

# RAINIER GROUP INVESTMENT ADVISORY LLC

500-108<sup>th</sup> Avenue N.E., Suite 2000, Bellevue, WA 98004  
Telephone (425) 463-3000 Fax (425) 463-3044

---

## **Memo**

**Date: August 10, 2010**

**To: Investment Clients**

**From: Mark J. Pellegrino, Chief Investment Officer**

---

## **A New World Order? Emerging or Emerged?**

Over the past 3 years, in the midst of the most dramatic market movements in decades, the world's markets have moved in tandem with one another, in both directions. Just recently, on June 29<sup>th</sup>, for example, the S&P 500 dropped 3.1%, Germany's DAX Index fell 3.3% and China's Shanghai Composite plunged 4.3%.

However, there appears to be a divergence coming. Within the next 6 months, we believe there's a good chance the developing (or emerging) markets of the world – China, Brazil, India, etc. – will be in clear uptrends, while the developed markets of Europe and Japan will be mired in decline. U.S. markets may be left in the middle, but tilted toward the fortunes of the developed markets.

The underlying economies of these different parts of the world are headed in radically different directions. Where economic underpinnings go, markets eventually follow. Let me paint a picture for you.

Let's start with government budget deficits. The U.S. budget deficit is forecast to be 10.6% of GDP in 2010. The UK's is forecast at 10.1%, with Spain's at 9.1%, France's at 8%, Japan's at 6.4% and Germany's at 5.5%. Let's put this in perspective. Economists believe that a budget deficit of only 3% of GDP is sustainable. Given the current pace at which the developed countries are layering on debt, they won't be able to repay this debt under reasonable assumptions of growth and manageable inflation. Eventually, this leads to declining GDP growth rates, rising interest rates and then fiscal crisis.

Is it any wonder then that the G-20's most recent communiqué was so strongly worded, with "deadlines" for cutting annual deficits in half by 2013 and stabilizing or reducing

government debt-to-GDP ratios by 2016? These weren't actual agreements, mind you, but rather "goals" and "expectations". I'll let you make up your own mind about whether the governments of the developed world will actually achieve these goals. Nonetheless, this stance does embody an economic landscape that looks like this:

Heavily-indebted developed economies will cut government spending over and over during the next 5 years or so, but the cuts won't be impactful enough to end the debt crises in these economies. The backdrop over this period of time will also include higher taxes, slower economic growth and rising interest rates. These are the austerity measures already chosen by the UK, France, Spain and (most likely) Germany.

The emerging nations, on the other hand, don't have enormous debts from the financial crisis and the piles of stimulus spending to draw down that their developed country counterparts are stuck with. The International Monetary Fund (IMF) estimates that the debt-to-GDP ratios in the developed economies will rise to 110% by 2015 from 91% at the end of 2009. By contrast, Brazil's government debt amounted to just 42% of GDP in April of this year and is forecast to drop to 30% by 2014. That is just one of the reasons Brazil earned its first-ever investment grade rating on its debt from Standard & Poor's this year.

To be fair, everything isn't perfectly rosy in the emerging economies. China may be experiencing an asset bubble in real estate and its runaway money supply threatens to send inflation soaring. Brazil and India are facing similar inflationary pressures. Measures put in place to control this inflation, like interest rate increases, could go too far. Combining these measures with slowing economic growth in the developed economies, to which these countries export, could very well cause the economic growth rates in these emerging economies to slow to lower levels than currently expected.

But these are very different kinds of problems. The difference is too little growth and the possibility of even more slowing in the developed world versus too much growth and the possibility of a misstep in the emerging countries as governments there try to keep growth under control.

The time frames are very different, as well. The developed economies are facing a long, slow grind back to fiscal stability – perhaps into 2016. There's also the very real possibility that the economic backdrop in the developed world gets worse before it gets better.

