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# Memo

**Date:** June 30, 2010

**To:** Investment Clients

**From:** Mark Pellegrino, Chief Investment Officer

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### **Sometimes the Best Offense... ... is a Great Defense**

This has seemed like a recurring theme to us over the past 3 years, but unfortunately that's what bear markets are about.

Yesterday the Dow was down 2.7% for the day to 9,870, the S&P 500 was off 3.1% to 1,041, and the NASDAQ was down 3.9% to 2,135. More importantly, we were given strong signals today of a market vulnerable to continued declines.

Here are some of the **fundamental** concerns weighing on the economy and the markets:

***The threat of deflation is more evident today than ever, which raises the risk of a Japan-style deflationary recession/depression.***

Consistent reports on the Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) certainly show deflation to be the global economy's primary risk. Muted economic growth and debt on top of debt likely make such a deflationary spiral a self-fulfilling prophecy. Given the sputtering economy, the fiscal belt-tightening being discussed within the G20 nations will likely intensify global deflation pressures, with the risk that the deflation will impede, though not necessarily reverse, the move toward fiscal correctness – a spiral to which the

Japanese can certainly relate. What's at stake? As we've discussed in previous pieces, the Japanese economy and stock market have been on their knees for 25 years! While there are many ways in which the Japanese economy is nothing like the rest of the developed world's, there are also some interesting parallels.

***The global debt burden keeps building...***

... and at some point the piper will need to be paid. Greece has agreed to harsh austerity measures, only to find its risk spreads growing ever wider. The markets simply don't believe that Greece will be able to get its fiscal house in order, which means their debt will likely have to be restructured. Ireland has imposed deep cuts in public spending, only to be treated by the markets as a worse risk than Spain, which obviously has its own problems (and doubters). The key takeaway at last weekend's G20 meeting is an acknowledgment of fiscal restraint – specifically, an objective to cut fiscal deficits in half by 2013 and stabilize debt-to-GDP ratios by 2016. Here in the U.S., the private sector debt-to-GDP ratio was 50% in 1950, but is now at 300%. Pressures are building in Washington to start exercising some fiscal prudence too, though there is little sign that Washington is really listening. The administration understands the dangers of premature fiscal austerity, but because various factions within Congress won't authorize additional aid to state governments, that austerity is coming anyway, in the form of budget cuts at the state and local level. That can't be good for an economy already struggling to recover. Most evident (because the markets are telling us so) is a renewed realization that there will have to be some bitter medicine swallowed in order to cure the ills of the greatest credit bubble of our generation. Whatever the medicine – whether swallowed more immediately (and fulfilling the deflationary prophecy) or swallowed later (and perhaps producing an even more dangerous hyperinflation) – the markets appear convinced that neither pill is likely to be good for economic recovery or for the stock market.

***Leading economic indicators are rolling over.***

We saw it in a recent downward revision to first quarter GDP growth. Yesterday we saw it in the June consumer confidence report, which came in at 52.9 versus a downward-revised 62.7 in May. Economists were looking for 62.5. Ordinarily, this index would be at much higher levels at this stage of a recovery. Even though the manufacturing side of the economy seems to be in recovery mode, it's becoming ever more evident that a classic consumer-led recovery is not in the cards, particularly with the employment numbers now turning in the wrong direction. In fact, our prediction of prolonged sub-2% GDP growth seems to be ever more likely. Other evidence shows that each of the last three rebounds in economic growth was smaller than the previous one. One has to wonder whether that has to do with the growing U.S. debt load. So what turns this ship around? Unfortunately, the Fed and the government seem bereft of any new policy options.

***The Housing sector is still in disarray.***

Even though this part of our economy started to collapse in 2007, there is still scant evidence of a bottoming. Not even the Tech sector endured such a long workout phase. New home sales were down 33% in May (to a new record low) and prices are down 10% year-to-date. One in four households with a mortgage owes more than the value of their home. Foreclosures continue higher. Estimates from *The Economist* suggest it will take 8 years to clear out the excess housing backlog, including the shadow inventory. Additionally, banks remain very slow in modifying mortgages, despite tremendous incentives to do so.

***Forward earnings estimates are vulnerable coming into the next reporting period.***

Consensus suggests that second quarter earnings for Corporate America, reported in the next 3 weeks, will be solid. However, the picture is much less clear looking out to third and fourth quarter earnings, also true of 2011. Price-earnings (PE) ratios are reasonable when compared to historical standards, but only if the “E” side of the equation holds up. Given the muted economic backdrop that continues to develop, one can’t count on the “E” being there in the out quarters. Therefore, a downward readjustment in forward earnings estimates looms, and these periods have always been a harbinger of a market likely to be in a downtrend.

The **technical** pictures on the market look equally dicey. Here are the signs:

***The markets have completed a classic “head and shoulders” pattern.***

Looking at the following charts, the first chart shows the last “head and shoulders” pattern for the NASDAQ, with the “left shoulder” forming in the summer of 2007, the “head” in the fall of that year, and the “right shoulder” completing the picture at year-end 2007 into early 2008... and you can see (and remember all too clearly) what happened after that!!! The second chart shows the “head and shoulder” pattern of today. With the NASDAQ closing at 2,135 yesterday, it has decisively broken the right “neckline” at 2,148, clearly a bad sign! This pattern has been confirmed by the other key indices, like the S&P 500, as well.

***Our Capital Preservation Model has given off 2 strong signals.***

Recall in our last piece that when the key benchmarks breach their 300-day moving averages to the downside, that’s a warning indicator of a market likely to decline further. The S&P 500 closed yesterday at 1,041, decisively breaching its 300-day average at 1,056. The other indices are following suit. A second signal, called a “dark cross”, is depicted in the final chart of the S&P 500. A “dark cross” is formed when a benchmark’s 50-day moving average breaches its 200-day moving average, which happened today in the S&P 500 and most of the major averages. You’ll see that the last time we saw this “dark cross” pattern in the S&P 500 was in January of 2008. Need I say more?

What's the likely downside from here? The next level of significant support for the S&P 500 is at 975 (down another 6% from here). However, if we don't hold that level, then 850 offers the next point of meaningful support, which is -18%+ from current levels. Recall that 666 was the ultimate bottom in March of last year. Because it depresses me, I won't go there. Besides we've got a lot of wood to chop before we get there.

With all this in hand, it's time to get more defensive again, so yesterday we took more equity dollars off the table. As has been true during the course of this bear market, our preference was to target those equity positions we feel are more immediately vulnerable to decline. Specifically, we liquidated the following:

- portions of our U.S. Mid Cap positions
- all of our U.S. Small Cap positions
- our remaining Developed Market (non-U.S.) Large Cap positions
- our opportunistic Asia-Pacific and Asian Technology positions

For the moment, proceeds of these sales have been guided to Cash Reserves. Over the days to come, we'll assess follow-through in the equity markets and identify go-to positions for these liquidated equity dollars, likely to include hedged positions and high quality debt vehicles with attractive current yields.

Please contact us if we can provide additional color.

Still hating to be delivering bad news,

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