3Q11

THE FSAG ADVISOR

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Economic & Market Perspectives

After weeks of general gloom on the economic front, a little sun shone through the clouds the past few weeks. Better readings on US manufacturing activity and a short-term resolution to the sovereign debt crisis in Greece pushed equity markets—and interest rates—notably higher.

Recent moves in asset markets and the real economy provide five hopeful, albeit still tentative, signs for second-half growth.

First, commodity prices have eased. Using a standard seasonal adjustment procedure, retail gasoline prices are back to end-2010 levels.

Second, despite the increase in interest rates over the past few weeks, financial conditions are easier than at any point in 2010. Bank lending standards remain tight, but these too are easing on the margin.

Third, the decline in house prices may be abating. Although prices are down about 5% on a year-over-year basis, the latest monthly readings suggest more stability, and a pickup in non-distressed home transactions in the late spring and summer months should reduce the downward pressure from distressed sales.

Fourth, vehicle production has rebounded following large disruptions due to the Japanese earthquake and tsunami. This probably explains much of the sharp improvement in the Chicago purchasing managers' index, and perhaps also some of the pickup in the ISM manufacturing index.

Fifth, labor market indicators seem to have stabilized after some worrying readings in late April and May.

1. Commodity prices have eased. Despite a rally over the past few weeks in metals and energy, commodity prices remain well below levels in the spring. Crude oil is down about $15/barrel since early May, perhaps helped more recently by the announcement that members of the International Energy Agency would engage in collective sales of their reserve supplies for the first time since Hurricane Katrina. Most importantly for US consumers, gasoline prices have come down significantly. On a seasonally adjusted basis—i.e. taking into account that gasoline prices are normally higher at this time of year—the entire spike in prices in 2011 has now been reversed. This should help consumer spending pick up the pace somewhat in the second half of the year.

2. Financial conditions are very supportive of growth. Equity market relief over the debt crisis in the European periphery helped our GS Financial Conditions Index (GSFCI) ease despite a backup in interest rates. The GSFCI—incorporating interest rates, credit spreads, equity prices, and the dollar—suggests a financial environment that is more supportive for growth than at any time in 2010. To be sure, still-tight US bank lending conditions are impeding the transmission of low interest rates to many households and small businesses. But even here, recent lending surveys from the Federal Reserve suggest a bit of a thaw.

3. The decline in house prices may be abating. US home prices are down about 5% from last spring's tax-credit-supported levels. But the very latest monthly observations suggest more stability: over the most recent three months of data—adjusted for normal seasonal variation—the CoreLogic and Case-Shiller home price indexes are down only 10-20 basis points. At least in part, this probably reflects a more balanced mix of sales. In the winter months, bank sales of distressed properties make up a very large share of transactions (ca. 40% in early 2011), but this share fades somewhat as the spring selling season gets underway. Since house prices have actually been rising recently for non-distressed sales, this helps to stabilize the overall price level.

4. Vehicle production is normalizing. The Japanese earthquake and tsunami led to a shortage of some key electronic components for motor vehicles. After inventories of these parts were depleted in late April, production by Japanese auto manufacturers fell sharply, both at Japanese and US-based facilities. Diligent efforts to restore supplies have begun to pay off, with production ramping back up quickly in recent weeks. US vehicle production is likely to be down 5% or a bit more in Q2 versus end-Q1 levels; this implies a hit in the neighborhood of ½ percentage point to annualized real GDP growth in Q2, which should be fully reversed in the third quarter.

Continued on page 4

2011 Returns

DOW	*8.56 %*
S&P 500	*6.10 %*
NASDAQ	*3.75 %*
Russell Small Cap	*6.21 %*
Russell Mid Cap	*8.08 %*
MSCI EAFE	*4.98 %*
Barclay US Agg	*2.90 %*
Barclay Muni.	*5.01 %*

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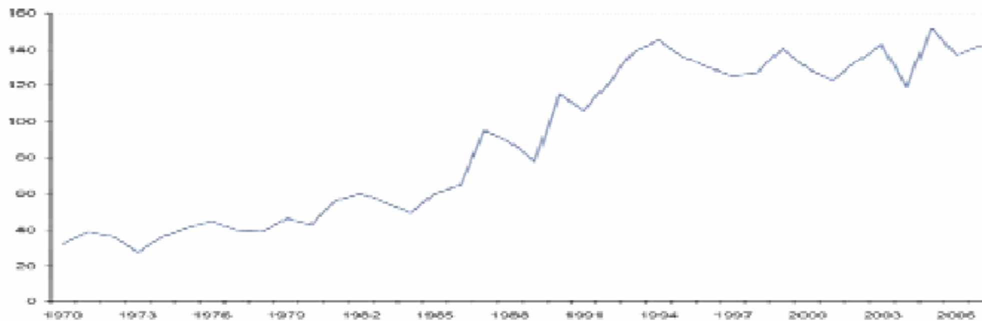
Charts of Interest

The New Normal? Number of natural catastrophes globally



Conflicting Reports: Number of global intra-,inter-state conflicts recorded by the UN

Source: Goldman Sachs

Estate Tax Exemption Is Portable (for Now)

Recent legislation introduced a new, but perhaps temporary, estate planning concept--exemption "portability." In short, the estate of a deceased spouse can transfer to the surviving spouse any portion of the federal estate tax exemption that it does not use. The surviving spouse's estate can then add that amount to the exemption it is entitled to, increasing the total amount that can be passed on to heirs tax free. This new feature makes it easier for married couples to minimize the potential impact of estate taxes.

