

# Market Commentary and Outlook

June 30, 2010

*Faced with the choice between changing one's mind and proving that there is no need to do so, almost everyone gets busy on the proof.*

-John Kenneth Galbraith

## It's a noisy market

On June 30, the S&P 500 index closed at 1030.71, ending the quarter down -11.43% (including dividends) having sustained increased levels of volatility during the past few months. Geopolitical risk has returned (i.e., situations involving Israel, Iran, Palestine, North Korea, Turkey), sovereign debt is under question, and as we write oil is still leaking into the Gulf of Mexico at levels that seem to mirror only the increased level of government spending around the globe. We are in a market correction.

Volatile market conditions evoke images of hundreds of traders yelling to enter or exit positions amidst a reverberating backdrop of an echo-laced stock exchange with trades being settled in person. Thanks to the technology of computer-aided trading, today's trading floors are generally much quieter places in a physical sense than they were just 25 short years ago. But when markets become volatile, they are still described as "noisy" by investors, and it is likely the days of open outcry trading floors that gave rise to this expression.

The May 6 "flash crash" in which the Dow Jones dropped about 1,000 points in a few minutes—the biggest intraday loss in history—is an example of the market noise introduced by computerized and high-frequency trading. While the Securities Exchange Commission (SEC) responded to the market events by enacting new trading curbs, it has yet to pinpoint the original culprit of the flash crash, and the effectiveness of the curbs has yet to be proven. Another form of noise can be seen in the fact that equity markets have remained hyper-sensitive to almost all headlines (for example: negative consumer sentiment releases, engine recalls, and oil spills).

Breaking news notwithstanding, we believe the current "noise" in the markets is a symptom of larger macro-economic and political issues. On July 1 Alan Greenspan stated that the current market correction could be attributed to an "invisible wall" that is consistent with a recovering economy. With all due respect to the former Federal Reserve chairman, we believe the "wall" which the economy is running into is built upon the following visible factors:

- The economy is still in the process of working through a massive deleveraging process;
- The housing market has shown signs of stabilization; however, it remains highly vulnerable. It remains to be seen if we have reached a bottom in the housing market, or if the recent stabilization is a pause before another leg down begins;
- Unemployment remains stubbornly high;
- The federal economic stimulus programs are ending;
- The federal deficit continues to balloon to record levels with entitlement programs coming under increased strain from an aging demographic;
- Uncertainty surrounding tax rates;
- Uncertainty of dealing with the ever-increasing liabilities of Fannie Mae and Freddie Mac;
- Banks and financial institutions continue to digest non-performing assets and at the same time to adapt to the new business operating paradigm in the post Lehman world;
- Lending to small business continues to be extremely tight; and
- The US consumer appears to be running out of gas.

Based in part on these factors, Jeremy Grantham of GMO, a highly respected asset manager, prognosticated that the market will experience "seven lean years" and that "after the initial kick of the stimulus, we will move into a multi-year headwind as we sort out our extreme imbalances."

So, is it all doom-and-gloom for long-term investors?

## Equity Environment

Let's not sugar coat it...it has been tough sledding for equity investors and it may continue to be so! Over these last 10 years, an investment in the S&P 500 would have lost -29.14% as of June 30. As a result, disdain towards equity investing has increased, the last ten years now being labeled by some as the "lost decade." Due to the economic headwinds mentioned in the previous section, we are concerned that the current market correction could be of meaningful magnitude.

From January 19 to February 8, the S&P 500 decreased -8.17%, and then proceeded to rally through April to post-Lehman level highs. Since the April 2010 highs through June we have seen a -11.57% decline, as measured by the S&P 500 index. Additionally, we are beginning to see articles and news commentary discussing the increasing probability that the markets continue their decline and officially fall into a bear market (typically defined by a decline of 20% or more). Investors are currently weighing the likelihood that the economy will deteriorate into a double-dip recession (Interestingly enough, you would have had a difficult time finding even a handful of economists giving any credence to a double dip scenario in March and April. What a difference a few months makes!)

