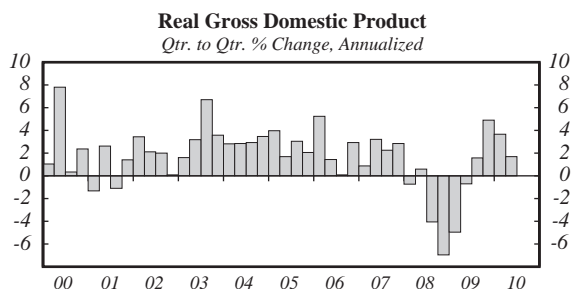


# WENTWORTH, HAUSER AND VIOLICH

## REVIEW AND OUTLOOK - FALL 2010

*The NBER determined the recession ended in June 2009.*



The National Bureau of Economic Research, a body of economists that determines the inflection points of economic cycles, announced that the 2007-2009 recession ended in June of 2009 after having started in December of 2007. The eighteen-month economic downturn was the longest in the post-World War II period, exceeding the sixteen-month recessions of the early 1970s and 1980s. The peak-to-trough contraction in Gross Domestic Product (GDP),

*The economic recovery is slow by historic standards.*

the total output of goods and services in the United States, was also a postwar record of minus 4.1 percent. In the 1973-1975 recession, the economy shrank 3.2 percent and in the 1981-1982 downturn, 2.6 percent. This past recession did not set a record in postwar unemployment as a percent of the labor force. Unemployment peaked in October of 2009 at 10.1 percent compared to 10.8 percent in 1982. Nevertheless, 7.3 million workers lost their jobs and falling common stock prices and home prices cut household net worth by twenty-one percent.

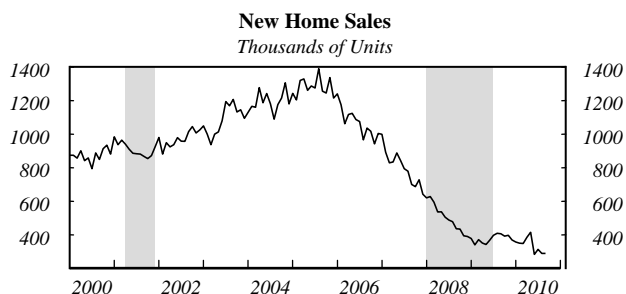
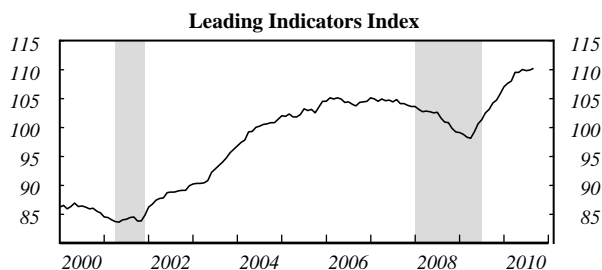
*Economic growth for the second half of 2010 will remain tepid.*

The recovery in the economy has now been underway for sixteen months and is tepid compared to past expansions in the first year of growth. For the second quarter of 2010 real GDP grew at an annualized rate of 1.7 percent and was 3.0 percent above the year-earlier level, less than half the rate of growth of prior postwar expansions in the first year of recovery.

Recently released economic indicators suggest that the economy will expand at an annual rate of about 2.5 percent in the second half of the year. The expansion seems to have lost some momentum compared to the fourth quarter of 2009 and the first quarter of 2010 which experienced GDP growth of 5.0 and 3.7 percent, respectively. The recovery is not spread evenly across industry groups or geographic regions. Manufacturing, resource extraction and farming are exhibiting strength as growing emerging markets are boosting export sales for farm and construction equipment, agricultural products and natural resources. Crop yields are expected to be robust, crop prices are firm and farmland prices are strong, having bucked the trend of commercial and residential real estate prices which are weak. Equipment and software sales are growing and retail sales have

experienced their tenth consecutive year-over-year increase following fourteen year-over-year declines during the heart of the recession. Other measures of economic activity indicate sluggish but positive growth in the period ahead.

