

H A V E R F O R D O U T L O O K



Following a torrid 80% move in the major stock market indices from the lows of March 2009, it isn't very surprising that the market has corrected in recent weeks. Nevertheless, the correction has been painful for investors, with the onslaught of negative news stoking fear that the latest swoon will morph into a new bear market. We don't believe that will happen.

We've been vocal in our view that the economic recovery will be moderate relative to previous expansions. This outlook is based on the myriad problems faced by investors worldwide: the continued deleveraging of consumers and businesses, high unemployment, fiscal budget deficits, the prospect of higher taxes, etc. When it rains it pours, of course, and recent events – the European sovereign debt crisis, the Gulf of Mexico oil spill, and a string of soft economic data – have added to the overall gloom.

A positive side effect of the persistent pessimism is that high-quality, large-cap growth stocks are the most inexpensive they've been in years despite profit growth that has surprised on the upside (up 35% in the first quarter) and should continue to grow strongly in the coming quarters. We believe that we are now seeing the tail effects of the global financial crisis, and are confident that long-term oriented investors will be well rewarded.

Economy: “Double Dips” Are Rare, But Soft Patches Are Not

We have been consistent in our forecast of a below-average economic recovery, but at the same time we always felt that there was only a slight likelihood of a “double-dip” recession thanks to the extraordinary amount of monetary and fiscal stimulus implemented both here and abroad.

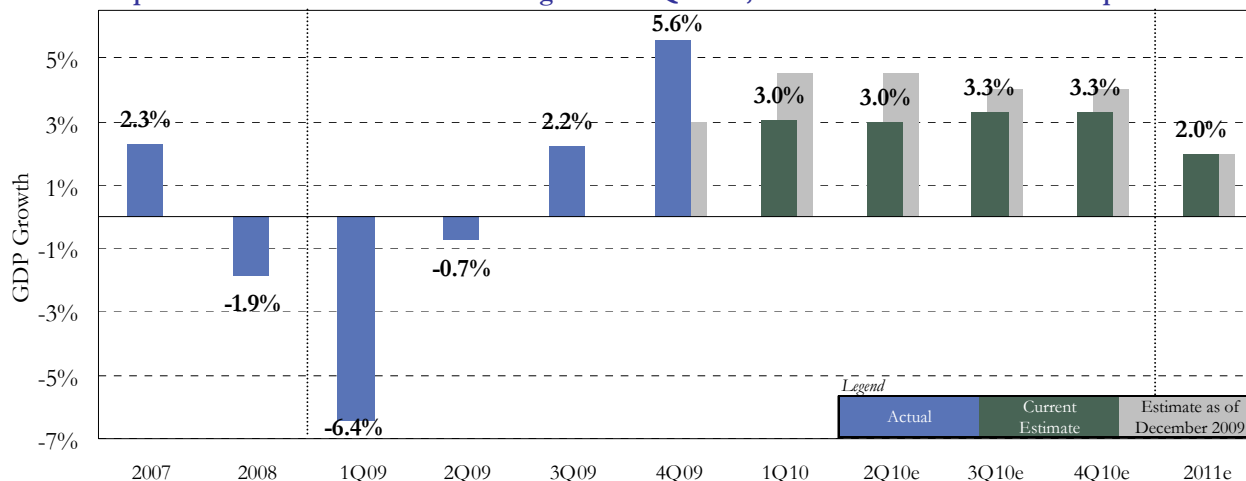
At the start of the year, we acknowledged the possibility of GDP growth outstripping our estimates due to unleashed pent-up demand following one of the most severe recessions in modern history. The European sovereign debt crisis has eliminated any such hope. The austerity measures these countries must take to assuage the debt markets almost ensures the euro zone will experience little to no growth in the near future, with a double-dip recession in Europe growing increasingly likely.

We estimate that Europe's ills will likely reduce U.S. GDP growth by 0.5% throughout 2010 and into 2011. As a result, the Fed will not likely begin to increase short-term interest rates until sometime in the first half of 2011, at the earliest.

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The slowdown in our economic recovery has heightened the fears of a double-dip recession, but history shows that double-dips are very rare. In fact, there has only been one since World War II: 1980-1982, and that was a time in which the prime rate of interest exceeded 20%! Soft patches, on the other hand, are not rare. For example, in 2002 GDP growth slowed to +0.1% and +1.6% in the fourth and fifth quarters of the economic recovery, only to be followed by +4.1% average growth for all of 2003. The same thing happened in 1991: GDP growth slowed in the second and third quarters of recovery, followed by much stronger growth in 1992. History shows that economic recoveries are lumpy, so despite the probability of some near-term softness, we are not deterred from our view that the recovery will transition to a sustainable expansion.

