11	1314.41	0.02%	5/25/11	1320.47	0.32%	7/7/11	1353.22	1.05%
4/14/11	1314.52	0.01%	5/26/11	1325.69	0.40%	7/8/11	1343.80	-0.70%
4/15/11	1319.68	0.39%	5/27/11	1331.10	0.41%	7/11/11	1319.49	-1.81%
4/18/11	1305.14	-1.10%	5/31/11	1345.20	1.06%	7/12/11	1313.64	-0.44%
4/19/11	1312.62	0.57%	6/1/11	1314.55	-2.28%	7/13/11	1317.72	0.31%
4/20/11	1330.36	1.35%	6/2/11	1312.94	-0.12%	7/14/11	1308.87	-0.67%
4/21/11	1337.38	0.53%	6/3/11	1300.16	-0.97%	7/15/11	1316.14	0.56%
4/25/11	1335.25	-0.16%	6/6/11	1286.17	-1.08%	7/18/11	1305.44	-0.81%
4/26/11	1347.24	0.90%	6/7/11	1284.94	-0.10%	7/19/11	1326.73	1.63%
4/27/11	1355.66	0.62%	6/8/11	1279.56	-0.42%	7/20/11	1325.84	-0.07%
4/28/11	1360.48	0.36%	6/9/11	1289.00	0.74%	7/21/11	1343.80	1.35%
4/29/11	1363.61	0.23%	6/10/11	1270.98	-1.40%	7/22/11	1345.02	0.09%
5/2/11	1361.22	-0.18%	6/13/11	1271.83	0.07%	7/25/11	1337.43	-0.56%
5/3/11	1356.62	-0.34%	6/14/11	1287.87	1.26%	7/26/11	1331.94	-0.41%
5/4/11	1347.32	-0.69%	6/15/11	1265.42	-1.74%	7/27/11	1304.89	-2.03%
5/5/11	1335.10	-0.91%	6/16/11	1267.64	0.18%			
5/6/11	1340.20	0.38%	6/17/11	1271.50	0.30%			

# of Trading Days	85	Average % Daily Change	-0.005%
# of Up Days	44	Days with moves >1%	20 of 85
Average % Change (Up Days Only)	0.626%		
# of Down Days	41	Percentage Change from 03/28/11 to 07/27/11	-0.678%
Average % Change (Down Days Only)	-0.681%		

For all the concerns over a potential Treasury default, stagnating employment numbers, dysfunctional government, European sovereign debt crises, Norwegian terrorist attacks, and threats of credit downgrades, the markets have been remarkably resilient. The lack of a sustained decline in the equity markets seems to imply that chaos and dysfunction have become the “new normal”, and since Treasury yields haven’t budged during the debt crisis, it’s apparent that the debt markets believe a deal is inevitable.

Parenthetically, I’d find the whole debate over spending cuts and debt reduction laughable, if it weren’t so disingenuous at its core. As I previously mentioned, meaningful “spending cuts” in virtually all these proposals are deferred to 2013, when, presumably, another Congress and perhaps another President can override, or change the terms, and likely will, depending on how the 2012 elections turn out. The truth is they are arguing over spending levels that would have to be re-authorized in *future* budgets, which presumes Congress can actually *pass* a budget in the future, something it’s failed to do for fiscal years 2010 in 2011.

