Weinstat Wealth Management, Inc.
516-621-3507 | MWeinstat@WeinstatWealthManagement.com

July 1, 2011

Greetings,

Enclosed is your investment report through June 30, 2011. We are at the end of the longest correction of this bull market. Last year's correction was deeper, but this one is longer and this is normal market activity. Other than the anomaly of late March 2009 to the spring of 2010, stock markets simply do not go straight up. As much as we would prefer steady returns of 1% (or more) per month, that is just not realistic. I did see much of this coming which is why I did some selling in late April and May before the market took a hit. We now have a nice cash position so we can take advantage of the buying opportunities that this illogical market has provided. You may ask, "If I saw this coming, why didn't I take even more cash off the table?" Well, what I saw coming was a thunderstorm, not a hurricane. You don't take in your outdoor furniture every time there is a thunderstorm, even a bad one. You will take out an umbrella to keep from getting soaked. If I correctly forecasted a hurricane, a much deeper correction like what happened last year, sure, I would have taken more cash off the table. Fortunately, however, this has not happened and your return reflects this. I should add that subsequent to this letter, I am seeing some more real dark clouds as a result of the potential of the debt ceiling not being lifted. As a result, I recently did some more selling since I always prefer to err on the side of caution.

What caused this correction was a combination of several things; the Japan Tsunami/Earthquake, the much worse than expected May jobs report and continuing problems in Greece. When I hear and read more times than I can count about how bad the economy is, I say to myself, please tell me something that I don't know. A year ago, many people were convinced that the economy was headed for a double dip recession. How wrong were they? What hurts the market is negative surprises. I don't think that anyone in their right mind (other than maybe some politicians) expected the economy to be doing significantly better than it is now. A little better, yes. The problem is that market psychology is so fragile that just one bad jobs report along with a couple of negative pieces of macroeconomic data is enough to send the market reeling. It doesn't make any sense. I never have said that what goes on with the market makes sense on a month by month basis.

As written in previous investment letters, it isn't a case of all or none with the economy. There is something in between a recession and a booming economy. I have rarely seen a booming economy over the last 30 years, although I have seen some outstanding years for the stock market. Something that many people don't realize is that historically, the stock market has done well in a slow growth (sometimes called a Goldilocks economy) environment. The stock market doesn't need a major improvement in the economy to do well. A decent improvement to get the GDP (along with at least some improvement in the labor market) up to the 3-3 ½% range would lead to an explosive stock market rally. The mood now is so gloomy amongst those in the investment community, that with equities so cheap, any kind of economic improvement will give us solid year end results.

My biggest concern as far as the economy isn't that things are so bad now, but that the economy is doing so poorly while being on life support by the government. First there was TARP. Did you happen to see the HBO movie, "Too big to fail"? If you didn't, I highly recommend that you make an effort to see it. It does a great job of showing how the U.S. Treasury department had to rescue the financial institutions after they (with the government's acquiescence) blew up the global economy. Ed Asner playing Warren Buffet and James Woods playing the ex Lehman CEO were classic. William Hurt playing Hank Paulson (the former Treasury secretary) was also pretty good. The best line in the move was when a Treasury official says to Hank Paulson after TARP passed "they will lend the money out"? Hank Paulson responds while looking out the window "of course they will". They were all wrong on that one! After TARP was the $ 830 billion stimulus package. The word stimulus leaves a bitter taste in most everyone's mouths and is a politically-bad word now, so the stimulus package is now referred to as the economic recovery act. Now, two years after this thing was passed, many feel that the ERA was a total waste of taxpayer money. The people (mostly the politicians) who say the ERA was a good thing try to make the case that the economy is better now than it would be had the government done nothing. Considering that the unemployment rate is now at 9.1% (the real rate is higher because this rate doesn't count people who have dropped out of the work force, doesn't count part time workers who want to work full time or the "underemployed", those who are forced to take jobs at a fraction of the pay that they had before), which is higher than it was before the ERA was passed, the housing market is worse now and energy prices are much higher, that could be a tough case to make. A much more interesting case to be made is that the government royally screwed up by not making the stimulus/ERA larger. Paul Krugman is a former Nobel Prize winner in economics and a columnist for the NY Times. Over the past year, I have seen him more times than I can count on various news shows. What Mr. Krugman; along with his disciples have stated is that the government needed to spend whatever it took, whether it be 2, 3 or even $4 trillion to get the economy going. I remember a little more than a year ago, President Obama acknowledged that at the time the ERA was being negotiated, he didn't realize just how bad the economy was. My take on that is he should have known and that since he didn't; his economic advisers should have known and then alerted him to how bad things were. I have a pretty good memory and I was following things very closely back then. From what I remember, President Obama, once he came into office was more focused on health care (even his supporters acknowledge this) than job creation and left the stimulus package, oops, the economic recovery act, up to the Congressional leaders at the time, Nancy Pelosi and Harry Reid. I also remember that the original ERA was supposed to be over $ 1 trillion. The politicians (both sides of the aisle) didn't like the sound of the total package being over $ 1 trillion, so 20% which amounted to $ 200 billion was cut. Martin Feldstein is a Harvard professor and a former economic adviser in the Reagan administration. Mr. Feldstein wrote an outstanding op-ed piece in the June 8 edition of the WSJ. He essentially agreed with Mr. Krugman in that the ERA wasn't nearly enough. Mr. Feldstein went into details about all the mistakes that were made and that much more should have been spent on both infrastructure and, even defense. He also pointed out that the "Cash for Clunkers" program and the one time home buyers tax credit were both a total failure. I agree because neither had a lasting impact on the economy.

