



Yellowstone VIEWPOINT

➤ MARKET PERSPECTIVE

The second quarter of 2010 introduced another clever acronym, PIGS. Though, this time the letters don't represent a government program, but a list of European countries (Portugal, Ireland, Italy, Greece, and Spain) whose economic woes stole the spring show that began with a very promising earnings season.

The advances that had been made in April on the back of positive earnings reports from across the spectrum of industries were quickly slung off in May and early June as waves of sovereign debt problems in Europe washed away the idea of a no-holds-barred global recovery.

Despite the increasing pessimism, the US recorded its third consecutive quarter of GDP growth, clocking in a QoQ growth rate of 3%—solid, but still slightly below the economists' estimates. Even a little downtick in the unemployment rate from 9.9% to 9.7% didn't spur the buyers to action and the market fell to retest the lows from back in February.

We have every reason to be wary of the notion that the problems in Europe won't create the same kind of credit problems that brought the market to its knees in 2008... after all, the comments about American banks having very little exposure to European debt sound eerily familiar to the "isolated" and "contained" terminology we heard in reference to subprime mortgage debt. The difference this time, however, is that it's coming with the backdrop of an economy that, by many measures is in full recovery mode, and by the most important measure - corporate earnings, is tracking ahead of expectations.

The only frame of reference we can soundly take for the market in the longer term is to consider the valuation and growth prospects under a given economic outlook. In the simplest valuation appraisal of an index, for example, an analyst would weigh the earnings per share against the price of the index itself - the P/E (price to earnings) ratio. To provide some reference, most analysts see the S&P 500 index earning close to \$81 this year, \$88 in 2011, and \$100 in 2012 based on forward estimates. With index settling in around 1060, that puts the forward P/E for this year at 13.06, relatively low by recent historical standards.

SECOND QUARTER S&P 500 EARNINGS

Sector	Reported/Total	Growth	Positive Growth	Negative Growth	Surprise	Positive Surplus	Negative Surplus
All Securities	433/496	56.39%	314	111	15.38%	352	77
Energy	39/39	62.39%	19	20	9.53%	32	7
Materials	30/31	380.36%	25	5	14.64%	26	4
Industrials	53/56	13.09%	34	16	13.15%	46	9
Consumer Discretionary	57/80	262.65%	51	6	20.89%	50	6
Consumer Staples	28/41	12.55%	20	7	3.19%	22	6
Health Care	50/52	17.13%	43	6	9.10%	43	7
Financials	77/78	165.52%	50	26	46.95%	57	19
Information Technology	54/74	72.20%	47	5	9.22%	47	6
Telecom. Services	9/9	-4.22%	4	5	-6.1%	6	3
Utilities	36/36	4.07%	21	15	5.60%	26	10

Assuming a more normal, but still conservative, forward P/E ratio of 14.5 for the given economic environment (with little to no inflation and very low interest rates), we'd put our end of the year estimate closer to 1180 on the S&P 500. If we continue to see companies outpacing their earnings estimates and fellow investors are willing to assign a more reasonable multiple, purely by valuation, you have a case for a much more cooperative market environment.

IN THIS ISSUE

MARKET PERSPECTIVE • ECONOMIC OUTLOOK

DIRECTIONAL MOVEMENT • FIXED INCOME OUTLOOK



➤ **ECONOMIC OUTLOOK**

DEEPWATER DRILLING

No quarterly newsletter for 2Q 2010 would be complete without at least a mention of the massive oil spill in the Gulf. Unlike previous spills, this one mixes a seemingly endless highly pressurized deposit with unprecedented inaccessibility. Worse still, for more than a month now, the investment industry version of paparazzi has been constantly streaming disturbing video of petroleum ceaselessly gushing into the ocean a mile under the surface.

The government’s attempt to be responsive was to put the deepwater drilling sector in the modern version of parental discipline, a “time-out,” a six-month moratorium. And the oil and gas drilling sector has been left decimated - sinking more than 15% from the end of April to June 9th.



It’s hard to look at the situation and say that it can get any worse from here, but there is a chance that the uncertainty surrounding the events will continue to be a negative catalyst. If we were to derive a pair of tailwinds from this event, they would be a continued narrowing of focus in the alternative energy space, and increased government regulation of deepwater drilling.

ISM MANUFACTURING INDEX

Before the weak euro arrived on the scene, all the talk was about the cheap dollar and the American manufacturing industry reaped

ISM MANUFACTURING INDEX



the benefits of an economic recovery combined with the weaker dollar, and thus, better exports. From the low to close out 2008, to the most recent data, the ISM manufacturing index has risen more than 83%.

