

The police sergeant on the TV show “Hill Street Blues” sent his men into the streets with the warning, “Let’s be careful out there”. That would echo our current sentiments about financial markets. There will always be risk factors to consider when making investment decisions, but the current political and economic situation presents downside possibilities well beyond the norm. Only the belief that global central banks will continue to provide liquidity and stimulus at signs of danger prevent us from being more bearish.

Consider the European Union; one country (Greece) can’t borrow money – another (Spain) must pay over 6% - and a third (Germany) can sell large amounts of debt today with a zero coupon. The word “Union” seems a stretch. Greece goes back to the polls June 17th with the likelihood a government that refuses the current bailout package will come to power. After 5 years of recession, with 20%+ unemployment (50%+ for the 18-25 age group), it is not surprising citizens would vote against further forced austerity. It also makes sense that Greeks are taking their euros out of the banks before they might become devalued drachmas, which only make matters worse for that country.

We believe (and hope) a compromise can be found; the alternative being very unpleasant. Germans have not forgotten the inflation in their own country during the 1920’s. The largest German newspaper recently printed a picture of a one trillion mark note from 1923 that was needed to buy groceries. Nevertheless, if Germany accepts a little more inflation and the European leaders ease the austerity program somewhat with a “growth package” attached, Greece can remain in the Union.

The other weak European economies will of course expect the same leniency that Greece receives. Spain’s economy is twice the size of Portugal, Ireland and Greece combined, and therefore twice the problem. This is how it has worked in Spain so far. Real estate values collapsed and Spanish banks’ balance sheets took the hit. In order to borrow, the banks needed the guarantee of the Spanish Government. With those borrowings, the banks bought Government debt and the circle was complete, but obviously flawed. Now that Spain is paying in excess of 6% in the market, that circle could be broken.

In our last letter we mentioned the presidential elections in Egypt. They are currently underway, with a runoff expected oddly enough June 17th, the same day as Greece. The outcome will have a major impact on the balance of power in the Middle East.

U.S. elections will take place in November. The divide between Republicans and Democrats has widened and deepened. Any progress on budget issues seems very unlikely before the election. Unfortunately, there is much to be dealt with before 2013. As a reminder, last July Congress couldn’t agree on budget matters during the debate about raising the debt ceiling. A “Super Committee” was formed, but by November there was still no agreement. In order to prevent a further downgrade of treasury debt, a “sequester” was passed in Congress that would force spending cuts to January 1, 2013. Coupled with expiring tax cuts on the same day, the effect is estimated to lower GDP by around 5% if no new legislation is passed. Fed Chairman Bernanke has named it the “fiscal cliff”. It will be brinkmanship at the eleventh hour to come to a compromise, with the outcome dependent on which party wins the election. In the meantime, both corporations and investors will be flying blind as to what rules and regulations will be in effect next year. As an example, the tax rate on dividends is currently 15%, without new legislation it will be 43.4% in 2013. The rating agencies are watching closely, and just to add to the problems the debt ceiling will have to be raised again in the first half of next year.

Thus, the U.S. economy is growing slowly, but with a wall of uncertainty entering 2013. Europe, which makes up 20% of the world’s economy, is in a recession with the exception of Germany. China and most other emerging economies are growing more slowly.

Of course, all of these negatives serve to make the central banks of the U.S., Europe, China, etc. likely to offer more stimulus to prevent a severe downturn. Each successive liquidity injection seems to provide a weaker impetus to

economic growth, but should make for an opportunity to purchase risk assets such as stocks and commodities. Even then, be very careful out there.

Based on our uncertain view of the global economy and the potential political overhang, we've become more defensively positioned within the majority of our funds with an increased percentage of call writing, combined with the purchase of protective puts in early May to provide some downside protection.