



## MCCABE CAPITAL MANAGERS, LTD.

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### **ECONOMIC AND MARKET COMMENTARY** *Second Quarter 2010*

Major European banks, especially French and German institutions, are heavily exposed to the debt of all the peripheral European countries -Portugal, Italy, Ireland, and Spain- in addition to Greece (the "PIIGS" countries). The opinion of EU politicians has been that Greece is a unique situation and that the other PIIGS countries are healthier and will be more able to adjust their fiscal policies to achieve a sustainable debt/GDP ratio. This political observation, though probably accurate, misses the point which is that smaller crises can escalate. First, there is financial interdependence among countries. Second, there is what Carmen Reinhart at the University of Maryland has described as, "the wake up call" hypothesis.<sup>1</sup> Consistent with this hypothesis, investors would look over their shoulders at countries like Portugal and Spain and say, "that looks a lot like Greece." Thus, fears about Portugal and Spain can become self fulfilling, unless official intervention occurs.

#### **Update from Europe**

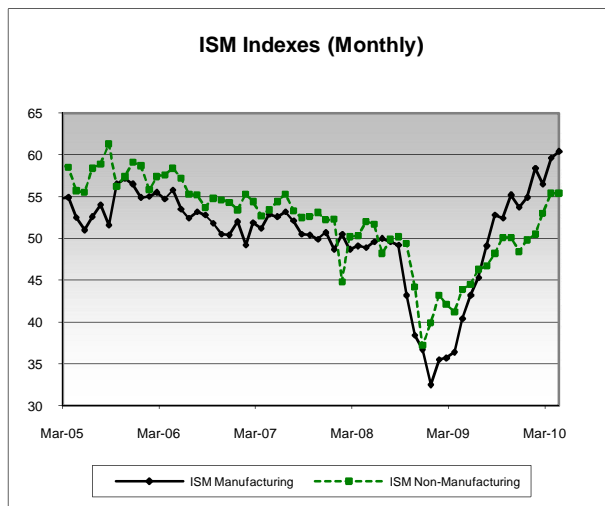
Market recognition of this reality led to a turbulent and disturbing first week of May. As a result, EU leaders, the ECB, and the IMF have agreed that they are willing to provide a combined facility of up to €750 billion to buy government bonds in the open market, make stabilization loans, and take other measures as necessary. The ECB will continue its current policy of extending unlimited short-term credit to EU financial institutions. The details of the program are unclear, but it will allow the ECB to break from its traditional neutrality to purchase bonds of individual countries. In addition, the ECB will be engaging in currency swaps with the US Federal Reserve to facilitate European bank lending in the dollar LIBOR markets. This will ease a potential credit crunch in the dollar lending credit markets in Europe, and should reduce the impact of the European situation on US exports.

This package would make an emergency lending program like that to Greece a much faster decision by eliminating the lengthy ratification process, provided that the recipients agreed to a rigorous austerity plan supervised by the IMF, the EC and probably the ECB. By reversing its May 6<sup>th</sup> announcement and agreeing to intervene in the debt markets, the ECB has increased the value of bank Eurozone debt holdings and enabled peripheral countries to take fiscal steps without going to the debt markets. Such interventions do not represent quantitative easing since they will be sterilized. However, the package announced on May 10<sup>th</sup> is unlikely to prevent the debt to GDP ratio of peripheral countries from rising in the next two to three years without an eventual debt rescheduling or exchange rate adjustment.

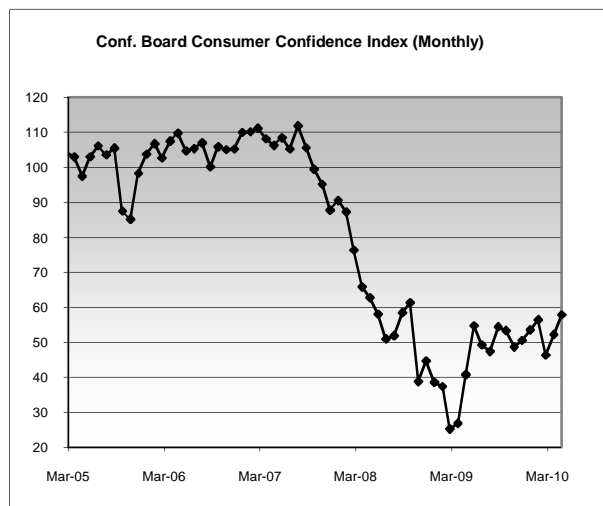
On the announcement, this massive program had the immediate effect of significantly lifting European equity markets and strengthening the euro from a low near \$1.25 during the first week in May to about \$1.30 on Monday. While asking Spain and Portugal to attempt fiscal reforms, in

