Marathon Investment Management

Summertime and the Living is Not So Easy

July 19, 2011

Second Quarter 2011 Results

After a rewarding January through April we experienced a 6-week stock market slide bottoming in mid-June. For the final few days in June the markets rallied to a level very close to where the second quarter began. With the 'zig-zags' over the last few months many investors headed for the sidelines. The markets continued to respond, on a daily basis, to the macro economic events both domestic and global. We saw ongoing volatility not only from stocks but bonds, currencies, and commodities as well. The Dow Jones Industrials (DJIA) realized a 4% rally during April, followed by a 7% slide, and in the final days of June rallied again 4% for a quarterly gain of 94 points – its fourth quarterly gain in a row and eighth out of the past nine[1].

The 6-month results are as follows:

Index	Return[2]	Index	Return[3]
DJIA	7.2%	Dow Jones Global	3.5%
TSM (Wilshire 5000)	5.1%	Dow Jones Global (ex U.S.)	2.1%
NASDAQ Composite	4.5%	London (FT-SE 100)	0.8%
S&P 500	5.0%	Tokyo (Nikkei)	-4.0%
S&P Mid Cap 400	7.9%	Toronto (TSE 300)	-1.1%
Russell 2000 (small cap)	5.6%		

Except for the DJIA and the Canadian markets, all major indices reported slightly negative results for the second quarter. See the following:

Index	Return[4]	Index	Return[5]
DJIA	0.8%	Dow Jones Global	-0.5%
TSM (Wilshire 5000)	-0.5%	Dow Jones Global (ex U.S.)	-0.5%
NASDAQ Composite	-0.3%	London (FT-SE 100)	0.6%
S&P 500	-0.4%	Tokyo (Nikkei)	0.6%
S&P Mid Cap 400	-1.1%	Toronto	-5.8%
Russell 2000 (small cap)	-1.9%		

Those industries that benefited most during this quarter included consumer goods and health care, while those that lagged were oil and gas (a reversal from 2010), technology and financials.

Best Sectors for 2nd Quarter	Return	Worst Sectors for 2nd Quarter	Return[6]
Health Care	7.70%	Oil & Gas	-5.50%
Consumer Goods	6.12%	Technology	-2.30%
Consumer Services	3.85%	Financials	-2.11%

Due to continuous and growing concerns about growth, deficits and debt, Asia joined most of Europe in a second quarter stumble. German stocks offered some of the best returns for the quarter which could be seen as a safe haven for the growing challenges facing the "PIIGS" countries (i.e. Portugal, Ireland, Italy, Greece and Spain). Investor concerns about rising interest rates to tame Chinese inflation and slow economic growth have put pressure on the stock markets of China, Hong Kong, India, and Australia. For a country by country view of equity markets based in U.S. dollars please review the following table[7]:

Best Countries 2nd Quarter	Return	Worst Countries for 2nd Quarter	Return
Latvia	10.0%	Cyprus	-19.5%
New Zealand	9.2%	Greece	-16.0%
Indonesia	6.9%	Peru	-14.9%
Switzerland	6.2%	Estonia	-13.1%
Mauritius	5.8%	Bulgaria	-10.8%
Philippines	5.6%	Finland	-8.5%
Ireland	5.3%	Bahvain	-7.7%
Chile	4.6%	Israel	-7.2%
Germany	4.0%	Russia	-7.1%
Lithuania	3.5%	Sri Lanka	-7.0%

Latin American market indices also fell in response to the global events in China (major importer of goods worldwide), the Japanese tsunami, Greek and other European debt woes, as well as the slow recovery here.

Many see attractive valuations in Brazil and elsewhere in Latin America. The Brazilian stock markets trade at about 10 times earnings according to Audrey Kaplan, co-head of international equities at Federated Investors[8]. The Chilean markets continued to perform well partly due to higher copper prices; Chile is a major exporter of copper and other industrial materials.

Regarding commodities, prices that had been firm, fell near the end of the quarter led by crude oil. U.S. oil prices have seen single-day drops of 8.6%, 5.5% and 4.6% within the past two months, and ended the second quarter down 11% at $95.47 per barrel[9]. Wheat prices plunged 23% and corn recently dropped 20% from its record high in early June[10]. Additionally, commodities such as silver, copper, and cotton, which have had dramatic run-ups finished the quarter well below their respective highs. Meanwhile, gold hit record highs on May 2, 2011 of $1,556.70 per troy ounce, and finished the quarter at $1,502.37 up 4.4%[11].

Although the situation is complicated, we feel that slow economic growth both domestic and global is the primary factor in commodity pull-backs including this one. Also, we see easing constraints of production along with continued uncertainty of debt resolution in Europe as contributing factors.

