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## Economic & Investment Outlook *2nd Qtr 2010*

### Kicking the Can Down the Road

What's the latest catch phrase for all the financial talking heads and politicians these days? You often hear them talking about "kicking the can down the road." It reminds one of J. Wellington Wimpy, the long standing character of the 1930s comic strip and cartoon "Popeye." Wimpy was often heard saying, "I will gladly pay you on Tuesday for a hamburger today." Wimpy personifies fiscal irresponsibility. Whether referring to entitlement programs (Social Security, Medicare, or Medicaid) or health care reform, the U.S. is mortgaging its future for a hamburger today. We are masters at "kicking the can down the road."

The financial markets have stabilized and the economy is showing some signs of improvement. Short term, our outlook is positive. Longer term, we have concerns. At some point, Wimpy must settle his debts and our can may run out of road.

Americans and businesses are still anxious about the uncertainty and cost of healthcare reform, higher taxes, lack of job creation, and leveraged balance sheets. Many focus on the plethora of deficits (federal, state, and local), increasing government regulations, and the possibility of a double dip recession.

We continue to forecast post recession sub-par 2010 GDP growth of 3-3.5%. This growth will be export and inventory rebuild driven.

While weekly initial jobless claims have improved modestly, they are still in unhealthy territory (400,000-plus). We need 300,000 weekly initial jobless claims or less to reduce the unemployment rate. The unemployment rate remains stubbornly high (near 10%) as 8.4 million jobs have been lost since the onset of the recession in December '07. The U-6 rate (unemployed and underemployed) remains stubbornly high as well, near 17%.

The output gap as represented by high unemployment and underutilization of resources has created a non-inflationary environment. We expect core CPI of less than 2% over the next 12 months.

The housing market remains weak. New home sales are at historic lows. Existing home sales are anemic. Tax credits for home buyers are soon to expire. Mortgage rates are headed higher. Stabilization in the housing market is not expected until the second half of 2010 at the earliest. Signs of improvement emerge in 2011.

### Fixed Income & Interest Rates

We are beginning to see the gradual rise in interest rates that we have been anticipating for some time. Interest rates are drifting higher with the 10-year Treasury note approaching 4%. The supply of treasuries will increase dramatically in 2010 with the issuance of \$1.6 trillion of debt, an amount necessary to finance the numerous rescue programs and stimulus packages and make up for falling tax revenues. Investors will demand higher rates to compensate them for the incremental risk associated with unsustainable debt levels. Bond returns over the next 12 months will be constrained by these rising interest rates. Intermediate- to longer- maturity U.S. Treasuries remain unattractive investments.

The Federal Reserve will initiate several programs in the near term to remove the \$1 trillion of excess liquidity from the financial markets – a precarious task. The Fed funds rate will remain at historical lows throughout the year for two simple reasons – a weak economic recovery and non-threatening inflation. Caveat: be wary of monetary debasement inflation in future years.

### Equities

Equity markets are the beneficiaries of reasonable valuations, strong corporate balance sheets, increased M&A activity, low interest rates, and improving profitability. Over the near term, equity markets can move higher. However, a sustainable economic recovery and corporate top line growth are necessary to propel equity valuations higher from these levels over the longer term.

Portfolio construction should include high quality domestic large cap dividend paying stocks with significant international exposure. International and emerging market stocks coupled with commodities such as gold, energy, agriculture, and industrial metals and mining should enhance performance and further diversify the portfolio.