Example: result without portability
Assume Henry and Wilma are married, have all of their assets jointly titled, and have a net worth of $10 million. Henry dies first, when the federal estate tax exemption is $5 million and there is no portability. Henry's estate passes to Wilma free from federal estate tax under the unlimited marital deduction and does not use any of his $5 million exemption. Assume that at the time of Wilma's death, the exemption is still $5 million, the federal estate tax rate is 35%, and Wilma's estate is still worth $10 million. With Henry's exemption completely wasted, Wilma can pass on only $5 million free from federal estate tax. Assuming no other variables, Wilma's estate will owe about $1,750,000 in federal estate tax: $10 million estate - $5 million exemption = $5 million taxable estate x 35% estate tax rate = $1,750,000.

Example: result with portability
Using the example from above, at Henry's death, his estate passes to Wilma free from federal estate tax under the unlimited marital deduction and does not use any of his $5 million exemption. Even though Henry's estate owes no tax, Henry's executor files a timely return on which he elects to transfer Henry's unused exemption to Wilma. Assume that at the time of Wilma's subsequent death, the exemption is still $5 million, the federal estate tax rate is 35%, and Wilma's estate is still worth $10 million. Since Wilma has "inherited" Henry's unused exemption, she can pass on the entire $10 million estate free from federal estate tax. Portability of the estate tax exemption saves Henry and Wilma's heirs $1,750,000 in estate tax.

To use the exemption portability, the first spouse to die must elect to use portability on his or her estate tax return. An estate tax return must be filed by the first spouse to die to use portability even if the return is not otherwise required to be filed.

Inflation or Deflation: Watching for Warning Signs

There's been much debate in investing circles over the last year about whether inflation or deflation represents a more likely threat to the future of the U.S. economy. With a recovery that's still tentative compared to previous recessions, measures designed to stimulate the economy or cut spending to rein in the budget deficit provoke warnings about their potential to create one or the other.

The case for inflation

As the economy has begun to recover, worries about the potential for future inflation have become widespread. The Fed has undertaken extraordinary measures to make sure there is plenty of money in circulation, but some experts worry that the increased money supply will eventually cut the dollar's purchasing power, especially if interest rates are kept at historically low levels for too long. They cite the easy availability of money as contributing to the late-1990s tech bubble and the mid-2000s housing bubble, and fear that another could be on the way.

The Federal Reserve Board's monetary policy committee maintains that inflation currently is too weak to support normal economic growth, let alone launch an inflationary spiral. However, those who see inflation in our future watch for warning signs such as increased Treasury yields, particularly on longer-term bonds. Higher yields when bonds are auctioned suggest that investors are increasingly wary of tying up their money for long periods at a fixed interest rate if they feel that inflation is going to erode the buying power of those fixed payments over time. Wholesale prices also are watched closely; higher prices at the wholesale level can be a precursor of higher prices at retail (that is, if retailers are able to pass those costs along to buyers, which is not always the case).

The case for deflation

At first blush, the falling prices that characterize deflation don't sound like such a bad thing. Who wouldn't like to be able to buy things for less than they cost now, especially when times are tough? The problem is that those falling prices can harm the economy in several ways, as Americans were reminded during the recent recession. When prices are dropping, people tend to postpone purchases, hoping to pay less in the future (consider what's happened with real estate since 2007). Delayed spending puts pressure on corporate profit margins and companies tend to cut spending themselves, creating financial difficulties for companies that rely on business spending. Cutbacks begin to ripple through the economy.

Deflation typically affects not only prices but wages; scarce jobs can lead to pay cuts even for those who stay employed. And lower incomes can start a new round of cost-cutting by both consumers and business. If this process sounds familiar, it's because for much of 2009, the U.S. experienced negative annual inflation rates for the first time since 1955.

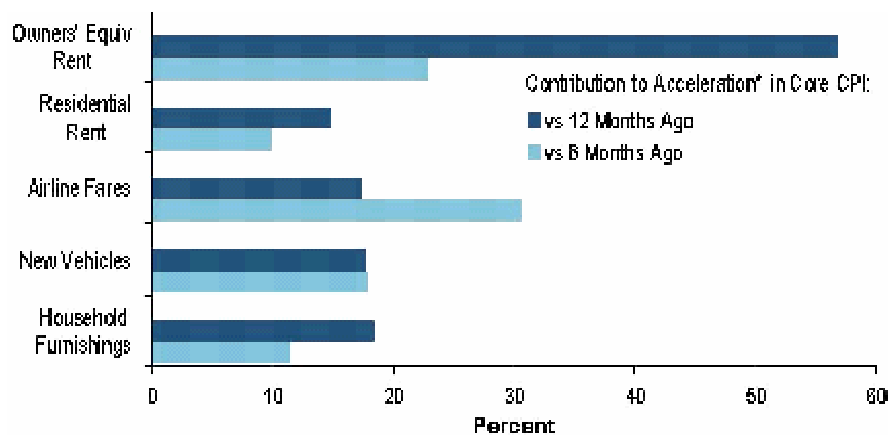
Though consumers have loosened their purse strings in recent months, deflationistas argue that if another financial crisis were to reduce credit availability, or if high ongoing unemployment once again begins to weigh on consumers' willingness and ability to spend, the threat of deflation could return. Those concerned about the possibility of a new round of deflation at some point keep an eye on consumer spending, the state of the credit and housing markets, and the stability of banks and other financial institutions.

