

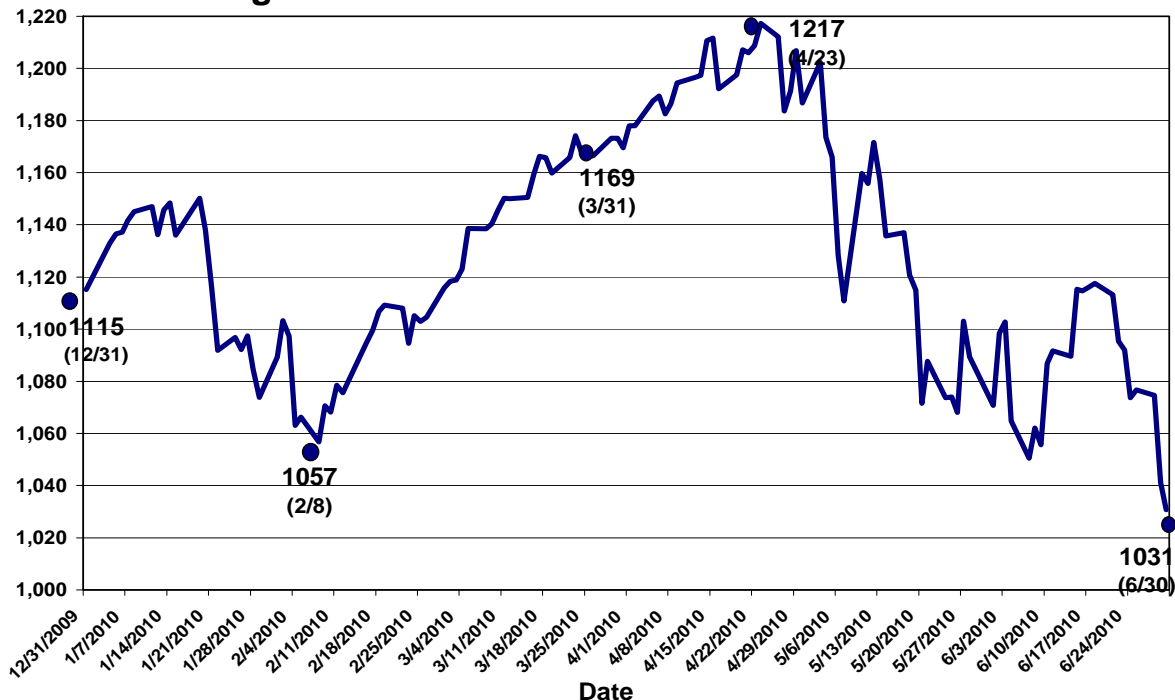
Q2 2010 Commentary: Looking “Less Good”

By Bob Marshalla
July 9, 2010

Less Good, with Brown Patches

A year ago we had just completed the recession’s last quarter of GDP declines and had begun the first quarter of a stock market rally which was to ultimately advance by an amazing 82%¹. Still, at that time, most of the economic data was still looking pretty bad². The best we could say then was that things were looking “less bad”. Today we have the near mirror image. Having completed four straight quarters of positive economic growth and six straight months of private sector job gains, our emerging economic recovery was looking pretty robust. That is, it was up until about a month ago. Now things have turned a bit sour, and while the recovery still seems unlikely to abort, we would have to say things are looking “less good”. The “green shoots” the commentators were fond of talking about a year ago have now given way to “brown patches”. We will return to economic commentary later, but first let’s first do our usual investment markets review.

Figure 1 - S&P 500 YTD 2010 thru June 30



¹ By June 30 of last year, the S&P 500 had already gained 36% since its March 9 low. GDP was essentially flat in Q2, 2009, but was headed for its first positive showing since the recession began in Q3 at 2.2%, and 5.6% in Q3.

² We lost 515,000 net jobs in June 2009, and the national unemployment rate, a lagging indicator, had reached its cyclical high to that point of 9.4%.

