Bellwether CONSULTING

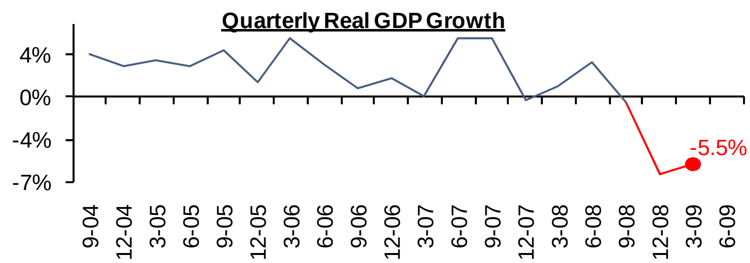
Your Quarterly Update on the Financial Markets

June 30, 2009

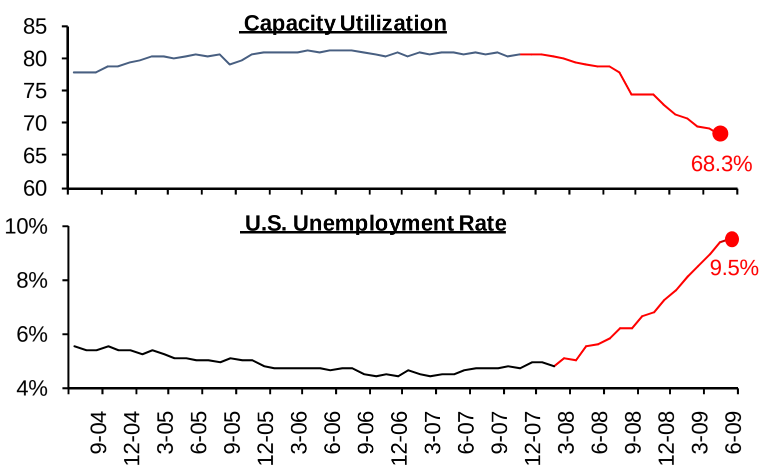
2nd Quarter

MARKET Recap

The Economy: *"Backwards at a Steady Pace"*

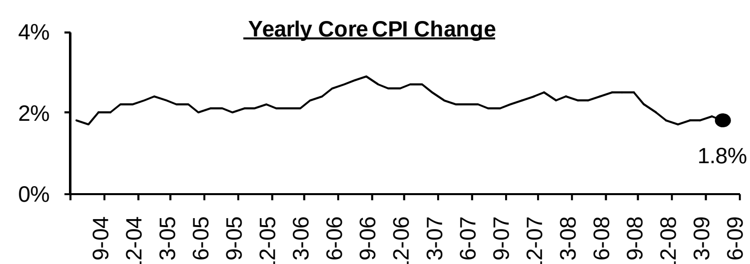


The US economy shrank at a -5.5% annualized pace in the first quarter, slightly better performance than Q4 but still indicative of recessionary shock. The problem areas were largely the same (e.g., residential fixed investment, exports, equipment & software) as the US housing market continued to contract and investment spending shrank. One major difference for the quarter was that personal consumption expenditures increased 1.4%, following a Q4 decline of -4.3%. Consumer spending continued to increase through May, although not in step with the rate of increase in personal income; said differently, the national savings rate continued to increase. In part, the greater savings rate simply reflects continued uncertainly and fear of mounting job losses, but it also reflects continued deleveraging as consumers begin to deal with the enormous debt overhang. While "savings" may seem like a new phenomenon, note that the current savings rate (6.9% of disposable income, or 6.2% of total personal income) remains below the pre-1985 average.



Through most of the second quarter predictions of impending recovery abounded. In our opinion, the data do not support that conclusion – rather, it is more likely that the "bow shock" is over, and that the pace of contraction will become more measured, but steady. Capacity utilization reached a 10-year low of 68.3% in May, due in part to consumption of inventories (which have decreased every month since August of 2008), but also to a new frugality among consumers that is, we believe, not entirely temporary. At some point capacity will need to be reduced, generating more layoffs and bankruptcies. There was little good news on the jobs front in the second quarter; payrolls fell by 467,000 in June following a 322,000 decline in May, and the unemployment rate climbed to 9.5% (a 15-year high). Debt overhang and excess capacity pose headwinds that will likely prove difficult to overcome in the near term.

