

Economic and Market Overview

By most accounts the “Great” recession has been over for close to one year. Unprecedented fiscal and monetary stimulus provided the financial confidence and liquidity to break the downward spiral of asset prices and economic activity. As the nascent domestic recovery has shifted to the inventory replacement phase, we are again reminded of the fragility of the global recovery by the market’s recent volatility in response to the worsening European Union sovereign debt crisis. The current market correction has at times retested the market lows for 2010 and broken through the levels established during the “Flash Crash” in early May. The litany of concerns include the slowing Chinese economy, impact of healthcare reform, pending financial regulatory reform, indictment of Goldman Sachs, local government and municipality balance sheets, impending tax hikes and the Gulf oil spill have all cast a shadow over the market and heightened fears of a “Double Dip” recession and a global deflationary environment. While the odds of a long-term chronic deflationary environment similar to Japan’s experience are of concern, we feel the economy will continue on its slow growth recovery pattern.

“Double Dip” recessions are rare. It has only happened twice in 100 years, namely 1920 and 1981. The 1981 “Double Dip” is attributed to Fed Chairmen Paul Volker raising nominal rates to 19% and real rates to 10% in an effort to break inflation. Even with all the recent bad news, consensus for global growth in 2010 remains at 4.5-5% supported by the following positive economic factors: modestly improving U.S. employment, a stabilized U.S. ISM reading above 50 (59.7 in May), and moderate increases in consumer spending. Corporate free cash flow and balance sheet cash are both at all-time highs 3.6% and 5.8% respectively indicating that companies have a wide moat of liquidity on hand. Signs of stabilization in the U.S. housing market are evidenced by a number of factors including the price-to-income ratio at 40-year lows and a clear up trend in the U.S. housing index reaching a level of 22 this year from well below 10 in 2008. Housing is a critical economic component, as it constitutes one-third of U.S. household wealth and approximately 30% of U.S. banks’ balance sheet assets.

The potential for a soft landing in China has significantly increased with a ‘favorable’ slowdown in the price component of the PMI, which leads core inflation by approximately 4 months. Even with a core inflation rate of 0.7%, it implies a respectable, albeit slower, GDP growth of 9.5% indicating China’s policy is beginning to work. Although China comprises only 13% of the global GDP, it has accounted for almost 40% of the increase of global GDP since 2006. Finally, China’s previously overheating housing market is beginning to correct in an orderly manner with turnover of 40% and prices down 5% subduing fears of a painful crash.

Adding to the global picture, banks’ holdings of government securities are at such extreme lows (13% of banks’ assets in the U.S. and 5% in Europe compared to 20% and 8% respectively in 1994 and 1999) that analysts believe banks have ample capacity to fund the majority of the potential increase in sovereign budget deficits. A caveat to this would be the crowding-out effect of a sharp recovery in private sector credit demand that offers a higher spread. Additionally, a consensus of future inflation over deflation prevails among global analysts and economists based on the fact that M1, currency and demand deposits, is growing at approximately 7% in the U.S. consistent with 4% real growth. It is also believed that policy mistakes made by the Federal Reserve in the 1930’s and Japan in the 1990’s are unlikely to repeat and policymakers would rather err on the side of inflation in their efforts to fight deflation.

Addressing the Euro specifically, most analysts agree that it will survive, as there is too much vested interest to allow it to break up. Additionally, the weaker Euro should add approximately 1% to the European Union GDP. The current bailout package to be implemented at this point amounts to approximately 77% of the government debt of Greece, Spain, and Portugal combined. It’s now believed

by most analysts that Greece will be allowed to restructure its loans when it is prudent and less dramatic to do so. If European banks had to write off 50% of Greece's private and public assets, the losses would amount to approximately \$100 Billion vs. the \$1.8 Trillion in the credit crisis. Maybe most telling, there is no major political party advocating leaving the Euro. Taking into account the advent of the Hungary 'crisis', banks have \$137 Billion of lending to Hungary, which has a 4.8% deficit to GDP (the IMF's target is 3.8%) excluding debt of the state.

However, there are some key risks to the recovery and global growth. The most likely risk is fiscal "overkill" driven by the fear of a repeat of Greece's situation. The Bush tax cuts will expire in 2010 and mandated balancing of state and local government deficits may reduce the U.S. GDP in 2011 by approximately 1.3%. It's generally accepted that politicians do not like to tighten fiscal policy and if the U.S. economy begins to slow down organically and bond yields are low, fiscal tightening may at best be small and very incremental. However, if fiscal overkill does indeed emerge, the potential for renewed quantitative easing is likely to re-light growth prospects. In addition to fiscal tightening risk, bank regulation on a global scale could contract balance sheets by 20%, specifically with the adoption of BIS 3 (Bank of International Settlement and Basel III) which calls for tighter capital adequacy and balance sheet tightening. However, for the record, it took eight years for Basel II to be implemented, so implementation may not take place until 2015 in one form or another. And, most importantly, the recurring theme is: Excess Leverage. It is estimated there is still approximately \$6.5 Trillion of excess leverage globally with \$1.4 Trillion of that by the consumer and a low savings rate of 3.6% in the U.S. A significant high of approximately 5% was reached over a year ago and has reverted to the lower rate since. However, if the savings rate could stabilize at 4% in the U.S., it would generate nearly \$1.5 Trillion in household assets and normalize by historic standards.

In summary, there are many moving parts to the global situation and most are positive to stable. However, close monitoring, prudent objectiveness, and an eye for "cracks" in the stabilization and growth of the economy are paramount.

