

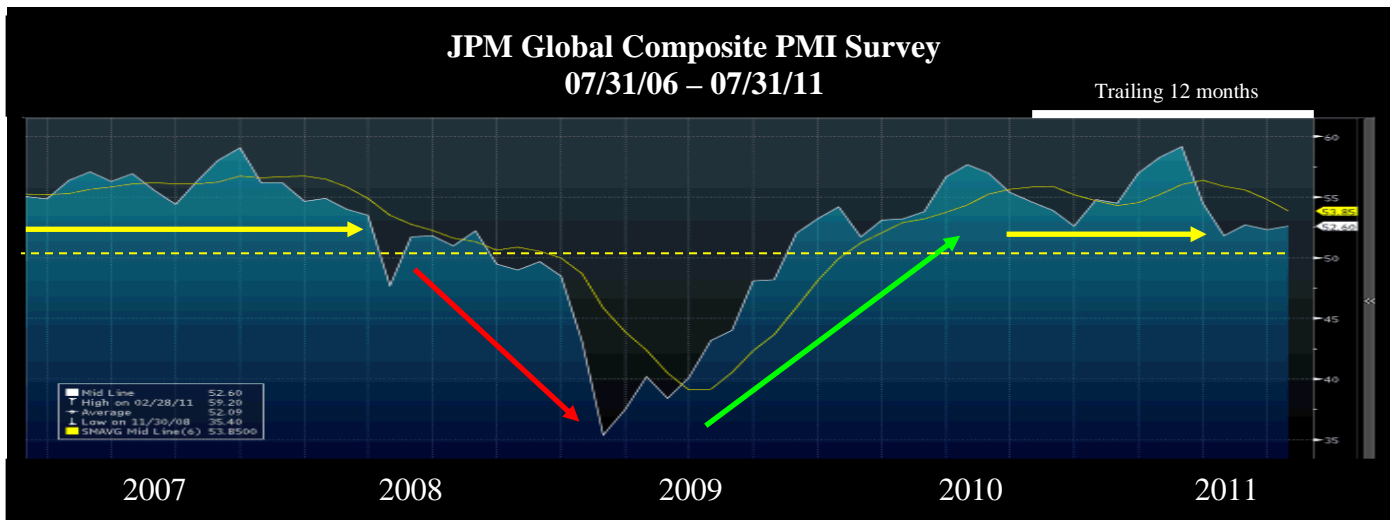
View from the Pier

Our long-term view has been that the mature economies of the world, those that have dominated global economic activity for decades, are destined for slower growth in the years ahead. History is filled with examples of aging populations that downshift from heady growth to slower overall activity, but the transition in play for the United States, most of Europe and Japan is an accelerated one and is exacerbated by the enormous amount of leverage that now suffocates these economies. At the same time, large and young populations in places like China, India, Brazil and other emerging markets are ripe for accelerating growth trajectories with the rise of middle-class consumers and improved infrastructure and capital flows. The full potential of these higher-growth economies will not emerge overnight and will not occur without periodic speed bumps, but the concentration of wealth and economic prosperity is undeniably transitioning from the mature markets to the emerging markets. This bigger picture backdrop is a challenge to stakeholders who had grown very comfortable with the “old” world and find themselves confused and unsettled by the “new”. This leads us to the present-day volatility in the financial markets and the complex set of economic relationships that investors are struggling to grasp and policy makers are reticent to accept.

In 2008 it was the enormous amount of leverage within the financial system that finally collapsed like dominoes across the globe. Western economies, namely the U.S. and Western Europe, found themselves burdened with excessive consumer debt that had made its way into the financial markets in the form of toxic mortgage loans and other asset-backed and collateralized securities. The recovery efforts were led by increasing sovereign debt through various fiscal and monetary programs, adding to already over-leveraged fiscal positions. But the recovery proved meager at best, particularly for the millions of unemployed in these regions. Recent data suggest that the U.S. economy expanded at a mere 0.4% rate in the first quarter of 2011, far short of the 3%+ expectations that were derived from QE2 when announced last fall. Many of the emerging economies maintained a strong growth trajectory during this period, but have also proven vulnerable to the weakened western consumer while their emerging middle class transition plays out.

The problem with economic recoveries that follow contractions caused by excessive debt (rather than the classic supply-and-demand cycles) is that **de-levering is painful and counter-productive to growth**. When consumers and governments have to cut spending in order to reduce their debt, they are subtracting from economic activity. When you spend more than you can afford, it eventually catches up with you; that is where we are in the U.S. and in Europe. Japan is much the same, although certain cultural and structural dynamics have allowed their economy to bump along between meager growth and recession for greater than two decades now. Whether the U.S. and Western Europe are destined to experience a similar fate will likely be determined by policy decisions made over the coming couple of years.

Fiscal stimulus programs and easing monetary policy actions by the Federal Reserve and ECB (European Central Bank) over the course of the last few years were enough to boost asset prices and, when combined with emerging-market growth activities, the economy was able to get out of 2008 and recover to approximately pre-2008 GDP levels. We observed the recovery through the set of global PMI's, monthly activity reports for the manufacturing and services sectors of country-specific economies, which demonstrated an astonishingly high correlation with global stock markets and to a lesser extent global bond markets. The composite that aggregates each of the country-specific PMI's is shown below. You need only to observe a few things about this graph, which covers the past five years so the ‘Great Recession’ is clearly visible right in the center of the chart followed by the recovery period of early-2009 through to a peak in the PMI's on the right (February 2011). If you follow the thin yellow line, you trace the path with a slight lag to the bottom of the recession and back up to expansion before wavering and heading lower on the far right. The absolute level of the PMI readings is still suggestive of expansion, but the direction of the thin yellow line is really what has the markets roiled. We've included a simple traffic light signaling system that contributes to our “risk on”, “risk off” tactical investment strategy as illustration of the role that macro analysis plays in our assessment of the financial markets and the positioning that we feel may be appropriate for client portfolios at any given time.



