Second Quarter | July*, 2010*
Constellation Quarterly

Greece Is the Word

In Review

The rally that began in March of last year came to an abrupt halt in early April. The following chart shows the performance of the major indices we track:

Benchmark Performance
Data as of June 30, 2010

	QTR	YTD	1 Year	3 Year	5 Year	7 Year
Barclays 5 Year Muni	1.68%	2.45%	6.88%	6.75%	4.85%	4.12%
Barclays Aggregate	3.48%	5.32%	9.48%	7.55%	5.54%	4.96%
S&P 500	-11.43%	-6.65%	14.43%	-9.81%	-0.79%	2.84%
Russell 1000	-11.44%	-6.40%	15.24%	-9.54%	-0.56%	3.29%
Russell 2000	-9.92%	-1.95%	21.48%	-8.60%	0.37%	5.83%
iShares MSCI EAFE	-13.78%	-13.14%	5.77%	-13.40%	0.83%	6.53%
iShares MSCI Emerging Markets	-9.53%	-8.58%	19.13%	-2.76%	11.58%	17.86%

Source: PSN Informa

The chart of the S&P 500 Index by quarter is displayed below. The pullback that began at the end of April resulted in a peak to trough decline of over 17% by early July. The decline brought stocks back to levels reached in November of last year, but still substantially above the low of March of 2009:

Source: Strategas

The catalyst for the sale of risk assets was the sovereign debt crisis in Greece, which triggered concerns about the Euro in general, and resulted in the return of duress surfacing in the interbank credit markets. Investors lost confidence in the Greek government's ability to pay their debts as well as the solidarity of the European Union (we discussed the mounting sovereign developed nation debt in our 2009 fourth quarter letter "A Different Kind of Recovery"). Yields on the weaker countries' debts widened versus the most financially sound country, Germany. This can be illustrated through the credit default market; the chart below shows the cost to insure Greek debt (in yellow) versus German debt (in green). The other weak countries, Spain (in orange), Italy (in light blue) and Portugal (in violet) are also shown:

Source: Bloomberg

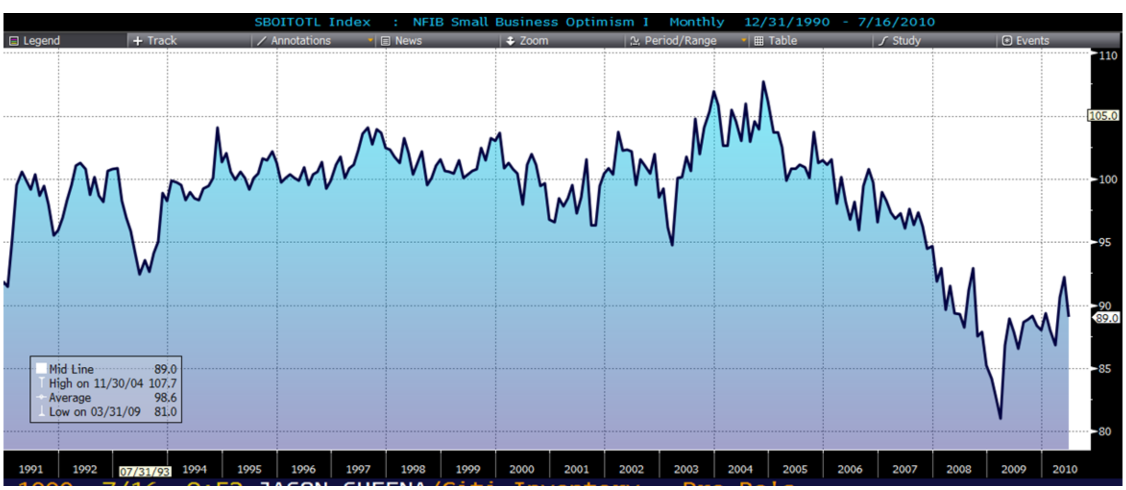
The risk aversion brought about a rise in the dollar and a flight of capital into treasuries of all durations which caused dramatic declines in yields for the quarter. The yield on the 10 year note went from almost 4.00% in early April to less than 2.95% in mid-July. The two year note went from yielding 1.17% to less than 60 bps, a near record low, during the same time period. Their one year yield charts are shown below:

Source: Bloomberg

Confidence measures also rolled over in their May/June readings; below is the University of Michigan Consumer Confidence Index which turned down sharply in June:

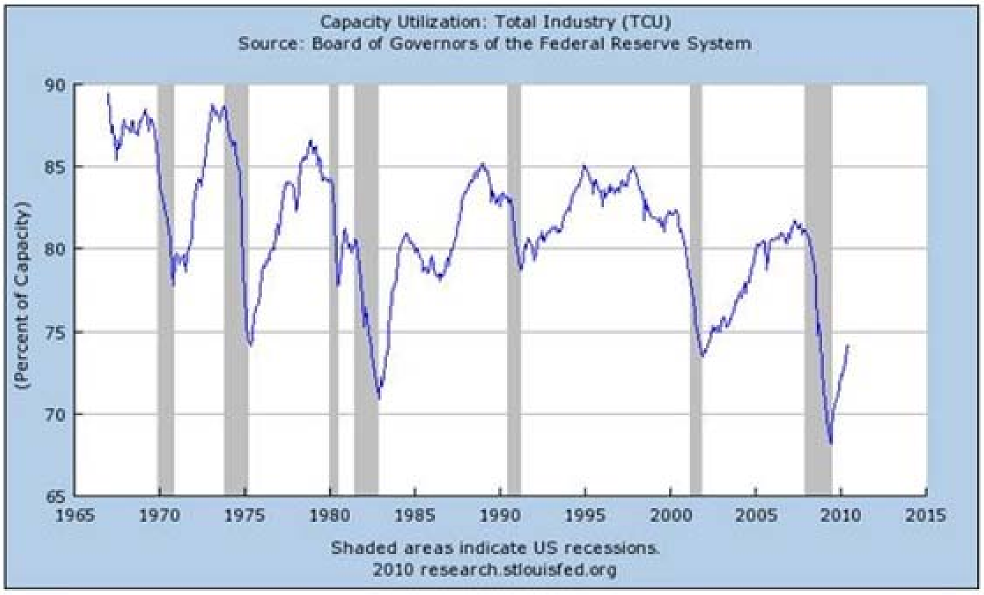
Source: Bloomberg

Small business is normally the engine for net job creation in the U.S. economy. But the NFIB Small Business Optimism Index declined in June from an already depressed level:



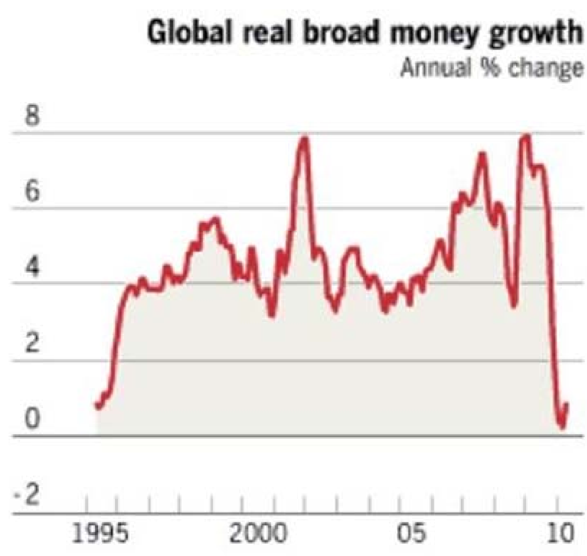
Source: Bloomberg

In other economic data, capacity utilization remains at levels usually seen at the bottom of recessions as opposed to one year into a recovery phase, although it has turned up from even lower levels:



