TRITON

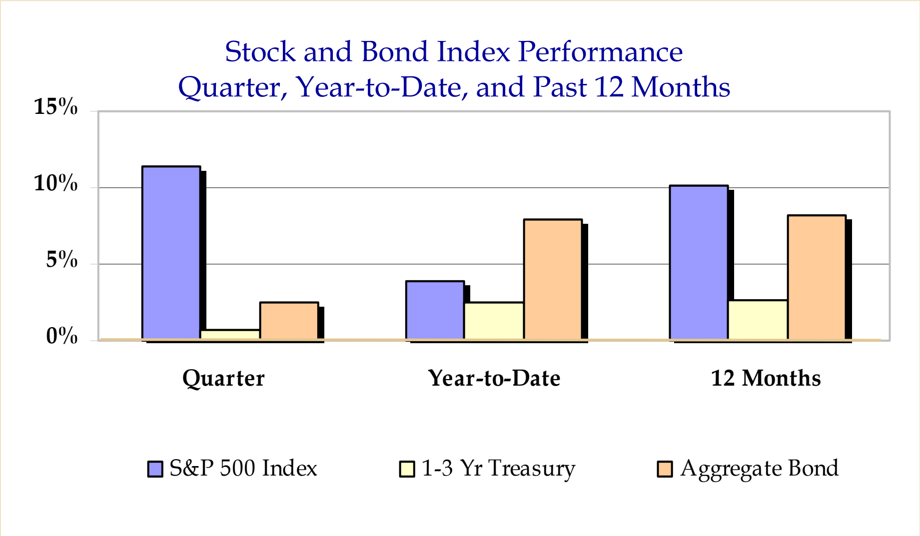
INVESTMENT ADVISORS, LLC

Now, here, you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that! ~ The Queen, *Through the Looking Glass*

Assets rally as the NBER declares an end to the Great Recession and the Fed pledges help.

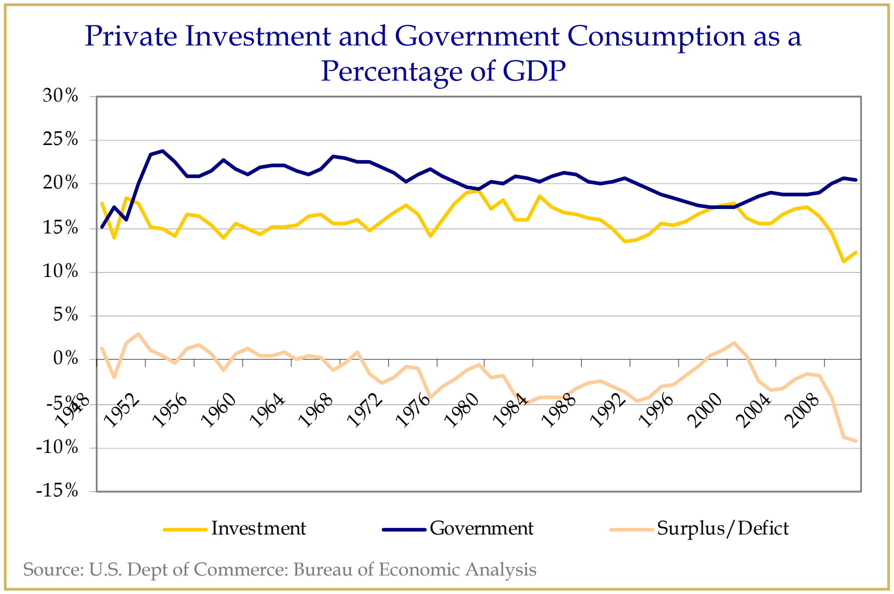
Back-to-school season sent a wave of excitement through the halls of our great institutions, as the promise of new and exciting adventures conflicted with the sense of foreboding one gets when leaving the comforts of home – and that was just in the offices of Hewlett and Oracle. Meanwhile, the National Bureau of Economic Research declared that the longest recession since the Great Depression ended June 2009, and the Federal Reserve renewed its pledge "to support the economic recovery." This, plus a dose of intoxicatingly low interest rates, put stock investors and corporate America in the mood to buy. The result was an impressive stock market rally that pushed 12-month stock returns past those of the beloved bond market.

