



Investment Commentary  
October 2009

The financial markets posted strong gains in the third quarter. Both bonds and stocks extended their 2009 rallies, building on initial recoveries that began in January and March, respectively. Depending on asset mix and types of securities held, investors on 9/30/09 found themselves within shouting distance of valuation levels that existed before the 9/15/08 fall of Lehman Brothers, as illustrated by the following table (dating from Friday, 9/12/08):

|                        | 9/12/08 to | 12/31/08 to | 6/30/09 to | 9/12/08 to |
|------------------------|------------|-------------|------------|------------|
|                        | 12/31/08   | 9/30/09     | 9/30/09    | 9/30/09    |
| <b>EQUITIES</b>        |            |             |            |            |
| S&P 500                | -27.8%     | 19.3%       | 15.6%      | -13.2%     |
| MSCI EAFE              | -27.0%     | 29.2%       | 19.6%      | -5.6%      |
| MSCI Emerging Markets  | -33.7%     | 64.2%       | 21.0%      | 9.2%       |
|                        |            |             |            |            |
| <b>FIXED INCOME</b>    |            |             |            |            |
| Municipal Bonds        | -2.5%      | 12.0%       | 6.7%       | 9.2%       |
| Investment Grade Bonds | 3.5%       | 9.2%        | 7.9%       | 13.0%      |
| High Yield Bonds       | -20.2%     | 32.9%       | 13.1%      | 6.1%       |
| U.S. Treasuries        | 15.3%      | -7.3%       | 3.4%       | 7.0%       |

The world's main stock markets still are about 33% below the highs they attained in October 2007, but as the table shows they largely have recovered from the trauma associated with Lehman's demise and the sudden seizure of the credit markets last fall. The S&P's 15.6% third quarter gain followed a 15.9% second quarter gain, the first consecutive quarters above 15% in almost 25 years. (Through the 9.75 years of this decade, U.S. stocks still are down a cumulative 14.6%.) Emerging markets, underpinned by resilient and dynamic economies, a perception of growing self-sufficiency, and relative absence of the debt issues that saddle the U.S. and much of Europe, more than erased their late 2008 losses as the succeeding nine months progressed. And high yield bonds, the most equity-like of the fixed income categories, followed the most equity-like return path, likewise benefitting from buying interest at what were historically depressed levels.

Like the high yield group, other bond categories also were powered by a normalization of their valuations in relation to Treasuries from the extremes of year-end 2008. Investors returned to the notion that non-Treasury bonds offer reasonable safety of principal, even without the federal backstop. Municipal yields, expressed as a percentage of Treasury

yields, returned to historic norms this year, steadily moving from an off-the-charts 201% on 12/31/08 to 99% on 9/30/09. Corporate bonds accomplished a similar feat. Triple-A and triple-B bonds respectively now yield 0.8% and 2.3% more than Treasuries, in both cases in line with long-term averages, both recovering from spreads that had spiked up to the 6-7% range late in 2008.

These return streams indicate a widespread belief that the depression scenario is safely behind us. While no one would give the government anything close to perfect marks, most agree that the extraordinary steps taken last fall, including the dramatic expansion of liquidity and monetary support provided by the Federal Reserve Bank and establishment of the U.S. Treasury Department's Troubled Asset Relief Program, served an essential role in pulling us back from the brink. A depression-like full retreat on the part of the private sector certainly could have happened, as it did in the early 1930s when the government failed to provide the needed levels of protection and assurance. By some measures, the early days were more painful this time around; according to the White House Council of Economic Advisers, we lost 17% of household wealth in 2008, compared to 3% in 1929, a time when home prices were relatively stable and fewer people owned stocks.

As the depression scenario receded and the rally in 2009 progressed, the markets appeared to transition sequentially from normalization of pricing extremes, to celebration of initial fundamental improvement, to expectation that these improvements will continue on a similar trajectory as we move into 2010. Today's valuation levels thus have set up a validation phase as we weigh the merits and gauge the staying power of economic and corporate recovery. This brings obvious challenges and risks. Given the unprecedented cause of the crisis – an overleveraging that brought down our largest financial entities – and the unprecedented scope of the response, we face a unique set of circumstances that are likely to hinder our progress toward full recovery.

The good news is that the overall economic picture is certain to be better next year. The International Monetary Fund now predicts the global economy will shift from 1% contraction in 2009 to 3% growth in 2010, helped by the increasing weight of fast growers China and India. But at the same time, we will have to contend with a hangover from the tapering of fiscal stimulus, and continuing process of digesting enormous levels of government debt. This is likely to be accompanied by higher interest rates, and, at some point (as implied by steadily rising gold prices this year) higher inflation. The sustainability of the economic growth scenario will face new headwinds whenever debt and deficit reduction measures are undertaken, through reduced spending, higher taxes, or a combination of both. One-time government spending programs are expected to wind down not just in the U.S., but also in Europe, Japan, and China.

