



Reinhart Partners, Inc.

*Registered Investment Advisor*

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**The Markets: Long-Term Challenges,  
Near-Term Opportunities**

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*“All attempts at artificial aviation are not only dangerous to human life, but foredoomed to failure from the engineering standpoint.”*

- American Astronomer Simon Newcomb, 1906 (three years after Kitty Hawk flight.)

*“It certainly seems to be a reasonable conclusion that the possible maximum for automotive passenger cars can not exceed one to every family.”*

- Forbes Magazine, November 24, 1923.

*“There is only enough natural gas for another 25 years or so...By the end of the century there will be practically no tungsten, copper, lead, zinc, gold, silver, or platinum.”*

- Teddy Goldsmith, Can Britain Survive?, 1971

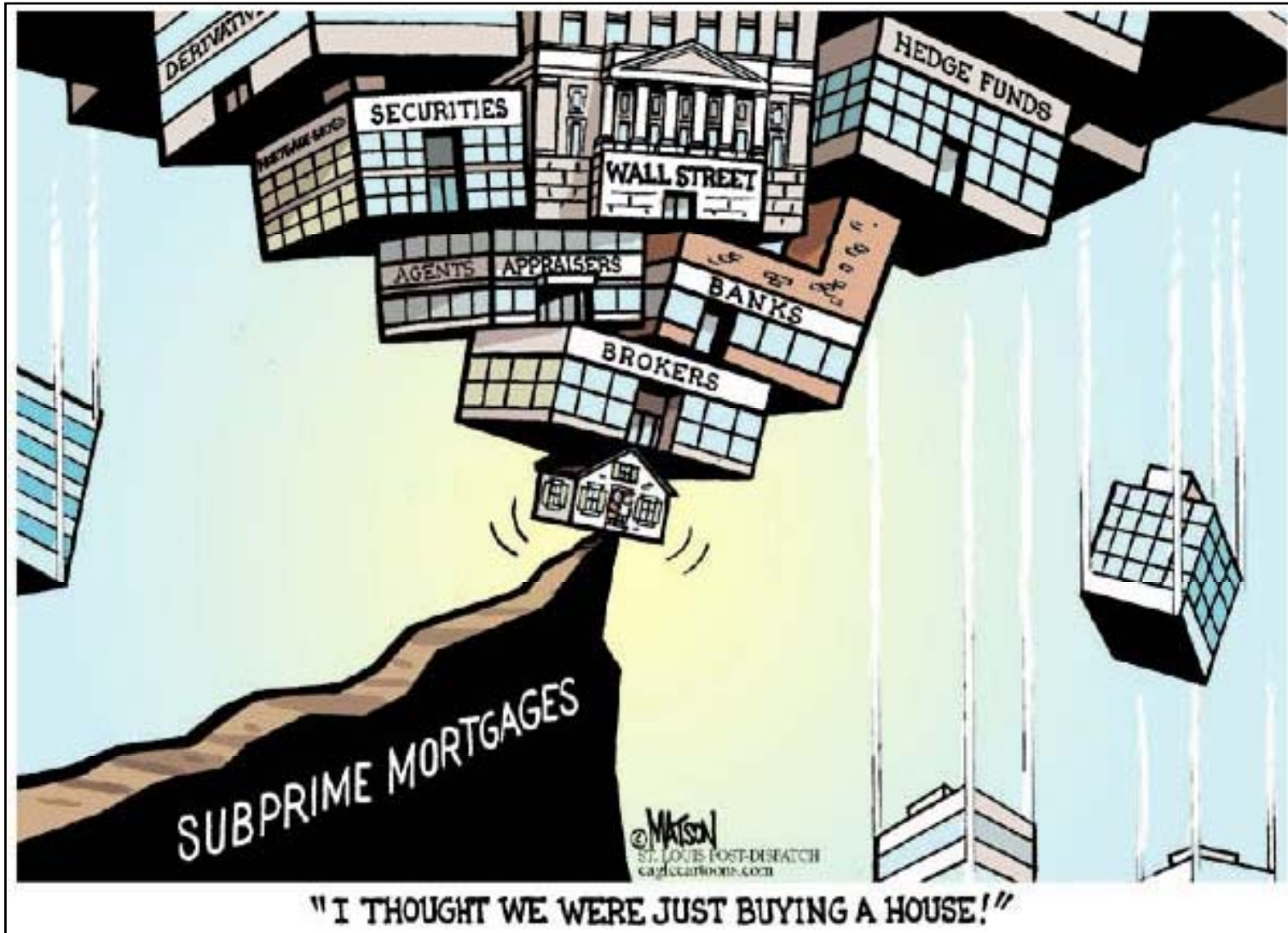
In 1952, IBM forecasted the total global market for computers as 52 units. In 1982, IBM forecasted the total global market for PC's as 200,000 units. In 1966 RCA forecasted that there would be 220,000 computers in the United States by the turn of the 21<sup>st</sup> Century.