One interesting effect of this recession is that price inflation has remained subdued; in fact, it is noteworthy that we have not witnessed deflation given the rapid decline in available credit (the balancing factor, of course, is massive government stimulus). Core inflation remained steady in May at 1.8% year-over-year, while overall inflation measured by the CPI has actually decreased due to the dramatic decline in oil prices over the last year. Although the near-term outlook for inflation remains subdued given the issues noted above, we remain very concerned about the inflationary nature of current monetary and (especially) fiscal policy in the long run. We are not alone in that thinking – inflation expectations manifest themselves in the bond market through steepening of the yield curve, as long-term lenders demand increased compensation to offset erosion in the value of funds they lend. While the steepness of the yield curve has not always been predictive of actual inflation, we do believe the current curve reflects a widespread concern among players in the capital markets, which if persistent will likely manifest itself in equity performance.



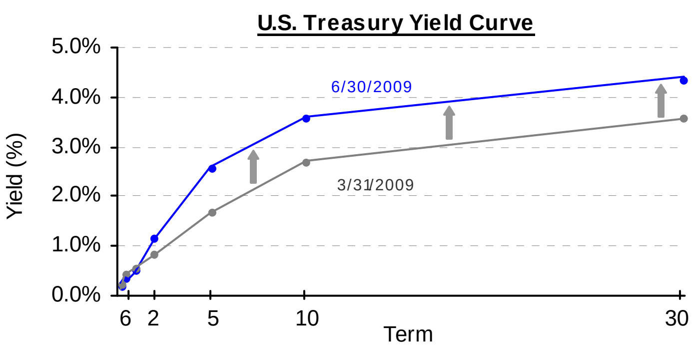
The U.S. Bond Market

Bond Indices - Q2 Total Return	
BarCap Aggregate	1.78%
BarCap Interm. Gov't	-1.44%
BarCap Long Gov't	-6.67%
BarCap Interm. Credit	7.59%
BarCap Long Credit	12.93%
BarCap High Yield	23.07%

The US investment-grade bond market performed slightly above its ten-year average in the quarter but reversed its relative performance against equities, which appreciated significantly. The global investment-grade market, Euro-denominated issues in particular, also out-performed the US by about 3.2%. The quarter saw the smallest change in bond prices since early 2007, suggesting a possible return to normality after 2008's tumult. In another sign of calmer conditions, the interbank TED spread fell from 99 basis points to 42 bps, closer to the historical average of 25 bps. Corporate Baa spreads over Treasuries fell from historically unprecedented levels close to 6% to merely "high" levels under 4%. In general, the dispersion of different sectors' yields is still very high by recent standards, so, if conditions are to return to what they have been, there is still significant room for Treasury and agency yields to rise and corporate yields to fall.

The high yield market had an extraordinary quarter, continuing to recover some of its 2008 losses; while we noted 6 months ago that wide spread levels for high yield debt represented an attractive investment opportunity, we believe that opportunity has largely passed by and spreads now provide fair (but not excessive) compensation for risk. Elevated levels of high yield defaults will probably continue into 2010, and weak covenants will keep recoveries low.

The Treasury yield curve's upward shift accompanied compressed credit spreads, but the yield curve also steepened significantly: the difference between two-year and ten-year rates increased by 56 bps. In contrast to the first quarter, in which very low long-term forward rates (i.e. market expectations for short-term interest rates far in the future) rose greatly, this quarter's shift indicated the greatest increase in three- to six-year forward rates – an expectation for rates to start rising earlier than previously expected. TIPS returned 0.66%, much better than nominal Treasuries. Break-even inflation expectations, roughly the difference between real and nominal yields, were running at a steady 2.5%. They reached a low of 0.25% for ten-year bonds in December 2008. During the most recent quarter, they continued to recover, rising from 1.11% to 1.75%. With regard to our extensive discussions of inflation elsewhere in the recap, note that even the longest horizon market inflation expectation (twenty years) has not yet recovered to the "steady state" of 2.5%.



