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Memo

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To: Investment Clients

From: Mark Pellegrino, Managing Principal & CIO

Climbing a Wall of Worry The Other Side of the Story

It's often said that bull markets climb a "wall of worry". As you know, we've been very vocal the past few years about our worries regarding economic growth and, therefore, the prospects for the markets. However, the markets have been remarkably resilient over the past year in the face of these lingering concerns. We, therefore, thought you should hear the other (bullish) side of the story...

The Shape of Recovery

- There is strong historical symmetry between the depth of a US economic contraction and the strength of its subsequent recovery, so to suggest that a V-shaped recovery can't take place just isn't fair.
- The truly unique aspect of this crisis has been the magnitude of the government's response.
- The recent advance in U.S. equities since the March 2009 lows mirrors the 63% nine-month advance seen after the very deep recession in 1981-82.
- It's thought that the 5.6% GDP growth in last year's fourth quarter was mostly due to inventory restocking. However, this restocking is ahead of previous recessionary episodes, given the extent of the drawdown.

Unemployment

- The Conference Board's Employment Expectations Index and initial jobless claims, both leading indicators, turned in early 2009.
- Initial jobless claims have fallen 30% from their April 2009 high, placing their pace of improvement well ahead of the 10-20% declines seen at comparable points in the last two "jobless" recoveries.
- Initial claims usually lead a peak in the unemployment rate by 7 months, while the Expectations Index usually leads by 9 months.
- Other leading employment indicators – corporate earnings, credit market spreads, temp hiring and manufacturing hours worked – show gains consistent with an improving labor market.
- There has been a return of private sector services employment to positive growth after 2 years of consistent losses. Almost 70% of U.S. payroll employment is concentrated in this category.