- Less than current weekly shipments.

***“P.A.S. Franklin, Vice President of the International Mercantile Marine Company, said this morning that... there was no cause for alarm regarding the safety of the passengers or the ship, as they regard the Titanic as being practically unsinkable...The Titanic is well able to withstand almost any exterior damage and could keep afloat indefinitely after being struck...Franklin was most emphatic in his assurances regarding the safety of the passengers and the steamer.”***

- Press release of April 15, 1912. (The ship had already sunk with 1,500 passengers.)

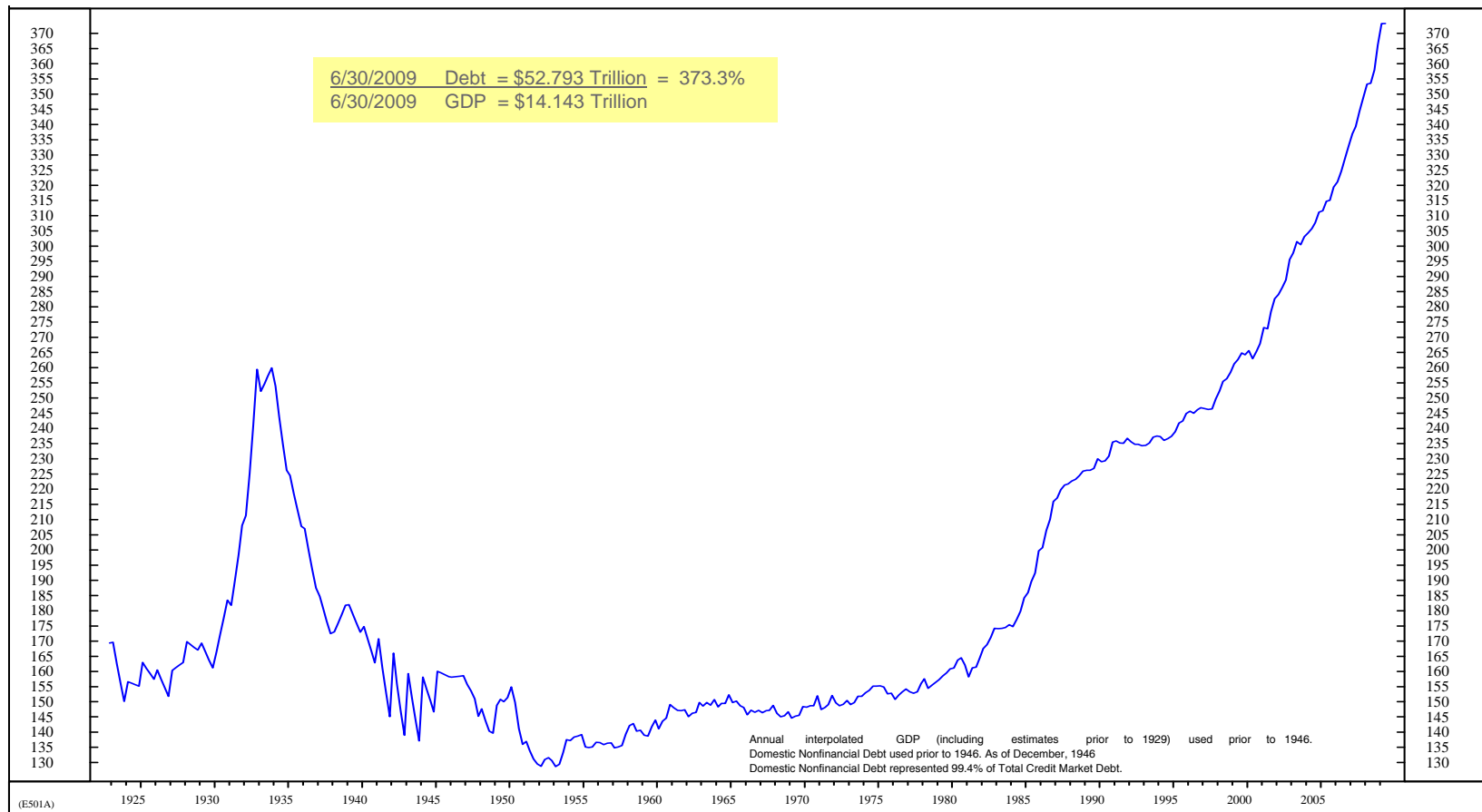
## Where Things Started To Go Wrong...





