SUMMER 2012 MARKET COMMENTARY

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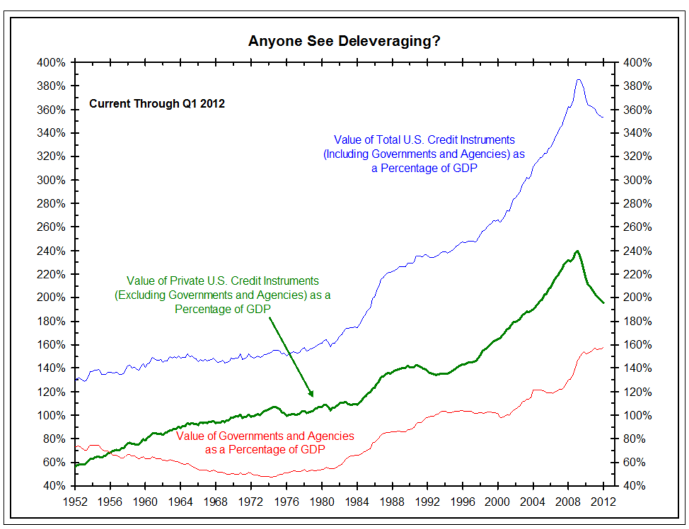
Stocks, Particularly the High Yielding, Still Preferred Over Bonds

Our economic view was well expressed last week by John Williams, president of the San Francisco branch of the Federal Reserve when he said: "We're seeing an economy that continues to grow," but "The growth is frustratingly slow." Deleveraging of both private and sovereign debt and other liabilities in the developed world continues to be a drag on economic and business growth, and is likely to keep growth slow. The corporate profitability rebound from recession depths is probably over and the benefit from cost cutting slowing. Assuming no near term recession, future corporate profit gains are more likely to be driven by industry cycles, corporate expansion and innovation. As for the markets, it is obvious that investors are avoiding stocks and seeking safety in government and other bonds. We prefer stocks, particularly high yielding and growth stocks over most bonds. However, we remain cautious, holding substantial cash in reserve for both asset protection and to take advantage of opportunities.

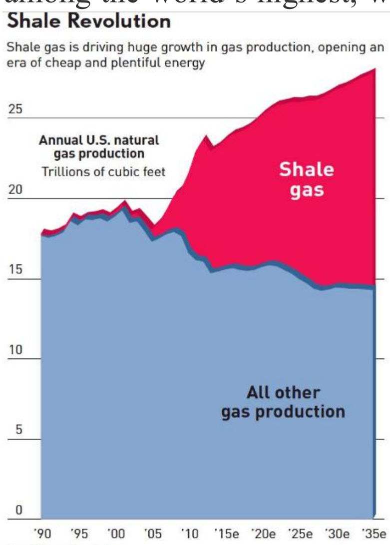
"The economy is in a bad way", to quote the Economist. "Unemployment is stuck above 8% and growth probably slipped below an annualized 2% in the first half of this year. Ahead lie the threats of a euro break-up, a slowdown in China and the "fiscal cliff", a withering year-end combination of tax increases and spending cuts." However, we also agree with their comment that, "Led by its inventive US private sector, the American economy is remaking itself."

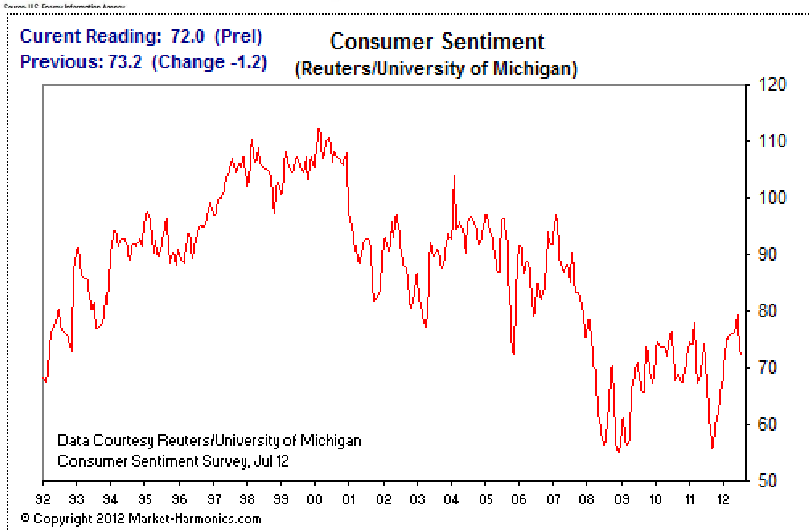


Our current problems are the consequences of excessive private and public debt. On this front progress has been made. Private debt has been significantly reduced; although it probably has further to go as households continue to repair their balance sheets. State and local debt, both on and off book, like pension and health benefits, is being brought under control in various ways by officials and voters from Boston to Wisconsin to

