Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

July 2010

Are Prospects for the United States Really So Terrible?

> U.S. stocks slid, capping the worst May for the Dow Jones Industrial Average since 1940.
>
> Bloomberg, May 28, 2010

> The fiscal legacy of crises: Declining revenues and higher expenditures, owing to a combination of bailout costs and higher transfer payments and debt servicing costs, lead to a rapid and marked worsening in the fiscal balance.
>
> *This Time is Different, Eight Centuries of Financial Folly*
> Carmen Reinhart and Kenneth Rogoff, 2009

The month of May is often one of the better months for the U.S. stock market, but not this year. The stock market sold off badly this spring. In fact, the decline for the Dow Jones Industrial Average in May of 7.9% was the worst drop since the 9% decline in May, 1940. While some of our clients can remember what happened then, a cursory glance at the history books for the rest of us reminds us that this was the month when Hitler's Wehrmacht conquered the Netherlands, Belgium, Luxembourg and a large part of France. May, 1940 ended with much of the British Expeditionary Force still trapped at Dunkirk, as the evacuation of 330,000 troops was completed on June 4. During the spring of 1940, the Dow Jones dropped approximately 20%.

During the spring of 2010, from April 26th through July 1st, the S&P 500 Index dropped 17%. What transpired to cause this sell-off? Was this painful correction just a normal pullback after the S&P 500 rebounded 82% from its March, 2009 low of 666? Or has the media's ubiquitous coverage of the daily spill of thousands of gallons of oil into the Gulf of Mexico from BP's Deep Horizon rig caused a surge of investor pessimism? What, in fact, has caused investors to view the world so negatively that the S&P 500 Index is now no higher than it was in September, 2009 when the U.S. economy was contracting?

Here are some of the factors contributing to the current wave of negativity among U.S. investors:

Enormous continuing U.S. fiscal deficits	Huge deficits of many U.S. states
Possible Greek default on sovereign debt	Fitch's downgrade of Spain's debt
Slower economic growth in China	BP oil spill in the Gulf of Mexico
Fear of U.S. economy's double dip recession	Stubbornly high U.S. unemployment
Fear of U.S. deflationary cycle	Fear of U.S. inflationary cycle
Disappointing U.S. retail sales	Absence of U.S. housing upturn
Uncertainty over U.S. health care reform	Fear over U.S. financial reform bill
Likelihood of higher U.S. taxes in 2011	Lack of credit to U.S. small firms
Geopolitical threats in the Middle East	War in Iraq and Afghanistan

In our comments below, we seek to separate the wheat from the chaff in this worrisome list of problems and challenges and provide some balance by emphasizing the positive features of the U.S. stock market.

The problems and challenges delineated above are perhaps best analyzed by grouping them into four rubrics: the direction of the U.S. economy, uncertainty over regulation and taxes in the U.S. in 2011, global geopolitical and economic issues, and the continuing huge U.S. federal and state deficits and growing burden of debt. Let's tackle them one at a time.

Tepid U.S. Recovery or Double Dip Recession

After U.S. GDP growth of 5.6% in the 4th quarter of 2009, 1st quarter 2010 GDP was revised in June to a 2.7% increase, signaling to investors that this might be a tepid recovery. The economic news in June – weak new home sales, disappointing retail same store sales numbers, a big drop in the consumer confidence index, a disappointing new jobs report, and lack of credit to small firms – contributed to a foreboding that the economy might slip back into a recession during the latter part of 2010 or in 2011. Perhaps the single largest factor contributing to the mood of economic malaise is the level of U.S. unemployment, which has fluctuated between 9.5% and 10% during 2010. With the civilian labor force in the U.S. totaling 153.7 million, the current 9.5% unemployment rate means that 14.6 million are unemployed. These unemployment statistics are distressing and represent much human misery. However, it is important to realize that the U.S. structural level of unemployment (the number of people out of work even in boom times) is roughly 4.5%. This means that the Great Recession has resulted in 5% incremental unemployment (seven or eight million additional people unemployed). As seen below, unemployment in the U.S. largely reflects the value of education:

