VOLUME 7, ISSUE 2

JULY 2009

CRESTWOOD PERSPECTIVES

MARKET OUTLOOK: GREEN SHOOTS OR WEEDS?

Given the uncertain economic environment, the strong equity returns in the second quarter surprised many investors. The S&P 500 closed up almost 16% for the quarter and up almost 40% from its March lows. The world equity indexes also performed impressively with EAFE up approximately 22% and the emerging markets up just over 30%. Even the bond indexes (with the exception of U.S. Treasuries) provided positive returns with the Barclays Aggregate index up nearly 1.9% and the Barclays 5 year Municipal index up approximately 0.8% for the quarter.

"Green shoots" or Weeds?

Do these strong performance numbers mean that green shoots are sprouting or will they just prove to be weeds caused by the record rainfall in the spring?

Consumers have been severely impaired during this recession. As they continue to digest the losses in their home equity and the devastation in their retirement assets, they are struggling with a lack of available credit, impending higher tax rates and, most importantly, fear of continued job losses. With unemployment close to 60 year highs and continuing to rise and the consumer making up about 70% of the U.S. economy, this economic recovery could take several years.

Given the enormity of these issues, we are not surprised to see consumers focused on saving money again: the May savings rate jumped to almost 7%, which was the highest in 15 years. An increase in the savings rate is healthy for an economy over the long-term but is counterproductive in the midst of a recession. While we do not expect the U.S. consumer to stay on the sidelines forever, until we see housing prices stabilize, credit spreads tighten and employment improve, we prefer to commit client capital to asset classes and investments where healthy fundamentals still remain.

Governments and central banks around the world continue to take unprecedented action to stimulate the world economy. These actions have included dramatically increasing liquidity, intervening in industry, holding overnight interest rates near zero and directly buying mortgages and government bonds. Short-term, many of these actions have halted what would likely have been financial catastrophes.

In the U.S., the Federal Reserve has aggressively provided liquidity to our financial industry to ensure a healthy flow of capital and credit.

Continued at top of page 2

LESSONS IN ENERGY INVESTING

Given the recent volatility in oil and natural gas prices, we thought it would be helpful to articulate our approach to energy investing. Three key lessons have re-emerged for energy investors during the past couple of years: 1) oil/gas prices and related investments can be exceptionally volatile 2) in the near term, oil/gas prices can be driven less by fundamental factors (i.e. supply, demand and marginal cost of production) and instead be dictated more by financial speculation, inflation/U.S. dollar hedging, and geopolitical concerns and 3) historical absolute price levels and relationships for oil and gas may no longer be relevant in the future.

Lesson #1: Volatility

Energy investing is inherently volatile, and large sudden swings in oil and gas prices can occur for any number of reasons. Hurricanes, pipeline attacks and war can have a dramatic impact on supply. Similarly, heat waves, excessive cold weather, expectations for improving economy and global energy consumption will affect demand. During the past two years the price of oil has risen from $75/barrel to nearly $150, then back down to $30 before recently doubling to the mid $60 range. Natural gas followed a similar pattern until late 2008, but has yet to experience the same strong rebound as seen in oil this year.

Continued at bottom of page 2

IN THIS ISSUE

Crestwood Advisors LLC
50 Federal Street, Suite 810
Boston, MA 02110
617.523.8880
www.crestwoodadvisors.com

Michael A. Eckton, CFA
Managing Partner

Robert G. Ix, CFA, CIC
Managing Partner

John W. Morris
Managing Partner

Leah R. Cadillac, CFP ®
Partner

Aaron M. Beltrami, CFP ®
Director

Matthew S. Morse, CFA
Director

Daniella M. Boni
Associate

Rushabh R. Shah
Associate

Margaret L. Sweet
Associate

MARKET OUTLOOK...(CONTINUED)

Though this has been very reassuring to the markets and depositors, the velocity of money has not increased as banks have preferred to hold this capital to shore up their balance sheets as opposed to making new loans. Additionally, these actions have potentially created unrealistic financial stability that, though comforting, is masking weakness in the banking system, especially in light of the vulnerable commercial real-estate market.