establishing the program, EU leaders claimed that much of the disorder in the markets during the previous week was caused by "speculation." The program sidestepped the profound fiscal weakness in a number of member countries, the need for an effective EU mechanism to assure fiscal responsibility in all Eurozone countries, and recognition that the "speculation" was the result of its previous unwillingness to act on these matters. The Economist noted that the "speculators" became "international markets" when the EU and ECB sought to fund its program.<sup>2</sup> Germany has long insisted that the ECB and the EU be available for cyclical stabilization, but that countries must show fiscal discipline in order to receive such assistance.

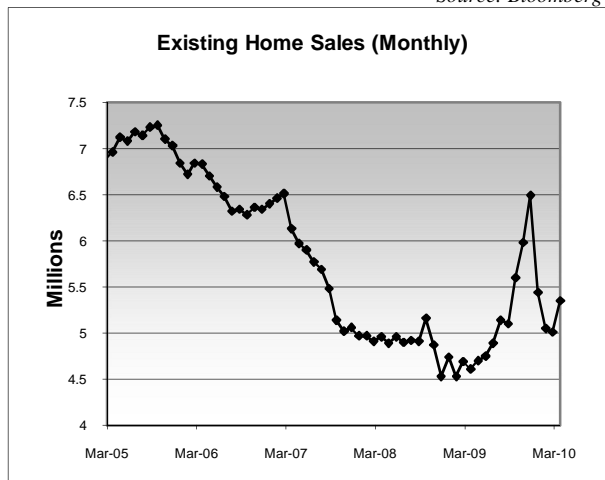
The first week in May had seen an orderly sell-off in global equity markets turn into a disorderly one. This was the result of a confluence of unexpected events, such as the previously announced reluctance of the European Central Bank (ECB) to stabilize credit markets by purchasing government bonds, the downgrading of the sovereign debt of certain European countries by the major credit agencies and a substantial reduction in the markets' confidence in European banks. This decline in market confidence was reflected in a sharply widening LIBOR/OIS spread and a nearly instantaneous equity sell-off when temporary pricing difficulties arose for certain large capitalization NYSE stocks. This was caused by high speed trading and the lack of circuit breakers on the NASDAQ market to which large cap trading had shifted.



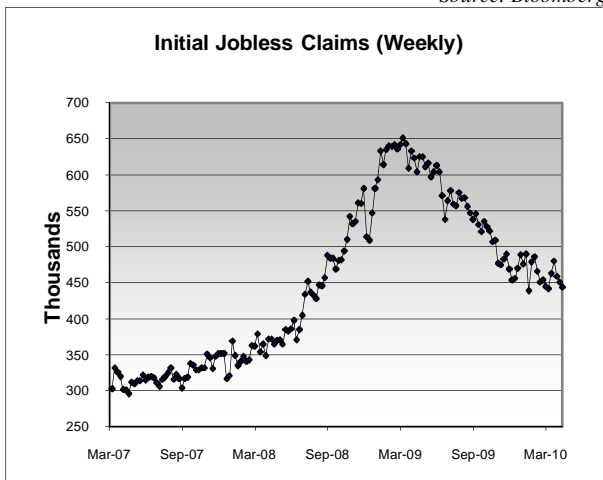
Source: Bloomberg



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

## **US Equity Markets**

The first four months of the year were good ones for US equities, which substantially outperformed both EAFE and emerging market indices. Consumer spending in the US was surprisingly strong, and both new and existing home sales showed some signs of life as the credit for first-time home buyers was about to expire. The preliminary estimate for US first quarter real GDP growth was 3.2% annualized with the main area of GDP weakness being government spending, which at the state and local level is anticipated to continue to be soft. The ISM Index for Manufacturing in April reached its highest level since 2004. Finally, the April payroll increase was unexpectedly strong.