Despite the latest news headlines (oils spills, engine recalls, geo-political events, etc.) and macro economic headwinds (deleveraging economy, unemployment, housing market, sovereign debt, etc.), opportunities are beginning to present themselves in the equity markets for long-term investors. In the face of a ton of "gloom and doom" there are several compelling scenarios for companies. First, there are several economic drivers that will improve the ability of companies to maintain revenue stability; second, there are several factors that will help companies control expenses resulting in improved earnings; third, corporate profitability is already at an all-time high; and fourth, improved equity valuations may start to emerge due to current short-term momentum of the market.

## Revenue Growth Drivers:

Increased corporate spending: while consumer spending typically leads economies out of recessions, there is little question that the American consumer has lost his will. With unemployment at stubbornly elevated highs and with decreasing trends in consumer confidence levels, it is doubtful that we can look to the American consumer to drive economic growth in this environment. It is more likely that large corporations will contribute to a recovery, as they have set aside \$1.84 trillion of reserves, the most that has remained on hand since 1963. Shareholder pressure will eventually lead these companies to begin deploying this capital in order to generate a larger return than is currently available in cash. Likely areas in which companies will spend eventually include:

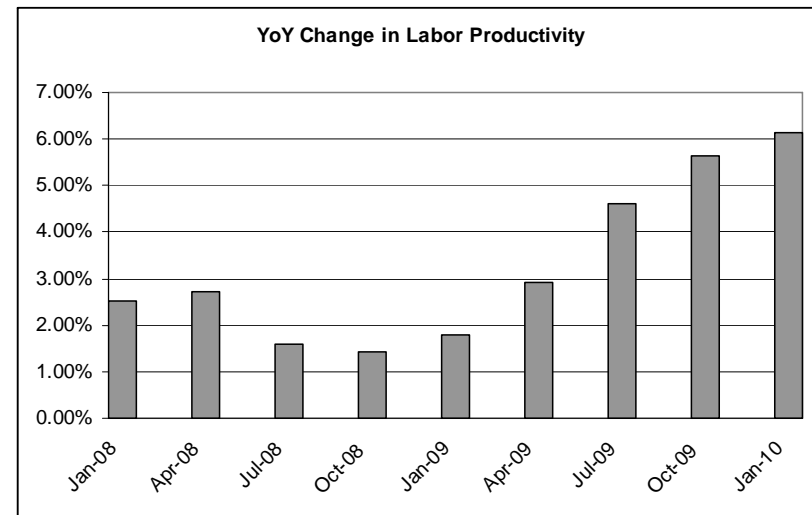
- Hiring new employees in the US or abroad
- Mergers and acquisitions
- Increasing dividends
- Share buybacks
- Capital expenditures

Emerging markets consumers are creating new sources of revenue: We think that American-listed companies will continue to search for revenue from overseas, and that the growth of a new consumer class in emerging markets will, in time, offset at least some of the newly-found reluctance of the American consumer to spend. Bank of America estimates that the average S&P 500 listed company generates 45% of its revenue from overseas. There are several signs that a new consumer class is on the rise in several emerging markets. In 2009, China outpaced the United States as the world's largest car market, with 13.5 million new cars, compared to 10.4 million units in the United States. A middle class also appears to be emerging in Brazil, where the poorest 30% saw incomes increase 9% annually over the last five years through January 2010 roughly twice as fast as the wealthiest 30%. The Indian labor force is highly skilled, English-speaking, and new millionaires are created annually: in 2009, the number of individuals with over \$1m to invest increased 50%. Accenture, the consulting firm, recently released a study and

found consumers in emerging markets are twice as likely to purchase and use consumer technology in 2010 than their counterparts in developed nations.

