



Q2 2010 Update

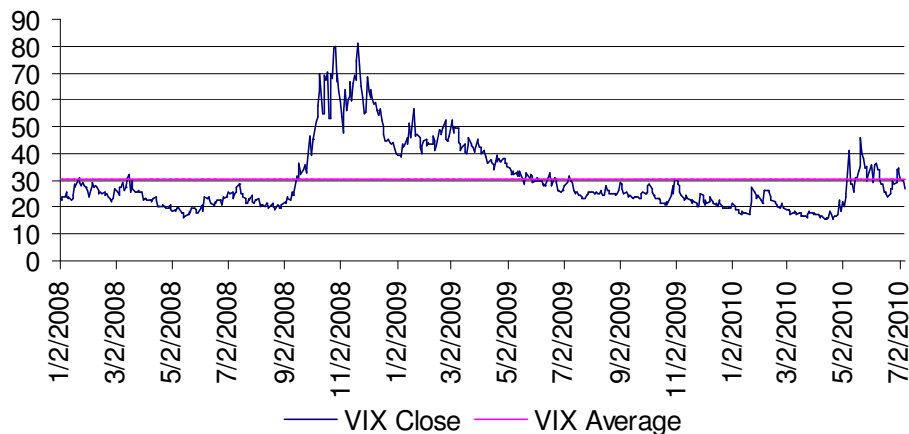
May You Live In Interesting Times

- Ancient Chinese Curse

After a great start to 2010, the second quarter was nothing if not interesting. This quarter brought a return to market volatility, increased focus on European financial stability and the PIIGS, a different opinion of BP, and potentially a new financial regulation bill.

Volatility- The VIX (the Chicago Board Options Exchange Volatility Index, a popular measure of the implied volatility of the S&P 500 index option and often referred to as the “Fear Index”) is up, but nowhere near 2008 levels. The 2008 max was 89.5, while the recent high was 48.2 on May 21, the day after the infamous “Flash Crash”. It’s reassuring to see the VIX trading near the average again and reflects that for the moment “fear” appears to be in check.

VIX Close Price
1/2/2008 - 7/7/2010



European Banking Crisis- Concern has been growing regarding the exposure of Europe’s banking sector to the sovereign-debt crisis in Greece and other countries in the Euro currency block. To ease these concerns, EU banking supervisors are expected to publish the results of bank stress tests representing 65% of the regions banking assets on July 23. These stress-tests include assumptions of an economic downturn and a “sovereign shock” that would generate losses on banks’ portfolios of government bonds. The consensus among analysts is that the larger European banks will remain unscathed. ECB (European Central Bank) President Jean-Claude Trichet has indicated that the ECB will not raise interest rates, which he still deemed to be at an “appropriate” level.

The silver lining in the European crisis is the boom in the sale of German cars. Due to the weakened Euro and the emerging middle and upper class in China, sales of German luxury cars such as BMW, Audi and Mercedes are all up double digit percents from last year.

BP- It now looks as if we are closer to having the flow of oil stopped. It will still be some time before we know the true cost of the cleanup and its effect on U.S. energy policy. We hope that any policy response will not be a knee-jerk reaction, but a well thought out response to the situation.

Financial Regulation*- The Wall Street Reform and Consumer Protection Act, expected to be signed into law by mid-July creates the “Volcker” Rule and a Consumer Financial Protection Bureau. The “Volcker” Rule aims to mitigate risk taking by federally insured banks by curbing the amount of allowable proprietary trading. Banks would be limited to investing no more than 3% of their Tier 1 capital in hedge funds or private-equity. Furthermore, the act severely limits banks’ derivative trading, and forces Over The Counter derivatives to be conducted through third-party clearing houses, increasing the ability for the market and regulators to track trades. A consumer financial protection bureau will be responsible for writing and enforcing rules to protect customers from credit-card and mortgage-lending abuses. It will also give Federal regulators the authority to seize and break up large troubled financial firms to avoid a taxpayer bailout. Unfortunately, Congress can’t legislate sound investment decisions, that’s why we think our job is so important.

In the U.S., we hope that the upcoming second quarter earnings season should give us some guidance on the direction the market will be taking. There remains a sense of trepidation in the U.S. economy. This lack of confidence is reflected in the amount of cash still on the side lines and on the balance sheets of U.S. companies. While growth may be slower for some time, we do not believe the risk of a double dip recession is high. There have only been two episodes that could be considered double dips in the U.S. and both were initiated by bad policy. The most recent was when then-Fed-President Paul Volcker (sound familiar?) raised the Fed Funds Rate to a record 20% coming out of the 1980 recession. At a current Fed Funds Rate of .25%, it appears today’s Fed is taking a different path.

Another domestic issue that calls for attention is the debate between inflation and deflation. With the record low yield (0.59%) set by the 2 year U.S. Treasury and the most watched 10 year Treasury trading below 2.90% recently, the deflation camp is speaking up. We don’t believe the U.S. economy is headed into deflation, rather we believe a prolonged period of slow growth is ahead of us. This period will need close attention and solid advice to maneuver through successfully.

Thanks for trusting us with your business. We welcome any questions you have.

Adams Hall Asset Management

*Our summer intern, Peter Zirkle, has written a more complete summary of the financial regulation bill that is available at AdamsHall.com or upon request.