

Alphabet Soup: The L, U, W, V of Economic Recovery

by Rick Pitcairn, Chief Investment Officer

Global Recovery: Where Are We Now?

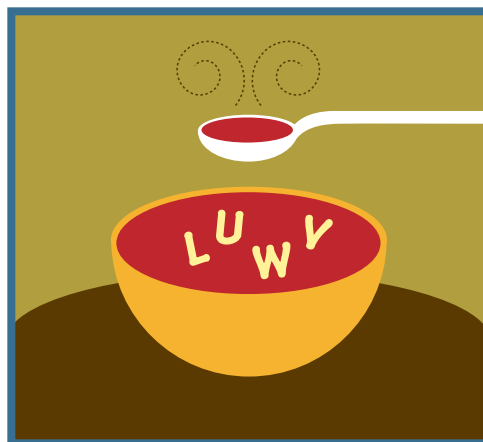
About two years ago, you could flick on any channel and everyone talking about the global recovery had a letter attached to their predictions. Many said the recovery would be L-shaped, which meant the economy was going to go down and never come back. Some predicted it was going to be U-shaped, which meant the economy was going to go down, stay down for a while and then loop back up. When we saw some growth in 2009, we heard the recovery was expected to be W-shaped, referring to a double-dip recession.

No one predicted a V-shaped recovery, the most positive and normal scenario, because they assumed the economic situation was too terrible for a V-shaped recovery. But a V-shaped recovery is exactly what we have experienced so far. The fact is that the 100% recovery in profits and market values is the fastest on record even though gross domestic product (GDP), a key measure of economic activity, continues to have fits and starts.

Global Outlook: Where Are We Headed?

Although the V-shaped recovery surprised the marketplace and silenced many naysayers, there are still very serious issues that extend beyond media hyperbole. In the US, we have a debt limit vote and a yawning budget deficit. The dollar is weak, while unemployment and gas prices remain high. Much of the US GDP is generated by consumption. If the consumer stops spending because of various

economic pressures, how will the recovery continue? Globally, commodity volatility is impacting markets; Europe is struggling with debt issues; Japan is working through the devastating aftermath of a historic tsunami; and political unrest and revolution, particularly in the Middle East and North



Africa, are rippling through the emerging markets. All of these challenges have created many questions among investors who are asking how we can remain optimistic with so many reasons to worry.

Because of this wall of worry, investors can quickly overreact and view any negative sign as the first step toward the beginning of the end. For example, in May and June we watched as the markets declined and gave back some of the gains made this year. Is this the end of our V-shaped recovery and the first step towards a global double-dip

recession? We think not. The market has been increasingly focused on the short term and as a result makes a trend out of each economic data point. While the market pullback is partly a reaction to weak economic data resulting from the challenges discussed above, and partly a response to the Greek debt crisis, we believe that the economy is experiencing a period of very normal market correction following a nearly uninterrupted rally since last August. Despite the challenges and uncertainty, we believe the market is signaling for continued recovery and growth and we remain positive on the long-term outlook for the global financial markets.

What Can You Do?

At Pitcairn, it is our job to help you discern the difference between media hype and good, solid analysis so you can make well-informed decisions. While not everyone needs to become a financial expert, I encourage all investors to educate themselves about what is happening in the global financial markets. I also believe in listening to different perspectives. There are bearish (negative) and bullish (positive) opinions to almost every debated issue. Hearing both views enables you to make sharper, more effective decisions. Being an informed consumer of economic and financial news will help you to stay focused on your long-term strategy and not become distracted by short-term ups and downs.



From the Chairman

My friend and author Tim Downs has a theory on leadership and idea generation. He thinks that all people in the creative process wear at least one of four hats: explorer, artist, judge, or warrior. The explorer finds and collects new ideas. The artist takes the ideas and crafts them into something tangible. The judge critiques and improves the work of the artist, making it stronger. The warrior takes the end product and champions it to the public. If a wearer of one of these four hats is excluded from the creative process, the strength and success of the idea diminishes.

Tim's theory speaks to my belief that great ideas can only be developed and brought to fruition when a mix of perspectives and personalities come together. I see Tim's many-hat philosophy in action everyday in Pitcairn's practice of collaboration. We put together teams that combine our own seasoned experts with consultants, advisors, partners, and professionals. These teams create a well-balanced mix of explorer, artist, judge, and warrior; and they get results.

