MACROECONOMIC QUICK TAKES

STRONG REBOUND RETURNS … NOT SUCH A SURPRISE

Now that domestic equities have advanced some 66% since reaching their nadir last March, the news department of a local radio station asked me to comment on whether I felt an economic recovery might finally have taken root. Keying on the word "finally," I answered with a sharp "no," then explained that the first blooms of recovery began to appear almost a year ago when the rate of economic *decline* began to slow. The fact that it took several months for that decline to actually reverse itself and another few months for the upturn to become evident to the masses is irrelevant. Unfortunately, investors often have difficulty seeing through the obvious negativity that is sure to dominate a given downturn.

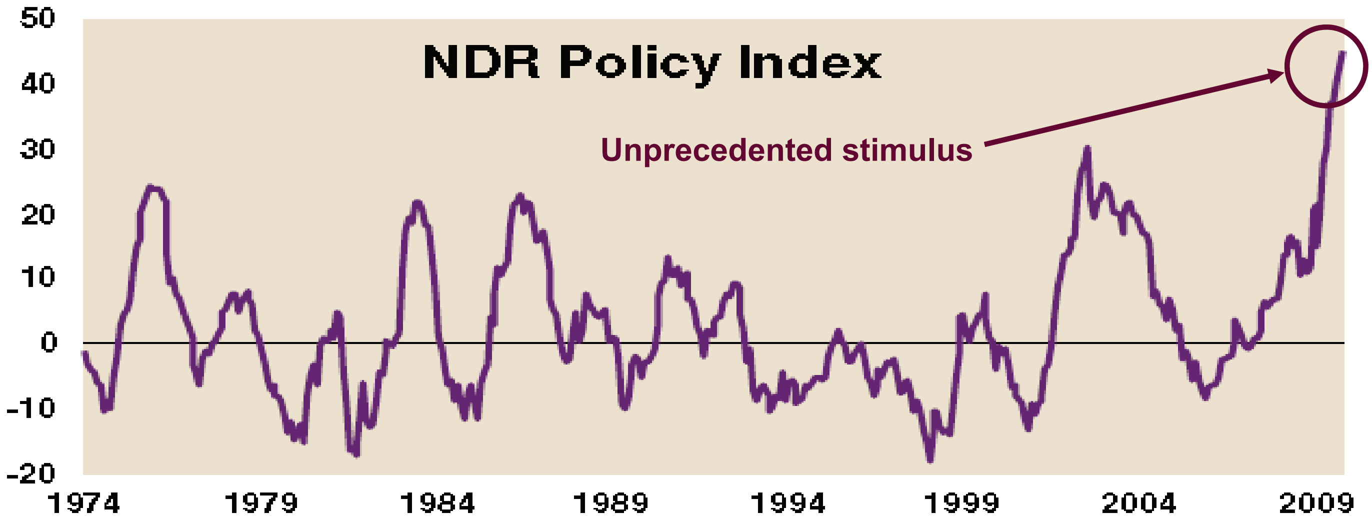
Before I explain why the sharp recovery in capital asset prices has not surprised me, let me at least outline the more obvious case for pessimism lest I be regarded as a blithe optimist.

GRAVE WORRIES …

The level of public indebtedness is on the verge of demanding the use of exponents and many states are suffering from large budget deficits. As a result, tax hikes seem inevitable. Having muddled through the sub-prime crisis, banks are now experiencing elevated credit losses in their commercial real estate and credit card portfolios. Unemployment has reached double digits, oil prices have risen some $9 per barrel over the past few weeks, and the Fed's continued easy money policy has (by the Fed's own account) set the stage for yet another wave of asset bubbles which can create giddy excitement until they burst.

… SO WHAT'S DRIVING THE RECOVERY?

