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<b>TO</b>	<b>: CLIENTS AND FRIENDS</b>
<b>FROM</b>	<b>: RDM CAPITAL ASSOCIATES</b>
<b>RE</b>	<b>: MARKET COMMENTARY</b>

The S&P 500 was down approximately 0.4% in the second quarter 2011 and 1.8% in June 2011, yet recently predictions that the economy is entering a double-dip recession have littered the mainstream media. Similarly, during the second quarter of 2010, the S&P 500 lost 12.11% in market value and the mainstream media predicted that the economy was also headed for a double-dip recession. In both cases, the poor performance of the equity markets was reflective of a temporary mid-cycle correction in an economic expansion. For example, in the second half of 2010, the S&P 500 recovered and gained 20.88% over that span. We expect the equity markets to rebound in the second half of 2011 as well.

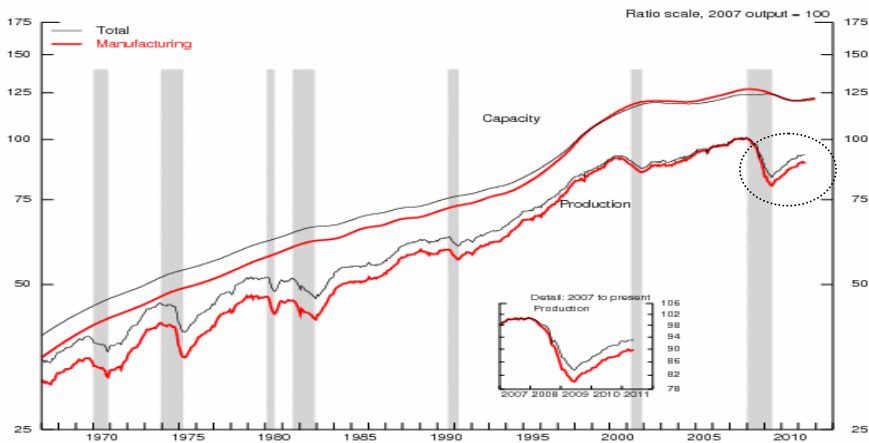
Negative economic reports began surfacing in the first quarter. The global economy suffered two significant shocks then, kicking off the current period of market volatility. The first was the political rebellion in Libya, which contributed to a run up of oil prices. The second was the Japanese earthquake and subsequent tsunami and nuclear crisis, which caused significant supply chain disruptions for many American and global manufacturers with Japanese operations. Combined with ongoing fears of the Greek debt crisis, the equity markets have lately been roiled by a number of international concerns. Furthermore, renewed concerns about the pace of the economic recovery based on recently published data have only exacerbated the volatility. In this market commentary, we will explain why these concerns are mostly near-term concerns and why our clients should focus on the attractive long-term equity market opportunities prevalent in the current environment.

### ***MOST ECONOMIC DATA POINTS TO MID-CYCLE CORRECTION***

The economy and the equity markets rarely experience a straight up or down path to recovery or recession. For example, for the year 2010, industrial production rapidly increased by 5.3%. Industrial production has only reached these levels on an annual basis twice since 1989. Over the previous ten years, production has on average increased closer to an annualized 2 - 3% rate. The chart below (*Figure 1*) reflects this recent growth and illustrates how this phenomenon is consistent with previous recoveries after prolonged economic downturns:



1. Industrial production, capacity, and utilization



**Figure 1** Source: Federal Reserve. Shaded areas reflect periods of business recession.

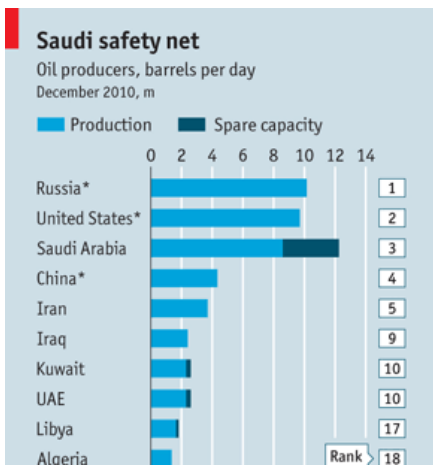
Based on historical data, industrial production generally slowly recovers to the pre-recessionary production levels over approximately five years following a recessionary period. Therefore, the 5.3% increase in industrial production experienced during

2010 was not sustainable in the long run, and recently slower growth in production is balancing out the very rapid growth experienced in 2010 to bring growth rates closer to historical norms over the next two to three years. This phenomenon is supported by other economic data points: for example, sales of existing homes rose 27.3% from August 2010 to January 2011, consumer spending rose at a 5.4% annual rate, manufacturer’s new orders rose at a 16% annual rate and exports rose at a 28% annual rate. These numbers were the product of a faster recovery from the recession than was sustainable over the long run, and we experienced a correction in the second quarter to bring economic growth back to a more modest pace than what was experienced in 2010. Without a significant improvement in the number of unemployed workers and a corresponding improvement in the housing sector, growth will likely follow this more modest trajectory for the foreseeable future.

