

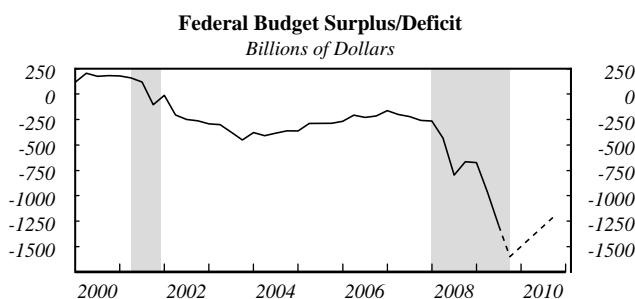
WENTWORTH, HAUSER AND VIOLICH

REVIEW AND OUTLOOK - FALL 2009

Financial crisis of past year worst in post-WWII period.

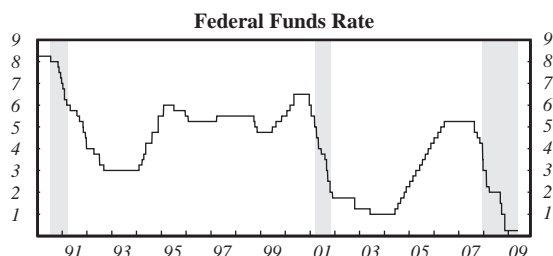
It has been a year since the credit markets collapsed, triggering a sharp decline in global economic output and employment, falling prices in global stock markets, and massive government interventions. In the course of one month, September 2008, the United States government took over Fannie Mae, Freddie Mac and American International Group (AIG), Lehman Brothers declared bankruptcy, Congress authorized the U.S. Treasury to spend \$700 billion to rescue commercial banks, Washington Mutual declared bankruptcy, Merrill Lynch was forced into the arms of the Bank of America, and Wachovia was forced into the arms of Wells Fargo. Additionally, the government extended insurance to money market mutual funds to forestall a run on these funds, guaranteed bonds issued by banks, purchased commercial paper from corporations, purchased mortgage-backed securities, and undertook other efforts to infuse capital into the banking sector, stabilize the financial sector, and restore confidence to the credit markets. Subsequently, in February 2009, Congress passed a \$787 billion spending package and in the spring the Executive Branch orchestrated the bankruptcy of General Motors and Chrysler and the federal government became the majority stockholder in both corporations.

Federal government committed \$12.5 trillion to rescue economy.



All told, in the course of the past year, between the Federal Reserve (Fed), the Federal Deposit Insurance Corporation (FDIC), the U.S. Treasury Department and the Federal Housing Finance Agency, the United States government has committed over \$12.5 trillion to over a dozen programs to try and rescue the United States economy. Of this commitment, over \$2 trillion has been spent over the past year.

This does not include the \$787 billion “stimulus” package. To place this in perspective, outstanding U.S. government debt at the beginning of 2008 totaled \$9.2 trillion. It currently totals about \$11.8 trillion. The federal government deficit for the fiscal year ending September 2009 is estimated to be between \$1.5-1.7 trillion and \$1.2 trillion in fiscal 2010. Federal government spending represents about 27 percent of the total economy, the largest share since World War II and well above the average of about 20 percent in the post-WW II period. The national debt will likely double within the next ten years. The federal government is now the nation’s largest automobile manufacturer (GM and Chrysler), mortgage lender (Fannie, Freddie and the FHA), life insurer (AIG), and health care provider (Medicare, Medicaid and other programs), has a major stake in the utility (TVA), railroad (AMTRAK), communications (Postal Service), and auto loan (GMAC) industries, and is attempting to control the private health care industry. The federal government finances about 9 out of 10 of all new home mortgage loans in the country and will become the sole provider of student loans.



The Federal Reserve has responded to the financial crisis since its emergence in the summer of 2007 by lowering its short-term federal funds interest rate from five and one-quarter percent to near zero (0.00-0.25 percent) currently. It has also introduced a number of programs to support financial institutions, stabilize the financial markets and keep long-term interest rates low to support the housing market. The effect of

Fed has committed trillions to stabilize financial markets.

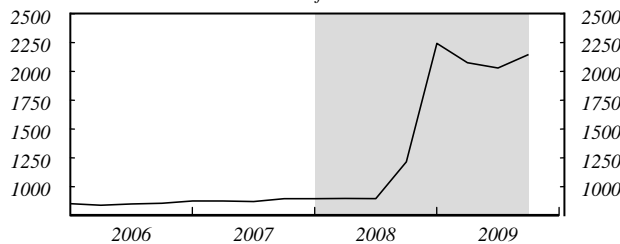
Fed's actions have future inflationary implications.

Can Fed unwind its balance sheet?

