

BONDS

We would like to devote the bond section to the insights of Mohamed El-Erian, Pimco's lead fixed income manager with whom we agree. For many years, Pimco has proven to be one of the best bond managers in the world. Our added thoughts are *italicized*. In a recent article, El-Erian states that the abrupt changes to markets, households, institutions and government policies are unlikely to be reversed in the next few years. Global growth will be subdued for a while and unemployment will remain high. The heavy hand of government will be evident in several sectors. The banking system will be a shadow of its former self. The core of the *previously so successful* global system is in retreat, banks and financial firms will no longer be accorded a preeminent role in post-industrial economies. Moreover, the balance of risk will tilt over time toward higher sovereign (*profligate governments*) risk, growing inflationary expectations and stagflation.

Put another way, markets are recovering from a shock that goes way, way beyond a cyclical flesh wound. It is not just about the major realignment of the financial system and the extent to which governments have intervened to offset market failures. It goes beyond the massive increase in government deficits and government debt in virtually every systemically important country in the world. It's also about the structural change in how savings are mobilized and allocated, nationally and across borders. It's about the shifting balance between the public and private sectors. Additionally, we won't soon forget the long-lasting consequences of the erosion of trust in such basic parameters of a market system as the sanctity of contracts and property rights, the rule of law, and the robustness of the capital structure. Such trust can be lost quickly but takes a long time to restore.

The result is a prolonged pause, or in some cases, a violent reversal in certain concepts that markets had taken for granted. We refer to it as the demise of the "great age" of private leverage, asset and credit-based entitlements, self-regulation, policy moderation, and shrinking direct government involvement. Not surprisingly given the extent of the gains that were privatized and the losses that are now being socialized, the demise is occurring in the context of popular anger and confusion. This is not to say that the global economy has no defenses. There are secular forces of productivity gains and entrepreneurial dynamism (*especially emanating from new emerging economies*). These forces will not disappear. And, there are pockets of considerable economic and social flexibility, high self-insurance and even some global policy coordination. Yet, while these factors help reduce the risk of a deflationary depression, they are not strong enough for a return to the high growth and low inflation that characterized 2002 through 2007. Simply put, there are insufficient demand buffers and fast-acting structural reforms to provide for a spontaneous and sustainable recovery in the global economy.

Similar to our fixed income suggestions in the last few newsletters, bond investors should emphasize short term maturities (aside from taking advantage of the cyclical interest rate spread between corporate and government bonds) and good quality. More aggressive investors may want to consider 'shorting' U.S. Treasury bonds.

STOCKS

The market hates a vacuum and we have experienced one in 'spades'. For almost a year, there has been a complete lack of visibility regarding the ultimate economic and business impact of unprecedented government intervention into the private sector. There has been no bigger vacuum (in our memory) than the 'gaping hole' engendered by the housing meltdown / credit crisis. The lack of visibility was most intense with the collapse of Bear Stearns and Lehman Brothers. Then, it was feared several major banks, namely Citigroup and Bank of America would also fail. Thinking a financial Armageddon would ensue; investors fled virtually every financial security – stocks, bonds, mutual funds, ETF's, even insured bank CD's – whether domestic or international. There was even a run on money market funds and bank deposits – no place to hide except for the ultimate 'safe haven' – U.S. Treasuries.

Despite Federal Reserve and U.S. Treasury assurances that the integrity of the banking system would be maintained (almost at any cost), the heavy crisis induced fog crept into the New Year with a vengeance. By early March, stocks sold off another 24% on the heels of a devastating negative 36% in 2008. Equity markets respond more to the 'critical inch' (on day to day news meanderings) than to longer term, macro trends. This latest 39% rally of the S&P 500 Index (bringing prices back to year end levels) off the March 9 low is a perfect example. Fundamentally, not much has changed since last December, however, there are now more 'known's' than 'unknown's' – and that has made all the difference. It seems clear now that the Orwellian mood smothering stock prices in the first quarter was overdone. Investors were assuming the worst – a 1930's style global depression. Instead, we now know it is a deep recession – something we can survive.

As suggested in our last newsletter, the raw fear of the last two quarters spawned vast ignorance regarding global economic fundamentals. The fact is – human needs and desires for a better life have not changed. The fall of the Iron Curtain in 1989 (brought about in large part by the policies of Ronald Reagan) has unleashed billions of new consumers (now with savings, entering the middle class) who want the prosperity we enjoy – just in time to inject new spending and capital into a seriously wounded global economy. How appropriate this is beginning to unfold as the statue of President Reagan is unveiled in the Capital Rotunda! New demand is coming from exports – almost 70% of major U.S. companies are beating earnings expectations – this despite moribund domestic demand and rising unemployment. However, it must also be noted that only 38% of these same companies are reporting revenues higher than expected. The disparity in the two percentages (earnings vs. revenues) is due to heavy corporate cost cutting. Thus, we think the market is now ahead of itself, due for a correction, likely not retesting the March 9 low. We look for a sideways to lower moving market for awhile. It is increasingly important to protect portfolios from inflation and higher interest rates.

Sometimes it's a good idea to step back a few paces to catch a glimpse of the big picture – what are the major investment themes? Domestically, we have some major concerns. Let's face it – this overzealous government intrusion in the private sector is very dangerous. In fact, we are witnessing the most anti-business government – administration and congress in the history of the country. The deflection of blame is disheartening – the perpetrators of the financial crisis (with the assistance of a biased media) have

successfully demagogued against the private sector and many people seem to 'buy it'.

