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Personal Wealth Management

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Looking Down From 30,000 Feet, the Landscape is Dominated by Mountains of Debt

A year ago the stock market had just started its rebound from the depths of the worst bear market in over 70 years. The powerful rally in "risk" assets over the past year is certainly comforting. While we take some satisfaction in the returns we've achieved for our clients since that time, we remain quite concerned, and our assessment of the key macro issues and risks that the global economy must deal with in coming months and years has not changed. Though the worst case of a great depression has been avoided, the global economy continues to struggle in the aftermath of massive wealth destruction and a hard stop to the decades-long trend of expanding indebtedness.

More so than in past periods, the investment climate in the years ahead will be highly influenced by how the key macro components of this environment unfold. We've seen massive growth in debt throughout society, reaching binge levels in the last decade. Think of all that debt as a form of borrowing against

Index Returns *Through 3/31/2010*

Index	YTD	1-Year	2-Year	3-Year	5-Year
			Annualized Returns		
S&P 500	5.39%	49.77%	-3.71%	-4.17%	1.92%
Russell 1000	5.70%	51.60%	-3.26%	-3.98%	2.31%
Russell 2000	8.85%	62.77%	0.86%	-3.99%	3.36%
MSCI EAFE	0.87%	54.44%	-9.11%	-7.02%	3.75%
Barclay Capital US Aggregate Bond	1.78%	7.70%	5.40%	6.14%	5.44%
Barclay Capital Municipals	1.25%	9.70%	5.93%	4.57%	4.58%
Dow Jones AIG Commodity	-5.03%	20.53%	-18.59%	-6.88%	-1.36%
CSFB/Tremont Hedge Fund	3.09%	21.20%	0.47%	2.52%	6.21%

future consumption – now we must pay it back in the form of less spending. This suggests a sluggish economy, possibly for many years to come.

Government spending has kept the economy from falling off a cliff, but at a longer-term cost of massive deficits that will be difficult to fix without causing more damage – including the possibility that shifting gears to cut budget deficits too early could throw the economy into a significant and ugly decline.

The recent economic strength stems mostly from this stimulus spending and smaller inventory drawdowns (companies are still drawing down inventories – selling more than they are producing so that inventories decline – but the drawdown has slowed). The problem is that both of these factors are temporary.

There is still a lot of government spending that will roll out this year but unless there is a new round of stimulus, which is quite possible, it will dissipate in coming quarters. Inventories will be a positive growth driver for a while as they are gradually rebuilt, but this too will pass as the year progresses. Other sectors of the economy are strengthening—manufacturing in particular has been impressive but it is still far below its prior peak and overall, the economy is on fragile footing. What we don't yet know is whether the economy will be on solid enough footing to stand on its own as government supports are withdrawn and inventories stabilize, or whether it will stumble and possibly contract again.

In normal cycles the consumer is the key to sustained growth. The weakness in this critically important sector suggests to us that a sluggish recovery is the most likely outcome over the next couple of years and that there is still risk of a return to recession if government policies are not skillfully managed.

The first quarter of 2010 was a good one, with U.S. stocks enjoying healthy gains and bonds earning at least small positive returns.

We have been spending significant time evaluating the manner in which macro trends could play out. The main story is that the need to reduce spending now, in order to reduce the massive debt built up in previous years, suggests the strong possibility of a sluggish economy for many years to come.

We don't believe that risk assets like stocks are priced attractive enough to merit an over-allocation to equities. But periodic declines in the years ahead could give us opportunities to improve returns by adding risk when we expect to be paid better for taking it on—this requires patience.

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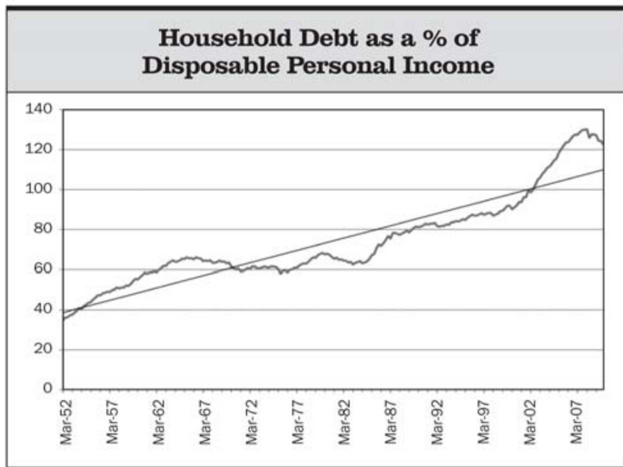


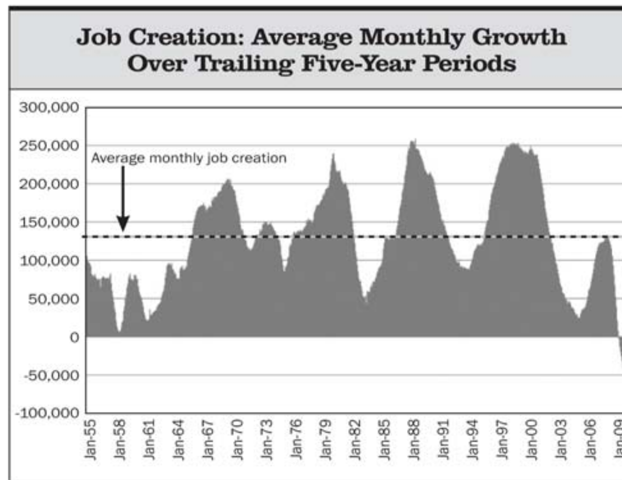
Debt is coming down, but is historically very high relative to income. Source: Federal Reserve.

