

# CHARTWELL REVIEW

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## Is It Safe?

Put simply, this is the question on every investors mind, as we've begun to recover from the worst free-fall of asset prices in our adulthood. Our grandparents had the Great Depression, and we've got the Great Recession. We've grown up and grown older on movie sequels and Broadway revivals. But, who'd have thought we'd ever have live through this particular horror show?

Per Table 1, they rang the "market bottom" bell sometime before the beginning of the second quarter. By March 31<sup>st</sup>, we had all heard it. Not everyone believed it, naturally, but the second quarter turned out to be a real doozy for risk assets. Not just large-cap stocks, but emerging market and small-cap stocks. Not T-bonds, but high yield and emerging market bonds.

Looking back over the past twelve months helps put the 2<sup>nd</sup> quarter in perspective. We had an old fashioned "worst-to-first" rally in the quarter, during which time the most beaten up asset classes bounced hardest off the bottom. Some have called it a dead cat bounce, as if to imply the next move for the higher risk asset classes will be to once again underperform. Others use the term junk rally. Active managers who underperformed in the quarter prefer the latter term, because it suggests their holdings lagged for all the "right" reasons. In any case, we've experienced a paradigm shift in sentiment.

Looking at Table 2, it appears domestic fund managers did very well during the quarter. This was indeed the case, but it depended very much on style. Low beta managers, which had been outperforming, lagged quite badly during the junk rally.

Finally, a plug for diversified global asset allocation. Chartwell's base case 65/35 recommended asset mix, which we've managed for just over 15 years, got back on track in the quarter, after a tough nine months.

**Table 1: Index Benchmarks**

<i>Market Index</i>	<u>Trailing Returns *</u>				
	<u>Q2 09</u>	<u>1 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>
S&P 500	16.0	(26.2)	(8.2)	(2.2)	(2.2)
U.S. Large-cap Stocks	14.9	(25.1)	(0.7)	(2.5)	(3.3)
U.S. Mid-cap Stocks	20.8	(30.4)	(9.3)	(0.1)	3.1
U.S. Small-cap Stocks	20.7	(25.0)	(9.9)	(1.7)	2.4
Foreign Stocks ( <b>devel</b> )	25.8	(31.0)	(7.5)	2.8	1.6
Foreign Stocks ( <b>emerg</b> )	34.8	(27.8)	3.3	15.1	9.0
T-bills (3 month)	0.0	0.6	3.0	3.1	3.1
U.S. Aggregate Bonds	1.8	6.1	6.4	5.0	6.0
High Yield Bonds	23.2	(3.5)	1.8	4.1	4.4
Global Bonds, unhedged	3.5	4.0	7.8	6.1	6.5
<b>CPI, annualized</b>	<b>3.3</b>	<b>(1.5)</b>	<b>2.0</b>	<b>2.6</b>	<b>2.7</b>
Dow UBS Commodity	11.7	(47.1)	(8.3)	(0.2)	7.2
Chartwell Global 65/35	16.1	(13.5)	(0.4)	4.2	4.0

**Table 2: Average Mutual Fund Returns**

<i>Fund Category</i>	<u>Trailing Returns *</u>				
	<u>Q2 09</u>	<u>1 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>
U.S. Large-cap	16.9	(26.4)	(8.0)	(1.7)	(1.0)
U.S. Mid-cap	18.8	(28.1)	(7.9)	(0.4)	3.2
U.S. Small-cap	22.4	(24.8)	(9.1)	(1.1)	4.4
International Lg. Cap	24.7	(31.3)	(7.4)	2.9	2.6
International Sm. Cap	32.6	(30.4)	(7.8)	4.1	6.2
Emerg. Mkt. Equity	34.1	(29.6)	1.6	13.9	9.2
Balanced/Hybrid	12.2	(15.2)	(2.9)	1.0	2.3
General Bonds	6.8	1.9	4.4	3.8	5.2
Government Bonds	(1.8)	6.5	6.8	5.2	5.8
High Yield Bonds	17.8	(6.7)	0.2	2.8	3.2

\* Annualized trailing returns for periods ending 6/30/09.

