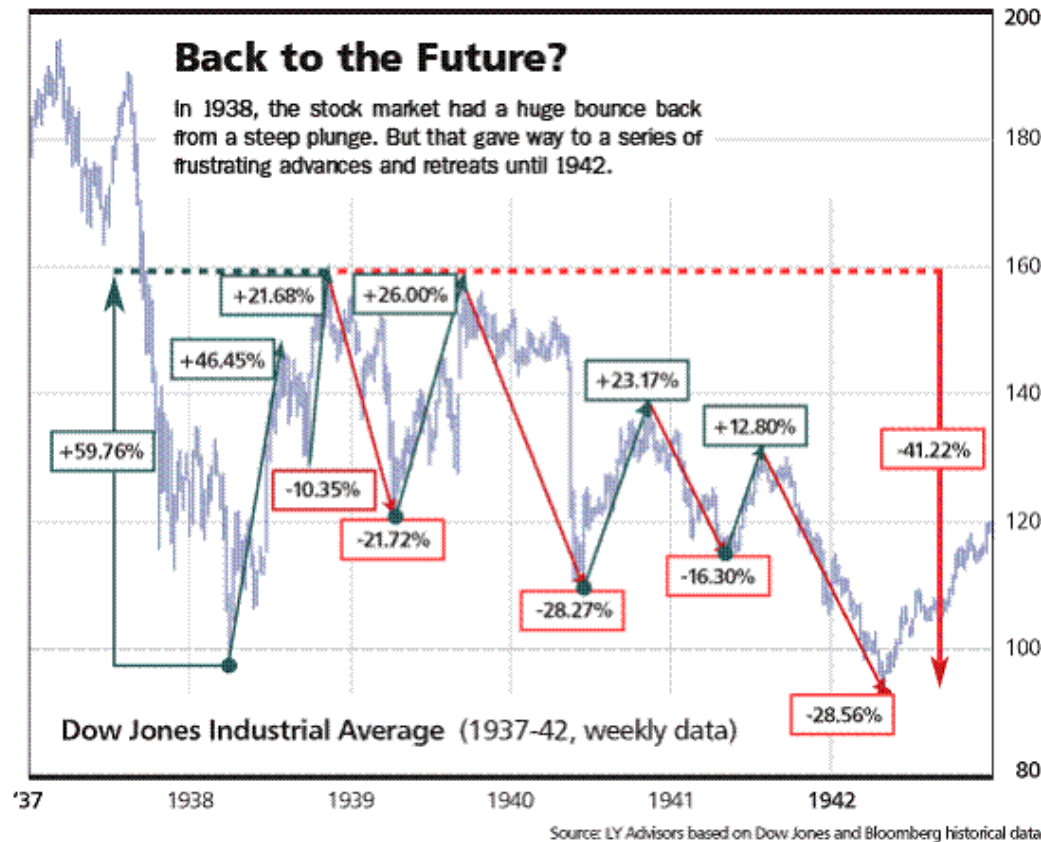


GREEN SHOOTS OR CRABGRASS?

Since the March 2009 lows, several of the broader equity markets have rallied between 30 to 40 percent. In our view, that current rapid ascension is unsustainable, both from a historical standpoint and when employing tangible economic data.

As you can see from the chart below, the recent run-up closely mirrors a span of time that the Dow Jones Industrial Average experienced from 1937-42, which was a strongly bearish period overall.



Note that six rallies occurred during this duration ranging from 12 to 46 percent, only to have those revivals retreat downward soon thereafter. It is our stance that the current rally, and other economic indicators, has combined to make the broader markets primed for a similar fall.

We believe that the months-long rally has largely been driven by the U.S. Federal Government's massive fiscal stimulus campaign. In fact, this dynamic has not only been existent domestically, but

internationally as well, as demonstrated by the hundreds of worldwide stimulus programs enacted since the beginning of 2009. The U.S. stimulus has pumped an inordinate and historic amount of liquidity into the markets, thus almost forcing equity prices to move higher, often despite the absence of sound economic reasoning.