**Expense Reduction Drivers:**

Reduced labor cost: The Bureau of Labor Statistics calculates an index designed to track the cost of labor to companies, including benefits like healthcare and vacation in addition to wages. While many use the index as a predictor of inflation, it also illustrates another important point. Flattening rates of increase in compensation expense means that corporate earnings are being eroded to a lesser degree. *And this indicator does not address cost savings from the net 7.9 million jobs that were lost in the recession or jobs that were shifted overseas.* In the 1980’s year-on-year increases in salary and benefits approached the 4-8% range, and for the full period sample the average increase YoY was 3.05% while annual increases for the last four quarters in the US were between 0.82% - 1.37%. This flattening trend in labor expense is a positive factor for corporate earnings and indicates the level of efficiency in labor expense from which equity investments can benefit.



Strategic benefits of high unemployment: In addition to reductions in expenses attributable to decreased payrolls and decreased rates of benefit and salary increases, there is a strategic benefit for employers to undertake organic growth given the degree of talent that is currently seeking new opportunities. 9.5% national unemployment as of June (10.6% in Oregon, 9.1% in Washington as of the most-recently available data in May) means that there are plenty of candidates from which to choose. In addition, these candidates are making concessions in terms of salary, benefits, and other perks; so it’s likely that when companies begin meaningfully adding to payrolls, labor will be less expensive than it was prior to the downturn—this means sustained levels of improved productivity for companies (and income for workers) going forward. So the American consumer’s pain in the labor market may also be the key to helping companies to exit from the current doldrums at an improved clip over their European counterparts (who were less-apt to reduce payrolls through the downturn).

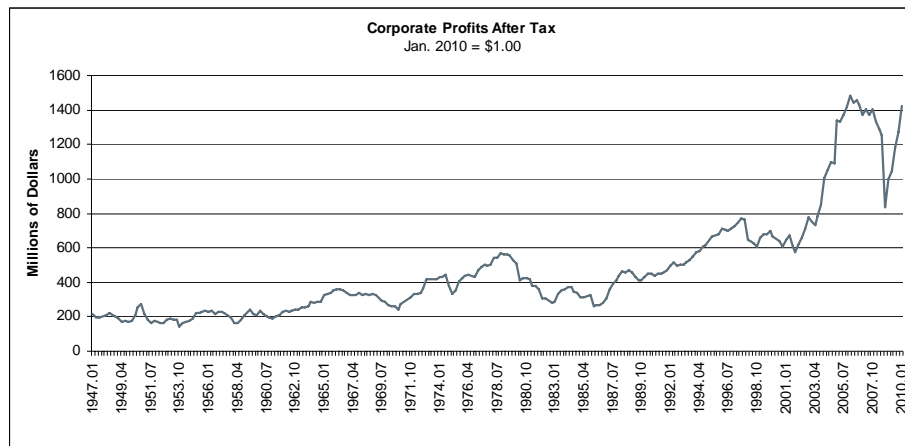
Record labor productivity: An additional measure of decreased expenses involves record labor productivity. The Federal Reserve tracks hourly productivity back to 1947. Over the last 10 years, the average increase in productivity each quarter YoY was 2.85%, an improvement over the full dataset annual average of 2.30%. The last three quarters on record saw productivity increases over the year prior of 6.12%, 5.63% and 4.61%. The productivity index has never been higher. Simply put, workers are doing more with less, enabling cost savings to translate to the shareholder’s advantage in the form of earnings.

Decreased energy expenses: In addition to labor, fuel costs are also down. About 75% of freight in the US economy is traditionally transported by truck. The price of highway diesel, a major component in freight transport, averaged \$2.948 compared to the all-time peak of \$4.703 which occurred just before the beginning of the 2008 credit crisis. This is a -37% reduction that enables cost savings in transporting finished goods and raw materials.

The US Energy Information Administration also tracks spot prices for West Texas Intermediate oil in storage at Cushing, Oklahoma, which is generally regarded as the standard measure for crude oil prices in the United States. Crude oil has also seen a similar reduction in value from an all-time high of \$145.31 per barrel in July of 2008, to \$75.23 as of June 29, a -48.2% reduction. In short, energy prices have remained significantly lower than their 2008 highs, lowering costs for companies.