June 2010 Unemployment Statistics
% Unemployed

Teenagers	25.7%
Less than a high school degree	14.1%
High school graduate	10.8%
Some college courses or associate's degree	8.2%
Bachelor's degree or higher	4.4%

Source: U.S. Bureau of Labor Statistics

Job creation is usually a lagging economic indicator. Robust job growth generally occurs a year or more after a recession troughs. Most economists believe that the 2007-2009 recession bottomed during the third quarter of 2009, and the U.S. Department of Labor's household survey has shown, in fact, that 1.7 million jobs have already been created in 2010. This news is quite positive but has been overshadowed by six million jobs lost during the recession. Another unreported story is that corporate earnings for U.S. companies are recovering very rapidly. Many analysts doing bottoms up research project that S&P 500 earnings will surpass the high water mark set in mid 2007 and reach an all-time high in early 2011. While the current economic expansion is by no means robust, we at Bradley, Foster & Sargent, Inc. do not currently subscribe to a double dip recession scenario – at least not in the near term.

Uncertain U.S. Business Climate

Several weeks ago, the Business Roundtable released a 54-page report detailing how Washington's regulation, reforms and taxes are killing new investment and job initiatives. Business leaders hate uncertainty, and there is currently great uncertainty about how this year's health care reform bill will play out. Congress is poised to pass a 2,000-page financial reform bill which will cause more uncertainty, this time for those in the financial services industry, as regulatory costs will mount dramatically. The devastating BP oil spill in the Gulf of Mexico and the moratorium on offshore drilling has energy firms concerned about upcoming legislation as well. And finally, the business community and investors are anxiously waiting to learn whether taxes on income, dividends, capital gains, and corporate profits will increase, as the Bush tax cuts expire in 2011 unless action is taken. Many analysts believe that until there is clarity on taxes and regulation, the economic recovery will remain lukewarm.

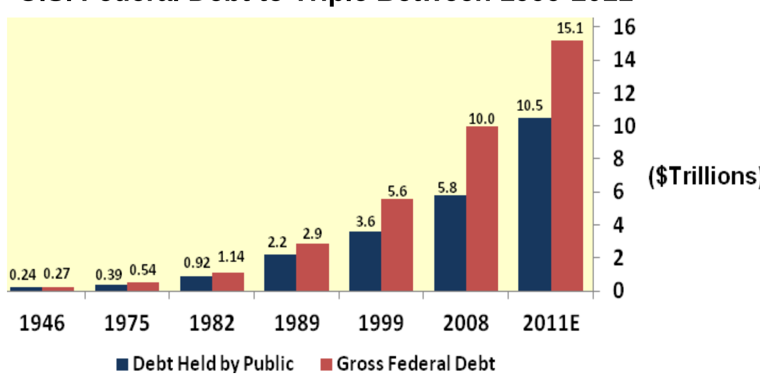
Global Challenges

Sovereign debt problems in the Euro-Zone have unsettled investors in the first half of 2010. In 2009, analysts first wrote of the PIIGS (Portugal, Ireland, Italy, Greece and Spain) – those European countries whose fiscal deficits and total sovereign debt were too high in relation to GDP. Then, in 2010, the financial crisis in Greece spun out of control, as investors balked at buying Greek bonds. The Euro sank 20% against the dollar, and the future of the Euro was even called into question. A massive fiscal rescue plan was hammered out by key European countries, which seemed to stabilize the situation. In June, Spain's credit rating was downgraded, and investors fled the Euro and bought U.S. dollar instruments, driving interest rates on the U.S. 10-year Treasury note to 2.95%. Many countries in Europe are adopting austerity plans in an attempt to overcome their fiscal challenges. Meanwhile, China has taken steps to rein in a housing bubble in some cities, causing a probable slowdown in GDP growth in 2010 (from an estimated 11% to perhaps 8%). Relations between Israel and its neighbors have worsened, and the U.S. military engagements in Iraq and Afghanistan continue. Much of the above discouraged investors, but it is difficult to see how the news of the spring of 2010 caused a decline in the Dow Jones almost as severe as the news from April through June, 1940.