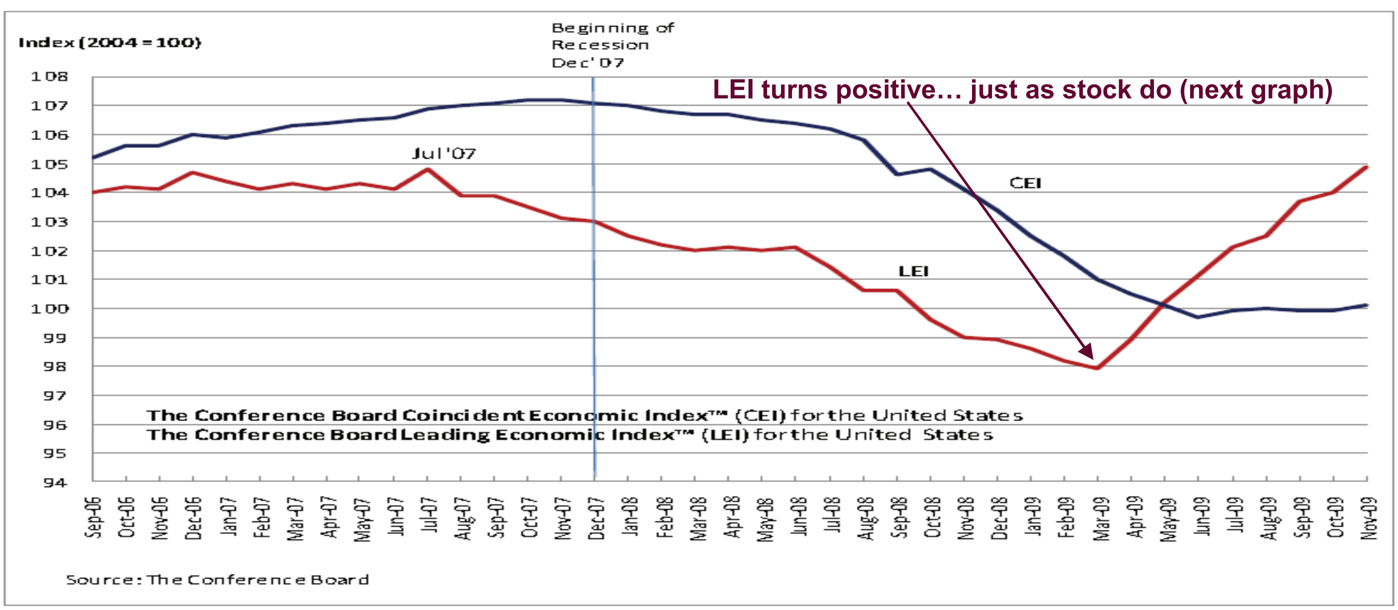
Asset prices are driven by money flows and there's certainly no shortage of it sloshing around these days. The graph on the next page represents the "Real Monetary, Fiscal and Exchange Rate Policy Index." In general terms, when this index is in positive territory, economic policies are, on balance, stimulative. Currently, the relative level of stimulation is unprecedented. This stimulation, combined with the extreme severity of the downturn that preceded it and the negative sentiment it generated, set the stage for an equally extreme rebound which seemed



to have begun once investors concluded that the situation was at least north of hopeless. The Fed's extreme intervention has worked inasmuch as we certainly do appear to have side-stepped economic ruin.

LEADING ECONOMIC INDICATORS ADVANCE 8 STRAIGHT MONTHS

The Conference Board's Leading Economic Index ™ (LEI) took a sharp turn for the better that neatly coincided with the rebound in capital asset prices. Compare the LEI below to the general price level of stocks as represented by the S&P 500 on the following page. Since investors are a forward-looking lot and because the LEI is, by definition, a forward-looking indicator, it should not be too surprising that the LEI has moved in tandem with stock prices.



The LEI's continued upward trajectory gives us at least some cause for further optimism.

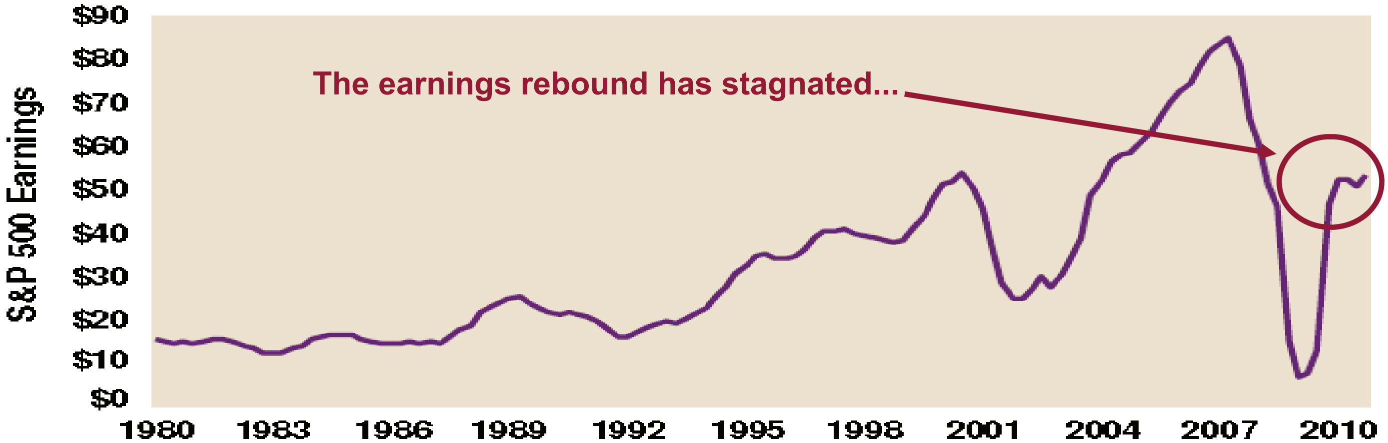
THE LAGGARDS LAG

Incidentally, The Conference Board Lagging Economic Index™ is working just as advertised. It has continued to deteriorate during September (-0.5%), October (-0.2%), and November (-0.4%). Of course, unemployment figures, which are so widely reported and hotly debated amongst politicians, are buried in this lagging index along with a host of other indicators that lack predictive power.

