HARBOR VIEWS

HARBOR ADVISORY QUARTERLY NEWSLETTER

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HARBOR ADVISORY

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THOUGHTS ON THE ECONOMY

The rate of descent in the economy has moderated dramatically but statistics continue to show contraction. The U.S. continues to shed jobs each month and the unemployment rate was 9.5% at the end of June. Industrial production and capacity utilization are at the lowest rates in many decades but may be bottoming and could improve during this quarter. Increasing output in the second half of 2009 will not feel like recovery to most Americans as unemployment will remain high by recent standards for years.

Residential real estate activity appears to be bottoming and inventories are declining. Prices continue to fall, but activity leads prices and may be indicating a bottom in prices later this year or early next year. Stability in home prices would go a long way to shore up banks' balance sheets. This is critical to a sustained recovery. Commercial real estate markets are now weakening rapidly and are the next area of problems for the banks. The Federal Reserve will need to design a program to allow for the refunding of commercial real estate loans and the securities derived from them.

Current Fed programs have stabilized the credit markets and are allowing the economy to slow its descent. The Fed must now contemplate how to gradually unwind all of these programs before the stimulus generates inflation as the economy recovers.

We continue to believe the worst is over for the credit markets and the economy and that next year will show improvement in output and a topping out of unemployment. The question now is "what is next?" The form the recovery takes will affect the performance of the financial markets. We continue to be concerned that as the stimulus draws to a close the economy could again weaken.

OUR VIEW OF THE FINANCIAL MARKETS

Financial markets are convincingly off their March lows and now show positive returns on a year-to-date basis. The "armageddon trade" is now off the table and it appears the wholesale nationalization of the banking industry will not happen. Banks are now able to raise private capital to rebuild their balance sheets and a few have done so convincingly.

A LOOK INSIDE HARBOR VIEWS

- *Thoughts on the Economy* – We continue to believe the worst is over for the credit markets and the economy….
- *Our View of the Financial Markets* – We remain cautious as the risks to current valuation levels remain many.

LATEST NEWS FROM HARBOR ADVISORY

- You can now visit us at www.harboradvisory.com. Take a look and let us know your feedback.
- 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.

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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.

Stock markets around the world discount higher corporate earnings next year and are returning to historically average valuation ratios. We remain cautious as the risks to current stock market valuation levels remain many. If the economy recovers more slowly than expected or if we enter a double dip recession stock prices would be vulnerable. Higher interest rates could negatively affect valuation levels as the Treasury attempts to finance record deficits that could approach $2.0 trillion this year. Higher tax rates on corporate profits to help finance the spending could also create drag. Although the rally we have seen is impressive we remain in a more conservative position than in prior years.

Bond markets have also rallied impressively this year and additions to our clients' fixed income holdings have performed well this year. Our TIPs (Treasury Inflation Protected Notes) have performed well as deflationary concerns subside and are replaced by inflation fears due to the record stimulus in the system. We willl continue to search for opportunities in the credit markets to employ cash balances.

Our caution should not be viewed as longer-term pessimism. We recognize all great Bear Markets end in environments like this. Severe economic contraction and credit crises will end this stock market decline. The question simply is when? The March low may ultimately be the low price point but we could trade within a range for many months before the next significant, sustainable move higher. We will monitor this action for the opportunity to increase equity exposure at low points.

CASH FOR THAT CLUNKER

One of the many Federal government programs called the Consumer Assistance to Recycle and Save (CARS) program just kicked in July 1, 2009. It helps consumers pay for a new more efficient car or truck when trading in a gas guzzler. Qualifications for up to a $4,500 credit, depend on vehicle type, and mileage differential between the purchased vehicle and the trade-in. Generally the program would not make sense for trading in a vehicle worth more than $4,500 and you must have owned it for a year. There are numerous other details involved in qualifying for the program (all of which are available from www.cars.gov or from your local friendly ***and hungry*** car dealership). The program is available until the sooner of, November 1, 2009 or when the allotted funds run out.