2011: The Summer of Our Discontent

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Executive Summary

As we near the end of summer — a time that is usually a relatively quiet season for investment markets, but not so this year — we thought it would be useful to review the major events of the past few months and address some of the questions and concerns that are most frequently asked by our clients.

Based on our assessment of the global and domestic landscape, it appears we are being confronted by issues on all sides. Understandably, investors are nervous and stock markets around the world have reflected that sentiment with huge negative and positive swings and a 50% increase in overall market volatility. With heightened risk aversion, cash reserves have risen significantly across personal and corporate balance sheets and the price of gold has increased dramatically.

In our view, while investment markets appear to have assumed that major financial crises are likely to happen, we conclude that the U.S. economy is likely to continue to grow, albeit slowly, that the European Union (EU) is not likely to fracture, but its economy is clearly struggling, and that the emerging economies, including China and India, are likely to continue to grow fast enough to help the global economy grow at a near normal pace. With corporations generally in good shape, currently low interest rates, and reasonable inflation levels, we remain reasonably constructive about investment performance over the intermediate term. However, with our expectation that higher market volatility will likely persist for the time being, we have gradually positioned portfolio strategies to be modestly defensive.

Recap of Recent Events

2011 started with the U.S. economy growing at a very slow pace. We had anticipated somewhat slower growth due to the expiration of stimulus programs put into place in 2009 and 2010. Unfortunately, the energy markets inflated, caused in part by political disruptions in several middle east countries, and pushed oil prices above $100 per barrel. This rise in prices acted as an economic tax, siphoning spending away from other productive uses and slowed the U.S. economy even further.

Japan, the third largest economy in the world, was hit with a devastating earthquake that triggered a tsunami and nuclear disaster in the aftermath. Japan's economy was thrown into recession and its manufacturing industries were severely impacted, which in turn impacted global manufacturing and caused a modest slowing of the overall global economy.

In Europe, severe financial distress was experienced in the so-called periphery countries of the European Union (EU), including Ireland, Portugal, and Greece. The European Central Bank (ECB), International Monetary Fund (IMF), and the key countries of Germany and France applied several funding and loan programs intended to forestall further financial crises and/or major bond defaults. Over the summer, the larger economies of Spain and Italy began to experience the first symptoms of financial distress.

The emerging market economies of China, India, and Brazil have contributed an unusually large percentage (more than 50%) of global growth since the 2008 financial crisis and deep recession. These less developed economies are actively attempting to slow economic growth to avoid destructive inflation, while hopefully not instigating a recessionary cycle. With many of the emerging market economies applying the brakes, the global economy is slowing further.
In the U.S., we were hit with three summer storms. The first was the political wrangling related to raising the U.S. governmental debt ceiling. The second was Standard & Poor’s rating downgrade on U.S. government debt. Two primary reasons were cited for the action — the very large increases in additional debt being created and the apparent disability within the factions of the U.S. Congress to work together to reduce budget deficits over the intermediate to longer term. The third involved an actual storm in the form of Hurricane Irene which was the first hurricane in decades to extend up the entire eastern U.S. seaboard into New England.

Frequently Asked Questions

• Is the U.S. heading back into recession?
  We believe that the U.S. will most likely continue to experience positive growth during the remainder of 2011 and at least into mid-2012. However, we do not completely discount the possibility of another U.S. recession in the near term. There are too many real issues facing our economy to be that sanguine. The key reasons we believe the U.S. is more likely to continue growing include:
  - Corporate profits are strong
  - Consumer spending is reasonably solid in spite of recently reported weak consumer confidence levels
  - Government policy is accommodative
  - Energy prices have moderated
  - Global growth contributions from emerging economies is solid
  - Japan is in recovery from its disasters

Barring shocks from outside the system, the U.S. economy tends to be resilient and buoyant. Restrained by the still very weak employment conditions and bearish market in housing, we expect the U.S. economy to grow during the next six months, but likely in the sub-par range of 1% to 2%.

• When will employment conditions improve in the U.S.?
  We believe the short answer is that U.S. employment is likely to remain weak through at least 2012. The U.S. economy typically doesn’t generate net new job growth unless our economy grows at or above about 3%. Given our outlook of 1% to 2% growth in the U.S., the unemployment rate is not likely to improve materially in the short term.

• When will interest rates rise in the U.S.?
  It appears interest rates in the U.S. are likely to remain low through 2012. Federal Reserve Chairman Bernanke’s recent guidance was that the Fed Funds rate is unlikely to be raised from its currently very low level until 2013. There are several factors that are related to interest rates, including the demand for capital which is typically driven by growth, the demand for debt which is typically driven by spending, and the demand for safety which is typically driven by the perception of financial and economic risks at various times. Let’s look at each factor individually.

Beginning with the demand for capital, growth tends to push interest rates higher if an economy grows above its average or “normal” rate for a sustained period of time. For the U.S., the normal rate is around 3.5%. Given our outlook for U.S. growth, there is likely to be little pressure upwards on rates due to growth, which otherwise might cause a shortage of capital.

