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Memo

Date: August 4, 2011

To: Investment Clients

From: Mark J. Pellegrino, Chief Investment Officer

Subject: When Leaders Fail to Inspire

When Leaders Fail to Inspire

This past week's market action is a sweeping confirmation of investors' lack of confidence in U.S. and European governing bodies' ability to deal with building debt issues on the two continents. The only difference between the reaction to the U.S. "historic" debt ceiling bill and the EU's earlier bailout package is that the rally following the latter lasted more than an hour. The reasons are few, but in the U.S. include:

- (1) The deficit reduction of \$2.4 trillion over the next 10 years falls well short of the \$4 trillion that the rating agencies were looking for. So far, Moody's and Fitch have given the U.S. a "hall pass", but S&P has yet to give their blessing. (As I pen this piece, I've just learned that ABC News is running a story that the White House has announced that they expect a downgrade from S&P tonight.)
- (2) It was assumed by many on Wall Street that the debt ceiling bill would include some form of "stim-sterity" -- targeted near-term stimulus combined with long-term spending cuts. No extended jobless benefits and no expanded payroll tax cut? Come on!
- (3) The Congressional committee charged with coming up with the additional \$1.5 trillion in spending cuts is likely to be fractious enough that it will lead business to go "on strike", as they will be unwilling to hire in great numbers or expand their operations until they have a better idea of what the new "rules of the game" will be. At the same time there

is similar concern that austerity measures, if either premature or too severe, will further slow an already decelerating economy.

In Europe, it's not just a liquidity crisis, but a solvency one. A combination of tight monetary policy from the ECB; an overvalued Euro; and significantly higher long-term interest rates in Greece, Portugal, Ireland and now Italy makes the chances of a full-fledged recession in the EU quite high. Yields on both Italian and Spanish bonds have spiked, causing investors to begin to discount bailouts for these two countries, believing they are far too large to save. European banks are not well-capitalized, and the explosion in credit default swaps (CDS) is evidence of this deficiency.

Mohamed El-Erian of PIMCO calls this ongoing debt drama "serial contamination of balance sheets" – balance sheets that must be rehabilitated ("de-levered") because they have gotten over-indebted to such an extent that they are unsustainable going forward. By far the preferred way to de-lever is through growth. (Other options – namely devaluation and inflation - are unappealing, though effective.) Unfortunately, the U.S. and Europe are not in a position to sustain the sort of economic recovery that would make a meaningful dent in their debt levels. Here's the evidence:

- (1) Last Friday's GDP number was a serious setback to economic growth. Year-over-year (YoY) GDP at a dismal 1.6% may be signaling a new recession, as history has shown that a recession has always followed when YoY GDP has fallen below 2%. As a result, economists left and right are ratcheting down their GDP forecasts, with some predicting probability of recession at 60-65% in 2013. Others see the economy only one shock away from falling into recession. Even if the economy were to muddle along in recent trend-like growth, it may still feel like a recession to a lot of consumers. With so many economists turning less positive on growth, it seems only a matter of time until Wall Street earnings estimates follow suit.
- (2) Manufacturing activity, as measured by the ISM, has declined precipitously. Once a consistent bright spot in the recovery, this sector is now showing data normally seen in the mature stage of the business cycle. Such a move in the past has foreshadowed six of the past seven recessions over the last five decades. Of the 25 times since the late 1950s that this indicator has fallen to its current level of 50.9, it went on to break below the expansion/contraction level of 50 on 24 of those occasions.
- (3) Unemployment is still hovering above 9%. As a point of reference, GDP must grow at 5% for one year to lower unemployment by one percentage point, so we're a LONG way from a normalized employment picture.
- (4) The consumer sector of the economy is still struggling to recover. One telling indicator is the "future expectations" component of the University of Michigan's Consumer Sentiment Survey, which just fell to its lowest level since the 2009 market bottom – a level only see in recessions. Additionally, durable goods are down for a third month in a row to the lowest level since November 2009.
- (5) On the business side of the economy, CEO Confidence has suddenly taken another sharp plunge, probably for the aforementioned reasons.