# The Real Problem: 56 Years of Increasing Leverage

## Total Credit Market Debt as a Percentage of U.S. GDP 12/31/1922 - 6/30/2009



- Massive build-up of corporate and consumer leverage supported by falling interest rates, declining underwriting standards, and reduced regulatory oversight



# Total Credit Market Debt and Components

Total Credit Market Debt and Components				
	1980	1990	2000	2008
Total GDP	\$2.8	\$5.8	\$9.8	\$14.2
Total credit market debt	\$4.7	\$13.8	\$27.5	\$52.5
Households	\$1.4	\$3.6	\$7.2	\$13.8
% of total debt				26%
Federal Government	\$0.7	\$2.5	\$3.4	\$6.4
% of total debt				12%
Agency/GSE mortgage pools	\$0.1	\$1.0	\$2.5	\$5.0
% of total debt				9%
State and local government	\$0.3	\$1.1	\$1.3	\$2.2
% of total debt				4%
ABS issuers	\$0.0	\$0.3	\$1.8	\$4.1
% of total debt				8%
Non Financial business	\$1.5	\$3.7	\$6.5	\$11.2
% of total debt				21%
Other	\$0.6	\$1.5	\$4.8	\$9.9
% of total debt				19%
(\$ Trillions)				

Debt as a % of GDP				
	1980	1990	2000	2008
Total Debt as % of GDP	169%	237%	280%	370%
Households	50%	63%	73%	97%
Federal Government	26%	43%	34%	45%
Agency/GSE mortgage pools	5%	18%	25%	35%
State and Local government	26%	43%	13%	16%
ABS issuers	0%	5%	19%	29%
Non Financial business	53%	65%	66%	79%
Other	22%	26%	49%	70%