In this investment-focused edition of *Pitcairn Update*, we've gathered the thoughts of an investment strategist, an economist, a university professor, and a fixed income manager to augment the thinking of our own investment leaders and to address some of the issues currently weighing on investors' minds. I hope you take away some ideas from this many-hat, multi-perspective discussion and I wish you a happy and relaxing summer.

Warm Regards,

Ten Questions Investors Are

In early May, with the second quarter of 2011 behind us and the end of the Federal Reserve's quantitative easing (QE) in sight, we asked a few investment experts to give us their perspective on the global economy and their outlook for investments. We spoke with Peter Ricchiuti, Director of Research at Tulane University, and Jason Trennert, Managing Partner and Chief Investment Strategist at Strategas, and asked them to share their thoughts with our clients. We have also included observations from Dr. David Kelly, Chief Market Strategist at JP Morgan Funds, whose insights into the markets are always enlightening. We've incorporated their thoughts with some of our own, to sum up what we consider to be the 10 most important questions that are on investors' minds.

1. Is the Recovery Different This Time?

All of our experts agree that in spite of what you might hear in the media, this recovery is not fundamentally different than previous recoveries, even given the recent slowing economic and market results. Dr. Kelly explains that sometimes we might feel as if we are still in a recession; that sometimes it can be difficult to distinguish between the feelings and the facts as they relate to economic recovery. Based on consumer sentiment, there is the impression that we are still in a recession. Chart 1 shows that even though we are nearly two years into recovery, consumer confidence levels are about 20 points below average. Confidence is weak because of high unemployment, the abysmal state of housing, rising gas prices, and international unrest, among other factors. However, according to Dr. Kelly, recessions are measured from peak to trough. In this recession, as measured by GDP, the peak was December 2007 and the trough was June 2009; we had 18 months of recession, and now have been in recovery for 21 months. The S&P 500 reached a low of 677 on March 9, 2009, and it has almost doubled since then.

It is important to keep in mind Jason Trennert's idea of "the tension between the cyclical and the secular...the cyclical meaning what's going to happen in the economy over the next 12 to 18 months and the secular meaning all the things that are raging on the airwaves right now." Certainly, there are secular nuances that lend a different quality to this recovery. For example, China and India are recovering faster than the US and are helping to pull us up;

whereas in the aftermath of previous dips, it has fallen to the US to drive global economic recovery. Additionally, this recovery is being led by the manufacturing sector, which was quite weak in the recovery of the 1990s and after the dot-com bust.

As noted above, officially the government announced that the recession ended in July 2009 and the economy is growing at roughly 3%. Peter Ricchiuti asserts, and Chart 2 illustrates, "Recessions always end and the economy always rises to a higher plateau."

2. Why Is Unemployment Still So High?

We are still struggling with unemployment returning to its pre-recession low and May brought disappointing job creation numbers. However, our experts are optimistic that better unemployment numbers are in our future. Chart 3 shows the relationship between employment rates and corporate profits as described by a regression model. While employment is not likely to rise as quickly as profits, the chart depicts the trend is moving toward improvement in the employment numbers. Jason Trennert and Peter Ricchiuti both see increased hiring in the future, particularly as some corporate fears relating to the financial sectors, health care and energy abate in the coming months.

In Jason Trennert's opinion, it will be difficult to get full employment without an improvement in the housing market. The US is unique in its ability to achieve such low levels of unemployment, and this in large part derives from the establishment and growth of many small and medium-sized businesses here. US entrepreneurs are able to generate small business capital by accessing their home equity. However, Dr. Kelly observes that since the peak of the housing market in the first quarter of 2006, when people had \$13.5 trillion in home equity, home equity has fallen to an estimated \$6.3 trillion as of the end of the fourth quarter last year. Homeowners have lost a lot of equity, which is stalling the recovery of the housing market, and in turn, having an impact on job creation. Jason Trennert concludes that until the housing market recovers, unemployment will not reach pre-recession lows.