Until the European stability concerns in early May, ten-year US Treasury yields remained in a 3.6% to 4.0% trading range and credit spreads on corporate debt continued to contract. This resulted in an outsized price return, especially in the high yield market. However, a recent global flight to perceived safety has caused Treasury yields to fall. Further, the Greek situation could cause a seizing up of credit markets because European financial institutions are exposed to sovereign debt in the region and to credit spreads which have started to widen again.

By the end of April, given the 80% advance in the S&P 500 since March of 2009 investors became increasingly concerned that the US equity market had become overvalued. However, the fundamental underpinnings of the market, especially corporate earnings, seemed to remain strong. With more than half of the companies in the S&P 500 reporting, 84% of the companies outperformed earnings estimates and roughly 70% of these firms reported positive sales growth, up substantially from the prior quarter's 59%.<sup>3</sup>

With the largely favorable US economic data and earnings trends, our estimate for S&P 500 operating earnings is around \$75 per share, about 30% above the 2009 level (but largely influenced by the return to profitability in the financial sector). After the recent sharp correction, this would put the S&P 500 at roughly 15 times 2010 estimates. In our opinion, with the current interest rate scenario, this is a justifiable multiple even given the European upheaval and uncertainties about the durability of the US recovery. According to Robert Schiller at Yale, the S&P 500 is presently trading at roughly 18 to 19 times cyclically adjusted real earnings (i.e., average earnings for the trailing ten years adjusted for inflation). This is slightly above the long-term average for the price to cyclically adjusted real earnings, which is approximately between 16 and 17 times. However, margins for US corporations are substantially above their long-term average, and it is difficult to make a compelling case that they will soon revert to the mean. We do not believe that this cyclical bull market is over, and anticipate that US equities will rise above current levels later this year after a soft summer period.

	3 Month	YTD	12 Months	3 Year (annualized)		3 Month	YTD	12 Months	3 Year (annualized)
<b>DOMESTIC EQUITY</b>					<b>FIXED INCOME</b>				
S&P 500	5.39	5.39	49.77	-4.16	Citigroup 3-month T-bills	0.02	0.02	0.13	1.80
Russell 1000	5.70	5.70	51.60	-3.97	BarCap U.S. Aggregate	1.78	1.78	7.69	6.14
Russell Midcap	8.67	8.67	67.71	-3.30	BarCap Muni	1.25	1.25	9.69	4.56
Russell 2000	8.85	8.85	62.76	-3.98	BarCap Int. Govt.	1.12	1.12	0.87	5.94
Russell 3000 Growth	4.87	4.87	50.51	-0.92	BarCap TIPS	0.57	0.57	6.18	6.01
Russell 3000 Value	7.05	7.05	54.46	-7.20	BarCap Int. Corporate	2.48	2.48	21.58	6.12
					BarCap High Yield	4.62	4.62	56.18	6.65
					JPM EMBI+ Composite	3.61	3.61	27.30	6.95
<b>INTERNATIONAL EQUITY</b>					<b>ALTERNATIVES</b>				
MSCI World (net)	3.24	3.24	52.37	-5.40	CS/Tremont AllHedge	4.99	4.99	23.03	-1.75
MSCI EAFE (net)	0.87	0.87	54.44	-7.01	Barclays CTA	-0.47	-0.47	1.33	7.63
MSCI Europe (net)	-1.80	-1.80	56.10	-7.80	Wilshire REIT	9.82	9.82	113.72	-11.96
MSCI Japan (net)	8.18	8.18	37.87	-9.02	DJ UBS Commodity	-5.05	-5.05	20.38	-8.40
MSCI Emerging Mkts (net)	2.40	2.40	81.08	5.15					
MSCI BRICs (net)	1.00	1.00	86.01	8.10					