**THE MIDDLE EAST AND RISING OIL PRICES**

Much attention has been paid lately to the rise in consumer prices for oil and other commodities. A major stimulus for this phenomenon with respect to oil is the ongoing civil war in Libya and its subsequent decrease in oil output. However, even though the loss of

Libyan oil production is significant, Libya is only the 17<sup>th</sup> largest oil producing nation in the world at 1.5 to 2 million barrels of oil per day and is the ninth largest OPEC member nation (out of twelve) in terms of oil production, only producing more oil than Algeria, Qatar and Ecuador historically (*Figure 2*).



**Figure 2** Source: The Economist; US Energy Information Administration. \*Non-OPEC Country



The recent rise in oil prices has had little to do with actual Libyan supply disruptions. In fact, oil prices rose over \$115 per barrel earlier this year before any announcement had been made by firms operating in Libya that production would be halted. Rather, much of Libya's contribution to the rise in oil prices has been due to speculative interest, mostly based on the possibility of the "Arab Spring" uprisings spreading to more significant oil producing nations. Undoubtedly, investors rushing to commodities as a hedge against inflation, and speculative traders capitalizing on their momentum, have also contributed greatly to the rise in prices. Nevertheless, there is no indication yet that the worst case scenario is playing out in the Middle East – namely, that unrest will spill over to Saudi Arabia and interrupt Saudi oil supply. If that happens, a truly meaningful oil supply crisis will take place. In the meantime, other oil producing nations will compensate for lost Libyan production. For example, the International Energy Agency announced on June 23<sup>rd</sup> that it will release 2 million barrels of oil per day for 30 days and the U.S. similarly announced that it would release 30 million barrels of oil from the Strategic Petroleum Reserve. As a result of these moves, oil prices have suddenly dropped to their lowest levels in months.

### ***GOLD'S INFLATED EXPECTATIONS***

All that glitters is not always gold and you can't use it to buy a stairway to heaven! It is our belief that gold is currently in a mother of all bubbles phase and our warning continues "Caveat Emptor"! It is important, therefore, to understand the causes of the significant move gold has had over the course of the past decade or so from about \$300 an ounce to over \$1500. We believe there are a number of reasons for such a surge in gold prices:

1. Gold has historically been a beneficiary of excessive money creation/inflation and government debt. As our deficits and national debt ballooned in the past few years, investors all over the world have sought the apparent safety of gold and silver, even though during the 1980's and 90's gold prices retreated by 20% while inflation doubled.
2. As a commodity gold is unique. Unlike other commodities such as grains, oil, copper, industrial materials, etc. which are consumed and must be replaced, very little gold is actually used during the year, except for jewelry. Annual production is less than 2% of the world's gold supply and, because of its scarcity, it is often considered an alternative currency by laymen and financial professionals alike.
3. The proliferation and consequent popularity and demand of gold backed ETFs has given retail investors, particularly from India and China, a cheaper and more convenient way to invest in gold, without the need to store and insure the bullion and/or jewelry.
4. In the past few years central banks have switched from being net sellers to being net buyers of bullion, thereby benefiting the rise in prices. Central banks currently possess over 30,000 tons of gold or the equivalent of ~ 15 years annual supply. Should these central banks decide to return to their historical role of suppliers of gold to the market, for political, social, or any other policy reasons, one can easily imagine a price collapse of major magnitude.



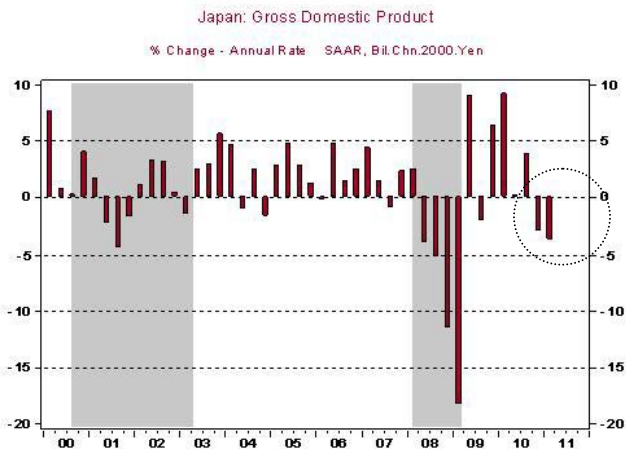
- Recent de-hedging activity by gold miners has begun to reduce the demand of gold in the open market for future contract delivery and eliminated one major source of upward price pressure for the bullion.

We believe that over the course of the next few months some these tail winds enumerated above will turn to head winds and the price will collapse.

***ECONOMIC IMPACT OF THE JAPAN FUKUSHIMA EARTHQUAKE***

We expect the Japanese economy to recover strongly from the severe economic consequences of the massive Fukushima earthquake on March 11<sup>th</sup>. In one month, Japanese industrial production dropped 15.3% to an annualized 86% rate of decline. In the first quarter, Japanese GDP dropped 3.7% - almost entirely attributable to the last twenty days of the quarter and the after-effects of the Fukushima earthquake (*Figure 3*). A similar or worse

result is expected for the second quarter as the full impact of the earthquake on the Japanese economy is absorbed.