Expectations Have Come Down During the Past Quarter, but GDP Growth Is Still on Tap



Source: Factset, Haverford

In January we wrote that the dollar was oversold and due for a bounce higher. The European debt crisis accelerated and magnified the dollar rally, which in our mind is clear confirmation that despite our growing deficits, the U.S. dollar remains the world's reserve currency. As we've stated before, deficit spending is a necessary evil to help prevent recessions from turning worse. As evidenced by the flight to safety (lower Treasury yields) and the rise in the dollar, investors have confidence in our ability to overcome these deficits. We believe our budget deficit can be brought under control through a combination of economic growth, spending cuts, and tax increases. Tax hikes and spending cuts are politically difficult and if overdone can significantly curtail economic growth, but it is imperative that the political establishment find a balance between these three levers, curtailing run-away deficits and allowing America to prosper through an emphasis on private-sector growth.

Equities: A Correction But No Worse

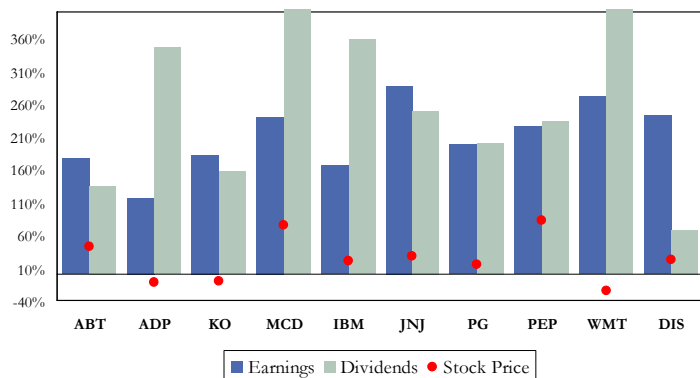
After a 14-month run in which the S&P 500 rose 80% off the March 2009 bottom, equity markets finally corrected, registering one of the worst performances during the month of May in recent memory. Again, while corrections are not pleasant, they are normal and healthy for bull markets since they help keep excesses in check. Unfortunately, they do not occur while news headlines are rosy and bright. The horrific pictures of rioting in Athens and the environmental catastrophe in the Gulf coast have only increased investor anxiety, resulting in a return of extreme volatility reminiscent of the fall of 2008.

While the volatility is familiar, the fundamentals bear no resemblance to that period. The economy was then contracting, and today it is expanding. Corporate profits were shrinking, today they are growing. The financial system was bleeding, and today it's healing. Remarkably, a mere 2 ½ years

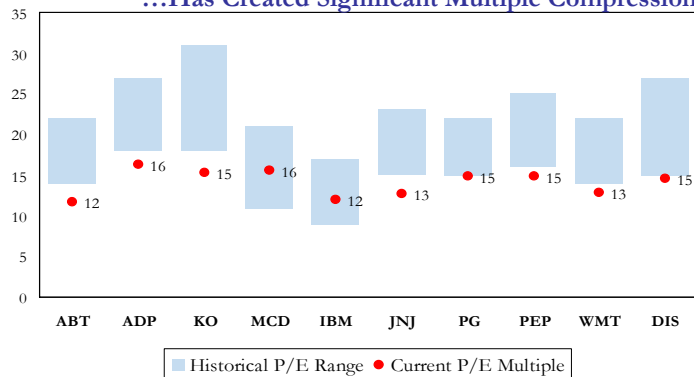
after the start of the recession, nominal GDP has exceeded its previous peak, and by year end total corporate profits will likely exceed their previous peak set in 2006. This is impressive given the severity of the recession and speaks to the resiliency of our economy and the dynamic nature of U.S. corporations.

International equity markets were not immune from the correction. Emerging economies currently enjoy the fastest growth worldwide and with their recent correction, equity valuations are beginning to look attractive. Developed international equity markets, meanwhile, represent the cheapest asset class, but that reflects the slower growth of their economies. We anticipate maintaining our position in developed markets due to their low valuation and the potential for upside earnings surprises due to the weaker Euro.

A Great Decade for Corporate Fundamentals, but Lackluster Stock Appreciation...



