

According to Wikipedia, ***ceteris paribus*** is a Latin phrase that literally translates as “with other things the same.” Probably the most common paraphrase of this translation is, “all other things being equal,” particularly in the world of economics. The entry goes on to describe, “A *ceteris paribus* assumption is often fundamental to the predictive purpose of scientific inquiry [and] it is usually necessary to rule out factors which interfere with examining a specific causal relationship.”

Economics is considered a behavioral science, not a “hard” science like chemistry or physics, partially since testing and proving causality in economic relationships is almost impossible. Though economists rely on equations and formulas to predict how changes in inputs will impact outputs like growth or employment, the results are still just estimates, not scientific laws. The movements between economic variables like unemployment and consumer spending are sometimes inconsistent, and as we wrote about in our last research piece “*Market Therapy*”, greatly influenced by investor psychology. In this vein, Friedrich Hayek, co-winner of the 1974 Nobel Prize in Economics, attacked the idea of “scientism” – the imitation of physical science methods in the social sciences. In his Nobel acceptance speech Hayek stated, “... in the study of such complex phenomena as the market, which depend on the actions of many individuals, all the circumstances which will determine the outcome of a process... will hardly ever be fully known or measurable.”

Omnibus Rebus Consideratis – All Things Considered

As we listen to economists on financial news channels and read “expert” opinions, it seems that most pundits are zeroing in on a particular relationship that supports their prediction of either, a) the dawn of the next great bull market, or b) the worst yet to come in the current recession. Some postulate that if the S&P 500 is trading at a multi-year high on valuations after such a quick run up, they would expect the market to correct from here. Others claim that if the employment situation improves, they would expect home foreclosures to subside, easing the burden on consumers and thus extending the rally in equities. However, if the wealth destruction experienced in the past two years permanently changes the way Americans view spending and saving going forward, then equity markets will have a rocky road ahead. In isolation, an argument can be made for almost any market forecast. All of these theories have some predictive power, *ceteris paribus*. In our view, however, the changeability of investor psychology and unpredictable timing of the flow-through of government stimulus muddy the waters. We, like everyone else, do not have a crystal ball, and must position our clients to benefit from the several ways the markets could play out in the months ahead. We broadly discuss the current landscape, the positive developments we have seen, with a few notes of caution, and how our clients can participate in the upside, yet be protected on the downside.

Status Quo – The Current Situation

We were never in the camp that believed the second coming of the Great Depression was upon us, and we are not now at the other end of the spectrum confident in a sustainable bull market. Equities are not the only game in town, though, and our clients have benefited from our diversified allocations while still mitigating risk. Admittedly, U.S. equities have shown more strength than we thought (and still think) was warranted by the economic fundamentals. A development we wanted to see was for the equity market to again become a forward-looking indicator instead of a day to day reactionary mechanism. We *do* believe that the markets are now a forward-looking gauge, but instead of only considering fundamentals they also seem to be pricing in an implied government insurance policy. Some are calling this government stance a moral hazard, while others depict it as a necessary risk-premium-bridge to the other side of the recession. Regardless of your view, many investors clearly feel confident that the government has put a floor under the crisis. Without the confidence of a government backstop, could the Financial Select Sector SPDR ETF (XLF) have rallied the more than 140% it has since its March low?

In our view, the tug of war in the markets now comes down to whether the “less-bad news” view can hold on long enough and steadily enough for real growth to resume before the low-growth/damaged consumer view gains critical mass. Currently, the less-bad-news-is-good-news sentiment is propping up equities, and there are gains to be made in risk-bearing assets. We believe it won’t take another extraordinary Lehman Brothers-type event to knock us off this path, but there could be a slow, grinding down of expectations over time. Our medium-term outlook for the economy is still anemic, resulting in low-single-digit returns likely for equities, but we believe the extreme risks that prompted us to move to the safety of short-term Treasurys in mid-2008 have subsided. Below are some of the developments that are encouraging us to move our clients out of an ultra-defensive portfolio allocation.