Economic indicators point to recovery in second half of 2009.

these programs has been to pump money into the system by buying assets from dealer banks and paying for them by crediting the purchase amount to the banks' reserve accounts at the Fed. Banks are required to hold reserves at the Fed equal to ten percent of their deposits. Reserves in excess of the ten percent of deposits are called excess reserves. Excess reserves have risen from about five percent of total reserves pre-August 2008 to more than ninety percent of total reserves since November 2008. As of this writing the Fed has bought about \$831 billion of mortgage-backed securities (MBS), \$975 billion of U.S. Treasury and U.S. Agency obligations, \$101 billion of AIG debt and other debt obligations through its various credit and liquidity "facilities" programs. All of these assets make up the Fed's balance sheet. The extent of the Fed's activities is demonstrated by the increase in its balance sheet to \$2.1 trillion currently, compared to about \$850 billion prior to the crisis.

Federal Reserve Banks - Total Assets
Billions of Dollars



This increase in the Fed's balance sheet is unprecedented and has future inflationary implications. The Fed's task is to supply enough reserves to support a sufficient amount of money and credit for an expanding economy and to avoid supplying too many reserves that result in inflation. Currently, because of its programs to stabilize the financial system, there are about \$800 billion of excess reserves at the

Fed, compared to about \$63 billion of required reserves. These are reserves that banks can use to make loans once the economy revives. Since banks are required to reserve at the Fed \$1 for every \$10 of loans or deposits, each excess reserve dollar could expand the money supply or outstanding credit by ten times.

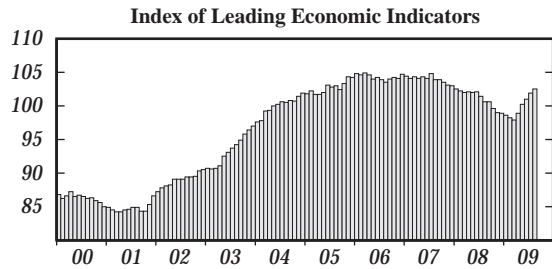
The Fed has committed to further MBS purchases and will likely have to help the U.S. Treasury finance the trillion dollar deficits of the future. With a return to growth in the second half of 2009 and in 2010, loan demand will increase and the money supply could explode, resulting in a meaningful increase in inflation. The Fed has stated that it will unwind its balance sheet to curtail inflationary forces at some future date. However, to do so in an economic recovery might create another recession. The only other comparable period of excess reserves was during the Great Depression. In 1936 excess reserves comprised over 50 percent of total reserves. The Federal Reserve decided to reduce these excess reserves by raising reserve requirements. Interest rates rose, credit contracted, the money stock declined sharply and the economy entered a steep recession in May 1937. Others will argue that the large gap between capacity and output along with high unemployment will mitigate pressures on wages and prices. However, inflation is a monetary phenomenon, too much money chasing too

few goods. It is also a supply-demand phenomenon, too many dollars relative to the demand for dollars. Dollar devaluation is inflationary. The dollar can be devalued relative to the cost of goods and services, relative to other currencies, and relative to traditional inflation hedges such as gold. The 30 percent increase of the price of gold to date this year suggests inflation may be a problem down the road.

Gold Prices
Dollars Per Troy Ounce



Fed Chairman Ben Bernanke stated in the third week of September the recession is "very likely over." There is indeed compelling evidence that the United States and global economies are recovering. Virtually all economic indicators are well off their troughs and pointing to recovery. The Index of Leading Economic Indicators has risen for five consecutive months through August, the first five-consecutive-months increase since 2004. Most economists are



Forecasts point to positive growth in 2010.

revising their forecasts upward for growth for the second half of 2009 and all of 2010. In the U.S., Gross Domestic Product, the total output of goods and services within the U.S., declined at an annual rate of 0.7 percent in the second quarter, compared to declines of 6.4 percent in the first quarter of 2009 and 5.4 percent in the fourth quarter of 2008. The consensus "Blue Chip" Economic Forecast is projecting growth of 3.0 percent in the third quarter of 2009 and 2.4 percent in the fourth quarter. The consensus estimate for 2010 is GDP growth of 2.7 percent. The recession started in December 2007. If it ended in June, the recession would have lasted eighteen months, the longest in the post-WWII period.