Source: Bloomberg LP

Meanwhile, the Fed has been very active. Its total balance sheet did not change greatly, but this reflected the various liquidity facilities' significant reduction, matched by big increases in the Fed's Treasury portfolio (now $650B) and MBS portfolio (now $470B). The Fed in effect set mortgage rates to encourage refinancing and prevent a wave of mortgage defaults. Now it is trying to figure out what to do next. The governors toy with mechanisms to "sterilize" this activity, but that would still leave the Fed considerably involved in the housing market – for which it has already doubled its markets group with excess private sector structured finance specialists. It will eventually have to start selling, with significant debt market implications. The Fed has also started to take Maiden Lane markdowns – Maiden Lane being the code name for the Bear Stearns and AIG bailouts – reminding us of our collective bill for those interventions.

On a sector basis, the large securitized issues sector returned in line with historical averages. Treasuries seemed to revert to the mean somewhat, losing some of their extraordinary depth-of-the-crisis popularity. Agency issues (primarily GSE debt) stayed relatively flat after their strong gains last year. That left corporate debt to have the strongest quarter (its best in ten years), although it has not quite recovered from 2008's trauma. There may still be room for caution: corporate defaults are still rising and financial debt, which appreciated most strongly, continues to reflect deteriorating fundamentals. Other sectors with poor fundamentals include gaming, lodging, restaurants, and insurance.

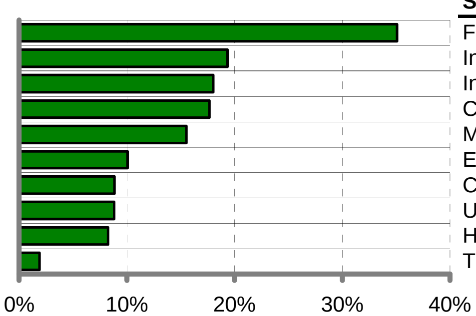
The U.S. Stock Market

The second quarter of 2009 closed with all major indices posting double-digit positive returns, despite a lackluster June, eliciting a sigh of relief from investors. The Dow turned in its best quarter in 5 years, up 11%, or 838 points, and the NASDAQ closed the quarter up 306 points. The turnaround that began in March extended through the first two months of the quarter, and brought the S&P 500 to 919 (up 121 points from Q1 2009) and its best quarter since 1998. Unfortunately, the gains did little to erase the losses of recent prior periods. For instance, while up 29% since March, at the quarter close the Dow was still 40% off its October 2007 peak. The S&P 500 needs to gain 60% in the next six months just to break even for the decade. Such a recovery seems more than unlikely, with many analysts wondering if another big jump in shares over the next few months would just be a sign that stimulus spending is inflating another asset-price bubble.

Stock Indices - Q2 Total Return			
Largecap Stocks		**Midcap Stocks**	
S&P 500	15.93%	S&P Midcap 400	18.75%
Russell 1000	16.50%	Russell Midcap	20.80%
Growth	16.32%	Growth	20.67%
Value	16.70%	Value	20.94%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	20.34%	S&P Smallcap 600	21.06%
DJ Wilshire 5000	16.79%	Russell 2000	20.69%
		Growth	23.38%
		Value	18.00%

The rebound was spread fairly evenly across the capitalization sectors, as well as among growth and value stocks. But predictably, small-cap growth holdings fared the best. Higher-risk holdings typically lead the market once it hits bottom (or is thought to have hit bottom), but earnings and growth are ultimately needed to sustain any kind of advantage. In the industry sectors, it was large-cap financials that outpaced everything else, bringing the strongly-linked information technology sector along for a bit of the ride. Defensive sectors like utilities and healthcare, did significantly worse. Telecom was at the bottom of the heap, brought down by widespread belief that growth for the sector would lag the broader market for some time. Early in the quarter, financial stocks snapped back from devastating prior quarters led by diversified banks and financial services after Treasury Secretary Geithner told Congress there were conditions under which the banks would be allowed to repay their TARP loans. By early June the official announcement came that 10 major banks would be permitted to pay back a total of $68.3 billion, representing more than one quarter of the bailout money given to banks since last October. While Citigroup, Bank of America, and Wells Fargo were not among those queuing up to return their bailout funds, they joined their large financial peers in posting quarterly gains that exceeded the broader market, some by 2-, 3- and 4-times. More than 600 banks nationwide have received TARP money, and 22 smaller banks already have repaid it, although not with the same fanfare of the banking giants. Financial sector stocks in the mid- and small-cap sectors also posted positive quarterly returns, but their gains (11.60% and 6.60%, respectively) were nowhere near those of their large-cap counterparts or even the benchmark indices for their capitalization sectors.

