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Memo

Date: May 21, 2010

To: Investment Clients

From: Mark Pellegrino, Chief Investment Officer

Subject: Markets Gone Wild

Markets Gone Wild (Yet Again)!

In the wake of the Vancouver Winter Olympics, who would have thought that people all over the world would be rooting so wholeheartedly for the Germans (other than the Germans)? Yet, that's exactly what's happening, as investors await Germany's crucial vote on its share of the Greek bailout package. Will they or won't they? We'll know shortly...

Investors clearly aren't confident about this or anything else going on in Europe right now. As evidence, the markets breached important thresholds in today's trading session, with the S&P 500 off nearly 4% on the day. And there is a shocking disconnect between the expectations offered by Wall Street fundamental analysts and those of traders and technical analysts. The fundamental analysts (those that gauge company valuations and earnings) see the markets climbing 20% from here, while the technicians (those that closely watch market movements) predict a 20% decline is ahead. Forget about why each group sees it differently than the other. What's important is that they're so far apart from one another... for when we look at previous periods where this degree of disconnect has been present, it almost always signals an inflection point in the markets. Since the markets have been mostly up over the past year, any guesses as to which direction they might be

“inflecting”? Given recent activity (and the associated volatility), you’d almost have to give the edge to the technicians anyway, right?

Bottom line

We feel it’s prudent to take additional defensive measures here. Here are our four key drivers for this decision:

- (1) Investors are clearly assigning a higher probability now to a meltdown scenario, and we can’t argue with that stance.
- (2) The S&P 500 breached its 200-day moving average in today’s session with very little difficulty, which is often a sign of a market that’s trending lower.
- (3) In an even more important signal, the EAFE Index (developed markets overseas, including Western Europe) breached its 300-day moving average. Telling is the fact that the EAFE has led the S&P 500 in both directions for months now. Is it predicting a similar breach of the S&P 500’s 300-day moving average? Could be. As a point of reference, the 300-day moving average on the S&P 500 is at 1,032 – only 40 points away from today’s 1,072.
- (4) Perhaps our greatest fear is that there is now a greater risk to **deflation** in the developed economies. Historically, deflation has been a death knell for the equity markets. Think Japan over the past two decades.

As for specific defensive tactics, we prefer to take a bullet approach. First, we’ll take some of our EAFE-based positions off the table, since these regions are at the heart of today’s economic issues. Second, since some of our opportunistic investments are more targeted and therefore more vulnerable, we’ll take some of them off the table as well. If the S&P 500 breaches its 300-day moving average, we’ll likely take additional measures. If it doesn’t, we’ll watch for additional signs as to direction.

Job #1 is still preservation of principal!

Hoping for a better (or at least calmer) day,

Mark Pellegrino
Managing Principal & Chief Investment Officer
Rainier Group Investment Advisory LLC