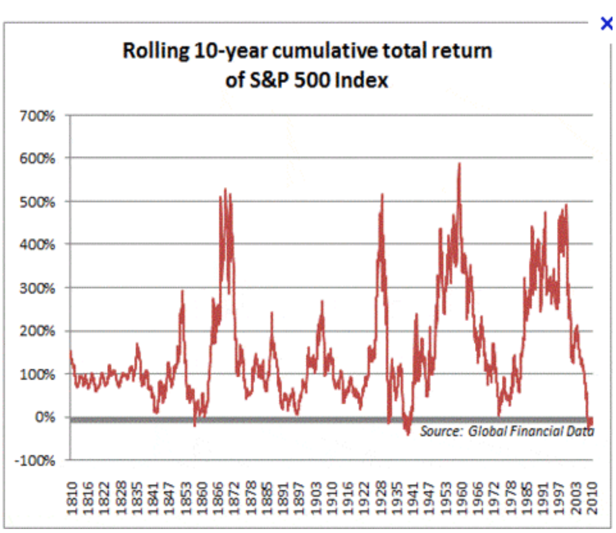
California. Although no one has yet stepped up to deal with massive federal debt and entitlements, we suspect this will change after the November election.

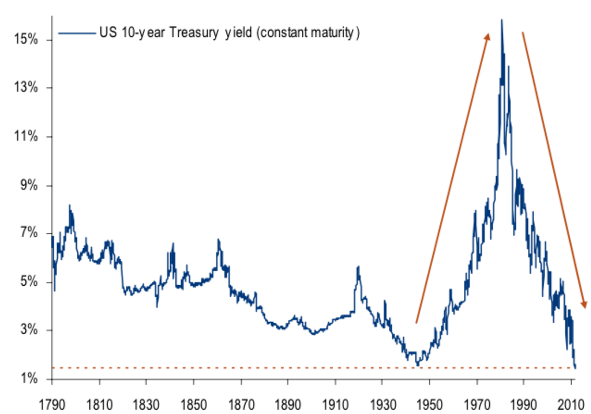
American corporations are among the world's strongest when it comes to balance sheets and profitably, two factors that are precursors of future economic growth. U.S. bank capital ratios are among the world's highest, which will allow lending when demand materializes. The American export sector is growing fast due to a weaker dollar since 2009, and because of consumption growth in China and emerging markets. Manufacturing has been growing as it becomes more efficient to produce in the U.S. Oil and gas production is reaching new highs. Imports of energy could be the lowest in nearly twenty years as shale gas and oil production booms. Less expensive domestic production enriches consumers and drives increased production of exportable products like refined petroleum, chemicals, and plastics. Less expensive energy is also at least partly responsible for a measurable increase in U.S. and foreign corporations moving and building new plants in the U.S. over the last year.





To date, none of these positives has shown up convincingly in people's attitudes or the markets. Consumer sentiment remains substantially below the levels of 12 years ago. Rolling 10 year cumulative returns from the S&P 500 remain negative, something rarely seen during 200 years of history, as shown on the nearby chart. Perceived to be risk free, 10