Asking: Insights from the Experts

Dr. Kelly sees the job market working itself out, having already regained 1.8 million of the 8.8 million jobs lost. According to his analysis, if we continue to create around 200,000 jobs a month, in two years we will recover all the jobs lost and in four years we will be at full employment (around 5%). In order to create the 200,000 jobs each month, the broad economy will need to be operating at a level of around 3% to 3.5% GDP growth. Even considering May's weak employment numbers, when less than 50,000 jobs were created, the three-month average shows the private sector is producing around 200,000 new jobs a month. We find the three-month average much more instructive of the broader trend.

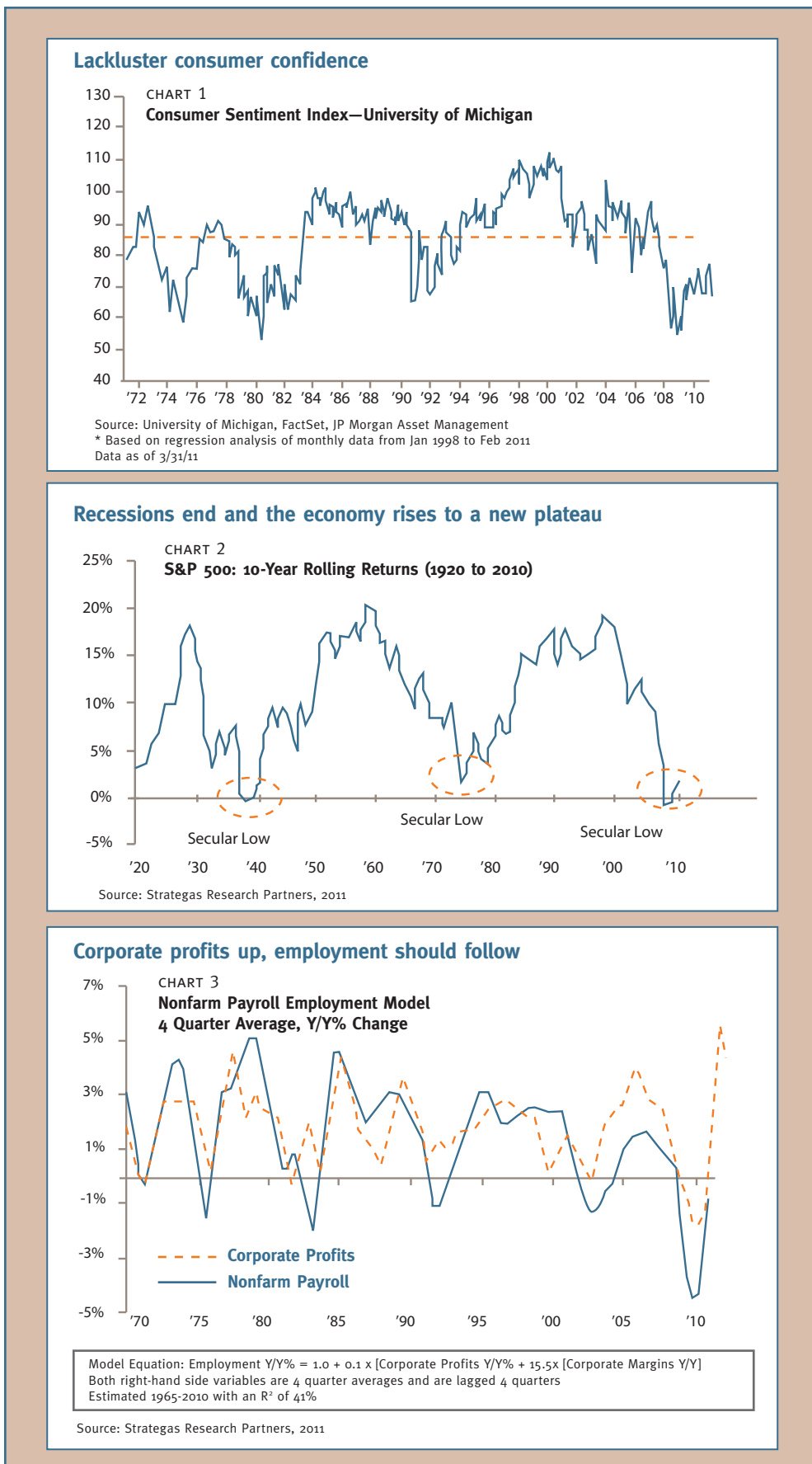
3. How Concerned Should We Be about the Level of Debt in the US and in Europe? What Are the Implications for Currencies?

