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July 9, 2010

Dear Clients and Friends,

At the end of our quarter-end conference call last week, we addressed a client's question about next year's increase in the capital gains tax rate. While the pending increase from 15% to 20% isn't music to our ears, it nevertheless sounds better than the 39.6% rate on dividends that some Congressional Democrats have suggested they are planning for those in the upper tax brackets. We expressed our concern about possible changes to the dividend tax rate on the call, and were somewhat relieved this week when Treasury Secretary Timothy Geithner responded directly to our worries. (No, we don't really believe he was listening to our conference call; however, there were a small number of "anonymous" eavesdroppers so we can't say for certain that he wasn't!) In a CNBC interview, Geithner said the Obama administration plans to hold the top tax rate on both capital gains and dividends to 20% next year. While it may come down to a battle between the White House and Congress over this and other elements of the Bush-era tax cuts set to expire in January, such a move may help lessen one of the predominant headwinds facing the economy and financial markets: concern over rising taxes.

By the way, if you were not able to listen to the conference call "live," you can hear a recording of it at our website, www.fbbcapitalpartners.com. Simply look for the audio player on the left side of our home page and press the play button to get it going.

Fueling the market's gyrations over the past two months were continuing economic discord in the European Union and a marked slowdown in economic activity in mainland China, previously one of the world's growth engines. These factors spurred a "flight to quality" in the global bond markets, driving the yields on US Treasury Bonds (still deemed the safest asset on the planet!) to new lows for the year. The flip side of the quality trade is that stocks came under selling pressure around the world. While our own stock markets were in correction mode, others fell deep into bear territory – China's Shanghai market tumbled 30% in recent months!

"For the moment, the broadly unanticipated behavior of world markets remains a conundrum."

- Former Fed Chairman Alan Greenspan, in Congressional testimony, February 2005

What we find most curious about recent stock market activity is that the downward pressure has continued despite persistently strong corporate earnings, at least here in the US. Throughout the last quarter and as recently as this week, earnings estimates for companies in the S&P 500 went up, even as stock prices went down. Just as Mr. Greenspan wondered aloud five years ago as to why bond yields would fall further each time he jacked up the short-term bank lending rate, we find ourselves with a new stock market conundrum today: why are stocks going down when earnings are going up and the interest rate environment is favorable to stock valuations? Either earnings are set to disappoint (possible), or stocks are becoming increasingly attractive on a valuation basis (also possible!)

The second quarter earnings reporting season begins next week, so we'll soon have a better feel for the corporate outlook for the remainder of the year. We do anticipate downward revisions to the Street's earnings targets (we are presently discounting the estimates a full 10% for our own models), and increasingly believe that the US economic recovery will be muted and choppy given the numerous headwinds we face (federal and state budget deficits, spending cuts, higher taxes, and the broader trend toward austerity.) But with the earnings yield on stocks about as high as it has ever been – even after we apply our discount – we think the downside risk is already largely reflected in prices, and we are currently evaluating several long-term investment opportunities in various market sectors.

Sincerely yours,

Mitch Schlesinger

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