SLOCUM, GORDON & CO. LLP
INVESTMENT MANAGEMENT AND COUNSEL

VIEWPOINTS

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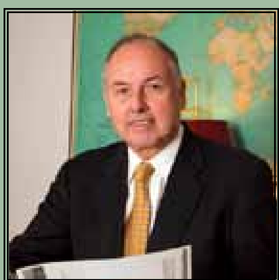
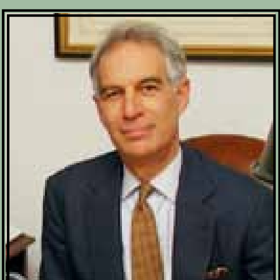
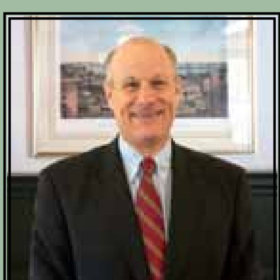
This Economic Commentary is designed to present the Firm's current views on timely topics that we feel may be of interest to our clients. Viewpoints is also available electronically on our website: slocumgordon.com.



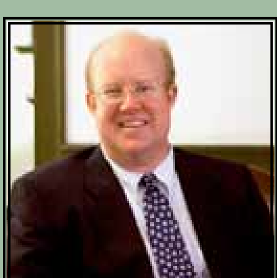
John J. Slocum Jr.



Jeffrey L. Gordon



Barclay Douglas, Jr.



Kenneth M. P. Lindh

Wall Street and the individual investor have a long and storied relationship. The early history of Wall Street centered around the ability of the individual to buy and sell shares of stock through the trading mechanism facilitated by brokers and their counterparts on the stock exchanges called floor brokers. The ticker tape of the day recorded each trade, 100 shares at a time, where stock prices were delineated in eighths of a dollar. Whether the buyer was speculating or investing for the long term, the process was normally slow and methodical, limited by the speed of the multiple human links in the system. Brokerage firms were ubiquitous with the large wire houses' offices nearly everywhere in cities across America so that the average person could participate in the great boom of the US economy. Institutional money back then, represented mainly by bank trust departments and insurance companies, was a small part of the normal, modest daily trading volume.

This early, somewhat sleepy picture of Wall Street, of course, has been punctuated with periodic chaos when events transpired to shake the foundations of trust and belief in the system. Wars, assassinations, unexpectedly bad economic news, and bursting asset bubbles have interceded along the timeline of inexorable growth of the US economy causing investors and speculators to run for the exits, cratering stock prices for a period of time. Human nature, led by the two inevitable motivators of fear and greed, has an enormous impact on the day-to-day experience of stock market participants, and in the final analysis, not much has really changed over the last 100 years of Wall Street's history.

So, why does the current economic picture and stock market feel disturbingly different from earlier experience? Normally, recessions occur when the Fed tightens interest rates to subdue inflation, and the overheated economy subsequently lapses into an inventory recession. More than five years have elapsed since the onset of the Great Recession of 2008-2009, and ordinarily a recovery of this length should have produced a more vigorous economy with full employment and higher living standards. This time, however, the Great Recession had at its root cause highly leveraged balance sheets with overloaded debt at all levels, public and private. The debt liquidation necessary for a rebalancing takes time, and since we have had so few of these cataclysmic episodes in our history, it can feel like uncharted territory...as it does today.

In addition to the deleterious effect on the economy of divisive politics and over-burdening government programs and taxes, corporations have been minimizing debt on their balance sheets, and consumers have been saving and paying off debt incurred during the great boom years. The Fed has kept interest rates effectively at zero for five years in order to add extra fuel to the sluggish economic engine. However, since companies have not been expanding, all that liquidity has to find a home somewhere, and rather than going into the wider economy, it has found its way into stock prices, restoring valuations to pre-recession levels and beyond.

A very different set of stock buyers now predominate the virtual trading floors that make up the daily volume on Wall Street. The individual stock owner is very much in the minority, perhaps chastened by the two debilitating bear markets since 2000, while the institutional component of the trading volume has ballooned, accentuating volatility up and down. Speculators in the form of hedge funds add to the confusion, and everyone is on edge because of the instantaneous transmission of news around the globe. Skeptics worry that when the Fed finally pulls back on the monetary throttle, the props will get kicked out from under stock prices, leaving the market vulnerable again to a major collapse. Fast money is on the lookout for this, and when a sell program of one of these large pools of money hits the market, gaps can occur in the bid and asked spreads in stock prices. All in all, not a pretty picture compared to the quieter days on Wall Street that some of us can recall.

As investment advisers, we need to be aware of so many conflicting data points to make an educated attempt to distill an investment strategy for the funds with which we are entrusted. One overarching driver for us is that quality assets, bought at the right price, with a good and improving cash flow in the form of dividends or stock buybacks, if held for the long term generally can outperform and provide a good hedge against inflation. We try to ignore the daily noise from talking heads in the media and focus on the larger picture. For example, while it is clear that interest rates will be higher five years from now, we think the climb will be more gradual than the market expects. We see modest economic growth ahead, with a relatively low risk of overheating that would cause the Fed to tighten rates more quickly, causing another recession.

The stock market has not experienced a 10% correction in nearly three years, and it would not be a surprise to have that occur, even though it would be the most predicted correction in history. As an economist friend recently said, “More money may have been lost trying to anticipate corrections than in the corrections themselves!” Higher earnings and dividends, mergers and acquisitions, and stock buybacks are all good indicators that these higher stock prices reflect improving business conditions that are moving ahead just slowly enough to keep the Fed at bay.

We continue to see value in many sectors of the market and are willing to be patient with stocks that we already own. As we consider adding new investments to our clients’ portfolios, we are patient to buy at prices where we feel there is an adequate margin of safety. One way or another, we think we might be in the fifth inning of a game that still has quite a way to go.