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The Economy

As my regular readers know, I spend most of my time using this newsletter to discuss current economic events, as well as our outlook not only for the economy, but the capital markets as well.

In this issue, it is my intention to spend most of the time discussing how our managed portfolios are currently invested. We do not discuss individual investment recommendations for compliance reasons, but I will endeavor to be as specific as possible regarding our strategies.

The Portfolios

No discussion of the portfolios is possible without having a good understanding of how we go about our investment process.

We are a top-down money manager, which means we start the process by establishing our big picture view of the global economy and the capital markets for the coming 12 month period. In addition to these forecasts, we look very closely at other variables such as market conditions in various countries worldwide, and exchange rates between countries. It is our goal, as a result of this analysis, to establish the best possible sectors of the global economy to be invested in.

Once we have established this top-down analysis, we start looking for attractive investment opportunities that fit within our global economic and capital market forecast. When analyzing individual investments, we look at a myriad of fundamental criteria. If we are looking at stocks, we start with the company fundamentals and management, and then move to relative valuations, price/earnings, price-to-earnings growth, price-to-free cash flow, and other metrics. Bonds and other alternative asset classes such as real estate go through their own rigorous due diligence process.

Many people often describe this approach as 'theme investing'.

In addition, we are always looking for those 'special situations' or investments that are usually riskier than our average holding, but in our opinion have substantial upside potential.

U.S. Stocks

Our best guess is that U.S. Stocks, as measured by the S&P 500, will continue *to trend up* at least until after the next presidential election or until the free money currently being made available to Wall Street and the Oligarchic Banks stops.

However, should anything go 'wrong', we think the U.S. stock market could get very bad, very quickly. While we do not think that stocks are particularly expensive right now and it does look to us that corporate earnings will be better than forecasted at least for the next quarter or so, we worry about other factors coming in to play, such as high frequency trading and potential future shocks to the credit markets.

To take advantage of this upside potential in U.S. stocks and at the same time take steps to limit the downside risk, we have been buying very high quality blue chip U.S. companies that have solid balance sheets, solid growth potential, pay good dividends and have a history of increasing those dividends over time.

It's important to remember that most companies like this—ones that are still in growth mode and also pay out a good solid dividend—are very rare. Most big companies that can afford a good dividend are way past their growth stage. However, we believe there are some unique situations out there right now that do in fact meet these criteria.

These types of companies should do better than smaller to mid-size U.S. companies because they currently have better access to capital than smaller businesses. As investors become more risk adverse, they will have the added benefits of not only good growth but excellent dividends helping to cushion any potential downside that the market may surprise us with. Finally, if the market does take a tumble, then we can reinvest those dividends into additional shares at a cheaper price.

Energy

It appears that industry insiders have finally made some headway in convincing the President and Congress to recognize that the energy path America is on today is unsustainable. There appears to be growing recognition that it is very dangerous to continue importing 9 million barrels of oil per day and exporting more than $1 billion per day in national wealth to oil exporting countries. Until recently, America's political leadership has not seemed overly concerned about this issue. Over the next ten years, America will likely export at least another $4 trillion in national wealth to oil exporters around the world. Already, this transfer of wealth has been the largest transfer in the history of the world. This is obvious insanity.

The good news is that we have alternatives right here in the U.S. that could significantly reduce, if not eliminate this foreign dependence. What I am talking about is natural gas. Many geologists predict that the U.S. and Canada could turn out to be the Saudi Arabia of natural gas. Unlike solar and wind, natural gas can be stored on the grid until it is needed, and it is a portable fuel. Unlike coal, natural gas has a much smaller carbon footprint and could be called a 'green' fuel.

The question is how to invest in natural gas. One of the ways we have chosen to invest in the potential of natural gas is with a relatively new company that makes engines for trucks and cars that run on natural gas. While it would be nice to think that we will all be driving around in cars that run on natural gas sometime in the near future, we believe that would be somewhat naive. However, the application for the trucking industry is

rapidly growing as more and more companies like FedEx, UPS, and other short-haul delivery trucks, trash trucks, city buses, etc., are replacing aging diesel and gas engines with natural gas engines. This company is a good example of the 'special situation' stock that we previously mentioned that could really be a big winner.

There are, of course, many other ways to invest in natural gas. Another investment that we have made in this space is in the delivery of natural gas to users via pipelines. Our investments in pipelines not only fit into our energy theme, but also pay excellent dividends. These pipelines act as toll roads as they collect a fee for every cubic foot of gas they deliver. This means that future revenues are very predictable regardless of the fluctuations in the price of gas.