With this backdrop, the recent strength of the stock market has not changed our cautious economic outlook and has actually made us more wary as investors. We continue to position portfolios defensively by ensuring that all clients have ample cash and fixed income exposure. In our last newsletter, we discussed the importance of managing risk and positioning portfolios to maintain purchasing power in light of expected future inflation. Domestically, ongoing government spending and plunging tax receipts has created a fiscal deficit that has grown from 2% to 15% of GDP in just two years (now the largest since World War II) and has increased the need for the government to raise trillions in new debt. While printing money to finance deficits is inherently inflationary, the destruction of credit combined with excess capacity (measured by low factory utilization and high unemployment) means that inflation and the potential for dollar decline is not likely to occur until we at least see early signs of a moderate economic recovery.

To partially combat likely rising future inflation, we continue to buy and hold gold and other inflation-sensitive investments in our clients' portfolios.

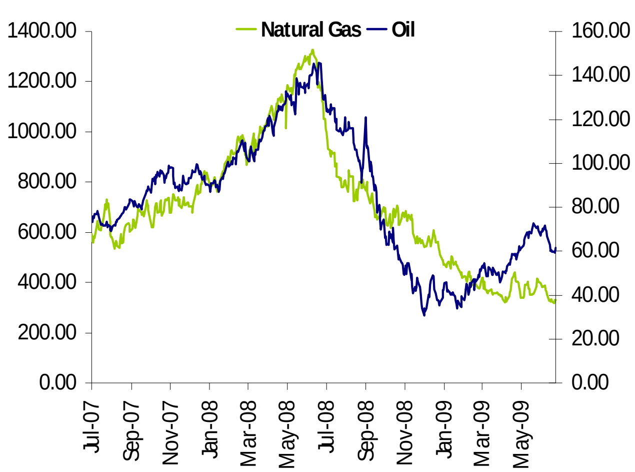
Even with a stagnant economy and a Fed holding short rates close to 0%, the markets have pushed 10 year Treasury yields from 2.2% to about 3.6% over the last 6 months. Though many believed that this move occurred as a result of anticipated economic growth, it is more likely reflecting the cost of financing deficits which includes the yields required to entice foreign governments to keep purchasing our debt.

With historically low money market yields and a steep yield curve, we believe the right tactical investment is to avoid the

Continued at top of page 3

LESSONS IN ENERGY...(CONTINUED)

Volatility in oil and gas prices means that, as investors, we must take steps to mitigate direct exposure to "peak" commodity prices and valuations – this can be achieved by investing in companies that hedge their exposure to commodity prices and by carefully analyzing the financial and fundamental factors that influence commodity prices.



Even Warren Buffett is not immune from the volatility of energy investing (from the Berkshire Hathaway 2008 Annual Letter):

"I bought a large amount of ConocoPhillips stock when oil and gas prices were near their peak. I in no way anticipated the dramatic fall in energy prices that occurred in the last half of the year. I still believe the odds are good that oil sells far higher in the future than the current $40-$50 price. But so far I have been dead wrong. Even if prices should rise, moreover, the terrible timing of my purchase has cost Berkshire several billion dollars."

<u>Lesson #2: Fundamentals Matter... Eventually</u>

Another major lesson of the past few years is that of the growing impact that non-fundamental factors can have on oil and gas prices in the near term. Because oil and gas prices are both globally denominated in U.S. Dollars, the price of the commodities often will rise as a direct result of inves-

Continued at bottom of page 3

Crestwood Advisors' Philanthropic Commitment:

Boston Health Care for the Homeless

Boston Health Care for the Homeless Program

Founded in 1985, Boston Health Care for the Homeless Program (BHCHP), provides top-notch, comprehensive healthcare for homeless individuals and families.

BHCHP believes that a trusting relationship between patient and provider is an important part of care, and providers seize every opportunity to engage patients and to earn trust through consistency and patience. Staff work in multidisciplinary teams to meet their mission of providing access to the highest quality health care for Boston's homeless men, women and children.

The core group served by BHCHP are homeless families who stay in the emergency shelter system, eat in soup kitchens or visit drop-in centers. They also care for formerly homeless people who have progressed into transitional and supportive housing programs.