Source: Federal Reserve Board

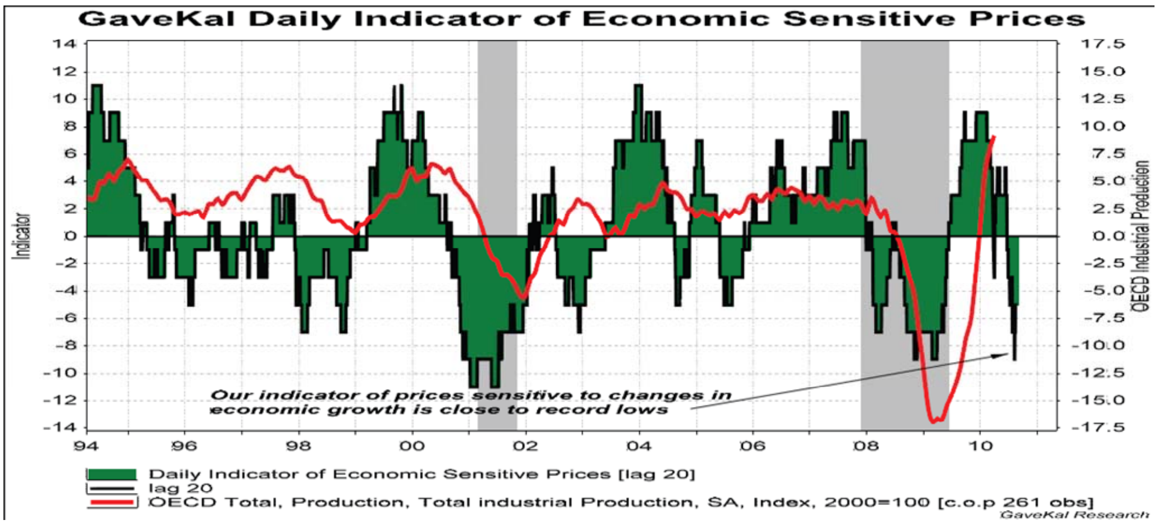
Money growth globally has been stagnant and when coupled with a decline in the velocity of money, the combination can be deflationary:



Source: Financial Times

Consequently, it is not surprising that the inflation data has been very tame as evidenced by the core CPI data (ex. food and energy) which registered a reading of 0.9% in June.

GaveKal, a Hong Kong based economic research firm, has an indicator that measures the most economically sensitive prices and it registered close to a record low in June:



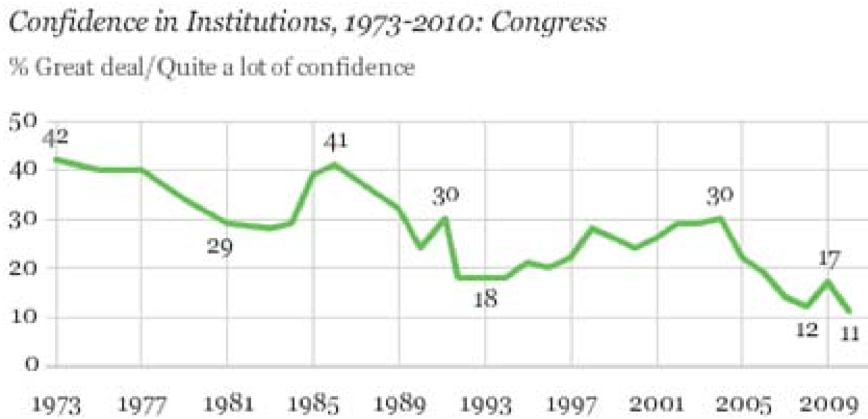
Source: GaveKal

In summary, the quarter was marked by a slowdown in the economic data subsequent to the European debt crisis. It remains to be seen whether this is more than just a temporary stall or if the momentum that has been building since last Spring will continue.

