CAUBLE & HARRE WEALTH MANAGEMENT

PETER B. HARRE, CFA
Principal

12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
OFFICE 314.576.1112 MOBILE 314.495.7100
peter@caubleharre.com

July 9, 2009

We know that the market fell from 14,000 to 6,500 and then rose back to 8,500. It has since fallen to 8,100. We know that at 6,500 we were expecting doomsday and the 8,500 reflected relief that the doomsday scenario was off the table. I don't know if the market's current valuation properly reflects the slower economy that I see as inevitable given the constraint of credit.

Second quarter earnings season has just begun. Companies commenting on their future should provide interesting insight. I think that investors during the first quarter announcements were looking for news that doomsday would not happen. I think that investors this quarter will be looking for news supporting the green shoot believers. I don't think they will be satisfied, but then I might be a fool for making the prediction.

The following contains more detailed information on my thinking and concerns. Recall for a moment how we got here. Three types of entities are involved in our economy: Consumers, businesses and government. Consumers trade their time and/or skills for an income. They spend a portion of this income, investing the rest. Business spends its money hiring people and on other inputs such as materials, to create a product or service which they can then sell. Typically they earn more than the cost of the inputs and the owners and lenders to the companies have a claim on these cash flows. Government takes money from both consumers and businesses. They spend a portion of these funds on their own operations, give money away to selected consumers in the form of transfer payments and/or services, and they might invest the money on things that benefit us all such as education, roads, police or an air traffic control system.

Consumers drive 70% of our economy. Over the past few years, they borrowed and spent too much money. By too much money, I mean that they had to borrow more and more each year to support their spending patterns. Where did all this money come from? Mainly from mortgages and home equity lines of credit. Many people believe that banks were the source of these mortgages in our economy. Actually, a great deal of this credit given to consumers was funded by the shadow banking system. A lot of mortgages were securitized. This means that they were bundled together and sold to mutual funds and other institutional investors. So ultimately, a lot of the money given to consumers came from mutual funds and other non-bank financial institutions.

Certainly credit is not all bad. Some items cost so much that consumers need to pay for them over time (cars and houses). Companies can borrow to purchase materials that they will sell in another form for a profit. The extension of credit is a healthy part of our economic system.

CAUBLE & HARRE WEALTH MANAGEMENT
PETER B. HARRE, CFA
Principal
12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
OFFICE 314.576.1112 MOBILE 314.495.7100
peter@caubleharre.com

What was bad was when these loans began to default. The bank and non-bank institutions that made these loans stopped lending. Consumers and businesses could not get credit and they stopped buying and investing. The economy began to grind to a halt. This was last fall.

Think of it this way. The economy was cruising along at 100 mph. If people had been borrowing reasonable amounts, it would have been traveling at 80 mph. This means that we might get back to 80 mph someday. The disruption that we experienced last fall slowed the economy down to 15 mph. That is when the government stepped in. They did two things. One, they tried through several actions to get the credit markets open again. Not every borrower who wanted money was a bad credit, but no one was getting credit. Two, the government wanted to spend money, to try to replace other spending that was not occurring.

At a pace of 15 mph, most every company would fail. This was the mind set when the Dow sold off to 6,500. Some of the government's activities are helping the credit markets improve. Some credit has begun to flow, and consumers have begun to spend on things other than ammunition. The economy sped up from 15mph to 50mph. Sensing that the doomsday scenario was off the table, the markets rallied to their current level.

What happens now? I believe that we do not get back to 80 mph soon. That level assumes that consumers have healthy balance sheets, and that the credit markets are back to normal, both banking and non-bank institutions. Before we get there, people have to pay down some debt. Before people pay down some debt, they might have to find a job. The securitization market remains broken. It will take time.

Companies have been cutting expenses to respond to lower revenues in an effort to remain profitable. Companies have different abilities to cut costs. Some have high fixed costs that cannot be cut, like debt payments. Some companies might not be profitable in a world that is traveling at 80 mph vs. 100 mph. These companies will go out of business. Some companies are dealing with a 50 mph world right now and may not make it. The auto companies fall into this category.

This will play out in the next several quarters. First quarter earnings estimates convinced investors that the doomsday scenario will not occur for every company. I believe the next few quarters will help highlight which companies will ultimately be profitable in an 80 mph world, and which companies might not make it until we get there.

Consumers, businesses and the government all have a role in the recovery. As I mentioned before, the government had a role in stepping in to help the credit markets heal and to spend some money to get the economy going faster than 15mph. From the perspective of an owner of assets, however, I am concerned with the involvement of government from this point forward. The current administration has let it be known through words and actions, that a shift of income from owners to labor and government is desired. While this may or may not be the right social

PETER B. HARRE, CFA
Principal

12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
OFFICE 314.576.1112 MOBILE 314.495.7100
peter@caubleharre.com

outcome, both the end result of the shift and the methods being employed to bring it about will damage the interests of owners and investors.

As a stockholder of a company, I have a right to the residual income of a corporation. If the tax burden of that company goes up, I will have less residual income, and all else equal, the value of my stock will fall. This is pretty straightforward.

As a creditor, the recent example of Chrysler and General Motors is instructive. The secured bondholders of Chrysler were offered a fraction of the company in the reorganization, while the unsecured creditors were offered far more. In my opinion, this tramples the property rights of the bond holders, and ignores established bankruptcy laws. But why is this important? The government sends a signal that the rules have 1) changed and 2) are now unpredictable. I believe that lenders will think twice about lending to firms that would subject them to such unpredictable outcomes.

The impact of higher taxes and more unpredictable rules related to property rights will work to dampen the pace of economic growth to the extent that they are pursued and/or enacted. This might keep the economy at a pace of 60mph rather than the new 'healthy' steady state of 80mph. Companies that are viable at a pace of 80 mph might not be viable at 60mph.

Finally, many people are wondering how we can escape high inflation rates given how much money the government has put into the system. The key will be the extent to which the government can pull this liquidity out of the system when the economy turns. Currently, this liquidity is in the form of bank reserves. Banks can lend out a multiple of the reserves they hold, so if you look at the historic levels of reserves held currently, a lot of lending could occur.

A deleverging economy tends to be deflationary, for a while. As capacity and inventories are reduced, new demand may outstrip supply quickly and lead to higher prices. The few new cars that have been sold in the last 12 months will help drive up or stabilize used car prices in 12 to 24 months. Demand will likely continue to increase for used cars at the same time the supply of 1 to 2 year old cars will shrink.

A reduction in the level of investment in extracting commodities coupled with renewed demand from both the developed and developing world could lead to higher prices. Shorter term, there have probably been some speculative pressures in these markets. These are some of the things I have been thinking about.

I am awaiting final performance figures for these accounts and benchmark returns. I will send out another letter discussing this material.

Please call with any questions you might have about your portfolios.

CAUBLE & HARRE WEALTH MANAGEMENT

PETER B. HARRE, CFA
Principal

12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
OFFICE 314.576.1112 MOBILE 314.495.7100
peter@caubleharre.com

Regards,

Peter. B. Harre, CFA

Enclosure