

TFC Market Update June 1, 2011

Marking Time While our “Zombie Economy” Regroups

In our April 14th letter, we suggested that “The disconnect separating Main Street and Washington from Wall Street persists.” Since then, reported first quarter U.S. economic growth (GDP) numbers have confirmed that despite the Federal Reserve Board’s continued attempt to stimulate consumer demand (QE2), our struggling economy has yet to achieve a self-sustained footing and move into a more robust recovery mode. The dreary housing market, although less than 5% of U.S. aggregate economic activity, continues to be a damper on consumer (investor) sentiment; and this could linger near term. All this, plus the obvious global geopolitical economic concerns and financial market malaise, plus the inability of our political class to break the Federal debt-entitlement-fiscal-deficit impasse begs the questions: why haven’t the equity markets broken down entirely?

Part of the answer to this apparent contradiction lies in the continued strength in foreign economies; for U.S. investors, evidence that global portfolio diversification works. Non-dollar revenue for many U.S. multi-national corporations now exceeds 50%, and overseas profits for such domestic companies have risen from 20% to 35%.* Although, in the U.S. at the moment the economic pace slackens, labor productivity improvement in the U.S. corporate sector has prompted profit margin improvement for the average company. Corporate earnings are now back to 2007 peak historic levels, and appear headed for record achievement in 2012. As we have evangelized ad nauseum, in the last analysis stock prices ultimately respond to corporate earnings. Today’s U.S. and foreign stock market valuations at 12-13x 2012 estimated earnings appear quite reasonable. Further room for modest improvement in equity market prices seems probable.

Number Two and on the Rise; China Continues the Driving Global Economic Force

Although for the West doubts about the longer range geopolitical consequences of China’s continuing economic expansion persist, at the moment its developing commercial base is the main engine of growth amongst the world’s interconnected developed and emerging countries. Fueling its internal industrialization and the urbanization of its rural Western territories, China’s seemingly insatiable demand for natural resources continues to put pressure on commodities prices around the world. For American and other developed country multi-national companies, trade with emerging Asian countries (principally China) is very important, but it has generated relatively low profit margins. Nevertheless, the need to capture market share forces many to continue to pursue a long-term investment strategy to assure a presence in what promises to be an important source of future demand. A mixed bag for Western developed

*BCA Research – *Special Report*, May 24, 2011

companies to be sure, but in the last analysis, investors today should probably celebrate the Chinese economic “miracle;” probably the seminal global financial market development of the 21st century.

Getting China right has been one of the key investment calls of the past decade. As clients will remember, our portfolio strategy has emphasized the China-driven natural resources play, but there is much more to the complex China equation. If the Chinese boom fails, globalization will be imperiled and risk assets vulnerable. To help sort through the maze of possible outcomes, we have engaged MIT Professor Edward S. Steinfeld to discuss this with us at our next client reception on Wednesday, June 15th beginning at 5:30 pm (note slight time change). Director of the MIT-China Program at the Sloan School, Professor Steinfeld’s most recent book, *Playing Our Game: Why China’s Rise Doesn’t Threaten the West*, provides a balanced view of how this might work out. We hope you will find the time to attend. A signed copy of *Playing Our Game* will be given to all attendees. If you plan to attend and haven’t yet indicated so, please let Susan Frodigh know (sfrodigh@tfcfinancial.com or 617-210-6711).

Should you have any questions or comments, please let us know.

Best,



James L. Joslin
Chairman, CEO & CCO

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