WOODSTOCK

QUARTERLY NEWSLETTER

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Mid Year 2011

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First Half Recap

At the beginning of the year, expectations for a double-digit equity return year were high because of the beneficial "wealth effects" of QE II (Quantitative Easing II) and the favorable stock market performance history surrounding third years of Presidential terms. Everything seemed "on plan" until the tsunami and nuclear plant tragedy in Japan disrupted economic activity, supply chains and growth forecasts. Commodity cost pressures intensified (thank you U.S. Federal Reserve) particularly in food and fuel, causing riots around the world and tightening economic policies in some emerging economies. And of course there is the recurring boiling financial cauldron in Europe with Greece, Spain, Portugal taking turns in the news headlines. Paraphrasing one wag as he put it recently in Barrons, eleven million Greeks are messing up the world's economy and capital markets. The weakest link in any chain always garners serious attention because of the bigger picture effects and Greece is the canary in the financial coal mine these days.

Through early May the S&P had risen over 8% and a healthy double-digit return seemed in prospect for 2011. Then over the next six weeks the S&P 500 fell to almost unchanged for the year in mid-June. In the final two weeks of Q2 stocks rallied to post +6% for the first half but unchanged for the second quarter and below the best gains of earlier in the year. Bonds of all stripes (Treasury, Corporate) and maturities (intermediate, long term) outperformed stocks in Q2 with bond returns clustered in the 3% area for both the quarter and the six months. Risk aversion dominated risk taking. Cash continued to earn essentially nothing for the tenth consecutive quarter. International equity investing was a mixed bag with Europe the standout and Emerging markets the laggard for the quarter and the half-year.

If markets climb a wall of worry, equity markets in 2011 have repeatedly absorbed more bricks being added to that worry wall. Hardly a day goes by that doesn't challenge the economic or corporate earnings outlook in some negative way and yet the stock market shrugs it off. Although at times puzzling, this is a classic sign of a bull market and it is the exciting element in the outlook. If some convincing progress can be made on the challenges in front of us (deficit spending, federal debt level, jobs, European country financial stability), then stock markets (here and abroad) could spike higher. This next fifteen month run-up to the U.S. elections could engender some badly needed confidence in consumer behavior.

Jobs & Debt

These two four letter words continue to stalk the investment outlook and sap consumer confidence. Without the employment velocity (job mobility) normally seen in economic recoveries, housing turnover (demand) suffers and helps delay the onset of a housing recovery. For most Americans it is their sense of net equity in their home along with their job prospects (security and income potential) that inspires confidence in their situation which "greases" their spending patterns. It cannot be over-estimated what a 5% or 10% increase in home prices could do for this economy. While it may already be occurring in a few markets, it would seem several years off for it to be a national trend. Equity investors are aware that stock values have doubled from their March 2009 lows. They are feeling "wealthier" on this front, but the lingering housing recession is a major offset and an important psychological factor in their cautious spending behavior.

In December 2009 the Bureau of Labors Statistics (BLS) published its 2008-2018 Employment Projections by industry. As can be seen in the table on the next page, six of the fourteen industries cited were to account for 90% (13.2 million) of the expected 14.6 million total new jobs over the decade. Instead, over the intervening two-and-a-half years these six

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industries have shed 2.3 million jobs. This illustrates how intractable the employment situation is and why major new creative solutions are needed if unemployment rates below 7% are ever to be seen again.

The other four letter word investors are tired of hearing about is debt. U.S. debt, Greek debt, Portuguese debt, Irish debt - any sovereign's debt - go away already! However, we all did it to ourselves as we elected the representatives who brought us the fiscal circumstances that we find ourselves in. Nevertheless, most individuals and families do not deficit finance their operating expenses and know that it is not a viable long term strategy. At the state, federal and country level the major part of the solution to the debt problem has to be "bending down" the spending rate of the growth curve to or below the revenue growth curve. With deficits of up to 10% of GDP some countries will need to hold their spending curve growth rates below revenues for five to ten years to solve the structural problem. This assumes countries take the responsible approach to their debt problems as opposed to the irresponsible route, which would be devaluing the debt through inflationary monetary policy. Gold investors assume governments will resort to this latter inflationary approach.

In the U.S. we reached the debt ceiling limit of $14.3 trillion in June, a doubling over the last seven years and quite pronounced growth since Q4 2008 when the financial meltdown occurred.

While there is not much that is good about a $14.34 trillion U.S. public debt, the annual growth has been trending down since the stressful 2008-2009 period as can be seen in the above chart. In fact, the year-over-year growth of ~$1 trillion is half of what it was at the peak in mid-2009. We have extended the time frame six years to 2017 and assumed a $1 trillion a year annual growth. Thus, in 2017 we will likely be referencing a $20 trillion debt level rather than today's $14 trillion.

