

Third Quarter 2010 Commentary and Outlook

Equities followed a rapidly shifting path during the third quarter, driven by a combination of fundamentals, sentiment, and news flow. July's rally on the back of strong second quarter earnings gave way to August's decline as disappointing economic data sapped investor enthusiasm and erased gains. Then, with growing talk of a lapse back into recession and the rising threat of deflation, the Chairman of the Federal Reserve Board signaled that the monetary authority would do what was necessary to avoid an undesirable economic outcome. With the prospect of stimulus thus on the way, investors took heart, and ever since the Fed Chairman's speech in late August equities have rallied, industrial commodities and gold have risen, and the trade-weighted dollar has declined.

Looking ahead, the prospect of tepid economic data reinforces the likelihood that the Fed will soon embark on another round of quantitative easing in the form of large-scale asset purchases. The Fed's actions should bolster the economy, but the stimulus effect will come with a lag and it will be offset in no small part by fiscal tightening from cash-strapped state and local governments. Given the recent sharp rise in equities in anticipation of Fed stimulus, and factoring in the high potential for extensive drag from state and local governments' shift from stimulus to austerity; investors may adopt a more temperate appetite for "risk assets," at least in the near term.

Risks of Recession Appear Low

In the absence of an unexpected shock from events such as the development of sovereign risk contagion in Europe, foreclosures disruptions, or turmoil in currency markets escalating to crisis levels, the odds of a relapse into recession are low but not insignificant.

The risks of recession appear low in large part because cyclical sectors of the economy cannot fall much further, which suggest limited downside from current levels. In housing, new home starts have declined to around 500,000 units annually, down from a peak of 1.5 million, and well below the level required to keep pace with new household formation. Similarly, auto sales at 11.5 million units annually compares unfavorably not only to the 16 million units sold annually prior to the recession but also to the level of new vehicle sales 20 years ago. While capital spending has bounced from recessionary lows, there is still barely enough new investment to maintain pace with the depreciation of the capital stock. Further bolstering the case against recession, exports, which account for about 12% of GDP, should benefit from the recent decline in the value of the dollar against the currencies of our principal trading partners. Finally, household savings have increased to 6% from 2% prior to the recession, moving closer to the historical average of 8%. This reduces the risk that further large increases in savings would undermine recovery. If payroll growth continues to eke out gains, consumer spending growth will also likely stay positive.

Impediments to Growth

All of the above suggests we may reasonably expect an economic recovery, albeit sluggish, in the months ahead. However, even with the bottoming of cyclical sectors and the additional stimulus of quantitative easing by the Fed, the economy faces significant headwinds. In September, state and local governments cut jobs at the highest rate since the 1980s. While the bulk of cuts were in education and have probably concluded, tax collections at the state and local level remain below the peak levels of 2007 and 2008, making budget balancing difficult. Some observers estimate the rapid shift in fiscal behavior from stimulus spending in 2010 to austerity in early 2011 may strip as much as 3% from GDP, from first quarter 2010 to first quarter 2011. A second but less likely threat comes with the potential for the expiration of Bush-era tax cuts for households earning less than \$250,000 per year. This would result in an estimated additional drag of 1% of GDP.

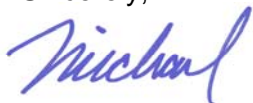
With the inventory cycle all but over, there is little reason to expect a pronounced acceleration in growth in the months ahead, particularly in view of the expected headwinds from fiscal policy. Unless the Fed opts for a level of quantitative easing, much greater than the roughly \$1 trillion the markets anticipate, interest rates in the near term are unlikely to fall much further.

Conditions Create Opportunities

Equity markets have moved significantly, at least in the short term, toward discounting positive results from the new round of stimulus and the coming mid-term elections. For stocks to move up meaningfully further, investors may need to see substantive signs that point to long-term economic growth in the form of better employment numbers and more robust consumer spending.

With so many crosscurrents confronting investors, financial markets are likely to remain volatile. This should provide an excellent background for us to accumulate positions in several companies our research team has identified as having compelling risk-reward profiles. In addition, as our clients of long standing may recall, we have had an interest in the uranium related equities for a number of years. We are now prepared to enlarge our investment exposure to this business because we believe a developing supply-demand imbalance will emerge by 2012. This should result in a sharply higher market price for this commodity, which will translate into leveraged earnings gains and material increases in values for the well-positioned companies we have identified.

Sincerely,



Michael A. Steinberg
Managing Partner