



North American Management

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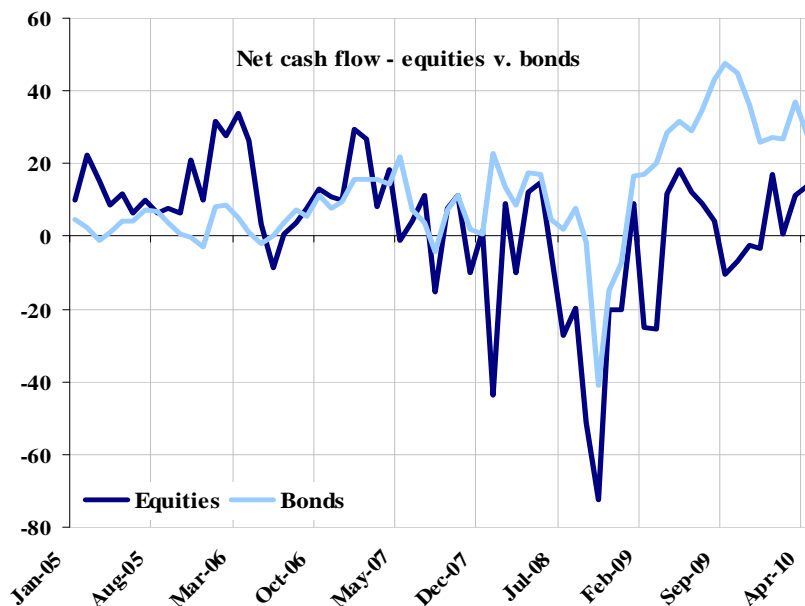
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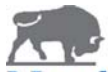
Correction or Bear Market? June 2010

Global equity indexes plummeted 8% - 10% in May, volatility surged and the credit markets struggled to digest the unfolding, eerily familiar debt crisis in Southern Europe. Meanwhile, gold and US Treasuries rallied, the ten year yield almost touched 3% on May 25th, and the cover of the *Economist* proclaimed: "Fear is Back." Investors are left to wonder if the European sovereign debt crisis is an aftershock or a second earthquake to derail the global recovery. At North American, we are expecting risk premiums to remain elevated for some time as public safety nets in highly indebted nations contract. This is an entirely new experience for most developed nations, and is in stark contrast to rapidly expanding infrastructure and social services spending in surplus nations, many of which are actually raising interest rates and contracting credit to avoid inflation. A number of Western economies face an ugly choice: slash spending and entitlements and risk deflation, or maintain the status quo and risk default and higher inflation. While it is arguable that the worst is behind the US, Europe looks unlikely to exit this crisis without one or more sovereign defaults.

For investors, the divergence of possible outcomes is more pronounced than we have seen in some time, leading to lower prices and higher risk premiums for most securities. Equity multiples are contracting, sometimes painfully, to single digits in Europe, Australia and Brazil, and to low double digits in the US. Investor fear can be gauged by the relative price of puts (bear) and calls (bull). Currently, investors seeking downside protection are paying 75% more than those buying calls, the largest premium on record.

This raises the questions of how risk will be priced going forward and what is a sustainable level of global growth? In our view, the most likely scenario is a protracted stretch of subpar growth relative to previous periods following a recession, but not low enough to significantly destabilize equity markets. Current valuations seem to discount the possibility of subpar growth and, barring an exogenous event, volatility should eventually decline as consensus builds around spending cuts in the public sector. Graph 1 illustrates the widening gap between the earnings yield of the S&P 500





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and investment grade bond yields. This suggests to us that as volatility diminishes the gap may converge and produce higher share prices.

We are seeing some attractive investment opportunities amid the uncertainties. For example, we have recently been taking gains on corporate bonds, investing the proceeds into less interest rate sensitive income sources such as high dividend, blue chip equities. We have also taken initial equity positions in higher growth, developing economies as their tightening cycles may conclude sooner than expected. Such measured initiatives are in contrast to retail investment behavior we have seen in mutual fund flows over the past two years - mutual funds have seen record inflows into fixed income securities and gold and wholesale abandonment of equity risk, in spite of the impressive recovery performance of 2009.

** Source of charts and data: Bloomberg*

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.

Source: Bloomberg