Scrap-Metal Recycling

Scrap metal production has soared since 1999 while at the same time metal prices have more than quadrupled. According to the *Cannaccord Genuity Recycling & Environmental Service's Index,* prices have climbed 10.2% so far this year versus about 0% for the S&P 500 (as of June 22, 2011). Currently, scrap metal supplies remain tight as people cling to appliances and cars longer amid a slow recovery. As long as basic material cost remain high (which is what we are expecting) that will mean a larger profit for scrap metal recycling companies. The U.S. is the world's largest scrap metal exporter and therefore this business could be a bright spot in the countries overall economic recovery. Infrastructure projects in developing economies drive worldwide steel consumption. Countries like China, India, Brazil, Mexico and other emerging countries continue to spend heavily on steel-intensive Fixed Asset Investments. Our investment exports over 70% of their production to these countries. Scrap metal recycling is also very environmentally friendly. While already very important in the developed world protecting the environment is becoming more of an issue in the emerging markets as the middle classes grow.

Japanese Reconstruction

By some estimates the rebuilding of Japan, after one of the worst natural disasters of modern times, may well end up costing more than 300-500 billion dollars. We believe that several industries stand poised to make big gains as they assist in the reconstruction efforts.

Gold

In times of uncertainty, gold will behave as an alternative currency and as a hedge against inflation and uncertainty, both of which we see plenty of in the future. There are as many "good" reasons to sell gold as to buy, but we are not day traders. Because we see gold as a currency until we see the dollar actually start to trend back up and therefore becoming more competitive as a currency, we will remain long gold.

Mergers & Acquisitions and Event Arbitrage

The goal here is to invest in companies involved in pending mergers, takeovers, and other types of corporate reorganizations. When investing in a stock-for-stock merger involving a fixed exchange ratio, the portfolio

normally combines a long position in the target with a short position in the acquirer. In this way, the portfolio attempts to lock in the arbitrage spread between the two securities.

Activity in this space has been robust as smaller companies starved for capital seek larger companies to partner with. We do not expect the current restraints on capital availability for smaller companies to loosen any time soon so we expect activity in the M&A space to continue.

Long Inflation/Short Bonds

Our major theme in the portfolios in 2010 and 2011 has been that we have been expecting huge increases in inflation. While there is plenty of evidence to support this position, inflation is not showing up in the 'official numbers' put out by the government. This has caused our portfolios to underperform the market (as measured by the S&P 500) in 2010. However, we remain committed to our outlook and will wait for the day when the government has no choice but to admit what everyone already knows.

The bond market over the last 15 years or so has been on a tear while stocks have done nothing. This is because interest rates have come down so much over that period of time that bonds in the hands of investors have grown more valuable. With interest rates almost at zero, we find it likely that yields will at some time go back up and when they do our short position will increase in value. This is because as bonds yields go up existing bond prices go down.

If and when the current sentiment does change, the massive selling we expect would be very quick and very violent to the downside as investors currently buying treasuries head for the exits in masses thus driving down the price.
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Whether it's the government restoring some fiscal responsibility on itself or bond investors doing it for them, when rates start to go back up that's when our investors will be rewarded from this investment.

Real Estate

Real estate is something 'real' that usually does well in an economy that is experiencing some inflation. In addition, low interest rates and very uncertain stock markets have burned a lot of people and that has caused a loss of some confidence in these asset classes. Many investors are becoming much more active in seeking out other potential opportunities like real estate.

One of the real estate markets that we think is undervalued is the high end apartment (previously nice condos whose developers went broke in the '09-'10 crash) market. It wasn't too long ago that these types of buildings were being sold for steep discounts to their intrinsic value as developers were forced to sell for a variety of reasons. Besides what we consider to be good value these types of buildings also pay good well-supported dividends paid from rent by their current tenants thereby making this type of investment a potential solid growth/dividend play.

Many Americans are finding the 'American Dream' of owning a home to either be impossible or simply not attractive. Rental rates still seem very reasonable relative to the cost of owning a comparable property, and we expect those rates to increase as more and more homeowners find themselves looking for a new place to live and foreign investors take advantage of the cheap prices and a strong currency vs. the dollar.