*Housing remains weak as sales and prices continue under pressure.*



Housing remains weak as existing and new home sales bounce along the bottom after a steep decline. Residential construction currently represents 2.4 percent of GDP compared to 6.3 percent at its peak in 2005 and 2006. To put this in perspective, the decline in housing cut 3.9 percentage points off GDP in four and a half years compared to the 4.1 percentage point decline in total GDP in the eighteen-month recession. Housing starts are 73.7 percent below their January 2006 peak. New home sales are 79.3 percent below their July 2005 peak while existing home sales are 43.0 percent below their September 2005 peak. Home prices as

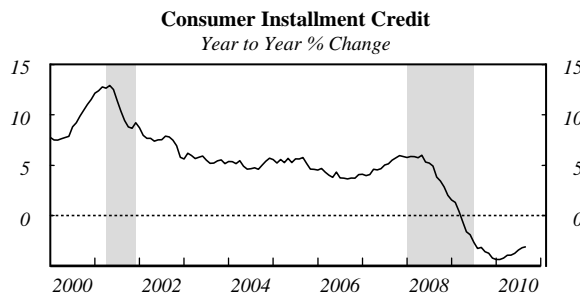
measured by the S&P/Case-Shiller Home Price Index have fallen 28.5 percent from their April 2006 high. Approximately 22 percent of existing home sales are foreclosed properties, placing downward pressure on prices. The inventory of unsold homes is about double the normal inventory-to-sales ratio. Three and a half million homes have been foreclosed, eight million home mortgage loans are delinquent, in default or in foreclosure, eight million homeowners have mortgages that represent ninety-five percent of the value of the home and forty percent of homeowners have mortgages that exceed the value of the home. Government's efforts to intervene in the housing market have been counterproductive. Half of the participants in the Home Affordable Modification Program have re-defaulted on loan modifications within twelve months despite substantially reduced monthly payments. Only a fraction of the expected participants in the mortgage modification program have signed up. The first-time home buyer's tax credit and the extended and expanded tax credit for home purchases caused sales to surge and then plunge when the tax credits expired, interfering with unencumbered market forces that were in the process of correcting the imbalance. In past economic recoveries, housing and construction related to housing have led the economy out of recessions. This time housing remains an albatross to overall economic activity.

The auto industry also remains at depressed levels. The government stimulus program, cash for clunkers, spiked sales until the program expired, and then sales plunged. Like the government stimulus for housing, the government stimulus for autos distorted normal market corrective mechanisms, stole sales from the future, and prolonged the downturn.

*The employment markets remain weak.*

The employment picture remains weak with job losses in the public sector and only modest job creation in the private sector. The unemployment rate continues to be elevated at 9.6 percent, having fallen only 0.5 percentage points since the peak unemployment rate of 10.1 percent in October 2009. The economy is not growing fast enough to create meaningful employment gains.

*The private sector is deleveraging.*



Two factors appear to be weighing on the economy. The first is the deleveraging occurring in the private sector. Consumers are continuing to pay down debt. Both revolving (credit card) and non-revolving (auto) debt have declined by record amounts. The savings rate jumped to 5.8 percent in August. From its peak in July of 2008, outstanding consumer credit has declined 6.5 percent or \$167.6 billion. Home mortgage debt is also declining as refinancing at

historically low interest rates and mortgage foreclosures have lessened the burden of mortgage payments on the part of current and former homeowners. Home mortgage loans have declined \$1 trillion or about 10 percent. Household debt as a percent of annual disposable income has fallen from 130 percent in the third quarter of 2007 to 119 percent at the end of the second quarter of 2010. Economists generally believe that a sustainable level for this measure is 100 percent or lower. After some 20 years of borrowing and spending, the consumer is retrenching.

