

In the US we have a negative feedback loop among consumption, deleveraging and unemployment that's slowing the pace of recovery. Until we break this cycle with better news on the employment front, we should expect cooler weather ahead.

Market Overview: Shifting Animal Spirits

It's hard to believe that only three months ago we were writing about investor sentiment getting overly ebullient. You'll recall that at the time (mid-April) the market had risen almost 80% over the prior 13 months. We said then that investors' enthusiasm should be taken as a warning. Little did we know.

No sooner was the ink dry on that missive than stocks began to sink. Over the course of the quarter the S&P 500 lost 11.4%, leaving the benchmark index down 6.7% for the first half of 2010. Precipitating the decline were debt problems in Europe, particularly in Greece, and fears that those problems would spread to other developed countries like the US and the UK.

Given the phenomenal run stocks had enjoyed, a pullback was long overdue. The problems in Greece, abetted by images of rioting Athenians protesting budget cuts, gave investors a handy excuse to sell. And sell they did, in fairly large volume, along the way trading their recent ebullience for the harder coin of fear.

By market's close on July 2nd the S&P was down 16% from its April 23 peak. Such a decline is a bit more than your typical "correction," but not yet deep enough to qualify as an official bear market (= down 20% or more). So, the question of the hour is now: Which is it? A normal correction or something more serious?

Economic Overview: *Après le Deluge*

As we noted last quarter, the key issue confronting investors in 2010 is how global economies will fare once the tidal wave of government stimulus begins to ebb.

In the US, the high tide of stimulative effects likely came last quarter. As that wave recedes, the earliest signs suggest (not surprisingly) a slowing in the pace of recovery.

In late June we found out that 1st quarter US GDP growth was 2.7% rather than the initially reported 3.2%. More troubling was the discovery that inventory rebuilding accounted for more of GDP than previously thought. Correlatively, final sales—people buying stuff—accounted for less, a mere 0.8%.

While this sounds arcane, it actually gets to the heart of the matter. After a recession inventories of goods to be sold are typically very low. As demand recovers there's an initial catch-up phase where manufacturing revs to rebuild inventories. This is what we saw in last year's 4th quarter where US GDP rose nearly 6%.

The problem is that this initial revving phase is temporary. As inventories reach normal levels rebuilding tapers off and the overall pace of economic growth converges on final sales. The anemic final sales number for the US tells us people just aren't buying much stuff. And that most likely spells tepid growth ahead for the US economy.

Not Your Father's Recovery

As we've noted previously, recovery in the US will be hampered by consumer "deleveraging." That is, the recovery will be less vigorous because a portion of any increased income to consumers will have to be used to pay down debt. It can't all just be spent buying stuff as in past recoveries.

continues on reverse

Major Market Performance 2010

	2nd Quarter 2010% chg.	1st Half 2010 % chg.
DJIA	-9.36	-5.00
S&P 500 (large cap)	-11.43	-6.65
S&P 1000 (small/mid cap)	-9.32	-1.21
S&P 1500 (all cap)	-11.18	-6.03
NASDAQ	-12.04	-7.05
Barclays State G.O. Municipal Bonds	2.31	3.52
Barclays Gov/Credit Intermediate Bonds	2.97	4.56

Not Your Father's Recovery (cont.)

While consumers paying down excessive debt is a good thing—too much debt is what got us into this mess—it doesn't add to overall economic activity and so doesn't create jobs, increase incomes, etc. That's what makes this recession and recovery different.

Ultimately, growth in an economy boils down to three variables: population growth, productivity growth and leverage effects. The US has solid population growth and strong productivity growth. For the past 15 years or so it has also had powerfully additive leverage effects—i.e., spending has been turbo-charged by consumers taking on more and more debt. That trend peaked with the sub-prime/housing crisis and is now reversing.

While the US should enjoy continued good population growth and strong productivity growth, our leverage effects are now subtractive, not additive. Where our economy had a tailwind of increased borrowing and spending for many years, it now has to fight a headwind of consumers borrowing less, spending less and paying down debt.

This is what we're seeing in the final sales numbers. It's what we're seeing in the rising US savings rate (paying down debt is effectively saving). And indirectly but importantly, it's what we're seeing in a "sticky" US unemployment rate that remains stubbornly and painfully high.

Without stronger final sales to drive a durably stronger economy, employers aren't going to hire as aggressively as they normally would coming out of such a deep recession. But without improvement in employment, it's hard to get much improvement in final sales given the headwind of deleveraging.

So what we have in the US is a negative feedback loop among consumption, deleveraging and unemployment that's slowing the pace of recovery. Until we break this cycle with better news on the employment front, we should expect cooler weather ahead.

