

Astor Asset Management Mid-Year Report: July 2010



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The first half of 2010 was mired with inconsistencies. The markets rallied to new recovery highs only to fall back to fourth quarter levels as uncertainty about the recovery and fears of the debt problems in Europe were said to be spreading. The reality is the markets finished the quarter about 12% above last year's Q2 close, even after digesting most of the bad news. Furthermore, GDP for the first half of 2010 outpaced 2009's first half and employment trends improved from, on a monthly basis, losing massive amounts of jobs to slowly adding jobs. Although the data is not as strong as one would like at this stage in a recovery, considering the severity of the recession we should take what we can get. As we mentioned in our 2010 Outlook Report, **Searching for the Afterparty**, the economy was likely to outperform the market for most of 2010. We have frequently stated that a return of plus or minus 8% was the likely path for equities this year. Who knew the market would take us so literally!

To be precise, 2010 has been a tale of three events. Early concerns about the stability of European sovereign debt sparked a 7.5% decline in the S&P 500 into early February. Even the employment gaining, tech-heavy, Nasdaq index shared the loss, paring back 7.8% while small cap stocks gave back 8.6%. Even heavier losses were seen in the higher beta and more economically sensitive areas. Emerging market stocks, measured by the MSCI Emerging market index, fell 13.5%, and copper prices lost 19.4% in 3 weeks as the first real concerns about the sustainability of the recovery were called into question. Ten-year U.S. Treasury bond yields dipped to 3.54% after being at 3.84% to start the year. As we moved on from the first meaningful pull back in months, improving recovery and growth prospects globally encouraged a renewed interest in risky asset buying, promoting a 16.5% rally by the S&P 500 into late April on the back of more broad-based job gains in March and April. The U.S. markets lead this charge however, as numerous international markets either barely, or failed, to mark new trading highs for the year. Mid-April marked the beginning of a two-week

volatile trading pattern that would ultimately mark the top of the market for 2010, as once again, concerns reemerged over European sovereign debt issues. This was punctuated by the flash crash that sent markets down 10% intraday on May 6th. Rallies and powerful selloffs ensued for the next seven weeks. The S&P 500 closed the first half of 2010 down 6.6%. Emerging markets shed 9.5% during the period, and ten-year Treasury yields spent some limited time under 3% for the first time since April 2009.

In our 2010 Outlook Report earlier this year, we discussed the prospects that the global economy was moving from the recovery phase into the next stage of the business cycle. Given the obstacles faced and stimulus that was thrown at the economy to prevent a prolonged and more deeply seeded recession, one had to understand that there would be obstacles to face against growth as we moved forward. We believed the growth phase would be uneven and that this would cause a slowdown in global GDP from the levels of the early recovery into the second half of 2010. The European debt crisis was a major catalyst that caused a forward shift to the present in the dealing of these issues. Even more than twelve months removed from the depths of the credit crisis, investors remain acutely aware of downside risks to the economy, and are quick to turn pessimistic, which left little room for error in the markets in the second quarter.

Where Now?

The second half of 2010 should be viewed in the context of a possible deflationary effect being felt in the markets. While many investors are preparing for inflation because they misunderstand its cause, the true threat at this point is deflation. Inflation is caused by higher wages and extreme levels of capacity utilization rates. There is so much excess capacity available as well as excess labor that the threat of inflation is highly unlikely. Although the monetary base is growing, actual money supply is contracting year-over-year.



as the velocity of money is near historical lows below 1:1. In plain English, the money that is entering the system from the Fed is not making its way through the banking system to the economy because for every 1 dollar deposited at a bank only 60 cents is entering the economy. To put this in perspective, the historical norm is somewhere near 1:8. Yes, for every 1 dollar deposited at a banking institution 8 dollars would enter the economy through lending and other financial transactions. Currently we are nowhere near that level.

The interesting point about deflation is that at first glance it might resemble a recession. The biggest mistake investors can make for the second half of 2010 is to adjust their portfolios on the premise of a double-dip recession unless the data suggests that, and currently it does not.

