

HARBOR VIEWS

HARBOR ADVISORY QUARTERLY NEWSLETTER

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THOUGHTS ON THE ECONOMY

Our outlook for economic growth in the U.S. and abroad has moderated since our last letter. We credit two sources for the weakness. The first is continued weakness in residential real estate which we had hoped would stabilize in 2011. We now believe that stability is a 2012 event. This weakness affects consumer confidence and spending levels through the negative wealth effect. The second source is the lack of leadership demonstrated in Washington and Europe. In Washington the prolonged negotiation over the debt ceiling increase and budget negotiations to deal with our exploding levels of Federal debt significantly depressed consumer confidence. That spectacle led to the S&P downgrade of our Treasury's credit rating by one notch from AAA to AA+, the first in a hundred years. This downgrade was not only misinformed but irresponsible. Clearly no investor believes the credit-worthiness of U.S. Treasury debt is any lower.

In Europe the sovereign debt crisis continues to spread with no solution yet acceptable to all parties. European bank stocks have fallen 50 – 70% in the last six weeks which is spilling over into the U.S. markets over the last month. Here shares have fallen 15% with our banks falling 25 – 50%. The effect of sovereign debt defaults and possible currency devaluations on bank capital is of critical importance. European finance ministers and ECB officials need to address bank capital as well as the sovereign debt issue. We believe a Eurobond of significant size backed by all members of the EU would do the trick. The proceeds would be used to buy some portion of the debt issued by the weaker EU members which would help solve their funding issues, strengthen their economies, and raise bank capital.

Weaker economic growth has precipitated lower oil and other commodities prices. This helps profit margins and consumer spending. Job growth has slowed to a rate of about 115,000 per month, slower than we saw in the spring with a corresponding affect on GDP growth. The economy is operating at very close to "stall speed" making it vulnerable to dramatic weakening if we get hit by an external shock. We need the Europeans to deal effectively with their sovereign debt and banking crisis and for Washington to make a debt deal that would reduce spending and raise revenue by a significant level over the next decade – something on the order of \$5 - \$10 trillion would

A LOOK INSIDE HARBOR VIEWS

- *Thoughts on the Economy* –stability in residential real estate pricing is a 2012 event.
- *Our View of the Financial Markets* – Price-earnings multiples on stocks have declined now for eleven years...investors are creating bubble prices in "safe" U.S. treasuries and gold.

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- You can 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, Fox Business News and National Public Radio.



“The S & P 500 currently delivers a dividend yield in excess of the yield on the 10 year Treasury Note...”

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balance the budget by 2020 which would be a worthy goal.

Economic growth was boosted over the last 10 years by consumers leveraging up. The next 5 – 10 years will entail unwinding some of that debt keeping real economic growth below historical levels. We face a reduction in the government stimulus provided by our \$1.5 trillion dollar budget deficit as we finally get spending discipline, a topic on which the 2012 elections will turn. This too will limit economic growth. The Federal Reserve will need to slowly unwind their \$2.0 trillion balance sheet over the coming years which also will suppress growth. These headwinds to growth will require bold fiscal policy decisions.

OUR VIEW OF THE FINANCIAL MARKETS

Stock price weakness in late July and August is the result of the fear we may enter a double dip recession. Much of this pain is self-induced in the form of a failure of leadership by U.S. and European governments. Financial markets hate uncertainty. Problems that require a political solution are by definition uncertain; it is hard to know what the politicians will do. We have maintained a low exposure to equities, helping to mute the pain, but still making for an uncomfortable summer. We expect equity prices to remain volatile until we find a solution or until the economy forces one.

Stock prices are fairly valued and dividends are strong and increasing. The S&P 500 currently delivers a dividend yield in excess of the yield on the 10 year Treasury Note which is currently 2.2%. This is an unusual situation and represents value. Financial stocks have weakened dramatically as contagion from the catastrophe in the European Banks has been transmitted across the Atlantic.

Investors have withdrawn money from equity mutual funds all year creating a real headwind for share prices. Deciding to buy 5 year Treasury Notes at .96% indicates real investor fear. Generally such an environment is one in which you want to be a buyer of stocks. Warren Buffett has said as much with his words as well as his wallet. His purchases of Wells Fargo and Bank of America shares tell us the financials are a value. If they improve, so too will the broad market.

Price-earnings multiples on stocks have declined now for eleven years, sentiment is very negative and investors are creating bubble prices in “safe” treasuries and gold. In the lexicon of contrarian investors, this sounds like a good time to invest. However, that economic growth will be anemic for a prolonged period which will keep investment returns low by historical standards.



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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.

Excluding periods of "flight to quality" buying, the U.S. dollar will weaken, especially against emerging market and hard asset currencies. We therefore continue to purchase securities denominated in currencies other than the U.S. dollar to protect your purchasing power.

PERSHING INVESTORS

For our clients whose assets are custodied by Pershing Advisor Solutions, changes are afoot. You will receive notification (if you have checking associated with your investment account) that new checkbooks will be issued. Upon receipt of the new checks, please immediately destroy the old checkbooks as these will no longer work.

There will also be discussion in the communication from Pershing relating to account fees. These fees do not apply to Harbor clients as we negotiated the custody arrangement prior to moving our clients to the Pershing custody platform.