It is "crunch time" on negotiations between the U.S. Congress and the President on raising the debt ceiling and future level of deficit spending. If there is a deal before the August 2nd deadline, it will be quickly analyzed and either found worthwhile or a failure. Past experience with Congressional decisiveness in critical matters is not grounds for optimism. Our sense is that the stock market is a coiled spring that will move decisively in one direction or the other, depending on how serious an outcome unfolds. Trumpeted spending cuts of $2 trillion or more that are heavily back-end loaded (beyond five years) will be ignored as they will never occur. On the other hand, if a significant part of the deficit reduction occurs over the next three years, the deal will be perceived as having some seriousness and will demonstrate to the foreign owners and buyers of our debt that we are intent this time. Either outcome could be good for 200 S&P price points as we think it helps or hurts P/E ratios by 2 multiple points. ($100 of S&P 500 EPS x +/- 2 = +/- 200 S&P points). This is our Greece moment. The current S&P 500 is priced for a 50%/50% probability as to the outcome – an opportunity seized or an opportunity lost.

Low P/E = Low confidence?

Since the March 2009 stock market low, stocks have doubled while forward earnings estimates have risen 60% implying the forward P/E has expanded 25% (from ~11x to ~14x). If there ever was a sign of restrained confidence, it is a low P/E at a time of robust earnings growth. There is low confidence in future economic growth and the ability of companies to maintain the near doubling of net profit margins over the past nine quarters. The case for more P/E expansion is compelling, both against history and in comparison to ten year U.S. Treasury yields. The charts on the next page, covering the past sixteen years (all the data that was available to us), demonstrate the attractiveness of S&P 500 earning's yield (reciprocal of the P/E) versus Treasury yields.

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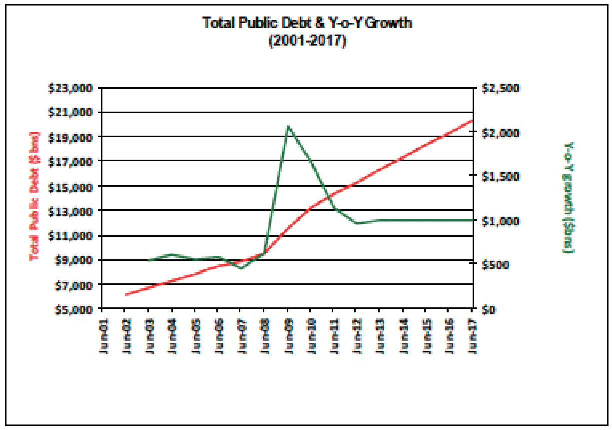
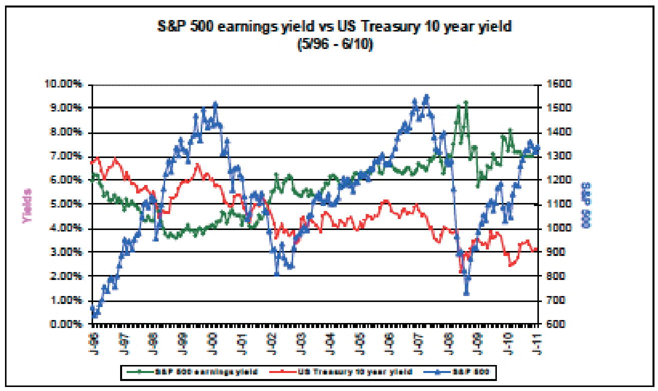
Employment growth by major industry, 2008-2018

	Projected Increase 000	% share	Cumulative Increase %	chg. to 6/30/11
Professional and business services	4,190	29%	29%	-151
Healthcare and social assistance	3,997	27%	56%	740
State and local government	1,591	11%	67%	-438
Construction	1,337	9%	76%	-1,036
Leisure & hospitality	1,142	8%	84%	485
Retail and wholesale trade	910	6%	90%	-1,221

source: Bureau of Labor Statistics, U.S. Department of Labor, "Employment Projections - 2008-18", chart 3, page 4, December 2009.



source: http://www.treasurydirect.gov/NP/NPGateway



source: Woodstock, Baseline

The spread between the green (earnings yield) and red (US Treasury yield) lines has been positive since June 2002 and currently is over 4 percentage points. At extremes it can rise to 5%-6% (stock market panics) but over the last sixteen years it has averaged 1.1% (median = 1.4%). Even allowing for QE II depressing Treasury yields, an above average earnings yield spread suggests that equities are undervalued and will normalize over time as greater confidence returns. The August 2nd deadline could be a catalyst.

Yields, the interest rate outlook, confidence in business conditions and the profit outlook, the level of government/business cooperation on tax and economic policies all influence P/E ratios.

Low P/E's can be a sign of peak earnings or no confidence in future earning power. Since we expect earnings to continue to grow in the next few years (but perhaps less than the bullish consensus) we isolate confidence as the biggest contributor to more robust valuations.

<u>Not Bad, Could Have Been More & Still Has Legs</u>

The stock market acts very resilient in the face of some horrible news and softening fundamentals. Against this backdrop, stocks could easily have been in the red so far in 2011 but instead there is a good shot at a double-digit return. Our sense is that the negotiations underway will be pivotal for the market over the next fifteen months. A deal will either result in increased confidence in the economic outlook or it will reinforce cynicism that the U.S. is following in the footsteps of a southern European economic system. Extending the 2% employee payroll tax relief into 2012 along with a credible deficit reduction/debt limit extension package would increase the odds of the "rosy" scenario playing out in the years ahead and would lead to a profitable fifteen month period leading up to the November 2012 elections. Stocks returned 6% in the first half, they could have returned more and there is still double-digit potential into 2012. Some political courage and common sense are all that is required. ◆

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