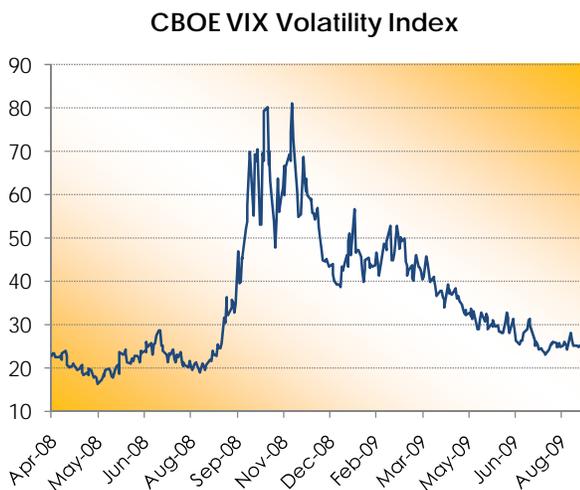
Differentiation – The decision to halve our equity positions in July 2008 and move to cash equivalents was an unusual (yet beneficial) move. We believe in the long-term risk control benefits of diversification, yet through our scenario analysis we know that

Correlation with US Large Cap Equity		
	History	2008
US Large Cap Equity	1	1
US Small Cap Equity	0.78	0.96
International Equity	0.70	0.90
Emerging Markets Equity	0.65	0.84
US Fixed Income	0.21	0.35
REITs	0.52	0.82
Real Assets	0.17	0.39
Inflation Protected Securities	0.08	0.53
Cash	0.11	-0.26

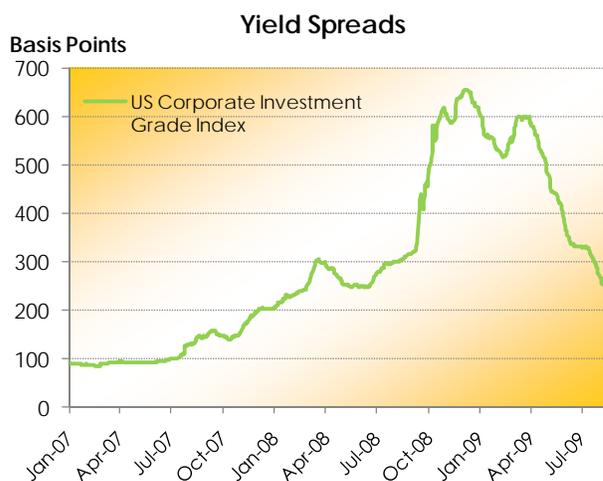
History: 1988-July 2009

asset class correlations go up when times get tough. In other words, the baby gets thrown out with the bathwater. Last year was an extreme event, and the only diversifying asset class in 2008 proved to be cash. Now that we are seeing some differentiation in performance across asset classes, and also across equity sectors, we are gradually putting cash to work to rebuild our long-term target allocations.

Lower Risk Premiums – The extremes we saw last year in credit spreads and the VIX volatility index have stabilized, signaling a renewed investor appetite for risk. This shift toward acceptance of risk is also a positive sign for higher-volatile equity investments such as emerging markets. If we were to see some reversal in investors’ risk appetites, however, this could be a drag on emerging equity markets, possibly pulling down developed markets with them.



Source: CBOE



Source: Merrill Lynch, Option Adjusted Spread

Opportunity Cost – Investment choices are tradeoffs, and so we have to look at the landscape from a relative point of view. The yield on the SPDR Barclays Capital 1-3 Month T-Bill ETF is under 0.1%, and the iShares Barclays Short Treasury Bond ETF is about 0.3%. The best current rate on a three-month CD is about 1.5%, and for that an investor gives up liquidity. While it may seem safer to sit on the sidelines, the potential opportunity cost to do so is large, particularly if inflation is remotely on the horizon. We believe that with Treasury yields so low across the curve, and higher rates more likely than lower ones, the best step away from cash would be into municipal bonds, which are currently yielding as much as corporate on a tax-equivalent basis.

