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MANAGEMENT & TRUST CO.

QUARTERLY COMMENTARY
Third Quarter 2011

The third quarter was painful for stock market investors with the S&P 500 losing 13.9%, leaving that index down 8.7% over the first three quarters of 2011. In a very difficult environment we are pleased that where we have complete asset allocation responsibility, client portfolios are up slightly both for the quarter and the year-to-date.

Investors read the news daily to learn whether Greece will soon join the ranks of countries currently in default on their debts. The bigger story surrounds speculation about whether much larger countries like Italy and Spain will also be unable to pay their bills. Greece is almost universally acknowledged to be incapable of financial survival without further bailout assistance. Spain's debt rating was just downgraded. The problems are growing.

In the United States, the situation has become severe enough to warrant a third-quarter downgrade of our formerly sacrosanct AAA debt rating. Further downgrades are possible if Congress does not quickly craft a credible debt reduction program.

Fundamental conditions throughout the developed world are extremely weak. In the U.S. a few recent economic readings have improved slightly, but remain at depressed levels. Many economists, those from Goldman Sachs among them, have argued strongly that the U.S. will skirt a recession. Other economists contend that, while we may not be in recession today, the economy could easily slip into negative territory. The highly respected Economic Cycle Research Institute states boldly that its readings are at levels that have always forecast a recession. In ECRI's view, a recession is inevitable.

Many contend that Europe is already in recession. At the very least, Europe is expected to be in recession soon. For years, emerging market economies have provided the bulk of world economic growth. These economies are slowing perceptibly and are unlikely to be able to carry the worldwide economy absent much greater support from the developed world.

A minority of analysts voice serious concerns about China, the leading engine of emerging economies. Some foresee an imminent collapse in the Chinese real estate market. Others point with alarm at dangers they perceive in the Chinese banking system. While growth figures remain substantial, something must be wrong in China. Its stock market is still more than 60% below its 2007 peak. A Chinese crisis would be disastrous for the world economy.

The global economy remains weak despite a record amount of on-going multi-country stimulus. Resulting debt levels now stand in the way of a continuation of such stimulus. Banking systems and sovereign debt structures are so precarious, however, that further government rescue money is seen as necessary to prevent imminent collapse, notwithstanding the long-term damage such additional rescues may cause. Current politicians are determined not to allow economic collapse on their watch. Defer the calamity to the future, even if it makes debt problems worse. Let our children and grandchildren deal with them.

Tom Feeney provides frequent economic and investment commentary on our blog at www.missiontrust.com/blog.

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Long-standing clients know that we began warning about an approaching long weak cycle at the end of the 1990s. We pointed to two primary reasons: 1) extremely extended stock valuations and 2) excessive debt (long before debt became a four-letter word). In the first decade of the new century, valuations have become less extreme, although in the aggregate they remain well above average. The debt issues, however, are far worse today than they were a dozen years ago, and there is no credible solution in sight. We pointed out that over the two prior centuries, long weak cycles averaged about a decade and a half in length and ended only after they had expunged the excesses of the prior long strong cycle. Unfortunately, we will not eliminate the problem of excessive debt for several more years at the very least. The persistent debt crisis doesn't preclude intermittent rising equity markets. It does make it less likely, however, that we will have sustained rising equity markets until debt problems are solved. So far in this century we have experienced two historic market collapses and two powerful rallies. The net of all that action is that stock returns are negative for the century-to-date and prices today are where they were in the late-1990s. With banking systems and numerous countries on the edge of failure, great danger remains in the equity markets.

In the long weak cycle to-date, we have protected portfolios extremely well through the declining phases. We have attempted to find low-risk opportunities in the rising periods. We have found some opportunities, missed others. Net of it all, our client portfolios are up 65% before fees, which vary based on portfolio size. For the remainder of the long weak cycle with its huge potential for losses, our operating philosophy will be that it is far better to miss an opportunity than it is to lose any appreciable amount of money. There will always be another opportunity if capital is intact.

Through the twenty-first century so far, bonds have been the premier financial asset category. As a result, investors have recently flocked to bond ownership. At interest rates very close to all-time lows, however, bonds have become a high-risk asset class. They could do relatively well in the years ahead if the economy remains weak, especially if it falls again into recession with a deflationary bias. On the other hand, a stronger economy would almost certainly lead to higher interest rates and bond price losses. Should the monetary authorities attempt to solve the country's overwhelming debt problems by printing large volumes of money, interest rates could skyrocket. One can make a plausible case for either rising or falling interest rates over the next few years. At today's extremely low rates, however, the potential gains from steady or declining rates are far smaller than the potential losses from rising rates. It is instructive to remember that when interest rates last began a long rising cycle, bond returns trailed risk-free cash for four decades from the early-1940s to the early-1980s. At these interest rate levels, even top quality bonds can be a very high-risk investment.

We are pleased to have been able to avoid the equity market's losses in 2011. We will continue to look for low-risk profit opportunities as the ongoing long weak cycle continues.

Thomas J. Feeney
Managing Director
Chief Investment Officer

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