## Corporate Profits are High

Some of these trends may have already combined to create a positive environment for shareholders since corporations are reporting record levels of profitability. The Federal Reserve tracks quarterly corporate profits after tax, and the most recent release in January saw the index at its highest level observed since the series began in 1947. The rebound in corporate profits during the downturn has been somewhat swift, with the most recent two quarters of releases having increased 52% and 46% on the years prior. The index for quarterly profits last stood at around \$1.4 trillion, an all time high.



## Valuations continue to improve

In June of 2000, the price-earnings ratio on the S&P 500 was 21.31 based on trailing four-quarter earnings. Since the end of World War II, the average PE ratio amounted to 11.13, which helps understand the extent of overvaluation that has been corrected out of the system.

Today's PE, based on estimates of June 2010 earnings combined with the last three quarters of earnings is a much more reasonable 14.91.

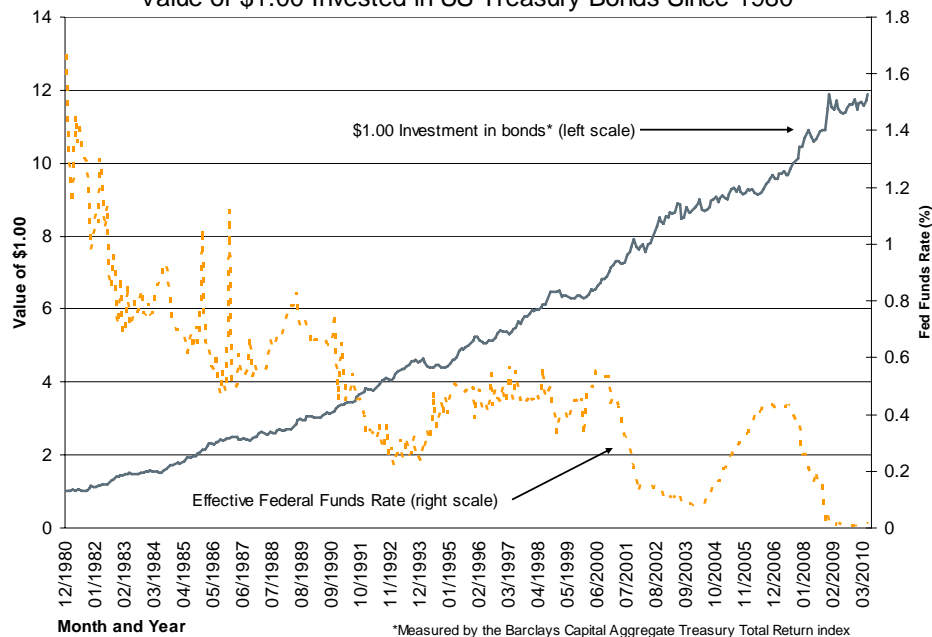
While short-term market direction has received significant focus lately, we choose to take a long-term perspective. At current S&P 500 valuations we are starting to become interested in selectively adding to equity assets on periods of weakness in the market.

## Fixed Income

While stocks have performed poorly over the last decade, bonds have been in a secular bull market since around December 1980. During this time, a \$1.00 investment in the US Treasury Securities represented by the Barclays Capital Aggregate Bond Index would have grown to \$11.90 by May 2010. This increase would have represented about an 8.6% average annual rate of return. An investment in the index when it was first available in February 1973 through November of 1980 would have resulted in an average annual return of 5.63% in comparison. Returns have been driven by a declining interest rate environment and low inflation. During these last 20 years, inflationary pressures have been relieved by improving technology, increasing productivity and the continued trend of globalization. While it is unclear if these two powerful forces (declining interest rates and low inflation) that created significant tailwind for the bond market will continue, the mere fact that interest rates are currently very low implies that bonds may not offer the price appreciation they once did. Rising interest rates place pressure on bond prices. Rising inflation erodes purchasing power of an investor's returned principal. Rising debt issuance can be linked to increased risk of default as debt service payments increase with new issuance. Is the party in the fixed income markets coming to and end? Time will tell.

