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Highlights

Many investors and market pundits prescribe to the Domino Theory, which states that one bad event tips over another issue that eventually causes everything to fall just like dominos.

The thought is that the already fallen dominos, such as unemployment, home losses, Greece, and others, have created a wave that will spread through the global economy.

While the Domino Theory certainly makes sense in the realm of little black stones with white dots on them positioned in an orderly pattern, it is based on assumptions that frankly do not hold water in the complex world of global markets.

While there has been much focus on the negative effects of the crisis in Greece and other European nations, the markets have not factored in that positive events have also sprouted as a result of these issues.

- Consumers have lower mortgage rates, lower gas prices, and employment has posted job growth to the tune of 1.1 million net new jobs (not including census workers) in six of the last seven months.
- Global central banks in economic powerhouse countries like the U.S., China, and Brazil once again have a reprieve from inflation concerns.
- Valuations are now set at attractive levels, and fundamentals of the market continue to trend towards the transition to sustainable growth.

But do not expect a straight up rally from here — volatility will likely remain very elevated.

The Domino Effect

For the last seven years, with only one failure, a world record has been broken in the small city of Leeuwarden, Netherlands. On November 13, 2009, in an hour and a half, almost 4.5 million dominos toppled each other over in a variety of ways; including climbing stairs, uncovering hidden pictures, tripping domino "trap doors," and creating a pyramid replica. The 4.5 million in fallen dominos broke the previous world record of 4.1 million set the previous year on what is now officially called Domino Day, occurring on the second Friday every November*.

The construction of the set took many days to complete as each stone (the official term for a domino) was carefully placed with tweezers to assure its position was perfectly situated. As remarkable as it was to set up and tip 4.5 million dominos, it is concern over the falling market "dominos" that has grabbed the majority of attention as of late. Ironically, just like the epicenter of the market's recent concerns, the falling domino world record took place in Europe, comprised of a team of 90 domino experts from 14 European countries.

The real question for the market remains whether the falling European dominos of Greece, Spain, Hungary, and others will be strong enough to knock over enough stones to topple the global economic recovery and emerging expansion.

The Market's Domino Theory

It is important to note that Greece — followed by Spain, Italy, and Hungary — is not the first domino to fall, it is just the latest. The fact of the matter is that there have been many victims of the aftershocks of the severe recession we have just exited. These include the nearly 8 million workers who lost their jobs, hundreds of thousands of homeowners who lost their residences, and the too-many-to-count number of small businesses that had to close up shop. Now, we can add troubled countries, like Greece and others, to the list of casualties caused by the most severe recession since the Great Depression.

As a result of the many victims that have been hindered by the after effects of this recession, many investors and market pundits prescribe to the Domino Theory, which states that one bad event tips over another issue that

*Regrettably, the financial downturn has impacted this record-breaking tradition and there will be no Domino Day in 2010.

eventually causes everything to fall just like the 4.5 million dominos that toppled in succession to break the previous world record. The thought is that the already fallen dominos, such as unemployment, home losses, Greece, and others, have created a wave that will spread through the global economy to systematically knock over all dominos and send the world back into a double-dip recessionary episode.

The Domino Theory looks something like this.

The Market's Domino Theory

The recession of 2008-2009 left many victims in its wake.

Domino 1:
These victims cause markets to be skittish, consumers to be timid in their spending, and investors to cling to conservative investment strategies.

Domino 2:
The nervous economic landscape means that retail sales are growing but softly, housing is stabilizing but not meaningfully improving, and business spending, including employment additions, is increasing, but not surging.

Domino 3:
As a result, more individuals, families, businesses, and countries face economic hardships and dial back spending and investing to a point that turns economic growth into economic contraction.

Domino 4:
Financial institutions, fearing a weak economic recovery, or worse yet, an economic contraction, begin to be stingy with loans which results in a seizing up of credit, similar to 2008.

Domino 5:
The weakened economy and a credit-market freeze causes stock markets to drop and the global economy to re-enter recession.

The bottom line is that not all dominos are the same size and thus have varying levels of impact from their falling.

The market is likely giving too much credibility to a serial-defaulting nation like Greece to be able to topple enough other dominos to derail global growth.

The Problem with the Domino Theory

While the Domino Theory certainly makes sense in the realm of little black stones with white dots on them positioned in an orderly pattern, it is based on assumptions that frankly do not hold water in the complex world of global markets. The bottom line is that in order for dominos to fall neatly in order, one has to assume that either:

1. All dominos are the same size or that small dominos can topple big ones and
2. That standing dominos can't push back.

Let's tackle each of these two assumptions.