*Figure 3* Source: Northern Trust; Cabinet Office/ Haver Analytics.

automobile production dropped 6.5% in April 2011 and 1.5% in May 2011, whereas total U.S. industrial production was relatively flat over those months. We agree with many economists that predict that Japan’s economy may have already bottomed. As the Japanese economic situation improves and manufacturing supply chains normalize, the U.S. automobile industry will feel the positive effects.

***THE EURO-ZONE AND GREEK DEBT***

One of the biggest areas of concern in the marketplace during the second quarter has been Greece. Greece is currently suffering from a tremendous amount of sovereign debt that was allowed to accumulate during the years preceding the latest recession. We believe that Greece (and several other Euro-zone nations) will need a combination of the three main tools that exist to combat this problem: austerity, restructuring of debt, and international financial aid. The biggest hurdle for Greece is not identifying these tools – they have already done so. Rather, the biggest hurdle is navigating the complex political and economic maze created by



the diverse interests of the member nations of the European Union within the constraints of a unified currency in the euro. We believe that the IMF and Euro-zone nations are moving in the right direction on all three tools to alleviate Greece's crushing debt burden, however the success or failure of these tools will take years to be determined.

### ***S&P 500 COMPANIES TRADING AT ATTRACTIVE VALUATIONS***

The recent correction has presented some great opportunities for investors in equities. As of the end of the second quarter, the S&P 500 traded around 14.5 times the past year's earnings. Historic data since 1991 tells us that the S&P 500 typically trades at approximately 20.5 times past year's earnings, implying that the equity market today is trading at about a 30% discount to historic averages. S&P 500 companies are expected to earn 18% more in 2011 than they did in 2010, according to a Bloomberg poll of more than 9,000 analysts. Despite these strong earnings expectations, the S&P 500 fell in the second quarter over 3% since April 29th (*Figure 4*).



*Figure 4* Source: Big Charts.com

This recent drop needs to be viewed within a historical context. Currently, the market has essentially priced in zero growth in S&P 500 companies, causing the lowest valuations in over twenty-five years. Further, the S&P 500 has seen temporary corrections of over 5% several times

during each of the various bull markets of the past fifty years and the current rally is no exception. Based on this historical perspective, we believe these periods of correction should be viewed as opportunities for investors to capitalize on momentarily cheap valuations during an extended bull market.

### ***SUMMARY AND PORTFOLIO IMPLICATIONS***

We believe the economy is experiencing a temporary midcycle slowdown during an otherwise sustainable economic expansion and that current economic and equity market concerns are far overblown by some commentators. The U.S. economy is recovering from one of the deepest and darkest recessions in American history. As the economy grows, it will experience temporary periods of correction following periods when the recovery moves too fast, which in turn will lead to volatility in the equity markets. Why has this correction occurred this time? Essentially, several major geo-political events along with uninspiring economic data have caused many short-term investors and speculative traders to become uneasy with the potential for future growth. For the reasons outlined above, we believe that long-term investors would do well to ignore the dire predictions of these pundits and instead



focus on the underlying fundamentals of the equity market and historic economic growth trends, which are the true indicators of long-term growth.

While commodities and fixed income securities continue to grab headlines, large cap stocks look particularly cheap relative to other asset and equity classes, given the recent pullback in the market and large cash balances persisting on corporate balance sheets. Within this market segment, we continue to favor energy, financials and health care, with selected investments in the technology and industrial sectors.

We would not recommend most fixed income investment strategies at the moment, as this market segment has remained greatly overvalued since the recession of 2008-09. As we have discussed at length in our recent market commentaries, we believe that the bond bull market of the past thirty-plus years is nearing an end. Yet another example of this phenomenon is the recent push of the yield on the ten-year treasury below 3%, which implies that investors are willing today to accept an inflation-adjusted loss on their investments when factoring in consensus inflation expectations over that time frame. Therefore, we would recommend only selected investments in short-maturity fixed income securities where absolutely necessary. For those investors seeking yield, we would recommend several top quality large-cap equities paying dividends of ~ 3% with significant potential for capital appreciation as well.

A summary and a forecast:

- 1) Equities will outperform fixed income securities this year and for the next decade
- 2) We will emphasize equities with healthy current dividend yields
- 3) We will emphasize large cap equities, both value and growth
- 4) Equities are cheap relative to other asset classes at this stage of the business cycle
- 5) We will favor energy, financials, health care and industrial sector investments
- 6) Inflation will remain subdued at ~ 1.5% at year end 2011
- 7) Interest rates will begin a slow but steady rise by year end with Fed Funds at ~1%
- 8) Gold and silver will crash and oil will trade at \$75 to \$80 a barrel at year end
- 9) DJIA will end at 13,442 and the S&P 500 will finish at 1,441
- 10) GDP will grow at 3.25% by year end

As always, all comments are welcome.

Sincerely,

**RDM CAPITAL ASSOCIATES**  
WEALTH MANAGEMENT

- *Matthew LaRocca, Vice President*