

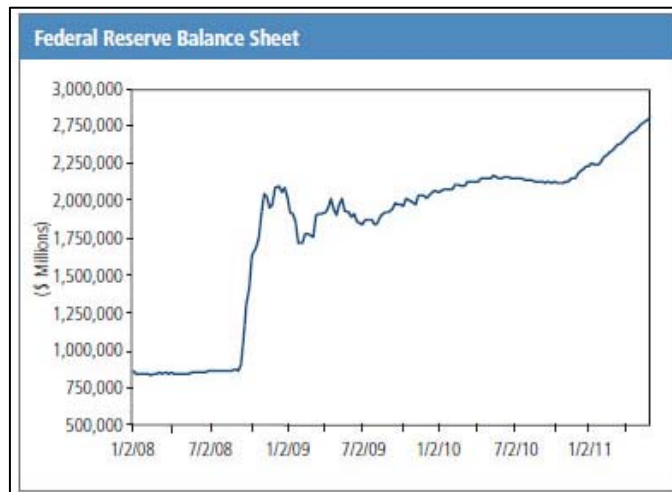
**Introduction**

One of the defining characteristics of the investment environment since early 2009 has been the importance of government policy actions in formulating an investment thesis. Risk assets such as stocks, corporate bonds, and commodities have either gained ground or struggled depending on whether policy is viewed as supportive or not. In early 2009 it became clear global governments would pull out all the stops to fight the Great Recession and risk assets rallied significantly. In early 2010 the Fed's Quantitative Easing program (QE1) ended and the economy promptly hit a soft patch. Risk assets sold off in tandem with the S&P falling over 16%. Only a few months later when the Fed announced their second round of Quantitative Easing (QE2) risk assets staged another major rebound. Gains were turbo charged by renewed fiscal stimulus at the end of 2010. This 'risk on/risk off' phenomena, whereby everything other than government bonds goes up and down in tandem, has been with us since 2008. And it isn't just in the U.S. where such a phenomena appears to work. The emerging world equity markets soared on massive domestic stimulus bills in early 2009. However, they have recently underperformed the developed markets due to tightening monetary policy. Such policy restraint has overridden an otherwise robust growth picture.

The importance of government policy in formulating an investment strategy is crucially important as we look into the second half of 2011 and into 2012. The Fed's QE2 program will mature at the end of June and fiscal tightening is all but assured over the coming months in many countries. To the extent the US and the global economy and markets have been spurred on by policy stimulus the last couple years, this trend change raises important questions about investment strategy and allocations. Below we attempt to analyze the investment landscape over the coming months and offer our thoughts on what the impact of policy change might be.

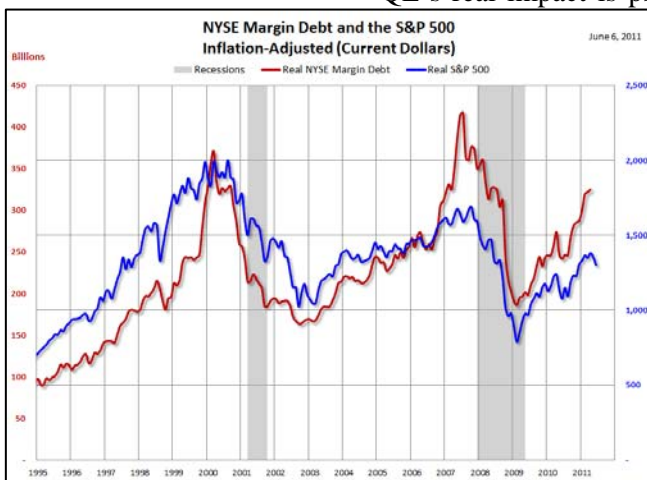
**Quantitative Easing – A Psychological Backstop**

