



“To World Peace...”

John Gustafson – 6 July 2011

Many of you who have known me over the years, and perhaps raised a glass or two containing a tasty adult beverage, know the title of this piece to be my standard toast – lifted directly from the great movie, “Groundhog Day.” The first time Andie MacDowell (“Rita”) meets the horribly self-centered character played by Bill Murray (“Phil”), he clumsily asks her, “What shall we drink to?” and she haughtily answers, “I always drink to world peace.” From that moment forward he woos her with that very line as each day magically repeats... Well, we weren’t wooing any beauties at the pub in the quarter just passed, but it was eerily similar to a year prior – as outlined in my note mid-May. Same people, same problems, similar results – they should take a lesson from the movie and learn from their prior mistakes.

Also, I state only similar results, because although the emotional energy of the quarter at times was just as negative as last year, with corresponding negative volatility, but this year the market lost < 1% for the quarter, whereas last year the S&P 500 was down almost 12% in the same period.

Our themes remain similar as well: a (very) muted global recovery with short term (month-to-month) ups and downs, terrible U.S. residential housing market, extremely low interest rates (more because banks refuse to lend, rather than lack of demand), “Old” Europe in rolling economic distress and every other reason in the world to NOT invest your money – the “wall of worry.” However, you know my feeling that going against the herd is generally the correct position – as long as you are not blind to the outlier symptoms that truly can cause havoc in the long term with little hedging ability.

Of course, those outlier risks also continue to dwell in the same neighborhood as before – in my opinion – and that is in the realm of the toxic political environment right here at home. Which is why my choice of title for this report narrowly won out over another pop-culture favorite, “Fear and Loathing in” the US - because my political fears outlined in May are also coming closer and closer to fruition.

The GOP seems to continue to focus like a laser on removing President Obama by employing the strategy of continuing to talk down any recovery, discussing doomsday scenarios as likely and directly acting in ways contrary to what is necessary to continue our climb out of the smoking economic hole of 2008. As stated before, I think this is disaster – for both the country and the Republicans. Yes, “it’s the economy, stupid,” once again as Mr. Carville famously stated, but if things remain weak – and more importantly negative psychology (“the malaise” discussed last summer) - takes hold of our citizenry once again, I think all incumbents are in danger. This will serve to completely scuttle the majority the GOP holds in the House and waste any chance they have of taking the Senate.

As you know, I have my interests politically, but I write these reports to give perspective to what I believe would be best for our portfolios. As my good friends at JP Morgan have shared in a past chart, the BEST scenario for our country – both in general economic terms as well as pure investments - is a Democratic President with a Republican Congress. Of course I realize we need to spend less, stop our wasteful wars, stop

funding everyone else's country with money we don't have and with little to no appreciation from the recipients, etc., etc. However, none of that is ever actually accomplished unless the political crazies are marginalized on each extreme. Both are useful as a foil to the other side's message, but their actual policies are too narrow and extreme to be effective and beneficial in country our size. (Unfortunately as any politician will affirm – moderates don't write checks)

The foolishness of Americans as it relates to finances and the culture of growing self-centered lack of understanding continues as well. There was a poll released the other day stating that an almost two-thirds majority thought it was preferable for the US to DEFAULT, rather than raise the debt ceiling with no further action. The marketing major in me recognizes how poorly the question was worded with nothing but a Hobson's choice – the correct answer would be of course to cut spending, trim future budgets and add a trigger to lower the debt ceiling again once the budgetary constraints kick in and our fiscal house swings back into balance – but the respondents choose worst possible outcome of any for the long term health and viability of our economy, not to mention the absolute destruction of our credibility as a global leader.

This to me outlines another emerging cultural trend that is equally as troubling as one experienced in the 1990's... Back then, there was a noticeable shift away from personal responsibility; everyone thought they "deserved" to be rich, that investing was easy and if they actually lost money, it was clearly someone's "fault" and they should be compensated. (See the continued wild growth of class action lawsuits & plaintiff's attorneys as blight on all business and innovation.) The current trend I guess is an offshoot of that mentality – there is no stigma attached to renegeing on your financial obligations, either via a "walk-away" from a home / mortgage, a credit card or whatever the case may be. There appears to be no cultural shame in not fulfilling an agreement – even those knowingly and freely undertaken - and that is troubling for our country's culture in general, not to mention the consequences in the investment world. You think complex mortgage bonds, a few big banks or a little country like Greece can cause trouble when people lack confidence in their willingness and ability to pay? Childs play...