Our experts have varying opinions on the levels of US and European debt. Peter Ricchiuti does not seem to view US debt as a great concern, offering that we have been at debt rates higher than this during the world war years (Chart 4). In his opinion, it is likely that we will have higher taxes as well as some budget cuts and changes to entitlement programs (like Social Security, Medicare, Medicaid) in the future. These, coupled with the higher revenue that the rebounded economy will provide, should help improve the debt situation. The weakness of the dollar is currently helping the US recovery, but the dollar will need to strengthen eventually.

On the other hand, Jason Trennert is more concerned about the current debt situation in the US. He believes that the method we are employing to fund our debt, using short-term Treasuries to fund massive long-term liabilities, is unsustainable. In his opinion, the most likely scenario to remedy this situation is controlled inflation and currency devaluation. This approach is more desirable than deflation, but less desirable than implementing sound policies to promote growth and to cut taxes and spending.

The European debt crisis is also a major concern. Dr. Kelly believes that the Europeans will solve their debt crisis problems. He is more worried about sovereign debt in Japan. Japan has a low long-term interest rate, but a

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Ten Questions Investors Are Asking

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lot of debt and will likely take on more as the country recovers from the earthquake and nuclear crisis.

Jason Trennert is worried about constraints imposed by a single European currency, which does not allow weaker European economies to use currency devaluation to play a role in correcting economic disequilibria. Further, Germany's strong recovery has the European Central Bank (ECB) raising rates to defend against inflation there, which is detrimental to Greece and Spain and the other EU countries struggling mightily in their recoveries.

4. Is Inflation a Real Threat?

Inflation and deflation have been concerns in this recovery and our experts agree that we appear to have successfully avoided deflation. This means that we will likely experience some inflation in the coming years.

Dr. Kelly identifies four possible inflation environments: high and rising inflation; high and falling inflation; low and rising inflation; and low and falling inflation. Currently, we are in an environment of low and rising inflation (Chart 5), and in this setting, equities and commodities have historically provided the best returns. Increases in food and gas prices have some investors worried. However, increased commodity prices usually lead to an increase in supply, which does not hit the market immediately. Oversupply, particularly with respect to commodities like corn, will eventually force prices down. Dr. Kelly concludes that there will be inflation, but outside of food, rent, and energy, it should not negatively affect investors too much. He predicts that the Fed will raise interest rates by the end of the year because of the slightly higher core inflation rate (inflation excluding fluctuating food and energy prices) and because other central banks are tightening. The current core inflation rate is 1.1%; overall inflation is 2.2%.

Peter Ricchiuti asserts that, absent wage inflation, we do not have to worry about hyper-inflation. We will not be in danger of wage inflation until unemployment dips below 7%, which our experts do not predict happening anytime in the next year.

5. Is There a Bond Bubble?

Our experts agree that we appear to be on the cusp of a bond bubble. A perceived problem with bonds is that they are being over utilized in investor portfolios. Chart 6 shows mutual fund flows in 2009 and 2010 combined.

Over this period of time, \$620 billion went into fixed income and the only flows into equities were in emerging markets. Bonds are traditionally considered a safe investment, but any interest rate increase, which Dr. Kelly predicts we could see by the end of the year, will cause bond prices to drop. In his opinion, "Nothing breeds complacency like long bull markets," and the bond market has experienced a bull market since 1981 when

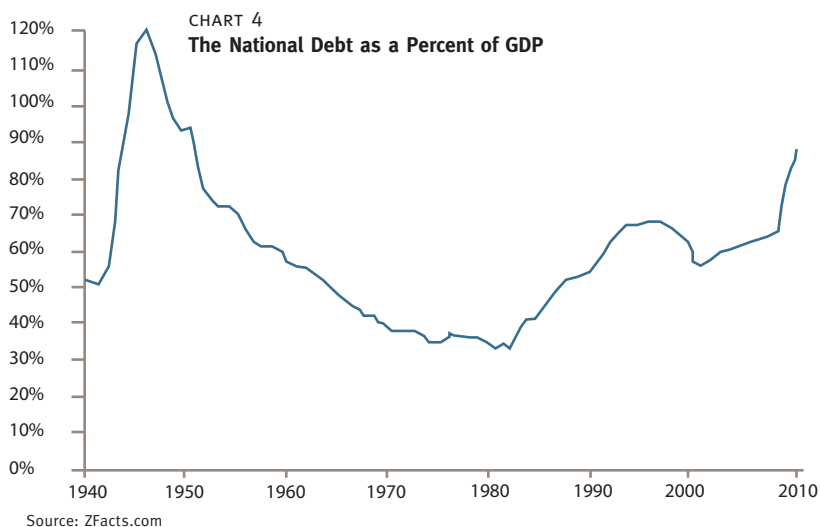
the 10-year Treasury hit its highest ever yield (Chart 7).

