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Memo

Date: December 28, 2010
To: Investment Clients
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What If They Threw a Tea Party and Everybody Came?

Last month's election was epic. Republicans gained more than 60 seats in the House and 6 in the Senate. They'll now occupy 8 additional governors' mansions and at least 500 more seats in state legislatures.

The GOP picked up more House seats than in any election since 1938, leaving Democrats with the smallest number in the House since 1946.

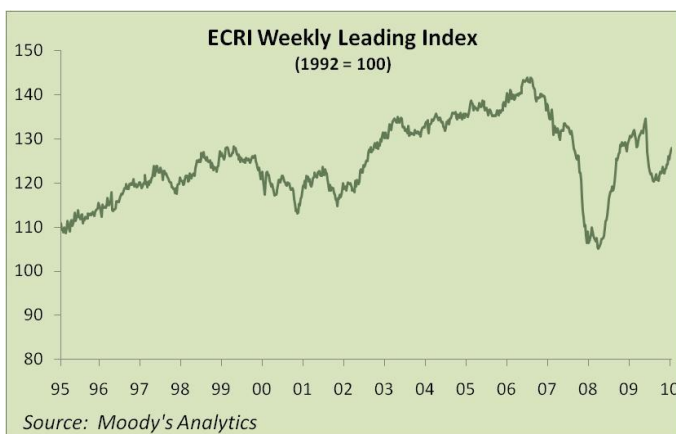
Fifty incumbent Democratic congressmen lost, including 22 freshmen. An astounding 9 senior Democrats with 18 years or more of service each went down, including 3 committee chairs.

On the heels of this remarkable political moment, here are some thoughts on what this might mean to the political landscape, as a prelude to the effects on the economy and the markets:

- This divided government is destined more for gridlock than accomplishment. The Administration and Congress are already spending a lot of energy in framing the agenda for the 2012 election. This posturing, plus the need to compromise, will keep any final legislative products modest.
- There appears to be a "stop doing new harm" mentality within the new leadership in Congress. With no new taxes or regulation likely to be coming out of the government, we're already seeing renewed business confidence.
- Clearly the focus is on faster economic growth and job creation, which was evident even in the lame duck session just concluded. The markets are already reacting quite positively to this sense of prioritization.
- With the national debt building to epic proportions, austerity measures will get a lot of attention. Some of the possibilities include reduction in domestic discretionary spending back to 2008 levels, ending earmarks, and a possible vote against lifting the national debt ceiling.

- Republicans will work toward repeal of the health care reform bill. While repeal may be voted through the House, it will likely die in the Senate or on President Obama's desk. This will put the Republicans in a position of attacking the bill one piece at a time.
- We may see limited compromise in: (a) energy policy, including exploration of traditional fuels, expansion of renewable energy sources, and nuclear power (b) tax code reform (c) China's currency policy and (d) immigration, including undocumented workers and pathways to citizenship.
- There is likely to be a good deal of energy focused on complex redesign of housing finance, including reform of Fannie Mae and Freddie Mac.
- This Congress will preside over regulatory implementation of the Dodd-Frank Act. Attention will be directed at a review of high frequency trading and dark pools (those trading programs thought to be responsible for last May's "Flash Crash" trading session), along with further refinement and extension of the circuit breaker program. Since Republicans are largely opposed to this legislation, it's quite likely they will work to limit critical funding needed by the regulatory agencies to enact the legislation.

We've been vocal all year long about the risks we saw to global economic growth and therefore to the markets. Our concerns focused on European sovereign debt issues, as well as on the threats of both deflation and a double-dip recession. While we aren't necessarily out of the woods yet on any of these three serious items, it does now appear that the policy responses to these risks have at least softened the potential blows. Additionally, in our



constant monitoring of the economic indicators, we've now begun to see a sea change in the data. As opposed to the "hit and then miss" numbers that were so prevalent throughout the year, recent figures are showing more consistent, positive momentum in the trend lines for a number of key indicators, including manufacturing, retail sales, corporate earnings and the leading index. Even the housing market, which has been consistently weak since the bursting of the bubble, now looks as if it's at least seeking a bottom.