Where do we start? Government debt to GDP has spiked from a historical average of 40% to over 60% (and rising). Annual deficits have gone from \$600 billion to \$1.5 trillion almost overnight. Just one year's deficit is 10% of GDP. Five more years of this gargantuan spending and we will easily reach total debt to GDP of 100%, a level that rating services and more important – the markets view as a point of no return. But, never mind the facts, more taxpayer bailouts are planned - good money chasing bad. Fewer people are working; many more receiving government checks; social security, medicare and medicaid are broke. The \$1.5 trillion annual deficit doesn't even address the soon to come 'demographic squeeze', expected to increase by 6% of GDP over the next decade.

Higher taxes (possibly even a retirement plan tax or wealth tax) and heavy handed regulations are coming. The government is nationalizing banks and autos, controlling wages and possibly even prices. There is talk of tariffs to raise revenue and protect key constituents (such as unions). Even more insulting to the system is government contempt for contracts and private property – the vital 'inner wiring' of our free economic system. And, of course, we cannot forget our old friend – the ever heightening geo-political risks including terrorism and a dangerous toleration of rogue states developing nuclear capabilities.

TRABANT REDUEX

Political solutions do not fix private sector problems. The most recent proof is the bankruptcy of GM (on the heels of a bankrupt Chrysler in April). In fact, the \$91 billion hole (excess debt over assets) could double, much of which will be shouldered by taxpayers - all because of the unintended consequences of political interference in the private sector. Government already provided an estimated \$20 billion in bailout dollars to GM earlier in the year.

This was the grand plan, designed to get the big automaker back on its feet. Progress reports from a dutifully compliant, newly government appointed GM management group were to flow from Detroit to Washington. What a colossal failure! Not only is the bailout money gone, taxpayers are now informed that another \$30 billion is necessary to 'save' GM, supposedly to become a complete ward of the state. Existing shareholders and secured bondholders (including many pension plans) are expected to sacrifice. Equity is worthless. Bondholders will end up with ten cents or less per dollar as GM becomes Amtrak – owned by the government, bleeding red ink and accountable to no one.

Enter the Trabant. Remember? The Trabant was the pitifully drab sedan produced in Communist East Germany from the late 1950's to 1989. The Trabant became the 'poster child' car of a state run industry – extremely inefficient, under powered, carbon belching, oil burning shoe box on wheels that rusted through in a year or two. Yet, there were shortages - long lines of needy consumers waiting years for delivery of the coveted Trabant. Of course, in a proletariat dictatorship, no other competition is allowed, institutionalizing mediocrity. But never mind, everyone was at least equal - equally miserable driving their Trabant.

Here is the bigger, far scarier picture than a GM Trabant: the budget committee of the US Senate just approved a bill tripling our national debt! In the 232 years of our Republic, big deficits have typically come from unexpected calamities – natural disasters or war. This time, it is caused by individuals in Congress – political irresponsibility. The total spending on this so called crisis far exceeds the total government spending on all previous financial crises and wars including the Iraq War, the 'New Deal' (costing \$500 billion in today's dollars), the 'Great Society' and the 'War on Poverty'. In fact, with this amount of debt (upwards of \$14 trillion), the U.S. could not even be admitted to the European Union, the focal point of western socialism. The only 'check and balance' on this irresponsible profligacy are foreign buyers of U.S. Treasury bonds and currency. In fact, they are pushing the notion of a single world currency, fearing the U.S. will continue devaluing the dollar.

Just think, this crisis could have been completely resolved by an unfettered, self cleansing, capitalist system at -0- taxpayer expense. Yes, there would have been economic pain – massive losses, layoffs and bankruptcies, but by now, the economy would be on the mend. Joseph Schumpeter a famous free market economist called this cleansing process 'creative destruction' – destroying the inefficient to make room for a new, better, less costly product or service.

Bottom line: we recommend portfolio insulation strategies that may consist of hard assets such as commodities, real estate, energy, hedge, precious metals, basic materials, consumer staples and companies that are capable of raising prices during inflationary times. Tax advantaged investments such as municipal bonds, annuities and direct energy may also be beneficial (depending on one's tax bracket). It is hard to project the severity of the expected inflation – many economists suggest it will be the same or worse than the 1970's. But, offsetting inflation this time is global competition, productivity and a growing reluctance to buy U.S. Treasury bonds and currency. Hopefully, these positive factors will temper excessive government spending and the severe inflation experienced 35 years ago.

FEATURED INVESTMENT MANAGER AND MARKET INDICIES:

	Year to Date thru <u>5/31/09</u>	1 Year Ending <u>5/31/09</u>	3 Years Ending <u>5/31/09</u>	5 Years Ending <u>5/31/09</u>
<i>This quarter's featured Investment Manager is:</i> Aletheia (One of ECA's equity managers)	19.6%	(34.1)%	(5.3)%	9.1%
STOCK AND BOND MARKET INDICES:				
S & P 500 Stock Index	2.9%	(32.6)%	(8.2)%	(1.9)%
Barclays Capital Govt / Credit Bond Index	(0.3)%	4.5%	5.9%	4.7%
Balanced Index	1.3%	(14.1)%	(1.2)%	1.4%
91 Day U.S. T-Bills	0.7%	1.0%	3.2%	3.1%
Consumer Price Index	1.4%	(1.6)%	1.7%	2.4%

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