

Market Insights

July 1, 2010



A Better Time...

The last couple of months have tested optimists. There's enough bad news, from BP, Eurozone, financial reform, deficits and conflicting economic stats, to make anyone run for the beaches and hang out until calm returns. We've seen stocks correct worldwide, the flight to quality take hold (nothing more sophisticated than a rally in Treasuries and the U.S. dollar) and good news ignored. If ever we needed proof of herd instincts in financial markets, recent behavior provides a solid case study.

But there's more going on below the headlines and opportunities abound for the thinking investor. Let's look at some of the big issues of the day.

1. Inflation or Deflation? Neither. Economics and markets rarely give Manichaeian choices. The inflation bears point to deficits, money supply and commodities as the inflation canaries. Deflationists point to ever-lower prices, consumption deferred and investment drying up. They throw in the specter of higher taxes for good measure. But broad price equilibrium is the norm in modern economies, not 1970s inflation or Japanese stagnation. We expect much of what we've had for the last decade: inflation running at 2% with occasional supply squeezes interrupting the steady state. Secular forces like household deleveraging and debt destruction will keep prices firmly in check. Please see Jason Doiron's "Deconstructing the Great Inflation Myth" at http://www.sentinelinvestments.com/pdf/51522_sentinelpersp_doiron0610.pdf for thoughts on the matter.

The market agrees. TIPS (inflation-protected bonds) predict 2% inflation for the next 10 years and have underperformed fixed-rate Treasuries for months. Commodity prices have drifted and real asset prices, another classic inflation hedge, stagnated. We don't know what the recently launched inflation protection funds are going to invest in, but there won't be money made fighting a chimera.

2. Eurozone Collapse: Not quite. The pressures to keep the euro intact and its economies going intensified in the last few months. Markets greeted the dramatic rescue of Greece with enthusiasm. Here, after all, was the TARP-like program to keep liquidity in the system and an impressive, if temporary, political unity. Bonds rallied and spreads narrowed. Sigh of relief.

However, fundamentals reasserted themselves. The bond and credit default markets quickly revealed the underlying stresses. Since May, spreads between 10-year Greek and German debt widened by over 350bp to 780bp and the CDS widened by 500bps to 928bp. The markets judged that you can not bring a liquidity knife to a fiscal gunfight. The tensions cannot hold. What we will see next is greater fiscal discipline from Germany and other balanced economies and slow demoralizing contraction for everyone else. The only solution for Greece is default but please call it a "restructuring" in polite company.

The good news is that Germany, Austria and Netherlands are all seeing steady progress in demand, manufacturing and business confidence. Germany will recover the way it always has: low deficit spending and exports. Nothing startling but the bearishness in Europe is overplayed. The weaker euro will be good for the region. So while European unity has taken a beating, we now know that sovereign risk matters, and good investments can be made.

Christian W. Thwaites
President and
Chief Executive Officer
Sentinel Asset
Management, Inc.

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3. U.S. Consumer: Flat but not broke. Recent statistics have been maddeningly ambiguous. What we are seeing is a winding down of distorting incentives. In the 2000s, the government incentives were to leverage and buy real estate...if you doubt this, check out tax incentives for borrowing, Congressional mandates on sub-prime lending and the constant Federal Reserve free put option. Recent incentives to buy cars and new houses merely brought forward unnatural and unsustainable consumption rates. With incentives removed, sales plunged 34% and 22%, respectively. Recent increases in consumption have come at a heavy cost of reductions in personal savings and U.S. total debt (government and households) stands at 300% of GDP.

When faced with a choice of deferred or instant consumption, American investors consistently choose the “now”. This is not sustainable. Therefore, we will see a classic deleveraging cycle, which will lead to repaired household balance sheets and a welcome new era of probity. This may not be enough to move headline unemployment numbers but sustainability is what counts now and it’s long overdue.

Outlook

Market and futures traders drive the summer season more than fundamentals so there will be plenty of opportunities to accumulate. One well-known large ETF, the SPDR, turns its stocks over 10,000% per year and bargains routinely come around with that sort of volume. So judicious timing works. Specifically,

Bonds: We firmly believe in a **3.05%–3.85%** Government 10 year yield range. The 10-year Treasury is the best-performing major asset class this year at +8.1%. Agency backed MBS continue to perform well with a 5.6% return. Investment grade (IG) corporate bonds spreads have widened to 182bps. We expect both IG and high yield corporates to perform well for the remainder of the year. There are plenty of opportunities in the fixed income market given that U.S. investors are woefully underweight fixed income and likely to remain so.

Stocks: The reasons we corrected were nearly all macro and political: Greece, China, economic reports, oil spills, financial reform, euro implosion, austerity... not because of corporate announcements and results. Markets ignore fundamentals when they trade almost exclusively on economic news and flights to safety.

The May correction (down nearly 10%) in very skittish conditions presents good entry points. Expect volatility to decrease in the months ahead and don’t pay attention to VIX¹...implied and actual volatility are very different and it’s a lousy indicator of what’s going on. Volume has been low and we would expect it to remain so.

Therefore, the next few months should allow some good trades as long as we stick to three rules:

1. buy management...not the market
2. buy strong balance sheets with strong free cash flows
3. buy companies that are in true recovery and proving it by shrinking their equity base

Some market valuations are exciting. The S&P 500² earnings are in line for \$85 to \$90 or 12-13x forward earnings. This puts it on an earnings yield of 8%, dividend of 1.9% and cash yield of 14%. Best of all: the S&P trades at a 19% and climbing ROE...while the Russell 2000³ is 6% and flat. This makes large cap stocks a very good place to be.

So...

- Stay with large caps and companies with strong cash flow yields.
- Buy into U.S. bonds anywhere above a 3.5% yield...and FNMA mortgages above 4.2%. Both will provide a strong support to any investment program for next 12 months.
- Avoid financials...we’re seeing downgrades because of commercial real estate (classic late cycle stuff). Financial reform is messy and heading to some sort of increased capital and margin requirements.

A reasonable time to re-enter.



1. Chicago Board Options Exchange Volatility Index (VIX) measures traders’ expectations of volatility in the stock market by tracking bid/ask quotes on the Standard & Poor’s 500 Index.

2. The Standard & Poor’s 500 Index is an unmanaged index of 500 widely held U.S. equity securities chosen for market size, liquidity, and industry group representation. An investment cannot be made directly in an index.

3. The Russell 2000 Index is an unmanaged index that measures the performance of 2000 small-cap companies within the U.S. equity universe. An investment cannot be made directly in an index.

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