"How can the market do well when no one is working?" I was asked recently. "It's not that no one is working," I replied, "it's just that those who are working are working harder." The Great Recession has turned many people's economic assumptions upside down. However, recent economic data suggest that several key economic components are functioning normally, and that with time and effort, even our most stubborn problems – unemployment and the deficit -- can be overcome.



Gross Domestic Product and its Moving Parts – a Primer

GDP can be measured by summing Private Consumption, Private Investment, Government Consumption, and Net Export expenditures. The smallest component, net exports (-3.5%), can be quite volatile, while the largest component, consumption (70.5%), tends to be surprisingly stable. Government consumption (20.5%) also tends to contribute a steady percentage to GDP, despite the accusations of runaway government spending. (This charge -- more accurately linked to deficit spending -- does not belong in this context, but we include it in the chart below for reference.) That leaves us with the private investment component, whose inconsistent nature

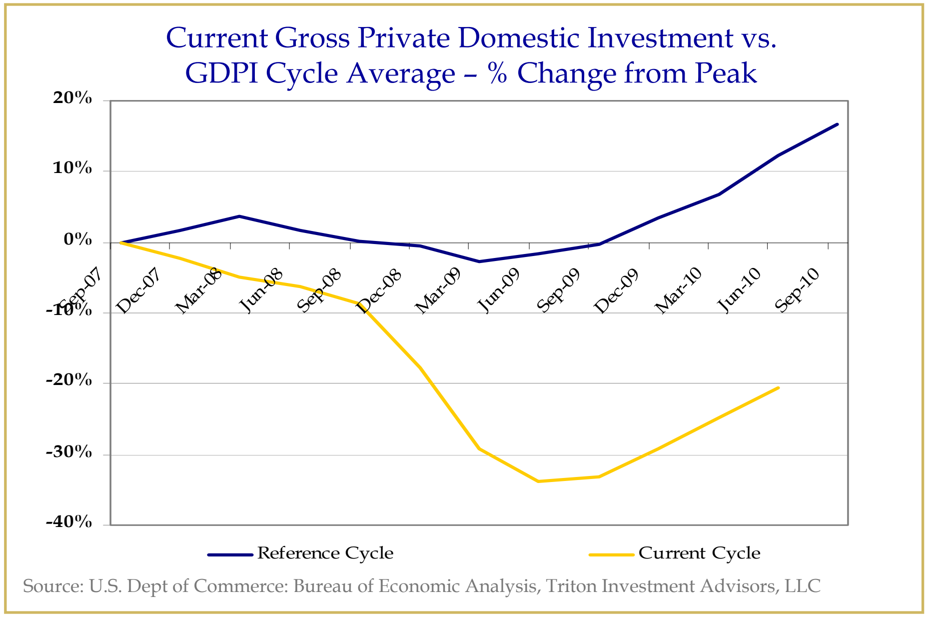


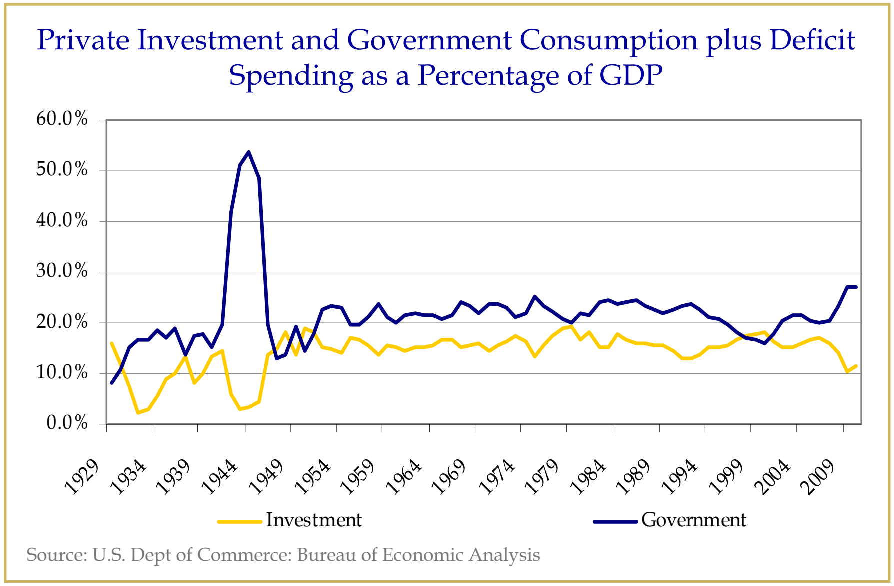
makes it a major contributor to the business cycle. If you review the movements of private investment (depicted above), you will probably notice a correlation between private investment and the deficit. Others have noticed this correlation as well.