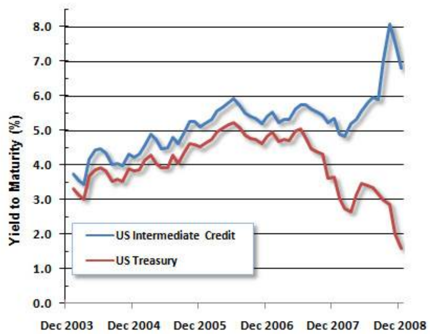
In 2009, BHCHP will serve more than 11,000 patients in more than 72,000 outpatient medical, dental and mental health encounters.

For more information, please visit www.bhchp.org.

MARKET OUTLOOK...(CONTINUED)

temptation to buy long-term bonds and continue to keep our clients invested in short to intermediate term bonds issued by healthy municipalities and corporations. These investments provide our clients a stable income stream, principal preservation, and the liquidity and flexibility to potentially take advantage of the higher yields we anticipate in the future. We have also complemented our clients' bond portfolios with exposure to international bonds, senior-secured bond funds ("bank loans"), inflation protected bonds (TIPS) and we are beginning to add "Build America Bonds".

Some of these bond investments have provided equity-like returns with significantly less risk while also diversifying clients' overall fixed income exposure. Specifically, as an asset class, bank loans are up over 20% year to date through 6/30, while international bonds have provided returns in excess of 10%. Additionally, Build America Bonds, created in the recent stimulus package, provided debt financing opportunities for state and local governments. Municipalities will now have the ability to raise capital in the taxable market and a portion of the interest will be paid by the federal government. For investors, they provide an attractive return as compared to their Treasury counterparts and offer lower default risk than corporate bonds.



What Does this Mean for Stocks?

The belief that stocks are inexpensive is not really the case. At the March lows, the trailing price to earnings multiple (P/E) on the S&P 500 fell to 16x but, given the recent market rally, is now closer to 23x. Granted, multiples are high when earnings are abnormally depressed but to get back to more normalized multiples of 14x to 16x, corporate earnings would have to almost double from current levels. Given that recent corporate earnings strength has come almost entirely from cost cutting, a significant acceleration in earnings over the next year seems unrealistic, especially in light of muted GDP growth. Additionally, with the U.S. government now directly involved in more than one-third of the economy (health, finance, autos, energy, housing, utilities, etc.) and given the probability of an increased regulatory and tax environment that may retard productivity, even healthy corporations face significant headwinds and these conditions are unlikely to lead to significant multiple expansion for the stock market.

While these conditions have made us more cautious on the equity market, we continue to seek opportunities in sectors and companies with solid fun-

Continued at top of page 4

LESSONS IN ENERGY...(CONTINUED)

tors hedging against declines in the dollar, regardless of what the fundamental supply/demand balance is for the commodity. In addition, oil and gas (and other commodities) act as inflation hedges, which creates yet another reason for investors to drive the commodity price up or down depending on inflation expectations.

> *"At some point, supply will have decreased enough and demand will have improved enough to support higher commodity prices".*

Finally, the growing availability of ETFs (Exchange Traded Funds) that offer exposure to oil and gas has had an increasing influence on the underlying contract prices for oil and gas. This can be witnessed by the fact that the price of oil is up 39% year to date while the supply/demand balance for oil has not materially changed. What has changed is investor expectations for economic recovery, particularly in Asia/China.

Currently, the energy industry is reducing the supply of oil and gas through lower drilling activity, so that reasonable returns on capital can be achieved. At some point, supply will have decreased enough and demand will have improved enough to support higher commodity prices.

Lesson #3: New (Long-Term) Paradigm for Oil & Gas

Lately there has been a lot of attention given to the oil/gas price relationship and the fact that the ratio of oil/gas prices is at historically wide levels. Economic theory suggests that natural gas and crude oil prices should be related because natural gas and crude oil are substitutes in consumption and also complements in production. The 10 year average ratio of oil/gas prices is 8:1, whereas today's $65 oil versus $3.30/MMBtu natural gas price represents a 19:1 ratio. However, over the next decade this oil/gas relationship may not be as tight as in the past decade largely because natural gas (U.S. shale gas) is much more abundant than oil and we have much more efficient means of accessing and extracting natural gas versus oil. As a result, in the years ahead the marginal cost of production for natural gas is likely to trend down (from $7+) while the marginal cost of supply for oil ($75) is likely to trend up due to rising cost structures for oil production.