During November last year the Fed rolled out their second

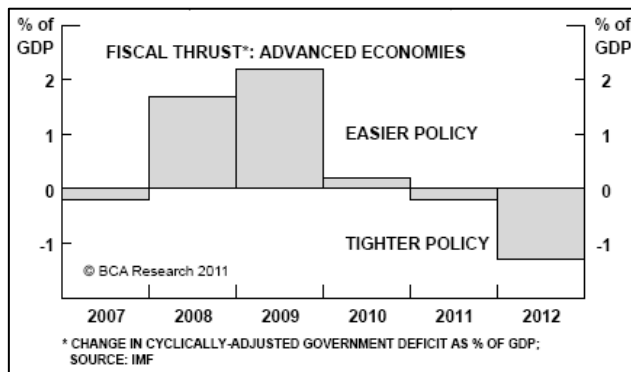


quantitative easing plan in response to renewed economic weakness. Under the so called QE2 plan the Fed announced their intention to buy \$600 billion of US Treasuries and reinvest another \$250-\$300 billion of coupon payments and maturing debt. This \$900 billion plan was greeted warmly by the markets and risk assets staged a major rally after a summer swoon. Once QE2 wraps up at the end of June the Fed's balance sheet will have ballooned to close to \$3 trillion (chart above). To put QE2 in perspective, the US budget deficit from November 2010 (when the buying started) thru May totaled \$789 billion. In a way the Fed financed the entire government deficit over this period, and much of the deficit spending since the Great Recession began.

Almost certainly the effect of QE2 on the real economy has been modest at best. Interest rates may have been pulled lower by the bond purchases, but in a world of stagnant credit demand, this really has little impact. The proceeds from the Fed's security purchases ended up sitting on bank balance sheets rather than being lent out. QE's real impact is psychological. What was once the Greenspan Put is now the Bernanke Put – the idea that the central bank will put a floor under the markets when times are tough. This is apparent if you look at the surge in NYSE margin debt levels (red line in the chart to the left). As investors and speculators gained confidence the authorities would do whatever it took to support the markets they increased their borrowing



(typically a very risky activity). Today margin debt is closing in on levels seen in 2000 – the peak of the internet bubble. While below early 2008's stratospheric levels, the idea that the Fed is standing behind the markets encouraged speculators and investors to move out the risk spectrum.



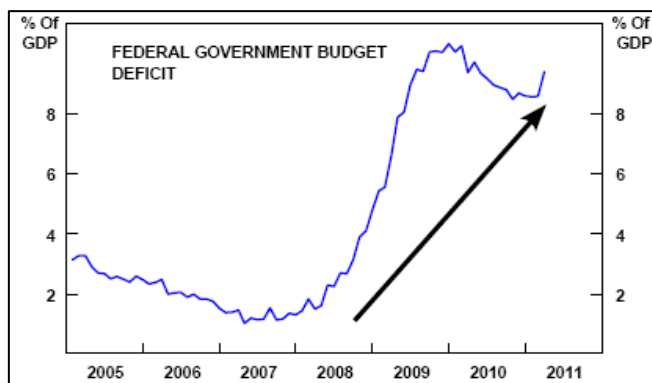
By driving rates to essentially zero the Fed has also presented investors with a dilemma. Fed policy made it unrewarding to hold cash, T-Bills, and high-grade bonds. Investors rotated into lower quality bonds and stocks, and this move pushed assets higher and indirectly aided the recovery. The Fed has encouraged risk taking as a way to boost asset prices and thus help the recovery. However, the dynamic of investors chasing the same asset classes has pushed risk spreads down to tight levels, thus the compensation for taking risk has fallen dramatically. So the dilemma today is how to deal with a world with a very compressed risk/return trade off.

A by product of Fed policy has been its inflationary impact on the emerging world. This inflation problem has led to the underperformance of emerging market equities the last few months and puts pressure on policy makers in the emerging world to tighten aggressively. We will explore the investment implications of a compressed risk/return trade off and inflation in the emerging world below.

### Fiscal Austerity – Not If, but How Much

When it comes to government policy the Fed's actions are but one of two tools the government can employ to spur the economy. The other tool widely used the last couple years has been deficit spending on such a scale not seen outside of wartime. Deficit levels ballooned to over 10% of GDP during the Great Recession (see chart below), but even during the recovery deficits have only moderated slightly. For fiscal year 2011 the fiscal deficit is projected to come in at a little over 9%. This works out to roughly \$1.4 trillion, close to a peacetime record. It is a similar story in much of the developed world.

It is safe to assume that fiscal policy is going to shift from supportive to contractionary over the coming quarters in the developed world. Europe has clearly run into a brick wall in terms of how far government



debt levels can be pushed, and even in the US we are talking not about whether to cut spending in the coming years, but by how much. The chart to the left shows that fiscal spending in the large advanced economies is going to go from adding roughly 2% to GDP in 2009 to subtracting roughly 1% in 2012. While the swing may

not sound large, in a world where Europe and the US are growing at roughly 2% or less, this will have a major impact.

### What Does the Future Hold?

So we are presented with a policy backdrop whereby monetary policy is likely to shift towards neutral in the US (combined with continued tightening in the emerging world) while fiscal spending is turning into a headwind globally. What does this imply for the economic outlook? In a word it is murky.