Investment Review

The U.S. stock market hit a peak on April 23 at which time it was up 9% for the year and 82% since the March 9, 2009 trough. Since then it has been on a choppy but mostly downward trek, and by quarter's end it had fallen by 15% from its peak and by 6.7% year-to-date. Is this a buying opportunity or does the tepid economic news imply the market deserves to be this low? Of course no one really knows, but the one year forward PE ratio of the S&P 500 is now only 11.5. That means the next 12 months profits would need to be 23% lower than analysts' currently expect just to get the PE back to its long term average of about 15. This is quite possible, of course, but consider that for the past three quarters about 80% of S&P 500 companies have been *exceeding* analysts' earnings projections.

Table 1 - Market Returns to June 30, 2010

	Representative Index or Fund (blue font)	2nd Quarter 2010	Year to Date
Equities			
Full U.S. Market (98% by MC)	Russell 3000	(11.32)	(6.05)
U.S. Equities by Market Cap			
Large Cap	S&P 500 (incl. dividends)	(11.43)	(6.65)
Mid Cap	Russell Mid Cap	(9.88)	(2.06)
Small Cap	Russell 2000	(9.92)	(1.95)
Micro Cap	Russell Micro Cap	(8.85)	0.12
Value & Growth			
Growth Stocks	Russell 3000 Growth	(11.6)	(7.2)
Value Stocks	Russell 3000 Value	(11.1)	(4.8)
Economic Sectors			
Best Year-to-Date	Consumer Discretionary	(0.4)	(2.6)
Worst Year-to-Date	Materials	(1.0)	(14.6)
International Equities			
Developed Large Cap	MSCI - EAFE Large Cap	(14.0)	(13.2)
	(in local currencies)	(11.2)	(7.3)
Developed Small Cap	MSCI - EAFE Small Cap	(11.3)	(7.1)
Emerging Mkts Large Cap	MSCI - Emerging Markets (Std)	(8.4)	(6.2)
Emerging Mkts Small-Mid Cap	MSCI - Emerging Mkts SMID	(6.6)	(3.1)
Real Estate			
Equity REIT's - Domestic	NAREIT Equity Index	(4.1)	5.6
	Morgan Stanley US Real Estate*	(3.6)	6.2
Equity REIT's - Foreign	EPRA Global ex US Index	(10.1)	(9.6)
	Eur. Investors Int'l Property*	(10.0)	(9.6)
Commodities			
Commodity Futures (Long Only)	Dow Jones UBS Commodity	(4.8)	(9.6)
	PIMCO Commodity Real Return*	(3.1)	(6.2)
Alternative Investments			
Merger Arbitrage	Arbitrage Fund*	(2.3)	(0.5)
Managed Futures	AQR Managed Futures Strategy*	(1.1)	0.9
Fixed Income			
Investment Grade Bonds	Barcap Aggregate Bond	3.6	5.4
	PIMCO Total Return Fund*	2.8	5.8
Inflation Protected (TIPS)	Barcap US TIPS	3.8	4.4
	PIMCO Real Return Fund*	3.9	5.2
High Yield Bonds	Barcap High Yield Corp Bond	(0.1)	4.5
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds*	1.4	1.8
Emerging Mkts Currencies	PIMCO Developing Local Mkts*	(4.3)	(1.7)
Short Term Money	3 Month T- Bills	0.1	0.1

* Based on mutual fund returns. Others are costless market indices.

A quick look at Table 1 shows that the effects of diversification have been evident. For the second quarter, returns for the asset classes shown range from +4% all the way down to -14%. For the year to date, they range from +6% down to -13%.

For the year to date, small and mid cap domestic stocks did considerably better than the blue chips comprising the S&P 500, as they lost only about 2% (versus the 6.7% loss for the bigger companies). Foreign stocks, especially larger cap stocks in developed markets (i.e., mostly Europe and Japan), did considerably worse. The EAFE large cap index was down 13.2% year-to-date. But most of the underperformance was a result of the relative strength of the U.S. dollar. EAFE returns in local currencies were only -7.3%, about the same as the S&P 500's. So the strong U.S. dollar cost American investors about 6 percentage points of returns. Emerging markets did about a half point better than the S&P 500, but the U.S. dollar was strong even relative to emerging markets currencies, causing us to lose a couple of points to currency translations there as well.