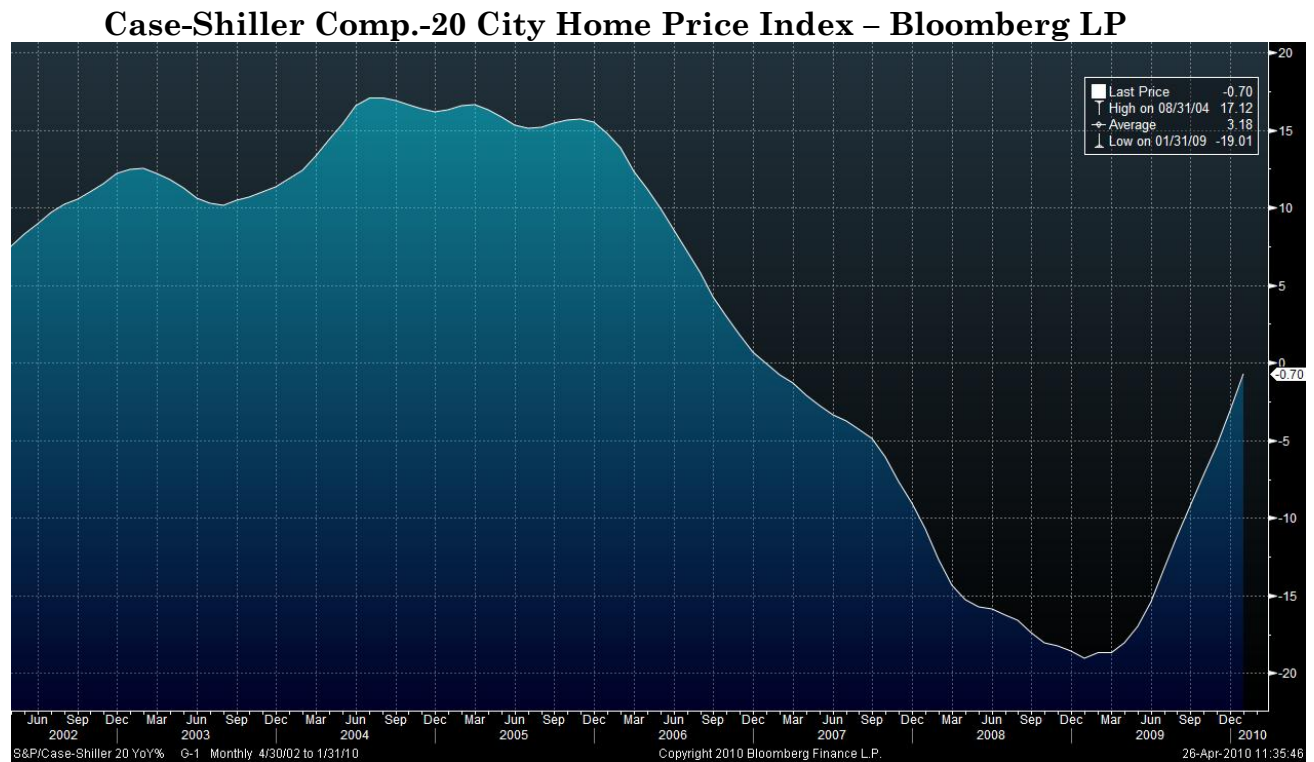
U.S. Unemployment Rate – Bloomberg LP



Housing

- Just 4 states – Florida, California, Arizona and Nevada -- accounted for 75% of the nationwide home price decline and still represent half of all mortgages with negative equity. Sales volumes in these areas have risen 60% from the trough.
- Median home prices are up 20% in California and 6% from the trough nationally.
- Existing home sales nationwide began rising last July for the first time since 2005 and have advanced strongly since.

- The share of mortgages with negative equity has declined from a peak of 33% to a current level of 22%.



Consumption

- Spending on durable goods is coming dangerously close to falling below the imputed depreciation expense of those goods, while the same is true of public companies. This has created a large pool of liquidity, which represents a future source of spending power.
- The top third of the income distribution in the U.S. represents 60% of discretionary spending. Deleveraging for this group is not a major headwind, as debt equates to just 6% of their assets. Their balance sheets are more equity-heavy, with stock ownership representing 5 times more of their net worth than that of the bottom two-thirds. Since spending and savings patterns are more closely linked to equity prices than in previous cycles, and due to the recovery in global equities off the trough, there is a potential upside bias to consumption going forward.
- The improvement already seen in consumer net worth should temper the tailwind to rising savings rates, which naturally affects consumption. If the consumer's not saving as much, he/she is likely to be spending more.

- According to a study done by Macroeconomic Advisors, for savings rates to revert back to the high end of their historical range would require a significant and permanent reduction in net worth.

U.S. Personal Savings Rate – Bloomberg LP



Credit Availability

- What matters most with regard to GDP growth is not the amount of credit outstanding, but its rate of change. Since two-thirds of estimated full-cycle credit losses have already been taken, that drag should abate much faster than in previous crises.
- Both price and availability of credit have been improving.