There are several important variables to a strong and sustainable economic rebound, but jobs are the most important. The big question is not whether the job picture will improve, but how much it will improve and how quickly. But while the labor markets remains very weak, monthly job losses likely peaked some time ago, and we appear to be entering a period of net job creation.

A strong snapback in job creation at some point would not be shocking. With over eight million jobs lost, there was probably some overreaction on the part of businesses that will be reversed. However, we also believe that businesses are adjusting to a smaller workforce in the face of continued concern about economic growth in coming years. We don't know how this will play out, but the weight of the evidence suggests to us that even with a strong temporary snapback, we shouldn't be optimistic about a return to a strong labor market for several years.

Other big problems include huge amounts of commercial real estate debt coming due, continued strains in the housing market, and possible high inflation down the road from deficit spending.

There are some positives that could contribute to a better outcome, including continued strength from emerging economies. Domestically, we could see stimulus spending, low rates, and inventory rebuilding create a virtuous circle in which businesses with strong balance sheets add jobs, and consumer and business confidence builds and feeds on itself.



According to Ned Davis, if job growth averages 150,000 a month over 10 years, unemployment won't fall below 6% until 2019, or below 7% until 2018. It would break below 10% in 2013. Average monthly job growth since 1950 has been 120,000. The last 20 years, excluding the impact of the recession, job growth has averaged 137,000 per month. Source: Bureau of Labor Statistics.

Global Stock Outlook

We think mid-single-digit returns are more likely for stocks than higher returns over the next five years. Our outlook for developed market foreign equities is similar and for emerging-markets equities is slightly higher across all scenarios. We believe risks are relatively high, but we can't predict timing. We can easily imagine good returns in 2010 if the economy continues to grow, low rates encourage risk taking, and there is no catalyst to cause risk aversion.

As we think about the equity markets, we also think about the potential for active managers to outperform, and we put some credence in the bottom-up views and analysis we hear from the stock pickers we respect (those who are not "perma-bulls"). There is some evidence that environments where overall stock returns are low but individual company returns vary widely are favorable for active managers; we believe we could see such an environment.

Emerging-Markets Local-Currency Bonds

Among other asset classes, emerging-markets local-currency bonds have again become a compelling opportunity from a relative-return perspective versus the other major asset classes we track. We think it can generate mid- to high-single-digit returns over a five-year period— admittedly not spectacular returns but

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as good or better than any other asset class. The returns are driven by the underlying bond yields plus an expectation of at least mild currency appreciation we expect given the stronger fiscal conditions in much of the developing world.

High-Yield Bonds

We did very intensive due diligence on high-yield bonds in late 2008. Back then we viewed high-yield bonds as an asset class that had better potential than stocks in almost every scenario, and much less risk. Our research left us highly confident in our conclusion and led us to make an allocation to the asset class. It worked out much more quickly than we expected and we captured a huge return in 2009. High-yield has continued to do well in 2010, though the returns have been much more moderate.

Since high-yield has rallied, we are considering gradually reducing our exposure. We no longer view the asset class as clearly superior to equities (both have low expected returns in most scenarios). High-yield could continue to generate decent returns in the short to intermediate term if the economy continues to gradually improve and interest rates remain low. But the huge increase in prices of high-yield bonds (now at or approaching par for most of the high-yield universe) means that our expectations for returns over a five-year investment horizon have fallen and we could be close to unwinding our positions as their appeal has diminished.

Flexible Fixed-Income Strategies

Eighteen months ago there were many table-pounding opportunities in the fixed-income market as everything outside of the government-backed market was in the bargain bin. Since that time every fixed-income sector except for government bonds has rung up big returns and that has been one of the key drivers of our performance. Now, however, the opportunities are not so compelling, though on a five-year basis the return potential is higher in non-government bonds. The multiple fixed income manager approach we employ allows for more flexibility and intellectual diversification, including US versus non-US bond exposure, management of duration (maturity strategy), sector allocations, etc., which we believe will be subject to less inflation/rising interest rate risk than the overall bond market and has higher return potential. It also provides us with some defense in the event of a double-dip scenario than the overall bond market.

Inflation

Although this dirty word is and has been talked about to great lengths as a result of the increasing deficit, we are more concerned with higher inflation longer term than near term. Over the next year or two, the combination of low demand growth (resulting from deleveraging) and excess productive and labor capacity makes a spike in inflation unlikely.

Regardless of the economic cycle within which we find ourselves, investment decisions involve determining if you are being adequately compensated for risk. We don't believe that risk assets like stocks are priced attractive enough to merit an over-allocation to equities. But periodic declines in the years ahead could give us opportunities to improve returns by adding risk when we expect to be paid better for taking it on—this requires patience.

Rather than skew towards a positive view when, in our opinion, an uncertain economic environment does not support such view, we are committed to working hard to understand the reality in which we live and make decisions accordingly. That said, we think a volatile, challenging environment plays to our strengths.

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