International real estate and commodity futures returns were not too different from the S&P 500 for the year-to-date period, although their price paths over the six months were quite diverse. The best returns, as we would expect when equities are down, came from our bond funds. The year-to-date returns for the five most widely held domestic bond funds at MAM³ ranged from +1.1% to +5.2%. This may not sound exciting, but they are gratifying returns to have when one's stocks are falling. (And who ever said bond funds were supposed to be exciting?) One bond fund we hold did have a loss year-to-date. PIMCO Developing Local Markets, which holds emerging markets currencies, lost 1.7%. This of course is entirely due to the recent (and presumably not permanent) relative strength of the U.S. dollar.

Economic Commentary

An Uncoiled Spring - The recovery of the American economy was progressing near the most optimistic end of the range of expectations by mainstream economists until sometime around mid-May. The proverbial "coiled spring" or "V-shaped" recovery was starting to look like a real possibility. But now, and rather suddenly, the economy is sputtering. Coincident with, if not caused by, the problems in Greece and Europe in general, it seems that business and consumer confidence have taken big hits. I could overwhelm you with economic variables and the stories they tell, but I will focus on just one: the monthly net change in jobs.

Loss of employment is arguably the most painful aspect of a recession, and recovery of employment usually takes the longest of any key indicator to return to pre-recession levels. The U.S. economy lost 8.36 million jobs in 2008 and 2009, so there is a lot of ground to make up. At the beginning of 2009, net job losses were still near their maximum loss rate, with 753,000 jobs being lost in January. After that, the job loss rate started to slow down, and by the beginning of 2009 we had finally turned the corner and began a pattern of adding jobs. The bar graphs in Figure 2 tell the story. We began adding miniscule amounts of jobs in January and February, but then things began heating up considerably. By May we were adding jobs at a rate of 433,000 per month. Then came the June numbers: Oops! The official figures show a net loss of 125,000 jobs in June.

Actually, the May and June figures are seriously distorted by plus and minus changes in temporary U.S. Census workers. We can correct this by focusing on net creation of private sector jobs. Figure 3 shows both total and private sector only monthly job changes since the beginning of the year. There was a huge increase in government hires in May and a huge decrease in June as temporary Census workers completed their tenures. So if we look only at the private sector jobs (the red bars) we see that there was a precipitous decrease in net new job creations in May, not June. In fact, the June numbers were considerably better than May's numbers, +83,000 jobs added compared to +33,000, respectively. So now

³ These funds, by ticker symbol, are PTTRX, PRRIX, JSOSX, PRRIX and TSIIX.

Figure 2 - Net Change in Jobs by Month
(In Thousands)

