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Memo

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To: Investment Clients

From: Mark Pellegrino, Chief Investment Officer

Subject: A May to Remember

A May to Remember… and Then Quickly Forget

The day of the "flash crash" got all the headlines, but it was just one day in a month full of difficulties for the financial markets. It was, in actuality, the worst May on record for the equity markets. More specifically, the U.S. equity market, as measured by the S&P 500, was down about 8% for the month. Was the downdraft confined to just the equity markets? Unfortunately, no. Just about everything was down. Here's a look at how a host of strategic asset classes performed in May:

Asset Class	May Performance
U.S. Equities	-7.95%
Developed Market (Non-U.S.) Equities	-11.19%
Emerging Market Equities	-17.41%
Commodities	-10.15%
Hedge Funds	-2.84%
High Yield Bonds	-5.17%
Senior Bank Loans	-10.91%
Emerging Market Debt	-1.81%

Eerily similar to the market environment of 2008, where everything was down except T-Bills and cash? Sure. The memories are still fresh enough to allow our minds to go there. Is this scenario likely to continue? Doubtful. In fact, Emerging Market Debt, Hedge Funds, Commodities and Emerging Market Equities have each either consolidated or staged a healthy recovery already.

Why were the markets so manic in May? Here's a short list of what had investors ultra-nervous:

(1) The European sovereign debt crisis appears nowhere near over. The markets have decided not to fund the Greek state, so the ECB, IMF and other European governments have stepped in to rescue Greece… or, more realistically, to defer a Greek default. The markets are simply concerned that the German taxpayer will have to fund a Greek debt default spiral. Further, Europe's debt-ridden nations have to raise almost **2 trillion** euro over the next 3 years to finance maturing bonds and fund deficits.
(2) There is a growing feeling that Western European debt issues equal growth problems in the Asian economies. Given that the Asian economies have been the growth engine in the recovery thus far, the North American equity markets look to be fixated on the potential for slowing growth in Asia.
(3) European banks, still hobbled by bad U.S. mortgage assets (call it Credit Crisis I), have been dealt a second blow – bad sovereign debt assets (Credit Crisis II?).
(4) The European Central Bank (ECB) doesn't have the U.S. dollars to support the risk in European banks should a major crisis ensue. The ECB's balance sheet is clearly deteriorating. In fact, on May 10th the U.S. Fed reopened emergency swap lines on U.S. dollar loans with the ECB to be the ultimate dollar funding lender of last resort.
(5) Certain sectors within the global credit markets are now showing signs of weakness, as evidenced by the recent rise in corporate credit spreads. Global economic growth, in a credit-constrained environment, will slow, causing a squeeze on profits due to the higher cost of capital. The bears see large gaps between where the credit markets are pricing risk and where the equity markets are currently priced. You may recall that this happened the last time around.
(6) There is growing investor anxiety over bloated government balance sheets. A huge health care bill and the costs of financial reform only add to the pile.
(7) High frequency trading (HFT), estimated to account for 40-80% of daily volume on the New York Stock Exchange (NYSE), is now being more widely recognized as the risk that it is, particularly following the "flash crash" trading session last month. These trading programs not only increase investor anxiety all by themselves, but have also exacerbated the uncertainty surrounding the legislative risk brought on by financial reform. Congress will surely voice its opinion. The "flash crash" session has given them cover. If they make a misstep, the markets will weigh in, as well.

While the markets suffered swift and compressed damage during May, we take comfort that the defensive posturing of our clients' portfolios caused a much more benign result. Equity exposure was maintained at levels well below our strategic

targets. A healthy dose of domestic debt positions were maintained, which held up much better than the more risk-based assets. In the government bond sector there were actually positive results, as there was a clear flight to that safety during May. Some cash and quasi-cash positions helped stem the downturn, as well.

As we look to the weeks and months ahead, we're compelled to maintain this defensive posture for now. Why? In a meeting this week with a client I was asked "What keeps you up at night?". Beyond all the current "noise" out there, it is this:

The stock market rally in early 1930 came after the market had fallen nearly 50% in the fall of 1929. This spring rally took the market up nearly 50%, to a level that was "only" 20% below the previous peak. That rally, of course, was the biggest sucker's rally in history. After the market peaked in April 1930, it crashed again, down 89% from the 1929 high and more than 80% from the 1930 high. **The market did not reach the 1930 high again for another 25 years.**

The rally that ended just this April came after a crash (at -53%) that was slightly greater than the 1929 crash. This past year's rally took the market up nearly 80% from the lows! It lasted a year, as opposed to the 6-month rally in 1930.

I don't mean to be alarmist! We're not calling for another Great Depression, nor are we calling for an 80% pullback from last month's peak. For either scenario to materialize, the "bad dominoes" in the global economy would have to fall in a way that we're just not calling for right now, so we've put a quite a low probability on either outcome. Nonetheless, I hope I've offered ample evidence as to why a defensive posture is still warranted.

Let me address a couple of questions I know are on everyone's minds:

(1) *Why not have zero equity exposure?* Very simply, we could be wrong. The bulls may have it right. We could, in fact, be entering the "next great bull market". With zero equity exposure, there would be no way to participate in one of those unique opportunities to add meaningful value to a portfolio.

(2) *If the "bad dominoes" fall in the worst of all ways, will there be signs?* We believe so. In fact, our Capital Preservation Model would suggest that if the S&P 500 breaches it's 300-day moving average, that's a sign of a market likely to be in a sustained downtrend for a while. (The 300-day average is at 1046. The S&P 500 closed the week at 1092.) If we see this breach to the downside, and on big volume, it's a sure bet we'll be taking additional defensive measures. If the market holds above the 300-day average and global economic conditions begin to improve, then that likely calls for a very different set of tactics. We'll cross each bridge as we come to it. In the meantime, we're comfortable holding positions as they are, awaiting a better sign as to the market's likely direction.

You've probably heard us talk about our business being one of probabilities. Right now, we can't assign a high enough probability on the kind of Armageddon-like scenario that played out in 2008. If at some point we can, we'll zero out equities. In the meantime, there are enough bad things out there to keep us at a level of equity exposure that's well below our intended norm, but enough hope to keep some of that exposure in play.

Until our next take on the probabilities,

Mark Pellegrino
Managing Principal & CIO
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