Seeing shades of gray

Inflation and deflation aren't necessarily an either-or proposition. It's possible to have inflation in some areas and deflation in others; anyone who has watched food prices or health-care costs increase while their paycheck stayed the same and the value of their house declined can vouch for that.

From an investing standpoint, inflation isn't black-and-white, either. Some industries and asset classes benefit from inflationary forces, while companies that are highly dependent on both commodity prices and cheap labor can be more challenged by rising prices.

Chart of Interest: A Sharp Pickup in Both Headline and Core Inflation



Share of net change in six-month annualized inflation rate.

Sources: Department of Labor. GS Global ECS Research.

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Stock in the News: Ford (F)

Ford is the second largest U.S. motor vehicle manufacturer. It produces cars and trucks, and many of the vehicles' plastic, glass and electronic components, and replacement parts. It also owns a 3.5% stake in Mazda Motor Corp. Financial services include Ford Motor Credit (automotive financing and insurance) and American Road Insurance Co.

In recent years, Ford's margins have been pressured by an increase in competition – primarily from Asian companies – and a shift away from the more profitable large pickup truck and SUV segments to smaller, less profitable crossover utility vehicles (CUVs). However, in 2009 and 2010, competitors' bankruptcy filings and recall issues and its own new products helped it gain market share.

Challenged by a shrinking U.S. market share and more recently by lower industry volume, the company has announced restructuring plans in recent years in an attempt to lower its costs. Also, even as global demand begins what we expect to be a multi-year uptrend, the company has worked to prune it product portfolio to focus on its Ford and Lincoln brands. Most recently, the company announced plans to discontinue production of Mercury brand vehicles.

We think Ford's president and CEO, Alan Mulally, has made a noticeable positive difference in the company's improvement efforts. Also, we have become more confident in Ford's ability to bring successful vehicles to market – one of the company's most important challenges, and we see progress in bolstering the company's image.

See attractive risk reward in autos

We would be buyers of auto stocks as we believe the sector has ample room to appreciate. We have run a downside scenario to our 2012 production and sales estimates for N.A. and Europe, which suggests 15% possible downside to our covered auto equities, were macro conditions to deteriorate meaningfully. Reflecting the 26% average upside to our price targets suggests a "risk/reward" ratio of 2-1. Among our buy rated names this ratio is even higher with Ford (F) at 3-1.

Expect sector data points to improve as supply constraints ease. We expect the tide of data points in the sector to improve as supply constraints abate. While inventories should remain tight until after scheduled OEM downtimes in July, weekly government production data already shows a significant increase at Toyota and a gradual increase at Honda, which we expect to lift overall inventory levels and help rebalance vehicle stocks towards cars, allowing a SAAR improvement.

Key Statistics: F

Price	*$13.24*
Trailing EPS	*$1.77*
Estimated EPS	*$2.10*
EPS Growth	*5%*
Current P/E	*6.3X*
PEG Ratio	*1.26X*
Dividend Yield	*None*
Market Cap	*$49.35B*
52 Week High	*$18.97*
52 Week Low	*$9.75*
Beta	*2.36*
ROE	*296.9%*

Stage of the cycle supports being long

While each cycle is different we are only 24 months into the current expansion. Past expansions have typically lasted 90 months according to the NBER. With auto equities prices historically peaking at 59 months (or 65% of the way through the cycle), this would suggest that auto equities are an attractive investment – a view supported by valuation and the sectors solid earnings and FCF growth prospects.

Sources: Goldman Sachs, Standard & Poor's

Economic & Market Perspectives *Continued from page 1*

5. Labor market indicators are holding up. A spate of higher weekly jobless claims numbers and a very disappointing May employment report made it easy to worry that the engine of sustained economic expansion—labor market improvement that provides income growth for the household sector—might be on the verge of a stall. But new jobless claims have held steady in the 420,000-430,000 range for the past six weeks and job advertising remains reasonably firm. Also, the employment index rose modestly in the latest ISM manufacturing survey. While we would prefer to see all of these figures improve further, the current levels are consistent with a somewhat better employment report in June. We expect an increase of 125,000 payroll jobs, with the unemployment rate dropping back to 9.0%. At this stage there is no question that first-half US growth will go down as a major disappointment: about 2%, far less than we and most others expected at the outset of the year. But with at least some of this disappointment due to temporary factors, we are cautiously optimistic that the second half of the year will see a meaningful improvement.

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