An indicator of the magnitude of spending in an economy is a country’s budget deficit. A general rule of thumb is that if a country’s budget deficit relative to the size of its economy is 3% or less, the relative level of spending is probably insufficient to drive rates higher. In our case, the U.S. is running a budget deficit of approximately 10% in 2011, which would indicate that pressure is likely building for interest rates to rise.

The third factor, the demand for safety, is probably overshadowing the spending factor for now. Given the unusually high number of simultaneously occurring issues globally, many
investors are seeking relative safety and so far appear to continue to have confidence that the U.S. government still stands behind its debts. As a result, they have continued to invest robustly into U.S. Treasury securities. This relatively high demand for U.S. Treasuries helps explain the current environment of very low interest rates.

On average, the U.S. government is borrowing approximately $150 billion per month of new debt in addition to ongoing refinancing of existing debt. Investors appear to be willing to accept exceptionally low interest rates in return. This may no doubt be a reflection in part of investor expectations that the U.S. will experience slow growth ahead, but is also likely a symptom of investor appetite for relative safety. Our view is that the global and domestic issues described will likely take a longer time to resolve and our conclusion is that demand for safety will remain high for the foreseeable future. At some point, if the U.S. continues to incur substantial deficits, interest rates could be forced higher by that factor, but we don’t think that is likely before 2013.

- **Is the European Union (EU) heading into a major financial crisis which could force its break up?**

  We actively observe and analyze events as they occur related to the EU. Our current conclusion is that a major EU financial crisis and potential break up is unlikely.

  The European Central Bank (ECB), along with Germany and France, has been willing to make increasingly harder decisions as pressure built on member countries. While we believe that Europe has not yet fully stepped up to face the longer term solutions that will likely be required, we sense that all parties involved view their alternatives as far too painful. In our view, this means that the ECB, Germany and France may ultimately agree to make the tougher decisions, including protection of the main European banks, meaningful fiscal policies for the EU, and possibly the use of a eurobond market which may provide a significant link across the budgets of EU member countries.

- **With the dollar weakening and large budget deficits and risks abroad, gold has performed very well. Is gold a good investment now?**

  We would advise caution with respect to investing in gold. Gold is sometimes thought of as an alternative currency and as such if investors worry about potential financial crises on the horizon, which could dramatically impact the dollar and/or other major currencies, then gold would seem to be a safe haven. Our view and concern about gold is three-fold. First, the international standard of basing currencies on gold was scrapped over 40 years ago so there is no current global structure or treaty that empowers gold to be an official alternative currency. Secondly, over longer periods of time, historically gold has performed about the same as cash, far below stocks and bonds on average. Thirdly, even if gold is viewed only as a trading strategy, given the recent run up in price, our view is there is likely elevated risk in participating in gold at current levels.

- **With all of the potential risks and concerns in the market, should existing investments be sold and reinvested into cash?**

  We do not advise replacing investments that fit clients’ longer term investment objectives with substantial amounts of cash due to market volatility. We are not market timers because we are convinced that it is impossible to accurately and consistently make those calls. We give this same advice to our clients. Our experience is that during times of high market volatility, riskier investments, like stocks, may lose value temporarily, only to regain value when the volatility conditions subside. Investor who sell during volatile markets tend to reinvest again too late to capture price recovery that often happens during sharp moves.
Situation Analysis

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Conclusion

What should investors conclude from all of these issues? Our macro view is that the global economies, developed and emerging are on two very different paths. The developed world is still wrestling with the aftermath from the financial crisis. Our historical review of data related to financial crises suggests that this extended recovery period is typical. It often takes as many years to recover as it did to build up the excesses that caused the financial crisis. In contrast, on average the emerging economies continue to grow at a far faster clip than the developed economies. We see a global rebalancing taking place that started a decade ago and will likely unfold for many years to come.

Investment Guidance

As outlined in this paper, we’re cautiously constructive on the economy both domestically and globally, but over the past several weeks, we’ve moved in a slightly more defensive direction in our recommended portfolio allocations.

- **Equities:** We recommend a general underweight position in equities and emphasize the use of larger and higher quality domestic companies. As appropriate, we are also inclined to utilize investment managers that are significantly more active than passive in their process and style.

- **Fixed Income:** Allocations to fixed income have moved to an overweight position as we view this asset class as a potential safe haven opportunity given our outlook on the current market environment.

- **Commodities:** We have moved to a neutral weight in this asset class. Our preference is to invest with managed or passive diversified commodities portfolios and vehicles that provide exposure broadly across consumable commodity types, including fuels, industrial materials, agricultural commodities, and some exposure to precious metals based more on relative commodity market weight instead of being primarily a speculative trade.

- **Real Estate:** While all real estate investment markets are not created equally, most of the dire news is known and appears to be reflected in current asset prices. This has caused us to move to a neutral weight position in this asset class.

Overall, we advise clients to maintain the investment strategy that fits their longer term goals instead of reacting to volatile market swings. As always, we encourage you to actively review your investment objectives, risk tolerance and current financial situation with your Wealth Management Advisor. Please contact us if you have questions.

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