### Fixed Income Bull Market:

Value of \$1.00 Invested in US Treasury Bonds Since 1980\*



When government debt issuance increases at a greater rate than projected GDP growth, risk associated with the debt theoretically increases. Currently, we are in an environment where many developed governments are increasing debt issuance, thereby increasing the risk associated with their bonds. In theory, this should increase yields on bonds in order to offset default risk borne by investors. Additionally high debt levels may make it more difficult for governments to finance their debts via taxation, and may instead turn to printing money to pay for them, increasing inflation risks. Since inflation erodes at the value of income streams generated by bonds, yields should also be increasing. Bond yields for United States 10-year Treasuries (and other maturities) have been reaching record lows as of this writing, and we suspect that these instruments may be overbought at the moment.

## Strategy Summary

While corporate profitability is reaching record levels and the equities market continues to trend downward, and while bond yields on the 10-year Treasury remain at record lows and investors continue to purchase we see opportunity in a selective allocation to high-quality equities. The decision on whether—and when—to begin adding to equity assets will vary on an individual's level of risk tolerance and investment time-horizon. For investors with a longer horizon and looking to increase market participation, we recommend a well-chosen entry into high-quality equity assets. Currently we have particular affinity for vehicles that provide a steady dividend income stream while offering the potential to participate in market advances when such conditions materialize.

In the longer term, once inflationary pressures begin to take hold—and we have not seen precursors to these pressures yet—we may be adding to inflation-sensitive assets such as real estate investment trusts, master limited partnerships, and potentially other instruments that can provide hedges against unanticipated increases in inflation. We anticipate these types of investments to offer a unique role in a given portfolio, especially if bonds decrease in value due to inflation and interest rate increases.

Our current fixed income strategy is to favor global funds that offer yield and currency diversification and domestic fixed income funds that have shorter duration characteristics (reducing a portfolio's sensitivity to rising interest rates).

In several of our recent market commentaries, we have taken a cautious approach to the strong rally the market has enjoyed since the March 2009 lows. In short, we believed the market was getting ahead of itself. The movement in the indexes over the past 15 months should serve as a caution to investors as the market can over do it to both the upside...and the down side! The stock market could significantly decline from current levels as investors wrestle with the headwinds outlined throughout this commentary.

When considering investing at this time, we encourage you to think on a time horizon that is consistent with your spending needs, understanding that while invested capital may be reduced in the short-term, long-term opportunities are beginning to materialize. These opportunities involve a highly-measured entry into quality equity assets. A full market cycle lies ahead. Even if corporate earnings fall under short-term pressure, we still anticipate opportunity for quality earnings growth especially in corporate bellwethers and funds that invest in high-quality names with stable earnings histories. Short-term pressures may also result in overselling and under-valuations (good opportunities to accumulate positions), and we are carefully selecting and allocating to fund managers who understand these dynamics and can help our clients benefit by gradually introducing these quality holdings.

Your investment time horizon and current spending needs should determine your asset allocation. Introducing equity exposure will result in added risk to your portfolio, and we prefer to discuss these decisions with you. In previous market commentaries we have stressed that investors should revisit their asset allocation to ensure they are comfortable with its ability to tolerate a potentially turbulent and noisy market. This approach enables investors to be opportunistic for long-term investment opportunities that may present themselves in market declines.

If the market continues its decline we believe it would be advantageous, over the long-term, to be the “strategic buyer” rather than a “panicked seller.” As always, please contact us if you have any question regarding your current allocation or about our strategy going forward.

We appreciate your business,  
Northwest Capital Management, Inc.  
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