



HARMONYTM
ASSET MANAGEMENT

Q2 2009 Notes on the Quarter

Overview of the Quarter:

- 1) The second quarter provided a big rally if you had the guts to stay in. The S&P 500 was up 15.2% (up 1.8% ytd) and the DJIA up 11.0% (down 3.7% ytd). Note that all this did was erase the losses from the first quarter.
- 2) The credit markets continued to act better in general. Yield spreads continued to narrow, partially by having corporate and munis rally, and partially because treasuries fell dramatically (10 yr treasury lost 5% and the 30 year lost almost 8% during the period).
- 3) Commodity prices are generally up from their lows at the beginning of the quarter, but are showing short term weakness again.
- 4) Investors are starting to take on risk again; certainly the professionals are. This is primarily being done by traders, which explains the continued volatility.
- 5) The Obama administration and Congress are in the process of trying to raise taxes substantially. With enormous spending on the way and a deficit dramatically higher than ever seen before (as a number or as a % of GDP), taxes will inevitably rise. This is making the market nervous, which can be seen the range-bound volatile trading.

Portfolio Specifics:

- 1) As the markets rallied into June, we started taking profits. With such big gains, plus our belief that volatility will remain high, we wanted to “lock in profits” so we have a way to play later on again. This seems to be working, as commodities have started deflating again along with the industrials.
- 2) Much of the gains in the past quarter in the stock market are in less than stellar quality names, but these were the names that dropped the most. This adds clarity to argument that stocks are not terribly cheap.



Looking Ahead:

So what is the deal? Stocks plummeted, then they are rallied just to sell off again –investors just can't seem to catch a break. There are a lot of moving parts, so let's break them down to figure out what to do going forward. To understand what is happening, we need to address two questions first: what happened and why didn't diversification work?

What Happened? In early 2008, we started moving into a recession. After eight years of economic growth, this was more than normal – it was overdue. While governments want to eradicate recessions because recessions don't help them get re-elected, recessions are actually very beneficial because they help remove excess capacity, rebalance supply and demand, and keep an economy around equilibrium. Over the past twenty years, the typical length of recession has become fairly short (about 9 months) as just-in-time inventories and high-speed communications have allowed the world's economies to grow without getting too excessive.

However, this time round, thanks to cheap money all over the world and excessive leverage, the economy over-expanded dramatically. Investors borrowed money at lower rates than they could put that money to work and did the obvious thing – took advantage of this disparity to the extreme (it is called greed). Because the government did not want a recession, they kept the money supply loose and rates low, even though they knew about the leverage (although I do not believe even they realized the extent of the leverage). Thus when rates should have been rising so that the speculation slowed down, they were kept intentionally low to help stave off the problems, which allowed the problems to grow even bigger.

This over-leverage resulted in a near collapse of our monetary system. I am convinced that the Fed and Treasury Department have been very careful not to let us know just how close we came. This near collapse, combined with investor panic, is what caused the collapse in 2008 and the first quarter of 2009.

Luckily, through a number of federal programs, the monetary system has been stabilized. Corporate lending is again available and spreads, especially in the short end, have tightened. This is one reason the stock, bond and commodities markets rallied during Q2 2009. But why aren't stocks rising even more? Because, while we have stabilized the monetary system, we still have a recession to deal with - oh yeah, forgot about that, didn't you!

In order to regain equilibrium, the excess leverage has to be removed. Remember, not only were investors leveraged but consumers as investors as well. Unwinding this simply requires time and will drag this recession out longer than the more typical six to nine months.



Looking Ahead (continued):

How long it will take for consumers to pay down debt and start spending again, will depend on employment, taxes and banks credit. Currently, banks are reducing the availability of consumer credit, which will be good for the economy long term, but extends the pain short term. When you add to this the leverage in commercial building, which has not been dealt with yet, you get an economy with headwinds.

Why didn't diversification work this time?

Diversification, when applied to low-correlated or non-correlated assets, creates a cushion; when one asset class is struggling, another is doing well. So why did real estate, fixed income, stocks and commodities all correlate almost perfectly in the past 12 months, and does that mean diversification no longer works?

The short answer is yes, diversification does work. Just as basic business principals always work over time, but not necessarily over short periods of time (the tech bubble in 1999 is a perfect example), the same is true when diversifying based on economic drivers (the fundamental differences that drives real estate, stocks, bonds and commodities). However, this time there was an unusual factor that correlated non-correlated investments – leverage. *Massive* leverage was being used, by individuals and by professionals, in *every* asset class. Not only did this lead to over-valuations – just like during the tech bubble – but when the cheap money suddenly became unavailable, investors were forced to sell anything that could be sold and thus all asset classes collapsed at the same time. As panic set in, assets became oversold and this led to bankruptcies, foreclosures and huge losses.