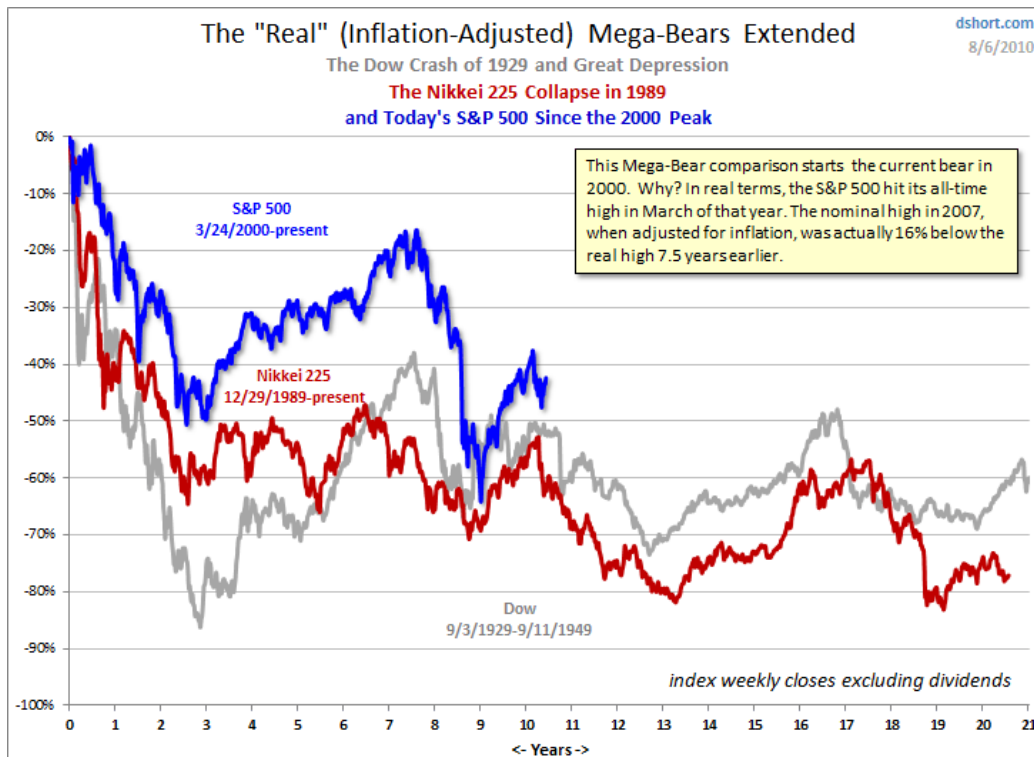
Emerging economies, on the other hand, face the shorter-term risks of slower-than-forecast growth and rising interest rates, but that could all be over by the beginning of next year. Brazil looks poised to stop raising rates and China is refinancing its banking system, which should put fears of a real estate bubble to rest. China has also had the advantage of learning from the developed world's mistakes on this score.

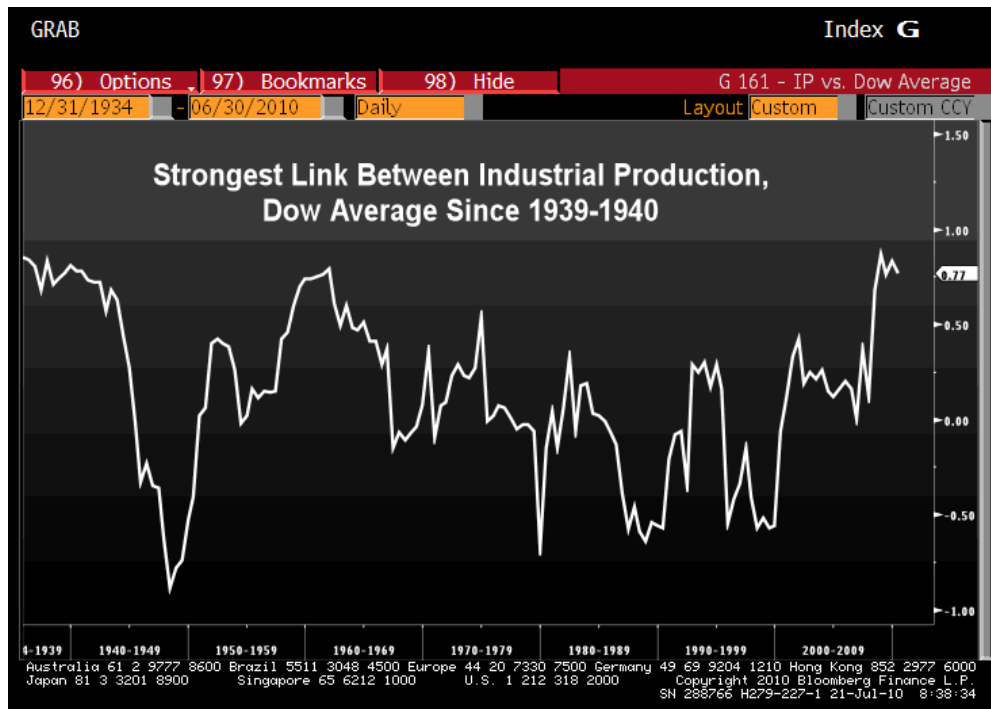
So, we're really talking about the difference between the potential for short-run pain in the emerging (emerged?) economies versus the likelihood of long-term, chronic pain in the developed economies.

