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DESPITE NEW NEWS, CURRAN'S VIEW REMAINS CONSTANT

It seems market sentiment changes by the day, and lately even more frequently.

As I discussed in my last email, in spite of the S&P 500 advancing more than 50% from March lows, my perception remains investors are relieved but not overly optimistic. Recent bad news has not helped. The war in Afghanistan is not going well and health care reform, as envisioned, will cost too much for our indebted nation.

Now we are faced with the high cost of "business as usual" to include wars and health care in addition to paying back all of the money borrowed for economic stimulus. Realistically nothing has changed. However, the perception has changed from hope for a fairy tale ending to a more realistic one that our fight for economic recovery is only in its earliest stages. There will be no "free ride" for 95% of Americans while only 5% pay the bill.

In spite of recent market sluggishness, my purpose today is to reiterate Curran's view: Buy high quality stocks for the long-term while being very cautious about the bond market.

OUR CONCERNS

The honeymoon is over for President Obama. It is impossible to know how politics directly impacts markets but my opinion is, over the long run, Presidents do not matter very much. It matters for partisans and it does influence how we all feel in the short run. However, the next election is always close at hand so hope eventually offsets despair and disillusionment.

So the honeymoon being over is nothing new. It will be dealt with as it has always been. Progress will be made with or without the help of Washington.

However, politics today is a little different and deserves closer scrutiny. We have a President who remains much more popular than his approval rating would indicate. Popularity may have resulted in an early blank check which now must be covered with action. As the political "wars" unfold this time, the attack may not be from outside the party in power but from within the Democratic Party itself as campaign promises collapse in the face of economic reality.

Just as George Bush lost control of his constituency, could we be witnessing the beginning of the same pattern in the Obama Presidency? It could be even worse than politics as usual especially if the fighting is mostly within the Democratic Party.

The war in Afghanistan is showing signs of escalation. With the war in Iraq only beginning to wind down, the cost to both our economy and national psyche will be very draining. Compounding the issue is a growing list of failed campaign promises and a war that could soon be as controversial as Iraq.

Curran is not too concerned. We believe the forces currently driving economic recovery are solidly entrenched and will soon be apparent to almost all of us except the unemployed. More will be mentioned below about the unemployment rate.

THE REASONS WE ARE VERY CONFIDENT ABOUT THE RECOVERY INCLUDE:

- Historically low interest rates are likely to remain low through at least next summer.
- Bank balance sheets are being rebuilt as previously written down assets are being written up. Together with newly raised capital there are signs banks could be better positioned to begin making new loans sooner than we previously expected.
- Residential real estate is showing signs the worst may be over. There remain major hurdles to overcome but recent reports show average prices improving in most markets as supplies of unsold houses are declining.
- About 60% - 70% of the economic stimulus remains to be spent. If the recession ended in June (my opinion) then the stimulus money could cause a "power boost" to an already expanding economy and growth in the GDP.
- We are skeptical the Fed will reverse the almost two trillion in quantitative easing any time soon. The result could be an even bigger boost to an economic recovery.
- Worker productivity has been surprisingly good during the recession which could have a dynamic impact on future corporate earnings. It is possible this recession has taught business how to more efficiently use technology to permanently eliminate workers and increase output. The result would be surprisingly better earnings at least through the early part of a recovery. We believe higher rates of unemployment will be part of the legacy of this recession as technology solutions dominate management strategies particularly in the financial sector along with government at the local, state and federal levels.

OUR CONCLUSION IS:

The ground work for an explosive recovery is in place. To be sure, there are problems powerful enough to stall our positive outlook to include:

- The savings rate continues to increase and is now more than 5%. Higher savings could slow the onset of a recovery. The long-term benefit of savings and investment more than offsets our short-term concerns but savings would slow the recovery.
- Commercial mortgages are a problem. Our belief is an expanding economy along with rebuilt bank balance sheets will allow banks to increase reserves and absorb commercial mortgage losses without stopping the recovery.
- Retail sales are likely to remain sluggish in spite of three billion dollars in government incentives for "cash for clunkers."
- Household indebtedness now stands at 128% of national output. In prior recessions it was never higher and in all except 2001 it was less than ½ the current figure.

Our view remains the real danger in the current market is not the prospect for a feeble recovery but rather one that is much too strong and occurs too quickly on the heels of too much fiscal stimulus and Fed easing. The mixture of too much government involvement (spending) and natural market forces could lay the foundation for an inflation that could prove to be as difficult to stop as the previous bubble in asset prices was to deflate.

The markets seem to be ignoring prospects for future inflation. The dominant opinion is the Federal Reserve is in control and will take the proper action at the right time to tighten credit conditions. Adding to that belief is there are no present signs that inflation is taking hold.

Tuesday's report showing producer prices fell more than expected in July adds to the belief that inflation is not a problem. The decline in prices over the last 12 months is the largest drop in 60 years.

We are not buying the notion that inflation is "dead." It is dormant. When it surfaces and takes hold it will be too late for investors whose strategies do not allow for inflation. Our conclusion is there is a growing bubble in the highest grade long term government bonds.

Each time the bond markets show weakness in the longer maturities, new buying seemingly takes hold and a new confidence builds in the Fed's ability to control inflation.

For us a few trillion dollars in quantitative easing by the Fed is a losing proposition no matter what course of action they take. If they choose to allow a natural pay down as debt matures along with selling longer maturities, rates are likely to rise. If they do nothing except allow a contraction of the money supply through the redemption process, rates are likely to rise. And if they take aggressive action to tighten credit conditions rates are likely to rise.

OUR ADVICE REMAINS:

Buy and hold highest quality equities while emphasizing highest quality fixed income securities with short durations.

Investors buying longer term bonds are receiving historically low interest rates at a time when inflation is benign. There is no margin for error in the long-term bond market. Buying bonds today is tantamount to buying stocks in 1999 or real estate in 2005 because there is no margin for error in the prices being paid.

Our outlook is very positive for stocks. It is equally negative for the long-term bond market.

Tom