Effects of Stimulus

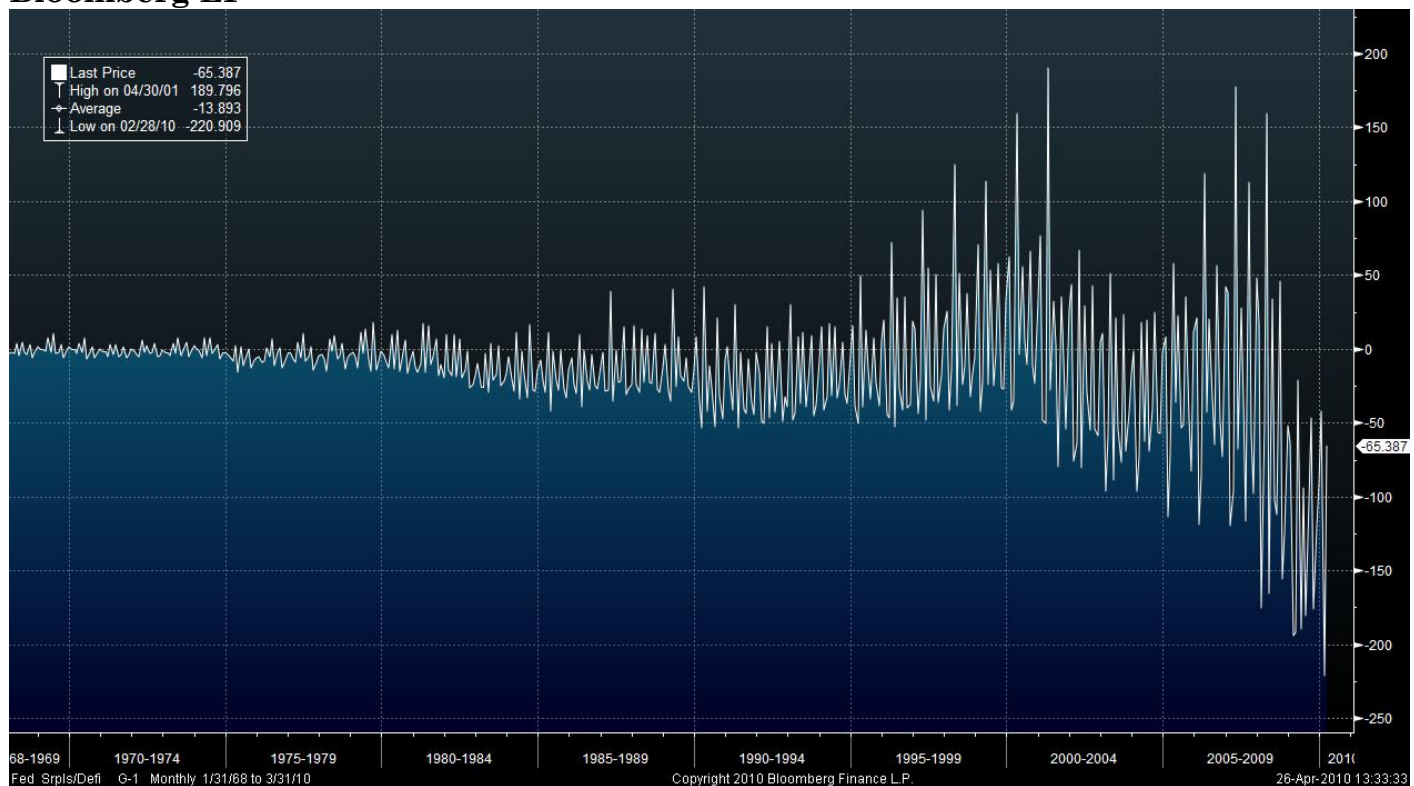
- Whether the economic growth seen thus far is primarily stimulus-based or not is less important than whether it creates a *perception of recovery* that, in turn, becomes a self-sustaining reality as it boosts confidence.
- We've seen nascent gains in various forward-looking consumer confidence measures.

Deficits

- A recent IMF study found that among the G7 economies, 60% of the deficit deterioration expected was due to cyclical factors which would eventually reverse as economic activity normalized.

- Renewed U.S. economic growth will decrease the deficit in 2 ways: (1) by increasing tax receipts via rising income and corporate profits and (2) by decreasing the need for further fiscal stimulus. History shows that for every additional 1% of nominal GDP growth, tax revenues tend to grow by 2.6% in the following year.
- The cyclical nature of deficits suggests that part of the current budget shortfall will naturally correct as economic growth resumes.
- There is scope for a rising tax base, as federal tax revenues stand at the lowest level relative to GDP since 1950. Therefore, a reversion to more typical postwar levels seems like a predictable outcome.
- The total tax base of the U.S. relative to GDP stands well below the level in any other developed country and the OECD average, providing the capacity for the U.S. to increase taxes without jeopardizing its comparative position in the global economy.
- Historically, higher tax rates have not been an impediment to economic growth.
- If the federal marginal tax rate on the highest income bracket were to revert to its pre-Bush level of 39.5%, it would still stand below the 50% threshold that some economic experts consider highly detrimental to growth.