Interestingly, Peter Ricchiuti also foresees the Fed raising rates, but he views this as a vote of confidence in the economy's recovery. Regardless, investors severely overweighted in bonds will take a hit. See the article from Samson Capital Advisors, one of our bond managers, on page 7 for more insight about the bond market and inflation.

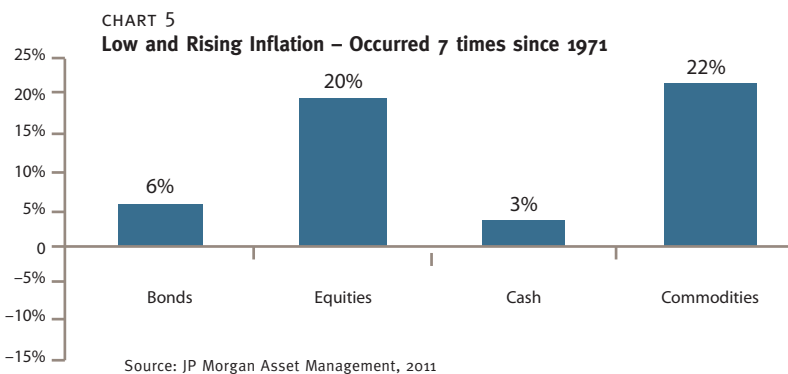
6. What Does Corporate Profitability Tell Us about the Economy?

Corporate profitability is a leading indicator of economic strength. As you can see in Chart 8, despite some ups and downs, corporate earnings have had an upward trajectory since the mid-1950s. Stocks have long been an attractive asset class because they are driven by corporate earnings, which have trended up. This is particularly good news now because corporate profitability

Although rising, debt level is below the historic peak



The current environment should support both equities and commodities



is nearing all-time highs (Chart 9). Jason Trennert and Peter Ricchiuti both agree that high corporate earnings indicate market strength. Dr. Kelly believes corporate profits and the economy will continue to grow, if a bit more slowly, in the coming months.

7. Is the Stock Market Too Far Ahead of the Economic Recovery?

The stock market has made an incredible recovery since the start of the recession. By the end of 2010, the financial sector had regained \$571 billion in GDP output, beyond the \$554 billion total output lost since the beginning of 2008, which is remarkable. Like corporate profitability, the stock market is a leading indicator of economic recovery.

There are still some troubling factors that we have to contend with including unemployment and the housing market, but our experts do not think that we have

seen the market top. Jason Trennert believes this is due in part to the lack of marginal buyers in the equity market resulting from the strength of flows into bonds. He explains, illustrated in Chart 10, "The average length of the bull market is around 57 months, rising an average of 164%. The current bull market is around 25 months, and has risen 102%. So, if the bull market were to end today, it would be one of the shortest and shallowest bull markets in history. At this point, it's hard to bet against the stock market."

According to Dr. Kelly, the forward price-to-earnings ratio, a commonly used valuation measure, as of the end of the first quarter was around 13, which is below the historic average of 16.5. Stocks are still cheap. Given the recent market pullback, valuations are even more attractive.