## “We Need a Bigger Boat”

Real GDP is estimated to have declined at a rate of 1% in Q2, compared to Q1. This is a smaller drop than had been expected, but the 1<sup>st</sup> quarter was revised downward by the difference. Our country has now endured four straight quarters of declining real GDP, during which the overall economy has contracted 4%. This is our deepest recession since World War II.

Gross private domestic investment tracks total capital spending by businesses on buildings, equipment and inventory, and by individuals on housing. After personal consumption, it is the largest component of GDP. This has declined on a quarter/quarter basis in 10 of the past 12 quarters. In the 1<sup>st</sup> quarter, total private investment fell at a 39% annual rate. In the 2<sup>nd</sup> quarter, it continued to fall, but at a slower 9% annual rate. The slower rate of decline is interpreted by many economists as a sign the bottoming out process has begun.

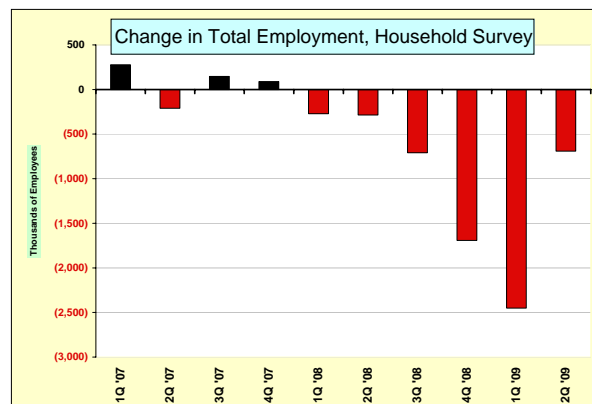
**Table 3: Breaking Down Real GDP**

Factor	% Change from Preceding Period (seasonally adjusted at annual rates)			
	3Q '08	4Q '08	1Q '09	2Q '09
<b>Real GDP Growth</b>	<b>(2.7)</b>	<b>(5.4)</b>	<b>(6.4)</b>	<b>(1.0)</b>
<b>Nominal GDP Growth</b>	<b>1.4</b>	<b>(5.4)</b>	<b>(4.6)</b>	<b>(0.8)</b>
<b>Disposable Income</b>	<b>(4.2)</b>	<b>(1.8)</b>	<b>(0.4)</b>	<b>4.6</b>
Personal Consumption	(3.5)	(3.1)	0.6	<b>(1.2)</b>
Private Investment	(6.9)	(24.2)	(50.5)	(20.4)
Fixed - Businesses	(6.1)	(19.5)	(39.2)	<b>(8.9)</b>
Fixed - Residential	(15.9)	(23.2)	(38.2)	(29.3)
Chg. In Inventories (\$)	<b>(37)B</b>	<b>(45)B</b>	<b>(127)B</b>	<b>(156)B</b>
Exports	(3.6)	(19.5)	(29.9)	(7.0)
Imports	(2.2)	(16.7)	(36.4)	(15.1)
Government Spending	4.8	1.2	(2.6)	<b>5.6</b>

One area promoting growth during the quarter was the continued decrease in our trade gap. Exports declined, but imports dropped much faster than expected – even though oil imports were up in \$ terms. Domestic demand has been woefully weak, and businesses are simply not stocking their shelves with imported goods.

Overall inventory liquidation has become a major element in this contraction, and occurred at an even faster rate in the 2<sup>nd</sup> quarter than in the first. The need to re-build business inventories is expected to be a substantial contributor to economic growth. However, if the build-up comes from increased imports, the positive impact will be mitigated. And, its not entirely clear inventories need that much re-building. The latest available data indicates total business inventories are down 8% from May 2008, but business sales have declined 18% over the past year. The inventory/sales ratio has risen to the very elevated level of 1.42, after spending four years in the 1.25-1.30 range.

Government spending has been the only consistent recent contributor to GDP growth. This has come at an unprecedented price. The federal budget deficit this fiscal year is estimated to hit \$1.75Trn, well in excess of 10% of GDP and the largest deficit since WWII.