- (6) The housing sector has nothing good going on in terms of real recovery. Foreclosures, and therefore inventories of unsold homes, remain high and home prices continue to come down.

Are there some bright spots out there? Sure. One consistent shining light has been corporate earnings. Of the 80% of the S&P 500 market cap having posted Q2 earnings, 41% surpassed consensus expectations by at least one standard deviation. Additionally, leading indicators for the U.S. economy are continuing to point upward. Inflation is not an issue for the economy, especially with energy prices having backed off nicely of late. On the market front, abnormally low interest rates provide much less competition for equity returns, while equity valuations look anything but expensive.

Even so, the markets are clearly telling us that the challenges for the economy and the markets are far outweighing the good stuff. In fact, while we expected a decline, we've even been a bit surprised by how swift and convincing the shift has been from positive feedback loop to negative feedback loop and from "buy the dips" to "sell the rallies". It's that loss of confidence that has clearly shifted sentiment to the negative.

Let's assess yesterday's (Thursday's) market damage. The Dow dropped 513 points or -4.31%, the S&P 500 by -4.78%, the NASDAQ by -5.08% and the Russell 2000 (Small Cap) by -5.95%. The last time we saw a 1-day decline greater than 4% in the S&P 500 was 4/20/2009, when this index fell -4.28%. The worst day in 2008 came on October 15th, when the S&P 500 closed 9.03% lower on the day. During the 2000-2002 bear market there were 4 days in which the S&P 500 declined by at least 4.78%. In the entire decade of the 1990s there were 2 days that produced a decline of 4% or more. Ninety-one percent of the stocks traded on the NYSE and NASDAQ were down for the day. Volume on the NYSE of 7.6 billion shares traded was the highest daily volume since December 2010 and was representative of the volume prevalent during the September 2008 to March 2009 period. It was worse across the other developed markets on Thursday, as the EAFE declined -6.98%.

How has your portfolio done? The average return for client portfolios in Thursday's trading session was -1.3% -- less than 1/3 of the decline of the S&P 500 Stock Index. Certainly your Growth (equity) holdings will be in a loss position on a year-to-date (YTD) basis. (See

RGIA Performance Year-to-Date	
Income	
Core Fixed Income -- Taxable	6.7%
Municipal Bonds	4.3%
Senior Bank Loans	1.5%
Emerging Market Debt	8.4%
High Yield Bonds	3.9%
Diversifying	
Hedge -- Multi-Strategy	0.9%
Hedge -- Equity Long/Short	-0.7%
Hedge -- Debt Long/Short	0.6%
Hedge -- Arbitrage-Focused	0.3%
Commodities	4.5%
Managed Futures	-3.2%
Global Real Estate	-1.7%
Major Equity Indices	
S&P 500 (U.S. Large Cap)	-3.5%
Russell 2000 (U.S. Small Cap)	-6.6%
MSCI EAFE (Developed Markets)	-4.4%
MSCI Emerging Markets	-5.2%
Source: Bloomberg, Black Diamond, RGIA*	

chart.) Recall, however, that our defensive posture has kept your Growth exposure far below your strategic targets and in a minority position in the portfolio. The majority position – across Income and Diversifying asset classes – have held up well, and in many cases produced a positive return. The accompanying table shows the average YTD returns for our various preferred managers across these Income and Diversifying asset classes, along with the YTD returns for some of the obvious equity indices. This defensive posture has produced an average YTD client return of +0.9%.

So where do we go from here? Serious technical damage has been done to the markets, as all of the indices have breached their 200-day moving averages, with some now breaching their 300-day averages. Additionally, less than 10% of all recommendations by Wall Street analysts are sell recommendations, leaving a lot of room for downgraded ratings. Fundamentally, we're looking at a loss in confidence in government, decelerating global economic growth, acceleration in the issues surrounding European sovereign debt, heavy volume on down days with light volume on up days, and a clear change in market sentiment. That said, we must ask ourselves, "Is this a consolidation before the next move up or is it a topping process setting up the next substantial drop"? It sure feels like the latter.