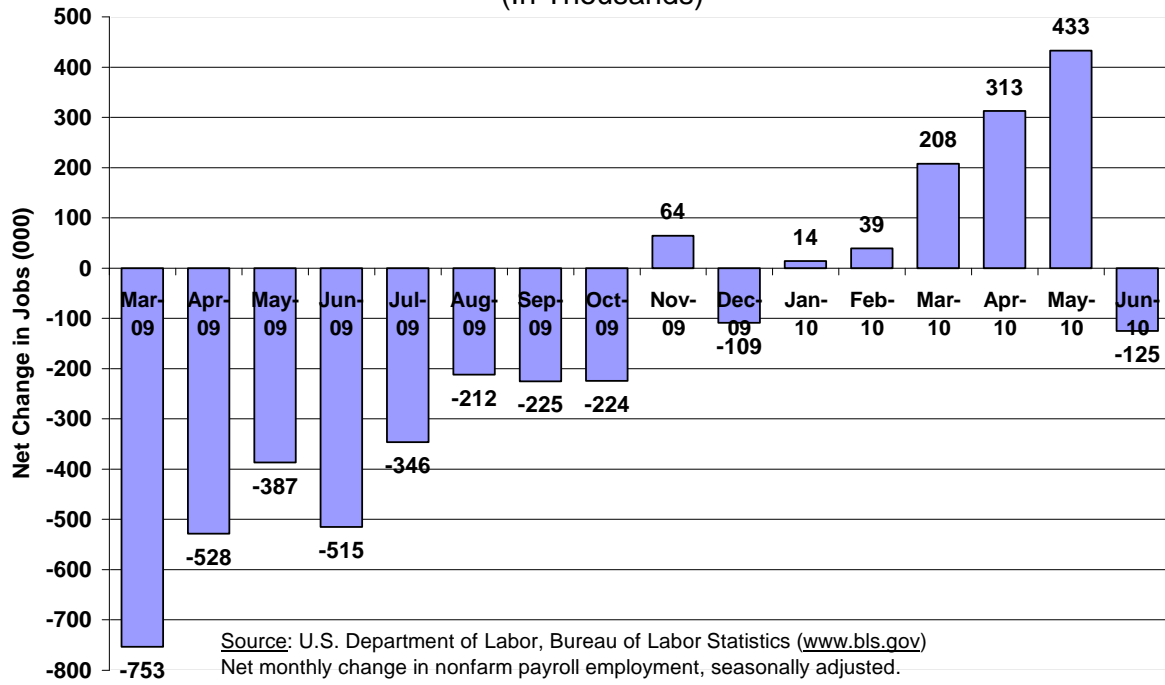
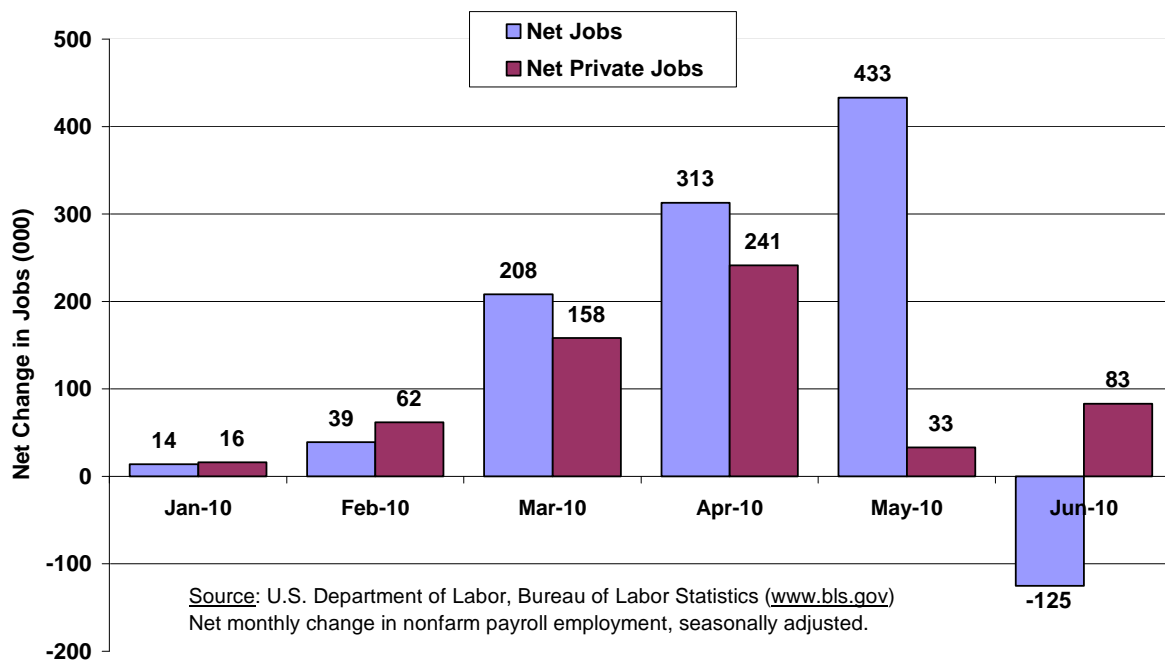


Figure 3 - Net Change in Total and Private Sector Jobs
(In Thousands)



the picture jibes with the story I told earlier. We were enjoying an increasingly robust recovery through the first four plus months of the year, when suddenly sometime in May the unsightly “brown patches” began appearing.