Volatility

The increased risk to global economic activity brought a surge in volatility, back to April 2009 levels. Investors were caught in a give back of market returns from the last twelve months. The non-ordered declines and rallies that marked the last two months have had the unfortunate side-effect of chopping up investor returns and sending many back to the sidelines. Recent reports have not created any renewed optimism toward the markets, therefore many investors are in no hurry to jump back in at this point. The arrival of the summer trading sessions will lighten up the trading volumes as well. The positive side-effect of this should be a decrease in volatility as the markets calm down. When you have pessimism as rampant as we have had and markets moving swiftly, time can be the biggest ally and this is what we need now to reset.

Interest Rates

A concern many investors and traders had twelve months ago as the recovery began was that inflation would eventually appear in such a low interest rate environment. This would be a confounding problem on the mounting deficits from a financing standpoint. The markets made a discovery in the second quarter as interest rates continued to dip lower. The "flation" we are seeing may actually be DE-flation, which brings about its own separate risks. As the global economy deleverages, consumer borrowing continues to decline, unemployment rates remain high and asset prices stay in check, there is no pressure to the upside on interest rates at this point. A mild growth outlook for Q3 and Q4 as well as consumer conservatism will keep that in place for the near term as we work our way forward. While rates have crept lower, we don't see this as an

opportunity to start owning these low return instruments at down here, even if the safety of owning equities seems tough right now.

Government

The job for governments in 2009 was to get the global economy out of the recession. By a coordinated collective force, we managed to do it. The repercussions of the tools used to do the job have been thrust upon us, as evidenced by the fiscal imbalances unveiled in Europe. The ECB is working to back stop any defaults, as well as quell panic that would accompany this. In addition, Eurozone leaders have met to discuss measures of fiscal balance to apply in the coming quarters to begin the withdrawal of stimulus. Germany, the most balanced economy in the Eurozone, announced measures to raise key rates as well as taxes in the near future to prevent inflationary impacts down the road. This was met with criticism globally as many leaders and academics worried about the effects withdrawing stimulus premature. That response exhibits the paranoid (though justifiable) outlook we have to the current economic scenario. If Germany raises rates a mere quarter percent would still be historically accommodative for certain, but policy leaders want to head off any effort that would be construed as non-growth oriented at this point.

Nonetheless, this is the very same issue the U.S. government finds itself dealing with on a somewhat more inconspicuous stage than our European brethren. The U.S. government debt currently sits at 59% of GDP. Financing costs at these levels can be manageable, yet expensive, at current rate levels. Spending cuts will be enacted to help bring the cost down to minimize the impact on GDP, but those same measures may have the same collateral effect in the medium term. However, taxes will be the focus over the next few months heading into the November elections. Many of the Bush Administration's tax cuts will sunset at the end of this year. This may send cap gains and dividend tax rates as high as marginal tax rates if not addressed. While having the impact of reducing the deficit, it will be at a major economic cost. We do not see the Obama administration allowing these rates to all reset. An increase in marginal tax rates across the board may happen as well if not addressed by the administration.

The government also faces some very real decisions related to corporate America in terms of how supportive their policies will be toward fostering growth. The gulf region oil spill represents one such example as the administration has put a moratorium on deep water drilling. While something must be done to further regulate/oversee the safety processes for these projects, this cuts off an-

other major source of income and jobs to the hard-hit gulf region, as well as tax receipts to the government itself. Congress must be careful to find the appropriate balance during these economic times. Self-aggrandizing acts could come at long-term costs. The administration also faces a large challenge in the implementation of the financial regulatory overhaul package to ensure it does not bite the consumers. How and when these are incorporated will no doubt have an effect on business; however the extent is up in the air. Prudence will be a virtue, but it is our guess that much of the market's downside behavior this year has taken some of the above measure into account.

Corporations

While concerns rage on government debt, US and global corporations are in a healthy spot. Cash levels on company balance sheets are at the highest levels in years. In fact, corporate profits are at an all time high at over \$600B. Many high quality companies are sitting in such good liquidity conditions that corporate bond issuance is starting to decline drastically. Although actually accessing the headline borrowing rates has been hard to achieve for some companies, many businesses have used this time as an opportunity to restructure debt covenants and capital structures, further positioning for strength in the long run. The problem now is many executives are not finding reasons to deploy capital by increasing capital expenditures, hire workers, etc. Coming into 2010, it appears we had this hiring impetus, but the recent spat of global financial concerns has put the brakes on many such plans for the near term. Executives are also weary about policies from the Obama administration and how un-accommodative they will be to business. Positive visibility will be needed to provide initiative for companies to resume business expansion plans from quarters prior. M&A and stock buyback activity will also provide a good signal as to the willingness of companies to spend, as well as their outlook on the economy. We have seen both instances of this activity tick up in 2010.