Adjusted for seasonality, **non-farm payrolls** declined by 1.3 million persons in the second quarter, after dropping 2.1 million in the first. Total employment (per the household survey) dropped much more sharply in the 1<sup>st</sup> quarter, but less so in the 2<sup>nd</sup> (see chart). While most economists expect employment to continue falling as businesses right-size themselves in order to protect operating margins, the slowing pace of employment decline is seen as an early positive sign.

The 4<sup>th</sup> quarter's sharp drop in prices is fading rapidly in the rear view mirror. **Consumer prices**, including food and energy, rose at an annualized rate of 3.3% during the second quarter, after rising at a rate of 2.2% during the first quarter. Food prices (16% of the index) declined 1.3%. Transportation costs (15% of the index) jumped 20% p.a., as fuel prices rose at an 80% clip. Housing costs (43% of the index, and not to be confused with prices in your neighborhood) declined 0.6%. Producer Prices also jumped in the second quarter, with most of the advance seen in June. Finished goods prices rose at a 9.5% annualized rate in the quarter, and have climbed at a 4.2% annual rate this year.

Our country's **industrial production** declined at a 12% rate during the 2<sup>nd</sup> quarter, compared to a 20% drop in the 1<sup>st</sup> quarter and a 13% drop in Q4. At just 95.4% of its 2002 average, total production is down 13.6% since last June. Manufacturing production has declined for 6 straight quarters, although the 10.5% drop in Q2 was about one-half the decrease recorded in Q1. The capacity utilization rate for total industry also continued to slip, falling to 68%. This is the lowest point for the measure since tracking began in 1967. The factory operating rate also declined further in the quarter, to a 60-year low of 64.6%. It's really little wonder that investment spending by businesses has dropped at double-digit rates for four straight quarters.

## **“Spread” Bonds Continue to Excel**

Last quarter, we observed that those exhausted by the stock markets’ volatility had a very attractive alternative in bonds. One could capture handsome excess spreads away from the Treasury sector, with limited credit risk. For those with a greater risk appetite, perhaps more optimistic about our economic recovery, junk bonds offered double-digit return potential. Conversely, those who were pessimistic about the domestic investment scene and our ability to finance our way out of the mess we’re in, could gravitate to international bonds, and bet against the US Dollar. Finally, everyone who wanted to buy Treasuries, had probably already bought ‘em, and Treasury bond prices would continue to falter compared to non-Treasury sectors, especially as the Fed’s were issuing new bonds in unheard of quantities.

**Table 4: Bond Market Total Returns**

<i>Bond Index</i>	<b>2Q ‘09</b>	<b>YTD ‘09</b>	<b>2008</b>
<b>Aggregate Bonds</b>	<b>1.8%</b>	<b>1.9%</b>	<b>5.2%</b>
3-mo. T-bills	0.1	0.1	1.8
US Treasury, long	(7.1)	(12.0)	24.0
U.S. TIPS, 1-10 yrs	0.6	6.5	(2.4)
Agency MBS	0.5	2.8	8.5
CMBS	12.0	10.4	(22.7)
ABS	7.6	15.8	(12.7)
Inv. Grade Credit	8.8	6.9	(3.1)
High Yield Credit	23.2	29.4	(26.4)
Non-US Global, Hedged	0.0	0.1	8.0
Non-US Global, Unhedged	5.1	(1.0)	11.4
Emerging Local Markets	9.9	5.6	(3.9)

From our lips to investor’s ears, as Table 4 sets out. All government bonds, which had performed so well in 2008, continued to struggle in the second quarter unless denominated and held in foreign currency. The weakest market sector, by a wide margin, was longer maturity US Treasuries, just the area that had rallied so hard in 2008. Conversely, the second quarter saw 2008’s “worst” bond sectors continue their moves to “first” in 2009. The quarter’s sharpest positive swings were in arguably the riskiest areas - high yield corporate and commercial mortgage bonds. Both are almost certainly headed for rougher times fundamentally, as default rates rise, but unprecedented price weakness in 2008 had left them trading at very high current yields, relative to their history and Treasuries.

The rotation out of safety assets and into risk assets notably accelerated in the second quarter. Table 5 isolates the excess returns achieved from spread bonds (non-Treasuries) for the quarter and the year-to-date.