8. Will Gold Prices Continue to Boom?

Like the bond market, in the wake of the recession and taking into account investors'

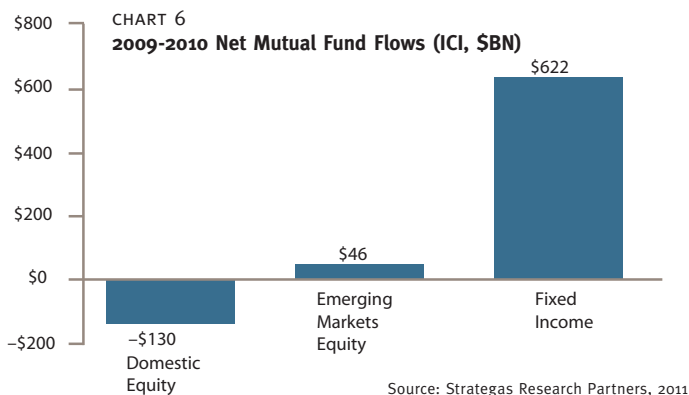
fears about volatility in the stock market, gold has been viewed as a safe investment and demand has driven prices to an all-time high. According to Jason Trennert, the popularity of gold has a great deal to do with fears about the sustainability of our current entitlement spending and related fears about the likelihood of the US dollar remaining the world's reserve currency. Until the US is able to address these issues, gold will remain popular.

9. What Can We Expect to Happen with Oil Prices?

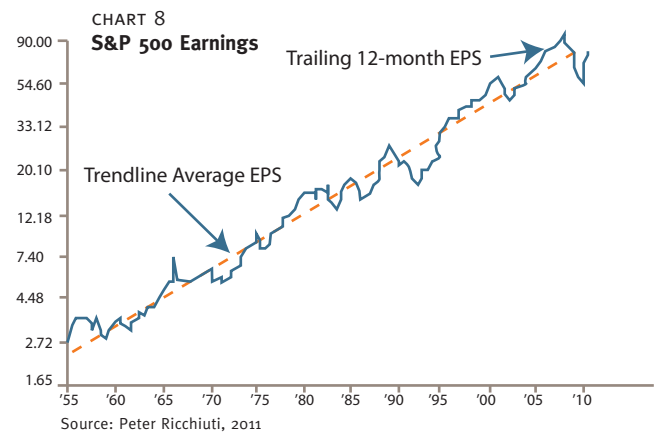
Oil prices have fluctuated quite a bit in the last few months, rising as high as \$114 a barrel in April. Peter Ricchiuti predicts that oil prices will stay around \$100 a barrel. While this is a high cost for consumers, it could have the positive impact of spurring domestic production as well as research and development into alternative energy.

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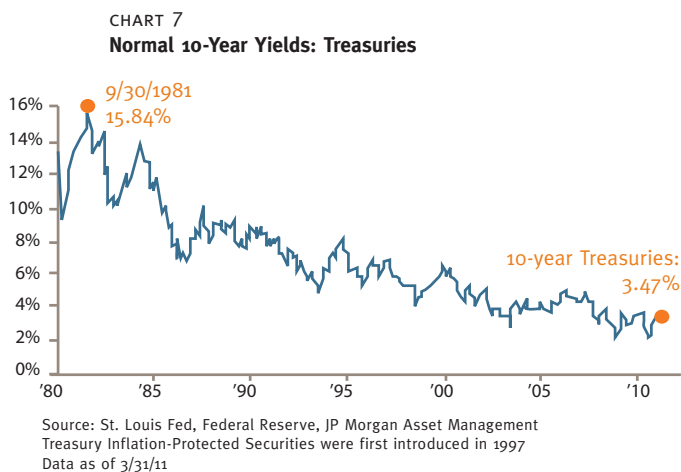
Many investors missed the domestic equity rally by flocking to bonds