That figure represents the most aggressive recovery in the manufacturing industry since the inception of the ISM metric. We’re getting used to superlatives these days, but strength in the manufacturing sector is not something to overlook.

At least a part of this rebound could be attributed to inventory replenishment, considering that inventories were drawn down to extremely low levels as businesses anticipated the weakening economy. We may see a leveling off in these figures for the next little while as inventories reach normalized levels, but anything over 50 still indicates expansion, which is enormously positive for the domestic economy.

ISI CFO SURVEY

In an effort to get a better idea of the pulse of corporate intentions midway through 2010, ISI performed their annual CFO survey six months earlier than normal. What they found was that CFOs have markedly increased their plans to increase hiring and capital expenditures.

The following chart details the results of the survey:

In 2010, do you have plans to...	Nov-09	May-10
boost capital expenditures?	+26%	+49%
increase hiring?	+10%	+30%
raise IT spending?	+13%	+41%

While it’s possible that CFOs’ plans have changed even since the May survey, it’s hard to discount the effect of optimism from corporate leadership. If you subscribe to the notion that the economy is basically a self-fulfilling prophecy, it seems prudent to give some credence to these numbers and buy into the encouraging intentions of the business world.



➤ **DIRECTIONAL MOVEMENT INDICATOR: A TECHNICAL INDICATOR ON NATURAL GAS**

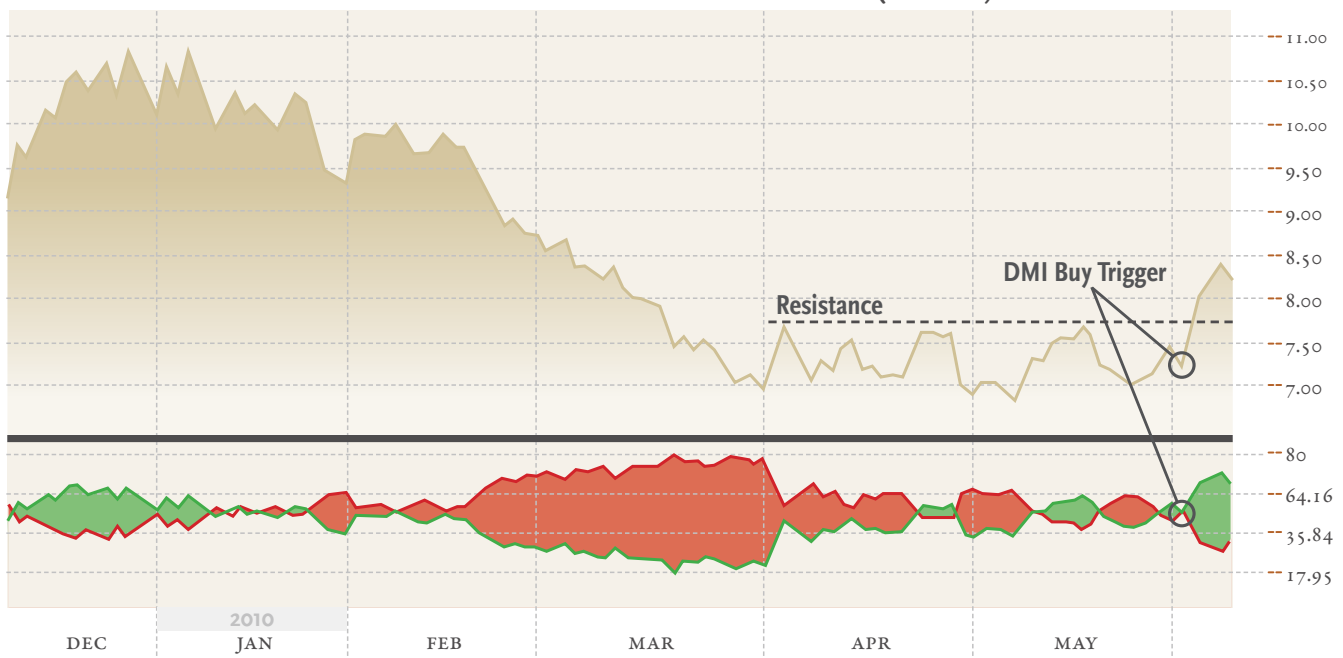
We don't see any reason to change our position that the core of market analysis is fundamental. We believe that there is no substitute for finding companies that are executing on their models and producing results that can be measured quantitatively. Yet, certainly there must be something to the trends and patterns that the human interpretation of value tends to create.

