

BONDS

We continue emphasizing short to intermediate term maturities – interest rates are slowly rising, but still historically quite low. Rates are likely to stay down as excess leverage unwinds in this deflationary environment that (we believe) will extend well into 2010. Corporate, high quality mortgage and some high yield bonds present a temporary opportunity as yield spreads (the difference between corporate and treasury rates) remain wide. They have, however narrowed considerably now that the worst of the credit crunch has passed. The boom / bust policies of the Federal Reserve and Treasury are unprecedented. In an effort to assuage the credit crisis, the Federal government has intruded into commercial and investment banking (picking winners – Goldman Sachs; Morgan Stanley, and losers – Bear Stearns, Lehman Bros.) while the Federal Reserve has flooded dollars into the economy, ultimately increasing inflationary pressures.

Then, there are the two massive government spending programs: the \$700 billion TARP (Troubled Asset Relief Program) in 2008 and the \$800 billion stimulus program in early 2009 - both implemented to prevent a collapse of the financial system and avoid another Great Depression. Neither program has fulfilled stated promises or intentions. TARP has not purchased bank toxic assets, which would have enabled banks to make new loans. Instead, the funds went toward shoring up weak bank equity capital (a partial nationalization). In other words, TARP is a ruse to control banks, not save them. The \$800 billion stimulus is just another big spending bill to fulfill political campaign promises, much of the largess planned to spill out after 2009. Current spending is being directed toward sectors that were already holding up well – healthcare, state and local governments – hardly the best way to stimulate the economy. On top of that, how can we forget the seizure of AIG and two car companies along with Fannie Mae and Freddie Mac (the government now controls more than half of all U.S. mortgages)? It will be very difficult for the Fed to raise interest rates (when the time comes) while encumbered with this conflict of interest. So sweeping and sudden are these federal grabs, we now seem to be completely desensitized.

The federal fiscal deficit is up to an astonishing \$1.8 trillion. At this rate, total federal debt (now \$12 trillion) as a share of the economy will double over the next decade from the current 41% to well over 80%, placing us in the top tier of profligate debtor nations. It is true that deflationary forces are at work and that we have a Fed Chairman totally dedicated to inflating our way out of recession, but the monetary base has exploded upward – the ‘punch bowl’ is flooding over. There is an end to its stimulative impact, ultimately leading to stagflation pressures, not unlike the 1970’s.

STOCKS

Valuations as measured by the price to earnings ratio (PE) are not particularly low. The S&P 500 Index PE is now about 17. The recent market low in March, 2009 was 12. The low in 1974 and 1982 (two other significant stock market debacles) was 8 to 9. The dividend yield at those times was 5% to 6.5% (vs. 3.5% at the recent market low in March). Bond yields remain low (presenting unacceptable returns), thus, stocks win by default – the excess money is flowing into equities for fear of being ‘left at the station’. Markets are full of momentum, meaning that trends can run beyond realistic limits of valuation (both up and down).

It is corporate earnings that ultimately drive stock prices. Indeed, earnings have been (tepidly) growing at 2% to 3% since late in the first quarter. However, consider how modest earnings growth has been achieved – cost cutting, layoffs and other ‘belt tightening’ efficiencies. But, now the ‘low hanging fruit’ has been picked. Going forward, sustained earnings growth can come only from top line or revenue growth, and that means renewed consumer demand – either domestic or foreign.

With American consumers tapped out in terms of debt and high unemployment, most top line growth will come from international sales, particularly emerging markets that are clearly in the best shape of all the economies of the world. There are certain ingredients necessary for the emerging economies to lead us out of global recession: 1) Free and open trade – no tariffs or other kind of protectionism. 2) Foreign currencies linked to a stable U.S. dollar. 3) Healthy and growing consumer savings in emerging economies. 4) A favorable business environment enabling U.S. companies to produce quality products efficiently (low taxes, reasonable wages, a modest regulation burden, etc.).

Two of the four ingredients for recovery are in place (it remains to be seen regarding the other two): 1) Trade is relatively open, but there are protectionist rumblings in Congress. 2) Emerging market currencies are now mostly linked to the dollar, but the dollar has not been stable. 3) The savings rates in emerging economies are robust; consumers need and want a multitude of products manufactured in the U.S. 4) The relatively low tax / moderate regulatory environment is threatened by ‘cap and trade’, ‘nationalized health care’, repeal of the Bush tax cuts, ‘card check’ and other big government ‘command and control’ type schemes.