*Household net worth declined in the second quarter.*

Household net worth is an important factor in determining consumer confidence and therefore consumer spending. Household net worth peaked in the second quarter of 2007 at \$65.8 trillion before plunging for seven consecutive quarters. Then, after four quarters of gain, it declined again in the second quarter of 2010. The 2.8 percent decline brought household net worth to \$53.5 trillion. It remains 19 percent below the 2007 peak.

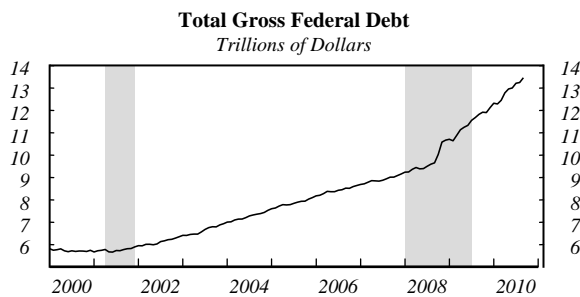
*Consumer sentiment and confidence are subdued.*

The tepid economic recovery, weak labor market, weak housing market and uncertainty regarding government policies are reflected in subdued consumer sentiment and confidence surveys. The consumer, who contributes about 70 percent to GDP, is not likely to provide a substantial impetus to GDP growth in the period ahead.

Corporations are also repairing their balance sheets by paying down debt, cutting expenses and curtailing hiring and investment. As a result corporate profits and cash flows are near record levels relative to GDP, corporate cash is at record levels approaching \$2 trillion, and commercial and industrial loans are down some 25 percent.

*Government policies have created a climate of uncertainty.*

This brings us to the second factor that is weighing on the economy: public policy. The government's attempt to stimulate the economy and resulting intrusion into the private sector is unprecedented. In February 2008, the Bush Administration signed the \$150 billion Economic Stimulus Act of 2008. It mainly consisted of \$500 tax rebates per household. Stanford professor John Taylor (creator of the Taylor Rule for monetary policy) has shown that the spending had no lasting stimulus and created no new jobs. In the fall of 2008, the Democratic Congress passed and President Bush signed the \$700 billion Troubled Asset Relief Program (TARP) designed to buy toxic assets from banks and insurance companies. Instead the money was used to lend funds to banks and insurance companies and provide them with liquidity and capital. This probably prevented many financial institutions from bankruptcy and saved jobs in the financial sector. It did not create any new jobs. The Federal Government gained an ownership stake in the industry. A portion of these funds have been paid back. In February of 2009, the Obama Administration signed the \$785 billion Recovery Act of 2009, the funds subsequently totaling \$865 billion. About half of these funds have been spent. Some jobs were saved or created by this Act, but they will be lost when the money runs out. In the spring of 2009 the U.S. Treasury, directly and through TARP, invested and loaned \$85 billion to General Motors and Chrysler. This may have saved jobs and the jury is out as to new job creation. Other spending programs include unemployment benefit extensions and aid to state and local governments totaling an additional \$65 billion. Along the way, the U.S. government committed over \$400 billion to bail out Fannie Mae and Freddie Mac. Economists differ as to whether all this spending saved or created new jobs. The unemployment rate is higher now than when these funds were authorized and the taxpayer is on the hook for an additional \$2.5 trillion.



During this period the Federal Reserve undertook a number of programs, called facilities, totaling hundreds of billions of dollars, underwrote Bear Stearns and AIG and purchased \$1.25 trillion of mortgage-backed securities.

These spending programs increased government outlays as a percent of GDP to 24-25 percent from 20 percent. Falling tax revenues from the recession cut receipts to 15 percent of GDP from 19 percent. The resulting 10 percent gap between revenues and expenditures produced a federal budget deficit of nearly \$1.5 trillion. Total government debt jumped by over 30 percent in two years to over \$14 trillion.

