McCullough & Associates LLC
INVESTMENT COUNSEL

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Given recent market volatility and global economic events, we thought a year to date critique of our 2010 outlook was in order. In January we did not buy into the pervasive negative sentiment, rather we believed the market levels would steadily improve over the course of the year for two reasons.

First, those sectors of the US economy tied to global growth would recover from the recession, while anticipating industries like auto's and construction would not.

While Asian expansion remained on course serious concerns over the likes of Greece's fiscal problems cast doubt on our view, we feel it was blown out of proportion by media hype. Anxiety immediately spread to other problematic members of the ECU (Portugal, Italy, Ireland, and Spain) with the Eurodollar trading to nearly five year lows. So dire were prognostications that academics, including Martin Feldstein, thought the crisis could splinter the Euro. In fact the Euro was overvalued and its revaluation will help weaker ECU countries, as a competitive Euro grows GDP through tourism and exports. GDP growth and subsequent tax revenues, address fiscal deficits quicker and more effectively than budget reductions, restructured debt and pension programs.

Second, corporate earnings rebounded in the last quarter of 2009, not just through cost cutting, but through increased sales. We believed this increased demand would be a harbinger of a sustainable recovery. We are experiencing stronger corporate balance sheets and in many instances cash is at historical highs. Non-financial US corporations are holding $1.84 trillion in cash, or 7% of total assets which is the highest level on record since the Fed began tracking this relationship in 1952.

Ford is an excellent example of strong management. Avoiding bankruptcy and TARP money, they built cash reserves through earnings, paying down pension liabilities and $3.8 billion in debt (opening the door for a reinstatement of dividends). Ford has a confident outlook, spending cash to improve the balance sheets and strengthen operations in anticipation of solid future earnings.

Completely unexpected was "The Flash Crash" of May 6th. This unforeseen event left investors feeling alienated from Wall Street and in some instances questioning the investment process. After reasonable gains for the year a market correction was due, however the violent sell off and correction was the product of speculative trading creating the perfect storm. There is no one reason for this event; computer driven programs, flash trading, and dark pools all combined to produce a 1000 point decline.

Clearly sentiment has gotten too bearish, stock valuations are lower than warranted. Not since the bear market lows of early 2009 have we seen price to earnings multiples like today. As 2nd quarter results are announced, not only are earnings validated but forecasts point to better result through yearend.

Volatility and speculation in the "new normal" environment make the investment process much more difficult. It's important to remember that markets are not perfect in the short term and are only perfect over time. A long term perspective and conviction are more important in the investment process than ever. It's times like these that our clients acknowledge the benefits of our efforts.

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