Reliable upward trend in corporate earnings



Thirty year trend of falling bond yields



Corporate profits near all-time high



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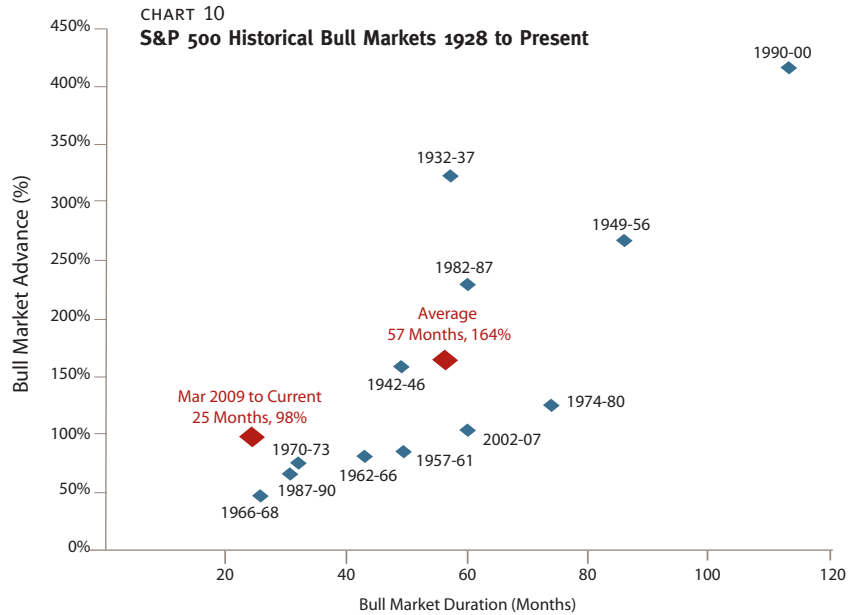
It is likely that oil prices will stay high. Jason Trennert points out that high oil prices may slow the economy down a bit, but the impact will not be felt as greatly in the US as it will in other countries where commodities make up a much larger percentage of consumer spending (Chart 11).

10. What is the Outlook for Emerging Markets?

All of our experts agree that over the long term, emerging markets will experience phenomenal growth. Still, Dr. Kelly thinks that emerging markets are expensive relative to their own history, particularly India, Mexico, and South Africa, as seen in Chart 12. He is also concerned that they may be susceptible to out-of-hand inflation in the future. Jason Trennert shares Dr. Kelly's sense of reservation concerning emerging markets.

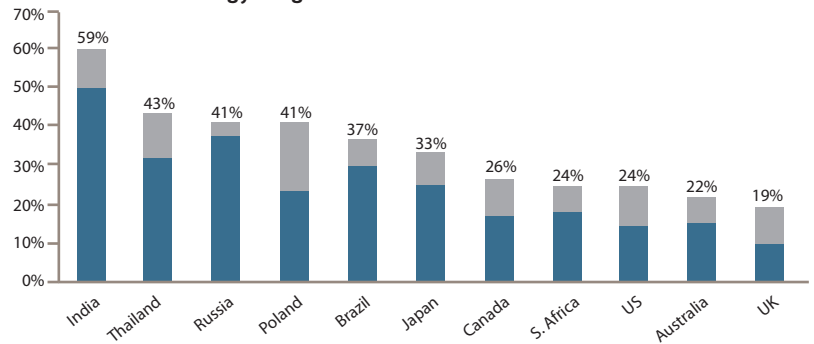
Dr. Kelly has concerns about interest rates and inflation in developing countries. The risk is that central banks are not responding appropriately with changes to monetary policy. Given how economies in developing countries are growing, we would expect real interest rates to be high; however, short-term interest rates are low relative to inflation in developing countries. Dr. Kelly has also made comments around the "new environment" emerging governments are finding themselves in. Extraordinary economic growth and a robust labor market can breed complacency. The question is whether or not these governments will have the discipline and conviction to raise interest rates and slow growth before reaching a point of runaway inflation.

Current recovery seems modest by historical measures. More to come?



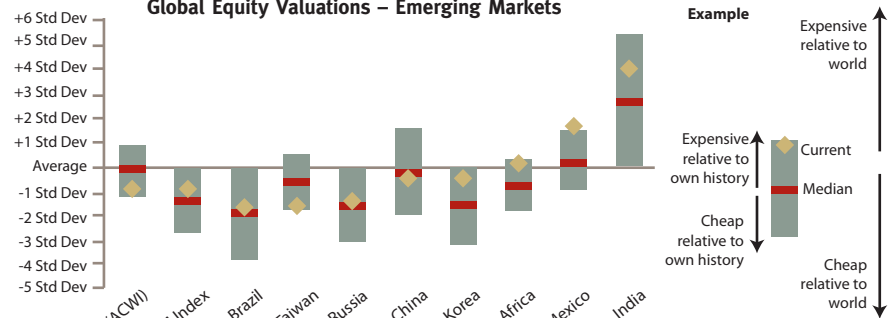
Food and energy take much bigger bite from emerging markets

CHART 11
Food and Energy Weight in the CPI



Lofty valuations for Indian and Mexican equities

CHART 12
Global Equity Valuations – Emerging Markets

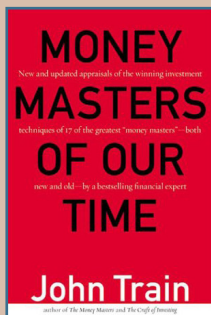


Recommended Reading

We look to our experts to supply us with new ideas and ways of thinking, so we thought it only made sense to ask them where they've turned for new ideas in the past. Jason Trennert and Peter Ricchiuti, along with Pitcairn CIO, Rick Pitcairn, shared a few of their recommendations. Enjoy!