Assumption #1: Can a Small Domino Really Topple a Bigger One?

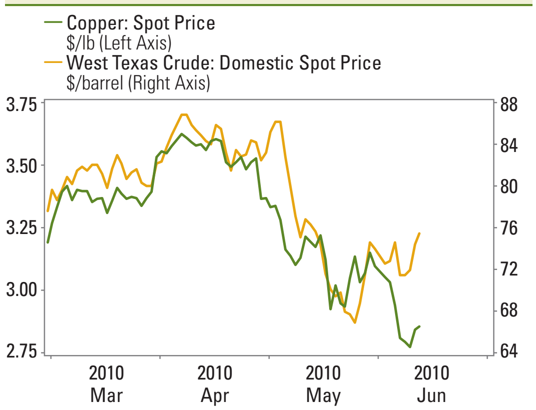
Within the global economic landscape, it is obvious that not all dominos are the same size. Greece, Hungary, and Spain are not on the same economic scale as the U.S., China, and India. So the question is, can smaller dominos actually topple bigger ones? Think of a regular sized domino that falls into another domino of the same size—both will fall. Now imagine a regular sized domino falling against a domino 10 times its size and weight. What is the effect? Most likely, there isn't one. While that is certainly exaggerated, the bottom line is that not all dominos are the same size and thus have varying levels of impact from their falling.

Domino theorists counter the small domino snag by arguing that if Greece falls, so does Spain. The combination of Greece and Spain results in a bigger domino, which could keep growing as each country falls until the combination is big enough to topple Europe and eventually the global economy. While this could happen, in theory, the market is likely giving too much credibility to a serial-defaulting nation like Greece to be able to topple enough other dominos to derail global growth. In other words, can Greece really be the "trigger" of the falling global economic dominos?

Interestingly enough, the most important "real" dominos in any world record attempt are in fact called "triggers." Domino builders strategically place "trigger" dominos to set off the next wave of toppling dominos. While workers create separate intricate designs with their dominos, each section is not connected in fear that a mistake could bring down the entire array of dominos and ruin weeks of painstaking work. Thus, once everything is in place, the "trigger" dominos are carefully positioned, often by tweezers, as the final pieces of the puzzle.

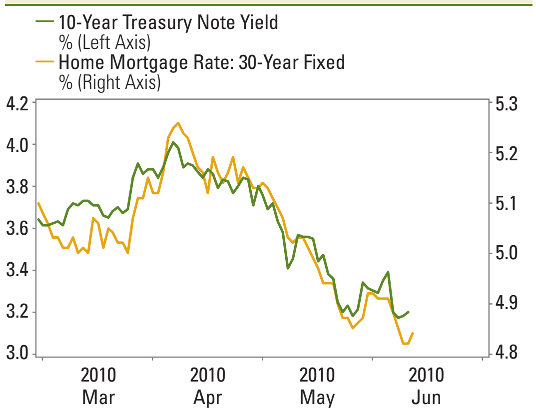
For the market, it seems that Greece has emerged as one of these "trigger" dominos. For whatever reason, the market is concerned about a country the geographic size of Alabama with an economic size smaller than that of the Dallas-Fort Worth metropolitan region. While not insignificant by any measure (who doesn't love Texas?), one wonders, how a domino the economic size of Dallas could actually derail the bigger dominos of the world's global economy?

1 Industrial Input Costs (Oil and Copper) are Lower



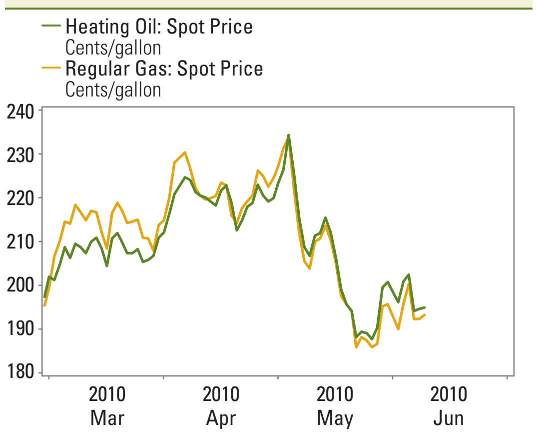
Source: Wall Street Journal/Haver Analytics 06/11/10

2 Fear has Lead Investors to Safety in Treasuries, which has Lowered Yields and Thus Mortgage Rates



Source: FRB, NYT/Haver Analytics 06/11/10

3 The Cost to Heat the House and Fill Up the Car is Down



Source: Department of Energy/Haver Analytics 06/11/10

Assumption #2: What Happens When Dominos Push Back?