After a roller coast ride of a session on Friday, the S&P 500 sits at 1199. Next support is at 1170. After that, there is meaningful support at 1120 and then 1020, with the latter representing the summer lows of 2010. It's widely thought that the markets would be pricing in a new recession somewhere in the 1020 to 1120 range. Our best guess is that this is a level we will see within the next few months or so. Even so, it's clearly a moving target. As we approach each level of support, a new decision will need to be made: Is there a greater probability that we again breach support or hold this time? What new economic or policy information do we have? While it's tempting to use weakness to increase Growth exposure, we also don't want to try to catch a falling knife. Nonetheless, here are some key triggers that could cause us to bump our Growth exposure as the markets approach stated support levels:

- Stabilization in global economic data – improvement in unemployment, housing, ISM manufacturing data, among others
- Fresh stimulus programs, featuring job creation
- Real solutions out of the ECB to relieve European sovereign debt – something more courageous and/or creative than offered thus far
- The Fed announcing a QE3 program

Our preference, of course, is to have more than one of these triggers in place before we're comfortable committing new equity dollars.

Naturally, should we see continued deterioration in the economic indicators highlighted earlier in this piece, we'll take additional defensive measures, especially if we continue breaching the stated support levels.

Given our belief in active management, it should come as no surprise that we've once again been "active" in portfolios during this period. Here are some of the tactical moves we've been making:

- Maintaining core equity positions well below long-term strategic targets
- Liquidating remaining positions in U.S. Small Cap, as we see these stocks as particularly vulnerable to additional declines
- Trimming positions in Developed Market (International) Equities, due to ongoing concerns surrounding European sovereign debt
- Trimming positions in High Yield Bonds, as they have recently breached their 300-day moving average
- Adding to positions in both Emerging Market Debt and Emerging Market Equities, as we believe the emerging economies will continue to carry global economic growth and therefore draw continual investment dollars
- Featuring opportunistic positions in precious metals – White Metals and Gold – as they are seen as safe haven investments

It goes without saying that these are trying times. Volatility is back, and when it's present, it's prudent to step back. The same is true when the weight of the economic evidence is skewed to the negative and/or uncertain. With both volatility and economic uncertainty in play, it's time to hunker down again, earn returns where we can in the Income and Diversifying sectors, and wait for a brighter day. If we get it, we'll step back up to the plate, but after having first preserved principal.

We'll look forward to sharing more in our upcoming discussions with you.

***PERFORMANCE DISCLOSURES:**

The average client portfolio return of -1.3% reflects the market-value weighted average investment performance on August 4, 2011 for all discretionary portfolios managed by RGIA, and it is presented net of all fees and expenses. Some RGIA clients may have results that differ materially from those presented here, and recommendations may change in the future. Portfolios are customized for each client, and individual portfolios may deviate from the firm's average, reflecting factors such as client objectives, risk tolerance, tax situation, liquidity needs, and client preferences.

Year-to-date performance is reported through August 4, 2011. Category average results presented in this report reflect the average returns of the firm's recommended mutual funds in each of the categories shown. Performance is reported year-to-date through August 4, 2011. RGIA's proprietary fund selection process was used to generate the primary fund recommendation for each category each month. The recommended fund for a category is included for its first full month of its recommendation, and it is removed when it is replaced on the primary fund recommended list. Category average returns are presented gross of advisory fees and net of fund fees and expenses. Performance is compounded monthly and includes the reinvestment of dividend and interest income and capital gains distributions. A complete list and description of all recommended funds maintained by the firm, the primary recommended funds included in this report, the related performance results, our advisory fees, and additional information regarding policies for calculating and reporting these results are available upon request. Our advisory fees are published in our Form ADV Part II and in the Investment Advisory Agreement entered into with all clients.

INDEX DESCRIPTIONS:

The unmanaged indices shown are representative of the equity market sectors presented in the report. The S&P 500 Index is a market capitalization-weighted index of 500 large U.S. stocks. The Russell 2000 Index is a market capitalization-weighted index of small U.S. stocks. The MSCI EAFE Index is a market capitalization-weighted index of companies in the developed markets of Europe, Asia and the Far East. The Russell Emerging Market Index is a market capitalization-weighted index of stocks in developing countries.

ADDITIONAL DISCLOSURES:

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