The U.S. will likely fall somewhere in between these two parts of the world, but much more in line with the track for the developed economies. The Obama administration hasn't yet stepped up to the plate on austerity measures, but it's doubtful they'll be able to avoid serious budget cuts. Before this past week, we thought there wasn't much of a chance of additional stimulus measures, but the slowing in most corners of the economy has the Fed and others still talking about it. With the specter of a mid-term election, it will be difficult to get those measures through Congress, however.

The portfolio response to this scenario seems obvious – build out Emerging Market Debt and Equity positions to an eventual overweight position versus long-term strategic targets. You'll hear this theme from us over the weeks and months, maybe even years, to come.

Let me turn our attention to recent market action and to a couple of "pictures" that, to us, warrant some consideration. We've witnessed a pretty healthy rally off the July 2<sup>nd</sup> lows, with the S&P 500 up about 9.7% through Friday's close. You've heard us say before that rallies of this sort, or even the monster rally of 2009, are not at all unusual during the course of a secular bear market. In fact, look at the chart below depicting the market of the 1930s (in gray), the era of the Great Depression. You'll see that today's market (in blue), encompassing the brunt of the recent bear market, overlays the 1930s market. We've also thrown in the Japanese market (in red), since they obviously haven't been immune to these conditions. What's striking is that the market of the 30's declined another 25% after a rally similar to the one we just had, and took 3 years to do so. You'll see a comparable look to Japan's bear market. Eerily similar patterns, don't you think?





Right below that is another interesting chart. This one shows the remarkably striking correlation between the Dow Jones Industrial Average (DJIA) and industrial production. Right now, we're seeing the highest correlation since the late 1930's. Is there reason to be concerned about the recent decline in industrial production, given that manufacturing has been the one sector of the economy that's been propping up growth until now? This picture suggests there is.

Now, are we suggesting that we've entered another Great Depression? No. Things would have to deteriorate from here to take us to that scenario. Are we putting a high probability on the two primary fears weighing on the markets right now – a “double dip” recession (meaning another round of negative GDP growth) and what we've called Credit Crisis II (caused by the spreading contagion of the European sovereign debt issues)? Same answer. Things would have to get worse. Could they? Sure. The ingredients are there... and if the threat is present and it's a serious threat, then we're always going to side on a defensive posture, until such time as those ingredients dissipate. These are the “big ticket” reasons for this ongoing defensive posture, meaning much less exposure to equities than our long-term strategic targets call for, along with overweight positions in Income and Diversifying forms of investment. With volatility in the equity markets once again at a fever pitch, these overweight positions in Income and Diversifying Investments have delivered, with far less volatility. The equity markets, as measured by the S&P 500, are dead even (+0.0%) for the year, and have gotten there in a highly volatile manner, highlighted by big up and big down moves. In such an environment, we'll opt for the steady, modest returns of our Income and Diversifying Investments every time.

As we position portfolios for an uncertain and uneven economic environment, you'll hear a great deal of conversation from us about these securities as the featured asset classes in your portfolio.

Until then,

Mark Pellegrino  
Managing Principal & Chief Investment Officer  
Rainier Group Investment Advisory