In the near term, however, it is easier to argue from a fundamental perspective for greater upside to natural gas prices than oil. Today $65 oil is already pretty close to the marginal cost of production of around $75, thus allowing many industry participants to earn decent returns on new capital projects. However, at $3.30 natural gas prices remain well below the current $7+ threshold that US E&P companies target for decent returns on incremental capital. As a result, rig counts are down nearly 60% and at some point in the near future it is likely that we will see a meaningful shift in the abundant natural gas supply which will likely

Continued at bottom of page 4

MARKET OUTLOOK...(CONTINUED)

damentals and strong balance sheets that continue to generate strong cash flow at depressed operating levels. We are targeting investments in companies that focus on what consumers and companies need as opposed to what they want, and are therefore avoiding industries tied to consumer lending or discretionary spending. Areas we find attractive include consumer staples (**Pepsi, Colgate Palmolive**), health care (**Teva, Alcon, Novartis**), energy (**British Petroleum, XTO Energy**), and technology (**Microsoft, Apple, Google**). Valuation work remains critical and will provide disciplined investors with unique trading opportunities in this volatile market.

We are confident that international equity exposure will continue to offer attractive returns. Not only will our deficit place structural pressure on the U.S. dollar over the long term, but emerging markets appear to be recovering from this global crisis in better shape than industrialized nations and many continue to maintain trade and budget surpluses. This economic strength has been reflected in recent emerging market equity performance so our short-term optimism for these asset classes is now more muted. The ongoing growth in emerging markets will also continue to drive commodity prices as these nations are large consumers of natural resources, predominantly oil (see adjacent article on energy). Despite the recent commodity dip, it has been our opinion that the commodity markets remain in a secular bull market. These views about equity and commodity opportunities are supported by a recent World Bank report that forecasted that EU and U.S. economies will contract 4.5 percent and 3 percent, respectively, this year as compared with 7.2 percent and 5.1 percent growth forecast for China and India. Additionally, China and India are also on the top of the GDP growth forecasts for next year.

"We are targeting investments in companies that focus on what consumers and companies need as opposed to what they want..."

Though we believe the darkest days of this recession are behind us, this remains a difficult economic and investing environment. However, we are confident that our clients are positioned as best as possible to face the challenges that lie ahead.

LESSONS IN ENERGY...(CONTINUED)

drive natural gas prices appreciably higher.

<u>How We are Positioned</u>

One certainty of the past few years was that anyone who was confident of what the price of oil or natural gas would be in 6 months or a year's time would be wrong. While predicting the commodity prices based on fundamental economic theory might make intuitive sense, it is simply not the way the commodity world works all the time. As such, we are spending more time analyzing absolute downside risk to oil and gas (and equity) prices. In addition, we look to identify companies that can still prosper, grow production, have access to capital and earn attractive returns on capital in a low commodity price environment, while at the same time be positioned to participate in a higher commodity price environment.

We are achieving our energy exposure primarily by taking a balanced approach with a cautious bias. Our equity holdings include companies with rock-solid balance sheets and industry leading returns on capital (**Exxon Mobil**), businesses trading at significant discounts to intrinsic value that pay attractive dividends (**BP**), and low cost natural gas producers with significant commodity hedges that are living within their cash flows and still delivering industry leading production growth (**Newfield** and **XTO Energy**). In June we trimmed our position in Newfield in accounts where it had grown significantly as the stock was up over 80% year-to-date and the valuation was getting ahead of the fundamentals.

"Our equity holdings include companies with rock-solid balance sheets and industry leading returns on capital..."

We believe that it is important for clients to have meaningful exposure to energy investments given the relative importance of energy to global growth as well as our expectation for a weaker dollar and inflation in the years ahead. As outlined above, we are well aware of the near term uncertainty and volatility associated with energy investing but we believe that it should remain a core element of client portfolios for years to come.