NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

SOFT PATCH

Most recently we recommended that portfolios be in a "risk off" position. We argued that the market was set to fall. Since early May, the S&P 500 has **declined 7.9%**,[1] a consequence of the weak economic data we reviewed in our "soft patch" thesis. The market was also vulnerable to the end of the Federal Reserve's QE2 stimulus program and a new low in U.S. housing prices. The market is back to fearing a "double-dip" recession and sees no immediate hope for addressing crippling deficit spending. Globally, markets continue to be impeded by spiking oil prices, European sovereign debt anxiety and the earthquake in Japan. The current economic weakness is quite similar to what occurred this time last year: a slowing global economy that could tip into another recession. We continue to call for slow and meager growth throughout the end of 2011. **Once, again, we do not see a "double-dip" recession.**

The S&P 500 index is up almost 100% since the low in March 2009. This has happened only two other times in U.S. history, 1934 and 1937. In those instances, the market had a subsequent, meaningful correction. A year ago, the U.S. market declined 15% from May until early July; we think something similar could happen this year. Now is not the time to be fully invested; it is a time to be cautious.

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Current Economy

U.S. Economy

High gasoline prices, government budget cuts and weak consumer spending resulted in anemic 1st quarter growth of 1.8%.[2] The second quarter growth should be modestly better at around 2.4%, with the year finishing at 2.3%.[3] The history of financial crises shows that they produce long, weak, uneven recoveries. Unemployment can remain painfully high for years. In addition to individual and government debt reduction and restructuring, (which is expected to negatively impact GDP growth by 1% over the next ten years),[4] accelerating globalization is proving to be a major hurdle to domestic job creation and growth. U.S. companies are outsourcing production, and building plants and research centers overseas because it's cheaper, easier and closer to growing markets. U.S. multinationals continue to shift employment abroad, even as they reduce it in the U.S. Between 2000 and 2010, U.S. corporations swapped 2.9 million domestic jobs for 2.4 million offshore positions. Compare this to the 1990's, when they added jobs everywhere: 4.4 million in the U.S. and 2.7 million abroad.[5] That said, the U.S. employment picture will improve, but slowly and unevenly. The burden of our current economic environment will be borne by the unemployed and underemployed. The broad measure of unemployment, which includes people who would like to work but have given up and people working part-time but who are looking for full-time work, now stands at **15.8%**.[6]

World Economy

World economic growth is also slowing. China is raising interest rates, aiming to prevent asset bubbles and reduce inflation in its red-hot economy. Central banks throughout the emerging markets - including India and Brazil - are also raising their interest rates in an effort to slow inflation. Although slowing down, the emerging and developing economies will still grow at a robust 6.5% this year, down from 2010's 7.3%. It is the developed economies that drag on global growth the most. For 2011, the U.S. will grow 2.3%, Europe at less than 2% and Japan at 0.5%.[7] The debt crisis in Europe remains a worry, but we think most investors have already discounted a debt restructuring in Greece and the effect it will have on European growth, unless it spreads to Portugal, Italy, Ireland and Spain.

Asset Allocation

U.S. Bonds and Stocks

The U.S. bond market appears to have priced in slower growth and/or a “double-dip”, since long-term yields have continued to fall. From current levels, we think bond yields could go higher (and prices decline) over the next six months, particularly intermediate and long Treasuries. We recommend corporate and municipal bonds with maturities of five years or less. International bond funds and ETFs, especially representing emerging market debt, are attractive because, as the world economy slows, central bank tightening will cease.

The 2011 U.S. stock market has been difficult and choppy. Just since February, the S&P 500 Index has been **down 7.1%, up 9.7% and back down 7.9%**.[8] We expect this choppiness to continue for the rest of the year as the battle of economic growth versus no growth, continues. While profit margins have rebounded to historically high levels, it is unlikely these levels can be sustained because of cost pressures; earnings could be disappointing going forward. However, unless there is a complete collapse in productivity and/or a major escalation in wage growth, there is little reason to expect a collapse in margins. We expect a gradual decline in margins over the next couple of years which implies limp profit growth. Since May, defensive stocks: health care, consumer staples and utilities have sustained the narrowest losses while financial, materials, energy and small cap stocks have plummeted. Having reduced overall exposure to the market for defensive purposes, we continue to favor our secular themes: health care, materials, industrials, energy and selected high technology stocks. We have a preference for large capitalization companies over smaller cap names.

International Stocks

Emerging markets have underperformed U.S. equities by 8.4% since November. Big cap international stocks have trailed the U.S. by 5.5%.[9] Emerging markets were damaged by inflation concerns and central bank tightening. Developed economies like Europe are dealing with sovereign debt issues; and in Japan, the earthquake continues to hurt productivity. International markets have done slightly better than the U.S. over the last month, which would indicate a small capital flow back overseas. With the slowing global economy, emerging economy central bankers may be finished with their monetary tightening; the Greek debt problem may be discounted; and Japan may begin recovering from the earthquake. Even though growth has slowed for emerging economies, they are still growing! It is too early to over weight this area, but when the time is right, emerging markets will probably be the first place we significantly add funds.

Natural Resources and Energy

Energy stocks were up 16.2% in the first quarter. So far, in the second quarter, energy stocks are down 9.9%.[10] We are under weight materials, resources and energy but remain steadfast in our conviction that commodities are in a secular bull market. The current profit taking should prove transitory. We expect to go back to over weight when it appears that market has discounted the current global slowdown. The secular case for gold remains intact: central bankers are net buyers not sellers; investors have easy exposure using gold ETFs, enabling a major overshoot in price before a major top; and the Fed has a strong incentive to depreciate the dollar. However, gold is also due for some profit taking. We want to maintain our minimum exposure, hoping we can buy more at $1400.

Real Estate

While REIT prices have rebounded nicely, cash flow growth has been negative and is likely to recover slowly. The risk in this cycle is that the market has already priced in a typical recovery, even though this may prove to be a much slower, longer recovery than normal. We continue to under weight this asset class.

Summary

Global growth is slowing. The U.S. economy is slowing. We do not expect the “double-dip recession” that the markets are currently anticipating. U.S. economic growth for the year should be around 2.3%. The current market could well be repeating last year's second quarter swoon; caution reins. We still like our secular themes: health care, materials, industrials, and selective high technology. We are currently under weight international stocks, natural resources and energy stocks and real estate. We like short term corporate and municipal bonds, bond funds and ETFs.

Dave Rahn Clara Basile Bill Oberman

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[1] www.bloomberg.com
[2] www.commerce.gov
[3] Cass Research Associates
[4] www.McKinsey.com/mgi
[5] www.wsj.com
[6] www.commerc.gov
[7] www.imf.com
[8] www.bloomberg.com
[9] www.bloomberg.com
[10] www.bloomberg.com

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