Information on Select iShares ETFs	iShares Barclays Short Treasury Bond ETF (SHV)	iShares Barclays 7-10 Year Treasury Bond ETF (IEF)	iShares S&P California MuniBond ETF (CMF)	iShares S&P National Muni Bond ETF (MUB)	iShares iBoxx \$ Investment Grade Corporate Bond ETF (LQD)
Distribution Yield ¹	0.30%	3.41%	3.86%	3.60%	5.60%
30-Day SEC Yield ²	0.26%	3.34%	3.73%	3.35%	5.18%
Avg. Yield to Maturity	0.36%	3.32%	3.86%	3.56%	5.13%
Tax Equiv. Distribution Yield ³	0.30%	3.41%	6.55%	5.54%	5.60%
Tax Equiv. 30-Day SEC Yield ³	0.26%	3.34%	6.32%	5.15%	5.18%
Weighted Avg. Maturity	0.34 yr	8.42 yr	9.55 yrs	8.19 yr	12.39 yr
Weighted Avg. Coupon	3.59%	3.94%	4.92%	5.13%	6.01%
Number of Holdings	28	14	120	461	101

¹ The annual yield an investor would receive if the most recent fund distribution stayed the same going forward.

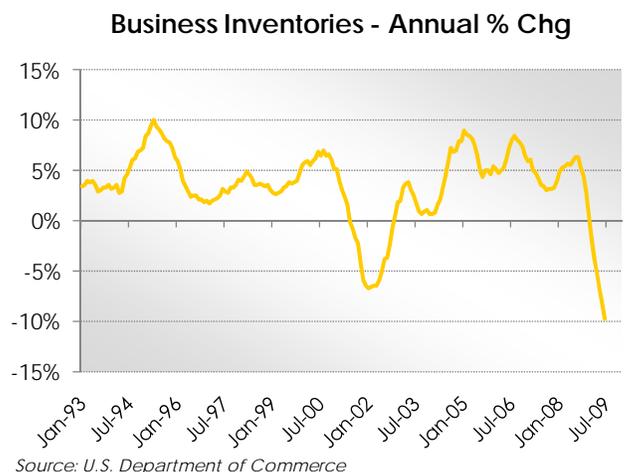
² A standard yield calculation developed by the Securities and Exchange Commission that allows for fairer comparisons among bond funds. It is based on the most recent 30-day period. This yield figure reflects the interest earned during the period after deducting the fund's expenses for the period.

³ Tax Equivalent Yield = Tax Free Yield/(1 – Tax Rate). For the California Muni Bond Fund, a blended Federal and State tax rate of 41.045% is assumed, while for the National Muni Bond Fund the highest Federal income rate of 35% is assumed.

We consider the current risk to holding good quality municipal bonds to be fairly low. As we discussed in December 2008 in *“Fixed Income Mechanics,”* the historical default rate of municipal debt is very low. Between 1929 and 1937, 1.7% of municipal debt was in default; however, all but 0.5% of that defaulted debt eventually paid its obligations¹. Furthermore, the hiccup experienced in the muni market last year was largely related to liquidity problems during the height of the credit crunch, not credit quality issues. Finally, California residents can be reassured that the interest and principal payments of California state general obligation bonds effectively have a second lien on all tax revenues of the state, second only to education. In light of these facts, we believe that the risk/reward tradeoff on municipals is favorable for investors.

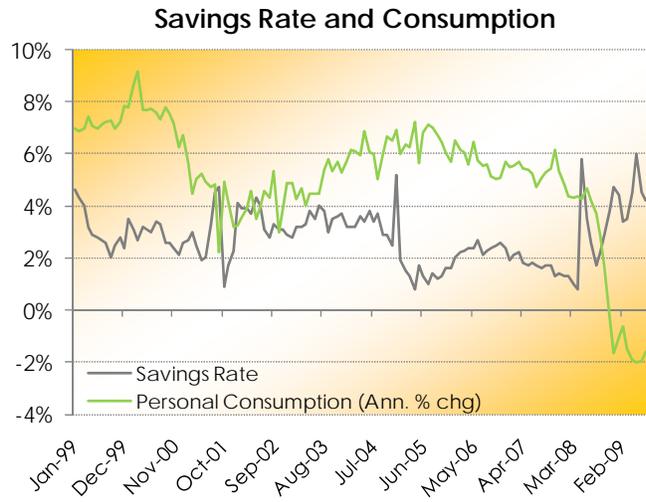
Sentiment & Momentum – As we wrote about in *“Market Therapy,”* investor psychology can be a force in the markets. While many people did experience real losses last year, including jobs, homes, and investments, even those who were not directly and immediately impacted felt sympathy pains. In 2008, we saw an extraordinary shift away from personal consumption across the wealth spectrum. Today, however, consumer and investor confidence readings are now generally improving – the Conference Board’s consumer confidence index jumped in August to its highest level since December 2007. In addition, each up-day in the equity markets is reinforcing a growing investor optimism (or even just receding pessimism). These increasing-confidence moves are generally a negative for Treasury bonds, since they are viewed as a safe haven investment. We would view sentiment that goes to a positive extreme, however, as a contrarian sign of a pullback in equities. On a cautionary note, we are slightly wary of September, when everyone returns from their summer holidays and gets back to business. We do not expect the same panic as last year, but if nothing else we should see a return to normal trading volume which will mean whatever trend we see will be more meaningful.