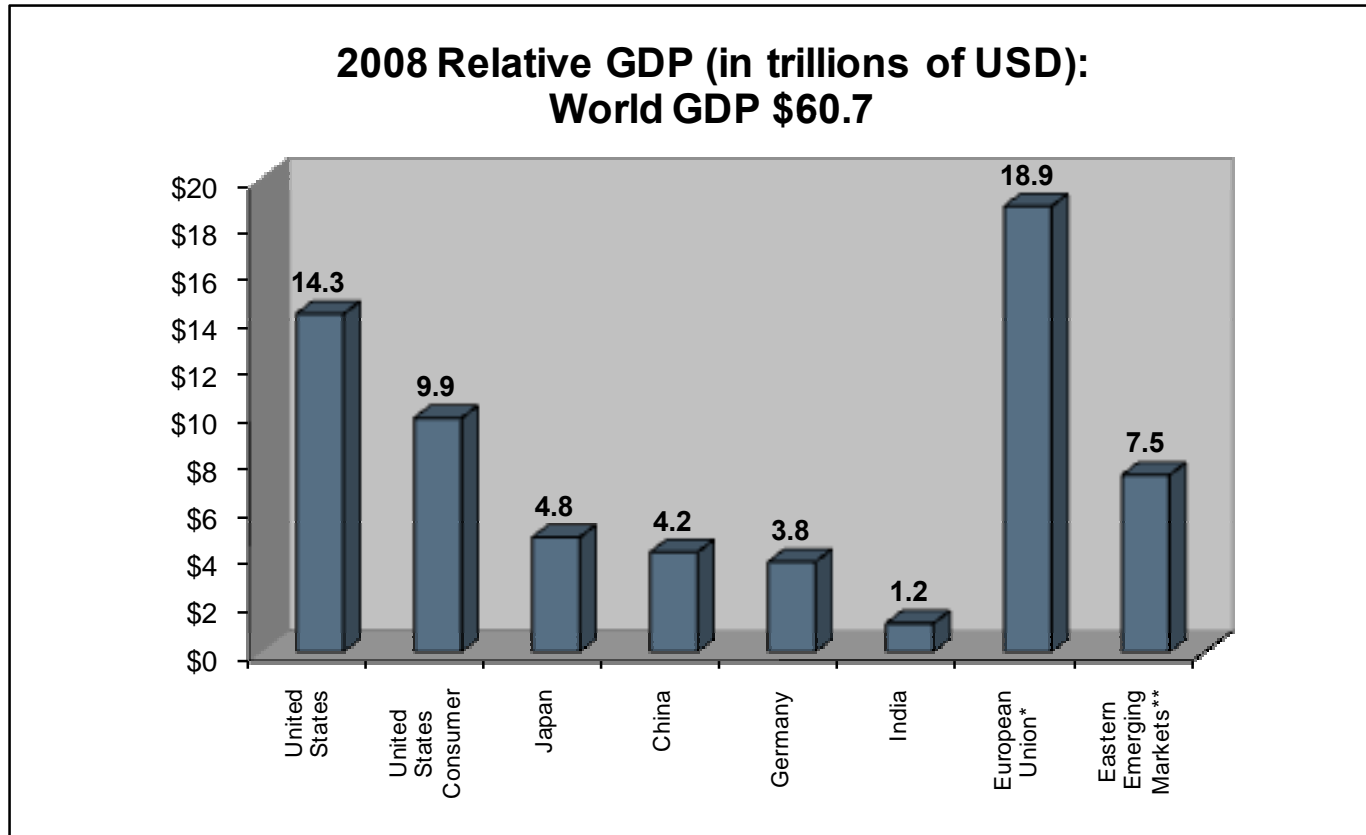


## Components of GDP: Where Will Economic Growth Come From?

### Components of GDP

(\$ Billions)	1980	% of GDP	1990	%of GDP	2000	% of GDP	2008	% of GDP
<b>Total GDP</b>	<b>\$2,790</b>		<b>\$5,803</b>		<b>\$9,817</b>		<b>\$14,200</b>	
<b>Personal consumption expenditures</b>	<b>\$1,757</b>	<b>63%</b>	<b>\$3,840</b>	<b>66%</b>	<b>\$6,739</b>	<b>69%</b>	<b>\$9,928</b>	<b>70%</b>
-Durable goods	\$214	8%	\$474	8%	\$863	9%	\$946	7%
-Nondurable goods	\$696	25%	\$1,250	22%	\$1,947	20%	\$2,839	20%
-Services	\$847	30%	\$2,116	36%	\$3,929	40%	\$6,143	43%
<b>Gross private investment</b>	<b>\$479</b>	<b>17%</b>	<b>\$861</b>	<b>15%</b>	<b>\$1,736</b>	<b>18%</b>	<b>\$1,906</b>	<b>13%</b>
-Nonresidential	\$362	13%	\$622	11%	\$1,232	13%	\$1,504	11%
1. Structures	\$136	5%	\$203	3%	\$313	3%	\$568	4%
2. Equipment and software	\$226	8%	\$420	7%	\$919	9%	\$936	7%
-Residential	\$123	4%	\$224	4%	\$447	5%	\$438	3%
<b>Net exports of goods and services</b>	<b>-\$13</b>	<b>0%</b>	<b>-\$78</b>	<b>-1%</b>	<b>-\$380</b>	<b>-4%</b>	<b>-\$545</b>	<b>-4%</b>
-Exports	\$281	10%	\$552	10%	\$1,096	11%	\$1,725	12%
-Imports	\$294	11%	\$630	11%	\$1,476	15%	\$2,270	16%
<b>Gov't consumption expenditures and gross investment</b>	<b>\$566</b>	<b>20%</b>	<b>\$1,180</b>	<b>20%</b>	<b>\$1,722</b>	<b>18%</b>	<b>\$2,911</b>	<b>21%</b>
-Federal	\$244	9%	\$508	9%	\$579	6%	\$1,107	8%
1. National defense	\$168	6%	\$374	6%	\$370	4%	\$757	5%
2. Nondefense	\$76	3%	\$134	2%	\$209	2%	\$350	2%
-State and local	\$322	12%	\$672	12%	\$1,143	12%	\$1,804	13%

## Lost U.S. Consumer Demand Not Easily Replaced By Foreign Demand



- U.S. Consumer is more than 2.3 times the size of the Chinese economy

Footnotes:

\* European Union includes Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and United Kingdom.

\*\*Eastern Emerging Markets includes China, India, Indonesia, Malaysia, Morocco, Philippines, Thailand, and Turkey.