I will humbly acknowledge that I am neither a Harvard professor nor have I won a Nobel Prize for economics. That being the case, I will chime in. I believe more in reality than in theories. In theory, I agree with Mr. Krugman and Mr. Feldstein that not enough was done and that if more was done two years ago, we would be in better economic shape now. Over the last 70 years; direct government intervention, when done efficiently, has produced positive economic results. In theory, if trillions of dollars are thrown into the system, you have to make the assumption the people in charge are competent enough to make sure those funds are spent wisely and that they can be trusted to do so. Personally, I do not think this is a valid assumption. I have read several books and seen many documentaries about the Great Depression. In the 1930's, Congress created the Tennessee Valley Authority to build roads, bridges and other important infrastructure projects such as the Hoover Damn. Two years ago with the economy falling off a cliff and hundreds of billions already appropriated for infrastructure, the politicians of the 21st century couldn't figure out where to spend the money! Everyone, whether they are left, right or center agrees that the quickest way to create jobs was with infrastructure spending. With the Country's bridges, roads and tunnels in dire need of repair, I just couldn't comprehend how the bureaucrats in the Nations Capital couldn't figure this out and put people to work. During WWII, the auto industry was converted to war production. I am not a proponent of a big Pentagon budget. However, Mr. Feldstein did point out that it would have been smart to increase military spending by updating weapon systems that eventually would have been needed to be updated anyway. My only problem with that would be that the money could very well be spent on systems that would never get any use and that the funds would go into the pockets of the politician's contributors without any true benefit to society. An example of this is the wasteful government spending after Hurricane Katrina. People in Florida who didn't need generators got them for free. In Louisiana and Alabama, thousands of mobile homes were built but then later, just laid empty and unoccupied. As smart as both Mr. Krugman and Mr. Feldstein are, I am disappointed that they didn't address the issues of government waste and pilferage.

Another concern I have with the economy is the lack of available credit. The flow of credit is essential for a strong economy. The banks 4-7 years ago would give a mortgage to virtually anyone who could sign their name to an application, even without a down payment and weak credit. Now, banks routinely reject qualified borrowers, especially small business owners who are looking to expand their businesses. Without a doubt, the banks needed to tighten their standards; however, they have gone way too far. The bankers will state a myriad of reasons why they aren't lending. Some will state it's the uncertainty of the economy; others will blame the Dodd/Frank act. Part of the regulations have required banks to hold more capital, which, considering how many large banks went under just three years ago, is a good thing. Many bankers, and I have seen a few on CNBC recently, have denied with a straight face that banks aren't lending and if they do acknowledge it, they say it is because of a lack of loan demand. When I saw a banker say this to the late, great Mark Haines on CNBC (he just died and I miss him because he was a real straight shooter and was a tough interviewer), Mr. Haines said that if he expected him to believe that, he was off of his rocker. In a case of incredible timing, the Wall Street Journal in yesterdays edition, page B-1, ran a story with the headline "Smaller Businesses Seeking Loans Still Come Up Empty". It was an outstanding article. Some highlights from the article are: according to the FDIC, there is an 8.6% drop in loans outstanding to small businesses from a year earlier. An analysis by the Federal Reserve Bank of Kansas City shows that big banks' outstanding loans to small businesses dropped 14% from this time last year while loans by smaller lenders dropped by 3%. According to a study by Pepperdine University, in the past six months, only 17% of loan-seeking businesses with less than $ 5 million in annual revenue landed bank financing. John K. Paglia, a finance professor at Pepperdine University was quoted in the story as saying "This area of the economy is in such crises, the lack of credit is improperly penalizing companies that will be very successful down the road". If anything, the reason why people and businesses aren't looking to borrow money is because they know that they will be rejected. I acknowledge that regulations are a problem for the banks but it is a problem that they brought upon themselves. In general, I am not a proponent of huge government regulations. After what happened in 2007/2008, the financial institutions have demonstrated that left to their own volition, they will do whatever it takes to enhance their bottom lines, no matter what the repercussions. As far as the uncertainty of the economy, sorry but I don't buy that. I have seen some very uncertain times over the last 30 years and I have never seen banks cut back on lending like they are now, not even close.

