



North American Management

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The first half of 2010 has been frustrating for most investors, as support for the massive relief rally of 2009 waned, and fears of systemic risk (this time at the sovereign level) returned. The deteriorating sentiment has been compounded by weak economic data emerging in the US, opening a heated dialogue about the dreaded “double dip.” Throw in an unhealthy dose of regulatory uncertainty (pick your sector: healthcare, financials or energy), and risk taking lost its allure, causing a 15% drop in the S&P 500 in ten, deeply unsettling weeks. After that meltdown, however, the S&P has rallied some in July, up over 4.5% month to date as we write.*

What to make of this unpredictable behavior, these nauseating gyrations between good and bad scenarios for the economy? In our view, there are several factors complicating a “clean” recovery. First, the *global* economy is in a multi-year transition in search of a more balanced relationship between deleveraging, developed economies (consumers) and historically thrifty, emerging economies (producers). Second, there are tensions between the present and the future, between younger workers and aging boomers, mainly caused by imbalances in entitlements built up over many decades.** Third, we see tremendous friction between the private and public sectors, as debt laden governments are constrained in their traditional, countercyclical role of promoting growth and easing pain felt by displaced constituents. We have maintained a view that the crisis is not fully passed until governments successfully shrink, though this has long been a political anathema to the West.

Each dynamic would, on its own, be enough to cause a period of subpar growth. Taken together, the obstacles sometimes seem unmanageable. Investors fear policy mistakes could tip the complex global relationship among currencies, trade flows and interest rates, and, after 2008, they are especially mindful of extreme outcomes: a deflationary spiral or runaway inflation, to name two. However, steps are being taken. The United Kingdom recently announced dramatic budget cuts of up to 40%, France is raising its retirement age (France!), and Spain and Greece have announced sweeping, painful cuts. We note with interest that most of those stock markets significantly outperformed the US in June. Initial forays into punishing taxation, on the other hand, have not worked - Australia recently dismissed its Prime Minister for a tax scheme that singled out mining companies.

Although we have gradually increased our allocation to equities in the first half of 2010, we have not generally favored the kind of deep cyclical investments that outperform in a V shaped recovery, and we are unlikely to reach a market weight in those types of equities for some time. However, we do believe spikes in volatility (sell-offs) can sometimes offer opportunities to slowly, carefully position portfolios for the future with high quality growth companies. At the same time, we endeavor to balance these risks with income paying, global brands that continue to look attractive. In this way, we strive to dampen the extreme vacillations between risking and de-risking that may plague us all for some time to come.

***Source: Bloomberg**

**We credit the research firm, GaveKal, for refining and explaining this notion.

The information in this discussion is taken from sources that North American Management believes to be reliable. Notwithstanding, North American Management does not guarantee the accuracy of the data.