# Private Investment Unlikely: Spare Capacity is at 40 Year Highs



- Historic high levels of spare capacity
- New investment less likely with current slack in capacity



# Restocking Inventories: Need Consumer Demand to Stimulate Shipments



- High levels of inventory relative to current demand
- Inventory management vastly improved
- Trend is improving



# Demographics: A Headwind for Personal Consumption and New Housing Starts

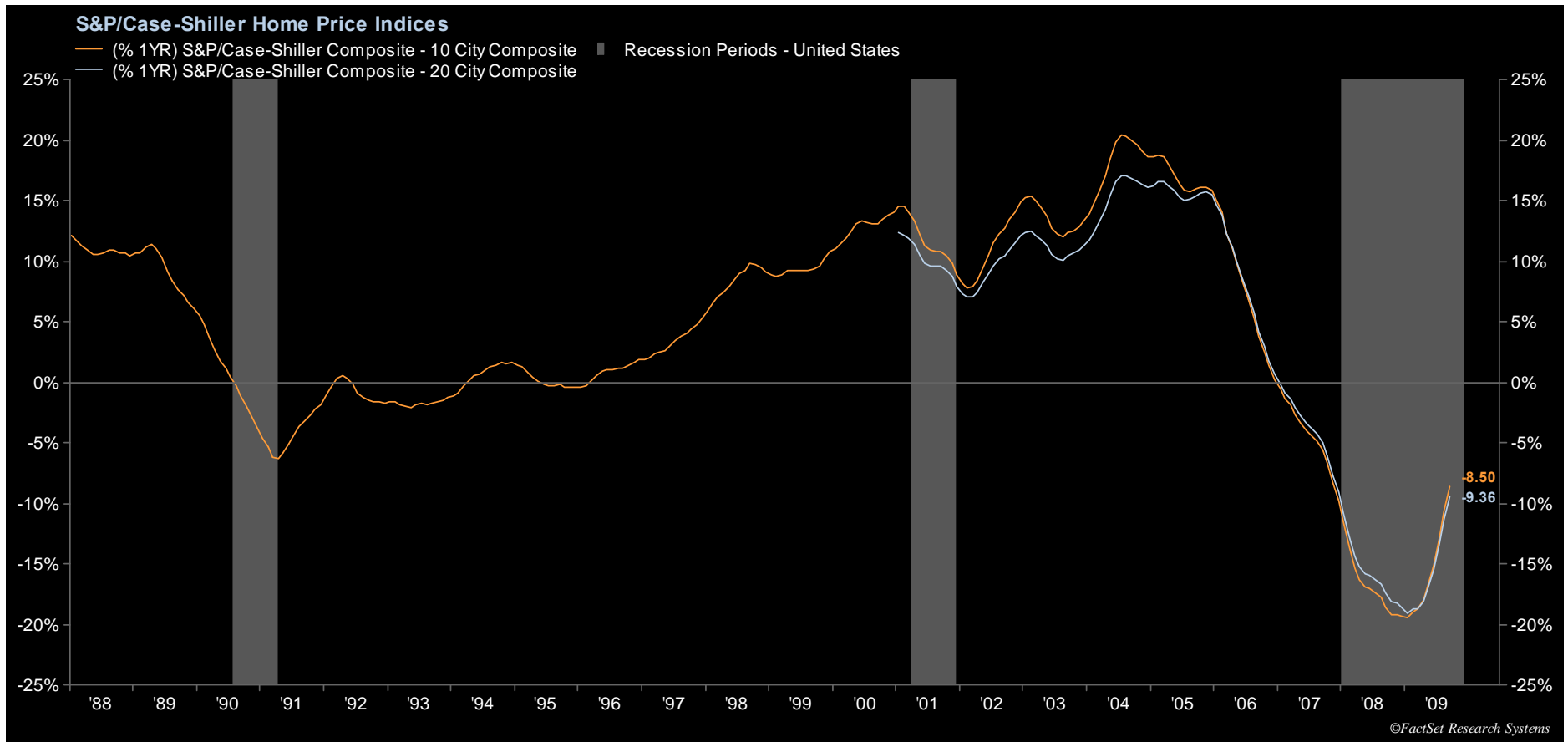
Percent Distribution of the Projected Population by Selected Age Groups and Sex for the United States: 2010 to 2050									
Sex and age	(Percent of total resident population as of July 1)								
	2010	2015	2020	2025	2030	2035	2040	2045	2050
<b>BOTH SEXES</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>
Under 18 years	24.25	23.99	23.93	23.74	23.51	23.29	23.17	23.14	23.14
18 to 64 years	62.79	61.62	60.02	58.38	57.19	56.80	56.80	56.85	56.69
18 to 24 years	9.90	9.49	9.03	9.11	9.12	9.16	9.13	9.06	9.01
<b>25 to 44 years</b>	<b>26.78</b>	<b>26.36</b>	<b>26.28</b>	<b>25.91</b>	<b>25.50</b>	<b>25.15</b>	<b>24.99</b>	<b>25.20</b>	<b>25.25</b>
45 to 64 years	26.10	25.78	24.71	23.36	22.57	22.49	22.68	22.59	22.43
65 years and over	12.97	14.39	16.05	17.88	19.30	19.91	20.03	20.01	20.17
85 years and over	1.85	1.93	1.93	2.03	2.34	2.94	3.50	4.02	4.34