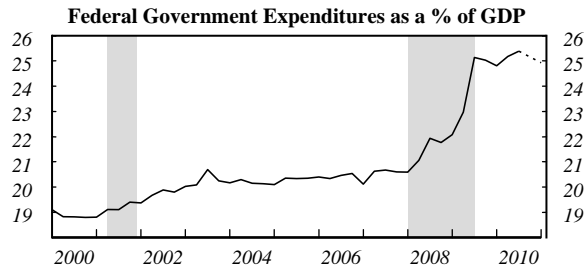
*The climate of uncertainty has curtailed spending and investment.*

The healthcare reform act and the Dodd-Frank Wall Street Reform and Consumer Protection Act impose an incalculable burden on the economy in terms of increased regulation, mandates and taxes that will stifle economic growth, raise the cost of delivering services to the public and reduce the availability of these services, be they healthcare or credit.

*Government policy on regulation, trade, taxes and spending will dictate the future course of the economy.*

Going forward, policy errors involving trade, regulation, taxes, spending and the Fed's monetary actions will dictate the course of economic activity within the United States. Trade policy is tilting in the wrong direction. Half a dozen countries are trying to devalue their currencies in order to promote exports and discourage imports. The U.S. House of Representatives in the last week of September passed the Currency Reform for Fair Trade Act aimed at China that would impose tariffs on countries that manipulate their currencies. If the Chinese yuan is deemed to be 25-40 percent undervalued a countervailing duty or tariff of 25-40 percent could be levied on all Chinese imports. Ironically this bill is an amendment to the Smoot-Hawley Tariff Act of 1930, arguably the principal cause of the Great Depression. Following the Tariff Act of 1930, the world embarked on retaliatory tariff wars that shrank world trade by over 60 percent in the ensuing 12 months. Is this a case of déjà vu?

The Federal Reserve's monetary policy has been to avoid deflation. In pursuing this policy, the Fed took short-term interest rates to near zero and purchased government securities and mortgage-backed securities that created excess bank reserves of over \$1 trillion. This could presage a major inflationary cycle in future years if the Fed mishandles liquidating these reserves.



Federal government spending has jumped to a new baseline percentage of GDP with resulting budget deficits in excess of \$1 trillion. Elected officials must develop the political will to rein in the bloated spending budget.

In the ultimate act of cowardice and irresponsibility, Congress adjourned for the mid-term elections before voting on whether or not to increase taxes on January 1, 2011. No

*Corporate profits are strong and near record levels as a percentage of GDP.*

vote will result in the largest tax increase in history. An increase of this magnitude, given an already weak economy, could send the economy back into recession.

All of the foregoing has created an unusual climate of uncertainty and caution among consumers and businesses alike that has stifled spending, investment and employment.

### SUMMARY

Forecasts for global economic growth have been pared somewhat as developed nations continue to struggle with weak economies, high unemployment, sovereign debt issues and weak housing markets. However, corporate profits are robust, inventories near desired levels and overall financial conditions have stabilized. The third quarter earnings estimate for the Standard & Poor's 500 companies is a year-over-year increase of 23.8 percent.

Growth in the emerging markets of the world remains robust and this should provide some relief to the export markets of the developed countries. Emerging market growth has also provided a floor under energy, resource and material prices as demand for infrastructure investment increases. Inflationary pressures in several of the emerging-market economies have occurred resulting in central banks raising interest rates.

Within the U.S. the Federal Reserve will keep interest rates low for an "extended period" and may purchase additional bonds, a practice known as quantitative easing, to keep long-term interest rates from rising. Despite tepid economic growth, corporate profits are strong and valuation levels reasonable for selected equities.

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## WENTWORTH, HAUSER AND VIOLICH

### INVESTMENT COUNSEL

301 BATTERY STREET, SUITE 400  
 SAN FRANCISCO, CALIFORNIA 94111-3203  
 TELEPHONE (415) 981-6911  
 FACSIMILE (415) 288-6153

801 SECOND AVENUE, SUITE 1210  
 SEATTLE, WASHINGTON 98104-1518  
 TELEPHONE (206) 219-2450  
 FACSIMILE (206) 219-2479