The most immediate challenges to the improvement story continue to come from the labor markets and what they imply for domestic consumption. The September employment report included an uptick in job losses from the previous month and a jobless rate of 9.8%, twice the percentage of just two years ago. While the jobs deterioration has been quick, the recovery, when it comes, will be far slower. Partly this

is in keeping with historical norms; it simply takes longer to add people than to reduce them. But there also is a good chance that previous employment levels will not be fully reclaimed. In this case the positive recent trends we've seen in corporate earnings have a flip side, as managements have embraced a new austerity. This has led them to aggressively cut costs, pay down debt, build cash, and find ways to operate with slimmer payrolls. Even with improved revenue growth, some jobs probably will not come back.

With constraints on consumers, corporate austerity, and an eventual tapping out of federal spending, economic growth may depend more heavily on exports and world trade. But here as well, the picture is cloudy at best. Recent measures taken by the Obama administration against Chinese tire imports into the U.S. (including a 35% tariff) may have been allowable within existing agreements, but raise tensions within a global commercial arena that still is recovering from the late 2008 freeze caused by the sudden unavailability of trade credit. Now that the mechanics of global finance are back to normal, and the world's main economies are recovering from the first synchronized recession in the post World War II era, protectionism may represent a more immediate threat. A World Bank-affiliated group called Global Trade Alert warns that numerous other countries are following our lead, mainly targeting exports from the U.S., China, Japan and Germany. Overall, world trade is expected to contract 10% in 2009. Global economic cooperation rose during the financial crisis, but seems now to have crested, giving way to turf defense.

Trade friction only makes more harrowing the battlefield we now occupy. There was a certain meaning in the closeness of the two anniversaries the markets whistled by last month – 9/11 and 9/15. Historians point out that a nation's vulnerability on the geopolitical stage is directly tied to weakness in its financial standing. There are profound examples in our own history, notably during the Depression (totalitarianism's rise in Europe, Japanese adventurism in China) and during the hyperinflation and economic malaise of the 1970s and early 1980s (Vietnam, Cambodia, the Iran hostage crisis and the U.S.S.R.'s Afghanistan invasion). Now, there are again signs of a power loss by the U.S. and its closest allies. Involving shadowy adversaries, wars cannot be cleanly won with an enemy surrender. Nations branded as members of an axis of evil shortly after 9/11 are pursuing nuclear weapons almost gaily. Russia and China's economic emergence challenges our authority as a global policeman. As illustrated by the inefficacy of three rounds imposed on Iran since 2006, the weight of economic sanctions fades when the U.S., Europe and Japan no longer are the only real trading alternative.

All this suggests to us that we're moving away from last year's parallel downshift in the world's economies and coordinated policy response to a more normal market landscape marked by self-determination and a more striking divide between winners and losers. From an investment strategy standpoint, this environment lends itself more than ever to approaches that are active, flexible, and unconstrained by geographic border. We want to preserve the option to tap ascendant entrepreneurialism and compelling growth themes wherever they may exist. Current hardships notwithstanding, people still have an unquenched desire to get ahead. Competition is sure to intensify, but that also promotes

higher levels of innovation and new investment opportunities. Also, now that the relatively easy money has been made off the extreme lows earlier this year, the ability to generate returns from here will depend much more on fundamental research and skilled security selection.

We are maintaining an overall tactical allocation that keeps a full commitment to bonds while moderately downplaying stocks, the latter based on a view that risks have increased and return potential is more constrained following the recent run-up. Within the equity category, our preference for non-U.S. stocks over their domestic counterparts remains in place. Both here and abroad, we continue to shy away from smaller companies, where credit conditions remain far more difficult than is the case for larger companies. It also is our view that market leadership in this new, testing validation phase will shift from low quality “back from the dead” names to higher quality market leaders who are better placed to achieve sustainable top and bottom line growth, and generate consistent cash flow in support of dividend and interest payments.

The overall objective, as always, is to maintain a high level of risk awareness, thoughtful allocation, broad diversification, and the highest possible standard for manager selection, while ensuring that risk levels are appropriate for each client. And whether times are adverse or relatively benign, the key is to maintain as steady a hand as possible within a disciplined investment process. This is something we say often outwardly, and we remind ourselves just as frequently.

Thank you for your continued support of RINET. If you have any questions or concerns, please feel free to contact any of us on the investment team.

David S. Beckwith, CFA  
Chief Investment Officer