The big question, in fact the only one that really concerns me now, is: are we headed for another recession? Let me start with my conclusion: I don't think so. Before the recent spate of bad news, I would have put the probability of a so called double dip recession at no more than 5% to 10%. Now I would put it at 20% to 25%. This is a significant increase in gloominess, but it still implies a 75% - 80% chance that we will get out of this alive!

Hope in Cash - Remember, I said that things are looking “less good”, which is not the same as saying they are looking outright bad. Despite all the bad news you hear, corporate financial fundamentals remain very strong. Annualized S&P 500 operating earnings in the latest reported quarter averaged \$66, compared to a shade under \$40 in the second and third quarters of 2009; and as mentioned above, companies' quarterly earnings reports have been routinely beating analysts' estimates since last summer. But perhaps the most impressive data point is the enormous mountain of cash that is now sitting on corporate balance sheets. According to the Fed, the 500 largest nonfinancial companies in the U.S. are now sitting on \$1.8 trillion of cash, which compares to \$1.48 T at the end of 2008. This is about 26% of total current assets, a fraction that has ranged only between 15% and 21% from 1995 to 2008. In fact, as a percentage of assets, this is the most cash American companies have held on their balance sheets in almost half a century.⁴ Why is this such a positive factor? Because this is money that companies can, and eventually will, spend on capital expenditures and operations, both of which are direct additions to economic growth. Furthermore, it means when they are ready to spend money, they will not have to depend to such a great degree on obtaining outside financing.

So Why Aren't They Spending? - The perplexing question is why aren't they spending it now? Increasingly I hear the story that corporate managements are reluctant to expand due to the currently extreme levels of uncertainty – uncertainty about sovereign debt problems, taxes, financial reform, health care costs, escalating fiscal deficits, weak economic growth and continued high unemployment. These are all significant uncertainties, and maybe the sense of heightened uncertainty is paralyzing corporate managements. But I am always suspicious when pundits expound on how uncertainty is somehow uniquely pernicious right now. When have economic and political futures ever – ever, ever – not been highly uncertain? I have trouble buying this as the cause of a potential derailment of the economic recovery.

I think it is more likely that the kernel of the problem is what we always thought it would be: weak consumer demand. As I have written in every commentary since the recession began, our recovery is likely to be slow and sporadic due to the consumer deleveraging that must occur to reverse the excesses of the housing bubble years. For years consumers lived beyond their means (i.e., spent more than they earned). Now they will have to live beneath their means for awhile, be it due to paying down debt or taking their turns in the unemployment lines.

Another factor taking a bite out of growth is export demand. Exports surged in the last quarter of 2009, enjoying about a 20% increase over the previous quarter. They began to level off in Q1 this year (5% increase), and will likely show a decrease in the second quarter. Europe's economies have slowed down

⁴ These data points are taken both from a recent presentation by Liz Ann Sonders, Schwab's chief economist, and an article by Fareed Zakaria in Newsweek, July 12, p. 20.

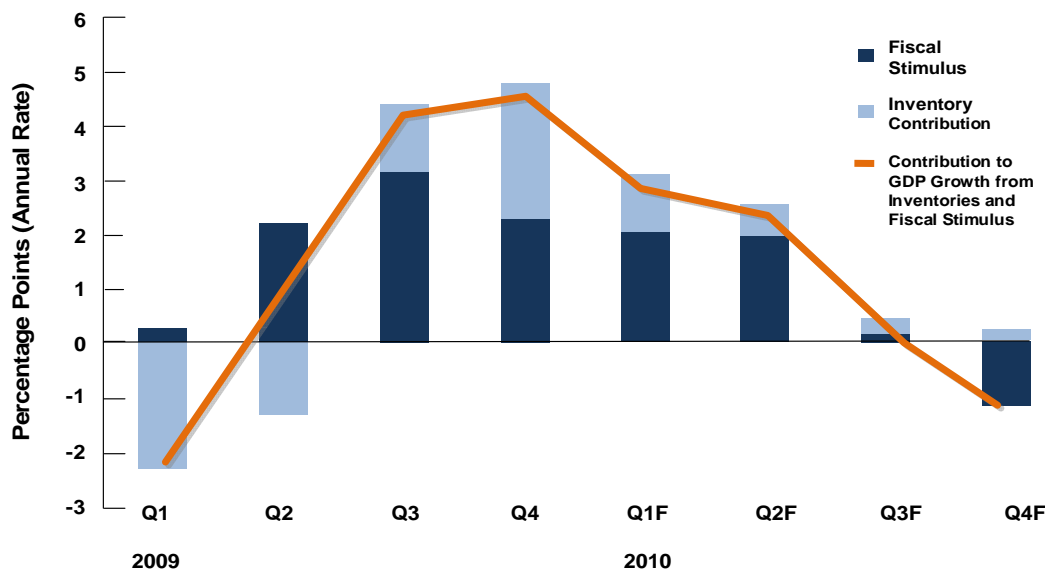
much more than the U.S., and this combined with the strong U.S. dollar, has and will continue to curtail U.S. exports⁵.