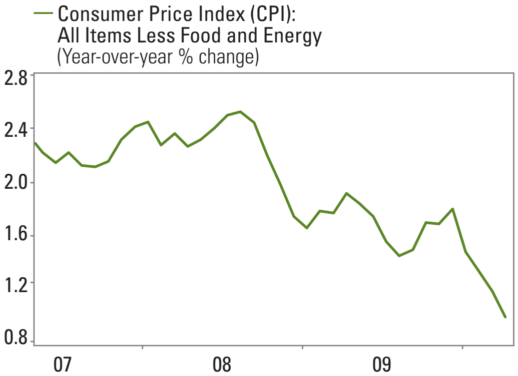
The second assumption has the greatest importance for investing. The assumption in dominos is that standing dominos cannot push back. While it is certainly true that little black rectangles with white dots seem to be just standing there "waiting" to be toppled, the same cannot be said about global markets. The U.S., China, and other countries are not just sitting around waiting for Greece to topple the global economy. On the contrary, these dominos are pushing back.

The interesting perspective that the market and many Domino Theory pundits are focusing on is the incorrect assumption that negative events do not foster a reaction. In Domino Theory, the next domino in line just waits to get toppled. However, with the markets the assumption that the world is held hostage by the emerging difficulties in parts of Europe is just erroneous. While there has been much focus on the negative effects of the crisis in Greece and other European nations, which are real concerns and real negative headwinds for the global economy, what the markets have not factored in is that positive events have also sprouted as a result of these issues.

The obvious concern over Greece is that it will eventually topple the world from growth back to recession. As a result, commodity prices are pricing in a huge global slowdown, which has sent oil prices from a year-to-date pre-crisis high of $87/barrel to the current $76/barrel as of June 17, 2010—a 13% drop which doesn't even highlight the fact that oil got as low as $66/barrel. Copper prices, a major input into industrial production of goods, has fallen from a pre-crisis 2010 high of $3.61/lb to the June 11, 2010 price of $2.91/lb—a 20% reduction in costs. [Chart 1] Thus, all of the manufacturing in Germany, China, Brazil, the U.S., and everywhere else around the world just saw a 13-20% reduction in input costs to make things. So, while the market is worried that Greece will slow down global growth, shouldn't it be optimistic that companies may now be more profitable since they can make products at 20% less costs than they could just 30 to 60 days before?

But the "benefits" of the problems in Greece do not just apply to manufacturing, they also help consumers. As the fears over the problems in Europe have intensified, investors have flocked to the safety of U.S. Treasury Notes and Bonds. The demand for these bonds has driven up prices and thus sent their yields plummeting from 4.0% to the current 3.2% levels (as of June 17, 2010, measured by the Barclays 10-Year Treasury Index). This means that mortgage rates for home buyers and refinancers have also moved lower given their near lockstep movements with Treasury yields. [Chart 2] In fact, the 30-year fixed mortgage rates have declined from 5.26% before the problems in Greece to a new low of 4.84% as of June 17. This means that the "benefit" from the recent market dislocation has saved a buyer of a $300,000 home almost $28,000 in principal and interest costs over the length of the loan. In addition, the costs needed to fuel up the car or heat the house have also declined meaningfully over the last several weeks due primarily to the concerns in Europe. [Chart 3]

4 Inflation is Not a Concern



Source: Bureau of Labor Statistics/Haver Analytics 06/11/10

The concerns for global growth caused by a country the size of Alabama with the economic impact of Dallas have essentially taken global inflation out of the picture.

Implied Probability of Fed Moves at 9/21/10 FOMC Meeting (Based on Fed Fund Futures)

Possible Fed Move	Implied Probability
No Change	74.1%
Decrease to 0 bps	13.9%
Increase to 50 bps	12.0%
Increase to 100 bps	0.0%

Source: Bloomberg, LPL Financial 6/11/10

But the biggest "benefit" of the problems emerging from the European fiscal crisis is far greater for investors, the economy, and therefore the markets, than just lower costs for commodity asset classes such as oil, gas, and copper, as well as lower mortgage rates. The fact of the matter is that the global economy that has emerged from this latest recession has rewarded countries and regions quite unevenly. Areas like China, Australia, Brazil, India, Germany, and the United States have all seen powerful economic recoveries, while parts of Europe and Japan have seen recoveries that are more modest. Because of these strong recoveries, central banks in those faster growing countries have begun to shift from accommodative monetary policies, which were the catalyst to fuel the recent growth, to more restrictive policies by raising interest rates and placing curbs on growth. The reason this transition happens is that unabated growth can create inflation and therefore countries with stronger growth need to find balance between growth prospects and inflation concerns.

