

INVESTMENT QUARTERLY

THE MUDDLE THROUGH THEORY

The Muddle Through Theory has always been my fallback position when presented with seeming equally disastrous options to resolve economic or market issues. The McGraw-Hill Dictionary of American Idioms defines the idiom as “managing to get through something awkwardly”. I shudder to think that the solution to the problems we face are in the hands of the politicians. Could anything be more awkward? As my Economics professor from college recently stated to his family members when asked what he thought of the current position, “Politicians don’t understand money.” I don’t think any of us would disagree. They may not understand money but they do understand politics and that is one of the reasons we are facing the difficulties and uncertainties that are overwhelming us today.

As we head toward an early August showdown of whether we can borrow more money to pay our bills the political issues of spending cuts versus tax increases continue to take center stage. The sad part of the problem is that no matter how we compromise (if we do) the loser will be the U.S. economy and our fellow citizens over the near and longer term. Raising taxes is no way to climb out of an economic slowdown. And decreased government spending will have its own negative impact on the economy. Despite early 2011 predictions of 3+ percent GDP growth this year and next, we will be lucky to get above the current 1.5% to 2% range. A recent Goldman Sachs comment placed the US economy in the mud, a good place for the muddle through theory to begin.

We have argued all along that without increased employment you were not going to get sustainable growth in revenue as consumers don’t have the money to spend and, without revenue growth, corporations aren’t inclined to begin hiring or investing without confidence that sustainable demand would be there. Nothing we have seen to date has changed this outlook. We are extremely disappointed to see that GDP has returned to prior levels with 7.5 million less employed persons. This looks like the ultimate in jobless recoveries. It is somewhat amazing that we have experienced any economic recovery to date without jobs and a still moribund real estate market. It is even more amazing that the stock market has shown the ability to record a 100% recovery from the 2009 lows in this economic environment.

To what can we attribute this market performance? Can you say “Thank you QE2”? Without interest rates at the current low levels and excess liquidity of QE2 we might not have seen the market results we experienced. With almost non-existent yields on short bonds, and longer term bonds unexciting because of the overhanging threat of future inflation, the only game in town has been the stock market. Yields on stocks are very competitive with bond yields. In addition, the understanding that stocks usually perform well in early periods of rising inflation, has made the stock market the recipient of much of the liquidity provided by QE2. Money flows have driven stock prices to recovery highs in recognition of stocks’ comparative advantage over bonds. Additional support for the market rally has come from better corporate earnings. These earnings

improvements have come more from restructuring than volume improvement. Unless sales volume begins to show sustainable growth it is hard to visualize profitability continuing to improve. Job opportunities have not improved in many industries and there are no programs to financially help those unemployed for longer than initial unemployment insurance programs. As we have opined in earlier quarterlies, unless there is renewed confidence at the individual and corporate level there is not a lot of hope for economic growth and employment increases. This sluggishness, if coupled with a combination of tax increases and spending cuts, could keep economic growth at an uninspired muddle through rate of under two percent for the foreseeable future.

What we need to break out of the Japanese styled malaise that affects us are targeted programs that will provide jobs, stimulate economic growth and find a way to stabilize the real estate market. This is not likely to come from the economically inept politicians playing the ultimate political game of debating over tax increases or spending cuts. Even trying to grow our way out of the current situation is likely to prove difficult in a world encumbered by challenges to the Euro economies and headlines trumpeting the possibility of default of one or more of the overleveraged member countries. Unless we can find a way to increase tax revenues through economic growth and bring our debt down to reasonable levels of GDP we are likely to muddle through at best, hampered by the very policies our politicians are debating as we move closer toward a budget crisis.

Despite the economic questions we face, the markets have, to this point, managed to avoid the correction that normally would follow recoveries similar to the one we experienced since 2009. Technicians as well as fundamental analysts are split on where the markets are heading, all with surety that their's is the only correct analysis. You can also find the "end of the world as we know it" proponents, some of whom have developed pseudo-defensive products, both untested and potentially harmful, to separate the ultra nervous from their cash. It is too early to forecast the final outcome but it is a time for caution. We still believe quality equity holdings offer the best potential return at this time as their yield is comparable to bonds and they offer a hedge to offset future modest inflation whenever it finally comes. With this being said, diversification is still critically important as a hedge against the unforeseen.

FIRM UPDATES

We have enclosed an update of our **Form ADV Part 2** reflecting our recent strategic alliance with Appleton Partners of Boston, a 4+ billion management firm specializing in tax-exempt and equity management. This provides long term continuity for our firm and gives us access to the many services Appleton offers. In addition we have added the capacity for our clients to invest in separately managed accounts where applicable. Please call us if you have any questions.

We also hope you will join us in wishing Jack Driscoll an enjoyable and relaxing retirement.

Robert B. Needham, CFA
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