That said, it's really the stimulative policy responses over the past weeks that have had the greatest impact on the outlook for continuing GDP growth (albeit at a slower rate than usual) and putting more people back to work. The Fed stepped up first by announcing its second round of quantitative easing (known as QE II), with the stated goals of averting deflation and creating a "wealth effect". This time they'll be injecting \$600 billion into the Treasuries market. Even so, it was the Christmas present offered by our lame duck Congress that finally made us believers in economic recovery. Extending the Bush tax cuts – income, estate and capital gains – have obvious consumer-oriented stimulative effects, but so do payroll tax cuts and extension of unemployment insurance benefits. Some additional business tax cuts don't hurt either. In our minds, these were the missing pieces, for we knew the economy couldn't get there solely on the Fed's back. We also needed the government to step up... and the Fed knew it too. European government bodies have stepped up as well, providing much-needed backing to countries like Ireland, which was teetering on the edge of a sovereign debt crisis.

Are there still serious risks? Of course there are! At the top of the list is the kind of funding crisis that's been bandied about ad nauseum since the bank bailouts and the Obama stimulus package. A LOT of debt has been injected into the system, and it's piling up. This debt will need to be paid for, perhaps at higher interest rates. Add a backdrop for a continually weakening U.S. dollar and you get the picture on the spiraling, self-perpetuating nature of these funding concerns.

Not far behind in terms of concern, and certainly interconnected to the debt pile-up, is the threat of hyperinflation. When we look back at history, every time there's been a large injection of capital into the system, it's resulted in inflationary pressures. Given the enormous amount of debt this time around, one must consider the consequences of future inflation, while not ruling out a period of **hyperinflation**, perhaps like we experienced in the 1970s.

Add to these the constant wild card – a serious geopolitical event a la 9/11 – both predictable in its eventuality, but unpredictable in terms of timing. When we think about those scenarios that could eventually trip up our economic recovery, it's the events just mentioned that catch in our throat, for they're the type of thing that could trigger another down-40% move by the markets.

Even with that in mind, the market's positive response to the government's recent stimulus "gift" tells us that these potential threats may now have been pushed out at least 6 months, to maybe a year or so, into the future. Throughout this year we've maintained a conservative posture. Serious risks to global economic growth, plus high volatility and headline risk across the equity markets, did not offer the form of risk-reward trade-off that makes us comfortable. That's especially true when various forms of debt and diversifying assets were offering unusually attractive returns, at meaningfully lesser levels of volatility than for equity securities. Now, with the potential for a really bad event pushed off into the future, it's time to be less conservative. Our lengthy discussion in our just-completed Investment Policy Committee meeting took us to a target rate of roughly 60% of our long-term strategic targets for equity exposure. In terms of tactics, our preference is for large cap over mid and small, and domestic over international. We'll fund any new equity purchases by taking gains in short and intermediate duration debt positions, total return oriented debt positions, and multi-strategy hedge positions. These are the moves we'll be making in portfolios as we close out the year and move into next.

We've also made some changes to our long-term strategic models. First, we've moved High Yield Bonds from our Diversifying category into Income, believing that this asset class has recovered from extremely depressed valuations and is more representative of the characteristics that comprise our Income category. Next, after a good deal of primary research, we've added Global Real Estate as a strategic asset class within our Diversifying category of assets. We believe this asset type offers very different return patterns than domestic stocks and bonds and therefore provides an extra layer of diversification. Finally, we've decided to compress our Growth and Aggressive Growth categories into a single category called "Growth", believing that all of the asset types in this category comprise the "growth engine" of the portfolio. You'll notice too that we're no longer distinguishing the growth sectors of the domestic equity markets from the value sectors. Instead, the growth/value tilt will be a tactical decision reflective of the market's dominant theme at any

moment in time. You'll see these various changes reflected in your fourth quarter report, and we of course will be reinforcing the changes in our future reviews with you.

As we close out another year, we want to thank you for your business and the privilege of serving your investment advisory needs.

We wish you and your family the happiest of holiday seasons and a New Year filled with joy and prosperity.

Until next time...