## Non-US Equity Markets

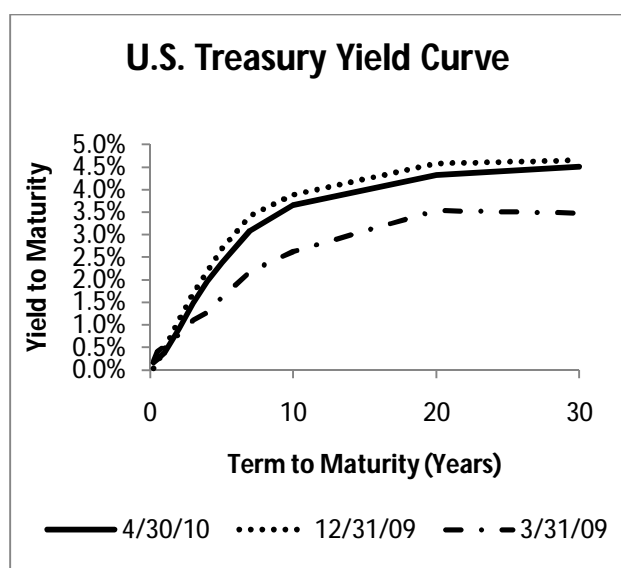
On May 7<sup>th</sup>, the MSCI World Index based on I/B/E/S estimates of earnings was trading at around 13 times estimated 2010 earnings, and EAFE equities are particularly depressed on an earnings multiple basis. The economic outlook for Europe is mixed although two dominant economies, France and Germany, seem to be performing well. The main issue is whether the need for fiscal austerity in the PIIGS countries and possible sovereign defaults in the event that IMF conditions are not met will cause the Eurozone region to grow at a slower rate. Growth will also be affected by additional debt that the EU is taking on. Japan seems to be in a well balanced recovery, and Australia appears to be in the midst of a major cyclical expansion.

The emerging market economies as a whole have experienced a V-shaped recovery led by China, whose expansionary fiscal policy has led to continued double digit real GDP growth. The main problem facing many of these economies is overheating and higher than normal inflation rates. This is being addressed by monetary tightening, particularly in Brazil and China, and restricted budgetary policy in India. However, emerging equity markets have recently been under substantial pressure as credit in the developed world has tightened and carry trades have been unwound. There is also concern by some pundits that restrictive measures will lead to a slowdown in China.

Much of Europe suffers from having adopted a common currency without meeting the fundamental economic conditions for doing so. Such an effectively fixed exchange rate regime is justified only if there is substantial labor mobility, similar government social programs, transfers from regions with low unemployment to those with high unemployment, a policy of maintaining balanced fiscal budgets, and willingness to cooperate in this common goal in the member countries. It took the United States over a century to become an optimal common currency area. Given the Eurozone countries' lack of ability to adjust exchange rates, substantial declines in nominal GDP in the PIIGS countries (which had been bolstered by massive government deficit spending) will be required in order to bring their external deficits back into balance. At the same time, there will eventually have to be a significant debt rescheduling in order to bring their public debt to GDP ratios down to manageable levels. Although we do not expect that the write-downs will be this extreme, according

to the April 30, 2010 Bank Credit Analyst (BCA), a 60% reduction of the value of PIIGS sovereign debt holdings would reduce the assets of the major European banks by an estimated 18%. We believe that a write-down in the 20% to 30% range is more likely at some time in the future, and such a write-down was already reflected in the credit default swap market on May 7<sup>th</sup>.

The global financial market situation is very similar to that which occurred in the summer of 1997 during the Asian debt crisis. During this period, there was capital flow to the equity markets of the stronger countries in the world, especially the US. This was partly the result of the maintenance of low interest rates in the G20 countries. We expect a similar liquidity-driven equity market recovery later this year, especially in the emerging markets, and in the US, Australia, New Zealand, and possibly some of the Scandinavian countries. For this reason, we would take advantage of global market sell-offs to add to equity positions in these regions, with particular emphasis on large capitalization high quality stocks. We believe that cyclically sensitive stocks, which have had a substantial run, are likely to underperform.