- Best predictor of future economic growth is population expansion in consuming age brackets
- Biggest consuming demographic is ages 25-44
- Fastest growing demographic is ages 65 and older (similar to Japan’s “Lost Decade”)
- Best working age demographics exist in emerging markets:
  - Next 7-10 years: Brazil, Mexico, Indonesia, Korea, Turkey
  - Next 15-20 years: S. Africa, India, Malaysia, Philippines

Source: U.S. Census Bureau – Population Division, August, 2008 (www.census.gov) and BCA Research



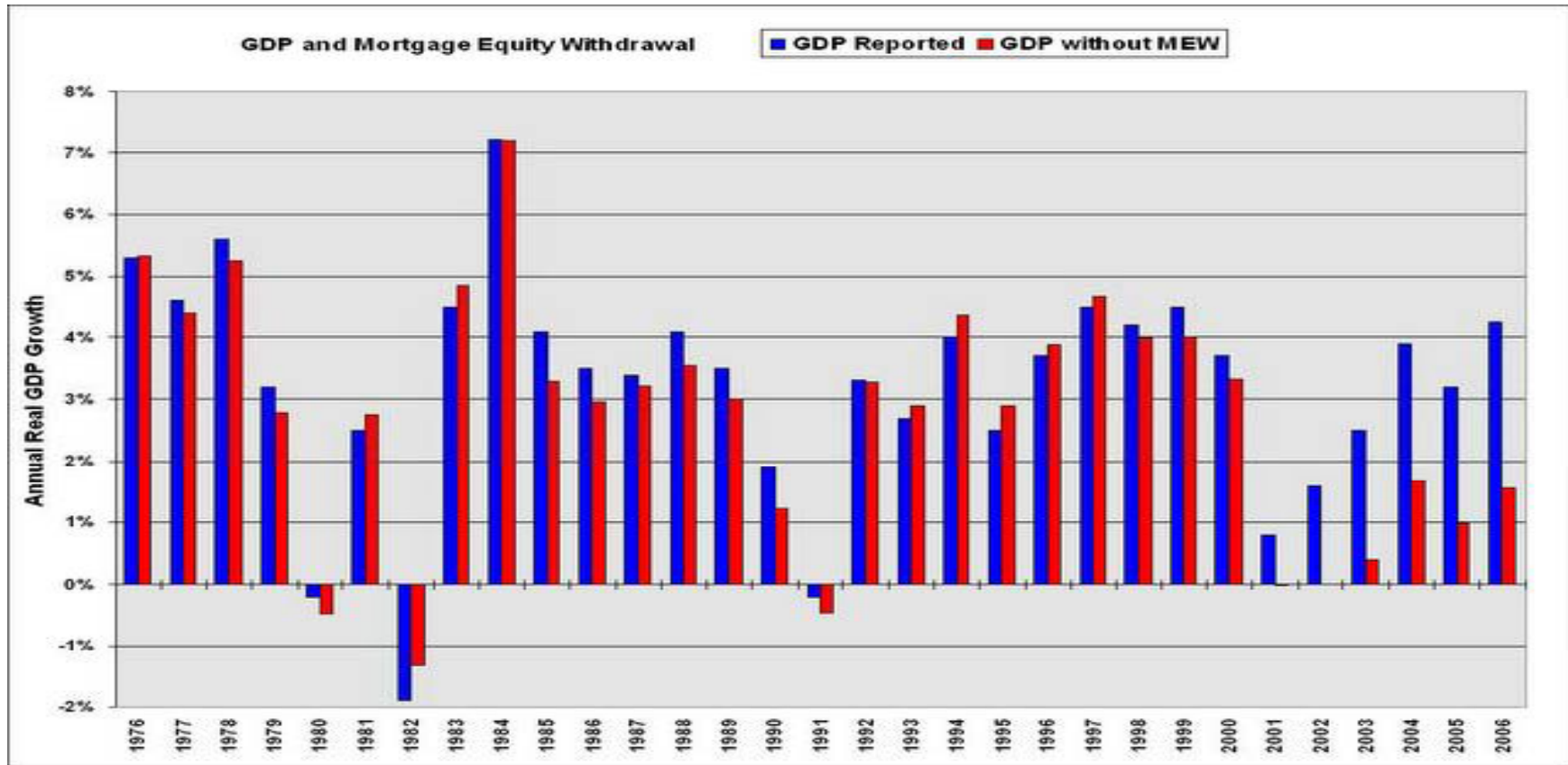
## Consumer's Largest Asset Down But Rising Recently



