

Quarterly Market Commentary and Outlook, June 30, 2011

“One of the funny things about acting is that, in a way, I come back to myself.”

Bill Murray

Groundhog Day, Again?

In the 1993 comedy *Groundhog Day*, Bill Murray plays a weather reporter stuck in the same day in Punxsutawney, Pennsylvania, prior to the town's annual Groundhog's Day ritual. The grumpy weatherman is forced to repeatedly relive the same day until he's able to rectify some of his personal issues. Although we are literally in the middle of summer, investors must feel somewhat like Bill Murray's character: The same headlines are repeating themselves, and the long economic winter drags on despite the recession's official end two years ago in June 2009.

As the same economic issues remain, each day investors wake up to peruse familiar headlines:

- Continued uncertainty about intended or unintended consequences of any recent artificial government stimulus programs
- More uncertainty in the Eurozone, sometimes directly questioning the long-run sustainability of the European Union
- Concerns about the level of US Government debt while slow economic growth, a soft housing market, and high unemployment continue
- Over two years in a bull market for stocks on the heels of the March 2009 lows

The S&P 500 was down by -2.78% over May and June, but was relatively flat for the quarter with about a 0.10% gain. From April 29 through June 15, investors endured a miniature correction of almost -7% on the S&P 500. Unemployment ended the quarter at 9.1% alongside stagnant consumer spending, and concerns in Greece were widely cited as the causes for the recent pullback. The tragedies in Japan also caused short-term supply-chain disruptions that have globally pinched recent manufacturing output (although the same economists who made this observation also expect a rebound in manufacturing activity when these supply chain issues are resolved and pent-up demand is satisfied). Meanwhile, a continued rally in commodities continues to raise inflationary concerns.

32 Months of Stimulus and Counting

Since the Treasury's unveiling of the Troubled Asset Relief Program (TARP) in the beginning of October 2008, investors have been continually re-reviewing headlines about stimulative measures for the past two-and-a-half years. Even more recently, the US Government released 30 million barrels of oil from the strategic reserves. Interestingly, this latest course of stimulus would offset some of the more negative side effects of a different stimulus program called Quantitative Easing which boosted commodities prices. To some extent, this could be considered akin to a physician prescribing medication to treat the side effects of another medication. But perhaps the biggest repeating headline of all is the second, and most recent, round of the Federal Reserve's \$600+ billion Quantitative Easing program (or "QE2"). QE2 is an unprecedented practice in which the Federal Reserve creates new dollars electronically and purchases US Government securities from the US Treasury Department to bid bond prices—and other asset prices by extension—upwards. Since bond yields decrease when bond prices rise, interest rates are artificially reduced by

the practice, in theory. QE2 officially ended on June 30, but the Federal Reserve is continuing to purchase its own bonds at a reduced pace.

Did QE2 work? Alan Greenspan, the former Fed Governor, stated that there is no evidence that QE1 or QE2 were effective in a recent interview. But in all fairness to the current Fed Governor, Ben Bernanke, it's probably too early to judge the program's success because there is conflicting evidence in both directions. After the program has truly unwound, the view will become clearer.

Some of the positives of QE2 include the fact that inflationary pressures have returned. One of the stated reasons for QE2 on August 27 was to re-introduce inflationary pressure in the midst of fears involving deflation. Deflation is a rare scenario with no known cure that is especially scary to economists because prices—and incomes—experience downward spirals, causing people to spend less and save more, and resulting in economic contraction. The Great Depression was just such a case of deflation. But it's still too early to call the inflationary goal successful. It's still possible that inflation becomes unwieldy before economic growth can take off (an undesirable outcome, but likely not as bad as deflation). A second positive of QE2 is its impact on the dollar in a manner that might result in increased exports that benefit US-based companies. The dollar dropped by about 8.5% over the same period compared to a basket of the United States' primary trading partners. A weaker dollar may help in the long run as American exports become less expensive for consumers overseas. While the Fed is not supposed to focus on driving stock market rallies, a third positive of QE2 is the stock market rally, which was a welcome side effect for many investors. QE2 did buy stockholders a significant upswing, as the S&P 500 rallied around 25% since the Fed's initial announcement of the program on August 27.

But those who agree with Greenspan would point out that a taxpayer-funded stock market rally is not the same as economic growth or job creation, especially if the current economic environment involves increasing inflationary pressures alongside weak labor and housing markets. The jury may still be out on whether QE2 "worked," and some claim that a certain time lag—say, 18 months—is required for stimulus to impact the economy. With over two years of stimulus behind us, and the increasing possibility of successive rounds, investors may keep asking how long of a lag to allow. In any event, bond yields are significantly lower because of QE2, and investors must consequently look more carefully for places to hide if they see their own shadows.

