

Investor Newsletter



THINGS TO WATCH FOR:

OIL

Still volatile after all these years. World demand as of July 2010 was 86.8 million bpd. Total supply stood at 86.9 million bpd. The market is still tight.

PENSION DEFICITS

It is estimated that pension deficits could be \$1-2 trillion. Most pension funds have over-estimated their expected return on investments. These numbers need to be brought down.

WORLD MARKETS

World governments have performed bank solvency tests. These do not truly reflect the amount of leverage and need of capital that should be placed into the banking system. Shaw Group estimates that the global banking systems need \$1.5 trillion in additional capital to be considered adequately capitalized at an 8% Tangible Common Equity Ratio. It is our estimate that U.S. GDP growth will be 1-2% and Europe will see .5% growth. Overall, developed countries will see 1% growth going forward.

Credit markets in turmoil part 2.

Rock Stars and Balance Sheets

Like 2009, 2010 is certainly proving to be a ride for investors. For 2009, the Dow and S&P 500 finished the year up 22.64% and 26.47% respectively. Over the last 10 years the Dow produced an annual return of 1.34% and the S&P 500 -.95%. The end of 2009 marked the first time that the broader indexes produced a negative 10 year return. This is truly concerning. For “equity only” investors, bonds were a wake-up call, delivering a return on capital as well as a return of capital. 2010 is proving to be the same.

During the last couple of years, investors have been exposed to absolute confusion. Companies that should have failed were provided support so that our global financial markets would not collapse. Fair? Probably not. Responsible? Yes. Most individuals and politicians were not aware of the complex spiderweb system our capital markets operate in. Money market accounts and the funds they invested in were thought of as safe. Companies that have a substantial presence in the Commercial Paper (CP) market and thus a huge presence in almost every money market account in the world found themselves on the brink of insolvency. Dramatic action took place and changes were made. These changes are structural. Make no mistake about that. Global markets will be adjusting to deleveraging.

Some fund managers are calling for a “new normal” growth rate. Others think the markets have almost repaired themselves and thus a return to the old days of growth are in our future. Who is correct? High growth rates experienced over the last 25 years are a thing of the

past. Growth of over 5% annually can not be sustained and are bound to return to an appropriate level. A “More Normal” level so to say or simply a reversion to the norm. Let’s look at the numbers.

The “magic” number appears to be 5. Why 5? 5% is produced by adding average historic inflation (3.8%) to population growth (1-2%). Real demand can not and does not outpace the rate of population growth. It can’t. In theory, there are only 1-2% more people being born each year. Demand for housing can not grow at over the population growth rate. If it does, an excess of inventory will accumulate. Hence, our current housing market collapse and reversion to a true norm of demand. This 5% number is found almost everywhere. 5% is the historic 200+ year average for interest rates for the United States. 5% is the rough average for stock market returns. By using these assumptions, one can get a feeling and be able to adequately compare security prices and returns on investments. A more appropriate normal level of growth is what investors need to be aware of when evaluating and considering investment choices these days.

Index	Historic LT Growth Rate	Target / Fair Value
Dow	5.75%	11,022
S&P 500	5.19%	1,173

82 YEAR CHART OF THE S&P 500 INDEX

S&P INDEX HAS DEVELOPED A DOUBLE-TOP CONSOLIDATION PATTERN

These patterns are usually followed by a 50% correction. Major repair is needed to consolidate gains the market experienced since the early '80s. Historically the S&P 500 has grown at an average rate of 5.19% per year.



54 YEAR CHART OF THE CRB INDEX

LONG-TERM TREND REMAINS INTACT

Having experienced tremendous gains, the CRB Index returned to the bottom of what appears to be its historic trend line dating back to the early '70s. It appears that the Index has found long-term support.





Several companies have recently come out, after releasing 2nd quarter 2010 numbers, and expressed concern that they will see weaker than expected demand going forward. This is due to weak consumer demand in mature markets in developed countries, global spending cuts by governments based on unknown expenditure/revenue data, uncertain capital markets, and slowing credit growth throughout the world.

In August the FSB and Basel Committee on Banking Supervision (BCBS) published reports on the implications of new standards of bank capital and liquidity. It appears that higher capital and liquidity requirements will offer long-term economic benefits, but could take 4 years to implement. The reason is so our global capital markets do not face too much pressure on credit growth all at once. The reports indicate that a 1% increase to TCE (Tangible Common Equity) equates to a negative .2% on GDP on a global perspective. Research indicates that the average TCE ratio of U.S. banks currently stands at 6.35%. Raising this to 8% will knock off .10% from GDP. Europe is a different story. Its average TCE ratio stands at 3.58%. To get to the 8% TCE ratio will knock off .64% from GDP. Growth rates look to be in 1-2% range for the U.S. and .5% for Europe. Shaw Group's view is that global GDP (ex - Asia) will be around 1%.

In summary, global markets find themselves in repair mode. The excessive level of current debt overhang is weighing down the possibility of an economic recovery. Like rock stars, corporations and individuals found themselves trying to look and act like something they were not. Many found themselves structured outside their realm of expertise by following the herd and looking to grow for

growth sake. Hogs truly feeding at the trough. After any good meal, time to undo the belt, unbutton the pants, lay on the sofa and take a nap. Time to digest the growth.

Recent activity

We sold our clients' holdings in **Micron Technologies (MU)**, and **Huntsman (HUN)**. Micron (MU) reached a level we felt comfortable with in taking profits. Our clients' holdings in HUN benefited from a severe sell-off in its stock price resulting in a miss-pricing on assets. Fortunately we were able to capitalize on this movement. As I mentioned before, rising global markets with the assumption of slower growth, it seemed prudent to harvest gains, redeploy money, and raise cash levels in accounts.