- Wall Street Journal claims 23% of mortgage borrowers are underwater
- Prices stabilized in the Summer and have risen in the Fall
- Government initiatives have worked (low mortgage rates and home buyer credit)



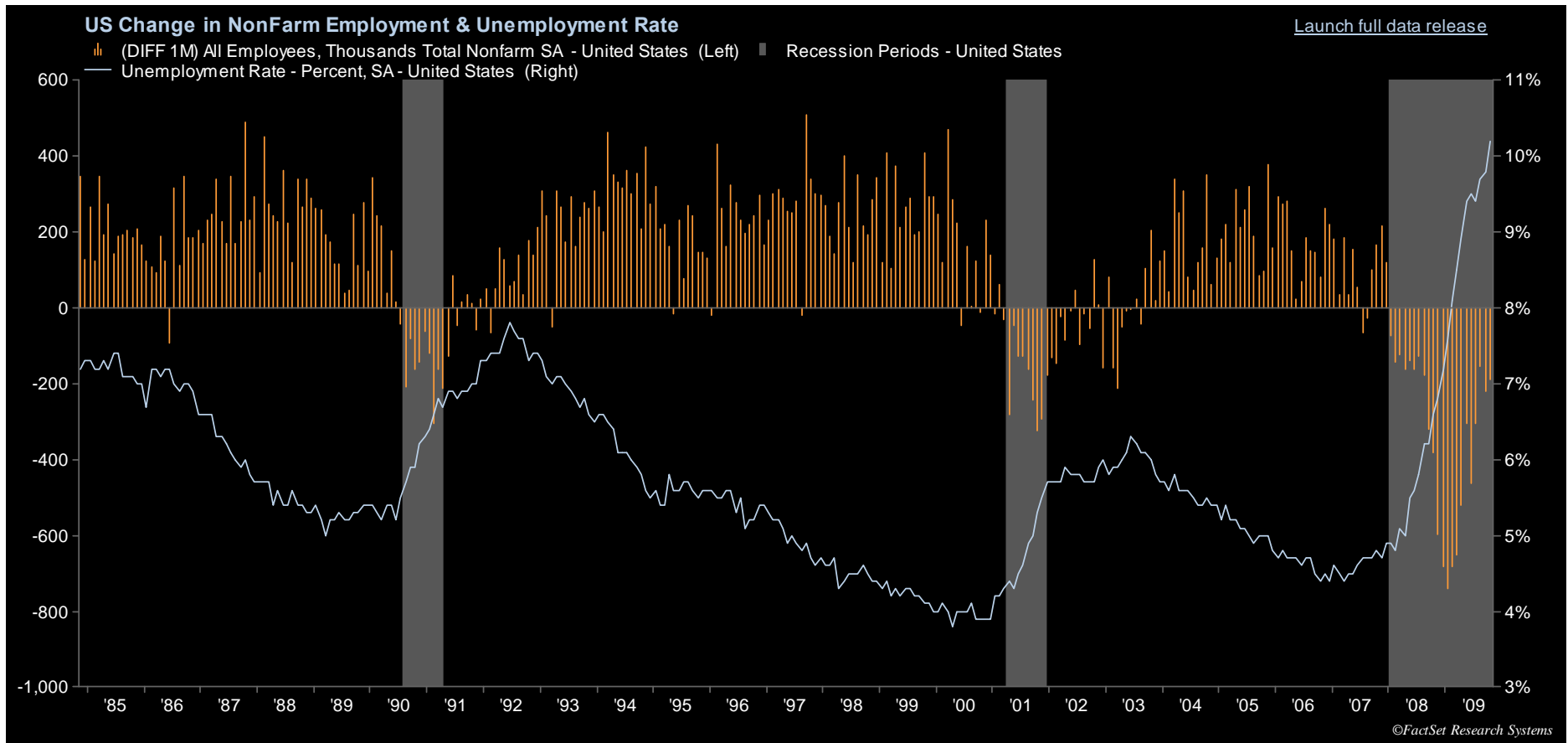
# GDP and Mortgage Equity Withdrawal



- 2001 – 2006: GDP growth 0%-1.5% without mortgage equity withdrawals
- Minimal, if any, home equity remains for borrowing