Government Debt and Spending

Europe - Concerns in Greece resurfaced toward the end of the quarter, but markets reacted positively to a majority vote in the Greek parliament for additional budget cuts. In exchange, the European Union and European Central Bank will extend the time period for which these bodies will provide support to Greece. Greece has a fairly small economy, but some investors are comparing its potential to that of a second Lehman Brothers. In 2008, when the United States Treasury decided to allow Lehman Brothers to fail, several other banks failed as a result, and the financial crisis intensified. The fancy term for this phenomenon is "contagion." If Greece were to default on its debt, some investors think a relevant parallel would be the failure of Lehman Brothers, but on a much larger scale involving contagion among sovereign nations instead of companies. Others are not as concerned about the Greek situation because the Greeks—despite media coverage—have already cut aggressively, and the European Union is

sufficiently determined, according to some, not to allow a traditional default if budget cuts do not continue. William White, of the Organization for Economic Co-operation and Development (OECD), notes that the Greeks have already reduced GDP by 12% over the past two years due to budget cuts, and the first round of reductions were close to target: the “miss” was less than one half of one percent. Parliament’s recent vote to renew budget cuts is also encouraging. If Greek voters replace the parliament with anti-austerity candidates or the Greek government does not adhere to cuts as planned, then investors could see more negative headlines (and volatility). Even in this event, there may still be plenty of incentive for direct, bilateral aid to Greece from individual nations. According to White, there is also a fair amount of “low hanging fruit” in Greece where GDP growth can be created: it’s still one of the most regulated economies in Europe, the government still owns substantial assets that are mismanaged and can be privatized, Greece has the largest informal economy in Europe, and most citizens don’t bother to pay taxes. An economist would consider privatization and tax code enforcement to be relatively low hanging fruit to spur economic growth and shore up budget deficiencies. Nearly any business leader, however, would point out the difficulty in opening a recently-purchased government facility in the midst of civil unrest among its former employees.

Greece aside, there are plenty of other economically weak nations in Europe. And a default does not need to be a literal default in order to cause problems for markets. If international organizations reach a “solution” or renegotiation to debt problems, and credit ratings agencies declare the solution a form of technical default, some investors fear that those circumstances alone may be sufficient to create a contagion effect. The Greek issue, and the issues of the weaker European nations, will likely not reach a solution in the near term and will continue to resurface as they have over the past several years.

The United States – Back at home, similar uncertainty continues to appear in headlines. Congress must increase the debt ceiling by August 2 (July 22 when considering time for the legislative process) or face the prospects of default. The Bipartisan Policy Center estimates that if the ceiling is not lifted, then the government would face a 44% reduction in spending overnight. While budget cuts are generally “good” economically speaking, when they are dramatic and sudden they are almost guaranteed to have a negative impact on the economy. Moreover, at least one leading credit ratings agency has warned of a severe downgrade on US debt if the ceiling is not lifted. The issue lends itself to a degree of brinkmanship and political negotiation, but ultimately the ceiling will probably be raised because of the severity of the consequences if it isn’t increased. Over the longer term however, it is difficult to ignore the massive levels of debt—both on the government balance sheet and off. Many of these issues resurfaced in 2010 and will continue to resurface going forward.

The Outlook

In our last commentary we stated that we would not be surprised if we hit a “soft patch” before year end. With a flat quarter for stocks that ended with back-to-back declines in May and June and some lackluster economic data releases, that soft patch may have already come. As a result, we are continuing to focus on managers who allocate to large companies with consistent earnings histories that have offered stable dividend payments (“quality companies”). At the moment, we prefer to gain a significant degree of overseas exposure indirectly, from managers who invest in US-listed companies that have sizeable

overseas revenues. We think that this approach will offer more stability in the current environment and will continue providing exposure to long-term overseas trends including the emergence of a global middle class.

During the past few months, weak economic data and fears in Europe have been cited as reasons for the recent increases in market volatility. To date, geopolitical events have been less impactful on markets than we would have expected, although though military involvement in Libya may have impacted oil prices temporarily. In this environment, economic data and geopolitical issues are one part of the equation. The second part is corporate earnings. It will be interesting to see, in the next two quarters of earnings reports, how companies have navigated a softening economic backdrop and rising commodity (input) prices. If earnings disappoint and the economic data remains weak, the near-term horizon for the stock market may be bumpy.

In Conclusion

Regardless of the stock market’s direction, the outlook and portfolio positioning described above are focused on improving returns on a risk-relative basis. Although allocating between different types of assets and choosing among best-in-class managers may reduce risk to a certain extent—and may even generate improved rates of return at times—these practices pale in comparison to your ability to save for retirement. Regardless of your portfolio’s performance, there is no substitute for saving as much as you can reasonably afford. Saving, and no other variable, is the number one determinant of reaching a successful retirement.

Your portfolio’s asset allocation should be tailored to your ability and willingness to weather a loss at any given time. Consequently, some portion of a portfolio should be invested in assets that are considered “safe.” As short-term market fluctuations continue, consistent savers will be rewarded by “buying low” or saving when market fears are high (the most difficult times to save and invest!). Setting aside a sufficient amount of “safe” capital may help ease fears when investing during declining markets. Ultimately, the most appropriate allocation for your portfolio will be based on your objectives, ability to withstand a loss, and market outlook. Whether your outlook calls for more bumpy markets or a quicker end to the economic winter, we would welcome your call at (503) 597-1600 to discuss reaching your retirement goals.

We appreciate your business,

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