The selling panic led to the broad rally of stocks, bonds and commodities at the end of Q1. The resulting rally, however, has gone too far. First, stocks are no longer cheap, even using overly-optimistic earnings assumptions. Second, the assumption that the economy is going to grow starting in the third quarter will turn out to be wishful thinking. Not only are most businesses not seeing any pickup, but the government has managed to undo most of the good it was trying to do.

Looking Ahead (continued):

Remember, the government's goal was to keep interest rates low (a la Alan Greenspan) so people would buy houses and stabilize housing prices. If you look at chart #1, you can see the government (I use this word because there is a great deal of inbreeding now between the Fed, the Treasury Department and the Office of the President) has failed.

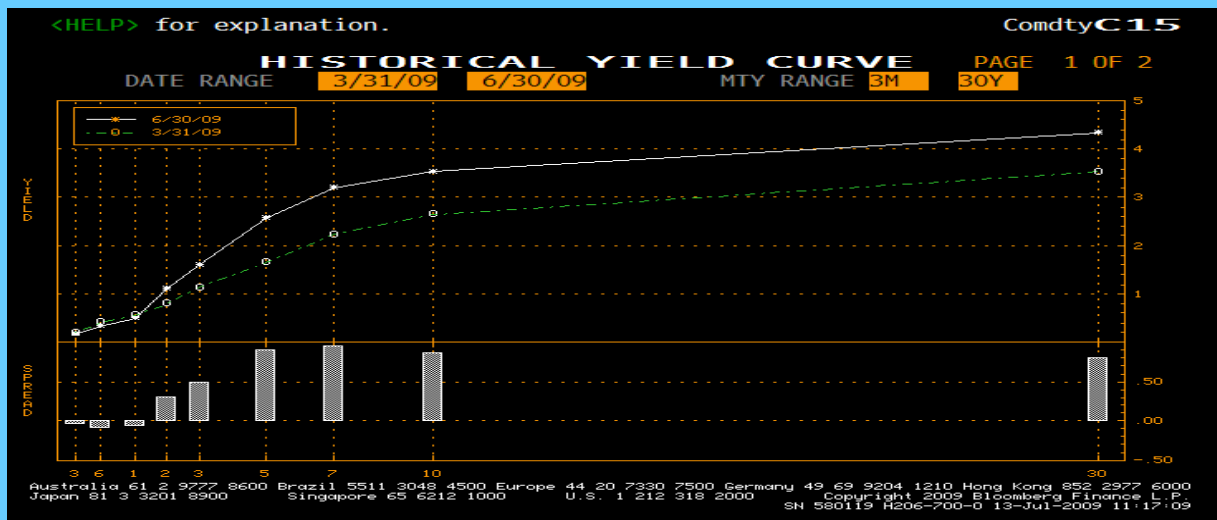


Chart #1

Interest rates are higher everywhere but on the very short maturities. Mortgage rates, which touched 4.5% briefly just a month or so ago, are closer to 5.5% currently.

Looking Ahead (continued):

But while spending extraordinary amounts of money to stimulate the economy (and much of the “stimulus” is highly questionable) the government has also pushed for dramatically higher taxes (funny, a few percent here and a few percent there and all of a sudden it is a real tax increase). This is having the effect of negating the stimulus because those who have funds to invest in or expand business are putting those plans on hold due to the threat of significantly lower returns from the potential tax hikes.

The same issues are apparent at the state and local levels as well. Stimulus money that has gone to state and local governments is largely being spent to balance budgets. As this will not solve a shortfall between tax revenues and spending (California is a good example), then once that money stops, tax hikes and/or reduced spending will be required, which is never a good way to stimulate an economy.

All of this suggests that a strong economy in the U.S. is not about to appear any time soon. But what about other parts of the world?

Europe: Europe has perpetually high unemployment, high government spending and a weak economy (and this is what Washington wants the U.S. to emulate!), along with a financial/banking mess. Most of Europe and the UK are behind us in dealing with these issues, so don't expect too much here.

Emerging Markets (“EMs”):

- 1) Asia has internal growth (read India, China and Indonesia) which will help their economies (China just announce 7.9% GDP growth in Q2 2009);
- 2) EMs are major consumers of commodities so that they can build out their infrastructure;
- 3) The Chinese government have been very successful in getting real stimulus money to work;
- 4) China has a growing banking loan problem, as the stimulus has made the banks sloppy. This could backfire on their economy, which still has very high unemployment.
- 5) Asian countries are primarily savers, not consumers. If this does not change, the stimulus will fail and will cause bigger problems worldwide as China has already tried to export (via low prices) their excess capacity;
- 6) These countries rely heavily on exports to the U.S. and Europe;
- 7) Russia and most of the South American countries are very reliant on commodity prices; while this will be good long term, it could hurt in the short term.

Looking Ahead (continued):

So while emerging economies have some attraction, they have their risks as well. If emerging markets are not strong, then deflation, not inflation will be an issue. This is what most governments are worried about and is why interest rates are still so low around the world.