Source: Bloomberg

	Latest Quarter End (3/31/10)	Latest Year End (12/31/09)	One Year Ago (3/31/09)	Three Years Ago (3/31/07)
<b>CURRENCY</b>				
U.S. Dollar Index Value	81.07	77.86	85.43	82.93
USD vs. Yen	93.47	93.02	98.96	117.83
Euro vs. USD	1.35	1.43	1.33	1.34
GBP vs. USD	1.52	1.62	1.43	1.97
<b>COMMODITIES</b>				
Gold (\$ per troy ounce)	1113.25	1096.95	919.15	663.79
Crude Oil (\$ per barrel)	83.76	79.36	49.66	65.87
CRB Metals Index	846.30	809.14	466.14	773.13
CRB Food Index	344.27	344.70	294.82	302.65

Source: Bloomberg

## **Fixed Income**

With respect to fixed income, US, German and Japanese government bonds have recently rallied substantially due to the flight to safety. These, along with gold and the long dollar/short euro paired trade, have made up a solid deflationary hedge portfolio. However, the real yield on US, German and Japanese government bonds is far below long-term equilibrium levels. This is true for a number of reasons. First, the real yield on these securities is significantly below the anticipated real growth rate of GDP in the countries of issuance. Second, in the case of the US and Japan, the debt to GDP ratio is approaching dangerous levels. At these levels, except during periods of exceptional central bank intervention, real interest rates on government paper tend to rise above the rate of growth in real GDP. This means that unless these countries are able to run a cyclically adjusted primary fiscal surplus (calculated before interest payments), the ratio of federal debt to GDP is likely to continue to rise, which will cause an increase in real interest rates. When the gross public debt to GDP ratio exceeds 90%, which is likely to occur by 2014 in the US, the higher interest rates associated with a perceived increase in credit risk tend to damage economic growth, according to a recent study by Reinhart and Rogoff of about 50 instances where this has occurred.<sup>4</sup> Goldman Sachs has estimated that at high debt to GDP ratios, every one percentage point increase in debt to

GDP ratio will increase real interest rates by 4 to 5 basis points. An additional difficulty is that countercyclical fiscal policy is generally much less effective with high debt to GDP ratios because it tends to be swamped by interest rate effects on the cost of capital and on consumer spending. This leads to further reductions in the trend growth rates due to deeper recessions and an even greater inability to contain the growth of government debt, as government revenues decline and the government interest burden increases.

We believe that the US government will attain the political will necessary to tackle the fiscal deficit problem as it has in the past when debt levels have approached 90%. This is likely to be accomplished through tax increases and a significant reduction in the growth rate of entitlement spending. However, this is unlikely to occur soon, especially for entitlement programs. For this reason, we believe that long-term US Treasury bonds are a particularly bad investment at current yields. The spreads on credit products were quite interesting at the time of our last quarterly letter. Since then, they have narrowed substantially and even though they have started to widen again recently, in some cases they still do not compensate investors adequately for the additional duration risk, as well as the default risk. Eventually a larger number of US corporate sector debt issues will become highly compelling again, particularly in view of the fact that the ratio of cash to tangible assets of US corporations is at a record postwar high of 15%.

As international investors become more familiar with the US debt problem at the federal and state levels, both the dollar's standing as a reserve currency and the status of US government bonds as being AAA will be at risk. While we believe that US government debt is likely to remain investment grade quality and America will avoid suffering the same fate as Greece, it may well be downgraded in the future. At the same time, other sovereign paper is likely to be upgraded, especially that of the BRIC countries.<sup>5</sup> We certainly believe that Canadian, New Zealand and Australian government paper represent better credit risks than US Treasuries since the necessary belt tightening, which must include drastic cuts in discretionary government spending and entitlement programs, as well as higher taxes, is going to be difficult to accomplish with the baby boom generation starting to approach the traditional retirement age.