The good news in this story is that when consumer and (possibly) export demand do pick up, capital constraints for business should not be a problem. Credit availability, while loosened up, is still tight, but with \$1.8 trillion in available cash this should not be an insurmountable constraint to business expansion.

“Sugar High” Is Ending – If we are now more or less returning to the slow and fitful path of 2½% to 3% growth we have long expected, maybe we should ask why was it looking like we might be headed for much higher growth rates? The reasons are not that hard to understand once we have the relevant data. There have been two extraordinary factors that have given our recovery most of its “oomph” over the last three or four quarters: inventory replenishment and government stimulus. PIMCO has called the effects of these two factors a “sugar high” for our economy. But unfortunately, the growth inducing benefits of both are projected to be coming to an end within the next few months, one due to economic reasons, the other for political reasons.

Business inventories had been run down to their lowest levels ever, and they they continued to decline through the end of Q2 last year. The country’s economic decline was exacerbated because businesses were producing even less net goods than consumers were demanding. But eventually inventories needed to be brought back to normal levels, and beginning last summer, American businesses began to do so. Replenishing inventories meant that businesses were now producing more goods than consumers were demanding, and this added a nice boost to economic growth. A slide from PIMCO reproduced here in Figure 4 provides an estimate of just how much of a boost this factor added. The light blue bars in the figure show the amount of GDP growth each quarter that was due to inventory additions or

**Figure 4 - Sustainable Recovery or Sugar High?
Fiscal Stimulus and Inventory Replenishment**



This slide taken from PIMCO presentation on 6/15/10 in Palo Alto, CA, “Post-Crisis Portfolio Construction”, p. 7
PIMCO SOURCE: PIMCO’s own estimates based on Congressional Budget Office data.

0

⁵ For review, the components of GDP include consumer demand (the largest), housing investment, business investment, government spending and net exports (i.e., export minus imports).

subtractions. The graph runs from Q1 2009 out through to estimates for Q4 2010. PIMCO estimates that inventories have now been brought back to roughly normal levels, and that inventory changes will be a net neutral factor by next quarter.

The dark blue bars in the graph show the estimated contributions to GDP growth due to government stimulus programs, primarily the \$787 billion packaged adopted in February, 2009. People hold widely divergent views about the wisdom of using purposeful fiscal stimulus as a tool for combating recession. Reasonable people can make different cases about what the long term efficacy or net benefits of Keynesian style stimulus programs will turn out to be in this case. But there is really no controversy among mainstream economists, even among those who hate the idea of adding to public deficits, that the proximate effects of the program have been to make economic growth higher than it would otherwise have been⁶.

The orange line in the graph shows the estimated net contributions to GDP growth from these two factors. If anywhere near accurate, these are truly major impacts. They would account for nearly all of the positive GDP growth we have enjoyed over the last three quarters⁷. But here is the really bad news: the contributions from inventory replenishment and government stimulus alike are now coming to an end. This is the issue that gives me the most concern of all about our immediate economic (and by extension, investment) future.