The problem for most investors is either they can't or don't want to own this type of real estate directly. We use what is known as a Real Estate Investment Trust (REIT) for this portion of our clients' assets. REITS can be publically traded or not publically traded. The selection of a publically traded or not publically traded REIT depends on a number of factors and is very client specific.

Timberland

While U.S. timber is not in demand for building new homes, the U.S. and Canadian lumber markets are picking up as demand for replacement homes in Japan are expected to reach the 1 million or more unit level per year.

One of the advantages of a weak currency is that it makes our exports cheaper than other countries. We believe that this will give U.S. lumber producers a strategic advantage as this new increase in demand ramps up. In the meantime, timber is used in all types of products from paper and packaging to medicine and sport drinks.

Owning timberland means owning both land – which may increase in value over time – and trees, a living, growing real asset. As an asset class, timberland may help to preserve capital in the face of rising consumer prices, because timberland returns historically have tended to outpace inflation. (according to the US Bureau of Statistics 1976-2009)

Pharmaceuticals

The population is getting older, not just here in the U.S. but on a global basis. As we get older, we take more medicine and this should be good for the pharmaceutical companies, but it hasn't been the case. Why? We think there are several reasons for this: managed care, generics, and probably most of all, the so-called 'block buster' drugs coming off patents, and therefore their developers and distributors losing billions in profit. Replacing these drugs with new ones in this country is a very risky and expensive process. Drug manufacturers have to contend not only with the FDA's laborious approval process, but also the potential for serious litigation should something unforeseen happen to a patient taking the drug.

While we are bullish on this space, we believe that for these reasons and others, the best way to participate in the pharmaceutical business is by owning drug companies that are headquartered and have a majority of their sales outside the U.S. This makes it much easier for these companies to develop new medicines and distribute those medicines to a global population.

Commodities

Commodities have had a huge run over the last 12 months or so, and we believe that while these markets look like they could continue to move up, we expect a lot more volatility. Part of this volatility has to be attributed to the so-called 'democration of alternative asset classes', which basically means that with the use of ETF's and ETN's, retail investors now have access to these asset classes that have in the past been limited to institutional investors. We worry about this so-called democration of commodities because we believe that average investors mistakenly believe that commodities have little correlation to stocks, and therefore will zig when the stock market zags. There is absolutely no evidence to suggest this is a correct assumption. Historically, commodities have actually traded on an almost 1-1 basis with stocks.

This could mean that investors could get a very bad surprise if the stock market tanks and so do their commodities!

We feel strongly that commodities are going to get a lot more volatile, so not feeling comfortable about being able to time these markets successfully over a long period of time; we have simply decided to invest in a company that executes and settles more of these types of trades than anyone else. So, the more volatility….the more trades… the more money our investors should make.

Summary

It seems to us that the free cash flow that has been coming into the market has fueled a rally in stocks, bonds, and commodities to the extent that the fundamentals of these markets have been seriously skewed. We believe that this condition will continue for the foreseeable future until such time as some measure of fiscal responsibility emerges from our policy makers or is imposed on them by the rest of the world. In our opinion, this free cash flow has trumped every other market moving event since the March lows in 2010.

This is not to say that the underlying fundamentals are necessarily bad. Indeed, it appears to us that U.S. companies, especially the multinationals, are in good shape, and demand is robust for commodities as so-called third world countries become less dependent on selling us their stuff and start selling it to each other.

The biggest problem with all of this is that 50%-70% of average daily volume in the stock market remains machines trading with one another based strictly on technical indicators with capital that has been provided to Wall Street courtesy of Washington at almost zero percent interest and has also been provided with an implicit guarantee against loss.

This probably means that should something happen that moves the mathematical algorithms from buy to sell, that event could set off another wave of mass selling much like we have already experienced in the so-called recent 'flash crash'.

If we are correct in our analysis of these scenarios playing out over the next 12-24 months, we believe that our clients will be well positioned to take advantage and make money.

As always, thank you to our clients for your confidence and trust.

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Michael K. Chrysler is a managing partner at Matrix Wealth Management, with accounts held at Raymond James & Associates, Inc., member New York Stock Exchange/SIPC and Fidelity Investments, Member NYSE, SIPC. All expressions of opinion reflect the judgment solely of Michael K. Chrysler as of this date. Information herein has been obtained from sources considered reliable, but not guaranteed to be accurate or complete. Matrix Wealth Management, its affiliates, officers, or directors may in the normal course of business have a position in any securities mentioned in this report.
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