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ASSET MANAGEMENT, LTD.
MEMBER FINRA-SIPC

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Second Quarter Report

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The S&P 500 finished the first half with a return of -6.65% while the Barclays Aggregate Bond Index finished with a return of 5.33%. The consumer discretionary and industrial sectors were the top performers while materials, energy, and telecom were the biggest laggards.

The capital markets have been caught in a balancing act between great fundamentals and broader macroeconomic issues. The major indices appreciated over 9% before experiencing the worst May performance since 1940 and even further declines in June. Concerns about the economic outlook, financial regulation, BP spill, flash crash, and sovereign debt issues within Europe all served as catalysts for the recent declines.

While we cannot rule out the possibility of a double dip recession, this is a rare economic phenomenon; we feel there is a low probability of this occurring. It is far more likely that the economy will continue expanding at a moderate pace relative to past recoveries coming out of deep recessions. We would define moderate as 3% GDP growth.

Out of the 32 recessions since 1850, the economy has double dipped 3 times with only one since 1933; this occurred during the election year of 1980 when Jimmy Carter's newly appointed Fed Chairman Paul Volker slashed the fed funds rate to 9% from 17.5%. Inflation returned with a vengeance and the Fed was forced to reverse course raising the Fed Funds Rate above 19% by the time Reagan took office in 1981. It is highly unlikely if not impossible that the Fed will be raising rates to >5% in the next few years much less 19%.

With regard to financial regulation, the biggest problem is lawmakers constructing regulation in markets they clearly do not understand. The proposed new bill will make it much more difficult for our banks to compete globally and does not address the biggest issues such as credit default swaps, Fannie Mae/Freddie Mac, and the ratings agencies.

The constant populist move against Wall Street has deflected the blame from the main culprits – people speculating on houses they could not afford and mortgage companies eliminating all underwriting standards. Wall Street was definitely complicit in helping create this crisis, but not to the extent that our politicians and media have portrayed.
It would be a far more constructive debate if they focused on how they packaged these loans and who is responsible for regulating the swaps market. With financial regulation about to pass, at least the regulatory cloud will be lifted and the financial sector and markets will know the new rules going forward.

It goes without saying that the BP spill has been one of the worst economic and environmental disasters our country has faced. This event had an incredible impact on investor psychology over the past quarter. The longer term effects of more regulation, reduced domestic drilling, lower tax receipts and royalty revenue to Gulf States, lower employment in Gulf States, and higher fuel costs will continue to weigh on the market. Economic recoveries are very vulnerable in their early stages and shocks such as this can tip the scales.

The flash crash on May 6th also had a huge impact on investor sentiment. It is estimated that quantitative trading by computers has accounted for 50-70% of daily volume in 2010. High frequency and algorithmic advocates claim to provide liquidity but there clearly was not any liquidity there when it was needed the most.

The SEC maintains they cannot determine the cause of this crash and investors have lost faith in the regulator that is supposed to be their watchdog. There continues to be strong debate about the causes of this issue and perpetuating the "high frequency trading is bad" mantra at this point would not be dissimilar to our criticism of lawmakers creating rules in markets they do not understand. There needs to be much more research on this issue before any informed conclusions can be drawn. The new trading curbs instituted a few weeks ago should prevent this kind of event from occurring so quickly.

The sovereign debt issues within Europe remain our biggest concern. We have seen the panic a credit crisis can create and unfortunately the ECB failed to address the problem in a manner that was acceptable to the markets until May. They finally adopted what economists refer to as "the nuclear option" by announcing a 1 trillion dollar package that has temporarily assuaged markets and will hopefully buy them enough to time to restructure.

Most importantly, they have helped prevent a run on the major foreign banks within Europe that hold so much of this questionable paper on their balance sheets. These EU banks are responsible for over 30% of the commercial paper issued by U.S. corporations and are crucial to a global recovery. Contagion fears are very real because it is currently estimated that U.S. banks have over $180B in exposure to Spanish, Italian, Irish, Portuguese, and Greek debt.

It is difficult to determine how much of an impact the European theatre over the past few months will have on the economic recovery. The decline in risk assets across the board will no doubt have an impact on hiring, lending, and spending in the short term. While there will be a negative currency translation for our multinational companies, the positives are also worth mentioning.

A flight to quality has moved capital into treasuries and therefore pushed interest rates down to record lows and the dollar to multi-year highs. In addition to lower input and transportation costs, this has resulted in a windfall for U.S. consumers by pushing mortgage rates to all time lows. A general rule holds that every one percentage point decline in mortgage rates is equivalent to a 10% reduction in the home price for the buyer. Real estate continues to be the second biggest headwind (behind employment) domestically and this will no doubt help.

In addition to the benefits listed above, the following table shows how little of an economic impact the recent declines in the euro will have on our GDP. The almost perfect correlation between the equities markets and euro can be attributed more to fears of a debt contagion than any real consequence to economic output. It is also important to recognize that the increased GDP in within the EU as a result of the weaker euro will help China and other emerging markets; these markets are the future engine of global economic growth that will ultimately provide the demand we need to sustain our recovery.