Peter Ricchiuti's Recommendations:

1. *Money Masters of Our Time* by John Train.

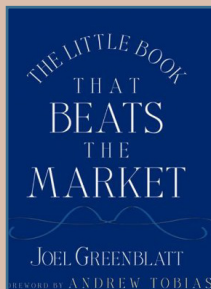


From Warren Buffet to George Soros, John Train examines the careers of 18 famous investors to understand how they achieved their success. Part biography and part investment

strategy, this book is an interesting study of some of the greatest financial minds of our times.

2. *The Little Book That Beats the Market* by Joel Greenblatt.

Joel Greenblatt explains his "value-oriented" approach to investing by looking at successful companies, like



Microsoft and Walmart, when they were very, very young. He identifies key characteristics that act as predictors of success and counsels investors on how to find companies that have those same characteristics today.

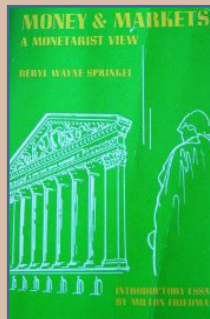
3. *Essays of the Great Depression* by Ben S. Bernanke. Federal Reserve Chairman

Ben Bernanke is one of the nation's preeminent scholars on the Great Depression. This collection of nine of his essays about the Great Depression explores its economic causes and the policies that it inspired.

Jason Trennert's Recommendations:

1. *The Mystery of Capital: The Reason Why Capitalism Works in the West and It Doesn't Work Everywhere Else* by Hernando DeSoto. Hernando DeSoto's book examines why some countries can generate wealth while others struggle to move beyond subsistence. In particular, it focuses on how the lack of appropriate legal structures inhibits the growth of capitalism in the developing world.

2. *Money and Markets: A Monetarist View* by Beryl W. Sprinkel. Beryl Sprinkel was an economist at the University of Chicago and a former Chairman of the Council of Economic Advisors. This book illustrates his simple approach, which was founded in the belief that if money growth is faster than nominal GDP growth, you don't want to be short financial assets; when money growth is slower than nominal GDP growth, you want to avoid financial assets.

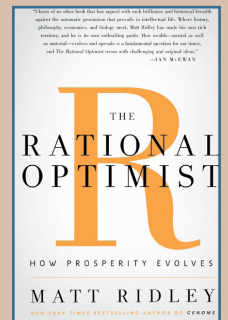


3. *The Forgotten Man* by Amity Shlaes. Amity Shlaes' book presents a unique historical perspective on government intervention in the Great Depression. In her view, FDR's excessive meddling in the overall economy did more to prolong the Depression than shorten it.

Rick Pitcairn's Recommendations:

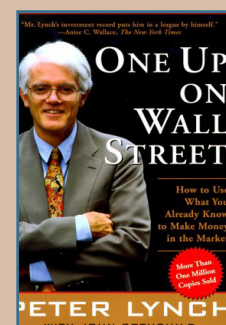
1. *The Rational Optimist* by Matt Ridley.

Matt Ridley applies his viewpoint as a science journalist to explain why, in spite of the myriad of problems that society is facing, humanity's awesome capacity to adapt to and generate change should enable us to feel optimistic about the future.



2. *Winning the Loser's Game* by Charles Ellis. A veteran of Harvard Business School and the Yale School of Management, Charles Ellis offers his lessons for sound long-term investments. Written with clarity and humor, Ellis' book aims to engage and inform the average investor about how to plan for success.

3. *One Up on Wall Street: How to Use What You Already Know to Make Money in the Market* by Peter Lynch with John Rothchild.



Peter Lynch with John Rothchild. Peter Lynch was the great money manager at Fidelity's Magellan Fund. This book offers advice to amateur investors about

how to research and identify companies with solid growth potential. Given Lynch's record of success, his advice is worth taking.

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