Marathon Investment Management

July 16, 2010

Dear Friends,

Perspectives
March through June 2010

For the recent quarter stock markets here and abroad gave up the gains of the first quarter and then some. As the Wall Street Journal reported, "Volatility returned to global financial markets with a vengeance…"[1] The Dow Jones Industrial Average (DJIA) lost 10% in the second quarter, the worst quarter since the first quarter of 2009 – and the first quarterly decline since then.[2] Please refer to the following[3]:

Index	2nd Quarter	Year-to-Date
DJIA	-10.0%	-6.3%
S&P500	-11.9%	-7.6%
Wilshire 5000 (total stock market)	-11.6%	-6.5%
Russell 2000 (small companies)	-10.2%	-2.5%
EAFE (large cap non-US companies)	-13.97%	-14.7%
Crude Oil, $75.63/barrel	n.a	-4.7%
Gold, $1,245.50/troy oz.	14.8%	13.7%

As mentioned earlier the second quarter was generally negative for foreign stock markets but especially for Western Europe, due to the worsening debt crisis. The best and worse stock markets in U.S. dollar terms are as follows[4]:

Best Year-to-Date		Worst Year-to-Date	
Venezuela	18.3%	China	-26.8%
Sweden	4.5%	Spain	-22.4%
India	1.4%	Italy	-16.9%
South Korea	0.9%	France	-12.5%
Germany	0.1%	Australia	-11.7%
Singapore	-2.1%	Brazil	-11.2%

Both the U.S. dollar and the Treasury market rallied in the second quarter due to global fears of debt defaults in Europe along with a Chinese economic slowdown. The U.S. dollar did lose some ground to the Japanese Yen and a few Latin American currencies. U.S. Treasury markets at quarter-end pushed the 2-year note yield to its lowest on record at 0.36%. The 30-year bond yield dipped below 4.0% to 3.88% - the lowest since October 2009. There are reports that Portugal, France, Spain and Britain, will have their sovereign debt ratings lowered. Also the Federal Reserve has stated its intention to keep rates exceptionally low for an extended period out of concern for the domestic economic recovery.

As quarter-end, yields on bonds stood as follows:

Government Bonds[5]		Corporate & Agency Bond Benchmarks[6]	
3-month T-Bill	0.17%	Intermediate	3.68%
6-month T-Bill	0.21%	Double-A-rated	3.32%
2-year T-Note	0.36%	Triple-B-rated	4.78%
5-year T-Note	0.96%	GNMA	3.12%
10-year T-Note	2.37%	FNMA	3.03%
30-year T-Bond	3.88%	FHLMC	3.13%

Another significant factor that affects both bond and stock valuations are the weekly and monthly employment reports. As of June 30th the ADP Employment Services survey reported that U.S. private employers added 13,000 jobs in June, down from a revised gain of 57,000 jobs in May, and well below forecasts of a rise of 60,000 jobs[7]. These reports add to the "flight to quality" approach – going towards 'risk-free' bonds from variable equities.

Questions and Answers

Q: I have read that consumer spending is the key driver for economic growth in the U.S. if not worldwide. Where do we stand now?

George: That is my understanding. In a current report the Commerce Department reported that sales at retail businesses – including department stores, gas stations and restaurants – fell 1.2% in May from April[8]. This decline was the first since September 2009, when sales fell 2.2%. Consumers are concerned about the stock market; about Europe and Asia; and about anemic employment. According to JD Power and Associates car sales for June were up 13% over last June – but this increase is considered dismal for a year of normal economic recovery[9].

Q: What is the unemployment rate?

George: This issue has a strong relationship to the previous question on consumer spending, as well as consumer confidence. The most recent report I read said the economy shed jobs in June as meager private sector hiring failed to make up for the thousands of temporary census worker jobs being terminated. Non-farm payrolls fell 125,000 in June – their first month of losses this year[10]. The unemployment rate did drop for June to 9.5% from a May 9.7% - but only due to a drop out of 652,000 from the labor force – those no longer looking for work.

Q: How serious is the housing and foreclosure situation?

George: May new-home sales fell 32.7% to an annual rate of 300,000, much less than the 430,000 expected by economists. This was the lowest figure since records began in 1963 according to the Commerce Department[11]. Sales were down 18.3% versus a year ago. One important reason for this drop is the tax credit incentive expired – a credit of up to $8,000 for home buyers.

Regarding foreclosures, more than a third of the 1.24 million borrowers who have enrolled in the $75 billion mortgage modification program have dropped out[12]. According to Barron's, 8 million loans are in some state of delinquency, default or foreclosure[13].

Q: How serious is the deficit and national debt and what is its effect upon the recovery?

George: The process of recovery is what I describe to clients as "deleveraging" – a painless word for debt reduction.

Regarding the deficit, this year the federal government will take in about $2.1 trillion in revenue while spending $3.6 trillion[14]. For the average American, this is equivalent to spending $85,000 on a $50,000-per-year salary[15]. In 2007 the federal government spent $2.7 trillion.

The U.S. debt will top $13.6 trillion this year and climb to an estimated $19.6 trillion by 2015, according to the Treasury Department[16]. The same report said that the ratio of debt to GDP would rise to 102% by 2015 from 93% this year[17]. The interest on the debt that the federal government must pay this year is estimated at $209 billion, and within 10 years, the annual interest payment may reach almost a trillion dollars. Under the Obama budget, interest on the debt would top 20% in 2020, the Congressional Budget Office projects[18].