Demand Side Economics - When a macro-economy begins to lose its mojo, it can generate downward spiraling negative feedback loops. A person loses a job. Now she stops paying payroll and income taxes and instead starts receiving government benefits. The government deficit gets worse a result. Since she now has less money, she spends less. This decreases demand for the products businesses would have sold her. Eventually, these businesses have no choice but to cut back output and lay off more people. And the cycle repeats. On the way back up, just the opposite happens, as the feedback loop becomes a positive one.

In most economic slowdowns since the 1930's, we have been able to use monetary policy to rekindle the economy. Beginning at the latest in the 1980's, I believe most economists came to agree that monetary policy is a more effective tool to manage the economy than fiscal policy. But when an economic downturn is especially steep, as has been the recent one, monetary policy may not be enough. The Fed long ago pushed short term interest rates all the way to zero and they still sit there. The economy is awash in liquidity, like never before. But the Fed cannot force people or companies to spend it. Monetary policy simply went as far as it could go. The only tool left in such a case is fiscal stimulus. In effect, the government becomes the spender of last resort. The goal is to reverse the negative feedback of a declining economy; in effect to "prime the pump". It is most definitely not a permanent solution. The longer that fiscal stimulus is applied, the greater the deficit that will have to be paid back by future taxpayers. The goal is to do it long enough to get the private sector back up and running so it can be self sustaining.

⁶ When the economy is running at near capacity, some would argue that adding government spending can just crowd out what would otherwise be private spending. But when there is serious, major slack in the economy, such as the case in early 2009, crowding out is simply not an issue. In fact, some types of stimulus spending like unemployment benefits and aid to states that avoids layoffs of teachers, nurses, policemen, etc. is measured by some of the better known econometric models to have GDP multipliers well above 1.0. I.e., adding a dollar of government stimulus increases GDP by more than one dollar in such cases. Some of the GDP additions will be given back down the road of course when taxes are paid to make up the deficits they created, but whether these are more or less in magnitude than the original additions is independent of the statement that this year's impacts, presumably when we need them the most, are positive.

⁷ The latest revised figures for GDP growth for the past three quarter, taken from the government's BEA.gov website, are 2.2%, 5.6% and 2.7% respectively. The PIMCO exhibit is based on somewhat earlier figures, so it is not directly comparable.

The stimulus payments will need to be paid back in the future, but if in the absence of stimulus the economy stays in the doldrums producing at well below its natural capacity, then future tax revenues would be much lower than they would be in a growing economy. How much lower is a complicated economic question that I cannot answer here. But clearly if the stimulus succeeds in jump starting the economy, the net cost to the budget would be less than the original amounts of spending. This is the case for demand side economics.

In general I don't like to have to use demand side economics. I have considered myself a "deficit hawk" for three decades. But I have come to believe that using demand side economics has been appropriate and necessary in this case. Without doubt, we face a very serious long term deficit problem. But I also think that anything we do or don't do to address the current economic slowdown will have only a negligible impact on the long term deficit problem⁸. So let's get out of this slump and not take any chances of falling back into a serious recession.

A succinct and well stated description of the current situation by well known political and economic journalist Fareed Zakaria is worth quoting here verbatim:

"I think there is a strong case for a temporary and targeted government stimulus. Both people and companies are being very cautious about spending. Right now, government spending is what is keeping the economy afloat. Without a second stimulus, state and local governments will have to slash spending and raise taxes, which will produce a downward spiral of higher unemployment, slower growth, lower tax revenue, and a larger deficit. Joel Klein, the New York City schools chancellor, told me that when the stimulus money runs out, at the end of this year, he will be forced to lay off 5,000 teachers. Multiply that example a thousand times to get a sense of what 2011 could look like."⁹