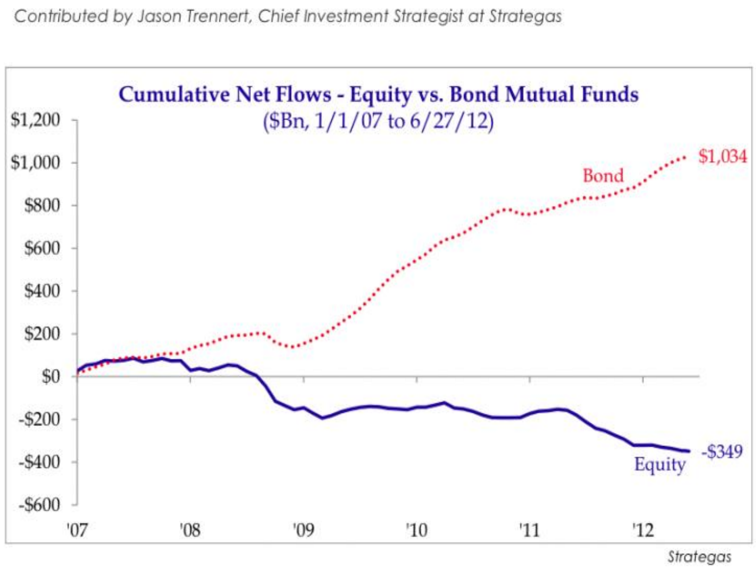




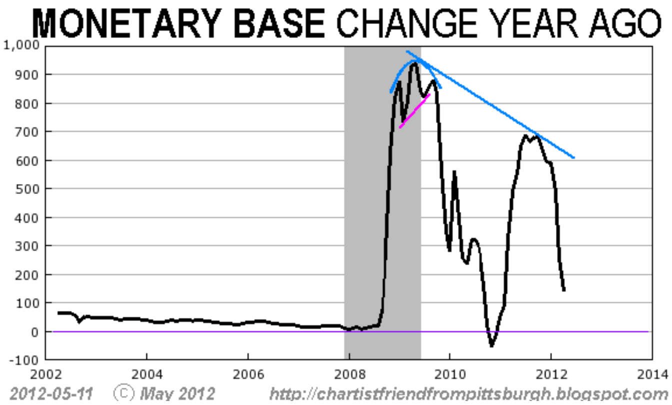
Monthly data
Source: BofA Merrill Lynch Global Equity Strategy, Global Financial Data, Bloomberg

years US Treasury bond yields have been this low (1.5% and below inflation) only once during the last 200 years – during the late 1940's when the government last engineered low rates to help pay off WWII debt. Whether seen as negative or positive, this is not normal!

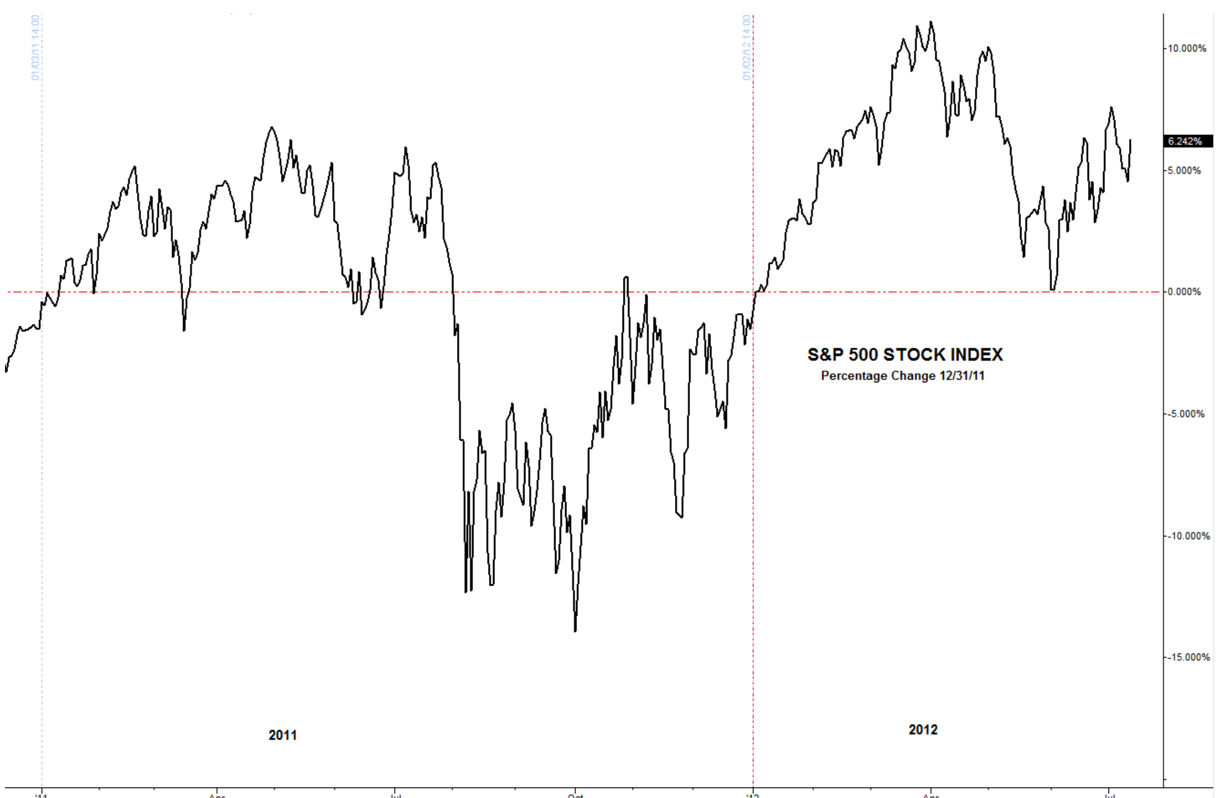
It is fair to say that investors hate stocks. The outflow of money from equity mutual funds and into bond funds since 2007 has been dramatic and compares only to the 1970s in our experience. It is particularly noteworthy since at least treasury bond investments are almost guaranteed to lose money in the intermediate future. As one investment manager recently said, "Panic and pain are forcing some invetors into buying pratically worthless 'safe haven' assets, and there is fear and loathing directed towards any investment that is perceived as being risky."



