

**Investment Outlook & Commentary  
Third Quarter, 2010**

To recap our thesis from last quarter's *Outlook*:

*...the trick may be pulling off to the sidelines before everyone realizes the [current market's] strength is not permanent. In fact, this is the foreseeable game plan going forward, being a few steps ahead in a revolving "boom-bust" game where government-stimulus and animal spirits give way to new sobriety and a focus on paying for an escalating fiscal bill—and over and over again.*

Our views have not materially changed in just three months time, and unfortunately, we have already seen how fast "boom" can turn to "bust." Concerns of fiscal ruin in Europe, slower growth in China, and lost jobs and tax increases in America, have prompted the first significant pullback in stocks since the Dow reversed out the March, 2009 lows. While exposure to equity and other "risk" investments had been cut to fairly modest levels, we of course wish we had had even more money hiding out in cash. Ridiculously low-yielding U.S. Treasurys would have been even better.

Beyond the jobs headlines and looming tax increases (as if that's not enough to be concerned about), something else out there has our attention, something we think finally and officially needs to be considered as we go about our daily investment work: the D-word—deflation.

Those here in Cadinha's Investment Committee know that since the late 1990s not a week has gone by without Harlan Cadinha invoking deflation. It seems he has collected enough clues over the years to see some deflationary mosaic while the rest of us, just like the market, have written off deflation as highly improbable. Our disregard for deflation was rooted in a belief—an assumption, really—that the Fed would "just print money" to prevent deflation; it's the lesson Ben Bernanke derives from the Great Depression, and one he vows history won't repeat. Thus, our thinking was, if the Fed will fight deflation, and you believe in the investment maxim, "you don't fight the Fed," then deflation can't happen today. *The U.S. is not Japan.*

But Harlan may be onto something. There are too many deflationary signs today—persistently low interest rates, the troubles in Europe and Japan, and the Fed's jawboning possible inflation, to name a few—that even devout believers in the Fed's powers need to consider deflation as reality. For investors, deflation's immediate effects include lower housing prices, contracting P/E multiples for stocks, debt defaults—a world of lower investment returns.

Besides the evidence on the ground, a deflation story is plausible from a “big picture” view: as a possible end-game to decades of borrowing from the future to boost living standards. Have we “maxed-out” our borrowing potential? We don’t know for sure, but we know there’s a level consumers and governments alike can’t realistically go beyond. Meanwhile, both lawmakers and the Fed are betting that level is still a long way out. Skyrocketing deficits and a new phase of “quantitative easing” have been initiated to jumpstart and refinance America out of ills.

Many academics and pundits applaud these efforts, with some arguing these historic efforts need to be doubled and tripled. We, of course, have our reservations. Growth by government expansion and fiat is no real expansion. People, especially managers, entrepreneurs and others in position to commit capital and put it at risk, rationally look forward and presume that, at best, the expansion will not be permanent; at worst it will require large increases in taxation to pay for it or result in higher interest rates. Government expansion makes capital suspicious.

This is being illustrated today: as huge deficit spending aims to “stimulate” aggregate economic demand, hundreds of thousands of jobs are being lost in America each month. Businesses are looking forward, and it’s causing them to tighten belts, under-invest in production, do less with more, and accelerate any obtainable profits this calendar year—*before* sweeping tax increases go into effect January 1.

I don’t know if Harlan’s right about deflation, but there’s certainly cause for vigilance. And it’s something that will keep us up many nights.

In addition to the deflationary Boogie Man, we’re keeping a close eye on what should be big events: the final federal budget (that will define the tax code in 2011 and beyond) and the mid-term elections. We are also piecing together our contingency plans. One of these plans (the one we hope we get to deploy) includes buying-up certain cheap equities should our concerns—especially regarding the D-word—start to fade.

Either way, we’ll keep you apprised throughout what should be an eventful rest of 2010.

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