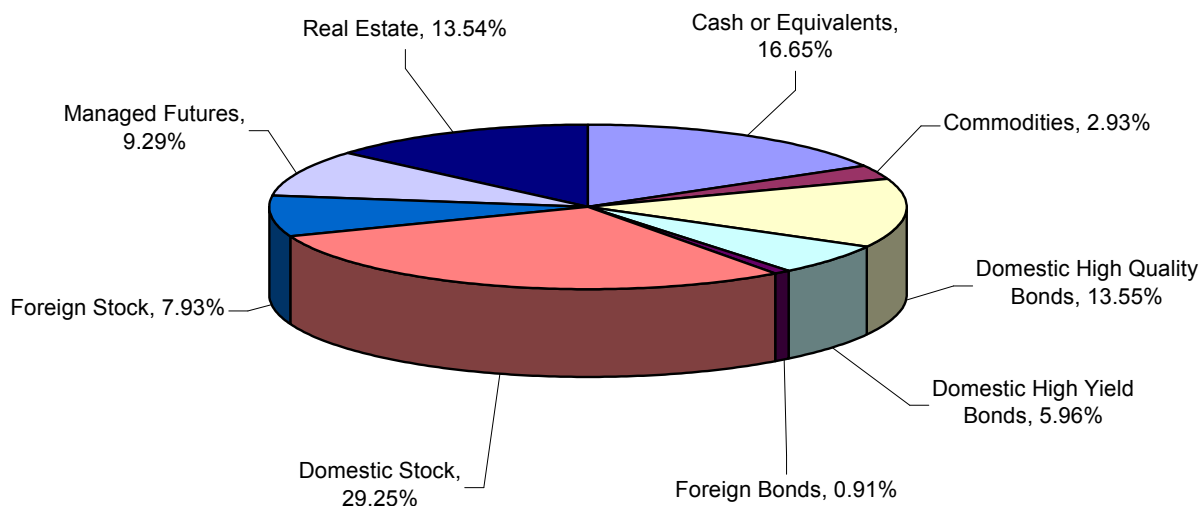
I also find the term “spending cuts” a bit misleading in that we’re not actually talking about *reducing government debt*, but rather *reductions in the projected growth in government debt*. The CBO currently projects *publicly-held* government debt (which does *not* include what we owe to *ourselves* in the Medicare, Medicaid, and Social Security Trust funds) will rise to \$18 Trillion by 2021. If the currently-offered House version supported by Mr. Boehner is passed, the CBO “scores” its impact as a reduction of \$1.1 Trillion in the cumulative future debt. The Senate version proposed by Mr. Reid brings it down by \$2.2 Trillion. In other words, all of this wrangling will leave us with publicly-held debt of either \$15.8 Trillion (Senate version), or \$16.9 Trillion (House version) in 2021. All these “cuts” result in a projected *increase* in the nation’s debt burden of between 75% and 87% in ten short years! Only in Washington can massive increases in debt be spun as “deficit reduction”! And with a projected U.S. population of (approx.) 336 million in 2021, the “best case” (Senate Version) per capita debt burden on each man, woman, and child in America will rise from the current \$28,900 (\$9 Trillion / 311 million Americans) to at least \$47,000 (\$15.8 Trillion / 336 million Americans). Way to save Congress!!! (Sources: Congressional Budget Office, U.S. Census Bureau)

But I digress... I see the indices’ “sideways” pattern as an indication that the markets are really adopting a wait and see attitude, looking for a break-out in either a positive or negative direction, once the “debt deal” is done.

My “gut” tells me that the markets will eventually break out in an upward trend, as reported earnings have been surprisingly good. The economic data has been mixed, but there is evidence that the economy is healing, albeit painfully slowly. This Friday, we’ll get the first estimate of growth in Gross Domestic Product (GDP) for the quarter just ended. If positive, it will represent the eighth consecutive quarter of economic expansion since the recession “officially” ended. However, if it’s below the 1.9% growth posted in the first quarter’s GDP, it will represent further deceleration in economic growth (4th Qtr. 2010 saw a 3.1% increase.), a troublesome trend....

Our money managers have been raising cash in recent weeks, keeping some powder dry for either eventuality. In speaking with most of them, there seems to be a consensus building that the equity markets will finish the year higher than current levels, although it seems to be anyone's guess if the markets will experience a mild to moderate "correction" in the interim. Given this uncertainty, we remain broadly diversified, and holding higher than normal levels of "cash".

\$1M Model*



*The pie chart is generated from a proxy account to represent the holding of a \$1M portfolio. Individual portfolios will vary in allocation.

Our managers have relatively limited exposure to a major decline in prices, but could quickly deploy cash if the markets show a clear upward trend, or if a downturn presented an opportunity to add to our positions at more favorable prices. Either way, I'm pleased with their performance thus far, and with our positioning going forward.

In closing, let me remind the reader that one can never predict a market's direction with any certainty, and the ever increasing level of drama unfolding in our nation's capital makes predictions an exercise in futility. "Buy and Hold" is dead for now. Defensive and tactical allocation of one's capital is a necessity when fighting the headwinds of economic uncertainty and political posturing. We're on top of it, and we hope that some resolution in the debt ceiling debate comes quickly, if for no other reason than the media's ubiquitous coverage of it takes away from more important matters, like the end of labor strife in the NFL, baseball pennant races, and other "reality" shows. As always, feel free to call us with questions and comments.

- JRP

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