S&P 500 Economic Group Components - Total Return



Sector	2Q2009
Financials	35.08%
Info Tech	19.35%
Industrials	18.01%
Consumer Disc.	17.65%
Materials	15.53%
Energy	10.06%
Consumer Staples	8.87%
Utilities	8.83%
Healthcare	8.27%
Telecom	1.90%

Earnings for S&P 500 companies are expected to decline by 36% in the second quarter of 2009, according to Thomson Reuters data. While all industry sectors are anticipated to fall, healthcare should fare the best, slipping just 2%. The materials and energy sectors are forecast to do the worst, falling 79% and 65%, respectively. Profits of consumer discretionary companies, a sector that includes retail and auto, should drop 36%.

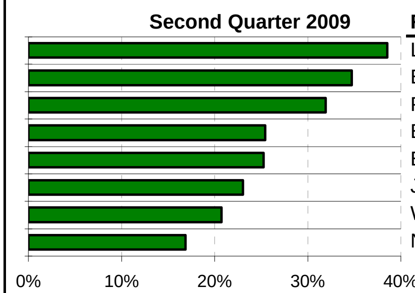
Overseas Markets

Global markets experienced a strong bounce during the second quarter. Economic data continued to deteriorate, but many regions were buoyed by a moderation in recessionary indicators. Significant liquidity injections by central banks across many regions also appear to be making an impact. Emerging markets appreciated significantly during the quarter, as commodity prices rebounded, outpacing their developed market peers by double digit gains in many cases.

The Eurozone continued to experience economic contraction through the second quarter with GDP falling 1.5%. Falling prices, a slight bounce in the stock markets and a marginal increase in both business and consumer confidence has led to a “wait and see mood” ahead of the next ECB meeting in early July. Eurozone CPI remained at a record low of 0.6% for the quarter as unemployment rose to a record 10-year high of 9.5% in May. Germany and France, the zone’s two largest economies, remain mired in negative trends. Both countries continue to experience high levels of unemployment along with low consumer confidence. At the close of the quarter unemployment in Germany had risen to 7.7% while in France it rose to 9.3%. In the U.K., GDP continued to fall during the second quarter but did begin to show some moderation. The increasing debt load in the U.S. has not helped the Eurozone as the resulting strengthening of foreign currencies versus the dollar has made exports less competitive. The MSCI Germany and France Indexes were up 20.1% and 18.4%, respectively.

In Japan, the central bank’s policy board warned that it was likely to cut economic growth-rate projections because data showed that the economy had worsened more than expected. In response to slowing growth, the central bank said it would broaden its purchases of government bonds to bolster liquidity and ensure market stability. At its April meeting the Bank of Japan took additional measures to help the flagging economy, further expanding the collateral that can be used to secure loans. Given the current climate, spending by both households and companies remained depressed early in the quarter. The BOJ indicated that there continues to be downward pressure on prices. In May, corporate service prices fell 3% (year-over-year), down for the eighth month and accelerating from a 2.4% fall in April. Japan's trade surplus also slipped as exports deteriorated in the wake of the global slowdown. The nation's exports fell 40.9% for the year ending in May, down for an eighth straight month. Despite all of the negatives, there is evidence that Japanese companies are growing more optimistic about the future outlook.