Outlook

"If the debt continues to accumulate and it becomes unsustainable…then the only way that it can end is through a crisis or some other very bad outcome."
Chairman Ben Bernanke in his July Senate testimony referencing the federal debt in the United States

The Greek situation brings to light that political promises made for the past several decades have no basis in economic or demographic reality. The remedies for these issues can only be addressed by our elected officials at the state and federal level. So all eyes are on government to address the problem, and unfortunately the public, perhaps for good reason, has little faith in their ability to do so. The chart below shows the percentage of people that has a high degree of confidence in Congress:

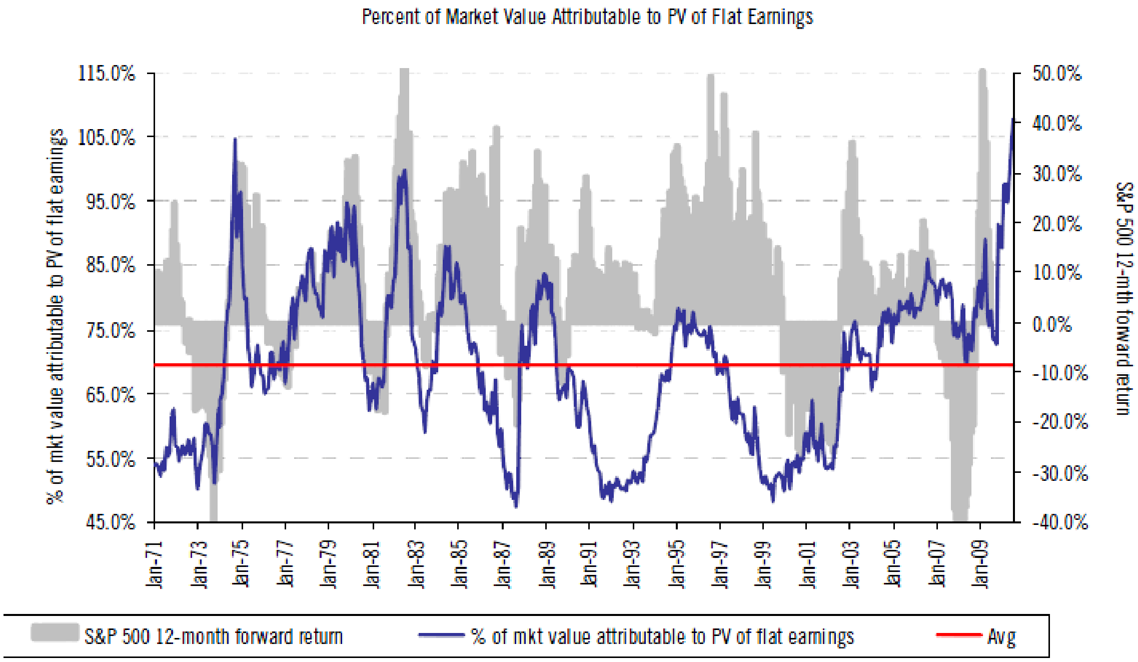


Source: Gallup.com

The current reading is not only at an all time low for Congress, but it represents the lowest level ever recorded for any institution since Gallup began the poll back in 1973. In our opinion, financial participants will need to see the entitlement issues addressed in a credible fashion before they can feel better about the investment landscape.

The crisis has highlighted tensions between those countries and economists that are calling for fiscal austerity and those (like the Obama administration) that believe they must spend to stimulate growth now to prevent a further leg down in the economy. Such a bet however, given the already stretched balance sheets of most developed countries, amounts to going "all in" and this is what Mr. Bernanke refers to in the quote above. We won't delve into the details of the Keynesian versus supply side debate, but it makes sense to us that a balance of the two schools of thought is appropriate. This would entail some continued government support in the short term while detailing a credible plan to reduce future deficits as we recover. Even the head of the European Central Bank, Jean-Claude Trichet echoed this sentiment when he said "Economies that lend credibility to their fiscal policy strengthen confidence, growth and job creation."

