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Client Newsletter

Quarter Ending June 30, 2012

My apologies for the tardiness of this letter, but I have been in Europe for a few weeks, sojourning, but also gathering information. I did not have any high level meetings, it wasn't that kind of a trip. One can get the flavor of macro thinking almost daily from news reports, not that I think they are accurate, but they do give a sense. I found European people on the street in a bit of a funk but still up beat. I was mainly in the former eastern block countries, so they have been used to turmoil and an upswing from communist days. They are so used to adversity that the current times seem like just another challenge to be overcome. The older generation longs for the good old communist days when things were more predictable. Then, there was nothing to buy and long lines everywhere, but everyone had a job, even if it only paid \$150 a month. Now they have to work and work had not to lose ground. For the less able and older, that is hard. But the younger people like the new opportunities, even if it is hard work, and even if the old guard still controls things. They believe in the future. In general, those who are part of the Euro zone feel that it is good, because it sets high standards for their leadership. Corruption is still a big problem, but the EU is trying to rid them of that. The EU has also invested a lot in their infrastructure. Some, of course, are not in the EU, but aspire to that status. They have come a long way in the brief time they have been outside of communist rule, but still have a long way to go.

Closer to home, we find the markets behaving much like last year. The first quarter was strong, the second quarter not so strong, and the third quarter a problem, but the fourth quarter was better. This year may follow the same path. We will have a political stalemate until after the election, and then we don't know what we will get. Given the circumstances, the Romney campaign should be further ahead than it is now, but President Obama's campaign has spent tens of millions of dollars to tear down Romney. The race is still nip and tuck. After the nominating conventions we should begin to get a clearer picture. Whoever wins, will have a challenge dealing with the so called fiscal cliff before the end of the year. The markets will be watching.

The markets are also watching carefully what is happening in Europe. While the political leaders do what they can to keep the European Union intact, the markets are tearing it apart. Angela Merkel is playing a very tough hand. She is forcing change in Europe, while giving grudgingly. If she plays too hard, all may come tumbling down. If she is not tough enough, Europe will continue to flounder. One can only wonder if they can save Spain, and at what cost. Is France next? Is there enough firepower in the various reserve funds to do the job? But there must be structural changes otherwise all the money will be wasted.

Central Banks in Europe and the U.S. are called upon to make up for the lack of leadership from the politicians. In recent Congressional hearings Ben Bernanke was told to “get to work” as if he had been sitting idly by in the crisis, which began way back with Bear Sterns. Congress has done little to help.

U.S. markets have seen the search for yield and safety drives the markets. Fixed income has remained strong with muni bonds providing the most total return. (In spite of various municipal bankruptcies) The search for safety means that much money which would otherwise be in equity markets is in fixed income, with very little yield. In equities, the search for yield has propelled REITS into first place in total return, with Utilities second followed closely by Telecom. Consumer services and health care round out the top five. Basic materials and oil and gas have been the worst performing sectors with the downturn in commodity prices caused by the slowing world economy and the strengthening dollar.

The turmoil in Europe has had a great impact on equities markets, followed closely by the slowdown in Europe resulting from that turmoil. The slowdown in the Chinese economy has also impacted the world. In the U.S., most of the firms that have reported earnings so far this quarter have exceeded expectations, but revenue has been light, and often the companies are light on future guidance. This has had dramatic effect in some cases. For instance Chipotle Mexican Grill, a star performer of late, recently announced earnings up 61% year on year, soundly beating estimates. However, their revenue was 690 million compared to 700 million estimated, and their guidance was cautious because of an expected rise in corn prices, a basic commodity in their business. The stock tumbled over 20% in one day.

We have faced dire conditions before and still come back. The case can be made that Fixed Income is overvalued and equities undervalued. The probabilities are that equities will outperform fixed income over the next ten years. However we expect the next quarter to be volatile; but do not panic, keep your focus on the horizon and long term returns. We are long term investors, not traders; so we tend to ride out short term volatility because we have confidence in the long term.

Should you have questions, give us a call.

Best wishes,

William D. Rutherford, Managing Director
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