**The Train Wreck with Nuclear Waste as Cargo**. The visual is really easy for most people. Just like the movie, "Unstoppable", there is a train that is out of control, without an engineer or driver, that is rambling towards a head on collision with another train. That image alone is horrible to contemplate, but add to the story the fact that the runaway train is carrying toxic nuclear waste, and you have the makings of a disaster of epic proportions.

## European Challenges

Now we know we have your attention! This illustration of a train wreck is exactly what comes to mind when we evaluate the currently popular economic soap opera "As Europe Turns". We recently had the opportunity to spend some time in Europe and view firsthand what is happening in Italy, Greece and Spain. The easiest way to summarize our findings is to say what you have heard from the press does NOT do justice to the magnitude of the problems there. It is almost unfathomable to find a viable solution to the region's problems absent a complete "reset and start over" resolution. To this point, we have attached a letter we felt would be helpful. The author has a very pessimistic view of Europe. His attached commentary articulates in great detail the complex situation the European leadership is trying to manage and the eventual outcome expected by the writer. As a matter of full disclosure, please remember that this manager is bearish and certainly supporting his views, including his current investment position(s). Nevertheless, we happen to agree with the manager's perspective. Therefore, we have invested with the firm via some of our private investment vehicles in anticipation of receiving attractive investment returns from this fund. The fund also serves as macro-economic hedge against a potential European problem for the rest of our portfolio. Be forewarned, their commentary is a long read. Nevertheless, it is a tremendous history lesson and very worthwhile.

A summary of our position would be the opening headline of this letter. We believe a train wreck in Europe is highly likely. If a wreck is not avoided, the nuclear waste (think toxic debt) is likely to be spewed all over the landscape. The timing is uncertain, but it appears the runaway train is gaining speed. As important, there definitely does not appear to be an engineer, driver or political leader that knows how to operate the train safely! The most difficult aspect of this dilemma is trying to gauge the impact on the U.S. economy and, more importantly, the investment choices that we have available to us. As always, Europe is only one piece of the economic puzzle. Unfortunately, we place the European economic situation solidly in the negative category.

## Economic Growth Outlook

Moving on to other pieces of the investment puzzle, let's stay international and review China. Economic growth in China is slowing down; that much is a given. What is probably under appreciated by most investors is how quickly China is slowing. Last week's economic reports indicated that growth in China is now the slowest it has been in more than two years. Long term, China will be an incredible engine for worldwide economic growth. However, at this time, there simply is not much worldwide demand growth. Therefore, China has an outsized impact on the worldwide economic expansion story. The result is that we need to see stability in growth in China and/or the worldwide economy. If China slows more dramatically, we will have to seriously consider the dreaded "R" word as a possibility when we look forward to 2013 ("R" = Recession and no one likes to talk about that!).

Do we expect another recession in short order? Hmmm… may we have another question? Answer we must, though, and the answer is probably not. How is that for a lukewarm answer? Yet it is the only one we can offer right now due to the other unpredictable factors that we will talk about below. The challenge is that we are expecting a reduction in growth of U.S.

Gross Domestic Product in the 2nd half of the year to possibly as low as 1%. If that is the case, it doesn't take much of an economic blip or stumble to push us into a recession. Moreover, it is not hard to build a scenario where economic blips and stumbles could occur.

## Common Stock Valuations

To be completely clear, we think high quality U.S. companies are in the best fiscal shape that we have seen in decades. Company management teams have done an outstanding job managing their businesses. Balance sheets are pristine and profit margins are spectacular. Even more important is the fact that valuations for high quality common stocks are not cheap; but, stock valuations are not expensive either. Regardless of the metric you use to value businesses in the high quality category, you will find that they are reasonable. So, our analogy of the "coiled spring" is still very accurate. Give these companies the green light that the timing is now logical and safe to invest capital and they will spend money, hire people and expand. Unfortunately, there is no green light for taking such optimistic action at this time. Rather, there is a solid yellow light being shown to company management teams, and they are behaving in a cautious manner.

