



ECONOMIC OVERVIEW

SPRING 2011

The US stock market was strong in the first quarter (Q1), returning 5.9% as measured by the Standard & Poor's 500 Index. The Dow Jones Industrials did even better, earning 6.1%. Non-US stocks lagged, as the EAFE Index of developed countries gained 3.5% and emerging nations rose 2.2%. Bonds had very modest results due to rising interest rates. The Barclays Aggregate Bond Index returned 0.4%.

The US economy continues to demonstrate gradual improvement. Real Gross Domestic Product (GDP) for Q4 rose 3.1%, up from its 2.8% increase in Q3. Exports have been strong, thanks in part to a weaker US dollar. Business investment, most notably software and computers, has been another important contributor to growth. Most important has been the increase in consumer spending, which rose at an annual rate of 4.4% during the past two quarters. Consumer expenditures are over 70% of GDP, so they are vital to a sustainable economic recovery. Improving labor market conditions helped encourage consumers to spend.

Unemployment declined to 8.8% in March, a significant improvement from 9.8% in November. During that four month span, one million jobs have been added, but the labor force, as defined by the Bureau of Labor Statistics, has contracted by 540,000 workers. Normally, the labor force would increase by at least 100,000 persons each month. Thus, there has been some much needed improvement in the labor market, but the sharp decline in the unemployment rate is somewhat misleading, as it is partly due to workers who are no longer trying to find a job. Hourly wages and hours worked have shown very little increase in the past year, suggesting conditions are still soft. Businesses will likely continue adding employees, but the unemployment rate may increase for a while as workers who have stopped looking for a job start to search for positions again. Government hiring will not

be much help. The number of government jobs has declined by 260,000 in the past year, and there is pressure to cut spending at all levels of government.

The persistent federal budget deficit is a threat to US economic health. The non-partisan Congressional Budget Office (CBO) projects that deficits for the decade from 2012 to 2021 will total \$9.5 trillion, using President Obama's budget as a basis for projections. The President's deficit estimate was \$7.2 trillion, but that relied on some overly optimistic economic assumptions. The CBO analysis of the budget projects that Treasury debt held by the public as a percent of GDP will rise from 62.1% in 2010 to 87.4% in 2021. The amount of Treasury debt held by the public would rise from \$9.0 trillion to \$20.8 trillion. Intragovernmental debt, which is mostly funds owed to Social Security, is an additional \$4.6 trillion, making our 2010 total debt \$13.6 trillion.

The US is clearly on an unsustainable fiscal path. The President's long-term budget projects that in 2085, interest expense on the national debt will be 10.9% of GDP and federal government spending will be 33.5% of GDP. Those percentages were 1.4% and 23.8%, respectively, in 2010. Interest expense will rise, both as bond yields increase and as the debt level climbs. We cannot continue to run huge deficits indefinitely, because we borrow by selling Treasury bonds, and eventually investors will not want our debt. About 47% of our Treasury debt is owned by foreigners, and if they start selling their holdings, our interest rates will rise sharply. We must get our deficits and debt under control or the consequences could be severe.

Many European countries also have debt problems, most notably Portugal, Italy, Ireland, Greece and Spain (the so-called "PIIGS"). Greece is likely to default if it is not bailed out by other countries. Even with assistance, the Greeks face a severe recession

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or depression. The problems of the PIIGS are making investors more careful about all sovereign debtors, including the US, Japan and Great Britain.

The best solution for excessive government debt is rapid GDP growth, which increases tax revenues and reduces government payments to the unemployed. Governments need to stimulate growth with policies to promote hiring and increase productivity. Another way for a country to boost its GDP is by improving its trade balance (i.e., more exports and less imports), but nearly all nations have that goal. This won't help nations collectively, because when one country's trade balance improves, another country's balance must get worse by the same amount. If too many countries aggressively try to improve their trade balance, such as by letting their currencies depreciate, a trade war may result.

Because GDP growth can't solve all the debt problems, some countries will probably resort to higher inflation and currency devaluation. Higher inflation effectively reduces the value of outstanding debts, and improves trade, because currencies usually fall in countries with rising inflation. Central banks fear deflation more than inflation, so they will err in the direction of higher price levels. Historically nations have often used inflation to debase their currency and effectively reduce their debt, at the expense of their lenders.

Inflation rates around the world are likely to rise. Commodities like food, energy, gold and base metals have already shown rising prices, which have driven up inflation in emerging nations. The 17 Eurozone countries share one currency, so they can inflate only as a group, and Germany will probably resist that policy. The US and Great Britain are likely to allow somewhat higher inflation, but rapid inflation could be damaging to their economies. In the US, the Federal Reserve has scheduled a June end to its second program of quantitative easing ("QE2"), which involves its purchases of Treasury securities to drive up the prices of stocks and

bonds. We expect the Fed to announce in May an end to QE2, as its continuation would drive up inflation risks. Given the high unemployment and excess productive capacity in the US, we don't expect inflation for items other than commodities to be a problem for at least a year or two.

The US stock market will likely go higher this year, but headwinds are increasing. Stocks demonstrated remarkable resilience during Q1. They were up about 6%, despite rising Treasury interest rates, the tragedy in Japan, and surging oil prices due to unrest in the Middle East. Stocks were able to produce solid returns in spite of these negative events because of their excellent fundamentals. Profits should rise about 12% this year, valuations are still attractive, and balance sheets are generally strong.

While the improving US economy will benefit stocks, other developments will be adverse. Interest rates will continue higher as the economy strengthens and the Fed begins to tighten monetary policy. The federal government has spent most of its stimulus funds, and Republicans are pushing to cut spending. State and municipal governments have already reduced expenditures, and more reductions are coming. Oil prices surged over \$100 recently, but could easily go higher if uprisings worsen in energy-producing nations. Emerging nations will continue to slow economic growth in order to combat rising inflation. These macroeconomic issues or some other event could derail the bull market, but we believe that it's more likely that US stocks will continue higher to produce a double-digit return in spite of them.

The US labor market and economic growth are gradually improving. Government deficits must be reined in or high interest rates will result. Stocks had an excellent Q1, and will finish the year higher, despite less favorable fiscal and monetary policies later this year.

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STANDARD & POOR'S 500 INDEX

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