Stocks we like

Marathon Oil (MRO): \$32 Explores, markets, refines, natural gas and crude oil. Marathon could report over \$5.2 billion in cash-flow for 2010. MRO appears to offer compelling value at current levels: trading at book value and offers a 3% dividend yield. Management has indicated that the company can grow at a 2-4 % range. Although this appears possible, Shaw Group values Marathon using a more conservative 0% growth model. Under this scenario MRO could be worth \$44 per share. A detailed analysis of its assets indicates that a break-up value of its assets could be worth \$44-49 per share. We like the value that is currently represented in this equity and see an Intrinsic Value at higher levels.

MARKET NUMBERS

Dow:	10,341
S&P:	1,092
Nasdaq:	2,209
Fed Funds:	.25%
3-Month T-Bill:	.12%
2-Yr. Note:	.49%
10-Yr. Note:	2.60%
10-Yr. TIPS:	.94%
U.S. GDP:	1.6%
CRB:	274
Oil:	\$73.68

Contributors

John R. Dismuke

Subscription

Shaw Group, LLC

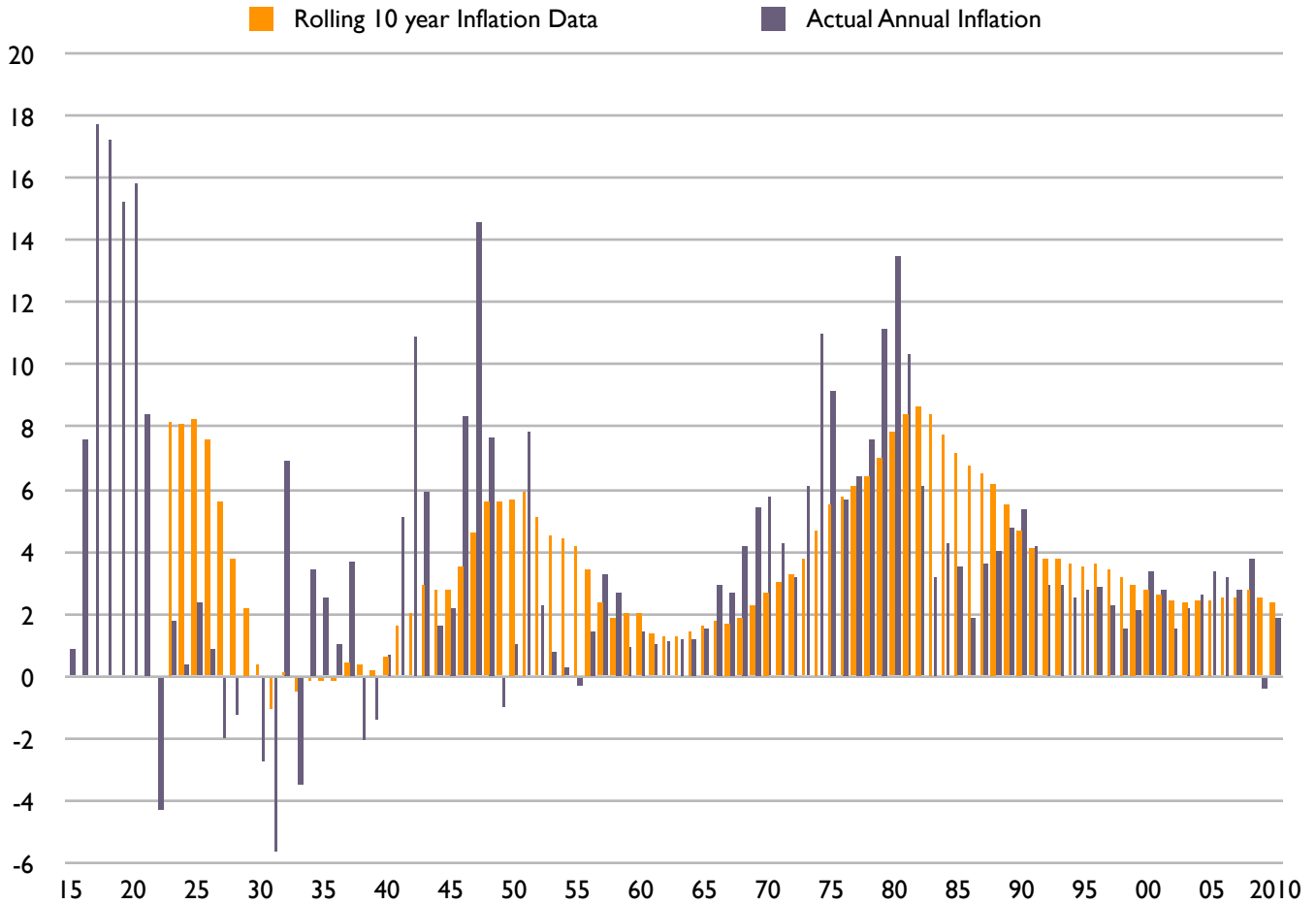
Investor Newsletter
7410 South Creek Rd.
Suite 102
Sandy, Utah 84093

801.572.7839

Inflation Data:

Long-Term Inflation data dating from 1914

Ninety-six years of data show that historic inflation averages 3.80%. Population is currently growing at .9%. This indicates that true demand cannot exceed 4.7%. Any assumption of higher growth would appear incorrect. It is important to note that when Actual Annual Inflation rises above or drops below the Rolling 10-year data a long-term trend is set. Current year 2010 data suggest that we will experience more downward pressure.



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