QUARTERLY COMMENTARY
Second Quarter 2012

During my 44 years in the investment business, I have never before observed a period in which governments and central banks struggled so hard to keep economies and securities markets from succumbing to deteriorating fundamentals. So far they have largely succeeded. With the exception of a relatively small number of European bondholders and a somewhat larger number of overleveraged real estate speculators, most investors have avoided debilitating losses. As a result, investors throughout the world appear to have lost their fear of systemic collapse, which nearly crippled markets just four years ago.

Despite the most prodigious government rescue effort in history, the world economy is slowing perceptibly. Europe is in recession, and an increasing number of countries are holding out their begging bowls to stave off bankruptcy. Massive stimulus has kept the U.S. economy in expansion mode, but recent readings indicate that the threat of recession has escalated. Perhaps most worrisome is the reality that China and the other BRIC nations, the erstwhile engines of global growth, have hit stall speed.

The Federal Reserve's acknowledged efforts to raise stock prices have worked magnificently since the 2008-09 crisis, but more recent efforts show clearly diminishing returns. Although stocks lost 2.8% for the second quarter, a well-timed European rescue rumor pushed our stock prices up by 2.5% on the final day of the quarter, elevating the twelve-month return for the S&P 500 to 5.4%. Rescue efforts elsewhere in the world have been far less effective. Among major world equity markets, only the Philippines and Thailand join the U.S. in the plus column over the past year. All other major markets are down for the last twelve months. Of the 18 countries that I follow on a daily basis (including our own), only the Philippines and Thailand are above their 2007 peak price levels, despite massive government support. Italy, the third largest economy in Europe, has seen its stock prices decline below the 2008-09 crisis lows. And perhaps most ominous is the fact that China's stock prices are down for one, two, three, four and five year time periods, notwithstanding having reported glowing economic growth numbers throughout those time periods. Something unhealthy is not reflected in the official statistics.

Most important for investors worldwide is to recognize that we are not in a "business as usual" environment. It's not a question of whether stocks might be up or down by 10% in the year ahead. If governments and central banks prove unable to solve the problems of excessive debt by issuing more debt, the entire financial system is in danger of freezing and becoming dysfunctional, as nearly happened just over four years ago. There is no way to measure the likelihood of such an outcome. Clearly, governments and central banks will do everything in their power to prevent it. Markets, however, don't necessarily wait for governments and central banks. So far investors remain somewhat confident that government officials won't allow markets to collapse. History demonstrates, however, that central bankers and other government officials are far from omnipotent. Despite best central bank efforts, stocks fell by 89% from 1929 to 1932, and by more than 50% from 2007 to 2009. In the early 1990s, the Bank of Japan addressed problems much like those being experienced today in other parts of the world. They offered various forms of forgiveness to keep alive banks that would otherwise have failed without government support. They also instituted a zero interest rate policy in an attempt to revive their sluggish economy. Tragically the Japanese economy has been moribund for the better part of two decades, and its stock market today trades more than 75% below its levels of over 22 years ago. While investors in this country still believe that our government rescue actions will succeed--despite the fact that essentially the same actions have failed dismally in Japan--that confidence could fade quickly. Investors should weigh carefully how much capital they can afford to put at risk of major loss.

For the past three decades bond investors have earned their best returns in U.S. history. With interest rates now at or near all-time lows, future bond returns are far more problematic. Short-term bills and notes of perceived secure credits yield essentially nothing. In the past few weeks investors have been willing to accept negative returns in Germany and Denmark. In other words, investors were willing to pay those governments to hold their money and give it back intact. These large, sophisticated investors, who recognize how risky other interest-bearing securities have become, are opting for safety over return. Longer term fixed income securities similarly pose problems for investors. You can obtain double-digit returns if you are willing to bet on the solvency of various sovereign or corporate bonds. At the other end of the risk spectrum, you can expect only about 1.5% (or less) if you are willing to loan money to the United States or Germany for ten years. If rates don't change, you will receive a ten-year annualized return of about 1.5% on these securities. You could make more than that if rates decline to new all-time lows and you make a timely decision to sell at a profit. Unfortunately, you could also lose a considerable amount of money if rates rise and you decide or have to sell at resulting lower prices. Most bonds and notes fall in between those risk extremes. All but the very shortest fixed income securities, however, will suffer if rates rise. And with rates near all-time lows, it is highly probable that rates will rise within the next several years. Ultimately, the only path to bond profits from these levels will be stable to lower rates followed by a successfully timed sale. If rates eventually rise, it is very likely that inflation will also rise. Then bond proceeds, even if securities are held to maturity, would almost certainly have seriously reduced purchasing power. We continue to believe that, at current interest rate levels, the reward for being right about bonds is far less than the penalty for being wrong.

In such an environment we continue to pursue a low risk investment approach. We expect volatility to rise in most investment markets, possibly very dramatically. Such volatility will likely provide far more attractive investment options than exist today. We want to maintain liquidity to take advantage of those expected opportunities. At the same time, we are attempting to maximize returns on essentially risk free short-term investments, and we continue to invest in the occasional security that appears significantly undervalued.

Because central banks have traditionally attempted to print their way out of serious financial crises, it is highly probable that the Federal Reserve will continue to pursue that policy, as it has quite aggressively over the past few years. The European Central Bank likewise has apparently chosen the printing press solution, and Germany's traditional objections to such an inflationary policy appear to be fading. While the unwinding of debt is currently a deflationary force, we believe that loose central bank monetary policies will eventually produce inflation--potentially even severe inflation. To hedge against that prospect, we have begun to add gold to client portfolios, a relatively small position so far. With no sound method to value gold above jewelry costs, we have little confidence in outguessing speculative supply and demand forces. Should gold prices rise from here, we will experience nice profits on a relatively small position. On the other hand, as long as central banks continue their aggressive money printing policies, we will build a larger gold position on price declines, which could prove substantial if world debts begin to unwind even more significantly in quarters to come.

We believe that meaningful profit potential lies ahead, albeit likely from considerably lower price levels for most asset categories. We are intent now on protecting client assets to leave them intact and able to take profitable advantage of the opportunities ahead.

With world events unfolding as rapidly as they have recently, I am attempting to post a weekly analytical entry on my blog at www.missiontrust.com/blog. I invite you to subscribe without charge to receive notice whenever a new entry is posted.

Thomas J. Feeney
Managing Director
Chief Investment Officer
July 9, 2012