Deflation vs. Inflation

With the U.S. economy emerging from the worst recession since the great depression, investors are facing the big question of deflation or inflation and how each will impact their portfolios. Both trends can be destructive to asset values and the economy. Presently, inflation is very low. However, longer term the concern is for higher inflation due to the massive government stimulus programs in place along with the Fed's liquidity injections relative to America's significant federal government deficit. Inflation erodes the purchasing power of money while deflation is destructive to real asset values (real estate, general price levels, etc.).

The Federal Reserve strives to maintain an annual inflation target of 2% over the long run. Their preferred measure is the PCE (personal consumption expenditures) and Core inflation, which are well within the Fed's target range of 1-2%. The most recent FOMC minutes of June 23, 2010 reconfirmed that the committee anticipated inflation to remain "subdued for some time" due to stable inflation expectations and substantial resource slack. Specific examples of resource slack are high unemployment (9.7%), high worker productivity and low capacity utilization rates. We believe the Fed will maintain an exceptionally low level on the Fed funds rate until the economy mounts a sustained recovery and unemployment shows improvement. In fact, the Fed is taking the position that the risks from an early tightening are greater than those from delayed tightening.

While keeping the Fed funds rates and discount rates at historically low levels, .25% and .75% respectively, the Fed has begun to unwind their easing bias and transition toward a normal policy stance. The first phase of tightening was the Fed's elimination of its purchases of Mortgage and Government securities (quantitative easing) and the closing down of its special lending facilities effective March 31, 2010. This effectively eliminates over \$1.5 trillion of purchasing power formerly provided by the Fed in

the fixed income markets. Thus we believe the Fed will take a “wait and see” attitude and the next phase of tightening is contingent on the performance of the economy and financial markets. However, the recent European debt crisis has put further development on hold for the foreseeable future.

Therefore we believe neither inflation nor deflation will be issues in the near term as the massive government stimulus is offset by the great unwind of worldwide leverage and excess capacity in the economy. We are monitoring a number of important economic variables to support our position: total domestic credit market debt as a percentage of GDP, the (V) velocity of money, and labor and capacity utilization rates. All four indicators suggest very weak future inflation.

Tactical Asset Allocation

Our Investment Policy Committee has observed the following in its latest economic and market analysis:

- Market action is a predictor of future economic activity. Recent Eurozone stress highlights the fragility of the global economic expansion. Research also indicates that most cyclical bull markets, like those we have seen since March 2009, take time to consolidate gains after the typical V-shaped recovery. With those factors in mind we feel that the odds of reaching new market highs in the near future are less than the potential for the market to go lower. However, a partial retracement of the recent market drop from April’s highs is quite likely.
- Market valuations, while much more restrained than in the past, still indicate a higher than normal level given expectations for earnings and growth. We see this mostly in the riskier asset categories such as small cap, lower quality stocks and emerging markets. These areas have all run up much faster from the market lows than their lower risk, higher quality stock counterparts.
- The recent rise in the US dollar only adds to the deflationary potential domestically. This may slow down the economic recovery as consumers put off purchases of goods and services as prices drop. Economic weakness and doubts regarding the ability of the ECB to address their sovereign debt issues may support further relative dollar strength.

The Committee recommends the following actions for client accounts:

- Reduce equity exposure to neutral targets or below on market strength. Eliminate major equity overweight portfolio positions.
- Reduce equity exposure to near neutral targets or below on international, small cap and emerging markets within equity portfolios.
- Increase the use of fixed income or low/negatively correlated alternative strategies within portfolios as equity positions are trimmed.
- Within equity portfolios, emphasize high quality names to include high dividend paying stocks.

Clermont Wealth Strategies remains neutral to the equity markets, with the cautionary measures described above and will continue to monitor economic and market developments as they happen.

CAPITAL MARKETS OUTLOOK

Performance as of: 6/25/2010	June to Date	YTD	12-Month Return
Strategic Growth Portfolio	-0.83	-4.22	14.65
Russell 1000 Growth	-1.08	-3.32	18.77
Strategic Value Portfolio	1.91	-4.44	14.84
Russell 1000 Value	-1.53	-0.99	22.35
Russell 2000	-2.41	3.72	28.34
Russell Mid Cap	-1.38	3.03	32.18
MSCI EAFE Index	1.48	-11.82	10.17
MSCI Emerging Markets Index	2.28	-4.24	26.30
S&P 500 Index	-1.04	-2.52	19.42
Barclays Cap Aggregate Index	1.10	4.85	9.13
Barclays Municipal	-0.23	3.01	9.49

Large Cap Growth Strategy

The portfolio has performed relatively close to the benchmark over the second quarter as an upswing in market volatility has increased investor interest in the higher quality stocks that are part of our strategy. Except for our overweight in Energy, which detracted from our overall performance, our sector selections have played out relatively neutral over this period. Thus, individual stock selection has been the major factor in portfolio attribution. A diverse group of stocks, which includes Apple, NetApp, Fastenal, ConocoPhillips and McDonalds, added to our performance. Conversely, an equally diverse group of stocks detracted from returns with Transocean, Monsanto, Microsoft and Noble Corp doing especially poorly. Portfolio turnover remains low and no swaps were made in the second quarter.

As the sovereign debt crisis in Europe increases the potential for a deflationary environment here and abroad, the portfolio will most likely trend toward more conservative holdings and sector weightings. This will most likely advance itself within the portfolio through the addition of a utility and the reduction in our exposure to the technology and materials sectors.

Fixed Income Review

The Treasury yield curve underwent an unusual bullish flattening where the long-term yields fell more than short-term yields. At the beginning of the 2Q of 2010, the 10-year Treasury yielded 3.83%. Given concerns of slower economic growth because of the European Union sovereign debt crisis and the most recent FOMC statement, the 10-year Treasury yield has fallen to 3.1%. As investors fled to safety, widening spreads returned to early 2008 levels, with the biggest move in the lower quality high yield bond sector.