Trimming the Fat – The Depression Era left a legacy of prudence and frugality in those who lived through it, and at first blush it seems the current crisis may have taught some lessons as well. Corporate America responded by dramatically cutting inventories and costs, the latter of which is both positive and negative since cutting costs usually means firing workers or slashing wages. This should, however, set the stage for a rebuilding over the next several quarters from a leaner and more efficient base.



¹ George H. Hempel, The Postwar Quality of State and Local Debt, National Bureau of Economic Research, 1971

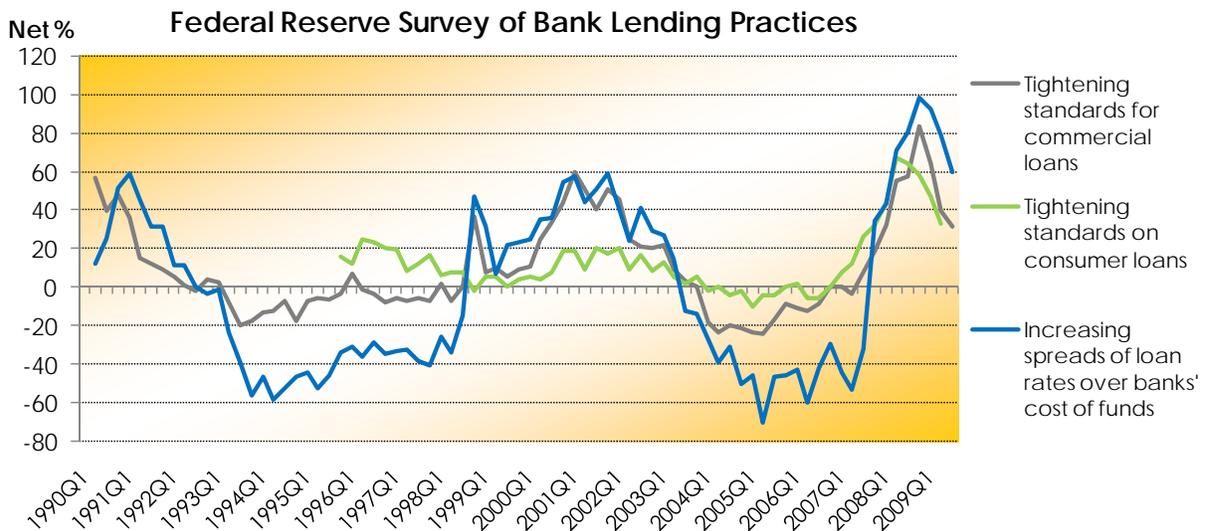
At the consumer level, at least temporary lessons have been learned as well. The personal savings rate stood at 4.2% in July, and while down from the recent high of 6% in May, still well above the 2.8% average monthly rate since 2000. The deleveraging of personal balance sheets, however, is an obvious headwind to consumer spending. From a big-picture point of view, the legacy of 10% unemployment could produce a more entrepreneurial generation, particularly if the issues surround health care for small businesses is addressed. Health care is an area where we may be looking for opportunistic investments going forward.



Source: Bureau of Economic Analysis

A recession also can serve as an opportunity to sever the weakest links in the economic food chain, allowing the strongest companies to flourish and have more availability of resources. This time around, the government may have altered this process by providing lifelines to companies that would have otherwise failed. The jury is still out on whether the deep-pocketed bailouts will have the same longer-term effects as the parent who does not carry out his or her threatened punishment, reinforcing the "bad" behavior.