Obviously, the market is not just comprised of high quality companies. There are companies of every possible grade that make up the market. We believe the valuations of common stocks in lower quality segments of the market are quite expensive. There are some asset class valuation specialists that we have a great deal of respect for, and we follow their work closely. Among the people we follow, the consensus belief is that both smaller companies' stocks and lower quality companies' stocks are expensive. Some of these specialists believe that there are negative returns in store for those assets over the next seven years! We don't know if they will be proven right. Nevertheless, their work clearly supports our position that there will be no free lunches provided by the equity markets for the balance of the decade.

## Uncertainty in the U.S.

Now, we must address the obvious questions regarding the U.S. economic pressures and the uncertainty that is going to permeate the next 3 – 6 months. The Supreme Court ruling on healthcare means that companies are going to reassess their expected employee cost (read: health care costs) increases and determine what the impact will be on their business. The costs are nearly impossible to accurately determine as most companies, as well as politicians we might add, do not completely understand the ramifications of the legislation. What we can say definitively is that any cash that will be spent by companies complying with the new rules will have to come from other potential spending choices (i.e., capital investments, new hiring, wage increases, etc., etc.). Further, the uncertainty of that impact will be a corresponding drag on company capital expenditures.

According to the odds makers, the Presidential election is a dead heat. The result of this non-decisive forecast is more uncertainty until a clear frontrunner emerges. The lack of clarity and the polar opposite views of the two candidates will likely create more gridlock. The most likely result will be less growth in the economy as business owners and consumers take a wait and see approach. The resolution of the election will likely be positive, regardless of who wins. Market participants care who wins, but all parties will celebrate an end to the negative ads and the arrival of clarity as to the direction our country will take. So, that translates to another several months of fence sitting followed by a somewhat clean slate come the first week of November.

That is great news, right? Well, maybe. The election cycle ending is a positive, but then we have to jump right into the high wire act that some have referred to as "taxageddon". Will congress pass legislation to prevent us from falling off a fiscal cliff and kick the can down the road? Or will they be so adversarial that nothing is done, which would allow tax laws to automatically revert on January 2nd to the higher levels of years past? We believe the outcome with the highest probability is that Congress will kick the can down the road and agree to an extension of the deadline in order to allow the winner of the Presidential election to have more time to reach an agreement with Congress. Don't be surprised to hear all the weeping and gnashing of teeth we will get in the months of November and December out of Washington. Think back to the debt ceiling debate….yuck. The taxageddon debate is unlikely to be civil or pretty.

## Our Market Outlook

Now, you know some of the pieces of the puzzle. With all the above information, where does our world view end up? We are still a "2" which is slightly bearish on the CAZ Scale (1= Totally Bearish and 5 = Totally Bullish). We believe there is more potential downside than upside from these levels for both the bond and the stock markets. Hence, our cautious stance. We would love to change that rating to become more positive. No doubt, we won't hesitate to become more optimistic or bullish when we believe that valuations become compelling or we see a meaningful resolution to several of the uncertainties listed above. Therefore, our investment strategy remains focused on:

- Preserving capital
- Identifying investments that we believe can give us exceptional returns that are uncorrelated to the market
- Finding ways to generate cash flow while we wait for all of the pieces of the puzzle to fall into place.

As always, our first objective is to protect your capital. From there, we will continue to find return streams that we can count on whether the market rallies or stays in this trading range. Along the lines of protecting capital, we reiterate how concerned we are regarding long dated fixed income investments, especially U.S. Treasury bonds. **We believe that long term U.S. bonds are the biggest sucker bet of this investing generation**. There may be a trade available in those instruments if the economy slips into a recession. However, the risk/reward ratio with U.S. bonds is so unfavorable we believe it is imperative that investors take their profits and move into other asset classes.

We hope that you are enjoying your summer respite. Please don't hesitate to let us know if you have any questions about anything we have discussed in this letter or if there is anything else we can do for you. Thank you for the trust that you have in our firm. We look forward to seeing you very soon.

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