**Table 5: Spread Bonds Earned Excess Returns**

<i>Excess Returns versus Treasuries, duration-adjusted (%)</i>			
<i>Bond Sector</i>	<b>2Q ‘09</b>	<b>YTD ‘09</b>	<b>2008</b>
<b>Lehman Aggregate</b>	3.6	4.3	(7.1)
US Agencies	1.5	1.9	(1.5)
Agency MBS	1.2	3.0	(2.3)
Comm’l MBS	14.4	12.8	(32.7)
Asset-Backed bonds	7.7	17.0	(22.2)
Invest. Grade Credit	11.7	11.5	(17.9)
High Yield Credit	25.0	32.9	(38.3)
Primary Non-U.S.	3.8	5.8	(6.4)
Emerging Markets	15.8	22.3	(28.4)
AAA MBS (subprime)	8.8	(33.0)	(40.1)

Every non-Treasury bond sector outperformed by more in Q2 than it had in Q1. Similar to the 1<sup>st</sup> quarter, most of spread bonds’ second quarter outperformance was shoehorned into the first half of the period. The Aggregate index beat relevant Treasuries by 2.3% in April and 1.7% in May. Corporate bonds were strong in April and May, as BBB’s beat by almost 6% each month. Bonds of financial institutions led the investment grade credit sector upward throughout the second quarter, ultimately gaining 14.7%.

Most of the securitized bond sectors (which make up nearly half of the Aggregate benchmark index), were strong in April and May, before steadying in June. Agency-backed mortgage bonds (representing 90% of securitized bonds) outperformed by nearly 2% in April, as the Federal Reserve’s mortgage purchase plan continued to be very supportive of the sector.

The big surprise in the securitized arena was the outperformance of non-agency securitized bonds backed by home loans, after prices had dropped over 35% in the first quarter. The remainder of the ABS sector again enjoyed superior outperformance.

The big surprise in the credit arena? Chrysler and GM were shepherded through bankruptcy proceedings by the US government, which in the process totally ignored 200+ years of contract law regarding bondholder seniority and collateral position. And investors are still buying high yield bonds.

## **U.S. Equities: Shooting fish in a barrel**

The second quarter saw global stock markets decisively break from the devastating collapse that began following the failure of Lehman Brothers last September, and which appears to have ended on March 9<sup>th</sup> with an intraday low of 666 for the S&P 500. The S&P index rose 15.9% in the calendar quarter, and was 38% off its low through the end of June.

**Table 6: U.S. Equity Market Size/Style Returns**

Periods ending June 30, 2009; % returns				
	<u>2Q '09</u>	<u>YTD '09</u>	<u>Trailing Periods</u>	
			<u>1-Year</u>	<u>3-Years</u>
<b>Growth</b>				
Large Cap	14.7	9.7	(25.1)	(4.4)
Mid Cap	20.7	16.6	(30.3)	(7.9)
Small Cap	23.4	11.4	(24.8)	(7.8)
Micro Cap	29.9	18.5	(24.5)	(11.7)
<b>Value</b>				
Large Cap	15.1	(5.0)	(28.4)	(11.1)
Mid Cap	20.9	3.2	(30.5)	(11.1)
Small Cap	18.0	(5.2)	(25.2)	(12.1)
Micro Cap	20.3	(4.3)	(27.2)	(15.6)

Per Table 6, the value effect (*Value* > *Growth*) was once again *not* evident during the quarter across the capitalization spectrum. Large and mid-cap growth indices matched value-oriented ones. Returns from small and micro-cap growth stocks substantially exceeded those from value.

Growth has sharply outperformed value in the 2009 rally to date. Yet, the two styles have generally matched returns over the past twelve months because value outperformed during the worst of the market breakdown last year. Cumulative returns over the past three years clearly favor growth indices.

The size effect (*Small* > *Large*) was clearly evident during the quarter as investors continued to seek out higher beta stocks that had been oversold during the 4<sup>th</sup> quarter's credit crisis. Thus, smaller growth stocks were the most heavily bought.

