

*Wilkinson O'Grady & Co., Inc.*  
499 Park Avenue  
New York, New York 10022  
Telephone 212 644-5252  
Fax 212 644-5342  
[www.wilkinsonogradyc.com](http://www.wilkinsonogradyc.com)

**WILKINSON O'GRADY**  
*Global Asset Management*

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While the S&P 500 Index has declined 32.6% year-over-year as of the end of May, the stock market has rallied from its lows of early March helped by the drumbeat of constant new government actions. This rise, despite the longer-term deterioration, has made many investors giddy about a new bull market. Professional opinion and advice in four months has swung from extreme bearishness to solid optimism. Certainly governments are throwing a vast amount of money at the problem and it is significant and welcome news that the rate of the decline in the economy is slowing. But we regard this rise as most probably a bear market rally that will hit a wall of reality by this fall.

Business conditions are no longer declining as rapidly as they were. Even so, investors' expectations of fairly rapid recovery seem too optimistic. The positive case surrounds the many actions governments, central banks and treasury departments around the world are taking to stem the tide of sinking economic performance and debt deflation of asset values. While it's true that all this spending will have some favorable economic impact in supporting consumption and liquifying financial markets, there remain serious unanswered questions as to whether our nation can borrow its way out of this crisis with more debt and without adverse consequences. The history of other burst credit bubbles as well as common sense clearly suggests that these periods take a longer time to heal.

Stock markets around the world had dropped by roughly 50% into early March from their highs in 2007, therefore a rally didn't surprise us. Neither does it surprise us if it lasts into late summer nor that the financial media declares this to be a new bull market. We have had other substantial rallies going back to 2007, each of which was heralded as a new bull market, but each of which succumbed to the serious underlying problems of debt. In the meantime, remember how often the news has previously turned prematurely bullish throughout this bear market. And remember how quickly in a bear market hard-earned gains can disappear in a portfolio if one is overexposed. The risks remain high.

While this rally has lasted longer than the others, it does not mean we are out of the woods. This is no ordinary global recession. What the financial and economic system is experiencing is a changed secular financial environment that ultimately involves systemic deleveraging or the need to pay down debt by the private sector. 2007 represented the peak of a 40 to 50-year credit cycle of historic proportions, which fed consumption far beyond its natural limits. It led finally to gross overindebtedness and a zero savings rate. Total debt to GDP rose to 370% and will go higher before declining. A healthy level of total debt as a percentage of GDP might be 160%. The only other period in U.S. history with similar levels of indebtedness was 1933 when total debt to GDP hit 300%. Japan in 1980 also hit 300% and subsequently that country has been caught in a 20-year deflation. We urge humility before this debt problem because throughout this cycle, from the Chairman of the Federal Reserve on down, there has been widespread underestimation of the

destructive power to asset prices and the economy when a debt deflation gets underway. We believe we will see more credit problems ahead.

Conventional wisdom about the economy has moved suddenly to an expected economic snap back in GDP with growth of 2% by the fourth quarter and 3.5% in 2010. These would be terrific numbers. Unfortunately, they are wishful thinking in our mind and it is more likely that the recession will last into the fourth quarter and that the recovery in 2010 and 2011 will be extremely slow and shallow. Conservatively, somewhere around \$15 trillion of consumer net worth has been lost through declining stock prices and house values up to this point. This loss of net worth, along with increases in personal income taxes and a growing frugality, will inhibit consumer spending for years and be a drag on economic growth. This implies slow growth in earnings, slower than the last ten years.

When some economists forecast growth of 3.5% next year, we ask from where in the economy is that growth going to come other than government? 70% of the economy is consumption. 2010 in our view will probably be more like 2002, when slow growth and fear of deflation for corporate profits kept many stocks under pressure until early 2003, even though the recession ended in 2001.

Naturally, we have great long-term concerns about the inflationary nature of our government's policies stemming from increased spending, taxing and regulating. Even so, over the intermediate term, the next one to two years, deflation still appears to be the greater risk as unemployment climbs to 10% and operating rates in manufacturing are under 70%. The current environment is all about overindebted balance sheets that have to be repaired. A debt deflation, as investors should widely recognize, is extremely dangerous to asset valuations and, therefore, to income, consumption and thus to growth.

It is most likely that the savings rate will trend up towards 10%, just as unemployment is trending up to 10%. House prices continue to fall nationally and the financial crisis cannot truly end until house prices stabilize. This to us is the critical, central problem for all the various financial programs to come to grips with. Mortgage rates are reasonably low and affordability of houses is historically high, but inventories are large and the inclination to buy is low. House prices may fall another 10%-15% this year before finally hitting bottom sometime in 2010.

Space doesn't permit us to touch on all the factors shaping this historic financial dislocation, but let us point out that Europe and Japan remain in deep recession. Some economies, like our own, are not declining as fast as previously. Yet much of the world economy has been dependent upon the U.S. consumer continuing to borrow to spend. That is over. We will save for another time a discussion of the continuing effect on asset values of an expanding government, more regulation and higher taxes, all of which are clearly in the cards. These are factors that can dramatically change the valuation of assets.

Over a 25-month period we shifted investment objectives beginning in May of 2007 in response to the deepening credit crisis and its impact on corporate earnings from *growth of capital* to *preservation of capital*, the posture we continue to emphasize. The year ahead still bears significant risks, especially this fall. Corporate earnings for 2009 have dropped very sharply to somewhere around \$40 for the S&P 500. At 900 and above in that index, stocks are certainly no bargain and still have

significant downside risk unless inflation and growth quickly appear. Earnings for the S&P 500 for 2010 may be \$50, leaving the market at a PE ratio of 18X. The banking crisis is hardly over, though progress has been made. For investors, the issue is how can you have an expansive private credit system without some semblance of a stable financial industry?

In summary, we don't believe prices in the equity markets reflect the economic and financial challenges ahead as yet, but instead are rallying short term to government hype and hope of a quick recovery along with a short-term shift in speculative emotion. As you know well, we like nothing better than to invest optimistically. And, we are not without optimism that time will heal all wounds.

The short-term implication is that with a lower allocation to stocks, portfolios are not rising as fast in the recent quarter as the S&P 500, but of course portfolios did not decline as much as the market either over the most recent several quarters. Over the last two years, portfolios have declined significantly less than the S&P 500. We have every confidence that there will be plenty of opportunities to make money when the risk/reward ratio seems more favorable and the risk of major loss to capital diminishes.