Marble Harbor Investment Counsel, LLC
Excerpt from
First Quarter, 2010 Letter

April 2010

Dear Client:

What a difference a year makes! The stock market continued to move ahead in the first quarter of our new decade. The upward trajectory was based on optimism for continuing improvement in the economy over the last couple of quarters. As we have discussed in the past, company inventories and balance sheets are in generally good shape. Further, job losses in the United States have begun to slow – though the country has still lost jobs year-to-date, especially if we exclude the temporary workers hired to conduct the decennial census. In the bond market, rates are hovering near record lows, and more importantly, the premium that companies and individuals pay to borrow money above what the government pays is at a historic low. This has either one of two implications: (a) the US Government has the same creditworthiness as you or I or a large company, or (b) investors are once again ignoring long-term risks. A recent headline declared "Buffett can borrow more cheaply than Obama." As far as we can tell, companies haven't been able to borrow more cheaply than the government since the Civil War.

A year ago as we diagnosed the downward spiral in both the economy and the stock market, we pointed to rays of light that tempered the gloom – newly found corporate discipline, a recovery in household savings, inexpensive valuations and stimulus spending by the Federal Government. In the way that extraordinary pessimism clouded last year's view, there may be undue optimism driving markets today.

Our greatest concerns revolve around debt and borrowing. While we have seen consumers begin the long, slow process of decreasing their debts (through repayment and forgiveness), the Federal Government has more than taken up the slack. In fact a good deal of the growth in the economy is due to government spending. Similarly, the low interest rates that we currently enjoy are a product of the enormous purchases of bonds by the Federal Reserve Bank: Most of the debt that the US Treasury has issued over the last year or so has been purchased by the FRB. Thus, the left pocket has lent money (by printing it) to the right pocket. The rest of our debt is primarily purchased by China and other nations. As this debt mounts, we are creating a larger and larger challenge for our children and grandchildren.

Another source of concern is unemployment. With two-thirds of the economy dependent on consumer purchases, we can't expect sustainable growth until the jobless rate improves. In this recession, we are seeing something uncharacteristic – people are losing jobs and *remaining* jobless for an unprecedented length of time. This has a pernicious effect on both the current economy, but also on tax revenues. And ultimately, that will determine how rapidly we can repay our national debt.

Finally, commercial real estate has a large wall of debt that is coming due in the next couple of years. Many office buildings are no longer worth as much as the loans used to buy them, and so the banks and owners will inevitably have to restructure. This may lead to less money available to lend to businesses.

All this suggests caution and a steady course for your investments. We may be on something of a sugar high – a brief, good feeling, but one that will require some true sustenance if it is to last. The economy is absolutely on better footing than it was a year or two ago – but our national balance sheet is fragile. And unlike a year ago, stock market and bond valuations are no longer dirt cheap. If the economy doesn't continue to grow on its own, without continuing stimulus from the government, then we risk sliding into a persistently sluggish environment. Your portfolio of good companies, with strong balance sheets and growth prospects around the world remains strong. In fact in relative terms, these companies are more attractively valued than a year ago.

We hope you are well. As always, please don't hesitate to call with questions or comments.

Marble Harbor Investment Counsel, LLC

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