A recent report by the Organization for Economic Cooperation and Development has shown a 10% decline in the trade weighted euro would only decrease U.S. GDP by 0.1% in year 1 and 0.2% by year 3. The following table shows the deviation from the baseline forecast for each period in the wake of a 10% depreciation in the trade weighted euro.

	Year One	Year Two	Year Three
Euro zone GDP	0.7%	1.3%	1.7%
Euro zone Inflation	0.3%	0.7%	1.0%
U.S. GDP	-0.1%	-0.2%	-0.2%
U.S. Inflation	0.1%	-0.1%	-0.1%
Japan GDP	0%	-0.1%	-0.2%
Japan Inflation	-0.1%	-0.1%	-0.1%

SOURCE: OECD, DEUTSCHE BANK

It has been said that "a credit crisis in the high seas for which no compass has been invented". The euro does seem to have stabilized for now but the sovereign debt issues within the Euro zone will continue to be our biggest concern for the foreseeable future. Going beyond the economic ramifications of an EU collapse, democracy could be at risk which could have an even bigger impact on political stability around the world.

Countries within the European Union, Japan, and the United Kingdom have reversed course and have pledged to get their fiscal houses in order at the G-20 Summit last weekend. It appears they have realized the limits to Keynesian economics and taking the tough austerity measures now to prevent a collapse of their currency. There is a strong debate within economic circles on whether this approach of taking away stimulus too early will prevent a further recovery. Comparisons to 1937 where the U.S. was clearly coming out of the depression only to fall deeper than before after monetary policy became too aggressive and sent us back into a deflationary spiral.

Economics, in its simplest form, is the study of people's propensity to do things. By forcing itself into almost every sector of private enterprise, government is creating uncertainty in the marketplace and making it more difficult for businesses to raise capital, hire new employees, and take risks. Daily moves in our capital markets have recently been determined by policy and politics instead of sensible economics and fundamentals.

Even with such strong headwinds, the underlying fundamentals look very good. The S&P 500 is currently projected to earn $82.20 in 2010 and $96.43 in 2011. This represents a 17.3% increase and easily surpasses the record earnings of $88.18 in 2006. The market is off over 31% from the high even though earnings are expected to be 9% higher than their former highs.

In addition to record free cash flow and cash/cash equivalents on corporate balance sheets being at record highs, operating earnings are also looking strong. The numbers below illustrate the multiple compression the market has endured over the past 5 years –

2005	2006	2007	2008	2009
P/OE	P/OE	P/OE	P/OE	P/OE
16.33	16.17	17.79	13.57	11.21

Instead of looking at the overall market from 30,000 feet, let's take a look at this from a micro perspective. Microsoft's earnings per share over the past five years are –

2005	2006	2007	2008	2009	2010
					ProjectedEarnings
$1.13	$1.21	$1.44	$1.90	$1.63	$2.05

Even though Microsoft has been able to increase earnings by 81% over the past 5 years, the stock is trading approx 8% lower than its average price throughout 2005. We are not talking about the lofty valuations assigned in the late 90's (which would put MSFT around $160 or 800% higher). The premier companies such as MSFT used to trade at a premium to the market but now they trade at a discount even though their profitability has never been stronger and balance sheets never healthier.

The earnings yield on the S&P 500 (earnings divided by the index value) of 8% is over 5% points above the < 3% yield on the 10 year Treasury note. The last time the gap was this wide was during the late 70's prior to the bull market throughout the 80's and 90's that produced returns in excess of 1,100%.

It will only be a matter of time before rationality precedes fear and investors will prefer the future earnings power and dividends of equities over the record low yields on fixed income. It is important to note, however, that just because things are cheap does not mean they could not get cheaper.

Another positive development this quarter was China revising their economic policy. The Chinese Central Bank indicated they are going to allow for a more flexible yuan which means they will increase the peg to the U.S. dollar. This will help them curb growth to more sustainable levels and lessen inflationary pressures. In addition, this will give their consumers more buying power thereby enabling them to increase consumption domestically and will therefore be less dependent upon exports. One issue to keep an eye on is the inflationary effects increased import prices from China could have. Most importantly, this prevents a trade war and lessens the likelihood of an important concern developing over the past year – protectionism.

Second quarter earnings and guidance are likely to be mediocre relative to expectations for all the reasons listed above. The recent declines in the market have most likely discounted most of the lower expectations. We are not seeing any of the signs you see at market highs such as a hot IPO market, high investor sentiment, large margin balances, rising interest rates, etc.

Pessimism has become synonymous with prudency over the past few years. The seemingly endless malaise felt by investors is being reflected in our capital markets. The world is in disequilibrium right now; however, by the time it is back in balance the biggest gains will have already been had.

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