In summary, our outlook for traditional asset classes, commodities and currencies is as follows:

Asset Class	Base Case Projection	Downside Risk
<b>U.S. Corporate Bonds</b>	<ul style="list-style-type: none"> <li>Potential for further spread narrowing seems limited. Careful security selection could produce income worthy of consideration.</li> </ul>	<ul style="list-style-type: none"> <li>Significantly rising rates or unexpected stress on US corporate balance sheets would likely spell losses in the asset class. Duration risk.</li> </ul>
<b>Developed Country Government Bonds</b>	<ul style="list-style-type: none"> <li>Wide forecast disparity as the US and much of Europe are not attractive on a risk-adjusted basis, but Canadian, Australian, NZ and some Scandinavian issues are still good investments.</li> </ul>	<ul style="list-style-type: none"> <li>An uncontrollable fiscal deficit in the US and greater than anticipated reschedulings in Europe cause a sell-off in commodity currency debt. (Canadian, Australian, Norwegian).</li> </ul>
<b>U.S. Large-Cap Equities</b>	<ul style="list-style-type: none"> <li>Favorable earnings trends and fairly valued markets indicate positive returns over the remainder of the year, although the summer could be soft.</li> </ul>	<ul style="list-style-type: none"> <li>If volatility remains high or European economic woes hurt US exporters more than anticipated, the valuation outlook could shift.</li> </ul>
<b>Other Developed Market Equities</b>	<ul style="list-style-type: none"> <li>EAFE equities are cheaper than the US as a multiple of earnings, but uncertainty about the health of European banks and the need for fiscal austerity are major concerns that dictate a cautious approach. Within the EAFE universe we favor Asia to Europe.</li> </ul>	<ul style="list-style-type: none"> <li>Though postponed, punitive restructuring of sovereign debt weakens the European financial sector leading to pain reminiscent of the credit crisis in the region.</li> </ul>
<b>Emerging Market Equities</b>	<ul style="list-style-type: none"> <li>Economies with the ability to lever up maintain a competitive advantage, and should be weighted in portfolios on a commensurate basis.</li> </ul>	<ul style="list-style-type: none"> <li>Stability fears lead to a stronger US dollar and take capital out of emerging markets.</li> </ul>
<b>Commodities/Hard Assets</b>	<ul style="list-style-type: none"> <li>Imbalance resulting from lack of investment in production and strong BRIC demand growth should lead to resumption of commodity price rally.</li> </ul>	<ul style="list-style-type: none"> <li>Accommodative policies have kept prices unreasonably high in areas like natural gas, which has expanded production. A major unwinding of risk trades will drive commodity prices down.</li> </ul>
<b>Currencies</b>	<ul style="list-style-type: none"> <li>The dollar has gotten ahead of itself relative to commodity currencies and the currencies of Australia, Canada, Norway, and Sweden appear attractive.</li> </ul>	<ul style="list-style-type: none"> <li>Global market or economic stress of unforeseen magnitude return the 'dollar/yen as safe haven' trade to the forefront.</li> </ul>
<b>Municipals</b>	<ul style="list-style-type: none"> <li>The short end of the curve is much more attractive relative to Treasuries than at the start of the year. The recalibration of the rating process will lead to widespread upgrades.</li> </ul>	<ul style="list-style-type: none"> <li>Municipalities which have benefitted from federal government fiscal stimulus may be hurt when that well runs dry.</li> </ul>

We are grateful to you for allowing us to manage your funds and for your continued confidence and support.

**James L. McCabe, Ph.D.**

**Adam B. Landau, CAIA**

***May 11, 2010***

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*The forecasts and opinions in this piece may not actually come to pass. The views and opinions expressed above are those of the portfolio management team at the time of writing and are subject to change based on market, economic and other conditions. They should not be construed as recommendations, but as illustrations of broader economic themes.*

*Equity securities are more volatile than bonds and subject to greater risks. Bonds are subject to interest rate, price and credit risks. Prices tend to be inversely affected by changes in interest rates. Unlike stocks and bonds, U.S. Treasury securities are guaranteed as to payment of principal and interest if held to maturity. Note that it is not possible to invest in a market index.*

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<sup>1</sup> Kaminsky, Graciela L., and Reinhart, Carmen M. *Bank Lending and Contagion: Evidence from the Asian Crisis*

<sup>2</sup> *The Economist*, May 10<sup>th</sup> 2010

<sup>3</sup> Source: Goldman Sachs

<sup>4</sup> Rogoff, Kenneth S., and Reinhart, Carmen M. *This Time is Different: Eight Centuries of Financial Folly*, pg 165. Princeton: Princeton University Press, 2009

<sup>5</sup> BRIC- Brazil, Russia, India, China