Consumer

Recent home sales (new and existing) were dreadful. Much of this was a result of the expiration of the home buyer tax credit, but is not a good sign nonetheless. We have maintained since 2008 that the housing market and real estate in general is not an area where we see growth on the consumer side. Payroll numbers have been mixed through the government and private sector reports. Consumer credit has continued to decline as consumers tighten up again in fear of round two. An unemployment rate still hovering

near 10% is not indicating a U.S. consumer-based recovery, and it may be that way unfortunately as a large amount of resource slack still remains in the economy as seen by high unemployment and sub-80 capacity utilization numbers. Companies don't necessarily need to hire more workers to ramp up production at this point, which is not necessarily a bad thing.

Outlook

The engine has downshifted globally in response to euro debt concerns and consumer deleveraging in developed markets. There is no questioning this. However, it is NOT our belief that these actions will lapse us into a double dip recession, but rather maintain the economy at a slower rate of growth for a period as we adjust. The causation of the recent economic downfall exposed our problems two years ago, but has left collateral situations to address and work through. Corporations remain in very good standing and poised to fuel growth when the time is right. There is just no real incentive to put themselves at risk during these uncertain times. Eyes will be on the U.S. government for the balance of this year, specifically heading into November. Plans to reduce the deficit will come forward and the uncertainty of the form will keep investors at bay to an extent. The dynamic of how each country handles their own issues, and how this ends up impacting the global economy (through globalization) will be very important to follow. Leaders of the major economic countries face the question of putting country before the world.

Unfortunately, this conjecture does make sitting through a 20% drawdown any easier. This is made especially difficult given the situations most investors find themselves in, having suffered deep losses in 2008/2009 without cushion or time to absorb another such period. The next few months will tell us if we are indeed tipping into a second recession, but this is all more likely exhibiting our move to the "new normal" as PIMCO coined about achieving sub-historical growth for the near term as we work off the debt and leverage until we can reach a optimal growth rate. We would attach another caveat to this notion, where the market is able to rise in the "new normal" environment, since this type of environment is still symbolized by growth, and jumping ship at this point is not what we believe is prudent action.

Astor has been following the activity closely. We may make some subtle adjustments based on what the economics and market are telling us, but our thesis remains now to remain correlated to the markets at a fraction of the beta until we see resumption of higher long term growth rates and employment.

ABOUT THE MANAGERS



Robert N. Stein, Senior Portfolio Manager

Rob Stein began his career in 1983 as a project analyst for the Federal Reserve, at that time under the chairmanship of Paul Volker. From there, he went on to hold senior trading or portfolio management positions with Bank of America, Harris Bank and Continental Bank. Mr. Stein also served as the Managing Director of Proprietary Trading at Barclay's Bank PLC in 1991. Mr. Stein formed Astor Financial, Inc., an investment and brokerage firm, in 1994, and formed Astor Asset Management, LLC, a division of Astor Financial, in 2001. Mr. Stein is the author of several books including the recently released [The Bull Inside the Bear: Finding New Investment Opportunities in Today's Fast-Changing Financial Markets](#) (John Wiley & Sons).



Scott D. Martin, Co-Portfolio Manager

Scott Martin is integral to the management and investment decisions of Astor's fee-based investment portfolios, and also handles new advisory relationships. He is a contributor to Fox Business Network and a former columnist with TheStreet.com. Mr. Martin graduated in Economics and French from Denison University, and began his career in the financial industry with TD Waterhouse. He holds the series 3, 7, 63, 65, as well as life and health insurance licenses.



Bryan M. Novak, Co-Portfolio Manager

Bryan Novak is responsible for assisting in all money management decisions made by Astor and oversees the trading operations for Astor Partners, LLC. He was formerly a trader for Second City Trading, LLC, an equity option market-making firm, at the Chicago Board Options Exchange. Mr. Novak graduated in Financial Management from Ohio State University. He holds the series 3 and 65 licenses and is a Level II CFA candidate.