U.S. Treasury Federal Budget Debt Summary (Surplus/Deficit) – Bloomberg LP



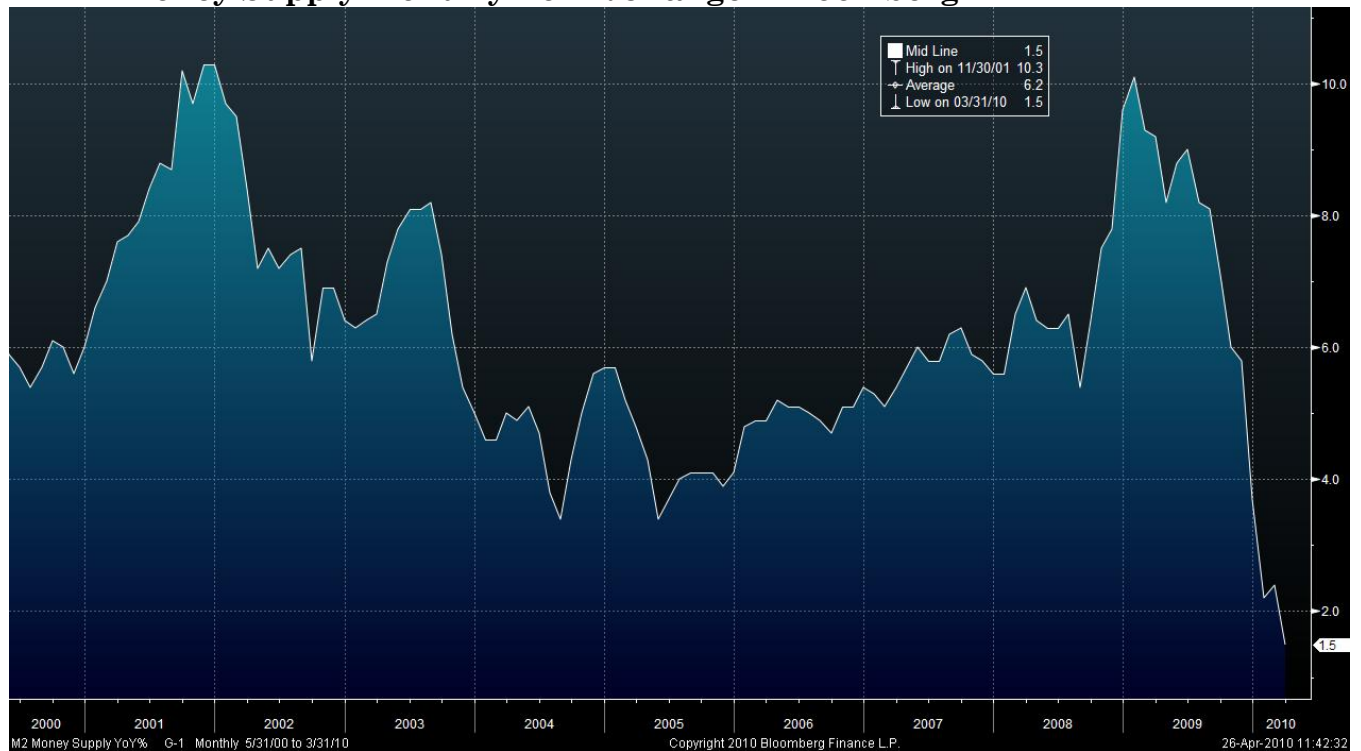
Inflation

- A recent academic paper that examined the relationship between fiscal deficits and inflation in six industrialized nations in the postwar period showed that governments ultimately took remedial action to close budget gaps before structural shifts in inflation occurred.
- Very little of the rapid growth in the Fed's injection of capital into the system has actually filtered into currency in circulation. Without the "velocity" associated with this capital being pushed out into the economy, rather than remaining as excess reserves on the banks' balance sheets, inflation usually doesn't occur.
- The broader monetary aggregates such as M2 have remained flat, signaling little inflationary pressure.
- The Fed now has many tools at its disposal to withdraw excess liquidity before it becomes problematic, including paying interest on reserve balances, removing reserves through reverse repos and term deposits, raising short-term interest rates and selling assets in order to shrink the size of its balance sheet.
- It can be argued that the Fed has already started tightening by ending its securities purchase programs.
- There are a large number of *disinflationary* impulses that exist presently, including significant economic slack.
- Unit labor costs remain depressed, creating a very different environment than what existed during the inflationary 1970s.