What are the prospects for the U.S. economy? We are in just the 4th or 5th inning of the credit crisis which means more defaults, bank failures, unemployment and deflation. The over-supply in real estate of all sorts (mostly residential) will take much more time to unwind. Although the financial

system panic has passed, new, small and mid-sized businesses (significant engines of economic growth) are not getting credit because banks are still hoarding cash to prepare for another wave of write-downs. Until the additional batch of defaults in the pipeline are written off, the economy (as measured by GDP) will continue to crawl at 1% to 3% - investors should thus remain guarded. There is literally no securitization of debt right now (freeing up banks to continue lending). From 2002 through 2007, 80% of the credit market consisted of securitization.

What are the prospects for the U.S. stock market? The impressive 49% stock market bounce off the 3/9/09 low of 670 for S&P 500 Index to the current 1,000 is unsustainable without earnings growth propelled by increased revenue. On average, stocks yield about 2.5%, below the average yield of almost 4% going back to 1980. This modest yield indicates that stocks are a bit ahead of themselves and that the secular (longer trend) bear market is still in place. The summer bounce could be considered cyclical (a short trend bull within the confines of the broader bear). Expect a range-bound, choppy stock market.

Cash (with a near zero return, subject to inflation) and U.S. equities (somewhat over-valued with declining earnings) should generally be under-weighted. Short to mid-term corporate notes, high yield bonds and distressed debt (such as mortgages) can be over-weighted (given the wide yield spread). Small cap and emerging market stocks have had a big run and should be trimmed. All investors should have an allocation to 'real' assets such as commodities and precious metals.

MARKET DISCIPLINE

The U.S. seems to be on a fast track Japanese style 'industrial policy' (the so called government / private sector partnership) started in Japan during the 1980's. This industrial policy was hailed by many observers as giving the Japanese economy a growth advantage. It has not worked – Japan has languished for well over 25 years in a deflationary, stagnant economy. The Nikkei 225 (Japan's stock market index) is lower now than it was at the end of 1983! Whereas, the S&P 500 Index over the same period is 6.3 times higher.

The government spending / industrial policy theory (a Keynesian idea) is that running budget deficits and increasing government spending enhances aggregate demand, pushing the economy into prosperity. Of course, to spend that money, government must first borrow it from elsewhere. If this theory were true, our economy today would be in nirvana, having gone from a surplus in 2000 to today's huge deficit. Instead, we are in the middle of one of the worst recessions in history. In truth, the American taxpayer is now saddled with massive, unfunded liabilities sure to hinder economic growth. Many believe to avoid a repeat of the 2008 meltdown; the government should more tightly regulate the financial markets. Yet, financial firms are already very highly regulated. It is impossible to think that the over-leveraged, over supplied real estate market and resulting credit crunch emanated from too little regulation. The reverse is true – it was government / political meddling in the markets that caused the problems (as discussed in earlier newsletters and ECA Notes).

Market discipline is far superior to government regulation and bailouts because in a free enterprise, market system, those firms implementing flawed strategies ultimately fail (such as the poorly managed auto companies and banks). The beauty of capitalism is the implicit 'built in' market discipline that encourages practitioners to strive toward excellence and ethical strategies, eventually leading to profits. Those that do not suffer loss and are weeded out through bankruptcy. Sadly, instead of trusting the market system, we have followed the Japan formula, bailing out the irresponsible and inefficient, thus rewarding and subsidizing failure – the reverse of free market capitalism.

One need understand only the most basic economic principles to see how pernicious these bailout / heavy regulation policies are. Producing useful, valuable products from less expensive resources contributes to a civil society's wealth and prosperity – these firms are rewarded with profits in a market system. Profit and loss are essential to the operation of a market economy, providing signals and incentives leading to the remarkable progress that has characterized America. When government re-directs resources (from taxpayers via bailouts) to enable inefficient companies to produce less valuable products than the resources they started with, they are harming the economy, institutionalizing and promoting loss behavior.

FEATURED INVESTMENT MANAGER AND MARKET INDICIES:

	Year to Date thru <u>7/31/09</u>	1 Year Ending <u>7/31/09</u>	3 Years Ending <u>7/31/09</u>	5 Years Ending <u>7/31/09</u>
<i>This quarter's featured Investment Manager is:</i>				
Polaris (One of ECA's Int'l equity managers)	34.8%	(18.9)%	(6.9)%	5.2%
STOCK AND BOND MARKET INDICES:				
S & P 500 Stock Index	10.9%	(19.9)%	(6.2)%	(0.1)%
MSCI EAFE International Index	18.3%	(22.2)%	(5.1)%	5.3%
91 Day U.S. T-Bills	0.11%	.45%	2.6%	2.9%
Consumer Price Index	2.6%	(1.9)%	1.9%	2.6%

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