Net Total Return of Selected MSCI Regional Indices



Region	2Q09
Latin America	38.53%
Emerging Markets	34.73%
Pacific ex Japan	31.93%
EAFE	25.43%
Europe	25.26%
Japan	23.05%
World Index	20.75%
North America	16.85%

After some positive news showing better than expected growth during the first quarter, China's economy appeared to be losing traction in the second quarter with some sectors showing signs of slackening after an initial growth spurt. The economy cooled noticeably in the second half of April, with electronic goods and department store sales both trending lower. Evidence of weaker data indicating a slowdown in the materials sector and electricity consumption has also been noted. Consensus among economists appears to be that China will move through a "soft patch" in the next few months, but that it would not derail the fledgling recovery. In fact, the World Bank raised its 2009 growth estimate for China to 7.2%, up from its projected 6.5% in March, linking much of the increase to strong stimulus spending. In the meantime, China continues to press for a new global reserve currency – a move away from the dollar. Since December, China has agreed to six bilateral currency swaps with central banks in Asia and Latin America to allow those countries to lend yuan to domestic importers to pay for Chinese goods. During the second quarter China reached agreement with Brazil to settle trades in their respective currencies. The MSCI China Index was up 35.5%.

Emerging markets performed well during the quarter. Developing market bonds returned 10.2% in the second quarter, the most in seven years, and nearly 14% for the first half of the year as investors' appetites were driven by the prospects of government stimulus plans, interest rate cuts, and IMF support to help developing nations deal with worldwide recession. Yield spreads have narrowed nearly 250 basis points since the beginning of the year, leading to what many investors believe may be the end of the best rally since 2002. According to data from Bloomberg, emerging market countries and companies sold more than $77 billion in international bonds during the first half of 2009; debt sales are expected to reach approximately $115 billion by the end of 2009.

Latin American emerging markets showed strength. In Brazil, the real enjoyed record quarterly performance as signs of Latin American recovery continue to attract foreign investments. The real rose 19% in the second quarter as Brazil's commodity export prices have begun to rebound. Brazil's GDP shrank 1.8% in the first quarter (year-over-year), less than the consensus estimate of 2.8%. The MSCI Brazil Index was up 40.9%. In Argentina, economic growth slowed in April from March, adding to concerns that the economy may shrink for the first time in seven years. President Kirchner seems to be pulling out all stops to prevent a contraction, introducing a stimulus package worth $29 billion to increase public works and fuel spending. She also allocated a portion of the pension funds she nationalized in 2008 to encourage construction, purchase of consumer goods and low-cost mortgages. Despite these actions, it is anticipated that a decline in consumption will cause a contraction of close to 2% for 2009. The MSCI Argentina Index was up 37.0%.

Focus On: *Hyperinflation in Brazil*

Only one year ago, US retail gasoline prices peaked at just over $4.00 per gallon, up from about $2.85 per gallon 12 months earlier. Fortunately, broader measures of inflation never approached this level, but a 41% increase in gas prices in one year had serious implications for the auto industry, the economy in general, and even the presidential election. Although recession and turmoil have since all but erased that price inflation from our memories, it was a real problem at the time. Today the average retail price for gasoline is about $2.60 per gallon. Imagine if one year from now the price at the pump was $80.00 per gallon. Unlikely, to be sure – but is it impossible? During the late eighties and early nineties in Brazil, the annual inflation rate reached almost 3,000% – not for a single commodity like gasoline, but for consumer prices broadly.