Of course, our political "leaders" have been brilliant as always in setting up a fall guy for their lack of ability to properly understand the issues or take appropriate actions that they feel have no obvious role in their reelection. That fall guy is currently Ben Bernanke.

I will by no stretch of the imagination say that I agree with everything the Chairman says or does, but I do believe that his grasp of the problem is far superior to those of his political bosses in Congress. And the fact that extremists like Ron Paul somehow think that having Congress oversee (and politicize) our central bank could lead to anything but disaster is laughable. Whenever things in rest of the world get crazy, money still flocks to U.S. Treasury Bonds – do you really think that is because there is confidence in the great stewardship of Congress?

I read the other day a pretty well thought out report that Ben Bernanke has almost the direct opposite problem as highly revered Paul Volker faced in the late 1970's to early 1980's – potential economic deflation now versus inflation then. And with the Fed's one tool in his toolbox – monetary policy - he has kept things moving away from disaster, even with the political clowns trying to trip him up at every turn and deflect blame from their own gross mismanagement. In effect, if Volker is Fred Astaire, then Bernanke is Ginger Rogers – doing everything Paul had to do (with the full support of Congress), "backwards, and in high heels" – to quote Bob Thaves.

The GOP's ham-fisted approach in trying to blame everything on the other side is as clumsy, uncoordinated and unbelievable as the Democrats trying the same tact as they (Obama included) continually exclaim that "we inherited..." – nobody cares or believes you, fix it! A key flaw in Team Elephant's blame strategy is that they continually forget the effectiveness of the bully-pulpit the office of the President commands. President Obama is at the Conn and delivered a very well-reasoned explanation of his positions at a press conference last week that made him look like a moderate, and the GOP to be a bunch of anti-American crazies. Whether what he says is completely accurate or not, the reality is that he is in a better position to sway public opinion to his side. Apparently Bubba Clinton's coaching sessions are starting to bear fruit.

Perhaps this is because I'm an unreasonable whacko, but it seems to me that what would make the most sense would be for the GOP to use their House majority to pass their package, twist some Senate Democrat arms (remember, there are 23 up for reelection next year!) to pass the same deal and make the President use his veto. They will NEVER win the game of "negotiating" in private and then trying to spin their version to the media. Nobody pays that much attention and the President can always own the message if nobody really knows what is said behind closed doors. He can't hide or spin much if he gets the veto pen out... And again, please realize, I didn't vote for President Obama, but I don't care (from an investment advisory standpoint) if he gets another term, as long as the other team captures the Senate, maintains the House majority and brings BALANCE. As we know, the thinking that got us here (one party, "earmarking" rule in a two party system for 10 years) is not the thinking that will get us out of here.

Again, sorry to slide off the investment road into the pig-sty of politics once again, but this is what is going to drive the short term emotions of our markets, likely through the elections next year - and potentially cause real problems for the much longer term if the "grown-ups" don't take charge soon. Most of you know how much I love quotes, and the best I can find to describe the current issues we face and the ineffective maneuvering by our politicians is from Friedrich Nietzsche, "To predict the behavior of ordinary people in advance, you only have to assume that they will always try to escape a disagreeable situation with the smallest possible expenditure of intelligence." If anyone has something better to describe politics in America, please send it along so I may add it to my collection.

In summary, I feel that we will continue to grind up and over the wall of worry as we have for a couple of years in a longer term trend – things do continue to improve and the general complaint is that it's not fast enough and/or doesn't look like other recoveries. However, as I've painfully outlined in great detail in this piece, we will continue to be bombarded with emotion caused by political ramblings and mismanagement.

I'll make the assumption that just as with the current NFL lockout, the Congress is not actually stupid enough to allow a default and that they will pass whatever compromise is hammered out over the next few weeks on the first try. If they don't, please remember the initial failed TARP vote back in 2008 and don't be surprised by that kind of extreme, short term volatility. Our global model so far has been quite good at moderating volatility of that nature, but we will of course continue our pattern of strategic tweaking to maximize our risk-adjusted performance whenever possible.

As always, I thank you for your business and I welcome any questions or further discussion.

A handwritten signature in black ink, appearing to read "John M. Gustaf". The signature is fluid and cursive, with a large initial "J" and "G".