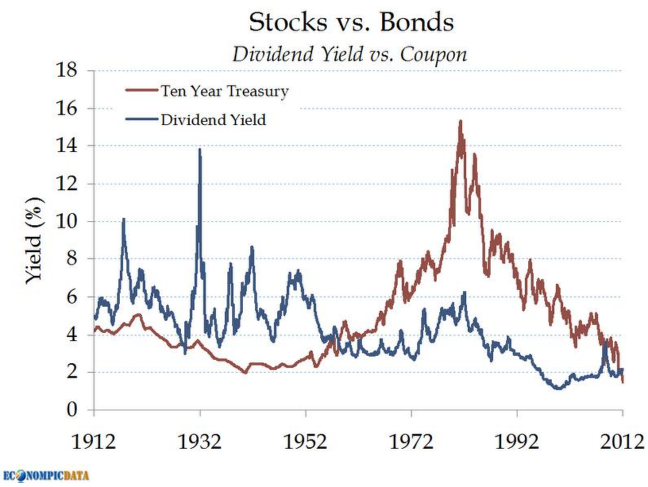
To be sure, some market watchers have become increasingly positive about stocks, although interestingly they appear to have all been around the last time we suffered from severe negativism during the 1960's and 1970's. One is David Rosenberg—the former economist at Merrill Lynch & Co. who now is at Canadian money-management firm Gluskin Sheff—In a recent report picked up by the Wall Street Journal on 6/15/12, he commented about his optimism after more than a decade of bearishness. This was crystallized by voter's actions in Wisconsin and California to tame budgets. He sees this as a sea change in how state and local governments are addressing their fiscal problems, and expects similar attitudes will sweep across statehouses and eventually filter up to the national level. The next 15 years or so won't be like the past 12, he says, and anybody who tries to project the future based on the immediate past is making a mistake of "gargantuan" proportions. "I think we may look back at the events of last week (voting) as a real inflection point," he says. Rosenberg isn't dismissing the sea of troubles that face the world, or that it may take a political crisis to force change on Washington and he doesn't expect immediate change. He isn't yet promoting stocks or advocating a big move into risky assets but the opportunity is coming.