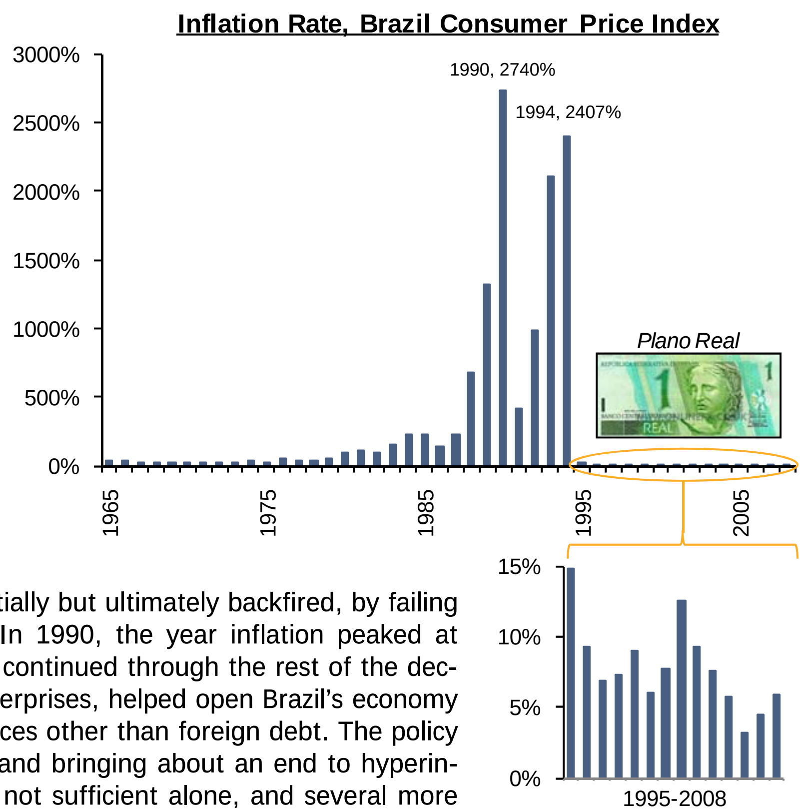
Hyperinflation devastated the Brazilian economy and its people, significantly impacting the average person's daily life. Most Brazilians were members of the lower classes with no access to bank accounts or other investments that were indexed for inflation. These people were hit the hardest, as the purchasing power of their savings evaporated. The middle and upper classes, who kept savings in inflation-adjusted bank accounts, were less affected by hyperinflation. The disproportionate impact of inflation on the poor made inflation a particularly disruptive political problem.

Recently, some have asked if the United States is facing a deflationary spiral and a "lost decade" like that experienced in Japan. While there are many differences between our situation and theirs, it was a sobering and useful exercise to examine the Japanese experience and to try to incorporate its lessons into current policy. We think a similar examination of the counter-scenario, hyperinflation like that experienced in Brazil, is equally useful.

Causes of Hyperinflation in Brazil

The hyperinflation of the eighties and nineties in Brazil did not develop overnight. The problem began as early as the 1940's and steadily worsened through the second half of the twentieth century. (We've provided a timeline of events at the end of this article.)

Before 1985, a military government ruled Brazil with a single-minded focus on rapid economic growth. By the seventies, Brazil was indeed the fastest growing economy in the world with a 10% annual growth rate. However, a policy of growth at any price drove suboptimal and risky decisions. In 1945 the Brazilian government established an overvalued foreign exchange rate that was fixed until 1953, when it was replaced with a managed multiple-exchange-rate system. A balance of payments deficit ensued which left domestic industry vulnerable. In response, the government introduced a policy of import-substitution industrialization. This policy used foreign-exchange controls and trade restrictions to protect specific parts of domestic industry, wide segments of which were state-owned or controlled. The import-substitution industrialization program, coupled with rapid growth of the economy, created a financing gap which was met by a large influx of foreign capital and an increase of Brazil's foreign debt.



With a clumsy system of production unable to respond appropriately to high demand, prices began to climb. In 1982 Brazil, along with Mexico, defaulted on its foreign debt. At the same time, international financial markets were closing to third world countries after the oil shocks of the seventies. Foreign investments were halted, internal debt grew, and there was little capital available for investments. As inflation and debt increased, political turmoil ensued. In 1985 Tancredo Neves became the first civilian president elected under the Electoral College in 21 years. But he fell ill and died before his inauguration. His Vice President José Sarney took office, ending Brazil's military regime.

