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Economic & Investment Outlook *3rd Qtr 2010*

Economics 101: Weak Economic Recovery + New Regulations + Austere Measures = A Double Dip Recession?

Last quarter, our Economic and Investment Outlook's title was "Kicking the Can Down the Road." Because our politicians and policy makers have decided to trade a heavily mortgaged tomorrow for a weak economic recovery today, that title would again be appropriate for this Q3 2010 Economic and Investment Outlook.

However, we prefer to recognize and address the latest concerns and hot topics frequently mentioned by the financial rags and talking heads — "Double Dip Recession and Austere Measures." Thus, this Outlook's title asks a question: Given the weak economic recovery and plethora of new policies and regulations, will the austere measures espoused by global leaders be the final straw – the one that causes our economy to fall into a double dip recession?

This type of recession is extremely rare, according to the National Bureau of Economic Research (NBER). It occurs when the economy falls back into a recession less than one year after the previous recession ends. Although the NBER has not officially declared an end to the recession that began in December 2007, most economists concur that it ended during Q3 2009. The last double dip recession occurred in the early 1980s due to double-digit inflation.

We warned at the end of 2009 that a double dip recession was not out of the realm of possibility, though we handicapped the odds at less than 50%. Today, chances are now greater than 50%, primarily the result of weak domestic job and housing markets. Additional regulation, an anticipated slowdown in global economic growth, and austere measures adopted by multiple G-20 nations further advance the rationale for a double dip recession.

Should the U.S. economy fall back into a recession, it will be difficult for the U.S. government to stimulate the economy due to its high level of debt as a percent of GDP and its mammoth budget deficits. Of the $787 billion stimulus program approved by the current administration in March 2009, approximately 30% remains unspent. Unfortunately, most stimulus dollars were spent on non-job-producing activities. We are not optimistic that the remaining funds will have an economically stimulative effect.

Accordingly, our outlook remains cautious and we have positioned portfolios defensively.

The Economy

Since 2008, NexTier Wealth Management has said repeatedly that sustainable and meaningful growth of the U.S. economy is contingent upon significant job creation and an improved housing market. However, recent economic data is not encouraging as we head into this quarter.

The current unemployment rate is 9.5%. Of the 15 million unemployed Americans, those out of work for more than 6 months and more than a year are 46% and 31%, respectively. At 31 weeks, the average length of unemployment is at its highest level since 1948. Harvard economist Lawrence Katz says the U.S. economy must generate 322,000 net new jobs over the next 45 months to recover two years of severe job losses. *Quite a daunting task.*

Recent housing data has been less than impressive. Both new and existing home sales are extremely weak. The housing market will continue to struggle for three reasons: the end of the tax credit, increasing foreclosures, and lack of job growth. Our country just finished its second consecutive month of record foreclosures.

Weak housing and job markets will continue to govern our economic engine, resulting in post recession sub-par 2010 GDP growth of 3%. Higher GDP growth is essential if we are to reduce the unacceptably high unemployment rate. Normal GDP growth for a mature and developed economy like the U.S. is approximately 2.5%. Every 1% rate of growth above this reduces unemployment by .5%. We need many consecutive quarters of 6-7% GDP growth to meaningfully reduce the unemployment rate.

Industrial production and capacity utilization are pockets of strength in a weak economy. However, their strength cannot offset the negative impact exerted on the economy by the weak job and housing markets.

Fixed Income & Interest Rates

During 2010's second quarter, the European debt crisis caused a flight to quality and an aversion to riskier assets. Inflation concerns were offset by deflation concerns. As a result, the yield on the 10-year U.S. Treasury note recently dropped below 3% from 4% just three months earlier. While we believe U.S. Treasury rates will trend higher longer term, they will most likely remain in the current range throughout 2010. The Federal funds rate has been between 0-.25% for 18 consecutive months. We anticipate the rate remaining at these levels well into 2011.

Fixed income portfolios should be well diversified and comprised of short-term investment grade securities. Intermediate– to longer–maturity U.S. Treasury notes and bonds are currently unattractive investments.

Equities

Stock markets did not perform well during Q2 2010, as investors had plenty of worries. These included a global economic slowdown, Eurozone instability and debt crisis, the financial health of European banks, the BP oil spill, and weak U.S. economic data.

However, the S&P 500 is trading at a reasonable valuation (12 x 2010 operating earnings per share estimate) versus an historical average of 16-18 times earnings. In addition, U.S. corporations (ex-financials) have strong balance sheets, including a record $1.84 trillion in cash (7% of assets).

Equity markets will finish the year higher than current levels based on attractive valuations, strong fundamentals, and low interest rates.

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