Outlook - So where are we headed now? The "sugar high" factors are pretty clearly ending, inventory replenishment because of basic arithmetic – inventories have just about been brought all the way back up to normal levels – and the stimulus due to politics. There appears to be almost no chance that the Congress will go along with additional stimulus programs, even if they are not called "stimulus" programs. Congress has already turned down the Obama administration's proposal to further extend federal unemployment benefits – this coming after the size of the original proposal was cut in half. Whether you think the unemployed "deserve" or "need" further unemployment benefits, the stimulative effects of such are relatively effective. They are said to have amongst the highest GDP multipliers of any of the spending or tax cut programs considered. The other type of stimulus spending that I think would be welcome, not only for its multiplier effect, but because of its social value, would be further aid to the states and local governments, specifically tied to averting layoffs of teachers, nurses, and police and firemen. States, which are not allowed to run official deficits (they find ways to do it anyway) are in dire straits, and will remain that way at least until economic growth restores some of their natural tax bases (like sales, gasoline and income taxes). But alas, I do not think it is going to happen.

⁸ The long term deficit problem is based virtually entirely on the divergence between benefit commitments for the big entitlement programs (Social Security and especially Medicare) and their funding sources. Without major changes in these programs, future deficits will mushroom to such a size that anything we do now related to stimulus would be lost as round off error. This is only a slight exaggeration. I would be happy to discuss further if you are interested.

⁹ From "Obama's CEO Problem", by Fareed Zakaria, Newsweek, July 12, 2010, p.20. Besides writing for Newsweek, Zakaria hosts the weekly CNN show "Global Public Square". He is a respected political and economic historian and commentator, the author of several books (two of which I have read and greatly appreciated) and an excellent public speaker.

Quite aside from any political leanings or social values, I find it fascinating to observe how conventional wisdom has so suddenly shifted to the belief that the time has come to switch from stimulus to austerity. During the previous decade we watched with surprisingly little concern as unfunded tax cuts, two wars and a gigantic new entitlement program (Medicare Part D) had the effect of raising the national debt from \$5.7 T to \$10.7 T by the end of 2008¹⁰. But now everyone seems to be a deficit hawk, and not just here, but throughout the G-20 governments as well. People seem to be spooked by the admittedly critical situation in Greece, and by a sense that we are letting public debt get out of control, just as we have been reigning in private debt.

Viewed from a longer term perspective, the newfound attention to deficits is great news. The deficits that we and others will be facing, due especially and primarily to the interaction of demographics and existing entitlement programs (Social Security and Medicare) would be disastrous if we do not find a way lessen the promised benefits and/or raise the taxes that fund the programs. But from a more immediate time perspective, meaning the next few calendar quarters, suddenly switching to austerity could be disastrous for our economic recovery. I could be wrong, but I simply think it is way too soon.

Recent economic weakness (weak employment reports, slower GDP growth, increasing fiscal problems in Europe, falling stock prices) makes it clear the economic pump has not yet been sufficiently primed. The withdrawal of the two extraordinary sugar high factors without any kind of external replacements will likely leave the economy foundering for some time. As I said, I don't believe it is likely we will plunge back into a recession (defined as two or more quarters of negative GDP growth), but excruciatingly low growth over a period of years (as has been the case in Japan for over a decade) is a real possibility.

Investment Policy

Does this outlook imply any significant changes in investment policy? Actually, the recent "less good" news brings me back to roughly the same outlook I held for most of the past year before we started getting the exceptionally good news of March and April. That is, we are most likely on the path of a plodding, but nonetheless upward moving, recovery. So no, I don't see any reasons for radical changes in investment policy. Only a double dip recession would sink the prospects for any and all of stocks, real estate and commodities. We can hedge our portfolios against this with bonds, alternative investments and equities from higher growth, non-debtor nations (i.e., emerging markets). But it makes little sense to design one's whole portfolio around a scenario that seems to have no more than a 20% chance of occurring.

In fact we never gear our whole portfolio around any one scenario. We never know what is going to happen, and need to be able to deal with many possibilities. But since the range of reasonably likely scenarios has gravitated towards lower growth and more frequent economic dislocations, our portfolio design should be adapted to such. This is something I have been doing fairly deliberately over the past year and a half. Rather than review these actions here, I have enclosed a separate short paper that does so.

Bob Marshalla
Your Financial Advisor

¹⁰ Yes, the Bush administration was intensely criticized for its tax and war policies, but concern with deficits was not the impetus for those attacks.