Stimulus – For some months now banks have used stimulus money to build up cash on their books. On an historical basis, lending standards are still very restrictive, but the latest Federal Reserve Loan Officer Survey shows some relief in the tightening of standards.



Source: Federal Reserve

Interbank lending has also picked up, with the benchmark three-month LIBOR (London Interbank Offered Rate) falling sharply in the last several months. For example, late last week the cost for banks to borrow from each other in dollars over three months was 0.36%, down from 1.215% in mid June, and sharply lower than the 4.75% demanded in October of last year. The liquidity pumped into the system by central banks also is fueling enough confidence for banks to lend to each other over a longer time frame. According to the Financial Times, brokers are seeing activity in one-year loans for the first time since the collapse of Lehman Brothers almost a year ago.

As we said above, the full effects of the government's massive stimulus programs will still be unknown for some time. Immediate-impact policies like "cash for clunkers" and the tax credit for first time home buyers have generated increased sales in both autos and residential real estate, but a concern is that these programs may have just shifted demand forward from future quarters. This could set the stage for a "double dip" recession once the incentives are no longer in place. There is, however, a tangential benefit from the clunkers program. In order to receive the government incentive the new cars purchased had to be fuel-efficient vehicles. Even if the program only shifted forward demand, it improved the efficiency of vehicles on the road and possibly created a group of newly environmentally-conscious consumers. The current administration's focus on alternative energy could lay the groundwork for attractive opportunistic investments in that area as well.

Inflation/Deflation Balance – The pullback in oil prices and commodities (e.g. food) have helped the Consumer Price Index to fall year-on-year in the last several months, but the deflationary spiral expected by some analysts never materialized. Our view has been, and still is, that inflation presents more of a problem down the road than deflation presents in the short run. While a lack of sustained deflation is central to finding our footing in this nascent recovery, we believe now is the time to make sure our portfolios are properly hedged for inflation. Oil prices plummeted to \$30 per barrel late last year after spiking at \$140 during the summer, and now they are climbing north of \$70 per barrel again. Commodities like corn continue to trade above historical averages, and commodity experts expect food price inflation to outpace the overall rise in the Consumer Price Index going forward. The weak economy is not keeping companies from increasing prices either. Anheuser-Busch InBev and MillerCoors have both announced a new round of price increases this fall to combat rising costs.

In November of last year, Treasury Inflation Protected Securities were pricing in an expected -2.2% rate of deflation over the next five years. Today, they are still priced for about 1.2% inflation over five years, and 1.6% over the next ten. We believe the actual inflation rate will be much higher than that, and our clients have and should continue to benefit from owning TIPS.

Another possible inflation catalyst could be the lag with which fiscal and monetary stimulus responses trickle through the economy. Only a fraction of the allocated stimulus money has been approved and put into action, and continued spending could prove too much fuel on the fire. For example, California is expected to get \$26 billion in stimulus funds over the next three years to use toward education programs, stabilizing the state's finances, and infrastructure projects such as highways and bridges. So far, only about \$5.6 billion, or just over 20%, of that spending has been approved. Overall, 15% of "shovel-ready" stimulus money has been paid out so far, with 75% expected to be disbursed by the end of 2010. In order to better track the path and timing of the money, the administration has created a "Stimulus Tzar" to oversee its disbursement. His staff is creating a publically-available website which will track every dollar from Washington so that Americans can compare the information to what they may or may not see happening in their local areas. This site could prove useful for understanding the impact of the spending, although it surely will be a lightning rod for controversy.

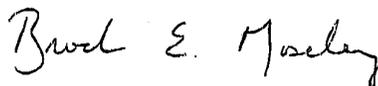
Ergo – Therefore...

With all of these developments taken together, we believe that at this point our clients will benefit from moving toward our fully invested, yet diversified, long term strategic allocations. We are still monitoring the risks on the horizon – commercial real estate, the number of bank failures at a 17 year high, a return to real earnings growth and not just cost cutting, unwinding our massive federal debt, and above all the consumer – and we see a post-Labor Day pullback as very possible. In our view, though, the risk of panic is low, and our portfolios are structured to provide downside protection, inflation insurance, and also upside capture. For these reasons, we feel confident that a risk-aware investor can profit in the current environment.

August 28, 2009



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