...Has Created Significant Multiple Compression



Source: Factset, Haverford

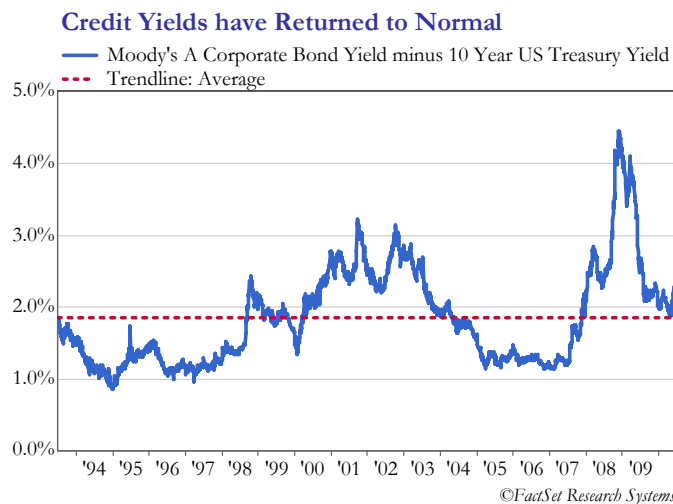
The past ten years – bookended by two deep recessions – have not been kind to investors, with the trailing ten-year return for the S&P 500 still negative. During this time period, however, fundamental corporate performance has been very strong. In the accompanying chart we highlight the growth in earnings and dividends of ten stocks currently in the Haverford Quality portfolio as of June 2010. Despite the excellent growth in earnings and dividends, the share price appreciation of these stocks has significantly lagged, resulting in some of the most attractive valuations seen in 25 years. These companies have something else in common: they all have impressive earnings prospects looking out over the next five years. We doubt that earnings and dividend growth will continue to outpace stock prices. Accordingly, we continue to argue that a positive “reversion to the mean” is inevitable.

Fixed Income: Increased Supply Will Eventually Trump Flight To Safety

The Federal Reserve’s policy on short-term interest rates remains little changed. Not only are rates likely to remain low, the events in Europe almost certainly have extended the time frame until the Fed’s first policy move. Fears concerning sovereign debt levels in Europe have precipitated a flight-to-quality that has benefitted U.S. Treasury bonds, resulting in falling yields across all maturities. For the remainder of the year, as we get closer to a move by the FOMC, we expect the trading range on the ten-year yield to remain between a high of 4%, which has held several times, and a low of 3.15%, the level reached during flight-to-quality rallies. The accompanying graph on page four depicts the volatile trading range of ten-year yields compared to the relative stability of two-year levels.

The recent strength in the U.S. Treasury market has come despite fears of the mounting budget deficit. The Treasury has issued \$830 billion in new debt thus far in 2010, compared to \$1.5 trillion for all of 2009. We continue to believe that the market can absorb these funding levels for a short period of time, but cannot fund large deficits continuously into the future without forcing interest rates to higher levels. Deficit financing remains our primary concern regarding the direction of interest rates, even in the absence of any inflationary pressures.

The continued strong performance by corporate bonds is supported by both fundamental credit strength and reduced new-issue supply. Earnings have rebounded over the past year and corporations have built up record levels of cash, leading to a sharp reduction in the supply of new bonds. New issues of investment-grade corporate bonds have fallen by 42% thus far in 2010 from the comparable period in 2009. The accompanying chart shows the improvement in relative yield spreads for A-rated corporate bonds. A combination of positive fundamental and technical factors supports a continued overweight to this sector.



gap that will likely take several years to close. The initial signs of recovery are at hand though, as tax receipts appear to have stabilized in many states and municipalities. One ongoing positive sign for most municipalities remains their ability to access the credit market for financing. Total new issue supply so far in 2010 has been \$193 billion, a 7.2% increase over the comparable period in 2009.

We continue to stress credit quality in municipal bond portfolios and seek to invest in specific issues that have strong bondholder protection measures. For example, “double-barreled” municipal bonds offer significantly more protection than straight revenue bonds. These securities are not only backed by the revenues of essential services such as water and sewer but are also general obligations backed by the full faith, credit, and taxing power of the underlying municipal issuer.

Conclusion

The deluge of negative news certainly tests investors’ resolve and perspective. While there is always plenty to be worried about, we find ourselves in a situation in which profits will likely post decent growth, corporate balance sheets are in excellent shape, and valuations are attractive. That’s a promising combination for those with a longer-term perspective.