Sarney was the first in a line of Brazilian presidents to engage in inflation stabilization plans. He and successor Fernando Collor were responsible for at least eight different stabilization initiatives, all of which involved price and wage freezes. All worked initially but ultimately backfired, by failing to curb inflation and generating painful shortages. In 1990, the year inflation peaked at 2,740%, a privatization program was introduced that continued through the rest of the decade. The policy of "aberture," selling state owned enterprises, helped open Brazil's economy to foreign competition and generate capital from sources other than foreign debt. The policy was a significant step in reforming Brazil's economy and bringing about an end to hyperinflation. Unfortunately, the privatization program was not sufficient alone, and several more stabilization plans failed.

Finally, in 1994 the Plano Real (Real Plan), initiated by President Itmar Franco and Minister of Finance Fernando Henrique Cardoso, tamed inflation and stabilized the economy. A major problem with inflation left unaddressed by previous plans had been indexation. Indexation occurs when buyers and sellers form high inflationary expectations and then adjust their prices to the expected inflation rate, creating a vicious inflationary cycle. To combat this, the Real Plan devalued Brazil's currency and created an entirely new currency to take its place. Brazil's currency at the time was the Cruzeiros Reais. The government created an intermediary index called the Unidade Real de Valor or URV which they pegged to the value of the United States dollar. All prices were then quoted in both the URV and the Cruzeiros Reais. Even with a rising Cruzeiros Reais, the URV remained relatively stable (because of its connection to the dollar) and discouraged indexation. In late 1994 the Cruzeiros Reais ceased to exist and the URV became the Real.

The Real Plan solved the problem of indexation and created a temporary period of confidence for investors. This confidence was shattered during the 1997 Asian debt crisis, when high interest rates and an overvalued currency hurt exports and increased imports. This increased Brazil's already significant balance of payments deficit. And with Brazil's economy now open for competition, falling exports drove several Brazilian companies to fail. In 1998 Brazil's economy was hit by both the collapse of the Asian stock markets and Russia's default on its debt, and was only saved by an IMF rescue package. Brazil was forced to devalue the Real again in 1999. The abrupt devaluation upset Brazil's economy, and the debt crisis initially worsened, with both retail and wholesale inflation increasing sharply.

In contrast to past practice, Brazil responded aggressively to the crisis. Short term interest rates were raised to control the spike in inflation and many of the central bank's directors were replaced. The Real's peg to the United States dollar was ended, and the government instituted a formal inflation targeting regime that is still used today. In 1999 the target was set around 8-9% and, as the years went on, the target was lowered. (The 2010 target will be about 4.2%.)

In 2002, financial markets panicked on the expectation that left-wing candidate Luiz Inácio Lula da Silva would win the presidency. The Real hit an all-time low, but Lula still won. His left-wing government, the first in more than forty years, has so far been relatively successful. In 2005, Brazil paid its debt to the IMF in full. And in 2008, Brazil actually became a net foreign investor for the first time. As of May of this year, inflation was at 5.2% compared 2,739% in the 1990's. Brazil's credit rating was upgraded to investment-grade levels by all major rating agencies except Moody's in 2008, and currently, Moody's has Brazil on credit watch for a possible upgrade.

Lessons Learned from Brazil's Experience

It has been decades since broad inflation posed significant problems in the US economy. One lesson from Brazil's experience is the danger of policy complacency regarding inflation. Unlike the high inflation that occurred in Europe after World War I, hyperinflation in Brazil was not a result of destructive war. Brazil's example suggests shocks can unpredictably and completely upset a vulnerable economy.

Factors that led to, or compounded, the inflation problem in Brazil included:

- Excessive focus on economic growth, domestic consumption, and domestic employment.
- Debt levels increasing faster than real GDP.
- State ownership of industries and protectionist trade policies.
- Indexation of social benefits and, ultimately, asset values to inflation.

The United States experienced strong growth for a developed country prior to the 2008 recession. That growth in part, like Brazil's rapid expansion, was funded by debt. Today the US government is accumulating even more debt in order to mitigate recession, but this may not be the best long-term solution – it certainly did not end well for Brazil. In order for Brazil finally to regain control after the hyperinflationary crisis, the government had to completely reform. Brazil was forced to open its industries to foreign investment and competition, devalue its currency, adopt a floating exchange rate, and institutionalize budget discipline through inflation targeting. Ultimately it took budget discipline and commitment to sound monetary policy to produce stability in Brazil.