M1 Money Supply Monthly YoY %Change – Bloomberg LP



M2 Money Supply Monthly YoY %Change – Bloomberg LP



The U.S. Dollar

- The U.S. has the largest GDP share in the world; the deepest and broadest capital markets; U.S. markets are open and free of capital controls; the U.S. currency is freely tradable and convertible and belongs to a stable country with a working democracy and an established rule of law. These elements of stability tend to attract capital, particularly during times of economic and geopolitical uncertainty.
- The recent economic crisis confirmed the safe haven status of the U.S. dollar, which rose 24% on a trade-weighted basis as world markets collapsed between March '08 and March '09.
- A Harvard Faculty Research Paper suggests that there is a strong bias in favor of using whatever currency has been the reserve currency of the past.
- International trade continues to be invoiced and quoted in dollars.
- The dollar's current valuation is close to its lowest levels since 1973. When valuations have reached such levels in the past – 1979, 1988, 1995 and 2008 – the dollar has gone on to appreciate over the subsequent 3-5 years.
- The yen faces significant uncertainties emanating from Japan's "worst-of-breed" fiscal position, as well as its growth and deflation outlook.

- The dollar is attractive relative to the euro, based both on valuation and the underlying fundamentals between the U.S and the European region.

U.S Dollar Index



So, where does this take us? First, let me offer some editorial comments. Some parts of the bullish case I've laid out for you are a stretch. Others have strong counter-balancing arguments, which we've set out for you in our various communications. Still other parts offer real validity. In all, we don't believe we're out of the woods yet and into a normalized, sustainable economic recovery, but we're resigned to the idea that the markets **may** not need that evidence to continue their move higher.

After a great deal of internal discussion, we're compelled to continue a staged re-entry into the equity markets. Our decision is based upon three key premises:

- (1) Investors appear to have wiped the chances of another meltdown scenario off the table. While we can't completely rule out a pullback that has the markets retesting the March 2009 lows, we're now assigning a low probability to this kind of event.
- (2) We are far less enamored with the risk/reward trade-offs in the debt vehicles that served us so well in 2009 and feel compelled to be moving out of them, particularly with the specter of the Fed's eventual need to start raising interest rates should inflation become problematic.

- (3) We're into the 10th year of a secular bear market that we now know started in the year 2000. Reason would suggest that we're much closer to the end of this bear than the beginning. Positioning portfolios for the next secular (sustainable) bull becomes more and more important.

Beyond the targeted positions we established earlier this year in Emerging Market Debt, Hedge Strategies, Global High Yield Bonds, Commodities, Emerging Market Equities, Asian Technology, Pacific Tiger and unconstrained managers, we're now moving our core equity positions to 50% or more of their long-term strategic targets. Our preference is for mid and small cap over large cap, and growth sectors over value sectors, so our new positions will be skewed that direction. In the overseas markets, while we're much more enamored long-term with the emerging markets than the developed markets, developed market valuations currently appear more attractive. As we see orderly pullbacks that hold at relevant support levels, we'll continue this staged re-entry.

Given the dangers that continue to lurk out there, this is still a somewhat defensive posture, but less so than was the case during the brunt of the bear market. Our preference is to work our way back to full equity exposure as we position for the next bull, rather than jump in with both feet.

We'll share the results of our recent tactical maneuvers with you in our upcoming reviews. Additionally, in the months ahead, we're anxious to share with you some added benefits as we complete the development of our new portfolio management platform. More to come on that later...

Our best to you this spring,

Mark Pellegrino
Managing Principal & CIO
Rainier Group Investment Advisory