

FROM THE ECA RESEARCH DESK . . .

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Stocks (as measured by the S&P 500 Index) have thankfully bounced about 36% from the over-sold, panic lows of March 9th. Still, we are just now getting back to 2008 year end values. And, of course, we are still smarting from the negative 37% brutalizing last year.

Investors want simple answers to complex questions.

- They want to be re-assured that their savings are safe; that their stock values, earnings and dividends will recover.
- They want decent income production from their investment portfolios.
- They would like to see a better economy with good paying jobs returning.
- They want housing price stability.

But, we know that a favorable environment for commerce and business must exist for these positive things to happen.

What are the favorable conditions necessary for uninterrupted, steady growth in business, financial markets, investment portfolios and global prosperity?

- 1) Low inflation and interest rates.
- 2) Falling tax and regulatory burdens.
- 3) Free and reasonably unfettered global trade.
- 4) Relatively low debt and leverage (personal, corporate and government).

Over the years, we have learned that (now global) consumer needs and wants are so profound and unrelenting (as expressed through the free market and the capitalist system) that the massive ship of commerce is capable of dragging heavy anchors. We are familiar with these ‘anchors’ from the past – high inflation and interest rates; excessive debt, taxation and regulation; trade protectionism.

What is the business environment today and how is it impacting our future investment prospects?

- We have low inflation and interest rates, but there is ample evidence they could begin to rise.
- We are over taxed and regulated – certainly not going away and bound to get worse.
- We have relatively free global trade, but it is being threatened in an effort to protect domestic jobs.
- And, last, everyone knows debt levels are very high and unsustainable – especially personal and government debt. Corporate debt levels are reasonable, but while personal debt is aggressively being paid down, government debt is ‘off the charts’, growing exponentially.

So, just two of the four conditions for growth and prosperity are in place – low inflation, interest rates and global free trade. When you consider that one of those two (inflation / interest rates) is vulnerable, it is easy to understand why financial markets will continue on a cyclical, erratic path without great prospects for growth – a U shape rather than a V shape economic recovery.

This environment, in our view makes a case for some active management in addition to the passive / index allocations already in place.

- Opportunities are plentiful, but they are hidden in sectors benefiting from the economic ‘fits and starts’ of the ship of commerce.
- Active managers are emphasized in the Counsel Trust private funds and they have successfully uncovered a number of opportunities.
- Experienced, active managers know how to exploit the changing growth sectors of a sideways / cycle market.
- Other times call for a more passive approach when equity price to earnings ratios all generally rise together in a more prosperous, healthy economy.
- Certainly not all ‘boats’ will rise in this choppy environment.

Here is an example of how to benefit in this choppy market.

- In keeping with this theme of finding ‘edges’ and opportunities in a cyclical / choppy market, earlier this year (in ECA Notes), we suggested an investment in corporate bonds. The corporate yield spread over U.S. Treasuries was historically wide (in other words, corporate bond prices were quite low). That investment has worked out very well and profit taking is in order.
- Now, we believe another opportunity has emerged - mortgage backed securities – large pools of prime, Alt-A and subprime mortgage prices have dropped as much as 90% in the credit panic.
- Over-burdened banks in particular have been ‘heaving them over the side’ (almost at any price) to re-gain liquidity and bolster capital.
- But, prime mortgages have experienced just a 5% default rate.

- The Alt-A loan (quality somewhere in between prime and sub-prime) default rate is 21%.
- Yet, current prices of these securities presume a far higher underlying default rate.
- The best way to invest in 'mortgage backs' is via an actively managed, broadly diversified, non leveraged institutional fund.
- ECA has identified such a fund and is actively adding positions to discretionary accounts. More information can be provided on request.



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