

Second Quarter 2010 Commentary and Outlook

Investor concerns over the health of the global economy and European financial system severely depressed equity markets in the second quarter. Following the sharp decline, it would not be surprising if strong second quarter earnings reports produce better, short-term market performance. Moving through 2010 and into 2011 however, global capital markets are likely to be further challenged by a synchronized global slowdown as weaker growth in China coincides with tighter fiscal policies and constrained credit conditions in Europe and the US, all of which would pressure corporate earnings growth.

Europe: Tight Credit and Fiscal Austerity Equal Slow Growth

The deteriorating state of eurozone public finances has led to credit and fiscal policy tightening and a dimming outlook for the region's banks, all of which serve to reduce Europe's growth prospects.

With exposure to around \$700 billion of public debt and roughly \$2.3 trillion in private debt in Greece, Italy, Portugal, and Spain, European banks bear considerable risk from the region's four most troubled economies. The scale of potential write downs in the event of a sovereign default of one of these countries is currently unknown but not without precedent. An Argentine debt default in 2001, for example, resulted in investors recovering just 30% of their investments while investors recovered about 50% on Russian debt after the 1998 default. Standard & Poor's estimates investors could expect to recover 30% - 50% in the event of a Greek government default. Each 10% loss on the restructuring of the \$700 billion in public debt would translate into about a 6% reduction in the banks' tangible equity. The banks also face the prospect of tighter capital and liquidity standards in the years ahead, as a result of a new regulatory regime, coupled with their need to refinance about \$1 trillion of debt before 2013.

The uncertainties surrounding these issues suggest European banks will husband resources. With businesses heavily dependent on bank financing, the resulting credit tightening will weigh on economic growth notwithstanding the potential beneficial effects of a longer-term decline in the euro versus the currencies of the region's principal trading partners.

On the fiscal front, recently enacted and proposed austerity programs may succeed in reining in deficits. However, if those initiatives undermine economic growth they would achieve a pyrrhic victory. Clearly, policymakers have few attractive options. If deficit reduction programs are not credible, then the bleak financial outlook would worsen. On balance, prospects of slowing for Europe, which accounts for about 25% of global GDP, present a headwind to world growth.

China: Economic Policy Could Stall the Global Growth Engine

The Chinese economy, which led the global recovery from its worst postwar recession, continues to grow in excess of 10% per annum. Government efforts to cool the economy, along with moderating demand for China's exports, have begun to translate into slower growth. If the government achieves its 7% growth target, it will likely succeed in mitigating the threat of asset-price bubbles, a welcome development. However, if China's growth stalls that would create an additional threat to global recovery.

Some experts contend the Chinese property market is already beginning a "collapse" that will impact that nation's banking system. Such a shock to the system would join notable others: Chinese stocks, as measured by the benchmark Shanghai Composite Index, have fallen 30% from their August 2009 peak and the Baltic Dry Index, a measure of global demand for industrial commodities, has declined 50%. These conditions warrant a cautious view: Even with China's able economic management team and the extensive tools available to it, engineering a soft landing will not be easy.

US: Jobs Creation Essential to Sustained Recovery

US GDP growth also shows signs of deceleration with data on jobs, housing, foreign trade, consumer sentiment, and spending, and activity in the service and industrial sectors all suggesting an economic recovery losing steam. As we have written in prior letters, such a development was to be expected as the one-time effects of fiscal stimulus and inventory adjustments began to wane. We believe the intensity of further slowing hinges on employment through its related impact on wage growth. To achieve a sustainable decline in the rate of unemployment, the US economy must produce an estimated 225,000 new jobs per month, which is well above the experience of the most recent quarter. If that level can be met or exceeded in the months ahead, then the economic soft patch should be short-lived. However, if job growth continues at or around current levels, it will likely impede both GDP and corporate profit growth.

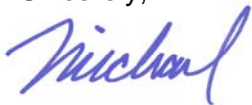
The outlook for employment growth faces challenges:

- State and local governments are likely to launch austerity programs as they battle to close large deficits. Those initiatives could cost one million to two million public sector jobs, adding to the ranks of some eight million workers who have been idled since 2007.
- Small business owners and operators express little confidence in the economic outlook, a condition that must be reversed if these companies are to assume their traditional role as the engine of jobs growth. Since the advent of the credit crisis in 2007, traditional small business funding sources, from bank credit to credit cards to home equity loans, have been severely constrained. As a consequence, small businesses have released some five million employees in two years, significantly outpacing the three million layoffs by large businesses. Legislation designed to reform the financial system appears unlikely to make credit more available.

Portfolio Implications

Conditions in the US, China and Europe may produce a synchronized global slowdown. Nevertheless, we believe your portfolio is well positioned for superior long-term performance. Your holdings are largely in businesses with distinct advantages. They include non-cyclical earnings compounders, consolidators that possess the financial strength to capitalize on periods of distress, businesses with unique asset bases and firms positioned to benefit from structural changes in their industry. The benefits of holding a portfolio characterized by these types of businesses were demonstrated during the second quarter when, as a result of widespread risk aversion due to macro concerns, equity correlations were driven to extremely high levels. These conditions challenged investors' abilities to achieve returns above the market through stock selection. Even during the quarter's market dislocation, these companies performed relatively well. Many of these businesses sell at attractive multiples of current and projected earnings and free cash flow. They have solid growth prospects in a world where growth is becoming increasingly difficult to achieve and sustain. We expect these investments to demonstrate strong long-term returns. Looking forward, an unsettled and volatile environment will produce some exceptional opportunities and our sights are set on capitalizing on these as they develop.

Sincerely,



Michael A. Steinberg
Managing Partner