The economic uncertainties also contributed to a solid quarter for the bond markets. Rates remained low despite QE2 bond buying by the Federal Reserve ending in June and investors, both institutional and individual, continued to add bonds to their portfolios. Investors added $16.87 billion to taxable bond funds in April and bonds of all types realized modest gains for the quarter[12]. In general Treasuries gained 2.78% while high yield bonds returned 0.77% and investment-grade corporates rose 2.59%[13]. Due to the Greek debt crisis we saw 90-day Treasury bill rates fall to zero during the quarter – last seen in March 2009, a classic flight-to-safety scenario. The 10-year T-Note closed June 30th with a 3.16% yield – down for the quarter.

In review, the market and investors seem to be in a holding pattern – similar to planes arriving at busy airports like O'Hare in Chicago. The fluctuating currencies, bonds, equities, and commodities reflect the uncertainties we face today. Among equities, the best performers in general were the "blue chips" led by DJIA winners American Express, Pfizer, IBM, Caterpillar, and Boeing. Our gut feeling is that until there is a real and last resolution to the problems facing Europe and the U.S., markets will remain volatile - reacting to the news of the day.

Going Forward

We see lots of political brinksmanship going on but with an August deadline on the debt ceiling, our best guess is that some type of stop-gap agreement will be made by a divided Congress and administration. This will initially be "bullish" for the stock market and “bearish” for bonds. Looking past August we anticipate seeing the U.S. economy continue to expand at a slow rate of perhaps 2-to-3%. This anemic expansion is insufficient to offset unemployment considering population growth for the U.S., and given the aforementioned conditions, inflation may remain mild. We believe economic growth (GDP) will remain stronger outside the U.S. especially in Asia and most of Latin America according to our estimates. The ‘tea leafs’ we see continue to show strong corporate balance sheets, especially among multi-nationals. We also observe continuing share-repurchase activity – the latest is Campbell Soup with a $1 billion share buy-back; its share price has risen 13% since the announcement[14].

Although less dramatic than the first quarter, we are seeing second quarter earnings coming in positive – especially for companies involved in the export of manufactured and agricultural goods. According to Fact Set Research analyst S&P 500 earnings are anticipated to grow by 14%[15].

Again, on a cautionary note, a major factor in the slow recovery for the markets going forward is personal debt. Household indebtedness reached 127% of annual incomes in 2007. This is up from an average of 84% in the 1990s. Households had worked their debt-to-income levels down to 112% by the first quarter 2011 – but like the national debt challenge that we anticipate, the process is slow and painful. If investors have less discretionary money in general, they have less to invest[16]. Most recent reports show that consumer confidence remains low – currently a negative for equities.

Closing Thoughts

In every report we have created since the founding of our company, we have described enduring strategies and principles that have brought success for our clients. In regards to investing, we have discussed dollar cost averaging, strategic diversification, investment discipline, the correlation of economic growth and rising investment values, fundamental analysis, etc. We have also talked candidly about financial planning concepts such as trusts, retirement strategies, education funding, budgeting and gifting.

Recently, for invoiced clients that live in the U.S. we mailed out 3 different books that we thought would be of benefit for them. So far, the feedback has been very positive – especially when local clients found out that the volume was in lieu of a Colorado Rockies game! We have found that the more educated our client becomes, the stronger the relationship is with Marathon and most important, investment and planning results are superior. So read on!

A few additional volumes that I have found of value include:

- The Intelligent Investor by Benjamin Graham
- Capitalism and Freedom by Milton Friedman
- One Up On Wall Street by Peter Lynch
- Basic Economics by Thomas Sowell
- Return to Prosperity by Arthur Laffer and Stephen Moore
- A Random Walk Down Wall Street by Burton Malkiel
- Management by Peter Drucker

Its summertime and times are challenging so pick up a good book to read, benefit and enjoy!

Sincerely,

George Gumbiner
President

Footnotes:

[1] Wall Street Journal, Volatile Quarter Spooks Traders, 7/1/11, pg. C1
[2] ibid. Major US. Stock Market Indexes, 7/1/11, pg. C4
[3] The Value Line Investment, Survey The Stock Market Review, 7/15/11, pg. 2126
[4] Wall Street Journal, Market Box Scores, 7/1/11, pg. C6
[5] The Value Line Investment, Survey The Stock Market Review, 7/15/11, pg. 2126
[6] www.djindexes.com, Dow Jones Indexes, 7/11/11
[7] Wall Street Journal, Country-by-Country Derby, 7/11/11, pg. C9
[8] Wall Street Journal, In Americas, Brazil's Slide Speaks Loudly, 7/1/11, pg. C9
[9] Wall Street Journal, Commodities Close a Quarter of Records, 7/1/11, pg. C5
[10] ibid.
[11] ibid.
[12] Wall Street Journal, Buy Bonds or Bye, Bonds? 7/1/11, pg. C5
[13] ibid.
[14] www.smartmoney.com, In Dark Times, It Pays to Lighten Up, 7/1/11
[15] Investors Business Daily, Corporate Profits Seen Strong, 7/6/11, pg. A1
[16] The Wall Street Journal, Inside The Disappointing Comeback, 7/5/11, pg. A6