Waycross
INVESTMENT MANAGEMENT COMPANY
1326 Commercial Street ▪ PO Box 1618 ▪ Bellingham, WA 98227-1618
Phone 360.671.0148 ■ Toll Free 800.292.8794 ■ Fax 360.671.8936 ■ Waycross@Waycross.com

Review and Outlook
Second Quarter 2010

The second quarter of 2010 was challenging. The S&P 500 returned -11.4% while the intermediate term bond index returned 3.2%. Stock prices continued their 2009 rebound in the first quarter. Reality set in during the second quarter as economic data showed the economy was improving, but at a lower than expected rate. Employment data confirmed a stressed job market and a stalled housing market.

Bond yields, both corporate and Treasury, are extremely low. The ten year Treasury yield is slightly *below* 3% and mortgage rates are at all time lows. In a normal economy, low rates would stimulate borrowing and spending. However, there are very few signs consumer spending is recovering rapidly. Americans are reducing debt and saving rather than increasing their spending and borrowing. Interest rates will likely stay very low as long as this savings mentality persists.

Interest rates have fallen for the last three decades. Now short- and intermediate-term yields cannot go much lower. Falling US interest rates over the past thirty years have benefited both bond and stock investors. As interest rates fell bond prices increased, providing capital appreciation to portfolios holding bonds. In addition, falling interest rates added to stock investors' confidence because the relative risk of owning stocks appeared to decline as the assured return from bond yields declined.

Starting from a point of very low interest rates, stable or even rising interest rates will not provide the same benefits. This does not mean that the likely trajectory of interest rates will impede stock returns. Rather, the potential benefits of starting from a period of high interest rates will be absent.

Many people believe interest rates must rise dramatically as governments throughout the world increase their borrowing. Recent research shows little, if any correlation between historical debt-to-GDP levels and long term government bond yields. Investors do not yet seem extremely concerned about the majority of the developed world's government bonds. However, there is considerable concern about the debt issues of southern European countries.

For the past six months headlines featured Greece for precipitating a financial crisis in Europe that torpedoed the Euro and roiled stock markets in the US. How could a tiny country that comprises only about 2% of the European economy cause so much trouble? The answer is related to the Greek debt held by French and German banks, as well as the direct and indirect impact of the Greek crises on the struggling economies of Portugal, Italy, Ireland, and Spain, and the level of their debt held by French, German, and British banks.

Interest rates around the world have been low since 2000, tempting governments, as well as individuals to borrow more and more. The borrowing initially fueled economic growth but soon eclipsed the growth as the percentage of debt to total economic activity grew. Debt to GDP reached 115% in Greece and Italy. Until late 2009 investors and rating agencies ascribed a high quality to the debt of the small, historically struggling, southern European economies because of their membership in the European Union. Investors demanded little more in interest rates for

Waycross
INVESTMENT MANAGEMENT COMPANY

Greek debt than for German debt. Greece and the other struggling economies simply borrowed more and more because interest rates were cheap. Borrowing was more popular than taxing. To make matters worse for Europe, most Greek debt (57%) is held by French, German, and British institutions. Similarly, 55% of Italy's debt is held by institutions in the same three countries, with France being the largest creditor.

In November of 2009 the newly elected Greek government announced that the budget deficit would be 12.7% of GDP, more than double the previous governments' estimate. Investors and governments became increasingly worried about Greece and the other southern European countries and their potential impacts on the world's economy. The interest rate these countries must pay to find buyers for their debt jumped up with these concerns. The higher interest rates exacerbate each countries economic problem, making worst case scenarios more likely.

Many European banks would likely fail if Greece defaulted. A Greek default could lead to a banking crisis in the stronger European countries similar to the banking crises in the US in 2008. While a weaker Euro would benefit European exports, the net affect of a Greek default was perceived as being so dire that on May 10 global leaders pledged Euro 750 billion (almost $1 trillion) to fund protection against defaults of any Euro zone country. While sold as a safety net for the smaller economies it is also a bail out of the banking systems of France, Germany, and to a lesser extent, England. The quid pro quo was stringent budget cutting by the PIIGS (Portugal, Italy, Ireland, Greece, and Spain).

The final outcome of this most recent financial crisis is not clear. However, one lesson seems to be gaining wider acceptance. Structural deficits by countries are not sustainable. Short term deficits to fund short term financial problems can be sound fiscal policy. But no country can expect to continuously run higher and higher deficits.

We continue to believe the US economy will be choppy over the short term due to the European crisis and concerns about a sustainable recovery here in the US. US corporate earnings are currently providing the only support to the stock market. Multinational companies continue to see robust revenue expansion in Asia and South America and their earnings reflect this fact. The current market environment, including the interest rate environment, increases the potential benefit of more portfolio diversification. Excellent returns with limited volatility were attained over the past thirty years with limited diversification. Much greater strategic diversification may be required in the future.

Michael F. Ryan
President

Egan Ludwig
Vice President

June 30, 2010