KINGFISHER CAPITAL
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Dear Client,

During the second quarter, the "headline" risks were plentiful from the Gulf Coast to Goldman Sachs to Greece, Spanish banks and even Hungary. However, in our view, these risks are part of the recovery process. Over the last hundred years, every major corporate credit crisis has been followed by a sovereign credit crisis. There are always "new normals" that emerge. This time it will be credit contraction in the western economies as governments deploy austerity measures.

At the recent market peak this spring, the S&P 500 had moved about 65% higher from its lows in March 2009. New uptrends that emerge following severe corrections like the one we saw in '08-09 universally encounter 10% corrections in the first 12-24 months and VERY OFTEN encounter 20% corrections within the renewed recovery uptrend. What we are experiencing right now is normal.

Investors who raised cash in 2008 could not get reinvested fast enough to recoup losses in the V-shaped stock market recovery of the last 14 months. During the quarter, we raised some cash and took some risk off the table incrementally in our equity investments in preparation for a possible test of 1040 and 950 on the S&P 500, which would be about a 20% correction from the April high. It would be at those price levels where we would be adding to energy and technology names.

After seeing persistent market gains through the first 3 months of the year, we reduced our equity exposure on April 15. We remained in a reduced market exposure, including a short position vis-à-vis the Inverse S&P Index fund until the “flash crash” on May 6. During the intraday sell-off we exited the hedge with a profit, only to re-establish the position at a better entry point a couple of days later.

I see the SP 500 likely testing the 1040 level and possibly the 950 level on the downside. Upside resistance has been at 1105, where the market has struggled to gain traction over the last couple of weeks. I do think we are in a global recovery, but it is U-shaped so far with respect to jobs. The coming months will hopefully reflect growth in private employment figures starting in July. The May and June readings were anemic, but were net positive. Corporate balance sheets are in very good shape, retailers are doing surprisingly well, auto and home inventories are continuing to deplete and replacement demand will drive growth over the coming quarters.

In addition, longer term (2-4 years) prospects for the stock market and energy in particular look promising. The US has no choice but to continue to try to reflate. With the 10 year Treasury bond yielding a paltry 3.2%, stocks look very attractive for the next cycle. Right now we are battling deflation. Historically, such a battle results in inflationary pressures. Yes we have unmanageable fiscal deficits in Europe, structural fiscal problems in the US, and a slowing growth rate in China. But we have supply-demand fundamentals that will begin to become more important as we emerge from the 2008 credit crisis.

One could not comment on the 2Q without mentioning the BP spill. Curiously, our holdings in alternative energy gave us mixed results throughout the disaster. This may be the result of lingering doubts about the strength of our economic recovery, however, longer term, it seems obvious to us that alternative energy and energy efficiency measures will take hold in the US at an accelerated pace in the aftermath of the BP spill. We remain confident of prospects in this sector.

Furthermore, positions in gravitational themes related to emerging middle class consumption trends, clean technology, and a renewed technology capital cycle are starting to show signs of life. We expect our stock picking to shine again over the coming quarters as we emerge from this trailing two-year period of highly correlated asset swings. The impetus for driving capital flows to our ideas has at long last begun to take shape, clarified by the BP disaster, room for credit expansion in India, China, Canada, Brazil and Australia, ongoing top-line constraints in western economies, and latent inflation (more in the form of stagflation) creating upside for stocks and certain commodities and efficiency technologies.

As always, please call with questions or to set up a call or visit.

All the best,

Alexander Miles
Managing Partner
Kingfisher Capital

Opinions described herein are subject to change.