But the problems in Greece have changed all of this. After all, where is the inflation? This is especially true when copper is down 20%, oil is down 13%, gas is down 19%, beef is down 8%, mortgage rates are down 9%, corn is down 10%, and the list goes on. The concerns for global growth caused by a country the size of Alabama with the economic impact of Dallas have essentially taken global inflation out of the picture and have allowed the central banks of China, the U.S., Brazil, and others the ability to not have to shift from the gas pedal (accommodative monetary policies) to the brake (restrictive monetary policies).

This potential policy shift is best shown by looking at the implied probabilities of future Federal Reserve (the Fed) interest rate moves based on the daily trading of Fed fund futures. As the nearby table illustrates, the market predicts that at the September 21, 2010 Federal Open Market Committee (FOMC) meeting, the most likely scenario is that interest rates will be unchanged and remarkably, there are slightly better odds for an interest rate cut than an increase. The same story plays out for the December 2010 and January 2011 FOMC meetings. That means that the Fed is expected to maintain its accommodative monetary policy stance geared towards driving economic growth.

Recent market pullback is not a reason to run for cover in fear of toppling dominos—it serves as an opportunity to try and take advantage of attractive valuations.

The real story is that where the market sits right now is a more, not less, attractive place than where we were 60 days ago.

I believe that now is an attractive time to consider adding risk. Investment themes such as adding to stock exposure, increasing commodity allocations, and shifting to a more aggressive bond exposure with greater use of high-yield bonds, may be good opportunities to help take advantage of this market dislocation.

We Should Be Thanking Greece, Not Worrying About It

The bottom line is that the market is focusing solely on the worst case scenario the impact of Greece (and other European countries) will have on the prospects for global growth. The problem is that this is only part of the equation and frankly, the smallest part. In my opinion, when you have larger dominos actually pushing back against smaller dominos, the result may be positive, not negative. And the recent market pullback is not a reason to run for cover in fear of toppling dominos. Rather it serves as an opportunity to try and take advantage of attractive valuations created by misaligned economic fears to position portfolios to help take advantage of what I believe will be the next, and perhaps last, bull market run for the markets in 2010.

While the market is focusing on the fact that Greece and a few other European countries may fall back into recession, the real story is not the concern that the 1% consensus growth rates of Europe will slow. The real story is that where the market sits right now is a more, not less, attractive place than where we were 60 days ago. No doubt, parts of Europe are worse. But consumers have lower mortgage rates, lower gas prices, and employment has posted job growth to the tune of 1.1 million net new jobs (not including census workers) in six of the last seven months. Businesses have lower input costs that improve margins. And, the market gets to pick up stocks at 10-20% lower prices than just 60 days ago. And as I mentioned, the grand finale—global central banks in economic powerhouse countries like the U.S., China, and Brazil, that were briefly slowing down global growth by shifting from accommodative to restrictive monetary policies, once again have a reprieve from inflation concerns and have their foot back on the economic growth accelerator.

As a result, I believe that now is an attractive time to consider adding risk. This pullback has been overdone, valuations are now set at attractive levels, and fundamentals of the market continue to trend towards the transition to sustainable growth. Investment themes such as adding to stock exposure, increasing commodity allocations, and shifting to a more aggressive bond exposure with greater use of high-yield bonds, may be good opportunities to help take advantage of this market dislocation. But do not expect a straight up rally from here. This market remains in a fragile state, with poor sentiment. While we expect an upward trending market, volatility will likely remain very elevated. That said, fear creates opportunity and there is an abundance of fear out there.

It is easy for the market to paint a picture where global growth falls like that world record of 4.5 million dominos set on Domino Day 2009. If so, the market would have shattered the record, as the recent pullback has toppled more than $440 billion in stock market value (market dominos). But do not be surprised if the market eventually realizes that normal rules of dominos don't apply to a "game" as complex as the global economy. In a world where not all dominos are the same size and some dominos actually push back, it could just be the positive side of the recent crisis that the market focuses its attention on next.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Stock investing involves risk including loss of principal.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of funds shares is not guaranteed and will fluctuate.

Investing in alternative investments may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potentially illiquidity. There is no assurance that the investment objective will be attained.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Precious metal investing involves greater fluctuation and potential for losses.

The Barclays 30-year Treasury Index is a managed index comprised solely of the most recently issued 30-year Treasury bond. The index changes upon the issuance of a new 30-year Treasury with a different maturity date.

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