However, nonfarm payroll figures, which closely mirror changes in corporate earnings, stopped deteriorating months ago. While recent payroll data still indicates net job losses, the rate of those losses has steadily shrunk. If history is a guide, joblessness might peak within the next few months. In cautioning against blind reliance on the historical record, however, Warren Buffet famously warned, "If … history is all there was to the game, the richest people would be librarians."

CORPORATE EARNINGS

Along with stimulative monetary policies, corporate earnings drive stock prices. As you might imagine, earnings plunged during the tsunami that was late 2008 and early 2009, but have since recovered to a large extent. Please refer to the chart at the top of the next page.



While the Index of Leading Economic Indicators has continued to march forward, the stall in the recovery of corporate earnings gives us some pause. Because we haven't had a material pullback since the recovery began, we've grown a tad more cautious with respect to equities. However, if equities do pull-back, our normal practice would be to rebalance our portfolios which would allow us to buy equities at relatively attractive prices.

An important truth is that the more volatile the markets are, the better a portfolio rebalancing strategy such as ours ought to work. Give us a call if you'd like us to explain this concept further. Nonetheless, we're not inclined to overweight equities for the moment. In general, the easy money looks as if it might already have been made.

FOLLOW THE CASH

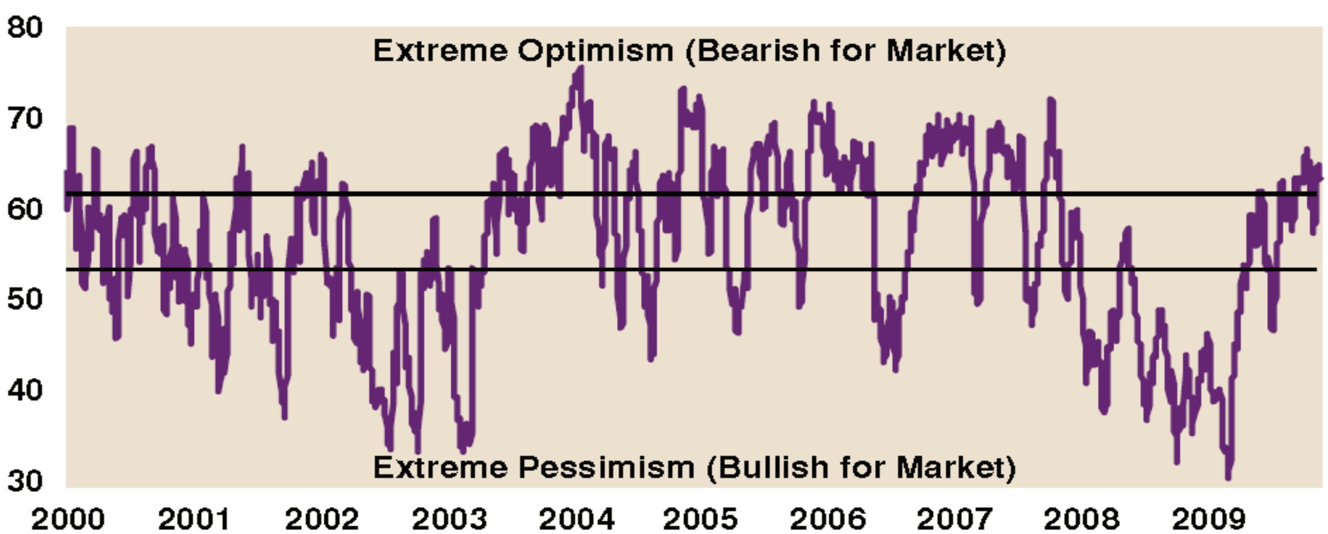
I alluded to this already, but for capital asset prices to be driven higher, cash must be flowing *into* those asset classes. Therefore, market upturns are typically preceded by an abundance of cash that has *not yet* been invested. The pie charts below represent the American Association of Individual Investors' (AAII) survey estimate of the asset allocations of investors in the aggregate. The chart on the left represents investors' overall positions in March of 2009. The very high level of cash (45%) was symptomatic of the pessimism that was

pervasive at that time. Since market advances require idle cash to be newly invested and because large amounts of idle cash tend to develop *only* during periods of high investor angst, it stands to reason that periods of high angst may coincide with attractive entry points. In fact, this has tended to be true and explains why emotional decision making tends to confound the investment process.

