HARBOR VIEWS

HARBOR ADVISORY QUARTERLY NEWSLETTER

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HARBOR
ADVISORY
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A LOOK INSIDE HARBOR VIEWS

- *Thoughts on the Economy* – …. "The world and the U.S. economy is in a long-term deleveraging mode that will last years and hold economic growth to an average of about 2%."
- *Our View of the Financial Markets* – "fixed income markets are more distorted in price by the 'flight to safety' than has been seen in most people's lifetimes."

LATEST NEWS FROM HARBOR ADVISORY

- Jack De Gan continues to make news with his regular guest appearances on CNBC's top rated financial shows "Squawk Box", "The Call", "Closing Bell" and on Bloomberg TV, Fox Business News and National Public Radio as well as commentary in the Wall Street Journal and Barron's Magazine.
- You can visit us at: www.harboradvisory.com to see his appearances. Take a look and let us know what you think.

THOUGHTS ON THE ECONOMY

The U.S. economy has slowed for the third consecutive year, in part, from the debt contagion fears emanating from Europe. Concerns the Chinese economy will slow too sharply are also adding uncertainty. Job creation has fallen from 200,000 per month in the first quarter to fewer than 100,000 jobs per month this summer. GDP growth was revised lower to 1.9% in the first quarter and 1.5% in the second quarter. Corporate earnings growth has probably further slowed from 6% to 4% in the most recent quarter.

China was successful in cooling their economic growth from 10% to 7.5% over the last two years to reduce inflation and prevent an asset bubble in real estate. They now are reversing some of their policies to allow for growth to stabilize in the 7-8% range. Since they have so many policy levers available to them they should be successful in this effort.

The policy makers in Europe have finally 'gotten it': they need to recapitalize their banks and stabilize the banking system. A European banking authority that would allow for direct injections of capital into banks and provide deposit insurance has been agreed upon. Timely and appropriate implementation of this agreement will be critical.

If European governments can stabilize their banking system then sovereign rates in the weaker economies can fall and provide breathing room for longer-term reforms to increase competitiveness and productivity. These include reforming entitlement programs, making labor markets more flexible, and reducing bureaucratic impediments to closing and starting businesses.

The world and the U.S. economy is in a long-term deleveraging mode that will last years and hold economic growth to an average of about 2%. Unemployment will be uncomfortably high for a number of years. We face great political challenges to reform our tax and entitlement spending programs and the need to work toward a budget that will stabilize, if not reduce our national debt. National debt in the U.S. exceeds 100% of GDP which comparatively, puts us between Spain and Italy. If we don't reduce our $1.5 trillion dollar annual deficit soon we face the risk that the markets will price our debt at levels we cannot afford to pay.

OUR VIEW OF THE FINANCIAL MARKETS

Financial markets have been very volatile this year due to the issues just discussed relating to the three major areas of concern; Europe, China and of course, the United States. Nonetheless, the performance of equity markets has been good; the S&P 500 finished the first half of the year up 9.5%, the MSCI-ACWI (All World Index) was up 5.7% and the Lehman Aggregate Bond Index gained 2.4%. We expect continued volatility with an upward bias after the elections.

If one were blissfully unaware of the significant macro issues detailed above, but looked at the corporate side of the ledger, one would think we were in a benign economic environment. Corporate earnings will be an all time record this year, margins are at record levels and dividends are being increased sharply. Corporate cash is at record levels and share repurchases are strong. This indicates to us that as the macro clouds begin to clear over the next year stock prices will tend to rise. Certainly the election will be decided in November and there is a good chance we will know by then if the Chinese government has successfully stabilized economic growth. The European issue will take longer to resolve but we should at least have a roadmap by year's end.

The fixed income markets are more distorted in price by the 'flight to safety' than has been seen in most people's lifetimes. Ten year treasury notes are trading at a yield of 1.39% at this writing. Rates will remain low for an extended period of time as de-levering continues but eventually that bond bubble will burst. The immense inflow of capital into bond funds will reverse as prices decline and those funds will be looking for a new home. Some of the bond money should go into equity shares which will provide a welcome tailwind.

We also expect the dollar to resume its downward trend as the flight to safety recedes. This would be helpful for our non-dollar investments.

NEW EQUITY BENCHMARK

Harbor has added a new equity benchmark index to performance reports. In recognition of the fact that international markets represent 60% of the world's equity market capitalization, we have added the MSCI-All Country World Index (ACWI) to performance reports. Over time Harbor has increased international exposure to client portfolios which makes a broader index useful for comparison. The index appears just below the S&P 500 on the performance page of the reports.

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Nod to the ubiquitous disclaimer: While we're not infrequently, and always quite accurately, accused of being of strong opinion – we want to let the reader know we've been wrong before, we will be again, but please don't hold it against us. The forward looking parts of the letter are the best efforts of fallible humans working at Harbor Advisory.