**Table 7: U.S. Sector Returns in the 2<sup>nd</sup> Quarter**

<u>Sector</u>	<u>Large-cap Returns (%)</u>		<u>Small-cap Returns (%)</u>	
	<u>2Q '09</u>	<u>YTD</u>	<u>2Q '09</u>	<u>YTD</u>
Financials	32.1	(3.2)	11.8	(15.3)
Industrials	20.2	(4.2)	24.3	(1.6)
Info Tech	19.9	24.7	26.7	27.1
Cons. Disc.	18.9	10.4	22.5	20.9
Materials	16.0	15.1	29.7	13.5
Utilities	12.1	(0.7)	8.4	(3.5)
Energy	11.6	(0.6)	31.4	11.5
Cons. Staples	9.7	(1.8)	21.3	10.6
Health Care	8.9	1.0	20.1	10.9
Telecom Svcs	4.2	(0.7)	10.8	7.5

All 10 of the S&P 500 sectors produced positive returns for the quarter, with Financials clearly exhibiting the strongest performance. In direct contrast to the first quarter, investors bet that the early signs of economic recovery would significantly help out these beaten down companies. The US government's "stress test" results, published in May, were also interpreted positively by investors. The Financial sector's 2<sup>nd</sup> quarter strength fully explained why large/mid cap value style indices were able to match growth indices during what was otherwise a growth rally. Similarly, weak YTD performance in this sector largely accounts for why value styles have underperformed in 2009.

The quarter's rally was not confined to Financials, as seven of ten sectors within the S&P produced double-digit returns. Telecom was the laggard, but still managed to gain 4%. The Information Technology and Materials sectors have produced the best YTD returns, as these companies seemed poised to benefit from strong balance sheets, low debt, or higher commodity prices. The rally in Tech stocks, which comprise approximately 30% of growth style indices, has been the driving factor in that style's leadership in 2009.

In the first quarter, "growth" industrials, materials, financial services, and consumer discretionary stocks, significantly outperformed (+10% or more) stocks of the same sectors that were slotted into the value indices. Hence the term "dash to trash." In the second quarter, this differential was not observable. Pure sector allocation really drove performance, not style.

### **International Equities – Global Green Shoots**

International developed markets posted their highest quarterly return since 1986 during the second quarter, with the MSCI EAFE index jumping 25.9%. The stage for this powerful rally was set because of the market's virtual collapse during the previous nine months, which drove stocks to the bottom of 25-year valuation ranges.

Initial signs that the global banking system had stabilized took the depression scenario off the table. Many countries continued to report negative economic growth, although the slowing rate of decline led investors to believe the worst had passed. This is the so-called second derivative effect (aka, "green shoots").

Regional markets were all strong during the second quarter. Developed Europe advanced 25.9% in \$ terms, and the Pacific region ex-Japan was up 32%. The Pacific region has clearly led 2009's global rebound.

The Japanese economy contracted sharply for a fourth straight quarter, making this the deepest recession for the country in 50 years. Despite this news, equity markets gained 23% as industrial production rebounded and consumer spending proved stronger than expected.

**Table 8: International Markets Returns**

<i>(index level = net)</i>	U.S. Dollar Return %		Local Currency Return %	
	<b>2Q '09</b>	<b>YTD</b>	<b>2Q '09</b>	<b>YTD</b>
<b>EAFE + Canada</b>	<b>25.9</b>	<b>8.4</b>	<b>17.6</b>	<b>6.6</b>
- EAFE Growth	21.7	6.7		
- EAFE Value	30.3	10.2		
- Europe	25.9	7.7	16.1	2.8
- Pacific, ex-Japan	32.0	29.1	18.9	17.3
- Japan	23.1	2.7	20.2	9.3
- United Kingdom	26.6	13.1	10.2	(1.3)
<b>Int'l Small Cap</b>	<b>34.4</b>	<b>22.5</b>	<b>25.5</b>	<b>19.9</b>
<b>Emerging Mkts</b>	<b>34.8</b>	<b>36.2</b>	<b>24.6</b>	<b>29.8</b>
- EM Asia	34.0	36.2	28.7	36.0
- EM Europe & ME	34.3	29.6	24.0	27.4
- EM Latin America	38.6	45.4	21.4	26.5
- EM BRIC	41.2	48.1	31.5	38.0

As they did domestically, international small cap stocks considerably outperformed large cap stocks, gaining 34% in the quarter. They are up nearly 23% in 2009.