Former Fed chairman Greenspan, writing in the *Financial Times* ("Fear undermines America's recovery", October 7), noted that historically the deficit ratio has been "leading the fixed investment share by nine months." Our view, influenced by the chart above, is just the opposite – private investment tends to drive the deficit. This discrepancy may arise because we are looking at Gross Private Domestic Investment, while he is looking at fixed investment *as a share of cash flow*. He is implying that the deficit, "which creates critical future tax uncertainty," is causing the business community to hoard cash. We are suggesting that hoarding cash is leading to a negative change in income, and a resultant jump in the deficit.

Historically, the deficit ratio – whether via its influence on interest rates or some Ricardian Equivalence – might have propelled fixed investment. This link is questionable in today's environment. A more plausible explanation might be that we are simply up against a time factor in the cycle, wherein excesses must be allowed a sufficient amount of time to clear the market. A review of the various investment components illustrates this point.

If you begin with Mr. Greenspan's fixed investment – structures, equipment & software, and residential – then add changes in inventory, the result is Gross Private Domestic Investment. The current GPDI cycle, when referenced to an average cycle, is characterized by its extraordinary drop from the peak (see chart below). However, the news is not all bad. Inventories have staged a dramatic recovery, while equipment & software are 13 percent above their lows – clearly not encumbered by "future tax uncertainty." Structures and residential investments -- victims of the recent real estate bubble -- remain depressed.





Government Spending – the Mirror Image of Investment

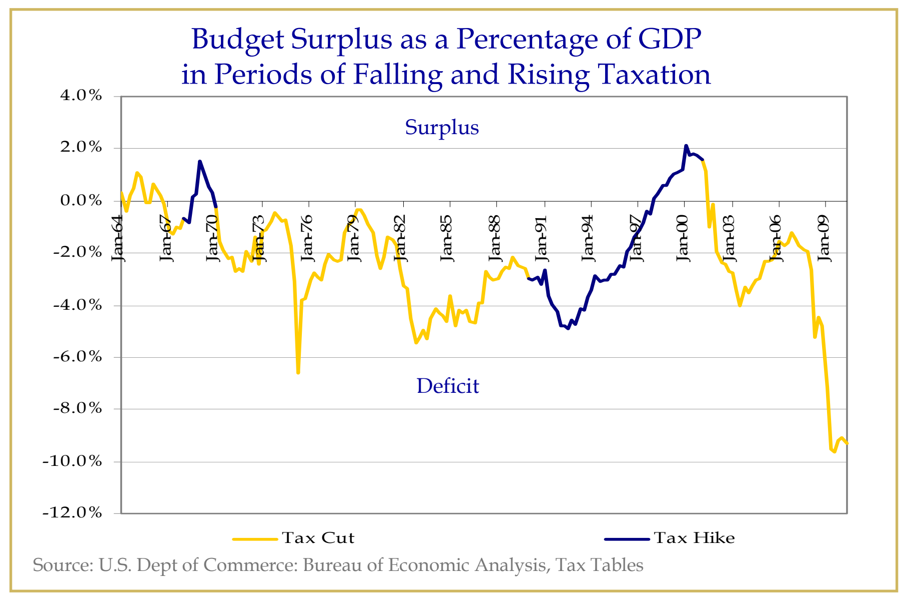
When investment is depressed – for whatever reason – government spending has a long history of filling in the void. We illustrate this point by adding deficit spending to the government consumption expenditure, and presenting this adjusted "GDP" depiction above. Other than during the war years, when both consumption and investment were suppressed, government spending tends to represent about 20 percent of expenditures. Today, in response to a collapse in investment, this figure is closer to 27 percent. In this respect, deficit spending has functioned according to historical expectations. The concern, of course, is the size of the deficit necessitated by the troubling collapse, and our ability to reduce the resultant public liability.