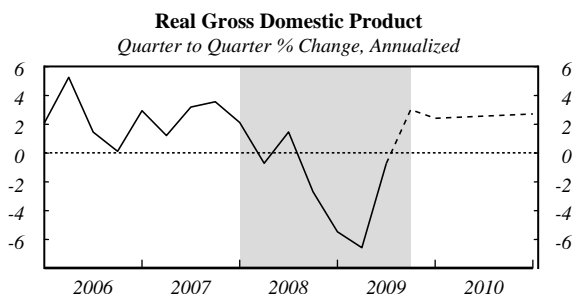
Factors contributing to a positive economic outlook include: continued monetary stimulus by the Fed, continued fiscal stimulus into 2010, low interest rates, normalization of interest rate yield spreads between AAA and Baa bonds, a steep yield curve between short-term and long-term interest rates, depleted inventories at all distribution levels, and fiscal and monetary stimulus in virtually every foreign country. There are signs that the housing market has bottomed as new home sales have risen for five consecutive months and existing home sales have risen in four of the past five months. The inventory of new and existing homes for sale is 36.4 percent and 16.4 percent, respectively, below year-earlier levels.

The Consumer Sentiment Index rose in September to its highest level since January 2008. Consumers' expectations of the current and future state of the economy have improved significantly since the low point in the fourth quarter of 2008. Although unemployment remains high, 9.8 percent in September, and the economy continues to lose jobs, consumer sentiment is most likely influenced by the upturn in household net worth. In the second quarter, household net worth advanced 3.9 percent, the first increase in seven quarters. The Fed's quarterly report tallies the assets and liabilities of U.S. households and for the second quarter this measure grew to \$53.1 trillion. Contributing to the gain was an increase in home prices, an increase in the stock market and a decline in mortgage and credit card debt. Indeed, since peaking in January 2009, consumer credit has declined \$85 billion, an annualized rate of 5.2 percent. Consumers are deleveraging by borrowing less, buying less and saving more. As measured by the S&P/Case-Shiller Home Price Index, home values turned up in June 2009, the first increase since May 2006. While household net worth has improved, it remains 19 percent below its peak of \$65.3 trillion in the third quarter of 2007.

Global economy also recovering.

The global economy also appears to be emerging from its worst downturn of the post-World War II period. The Organization for Economic Cooperation and Development, the International Monetary Fund, the World Bank and the European Central Bank have all revised their estimates of GDP growth in 2009 to be less severe than prior forecasts and 2010 to be a year of positive growth for the world economy.

Headwinds and crosscurrents remain for economic recovery.



Despite positive signs of an economic recovery, there are a number of uncertainties that will impact the vigor of the unfolding economic expansion. If the deleveraging of the U.S. consumer becomes a secular rather than cyclical trend, it will not only affect the U.S. economy, but also the global economy. Personal consumption expenditures comprise about 70 percent of U.S. GDP. Continued thrift on the part of consumers will moderate future growth. The United States also has

*Commercial
real estate a
looming problem.*

been the world's consumer. In 2008 the United States imported \$2.5 trillion of goods and services. To place this in perspective, \$2.5 trillion is approximately the size of Great Britain's GDP, the sixth largest GDP in the world. Another challenge is creating new jobs to replace the 7.4 million jobs lost since 2007 and providing jobs for new entrants into the work force. Commercial real estate is following the housing market into a downturn. Commercial real estate loans total about \$6.7 trillion with banks holding about \$1.7 trillion. Commercial mortgage-backed securities (CMBS) total about \$700 billion and their delinquency rate has climbed six-fold over the past year. Rents are falling, vacancies are rising and refinancing is difficult. In the residential market, delinquencies continue to rise as do foreclosures. Higher taxes in 2011 resulting from the expiration of the 2003 tax reductions may cause taxpayers to shift income from 2011 to 2010, adding growth to 2010 at the expense of 2011. Finally, the intervention of the federal government into the private sector is unprecedented and may have negative unintended consequences on the functioning of free market capitalism, which has been the driving force of the growth of the global economy of the past thirty years.

SUMMARY

The United States and global economies appear to have emerged from the longest and steepest recession of the post-World War II period. There are a number of crosscurrents and headwinds that could moderate the pace of economic activity after an initial bounce from inventory replenishment. These include high unemployment, continued housing market foreclosures, consumer deleveraging, rising commercial real estate vacancies and delinquencies and the intrusion of the federal government into the private sector which impedes market forces from correcting the excesses and imbalances that created the crisis in the first place. However, the positives appear to outweigh the negatives at this juncture.

*Corporate profits
poised for strong
recovery.*

U.S. corporate profits before inventory valuation and capital consumption allowance, called profits from current production, rose for the second consecutive quarter, advancing 5.7 percent in the second quarter of 2009 over the first quarter. While still off 11 percent year-over-year, the profit outlook is promising. Profits of the companies comprising the S&P 500 Index have exceeded analysts' estimates for the past two quarters and are expected to have done so in the third quarter. Productivity gains and cost cutting have been vigorous. Once revenues expand as the economy improves, profit margins should improve dramatically. This should bode well for long-term investors over the period ahead.

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