The best and worst performing countries in Europe were Greece (gaining 39%) and Ireland (gaining only 6.6%, as its economic problems are judged to be severe). Australia and New Zealand jumped 28% and 24%, respectively, buoyed by rising consumer confidence, stabilization of their housing markets, and increasing commodity prices.

Certain smaller country markets are dominated by a particular sector. The best performing developed market country was Singapore, gaining 46% on the back of the financial sector recovery. Sweden (+35%), is dominated by financial and cyclical sector exposures. Sector influence was also evident when looking at the weaker performance of Switzerland (+16%) which is dominated by pharmaceutical and food companies.

For US investors, currency exposure played a primary role in 2<sup>nd</sup> quarter international returns. The currency effect was +8.6% for developed market investments, and +10.3% for emerging market investments. The euro climbed 5.6% and the Japanese yen rose 2.4%. The best performing currencies for the quarter were the Aussie \$ (+16.4%), the pound (+14.9%) and the NZ\$ (+13.5%). The currency effect for developed market investors has been just over +3% in 2009, and +6% for emerging market investments. This contrasts with the last half of 2008, when global commodities and international currency prices nose-dived.

Emerging markets soared in the second quarter, gaining 34.8%. Growth in domestic consumption has restored conviction in the “decoupling” theory. Many again expect emerging markets will continue to grow strongly

despite economic sluggishness in developed markets. Emerging markets in Asia (+34%) were relative laggards compared to Eastern Europe (+38.6%) and Latin America (+38.6%) results.

The BRIC countries (Brazil, India, China and Russia), which were hard hit during 2008's market collapse, have come roaring back this year, led by India's amazing 60% second quarter return (+57.5% overall in 2009). This market benefited from positive sentiment surrounding the decisive election victory of the ruling coalition in May. China gained 36% (+38% in 2009), as continued expansion in manufacturing and rising retail sales bolstered confidence that the government's stimulus plan is working. Its GDP was reported to have grown 8% in the quarter.

Brazil climbed 41% in US\$ terms (+59% in 2009) after bank lending rebounded and interest rates fell to pre-financial crisis levels. Its currency gained 17% versus the US\$. Finally, the commodity-rich South African stock markets were up 31% (23% gain by the currency), and Mexico advanced 36%.

The global equities rally has been broad-based from a sector perspective. Every sector posted double-digit gains in the quarter, although cyclical and “lower quality” companies were the leaders. Sectors that were the weakest performers in the prior six months posted the largest gains – financials +39%, materials +26% and industrials +24%. The laggards were the defensive sectors of healthcare, telecommunications and utilities (up 10%, 12% and 14%, respectively). *Year-to-date*, firms in the pro-cyclical materials, information technology, and consumer discretionary sectors have widely outperformed. We think this evidences a clear shift in investor sentiment, because over the prior 12 months the outperforming sectors had been the most conservative ones – health care and telecom.

**Table 9: Global Sector Returns in 2009**

<i>As of June 30, 2009</i>	Large Cap Primary Market		Small Cap Extended Market	
	<b>2Q '09</b>	<b>YTD '09</b>	<b>2Q '09</b>	<b>YTD '09</b>
<i>(GICS Sector)</i>				
Financial Services	38.8	8.9	20.5	(3.0)
Materials	25.8	<b>22.8</b>	33.1	22.1
Industrials	24.1	3.5	30.5	9.0
Cons. Discretionary	22.7	<b>14.2</b>	29.3	21.9
Info Technology	20.8	<b>22.6</b>	30.9	28.7
Energy	16.5	6.9	34.5	26.3
Cons. Staples	14.7	1.6	22.6	6.0
Utilities	14.0	(6.0)	13.9	0.3
Telecom Services	12.4	(3.1)	21.5	18.4
Health Care	10.0	(1.0)	21.1	10.5

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## **Heads Up**

Investor markets have begun to recover, even though the economy has not (yet). It is looking like US GDP will be up in the 3<sup>rd</sup> quarter. The Conference Board reports seven of the ten indicators that make up its Leading Economic Index increased in June, and that the index has increased for three straight months.

