

Market Outlook Letter

July 20, 2011

INVESTMENT COMMENTARY & OUTLOOK

Our growth stocks are now in the midst of the second-quarter earnings announcement season, and everything is unfolding as we hoped. We have already had many technology stocks announce stunning quarterly earnings, and now cyclical stocks are surging. We are entering into an increasingly selective earnings environment where we expect the overall stock market will be less sector-oriented and chase fewer stocks. This is because overall earnings momentum is decelerating due to more difficult year-over-year earnings comparisons.

The analyst community was very cautious leading to the current quarter earnings announcement season, and the overall stock market was characterized by more downward than positive earnings revisions. Even though the analyst community was extraordinarily cautious, estimating S&P 500 earnings would rise only 13.9%, so far there have been many big earnings surprises. It appears the analyst community had been far too cautious. Naturally, our average growth stock is expected to post much stronger earnings growth, in excess of 50%, based on analyst consensus estimates. Since last quarter, our average earnings surprise was over 8%, and we expect that even in our most conservative growth portfolios, we will likely exceed 40% annual earnings growth when the second-quarter earnings announcement season is over. The following table illustrates the projected growth for our leading growth portfolios:

	Average Next Quarter Sales Estimate	Average Next Quarter Earnings Estimate	Average Last Quarter Earnings Surprise
Fundamental 'A'	36.21%	46.15%	41.29%
Large Cap Growth	26.40%	29.65%	7.97%
Mid Cap Growth	19.31%	47.55%	13.89%
Small-to-Mid Growth	45.10%	37.68%	9.01%

Source: Factset

Since both the overall stock market and our growth portfolios are not surging as much as their underlying earnings, the S&P 500 is now trading at 13.1 times median forecasted earnings. This low price-to-earnings ratio environment, combined with strong earnings growth, has caused Corporate America to boost their corporate bond offerings from \$20 billion per week to \$60 billion per week in recent months. In other words, Corporate America has gone from raising approximately \$1 trillion per year (i.e., \$20 billion per week) to pushing up to \$3 trillion per year (i.e., \$60 billion per week) in new low-yielding bond debt. Much of the money being raised has been put to use through companies aggressively buying back stock, which in turn helps boost companies' underlying earnings per share.

We hope this helps explain why the stock market rallied dramatically in late June and early July for several days on virtually no news. The fact that we are now in the midst of another stunning earnings announcement season is just more icing on the cake.

Investment in equity securities involves substantial risk and has the potential for partial or complete loss of funds invested.

The tremendous surge in corporate bond offerings and the healthy corporate bond environment lead us to comment on the impending August 2nd deadline when the federal government's deficit ceiling must be raised. Frankly, we suspect a deficit ceiling deal will get done, even if it is a Band-Aid deal, since members of Congress do not want to miss their August recess. Worst case, even if there is a federal government shutdown, most economists and Fed watchers expect the interest will be paid on Treasury securities, so there should be no technical default. Additionally, many members of Congress believe the August Social Security checks will still go out since there is plenty of funding for current payments.

We continue to believe the stock market will rally in the event of a short-term federal government shutdown, but all bets are off if there is a long-term federal government shutdown. Complicating matters, both Moody's and Standard & Poor's threatened to lower the country's AAA credit rating due to the small, but rising risk that the U.S. government will default on its interest payments. Specifically, S&P placed U.S. sovereign credit ratings on watch for possible downgrade saying the action "signals our view that, owing to the dynamics of the political debate on the debt ceiling, there is at least a one-in-two likelihood (50% chance) that we could lower the long-term rating on the U.S. within the next 90 days." Interestingly, S&P added, "the political debate about the U.S.' fiscal stance and the related issue of the U.S. government debt ceiling has, in our view, only become more entangled." Overall, rating agencies seem as frustrated as politicians and Treasury Secretary Geithner, who seems beside himself in almost every interview on the federal debt ceiling negotiations.

Speaking of these negotiations, President Obama now says 80% of Americans are in favor of higher taxes (despite last November's historic elections in State Houses and Congress), which is indicative of deficit negotiations now becoming desperate, since both sides are trying to take their respective cases to the American people. The GOP Congressional opposition continues to mock President Obama for not having any plan and has released its own "cut, cap and balance" plan. To his credit, President Obama has urged House and Senate leaders to present their "final offers," so clearly some deal may be in the works. Wall Street seems to be secretly rooting for a spending cap or a short-term government shutdown, since if the federal government is capped or constrained, it will help unleash the private sector and ultimately help boost the stock market long-term.