Goldilocks: The World Tour

That said, we still expect continued recovery in the US, albeit at a somewhat sluggish pace. We do not see a "double dip" return to recession in the cards. In Europe, however, lower levels of productivity and population growth combined with more severe debt problems (both private and sovereign) may well push these economies back into recession.

In the emerging economies of China, India *et al* where productivity is rising sharply and debt levels are low, the pace of economic growth will nonetheless ease as well. Here, deceleration is by design. These countries have been showing signs of overheating (= inflation) and their governments have taken action to cool them down, e.g., by raising interest rates.

So despite the different economic dynamics at work around the globe, wherever you put your finger economic growth is slowing. That, as we've been saying all year, is cause for caution. Whenever the pace of economic activity peaks, equity returns get wobbly as investors wonder what the future holds. That's what we experienced in the second quarter, and what we anticipated in our comments three months ago.

What We're Doing

Despite investors' enthusiasm for stocks earlier in the year, we have been gradually lowering equity and raising fixed-income exposure since January for accounts where we have such discretion. Consistent with this defensive asset allocation move, we've also been steadily shifting our sector emphasis away from cyclical shares like technology and energy and toward more stable areas such as staples, healthcare and utilities.

If you liken portfolios to sailing ships, we'd say that during the first half of 2010 we've been taking in sail (stocks) and putting more ballast (bonds) in the hold. The point has been to make portfolios more steady and returns more predictable. This more defensive posture does not so much reflect pessimism as agnosticism.

We don't know whether the current economic deceleration is a temporary "soft patch" or something more troubling. Nor does anyone else. If hiring in the US begins to pick up, so will final sales, and a positive feedback loop will replace the current negative one. Should that occur, stocks would move higher, even sharply so.

For now, however, visibility on this key issue is poor. When driving, you slow down when entering a patch of fog. So it is with portfolio strategy. At such times caution takes precedence over speed.

Farnum Brown
Chief Investment Strategist

Shareholder Advocacy Highlights

In response to the **BP disaster**, Trillium joined a broad group of investors and environmental groups in sending letters to 50 oil and gas companies with offshore drilling operations and reinsurance companies with offshore oil and gas underwriting exposure. The letters request information from the companies on how they are managing the risks posed by offshore operations and what steps they are taking in light of the industry-wide weaknesses exposed by the BP catastrophe. We anticipate a wave of new shareholder proposals at companies that cannot demonstrate strong policies and programs to hedge the risks posed by offshore drilling.

A disturbing cluster of suicides at the Foxconn factory in Shenzhen, China, which manufactures iPhones and other consumer electronics, has renewed attention to **working conditions in China**. We are working with our colleagues in the ESG community to press Apple, HP and Dell to address issues like excessive overtime, misuse of toxic chemicals, and migrant labor in their supply chains. These companies have taken positive steps in the past, but now is the time to address the systemic issues at the root of the problem.

By all accounts **water availability** (droughts and floods) is going to be the primary way in which climate change will be felt. As such we are particularly interested in how companies will reduce their water footprint in areas where they operate and buy materials. The food industry, in particular, needs to ask these questions because approximately 70% to 80% of fresh water use goes to agriculture. As such, we are working hard to ensure that companies like General Mills, Sysco, and Smucker minimize the negative impacts they have on watersheds and reduce their exposure to water supply risks.

The long running resolution and dialogue with Home Depot asking for disclosure of the makeup of their workforce by gender, race and employment rank – known as **EEO disclosure** – continued into its thirteenth year. This year, our disclosure resolution, filed with a dozen additional investors, garnered 27% of the vote (a 22% increase from 2009.) Management finally acknowledged in a recent conference call that they do not have formal data on the effectiveness of their diversity programs, but indicated a willingness to consider some options for tracking and disclosing diversity performance. We are cautiously optimistic Home Depot will improve transparency and shed its reputation as a laggard relative to large brands such as Coke, Intel and Walmart, who report diversity data over multiple years.

Our resolution at Gardner Denver, the industrial machinery manufacturer, calling for a more **inclusive equal employment policy**, received a near-majority 49.11% vote in favor from fellow shareholders. It called on the company to add the phrases ‘sexual orientation’ and ‘gender identity or expression’ to its nondiscrimination policy. Shockingly, it’s still legal in 29 states to fire employees for being gay. Gardner Denver didn’t like it when one of our analysts asked – politely – at an analysts luncheon how the company would be responding to the near-majority vote, and told the event organizer we shouldn’t be invited to future gatherings. This prompted us to wonder whether Gardner has an unwritten “don’t ask, don’t tell, don’t even inquire” policy.