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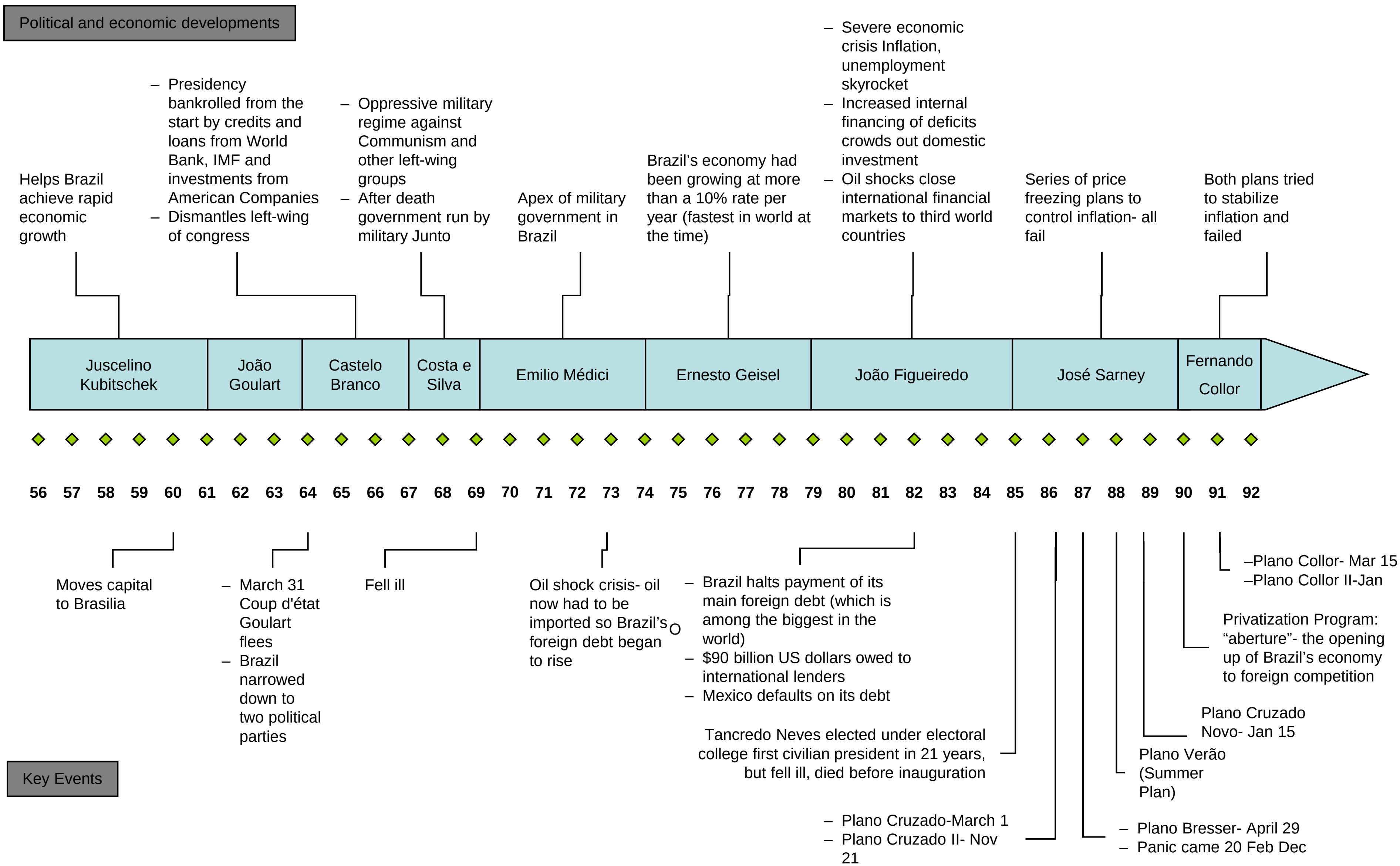
Recent Economic History of Brazil (1956 - 2009)



Recent Economic History of Brazil (1956 - 2009)