* Bloomberg

The graph also reminds us that almost exactly one year ago a similar set of concerns emerged as the PMI's sank on the heels of a fading fiscal stimulus package in the U.S. and revelations of the emerging sovereign-debt problems in Europe. At the time, it was the Federal Reserve's QE2 solution and Europe's first pass at solving (then Greece's) the debt crisis, which pacified the financial markets long enough for the "soft" patch in the economy to give way to increasing levels of economic activity.

The ebb-and-flow of economic activity illustrated by the global PMI graph above is reflected clearly in the global equity markets below. The exceptionally strong correlation between these two data sets is clear, as the equity markets use the condition of the economy to discount what corporate earnings may be.



* Bloomberg

Media outlets can call it what they like, but it is the thin yellow line in the PMI graph that is moving the markets. A U.S. debt downgrade doesn't help but it has been priced into the bond markets for months, if not years, at this point. We know this because U.S. bond yields have *declined* since the S&P downgrade announcement, rather than rise as one would expect with a debt downgrade. The debt-ceiling debate certainly damaged confidence domestically and abroad, but the global economy was already slowing heading into the heat of the debate. The fact is that **reduced spending by stretched consumers who are lacking confidence, worried about jobs, and saddled by a home that is worth less than they paid is subtracting from economic activity at a time when debt-burdened governments no longer have the resources to support the cause.** This is really what has markets worked up, the realization that the economic growth trajectory that has been enjoyed within western economies for decades is now so flat that the system lacks the financial resources to support a vibrant economic climate. We are not experiencing a classic recession as much as we are experiencing stagnant growth that is associated with a de-leveraging process, one that may indeed take years to emerge from. The emerging-market economies are not yet prepared to carry the torch. They may be some day, but not yet. This is not pessimism, this is realism. It does not portend a dire economic outlook as doomsayers suggest, but it cannot be viewed through rose-colored glasses, either. In our opinion, reality, as it often is, is

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somewhere in the middle, a more moderate future global growth trajectory than many have anticipated, a path that contains many fits and starts, and an environment that is more vulnerable to policy mistakes. The volatility in the financial markets is a reflection of investors succumbing to this reality. Growth will be slower and corporate profits will be less robust.

During periods of transition and heightened uncertainty, the value of diversification is highlighted. The wisdom of owning a variety of asset classes that don't always move in the same direction at the same time becomes apparent as the market volatility rises. Our portfolios are comprised of bonds that span multiple geographies, multiple sectors, and multiple points across their respective yield curves. These bonds have performed handsomely so far this year. We own stocks of companies that do business in myriad countries around the globe and in numerous industries. The stocks in client portfolios have good fundamental valuations, strong balance sheets, and terrific cash flows – many of which pay out nice dividend yields. They are not immune to recent downward pressures and certain of our positions are strategically cyclical in nature, but year-to-date they have held in well and we have high expectations for their future performance. We have exposure to commodities that are in great demand around the world despite wavering growth, including broad exposure to energy, agriculture, industrial and precious metals, along with holdings of gold that we have had in portfolios going back to 2004. And critically during periods of high volatility, we hold cash in client portfolios, and today we hold levels that are considerably higher than normal in a strategy that we've historically referred to as "Staying Power".

"Staying Power" allows the investor to meet their cash-flow needs during volatile periods without having to sell assets into down markets. This approach buys time for investors, giving them an opportunity to ride through the rough patches that occur more regularly than most appreciate. We started building "Staying Power" across portfolios when we observed the peak PMI's earlier this spring. We use these leading indicators as a guide to our tactical maneuvers within the markets and, as the PMI's have decelerated from their peak in February, we've been shifting to a more defensive posture in portfolios. More specifically, we have been raising cash on the margin over the course of the last few months, taking a little out of our bond holdings, taking a little out of our stock holdings, and rotating our remaining exposures into more defensive securities – it is what our "yellow light" has been telling us. It means that heading into the volatility of the markets of the past two weeks, we had already raised cash levels in client portfolios and had built up "Staying Power" so that we can remain calm during this period and make the best decisions we can based on facts and data rather than emotion, which can be strong in these instances. And one of the great benefits of "Staying Power" is that it can provide dry powder for investment opportunities that emerge when fear is running rampant on Wall Street. We fully expect to be making a host of tactical investment decisions during this period that will include both sales and purchases of securities, taking advantage of opportunities that we feel are appropriate and will drive future returns.

What ails the US, European and Japanese growth trajectories will take years to play out, while economies of emerging markets will vacillate between stretches of prosperity and moments of seeming despair. Business cycles will come and go, perhaps shorter in duration and more volatile than cycles past. Through this, investors must be nimble, and yet exhibit patience, be open to new ideas, and yet show discipline. Most of all, investors must remain alert, watchful to avoid danger and outsized risk, for the wrath of the financial markets can be difficult to recover from. We believe that investors can achieve reasonable returns in the environment that we for see, but they will not come in a straight line and are likely to deviate from history.

We fully appreciate the unnerving impact that fluctuating markets have on the emotions of investors. Days of extraordinarily high volatility can scare even the most seasoned investors. "Staying Power" allows investors to sleep a bit better at night and reduces the risk of abandoning a well-designed plan for achieving long-term goals. We do not expect a smooth ride ahead, nor do we anticipate an apocalypse. But all investors should be prepared for periods of high volatility that will accompany the sea change taking place among the "old" and "new" economic powers of the world.

We are grateful for the opportunity to bring you the View from the Pier and, as always, we welcome your questions and comments.

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