The technical analysis metrics that are used by believers across the industry vary from simple moving averages to complex mathematical and even geometrical designs and interpretations.

The basic premise is that at any given point, the movement of the price of a security depends on the strength of its buyers vs. the strength of its sellers. DMI simply plots the strength of the two and looks for changes in leadership or dominance.

To illustrate, consider the following price chart of UNG (an exchange traded fund whose objective is to track the performance of the price of natural gas). In early June, the strength of the buyers overtook the strength of the sellers for the assumptions given in this model, thus triggering a buy signal at roughly \$7.15. While you

DMI ON THE US NATURAL GAS FUND (UNG)



The patterns that market technicians track are as easy as support and resistance lines, and as complicated as Fibonacci-sequenced cycles.

To be a believer in all of them would be to be a believer in none, and thus, we're forced to make a determination as to which indicators are reliable enough to reference for buy and sell points. We find ourselves particularly keen on J. Welles Wilder's Directional Movement Index (DMI).

can see from the chart that this isn't the first time there has been a buy signal in the past few months, the case for a technical buy did get stronger when it was confirmed by a move upward through the resistance around \$7.70.

Clearly, this is only one minor factor in a host of other considerations, but this is exactly the kind of indicator we turn to as we weigh investment options.

"Always be the best, my boy, the bravest, and hold your head up high above the others. Never disgrace the generations of your fathers."
 —Hippolochus' instruction to his son, Glaukos, in Homer's *The Iliad*

"To support themselves they [governments] are obliged to be oppressive and tyrannical."
 —Adam Smith



➤ **FIXED INCOME OUTLOOK: LABOR FORCE GROWTH**

Rick Baird, CFA Director of Fixed Income

Government stimulus programs over the last several years have many investors wondering if this will result in rising inflation and higher bond interest rates. There are many factors we could look at, but in this issue we look at labor force growth and how it has been relevant historically.

Labor force growth has a track record as being one of the best predictors of nominal GDP growth, inflation and long-term interest rates. Various studies, including Ivan O. Kitov's 2006 report shows that labor force growth predicts inflation with a 2 to 2½ year lag and an 82% correlation. If a 2-year moving average, or "smooth" is used, it has an 87% correlation, and if a 4-year smoothing is used it has a 96% correlation. The Labor Force Growth indicator effectively outperforms almost all other forecasting tools available.

Why is Labor Force Growth such a reliable indicator? Consider periods that saw significant gains in the labor force, such as the 1970's. It is clear that entry into the labor force is the crescendo of the very expensive cycle of raising and educating our kids. When they enter the labor force there is a need for cash to fund housing, factories & offices, mortgages, home & office furnishings, inventory, resource extraction, automobiles, business working capital, etc. Think about automobiles; at this point in most people's lives, they go from not owning an automobile to owning one. Thereafter, they typically only replace vehicles on a one-for-one basis. It is the initial zero-to-one that has the greatest impact on aggregate demand, particularly when multiplied across a generation of new labor entrants.

This high capital demand is great for nominal GDP growth, but it comes at the expense of inflation and interest rates. An important aspect of labor force growth is that, aside from modest contributions from immigration, we know what the number will be well in advance. Current non-farm payroll stands at about 133 million, a level first reached in 2000. The next half dozen years

show labor force growth ranging from 0-3% annually. Add in a real interest rate of 2% and, under these assumptions, long U.S. treasury bonds are expected to trade in a 2-5% range, compared to the current rate of about 4.14% - not much of a change at all. In fact, the average treasury rate from 1870-2009 has been 4.3%.

In future reports, we'll consider other variables that are currently important to the discussion of interest rates, including the output gap, taxes and fiscal policies, velocity of money, deleveraging and debt, and opportunity cost. Our overall conclusion is that various domestic indicators point to a benign interest rate environment. However, record government deficits must be reflected somewhere. We think it more likely that deficits show up in a weak U.S. Dollar relative to gold, resource currencies (Canada, Australia) and currencies of economies less reliant on

deficit financing (Asia, New Zealand, some Latin American countries) than in domestic intermediate-term interest rate increases.

Our style of fixed income management focuses on value and

structural opportunities in the market and less on interest rate predictions. Nevertheless, we believe there are good values in the market, particularly in the intermediate maturity range of non-treasury bonds. We're not forecasting a policy tightening anytime soon, but it is interesting to note that in the last period of tightening, when short-term interest rates were increased on 17 separate occasions, the Merrill Lynch 5-year muni index returned 7.65%, while the 15-year muni index returned 15.56%.

The Labor Force Growth indicator effectively outperforms almost all other forecasting tools available. ”

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