When all the dust settles about this contentious battle between the White House and Congress, we suspect corporate bonds will emerge as the oasis. All we care about in the end is that investors finally and definitively realize the private sector is safer than the government sector. Any concerns regarding Treasury securities should boost even more money flowing into corporate bonds and drive their yields lower. Since corporate bond rallies and a healthy bond market tend to precede stock rallies, the more corporate bonds become an oasis amidst the government chaos, the better for the stock market for the next several months. In addition, a healthy corporate bond market promotes more stock buy-backs, so we have a lot to celebrate and look forward to in the upcoming months.

In relation to the private sector, the global economy is not slowing down much. China's official GDP growth slowed to a 9.5% annual pace in the second quarter, down slightly from a 9.7% annual pace in the first quarter. This is like slowing down from 160 miles per hour to 157 miles per hour, so clearly fears that China may be slowing are grossly overblown. Interestingly, based on economic output, China's GDP was actually stronger in the second quarter than the first quarter, when the Chinese New Year curtailed output. So if anything, it appears China's economic engine is stronger than ever, which is a relief to many on Wall Street since Asia's economic growth is fueling the profits for many multinational companies. The Bank of Japan has also been surprisingly upbeat as Japan resurged after its devastating earthquake and tsunami, which also bodes well for Asia and overall worldwide economic growth. Finally, U.S. industrial production continued to rise in June, which just helps reinforce that economic growth remains steady.

The Commerce Department recently announced that June retail sales rose only 0.1%, but this was significantly better than economists' consensus expectation of a 0.2% decline. Furthermore, gasoline station sales declined

1.3% in June, so sales excluding gasoline rose 0.3%, implying that overall consumer spending was still steady. Also notable is that vehicle sales rose 0.8% in June, so consumers are finally buying more big-ticket items, a sign that consumer confidence may be improving. A good example of strong consumer spending is Costco's same-store sales growth, which rose to 14% in June and an even more impressive 8% when excluding gasoline sales.

Overall, approximately 60% of our Large Cap Growth stocks' sales are attributable to sales outside the U.S. and are benefitting from rapidly growing middle classes in Asia, Latin America, and India. We should add that all our technology stocks in our growth portfolios have vast international sales and are benefitting from the 4G revolution, faster broadband and cloud computing, as well as all the nifty smartphones and tablets. The U.S. economy is widely expected to reaccelerate in the second half of 2011, especially if the federal government can avoid any significant tax hikes in the budget debate that would slow economic growth.

A growing middle class around the world combined with a resilient U.S. consumer, represents a powerful one-two punch that should continue to propel global GDP growth and continue to boost corporate earnings. This consumer spending is being aided by moderating domestic food and energy prices. A weak U.S. dollar is also boosting earnings for the multinational stocks. Finally, a healthy corporate bond market continues to promote more corporate stock buy-backs (which boost earnings per share) as well as the impression that the private sector is a better investment than the government sector.

If history repeats, the stock market will rally into the 2012 Presidential election, since the third and fourth years of a Presidential election term are historically the strongest years for the stock market. As we approach the August 2nd deficit ceiling deadline, we are about to learn that very little gets done during the third and fourth years of a Presidential election term. Since we invest in the private sector, rather than the government sector, we remain especially optimistic that any short-term federal government shutdown will be viewed as a positive development, especially if Treasury interest is paid and Social Security checks go out. Naturally, a longer-term government shutdown might pose a problem. We are certain the debate over higher taxes and expanding the federal government's role will continue to dominate the political debate leading into the 2012 Presidential elections. This is great rhetoric for the stock market, since the private sector has historically prospered when the government sector sputters, especially during the third and fourth years of a Presidential election term.

SUMMARY

Overall, we remain optimistic that our growth stock portfolios will remain an oasis amidst the chaos that the news media likes to report. A Treasury default and suspended Social Security benefits make spicy headlines, but are not going to happen, since there is plenty of money in the federal government's cookie jar to pay both, even in the event of a short-term government shutdown. Even though a long-term government shutdown could trigger a stock market correction, we think it is unlikely due to both sides posturing for the 2012 elections and not wanting to make a mistake. If history repeats, the stock market will rally right up to the 2012 Presidential elections, since the stock market loves government gridlock that unleashes the private sector. In the meantime, it is clear that as sales and earnings are announced, our stocks are responding positively and issuing positive guidance due to the improving economic outlook for the second half of 2011.

Sincerely,



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