QE2 is now over. Good bye and good riddance. QE2 for those who have not heard of this term, is quantitative easing 2. It was a $ 600 billion program where the Federal Reserve expanded its balance sheet by purchasing Treasury notes (mostly short term) with newly printed money. This followed QE1 which was when the Federal Reserve purchased mostly $ 1.4 trillion of mortgage backed securities in the open market. QE1 was done in 2009 and helped bring some confidence to the financial markets. Very few people criticized QE1. I do not believe that QE2 had the same desired effect as QE1. It certainly didn't improve the overall economy since it was announced nearly a year ago. Ostensibly, the primary purpose was to keep long term interest rates low. Lower long term interest rates would lead to lower borrowing costs, help the housing market by making mortgage payments more affordable and encourage refinancing. Again, in theory it wasn't a terrible idea. In reality, the problem is that with the banks not lending, very few people are able to refinance. In all fairness, it isn't all the banks fault as far as refinancing is concerned because with real estate values on a national level now down to 2002 levels, 25% of all home owners who have mortgages now have debt that exceeds the value of their homes. Bankers are also fearful to lend against a depreciating asset which Real Estate is now.

Historically, the Federal Reserve has had a duel mandate to keep inflation low and to achieve full employment. History has been rewritten over the last couple of years because now, with QE2 and with zero short term interest rates, Ben Bernanke has said he wants to raise asset values. Asset values include (not exclusively) stock prices. This is one of the reasons why I have been so bullish on the stock market both the last couple of years and will be for the next couple of years. When one of the most powerful people in the world says that he will do what it takes to get the stock market to move higher, all things being equal, the stock market will move higher. I believe in not fighting the Fed. The reason why the Fed is doing this is because Mr. Bernanke believes in the wealth effect. He feels that if stock prices increase, then people will feel better, consumer spending will increase and with consumer spending accounting for 70% of GDP, then the economy will improve. While I respect Mr. Bernanke and I think that he has done a decent job since he has been the head of the Federal Reserve, I don't agree with the theory behind the wealth effect. During the tech. bubble of 1999 and early 2000, I believe that the wealth effect had some validity. After two horrible bear markets in ten years, I just do not believe that too many people will take more vacations, purchase better cars, or eat out more often just because their retirement accounts are higher. Historically, lower interest rates have helped the overall economy for many reasons. When the economy benefited the most was during times when interest rates were actually going down. The biggest benefit was lower borrowing costs resulted in more cash in the pockets of both businesses and the consumer. There are many problems that exist now which are why the low interest rates aren't helping the economy. First, whoever was able to take advantage of the low rates have already done so 2-3 years ago. Second, large multi national companies don't need to borrow money because they are flush with cash so low interest rates aren't helping them. Third, the consumer, as well as small businesses can't take advantage of these record low rates because the banks (for the most part) aren't lending. Once again, I saw the late Mark Haines on CNBC interviewing a business owner who had about 100 employees who was looking to expand his business. He said that even though he had great credit and strong financial statements, he was turned down by several banks. He also added that he knew of other small business owners who would like to expand but they didn't bother to apply for loans because they knew the bankers would turn them down. There are some establishments which are benefiting from low interest rates. The banks can access the Federal Reserve window and borrow money at just above zero and they are obtaining deposits at near zero interest rates. The hedge funds are also benefiting. The hedge funds can't access the Fed window but the banks are happy to lend them money at the prime rate of 3.25%. Since hedge funds are heavily leveraged, when their borrowing costs are cut in half, then it is a huge savings for them which flow right to the bottom line.

There is very little chatter among anyone about who gets hurt by having near zero short term interest rates over such an extended time period. Energy prices have risen as a result of the weak dollar. Food prices have also risen. While overall inflation is tame by historical standards, the increase in food and energy prices are hurting the people who can afford it least. More importantly, it is really hurting the senior citizens in a big way. I find it tragic how, basically, the Federal Reserve is throwing the senior citizens under the bus to enrich the bankers, the hedge funds and the wealthiest investors in the stock market. Sure, all stock market investors are benefiting since a rising tide lifts all boats but the average investor has less then $ 100,000 in the market so the big boys are by far and away benefiting the most. Seniors on fixed incomes need to eat and to drive their cars, and with social security payments barely rising because the overall inflation rate is very low, their real incomes are going down. What is even worse, is because they rely on fixed income to survive, mostly from CD income, other savings accounts and Treasury bond income, their interest income is only a fraction of what it was five years go.

Without a doubt, there are problems with the macro economic environment. As I told a very smart client recently, market psychology changes on a month by month basis, depending on which direction the wind is blowing. A perfect example is that just a couple of days ago, with Greece voting for austerity and yesterday with just one piece of positive economic data, the stock market has seen a huge rally. Earnings season is right around the corner. Equity valuations are ridiculously cheap and short term interest rates as mentioned are near zero. I can assure you that all the stock market needs is a couple of good earnings reports or a jobs report that isn't as bad as expected to ignite a strong market rally. By design, the Federal Reserve is telling the investment community, don't keep your money in the bank in a money market account at an interest rate just under 1% and don't buy a two year CD at just under 2% (before taxes).

I know that I gave you a heck of a lot of information to absorb. I hope that I didn't lose you because of the length of this letter. There is much important information that I feel is necessary to communicate to you and I believe that knowledge is everything. If you have any questions or if there is anything that you would like to discuss, then please send me an email or call me.