U.S. Federal Debt

It now appears likely that the gross Federal debt (including bonds owned by the Social Security administration) will exceed $15 trillion by September, 2011. It is difficult to fathom that it took the U.S. 210 years for the Federal debt to reach $5 trillion but only 12 additional years to attain $15 trillion, as shown below:

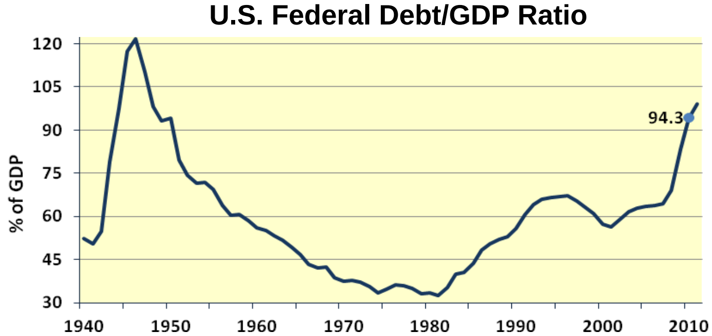
U.S. Federal Debt to Triple Between 1999-2011



Source: United States Office of Management and Budget

The chart below shows the relationship between Federal debt and GDP. Historically, when this ratio exceeds 100%, it has spelled trouble for most nations:

U.S. Federal Debt/GDP Ratio



Source: United States Office of Management and Budget

The Federal debt/GDP ratio in the U.S. peaked at the end of World War II in 1946 at 120% but then dropped for the next 35 years to below 40%, as the U.S.'s average annual GDP grew at more than 3% and fiscal deficits were reined in. From 1981 through 2008, this ratio expanded from 40% to 64%, as government spending grew even faster than the robust economic growth for this period. However, the Great Recession of 2007-2009 and its aftermath has put the U.S. on a perilous course. To put this chart in context, Spain's debt/GDP ratio is currently at 70% and Greece's is at 115%. And this chart does not even take into account the nearly $3 trillion of state and municipal debt and the huge unfunded pension liabilities that must be faced. Most worrisome for investors is the trajectory of the projected U.S. fiscal deficits over the next several years. The U.S. fiscal deficit for the year ending September, 2009 was $1.4 trillion, and the projected deficit for this year is even larger: $1.5 trillion. And the torrent of red ink does not diminish much in the following year, as the Office of Management and Budget projects a deficit of $1.27 trillion for 2011.

Summary

The U.S. currently faces a wide range of challenges – a tepid recovery, high unemployment, global geopolitical problems, and even the threat of a new deflationary cycle. Perhaps the most worrisome problem, which the electorate appears to sense, is that the U.S. is a nation living beyond its means. And the question is: Do we, as a people and as a nation, have the political will to take the necessary steps to right the ship and set a new, more moderate course to achieve fiscal stability? Do we have leaders and politicians in the U.S. who will consider the good of the nation as a whole rather than thinking of their own political constituencies and interest groups? America has faced far tougher challenges in the past – the Civil War when approximately 5% of American men were killed and the South was laid waste, the Great Depression when 25% of the workforce was unemployed, and World War II when the country faced powerful enemies in Europe and Asia. Let us hope that a crisis of equal magnitude will not be required before a solution can be agreed upon, and we set forth on an economic course which will address our fiscal challenges.

The recent stock market correction has been largely caused by investor psychology – not sagging earnings or tight money. Aside from the historical fact that the stock market almost always corrects 10%-20% following a huge rally from a market bottom, investor uncertainty and fear is palpable, as many doubt that we have the will to conquer these challenges. The good news is that the stocks of many quality companies with multi-national brands, low debt, strong earnings and cash flow are selling at the lowest valuations in several decades. If you believe, as we at Bradley, Foster & Sargent do, that Americans are ultimately a pragmatic people who can once again put the common good above political ideology, then this is a good time to invest in world-class companies for the long haul.