Despite widespread optimism in many corners and perhaps good old-fashioned wishful thinking that the bull market trend since March will continue, the graph below provides possible evidence to the contrary. It lists six bear market phases in the past 80 years that have contained at least one 15 percent rally, including nine such occasions from September 1929 to June 1932, a period encompassing the Great Depression.

Ugly bear, big rallies
Based on the S&P 500

Bear markets	No. of 15% rallies	Avg. duration in days
Sept. 1929-June 1932	9	15
March 1937-April 1942	9	82
May 1946-June 1949	2	57
Aug. 1956-Oct. 1957	1	100
March 2000-Oct. 2002	3	26
Oct. 2007-present	3	5

Source: Morgan Stanley

Many of the conditions currently being seen also makes us wonder whether the United States is on its way to becoming the next Japan. That country, embroiled in a prolonged bear market since 1989, has experienced five major rallies during that span, which have all been wiped out with subsequent spikes downward.



Figure 2. Source: Datastream

It is also our view that both banks and the American consumer will see their respective income levels decrease in the near-term, leading to decreased spending and lower corporate profits. The latter is one

of the catalysts often cited by bull market pundits. Although many first quarter earnings reports did fare better than expected, we believe that dynamic prevailed more from a combination of very low expectations, monetary and personnel cost-cutting and adjusted inventories than improved economic activity. Given the magnitude of personnel cuts, it is very unlikely that companies can continue to repeat these levels of cuts and remain viable.

Another danger sign we see on the horizon involves what is currently playing out in the interest rate markets. Recent fears regarding the U.S. Government's insatiable desire to borrow has led to a spike in interest rates. The 10-year treasury yield has risen from 2.06 percent in December to over 4 percent in the early stages of June. And 30-year mortgage rates have increased over the past few weeks from as low as 4.75 percent to a range around 5.50 percent.

Another offshoot of the U.S. government's aggressive stimulus spending is a massive increase to the country's debt. At this stage of the game, the U.S. government's debt is almost unable to be financed and stands at a level not seen since the Great Depression, as seen by the chart on the following page.

U.S. total debt as % of GDP



Note: Include public debt and private financial & non-financial sector debt.

Source: CLSA Asia-Pacific Markets, Federal Reserve – Flow of Funds Accounts (1945-2008 data), Census Bureau – “Historical Statistics of the United States, Colonial Times to 1970” (1916-1944 data).

These are some of the reasons we have arranged our portfolios the way we have. We are positioned to protect against many of the risks outlined above but also have identified investment spaces where we are confident money can be made.

Specifically, we believe that managers who benefit from heightened inflation will outperform in the near-term environment. A primary reason we see inflation rising revolves around our expectation of a weakened U.S. dollar.

Another inflationary factor stems from the U.S. government's ongoing need to repay its debt. As mentioned above, these debt obligations are increasing exponentially to fund the various bailouts, ongoing military operations and general government-provided services, such as social security. Historically, the U.S. government has financed its debt obligations through a combination of tax dollars and foreign government bond sales.

However, domestic tax revenue has diminished significantly with the country's rising unemployment and less taxable corporate profits. Compounding this issue is the decreased appetite on the part of foreign governments to continue financing the U.S. government's growing balance sheet. Without these

sources of capital available to the extent that they previously have been, it is our belief that the government will be forced to use its only other viable option to refinance debt – printing more U.S. dollars. This course of action, on the scale that is required, will result in substantial inflation.

To take advantage of these conditions, we have kept larger weightings in hard assets, TIPS and non-dollar foreign currencies and bonds, which all benefit from inflation and a weakening U.S. dollar.

As always, we welcome the opportunity to discuss investments with you in greater detail. Please let us know how we can help you meet your goals or how we might serve you more effectively. Thank you for your support and confidence.