



	<u>Jun. 30 Close</u>	<u>2011 YTD</u>
Standard & Poor's 500 Index:	1320.64	↑5.0%
10-Year Treasury Note Yield:	3.16%	

Investment Outlook: Summer Slowdown Redux

July 1, 2011

Dear Investors,

Huge drama surrounding the debt morass in Greece, slowing economic growth in the U.S., weak equity markets in May and most of June. . . . What year am I describing? 2010. But also 2011. This year's second quarter had many similarities with last year's 2Q, with a number of the same concerns taking hold.

The S&P 500 Index, thanks to a massive rally in the final four days of the quarter, lost only 0.4% for the quarter and is now 3% below its April highs. The market weakness in May and June resulted mainly from three factors. First, the U.S. economy slowed considerably during the quarter; we have definitely hit a soft patch in our stop-and-go economic recovery. The steady trend of improvement in employment was broken in May, when the economy only added 54,000 jobs and the unemployment rate remained stuck at 9.1%. Many analysts also downgraded their outlook for GDP growth for the remainder of 2011 and are now forecasting growth of around 2.5% rather than 3.0%-3.5%.

While the economic data overall point to a slowing of economic activity, the origin of much of the weakness in April and May can be traced back to supply disruptions for the automotive and technology industries in the wake of the earthquake and tsunami in Japan on March 11. I was recently at my Honda dealer and asked the manager how his business was going. He said things were very difficult at the moment because his dealership had been getting only a few new Hondas per month from the factory. It will probably be a slow summer for the economy, but come autumn growth will likely tick up again.

A second factor that weighed on investor sentiment during the quarter was the approaching end of QE2, the Federal Reserve's \$600 billion bond-buying program. This program ended June 30 and many investors are skeptical that the U.S. economy will be able to walk without this artificial and temporary crutch. Without the Fed out there as a buyer of Treasuries, the logic goes, long-term interest rates on U.S. government debt will have to rise to make them a bit more enticing to investors and will thereby act as a brake on an already sluggish economy.

Finally, the European debt crisis re-ignited itself as riots broke out in Greece as its Parliament pushed through hugely unpopular austerity measures in order to secure a loan from the European Union and International Monetary Fund to help the country stave off bankruptcy. The Greek debt issue is by no means solved, however, and investors should just consider this the latest act in a drama that will go on for years and likely involve other actors such as Portugal and Ireland—but also potentially even Italy and Spain.

As the quarter came to a close, the International Energy Agency (IEA) made a surprise announcement on June 23rd that it would release 60 million barrels of oil held in strategic government reserves over the next thirty days. These reserves are held by the members of the IEA that are net importers of oil as a cushion in case of emergency or a prolonged supply disruption. The U.S. share of this release was 30 million barrels from its Strategic Petroleum Reserve.

The putative reason for this release of oil was to ease the supply disruption caused by the Libyan civil war. (Libya accounts for 1.5% of global oil production.) The timing of this release was somewhat puzzling, however, as oil prices (West Texas Intermediate crude) had already retreated 18% from \$115 per barrel to \$94 in the prior two months. (If there had been a bona fide supply problem oil prices would have held higher levels.) The news of the release sent oil down nearly \$5 to under \$90, but in the week since then oil has climbed back to \$95. In the end, the Libyan conflict is already three months old and the world has gotten used to operating without its oil. This release will likely have little impact in holding down prices. In fact, if nothing else it served to highlight the very tight supply-demand balance in a world that continues to grow thirstier for oil by the day.

As July begins, global investors are beginning to focus on sweltering Washington, D.C. and its ongoing political skirmish over raising the U.S. debt ceiling. For this country to avoid a very bad outcome in the financial markets and a body blow to our still-weak economy, the debt ceiling must be raised—and in all likelihood will be raised. The main question is how much or how little damage is done to investor confidence in the process as Congress continues to play a game of “chicken” with this issue. The date at which the U.S. Treasury will be in technical default is August 2nd, but if this issue comes down to the wire we will be needlessly hurting ourselves. Despite the \$14.8 trillion debt hole we have dug for ourselves, the interest rates at which we are able to fund this spending have remained at remarkably low levels and we have benefitted immensely from the kindness of foreigners who are so willing to lap up our debt at such low rates. If Congress does not act promptly to resolve the debt ceiling debate, these low rates in jeopardy. Foreign investors in our debt will demand higher interest rates if our Congress cannot agree on whether or how we are to service our debt obligations.

I welcome your comments and feedback.

Best Regards,

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