Tough Choices, but not Necessarily Tough Times

Thus far, we have managed our deficit via willing buyers of our debt and low interest rates. Eventually the economy will gain traction, and this dynamic will change. Interest rates will rise and greater expenditures will be necessary to service our debt.

Employment growth would do a lot to alleviate this problem, but for now, companies prefer to run lean. Targeted tax breaks won't stimulate the depressed areas of investment, and income tax cuts won't decrease the deficit (see chart below). That leaves us with some difficult choices regarding spending, taxation, stimulus, and austerity. J. M. Clark, writing in his *Strategic Factors in Business Cycles* noted that "to assume that the economic system will give us unlimited time to find cures for its worst evils is not wise." We have time to unite around a realistic combination of policies, but we don't have forever.

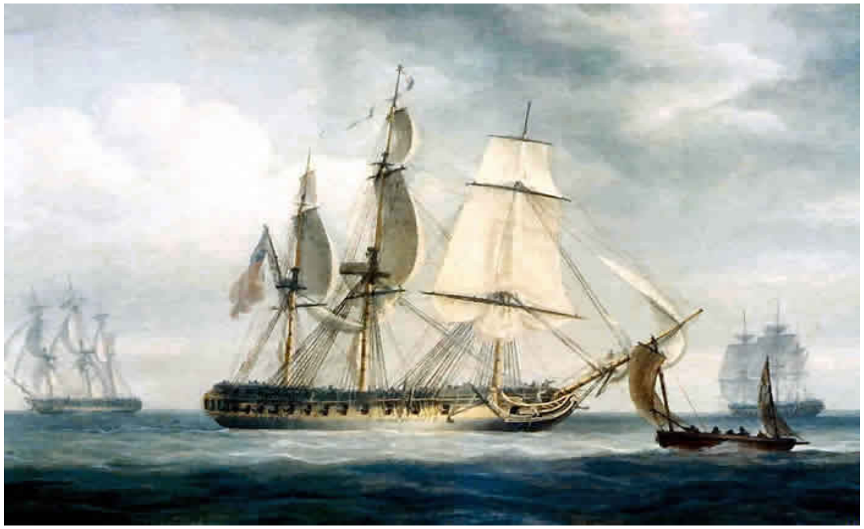
For now, corporate productivity is high and inflation is low. This has traditionally been a great environment for investors. Let's hope it turns into a great environment for all.



Investing in an Uncertain and Volatile Environment

Several encouraging items provided some good news to a market in need of good news. Stocks performed very well, and judging by the earnings estimates, should continue to outperform bonds. The National Bureau of Economic Research, by declaring the end of the recession, has taken the double dip off the table. Any future downturn will be a new recession – investors take heart!

The real estate implosion and resultant economic collapse has taken its toll on the spirit of America. We are tired, and having avoided the abyss, we must now endure the climb. The recovery thus far, particularly as it relates to public investment, has been subpar. Certain areas are performing according to prior recoveries, while others are in need of time, and time is a luxury for a country where the majority of its citizens are nearing retirement.



Fiscal stimulus has provided an offset to the fall off in investment spending, but not without consequence. The federal deficit has ballooned as a percentage of GDP, as receipts have fallen and expenditures have risen, both victims of huge job losses. Employment growth would greatly benefit the country. More employment means more tax receipts and less assistance. It means more demand and more private investment. And it means a lifted spirit. However, as corporations wait for demand, they grow accustomed to generating output with fewer employees. As callus as this sounds, it is good for profitability, and good for the stock market. We continue to see opportunity, but of course, we monitor the landscape for change.

Glossary of Terms Mentioned

Ricardian Equivalence – An economic theory first put forth by David Ricardo, stating that taxpayers, in response to deficit spending, will put aside funds in order to pay the necessitated future tax obligations, thus negating efforts to stimulate demand.