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Investment Perspectives Second Quarter 2010

FEAR IS BACK

Having survived the worst global banking crisis since the Great Depression, largely as a result of an astonishing amount of governmental life support, the relative calm of the past six months or so has been a head fake for investors. Anxiety in the financial markets had clearly abated and there is no question that fundamental economic improvement had taken hold in most of the world.

In the U.S., corporate profits have rebounded, financial institutions have bolstered their capital, the real estate market seems to have found a bottom in many areas, and stock prices have regained a surprising amount of their losses of the past few years. Indeed, it appeared that a steady recovery was underway which might actually buy enough time for the Great Workout of global debt to proceed. Excessive leverage and debt at every level of the global economy, i.e. consumer, corporate, and government, were root causes of the economic crisis and deleveraging is needed to sustain healthy economic growth. Unfortunately, the global rescue simply layered on more debt.

In the depths of the global recession, governments around the world issued debt to infuse the banking system, to backstop entire industries with debt guarantees, and to substitute large swaths of private debt with government debt. Much as the research by economists Ken Rogoff and Carmen Reinhart predicted, sovereign debt worries have now surfaced as a second derivative to the global banking crisis. Investors are now asking whether countries have the economic resources and political will to repay their debts.

Very quickly, concern has shifted from the anxiety that U.S. commercial and investment banks could fail in domino fashion to a growing worry that countries in the Eurozone could tip each other over into a daisy chain of defaults. Greece seems to be the canary in the coal mine and a 750 billion euro (\$1 trillion) bailout plan has been crafted to stem the Eurozone debt contagion. Riots on the Greek streets have unnerved global investors and policymakers have sought to prevent Portugal, Spain, Italy and Ireland from tumbling down the same path. Yet, markets seem unimpressed. The euro has continued to fall and money has flocked to the safe haven of the U.S. dollar and U.S. treasury bonds. I'm not an economist, but I don't see how Greece and others avoid a default and restructuring of their debt. What are the consequences of this disruption?

At the extreme, questions are being asked as to whether the European Union will remain intact. More immediately, the euro continues to decline. A weakening euro and strengthening dollar helps the export driven economies of the Eurozone, particularly Germany, while hurting the U.S. economy. The Eurozone exports become more affordable, while our exports become more expensive. This loss of U.S. price competitiveness may represent another headwind to our economic recovery. Further, if Greece or other Eurozone countries do default, another round of bank write-offs and

capital raises may be triggered for those financial institutions, predominantly European, which hold the debt. We are potentially facing another global banking crisis this time originating in Europe, not the U.S. And finally, given the recent riots in Athens, it is not clear whether the Eurozone countries have the political will to follow through with the harsh austerity measures needed to slash their budget deficits and outstanding debt. Imposition of multi year, Eurozone spending cutbacks will slow European economic growth. At best, the Eurozone bailout puts us back to once again buying time for the Great Workout to slowly work out. What are the investment implications of this new crisis and does this change our portfolio strategy?

While we've been somewhat wrong so far on our view that interest rates would back up as governments withdrew their life support, it's hard to accept that rates will not cycle higher given the longer term inflation impact of flooding the global financial system with liquidity. The rush into safe U.S. treasury securities has led to lower interest rates. Consequently, our positioning of being somewhat short the long term treasury via our exchange traded fund holdings has not been profitable yet. We continue to believe that high quality, short term corporate paper should dominate bond portfolios, but finding this paper, given our quality guidelines, is challenging and requires considerable patience. We also have a hard time buying U.S. treasury securities, believing that they represent a bubble and should really not carry an "AAA" rating if properly analyzed and graded. We have observed that, at times, the debt of Berkshire Hathaway (the investment vehicle of Warren Buffett) has yielded less than comparable U.S. treasury securities. This should be a wake up call for fixed income investors! Our cash awaiting deployment in fixed income is probably too high, but we're trading security of principal for unappealing yield and inadequately compensated risk.

Our equity allocation is below our asset allocation targets. We have reduced our international developed markets stock exposure, feeling that the Eurozone, including the U.K. are facing considerable renewed growth challenges, political change of an uncertain nature (the U.K. and Germany), and difficult macroeconomic restructuring. Valuations in the U.S. stock market have been unattractive, especially when we apply Shiller's long term price/earnings model, and while we have a short list of companies we would like to own, the prices just seem too high. Consequently, we are trying to be patient and await a market opportunity to come in. We should also note that the ongoing revelations surrounding the debt deals underwritten by the investment banks over the past few years and last week's unexplained Flash Crash certainly don't help investor confidence. Economic fundamentals may improve, but unless confidence is intact, stocks will have a hard time moving forward. Having been scorched twice in the past ten years, financial markets seem clearly back in the fear mode.

At times, we tend to sit on our hands and wait. This seems like one of those times. We'll try to be patient and await the opportunities that the markets invariably offer long term investors. Thanks.

Jeffrey M. Harris, CFA