This is clearly unsustainable - considering the 1930s as precedence, it is impossible to tax our way out of our deficit and debt. This is especially true, with our high unemployment along with about a 16% under-employment to boot. In 1932 the personal income tax was raised to 63% at the highest-rate. In 1934 the highest estate tax rate was raised to 60%; the gift tax that year was raised to 45% and then to 52.5% in 1935. In 1936 the highest personal income tax was raised again to 79%. The Great Depression did not end until the early 1940s with the advent of World War II. Raising taxes did not "deleverage" our way out of the Depression in the 1930s and I doubt it will do so today.

Q: With all of these negatives, why are you not recommending selling everything and putting one's savings in a tin can or shoe box?

George: As most clients know, most investment advisors are generally optimistic by nature. We look for opportunities wherever they present themselves. Most important, consider corporate earnings – Alcoa reported better than anticipated earnings as did Intel. Many of Wall Street's analysts expect a 27% profit gain from S&P 500 companies according to Thompson Reuters[19]. The gain anticipated is due to continued cost cutting as well as a 9% climb in revenue. Leading sectors for earnings growth are materials (steel, chemical and oil), technology and consumer discretionary firms.

Q: Earnings may be key, but what are other important factors that are bullish about corporate America?

George: The Federal Reserve reported recently that non-financial companies had built up cash reserves of $1.84 trillion as of the end of March[20]. This is up 26% from a year ago and is the largest increase on record. The monies received from sales, bond offerings and expense control are readily available for plant expansion, inventory rebuilding and hiring – once confidence is restored. As of now, cash is still king, yet U.S. companies collectively are lean, productive with capital structures based on low interest-rate debt and ready to expand operations.

A related issue to large corporation's liquid assets, is growing dividend payouts. According to Standard and Poors the second quarter total of dividend boosts among the approximately 7,000 publicly owned companies followed by S&P surged 70.7% over and above second quarter 2009. Only 22 companies reported reduced disbursements in the April-June quarter. In 2009 178, or eight times as many, reported cuts[21]. Standard and Poors counted 535 dividend hikes so far this year, up 57.4% from the 340 in 2009's first half[22]. Cash on the balance sheet for U.S. S&P 500 corporations is reported to be close to 11% of assets – a 60-year high[23].

Other factors that I have found encouraging include:

1. Positive albeit mild growth in U.S. manufacturing
2. Estimated S&P 500 price to earnings multiple of 11 versus an average being a substantially higher 15
3. With Federal Reserve rates near zero, short term obligations – CDs, T bills and notes, and corporate bonds offer historically low yields
4. A replenishment of inventories
5. Growth of initial public offerings which leads to growing employment especially of the U.S. skilled labor force
6. The distinctive entrepreneurial spirit of American businesses – or during difficult times recall the saying that "necessity is the mother of invention"
7. A general sense of despondency from "main street" and Wall Street as opposed to the euphoric build-up to the 2000 stock market crash and a lesser extent to the 2007-8 recession – or as David Dreman of Forbes puts it: the 'battered investor syndrome' is everywhere[24]- contrarians will take note
8. Even with a 54.6% recovery from the March 6, 2009 low of 666, the S&P 500 remains 34.6% below its October 11, 2007 intra-day high of 1576.

As discussed in previous letters, we at Marathon see opportunities going forward but remain diligent both for income-oriented as well as our growth clients in these difficult times. In the near future we will write about specific areas of investment opportunities that we feel are attractive during this challenging period. Please feel free to call us with any questions or concerns – we are here to serve you!

Sincerely,

George Gumbiner
President

Footnotes:

1. Wall Street Journal, Dow Slides 10% in a Volatile Quarte, 7/1/10, pg . C1
2. CNBC.com, Dow Losses 10% in Q2, 7/1/10
3. Wall Street Journal, Major U.S. Stock-Market Indexes, 7/1/10, pg. C4
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5. www.smartmoney.com, Treasury Slip After 2-year Yields Reach Record Lows, 7/1/10
6. Wall Street Journal, Tracking Bond Benchmarks, 7/1/10, pg. C6
7. Investors Business Daily, Bonds Mostly Rise In Quarter-End Session, 7/1/10, pg. B11
8. Wall Street Journal, Consumers Tighten Belts, 6/12/10, pg. A1
9. ibid. Car Sales Are Stuck, 6/29/10, pg. C10
10. ibid. U.S. Jobs Picture Darkens, 7/3/10, pg. A1
11. Investors Business Journal, Without Tax Credit, New-Home Demand Takes 33% Tumble, pg. A1
12. ibid. More Dropouts Mar Obama's Program to Halt Foreclosures, 6/22/10, pg. A1
13. Barron's, A True Horror Story, 7/5/10, pg. 7
14. www.invesotrs.com, Can We Balance The U.S. Budget?, 6/22/10
15. ibid.
16. www.reuters.com, U.S. debt to rise to $19.6 trillion by 2015
17. ibid.
18. www.investors.com, U.S. Debt Shock May Hit In 2018, Maybe as Soon As 2013, 5/9/10
19. Investors Business Daily, Q2 S&P500 Profits Likely Climbed 27%, 7/12/10, pg. A1
20. Wall Street Journal, U.S. Firms Build up Record Cash Piles, 6/11/10, pg. A1
21. Barron's, Half-Time Hosannas, 7/12/10, pg. 32
22. ibid.
23. Wall Street Journal, The Bullish Case for U.S. Equities, 6/8/10, pg. A19
24. Forbes, Battered Investor Syndrome, 7/19/10, pg. 74