July 15, 2011

> *To prove that Wall Street is an early omen of movements still to come in GNP, commentators quote economic studies alleging that market downturns predicted four of the last five recessions. That is an understatement. Wall Street indexes predicted nine out of the last five recessions! And its mistakes were beauties.*
>
> *Paul Samuelson, Nobel-prize winning economist*

Investors who worry about big-picture economic troubles have had plenty of fuel for their concerns, as reflected in the 7% pullback in the S&P 500 late last month. As stocks fell, it became progressively easier to believe the market was foretelling a return to recession. Soothsayers fretted about the end of monetary easing by the Fed, a debt crisis in Greece, the ballooning of our own national debt, looming bankruptcy of Social Security and my own personal favorite: political gridlock in Washington over the raising of the national debt ceiling, with a looming deadline of August 2nd. I recently returned from Minnesota 24 hours before its state agencies were forced to shut down by just such a faceoff, between Democratic governor Mark Dayton, an old classmate and heir to a large retailing fortune, and a Republican-dominated legislature. State parks are now closed, construction projects mothballed and 20,000 state employees are out of work. “This is a terrible situation,” says Governor Dayton, and he isn’t kidding.

But the stock market is not ruled by worried economists and political observers. It is driven by animal spirits and played out on a field where every day there is a struggle between the opposing forces of fear and greed. For those of us who make a living in that marketplace, it’s best to write down a list of all the news that gives us the jitters, tear it up and throw it away, so that we can resume our bottom-up focus on the basics—strategy, discipline and research.

Following a trail of facts gathered over the past two quarters, here is what we find: the economy as a whole continues to rebound at a modest rate, as shown by the latest ISM manufacturing numbers. The earthquake and tsunami in Japan was a tragic, temporary shock to our system, but the continued expansion of the developing world, particularly China and India, keeps on driving a profit recovery for those U.S.-based corporations with a large foreign presence. Thanks partly to these businesses, domestic corporate profits are up 47% since the beginning of the recovery that started in June 2009. PACCAR, one of our investments in the Model Portfolio*, saw its earnings increase 280% from the first quarter of 2010 to the same period in 2011 due to strong demand for its heavy-duty trucks in Europe, Australia and here at home. Another of our Model companies, ConocoPhillips, saw its full year earnings in 2010 increase 83% over 2009. Luxembourg-based Arcelor-Mittal, the world’s largest steel maker, with a sizeable presence in the U.S., saw its first quarter operating profits jump from $27 per ton of steel produced in 2010 to $64 this year.

But some economists say the current recovery in the U.S. is the slowest on record because of the continued decline in house prices, a stagnant employment picture and our anemic personal spending rate. The inescapable fact is that we are in a two-tiered economic rebound, one that does not feel like a recovery to many of us. Main Street USA is suffering because big money center banks are not lending or are being extremely selective, and corporate America is not hiring new workers. It prefers instead to drive its existing employees harder for roughly the same amount of pay, knowing they are unlikely to quit in such a highly competitive job market.

"I've been doing this for 25 years and I've never seen the corporate sector in such profoundly good shape, even with the economy arguably struggling," said Rick Rieder, chief investment officer for bond portfolios at BlackRock, the world's largest asset-management firm. This is a remarkable thing to say amid widespread misery in the workforce and at a time when home prices are continuing to fall, putting an increasing number of people underwater on their mortgages. But he is right—the companies we currently own in our Model Portfolio and the companies we would like to own are financially strong and getting stronger. However, until they start feeling more optimistic about deploying the capital most have been conserving, the pain at the consumer level is likely to continue.

At Peak, it is hard to complain about the companies we invest in becoming leaner, stronger and more profitable, especially if their share prices remain in a reasonable range. There are far fewer bargains available in the stock market now than at the end of the recession in mid-2009, but the shares of companies we do own have not escalated to the point that we are forced to begin selling. And, just as important, the not-too-expensive pricing in the marketplace keeps us motivated and actively looking for outstanding candidates to add to our Model. Last month's pullback was starting to get us excited about buying. Another downturn in stocks, especially a steep one, would enable us to add more quality and potential growth to our portfolios.

Best regards,

Noel F. Bennett

**The Model Portfolio is not a real cash portfolio. It represents the core direction of our portfolio management strategies. Individual client portfolios are managed in accordance with the clients' specific investment objectives and constraints. Historical results are available upon request.*