So what do we do as investors? First, we have to realize that the returns of the prior two decades (+10% annually) are not going to reappear any time soon. Thus, an investor can either increase their risk profile or accept lower returns. We vote for the latter. Wealth is created over time and with patience. Now is the time to be well-diversified, flexible and patient. The end of the world is not coming – and if it is, none of this matters anyway!

Stocks: We are in a stock-pickers market. Finding companies that have their own special situation, un-followed by the Wall Street masses, will produce results. We will have to be more willing to take profits (no longer quite the buy-and-hold of yesteryear) as volatility produced by traders will send stocks surging both up and down.

Commodities: Just like the stock market, traders are increasing the volatility. Look at the charts below for examples over the past three months.

Oil



Gold





Looking Ahead (continued):

Silver

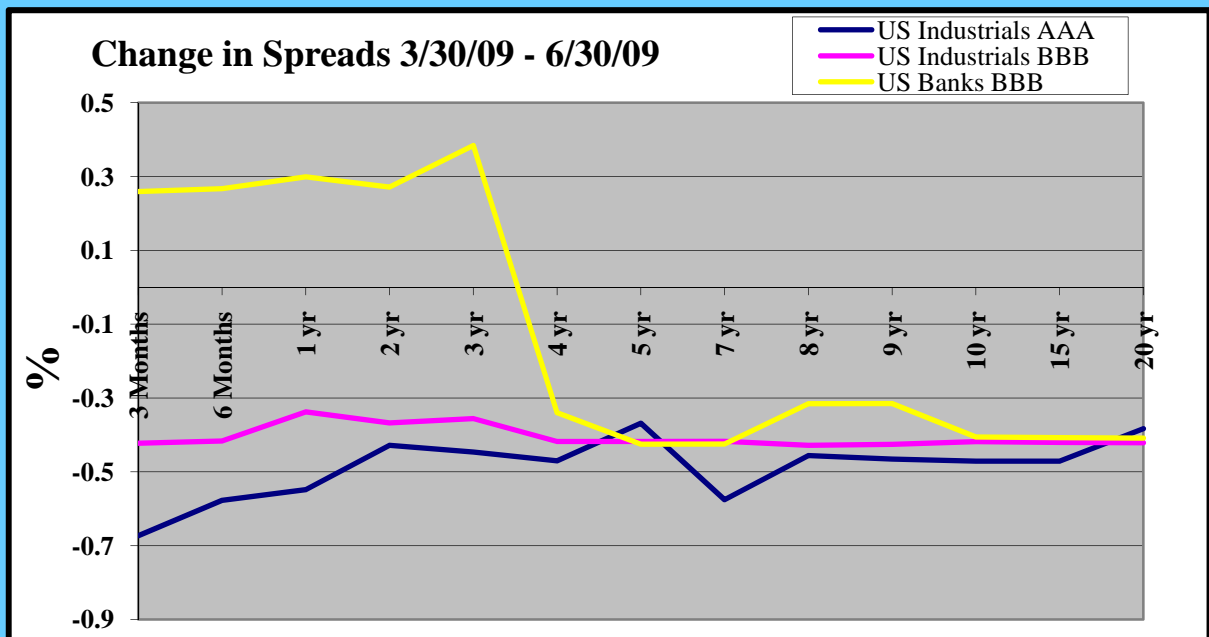


Soybeans



This volatility will provide opportunities to add positions using ETFs and individual stocks, at reasonable prices and diversity the portfolio. Commodities should do well as economies either slowly expand, rapidly expand, or are impacted by inflation.

Fixed Income: While inflation is a long term concern, deflation may be a bigger problem over the next year, depending on economies worldwide. Although spreads have tightened, especially in the AAA corporate space, we believe there is more room (see the chart below). With yields in the 4% - 7% range, this offers an attractive alternative to many equities.





~ The Bottom Line ~

The markets are now working through excess leverage in the private and public sector along with a recession. Concerns about inflation and higher taxes will continue to keep a lid on the upside for many asset classes.

Reasonable returns will be achievable by focusing on two broad portfolio strategies. First, it is imperative to use laser-like focus on fundamental valuations. When values are too high, profits must be taken. Locking in gains will help reduce the effects of a volatile and uncertain market. Second, diversification does work when not leveraged and is a pivotal portfolio strategy. Combining these strategies should help produce solid results.

This period of deleveraging and consolidation, while not much fun, is necessary and healthy. There are still a number of serious issues that need to be addressed both nationally and internationally, so ongoing diligence will be critical. However, we will get through this stage and there will be growth again in the future.

Successful investing requires time, it does not happen overnight. By building the portfolio foundation now and tolerating slow and steady returns for a little while, investors will be well positioned to make much larger gains later on when the economy is truly ready to grow.

As always, we want to thank our clients for their business and look forward to reporting to you again in October.

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