Unfortunately, that is not the same as saying we'll soon be in the midst of a robust recovery. It's not easy to see what the growth engines would be. Businesses will soon stop *cutting* investment and inventory spending, but that only adds a one-shot to the GDP numbers. The US consumer (70% of GDP) can't be the engine of spending growth and simultaneously repair their personal balance sheets, unless real wages rise. This leaves net exports and the government, with the latter really only a re-allocation scheme.

Nonetheless, capital markets are clearly demonstrating encouraging signs of normalcy –

- Credit markets have eased from last year's severe dysfunction, and credit spreads have narrowed;
- Firms are issuing debt without government aid;
- Interbank lending rates have returned to pre-Lehman levels of 0.5%;
- Nonfinancial and financial credit default swap premiums are approaching pre-Lehman levels.

In essence, liquidity has returned to investor markets. With government programs pumping trillions into the markets since last year, there is now some concern that we are in danger of getting ahead of ourselves. Market finances have improved dramatically, and credit spreads have come in, but concern is centered on the current level of national indebtedness relative to our collective income (i.e., GDP). It is far higher than it's been in the past 60 years, as are our expected fiscal deficits. Both will have to be unwound, and will take a long time to resolve. Rising inflation could help "solve" the problem, but only by trashing the underlying value of debt securities and much else.

To sustain the equity rally, stock markets will ultimately need to see earnings recover. Fundamentals must catch up to the price rally, or prices will fall back to meet fundamentals. Given these circumstances, it would not be surprising to see international markets, in particular, pause and retrench. If you look at historical performance from a 1-year perspective, international markets are not that far ahead of domestic. Emerging markets are up big in 2009, but only because they were crushed in 2008. Nonetheless, from a relative current valuation perspective, emerging markets **are** trading at the high PE, followed by developed markets, US small caps, and US large caps. The most expensive region is Asia ex-Japan, which is also the fastest growing.

The bond sector is also particularly vexing at this juncture. Differential returns from non-government sectors have been rather unbelievable this year (see Table 5), as investors aggressively bid up the prices of what were clearly undervalued securities. Now, US investment grade corporates (for example) at option-adjusted spreads of 2.7-3.2% aren't quite the slam dunk they were with year-end spreads in the 5.5-6.0% range. Riskier areas, like high yield corporates, CMBS, home equity ABS, and emerging markets, continue to offer attractive relative yields, but who knows what their cumulative default rates will end up at in this cycle. For our part, we still favor hefty doses of investment grade corporate and emerging market bonds, but acknowledge that the easy short term money has already been made.

Finally, while liquidity has receded as a bright-line issue, we are now concerned about future inflation from two perspectives –

- Over the longer term, record-setting levels of government spending will propel inflation pressures higher. If (when) interest rates follow suit, bond portfolios could be hit hard;
- If the global economy does rebound smartly, whether we're the engine or China is, commodity price inflation is likely to follow. This will further hold back what in this country is expected to be a fairly tepid recovery (i.e., stagflation).

All this makes setting and sticking to a long-term investment strategy very difficult indeed. The chances of being whipsawed are very high. We talked about this at some length in last quarter's "Review." All of the same issues remain in play, and have been made even more opaque by the second quarter's dramatic rebound in risk asset prices. Heightened market volatility has been great for prop trading desks, but it's anathema for institutional plans which meet only quarterly. Strategic asset allocation, with its reliance on normally distributed return patterns, and stable asset class correlations, is giving way to tactical trading models.

So, what's our heads up?

- Plan sponsors need to develop, and keep updated, a non-passive "investment view" on matters like inflation, credit, the US\$, and equity risk premiums.
- Portfolios need to get invested around that specific view, and then be actively re-balanced to continually reflect the current view. In a higher volatility world, allocation "drift" costs too much.

**Sell high, buy low. See you next quarter!**

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