We suspect the expiration of QE2 alone won't push the economy into recession and the markets into a prolonged bear market. Expiration has been well advertised and the markets have probably priced in this fact with the recent correction in risk assets. Furthermore, the recent downgrades in growth expectations are being exacerbated by what may prove to be temporary factors. The global economy has been hit by rising energy prices, the disruption related to the Japanese earthquake, and unusual global weather patterns. Also, in the emerging world policy tightening to combat inflationary pressures is cooling growth. All the above factors may turn from a negative to at least a neutral factor in the second half.

However, QE2's expiration does bring back into focus the fragile nature of the US economy. Ever since 2008 consumers have been going through a profound change whereby twenty years of ever increasing debt levels began to decline (see the chart at the top of the next page). Savings rates have increased and household debt

levels are beginning to fall. Unfortunately this trend has a long way to run, and it will take a number of years before debt burdens are back to more manageable levels. As consumers enter what is likely to be a prolonged 'Era of Thrift' growth in much of the developed world will prove to be far more tepid than in prior decades.

## Three Scenarios of the Future

So what does this all mean for the coming year? In our work we spend a lot of time building scenarios for the coming months to capture possible economic and market environments. We would argue that of all the possible scenarios, three in particular are noteworthy:

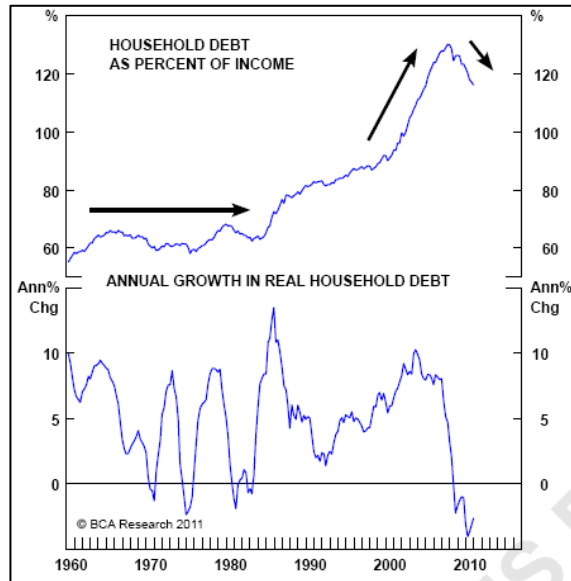
1. The first is a replay of last year's experience. This would entail a significant economic slowdown that causes investors to worry about a renewed recession. The Fed is at first reluctant to enter into QE3 but is eventually forced to do so by the rising risk of recession and falling equity prices. Growth then picks up because of the renewed stimulus and risk assets rally in unison.

2. The second scenario entails the Fed standing by and doing nothing as the recession develops. A recession could very well be triggered by an external shock. Of course you don't have to look too far to identify the risks. Oil prices spikes, Greek defaults, further housing weakness, a policy mistake in Washington, Europe, or China are all issues we are familiar with. Even given the recent correction it would pay to get defensive now.

3. A third scenario is less dramatic but probably more likely than the first two. Let's call it the 'mush' scenario. Growth doesn't deteriorate further in the second half of 2011 as recent headwinds abate, but growth doesn't accelerate either. US and European growth remains stuck around the 1% to 2% range, unemployment rates remain elevated, and earnings growth falls to the single digits. Growth is slow enough to keep the Fed from tightening, thus liquidity levels remain supportive, but the anemic growth outlook leads to modest equity returns for the foreseeable future, albeit one with lots of volatility.

We believe the odds favor scenario three over the coming months and quarters, although we wouldn't rule out the first scenario. Either way we doubt we'll see another recession this year. The risks to our base case scenario are well known but would include:

- We see much more fiscal austerity sooner than we think. This would raise the recession risks materially.



- A spike in commodity prices would also undermine the recovery.

- Major renewed weakness in the housing/jobs market would seriously jeopardize our outlook.

- The Euro debt crisis continues and it isn't clear if a solution will be found. A disorderly default of Greece could trigger serious banking problems in Europe. The authorities clearly know this, but a policy mistake here would have grave consequences.