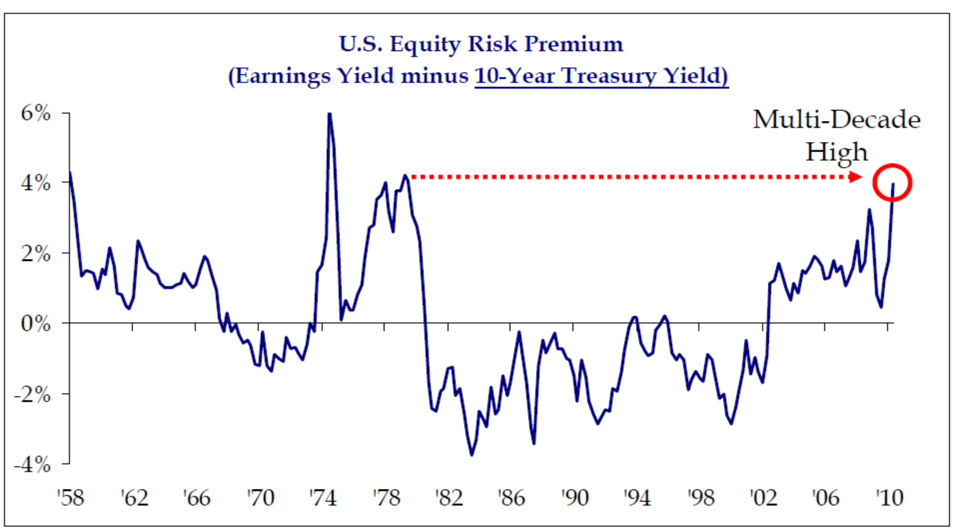
Our forecast continues to be for below trend, but uneven, growth for the U.S. economy for the next several years. We have been predicting this outcome for some time now and do not want to belabor the uncertain economic landscape. Given the confidence readings mentioned above, it appears that the population at large realizes that this recovery may be more difficult than similar time periods of the recent past, and the persistent unemployment situation drives that point home. In his most recent Congressional testimony, Mr. Bernanke called the outlook "unusually uncertain", a phrase likely to become as much a part of the economic lexicon as "green shoots" did two years ago. The big question is how much of this outlook is already being discounted by the markets. The chart below from Citigroup provides some perspective in that regard. The graph takes the trailing twelve month earnings for the S&P and discounts it in perpetuity. That determines how much of the S&P's value is due to future growth and how much is due to what is already known. For the first time since the bottom of the 1973-4 bear market, equities are discounting no future growth at its current valuation:



Source: Citigroup

The blue line shows that over 105% (left scale) of the S&P's current value is due to discounted trailing earnings, so unless an earnings recession is one's forecast, this metric suggests stocks have decent upside from current levels.

The decline in bond yields coupled with the equity correction has also made stocks attractive on a relative basis. Below is a chart comparing the earnings yield of the S&P 500 (earnings divided by the index price) to the yield on the ten year treasury note. Again, this metric shows stocks at levels of attractiveness not seen for several decades:



Source: Strategas

It should be noted that this extreme reading can be resolved in more than one fashion: a rally in stocks, a decline in treasury prices (i.e. a rise in yields) or most likely some combination of the two.

The segment of the equity market that is most attractive remains the large capitalization issues. The chart below breaks out the valuation and top line growth metrics of the S&P 500 by market capitalization quintile:

S&P 500 Market-Cap Quintiles

	Mkt-Cap $MM	NTM P/E	Y/Y Revenue Growth
Quintile 1	110,096.5	13.2x	19.0%
Quintile 2	17,453.0	15.2x	12.5%
Quintile 3	9,531.5	17.5x	14.8%
Quintile 4	6,060.9	17.1x	40.9%
Quintile 5	3,497.8	22.3x	9.5%
Average*	**76,620.9**	**14.4x**	**18.5%**