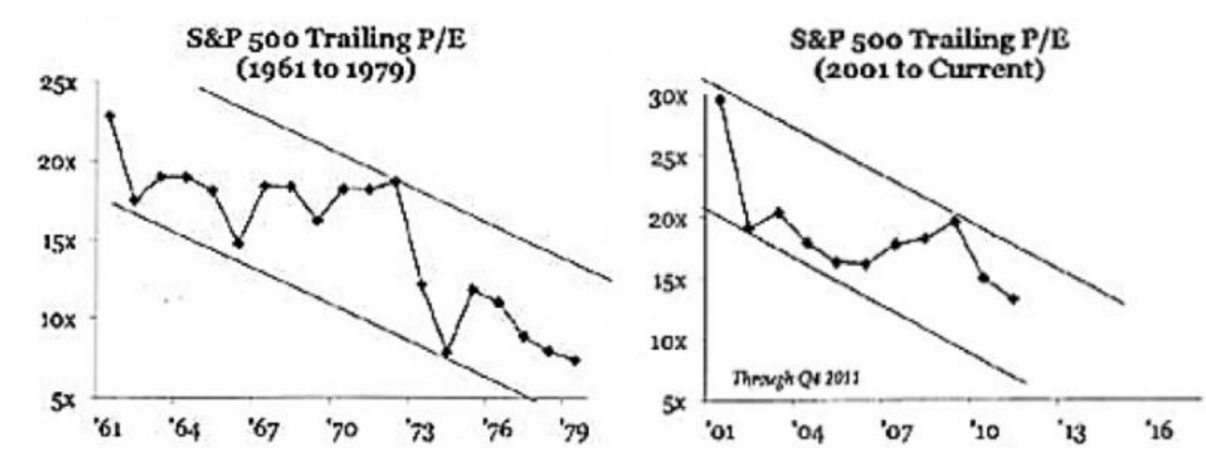
Nearer term, investors seem to be suffering from continued fear over European issues and monetary issues, and now the "fiscal cliff", as we discussed in January. Stock prices, after reaching an April high, collapsed sharply lower during May and early June, after which they have partially recovered. We think much of Europe's problems are in prices after more than a year of negative news on that front. In fact, European stock prices are just above their lows of 2010 and 2011. We also continue to doubt that the fiscal cliff will occur as programmed - politicians like their jobs. However, there has been a sharp slowdown in Federal Reserve monetary stimulus (the chart to the left) which reduces the cash available to be invested in riskier assets like stocks. We don't believe this the beginning of the Fed proverbial "taking away the punch bowl" to avoid inflation from the massive stimulus they have provided since 2008 (the Fed's balance sheet has grown an unprecedented 3.5x in less than 4 years), but rather just a lull in their efforts, based on their own members' comments, We think liquidity will remain a positive for domestic stocks, once investor sentiment turns more positive.



Another part of the market riddle relates to asset valuations. While not at panic levels, as seen during 2008-2009 or even during 2011, values still appear attractive in our opinion. For example, the dividend yield of the S&P 500 is above the ten year Treasury yield for the first time since the financial crisis. Before that we have to go back to the 1950's and early 1960s to find a time when this was the case, which was a good time for stocks. Of course, as during the 1930s and 1940's, todays problems could continue or get worse. But looking back, the 1930's and 1940's, while volatile, was also a great time to invest in stocks. Stocks only stagnated once the government succeeded in inflating the country out of slow growth during the mid-1960s and 1970's (a bad time for stock investors).



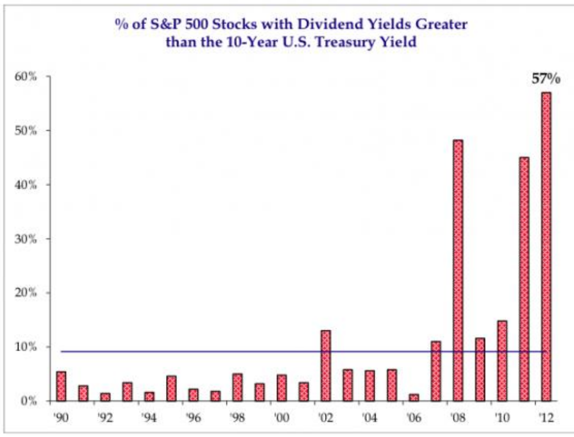
Contributed by Doug Kass, President of Seabreeze Partners Management



Strategas

Another measure of valuation, price earnings ratios, also appear reasonable and on a similar track as during the 1960s and 1970s'. After 12 years of investor fear, these multiples have been reduced by half. Although somewhat less of a haircut than during the 1970's, today's market naturally reflect substantially lower inflation and interest rates than at the 1974 when ten year treasuries were yielding near 8% and on their way to 15%.

Contributed by Jason Trennert, Chief Investment Strategist at Strategas



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Today, 57% of S&P500 stocks have a dividend yield greater than the 10 year US Treasury, and the potential for dividend growth, whereas U.S. Treasuries run the risk of losing money, even without higher inflation rates. Without trying to time a market bottom, today's prices and yields could be a rare opportunity for investors.

The bottom line for PVG is that, despite our economic problems, stocks, particularly high dividend yielding stocks, and riskier assets appear as attractively valued as they have for the last forty or even seventy years. Likewise, investors appear uninterested in anything but bonds, much as they did during the 1970s and 1930s, just when they should have been interested. What investors are buying, US treasuries, carry substantial risk that yields may rise wiping out a decade or more of interest yield with principal loss. Near term, however, we are being careful and continuing our Loss Averse investment management approach by holding substantial cash reserves. The markets remain highly sensitive to near term economic, political, and other events that could cause lower prices. While we are increasingly optimistic, we remain dedicated to the preservation of our clients capital investments. We appreciate your confidence.

Regards,

Patrick S. Adams, CFA
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