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DÉJÀ VU ALL OVER AGAIN
INVESTMENT STRATEGY
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Today the stock market indices declined more than 2% reacting adversely to the poor jobs report this morning, and overnight fears about Greece and Spain. As someone once said, "It's *déjà vu* all over again." Just like last year and the year before. As we have said time and again during the last two years, neither the China nor the US will enter recession during the next 6-12 months, nor will Spain default on its bonds nor Greece exit the Euro-zone any time soon! We discuss them in reverse order. In the meantime, we view the declines in financial markets as a buying opportunity.

Greece: despite popular opinion to the contrary, our view is that Greece will not exit the EZ because, as the old union expression says, "Money talks, nobody walks!" Greek voters have a choice: austerity with EU money, or austerity and inflation without it! A recent poll showed that 78% of Greek voters thought they should stay in the EU. We think the first election which resulted in no government was a protest vote that will change substantially on June 17th. Without predicting who wins how much, we expect the electees will be such as to allow the formation of a unity government to implement the reforms required by the EU for its financial support.

Germany and its exports have benefited greatly from having the Euro as its currency (because the Euro's strength is diluted by the weaker countries backing it) rather than the Deutschmark which would otherwise be going through the roof like the Swiss Franc. Conversely, Greece has benefited from the relative "strength" of the Euro which has given it greater buying power than it would have had with the Drachma. Both sides in this drama have reasons to keep the Eurozone intact.

We expect some concession to be made by the EU as to the time frame for Greece to implement its reforms, and some concessions may be made in terms of funding for growth initiatives. We expect Greece to remain in the Euro-zone, and the Europeans to continue funding Greece until European banks are no longer vulnerable to a Greek withdrawal because of its adverse impact on the valuation of Spanish, Italian and other European bonds.

Spain: for similar reasons we expect the EU to support Spain with funding even though Spain's problems center around its banks and their mortgage loans that are bad (they have a real estate bubble worse than that of the US), and the profligacy of some regional governments which are in financial difficulty. Although Spanish government debt as a percentage of their GDP is less than that of the United States, when one adds the amounts needed to fund the banks and the regional governments, the debt level should rise substantially. Thus, interest rates in Spain are rising to unsustainable levels. In the meantime, depositors are beginning to withdraw substantial amounts from the Spanish banks, i.e. about Eu$100 billion last quarter.

Unless Spain suddenly exits the EZ – which we do not expect – its crisis will be instrumental in the expansion of a more powerful European central bank: that might even be permitted to provide capital to its member banks. In the meantime, the ECB can provide additional LTRO funding to meet the withdrawal requirements. Since about 45% of Spanish government bond issuance is purchased locally, the government's funding requirements can be handled via the various European government agencies and facilities.

A clue in today' markets in Europe is that while European markets generally were down 1.5% plus, Germany's was down 3%, indicating that demands were increasing on Germany's financing capabilities. We do expect them to step up to the plate in due course!

The US: today the "jobs" report for May was weaker than expected and reports for the prior two months were revised downward. Although we attribute some of the recent weakness in jobs relative to December and the first

months of this year as pay back for an overly warm winter (and the better employment numbers), we are somewhat surprised at the softness of these statistics. But we know from long experience that these statistics are often revised fairly substantially and can never be taken totally at face value. Because today's numbers are not supported by other data, we expect them to be revised upward, and at worst they imply simply that growth in the US may not be the 3% plus or minus that we have expected, but more like 2%-2.5%. This is not cause for a 2% market decline in one day, nor for longer term concern either.
Housing has begun its recovery – permits which indicate future new housing starts are picking up, and the inventory for sale has normalized to a 6.5 months' supply, down from a peak of 11 months. While there is undoubtedly shadow inventory coming from both foreclosures to be completed as well as homes being held off the market, the new housing market has begun its recovery. It is starting from an extraordinarily low base, but its recovery over time results in rising employment. We think there are still 2.5 million people out of work because of the housing industry. Each new home built provides about 3 new jobs. Watch housing for a clue as to what is really happening in the US!

China: The GDP growth rates of both China (and India for that matter) have slowed (as expected) as their economies have responded to the lagged impact of government interest rate increases (higher rates) last year and the slowdown of GDP growth in their export markets. China's two largest export markets are Europe (first) and the US (second). We noted in our prior strategy piece that China was prepared not only to lower interest rates, as it has been doing this year, but was also prepared to implement a fiscal spending plan to keep the economy on track at a solid 8%-10% growth rate.

We are beginning to hear more frequent references to such a plan, and expect further announcements during the next six months. If growth is less than 11%, it is good because of the inflationary pressures that are created by such a growth rate. But if it is in 8%-10% range – that is excellent. At 6%-7%, which is what the market now expects, we expect to see multiple stimulus packages.

Financial Markets: The US Treasury 10 year bond reached a new low of 1.45% which is astounding given that both the inflation and the yield on stocks, e.g. the S&P 500 Index, are higher. However, it represents fear, both here and abroad, as investors, both US and foreign, abandon European bond and stock markets and invest in US Treasuries. The technicians expect the S&P 500 to retreat to 1250, i.e. the year-end value of the Index, and we can foresee that possibility in the current climate. Nonetheless, we remain relatively optimistic on the equity market because:

- Greece will form a unity government that, with perhaps some help on the growth side from the EU, will implement the reforms required of their "austerity plan".
- The Europeans will continue preparations sufficient to handle any difficulties Spain may have. For example, the ESM will be funded July 1st, possibly sooner.
- US Financial markets will anticipate further monetary stimulus by the Federal Reserve, even though it may not be necessary.
- China will increasingly stimulate its own economy.
- Better economic statistics in the US through the remainder of the year than the last two months.

Much has been made by the media about the coming "debt ceiling battle" and the need to deal with the expiring "Bush tax cuts" (the coming cliff over which the US economy may go). Assuming the elections effectively decide nothing, we think Congress will continue the bulk of the Bush tax cuts as well as the employee withholding reduction in order to avoid having their repeal act as a drag on a "fragile" economy.
In the meantime, corporate profits will continue to grow, and in anticipation of them, eventually we look for 1500 by year end and possibly 1600 on the S&P 500. We view the current decline as a buying opportunity. It is not time to head for the hills, yet….

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