### Investment implications

If the slow growth 'mush' scenario pans out both bulls and bears are likely to be frustrated. Tepid growth will lead to a flattening in profit growth but not the outright contraction the bears hope for. Certainly the economy will remain susceptible to outside shocks, but barring that we suspect we are transitioning to a much flatter price trend for most developed markets. Key points in our outlook would include:

1. The 'risk on/risk off' environment may not persist. This implies that not all risk asset classes will either prosper or flounder together, and the market may not exhibit clear bullish or bearish trends. Falling correlations between asset classes is likely to make for a better environment for active managers. Market timing strategies that rely on trend following may struggle.

2. Investors are likely to seek income over capital gains, and investors searching for yield could compress risk spreads to very tight levels. This means high-yield bonds are likely to be attractive equity alternatives once again because investors can earn a 7% to 8% yield. The slow growth environment should preclude major defaults (the big risk in owning high-yield bonds). Along these lines dividend strategies, such as those employed by Tweedy Browne and Matthews, could add value.

3. Treasury yields have little downside from current levels. To get a sub-3% 10-year yield we'd need to see recession risks rise materially and/or see another round of QE. However, yields are unlikely to spike over 4% because the Fed will be on hold for a number of quarters under the 'mush' scenario.

4. The emerging world will have to contend with ultra loose liquidity conditions in the US for quite a while longer. While interest rate hikes and credit

controls will play a part, greater currency flexibility will also be important. Thus, we see investment opportunities in emerging market debt denominated in the local currency. While not a low risk strategy, such an allocation would benefit from dollar weakness versus emerging currencies while also capturing a decent yield.

5. Another higher risk opportunity would be in the commodity markets. The best scenario for commodities is a soft landing in China and lackluster but positive growth in the US that keeps the liquidity taps open. Gold should also prosper under the slow growth scenario. The biggest risk to gold is rising real yields. A slow growth/deflationary environment should keep real yields low and be supportive of precious metals.

6. Alternative asset strategies will become an important part of any portfolio allocation. Strategies such as merger arbitrage, long/short, managed futures, etc. were popular in 2008 but have generally cost investors in 2009 and 2010. We suspect these strategies will become important again in the second half of 2011 and into 2012 as risk reducers.

### **Conclusion**

In many ways 2011 is proceeding in a similar fashion to 2010. Bullish expectations at the beginning of the year are confounded by policy changes and renewed economic weakness. However, we think 2011 differs from 2010 in one important dimension. While economic growth is softening similar to last year, we are extremely unlikely to see a significant stimulus/liquidity response to a poor growth environment, at least over the short-run. Fiscal policy is basically hamstrung and the debate is centered solely on fiscal consolidation. While addressing long-term spending patterns is clearly critical, shorter-term spending cuts will weigh on growth. Monetary policy is unlikely to move beyond rhetoric. The Fed will continue to promise to keep rates low for an extended period and not allow their balance sheet to shrink, but we think QE3 is unlikely over the next three-to-six months.

This leaves us with an economic and market environment that is likely to be far trickier to navigate than the last couple years. Without the tailwind from fiscal and monetary stimulus the economy is likely to

grow in the 1% to 2% range for the foreseeable future. While positive, growth is unlikely to be rapid enough to bring unemployment rates down significantly or stabilize the housing market. This means corporate earnings growth will slow and deflationary pressures are likely to build. Risk assets such as equities and high-yield bonds can still make money in this environment, but we think returns will become more volatile. The US economy also remains susceptible to another shock. Oil spiking to \$120 or more would increase the recession risks significantly.

Should we rule out QE3 beyond the short-term? We suspect the hurdle is high for another round of monetary stimulus, but we wouldn't rule it out. If the risks of recession increase and/or deflation risks spike then Bernanke will not hesitate to try another round of stimulus. He is clearly cognizant of the risks of allowing deflation to infect a highly leveraged developed economy and will do whatever he can to try to prevent a deflationary spiral from setting in similar to the Japanese experience. It is too soon to predict such an event, but risks will rise further in 2012 if we see meaningful fiscal spending cuts.

And in a way this highlights the biggest risks for both bulls and bears. Just as the last couple years have been driven by policy decisions, the next few years are likely to be more of the same. While the economic risks are clearly known, the biggest risk to the global economy is political. Policy moves pulled the global economy back from the brink in early 2009, and a policy mistake today could push the world back into recession.

Finally, it is likely to be a trickier environment for investors over the coming months. We suspect equity markets will continue to advance, but returns will be more volatile. We are researching numerous alternative investment options that will moderate portfolio volatility in uncertain times. We would also encourage investors to consult with their financial advisors on their portfolio exposure. It is crucial to be invested in a portfolio mix that you are comfortable with and allows you to sleep at night.

***Charles Blankley, CFA***

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