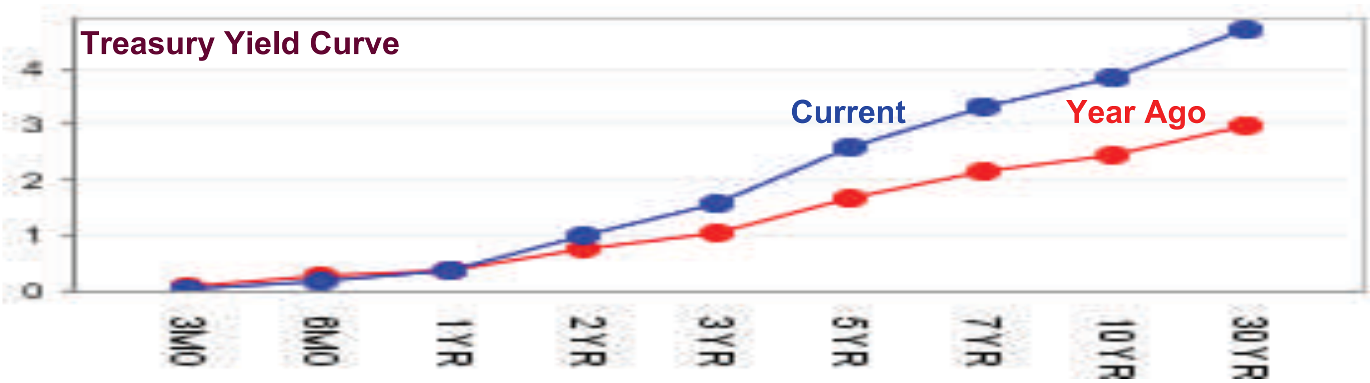
The cash figure of 27% that appears in the right-hand pie chart on the previous page reflects the AAII's November 2009 survey. Since capital asset prices have drifted higher since that time, it's safe to assume that some portion of that remaining market fuel (cash) has already found its way into the capital markets.

INVESTOR OPTIMISM … NOT SUCH A GOOD THING

Predictably, higher asset prices have induced investors to be relatively sanguine about future market prospects. Nonetheless, the fact remains that the higher asset prices we currently enjoy are the result of huge amounts of cash that have *already* been invested. Since investors tend to become highly pessimistic *after* asset prices plunge and highly optimistic *after* asset prices soar, investors' emotional underpinnings have tended to be at odds with the follow-the-cash dictum which has induced many to get whipsawed by sharp market movements (which are a normal part of the investment process). We try hard to avoid being whipsawed, but our rebalancing strategy sometimes puts us at odds with those of our clients who gravitate toward a follow–the-herd mentality.



The chart on the previous page represents a Crowd Sentiment Poll conducted by Ned Davis Research. It indicates that investor sentiment has indeed been a powerful indicator of the future investment climate — except that it works in reverse. The more pessimistic investors are, the more favorable future market conditions have tended to be, and vice versa. The takeaway here is that market corrections and downturns can actually *aid* portfolio returns to the extent a disciplined rebalancing process is followed.



INTEREST RATES SET TO RISE

Longer-term interest rates have risen significantly during the past year which is a natural by-product of economic recovery. Recovery spurs demand for resources which forces their prices higher. To adjust for this higher cost of living, bond yields must adjust (rise). Since most bond coupons are fixed, bond prices must therefore fall to create a suitable rate for the *next* investor who buys a given bond. (The investor who holds the bond *while* rates are rising is the one who suffers the loss.) Importantly, the longer the maturity of a given bond, the more its price must fall in response to a given increase in the expected rate of inflation.

Although inflation is currently tame, persistent budget deficits, a weak U.S. Dollar, and an eventual Fed tightening of monetary policy (the Fed has already hinted at its plans) all point to rising interest rates. Consequently, we have already tilted our bond holdings toward the shorter end of the maturity spectrum to better preserve existing portfolio value. We have also moved toward certain instruments that have explicit inflation adjustment provisions and lightened up on lower quality corporate bonds and municipal bonds of all stripes since these asset classes appear to be fully valued. We may have acted a bit sooner than we needed to, but the best time to react to a given set of circumstances is well before it becomes obvious to the masses. Please do call if you'd like to talk things over. — Glenn Wessel