



North American Management

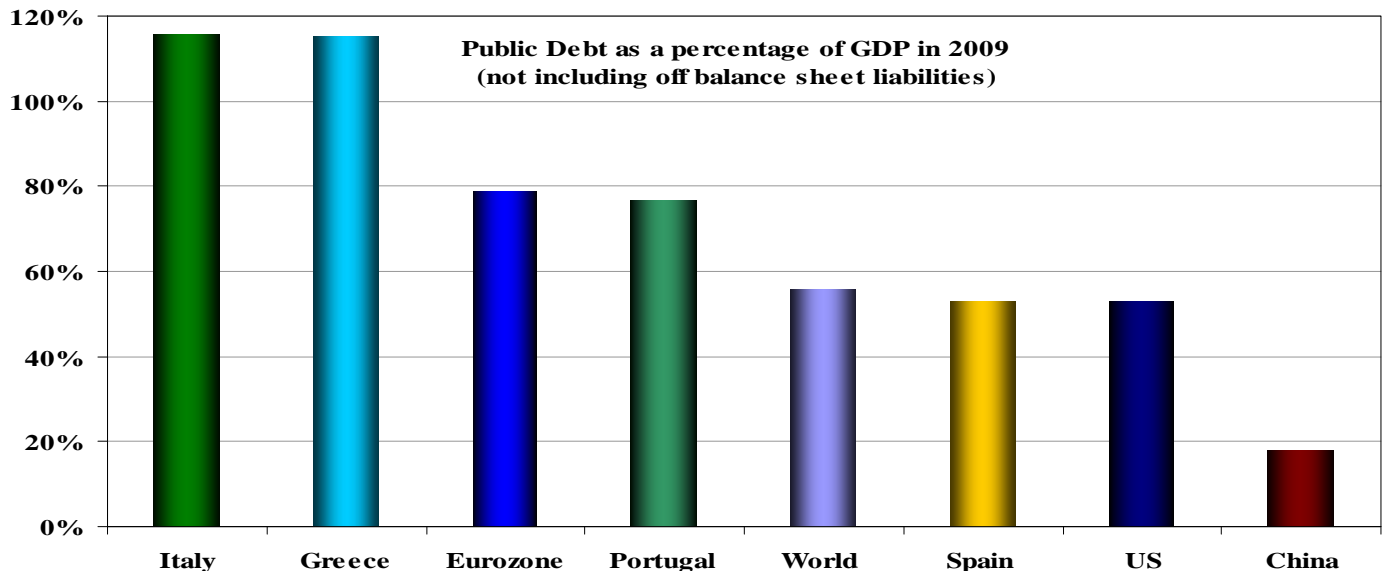
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The Latest Bubble May 2010

Investors have endured two painful bubbles in the past decade, each resulting in peak to trough drops of fifty percent or more in equity prices. First, in technology related equities (we note that the Nasdaq Composite Index is *still* trading at less than half its high of 5049, reached in March 2000*); second, fresh in our memories and only tentatively stabilized, a gross misallocation and mispricing of credit, especially for consumers (houses, cars, flat screen TVs, etc.), fomenting and institutionalizing leverage to an extraordinary degree. Of course, all bubbles are characterized, in hindsight, by inefficient allocation of capital, be it credit or equity. Credit excess, however, often takes longer to unwind, insidiously drawing resources away from other, more productive endeavors.

Are we done yet? Apparently we are not, given the extraordinary events in Europe of the past few weeks. One could argue that years of low interest rates, benign inflation, escalating retirement benefits, runaway entitlements, and, finally, “quantitative easing,” have created our largest and most significant bubble to date: western, sovereign debt. Most modern political systems don’t seem wired for downsizing, and when government expenditures represent 35% of GDP, as with Greece*, extraction can lead to negative growth, raising social and philosophical issues that politicians and the media can lever. The graph below illustrates the scale of the problem among Western economies.



Recently announced EU bailouts for Greece were initially well received, but funding will only be provided if the draconian cuts are actually made, and investors seem to be questioning Greece’s will to follow through. Many are recalibrating growth assumptions as they value stocks, government debt and currencies, so it’s not surprising that market volatility has spiked in May. We view this evolution as highly disruptive, yet ultimately positive. In our opinion, US corporations are ahead of the curve, having attacked their imbalances early, and continue to generate robust cash flow despite persistent idle capacity in the global economy. Troubled US banks have raised considerable equity over the past year and most are earning their way out of legacy non-performing loans at a decent clip. Domestic consumer spending is rising from its lows and should be sufficient to support improved employment growth, if a bit below average. All of this without “the multiplier effect” of new lending on the economy – it may be a while, but when lending picks up we should be in the final stage of healing.



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There are pockets of opportunity in this volatile environment. For example, somewhat slower growth in developing nations may offer us the opportunity to raise client exposure to emerging economies at attractive prices. We are also looking at European blue chip multinationals with global revenues, as a surge in export growth from a severely weakened Euro may substantially benefit their prospects. Lastly, we are bit cautious on credit markets, focusing instead on high quality, dividend paying equities.

Source: Bloomberg, IMF Economic Outlook 2010

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.