**Weighted Average Used for Each Quintile Metric*

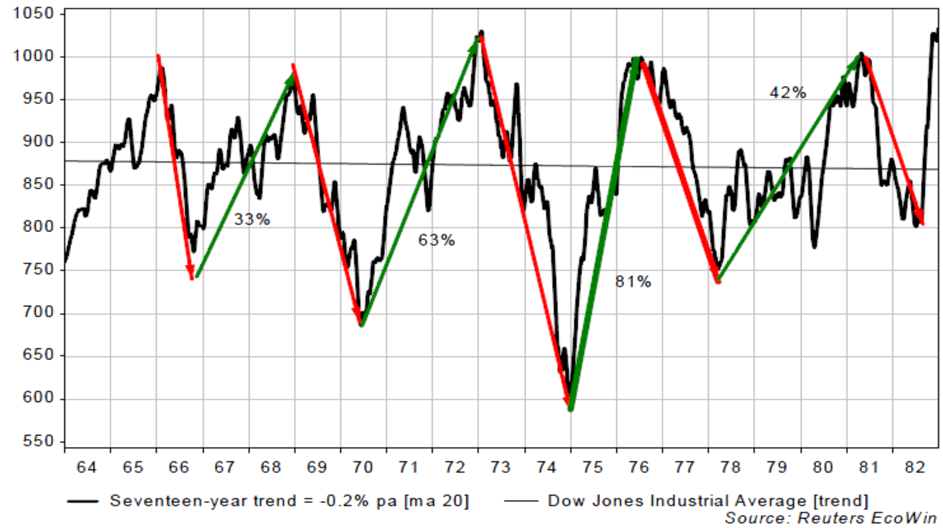
Source: Strategas

<u>Recommendations</u>

- As shown above, we believe the large cap space is compelling as far as equities are concerned. The recent rally in bonds coupled with the stock correction has made many of the dividend paying stocks very attractive on a yield basis, even versus the ten year treasury. At thirteen times forward earnings, many large cap companies are as cheap as they have been for some time, and many of these companies have a material and growing exposure to the emerging economies, diverse revenue streams, low funding costs and strong balance sheets.

- Internationally, emerging markets still remain interesting to us and we would use weakness in that space to average in. As we have mentioned in prior letters, these economies have better balance sheets than most of the G7 countries and are beginning to transition into economies more focused on domestic consumption in addition to exports. Currency appreciation should help in this regard and provide additional appreciation for dollar-based investors.

- We continue to like long/short equity hedge funds as we expect the volatility in the markets to continue and want to have exposure to managers who can trade both sides. The chart below shows that in secular bear markets like the 1964 to 1982 period, the market can have dramatic multi-year rallies and declines; we would expect proven long/short hedge funds to do well in such an environment.



- Lastly, in fixed income, finding yield where the risk/reward trade off is somewhat favorable is becoming increasingly difficult. As the second quarter began, Mr. Bernanke was beginning to talk about ways the Fed could remove some of the monetary accommodation that it provided during the crisis (selling some of the mortgage backed securities on the fed balance sheet). Subsequent to the Euro crisis however, the Fed issued one of its most dovish statements ever, and it appears the Fed is on hold for at least a year, if not more. That has an underestimated effect on intermediate term bond yields as banks and other market participants can borrow at very low short rates to purchase intermediate term treasuries and lock in a meaningful spread. Investor sentiment towards bonds is reaching extremes, and flows into bond funds continue unabated. However, until the Fed hints at a pending change in monetary policy, we expect rates across the curve to remain low. We continue to recommend a ladder or barbell that has some long and short money that balances the risk of a potential fall in bond prices with the extra yield available in the intermediate part of the curve.

Please feel free to contact us with any questions or comments you may have. As always, we thank you for your trust and confidence.

A copy of Constellation's Form ADV Part II is available upon request by calling Philip Frank at (212) 697-2500 or e-mail philip@constellationwa.com.