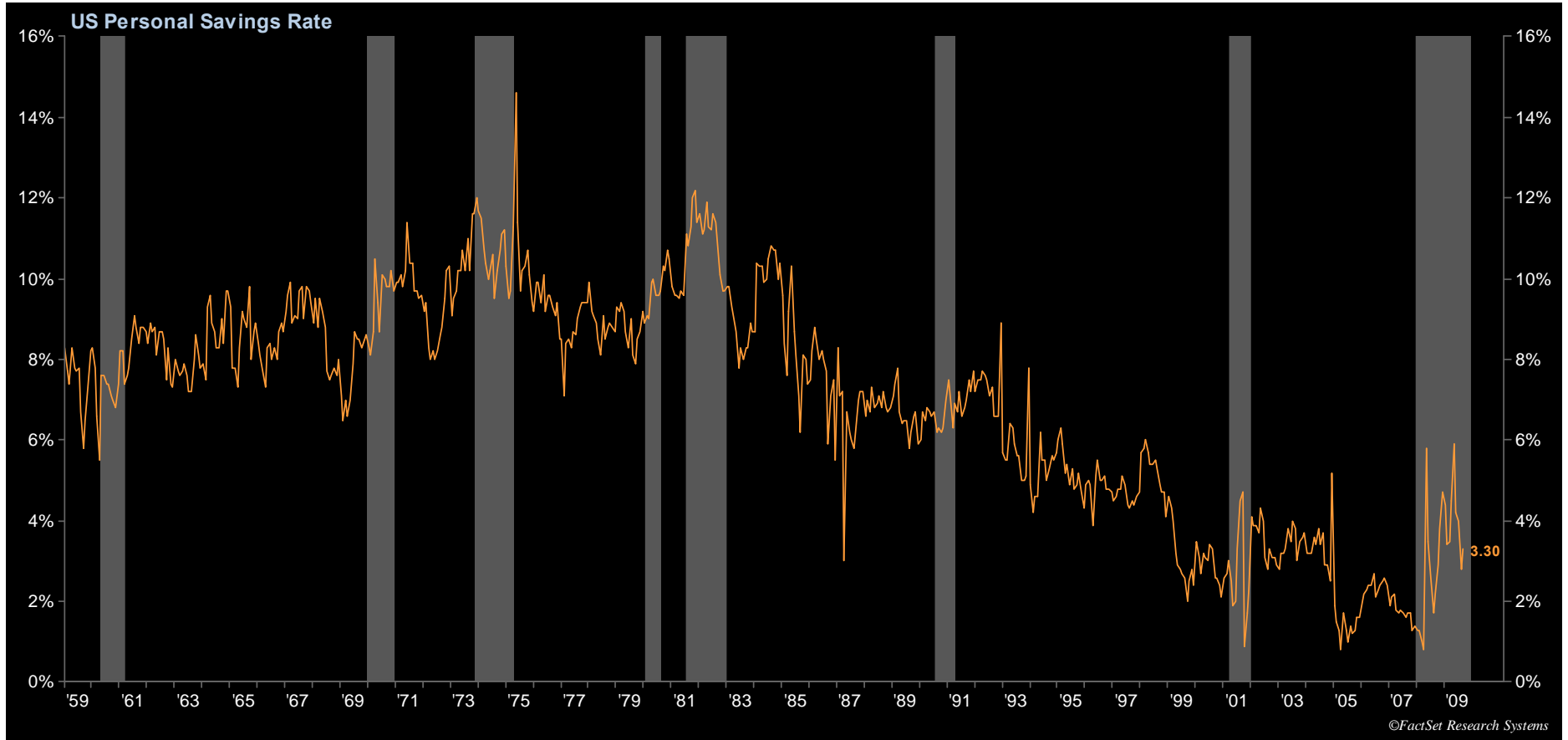
# Consumer Demand Challenged by Rising Unemployment: Where Will It Peak?



- “U-6” data paints a worse picture than “U-3”: current unemployment is > 17.0%
- Over 8.0 million jobs lost so far on a base of 154 million workforce
- Part-time workers who want to work full time: 4.0 million jobs
- Workers who have not looked for work in a month: 2.0 million jobs
- Workforce population growth who need a job: 1.8 million per year: 3 years = 5.4 million
- Conclusion: need to add 19-20 million jobs during next 3 years to return to official unemployment rate of 5.0%



# Cultural Change in Consumer Behavior: U.S. Personal Savings Rate

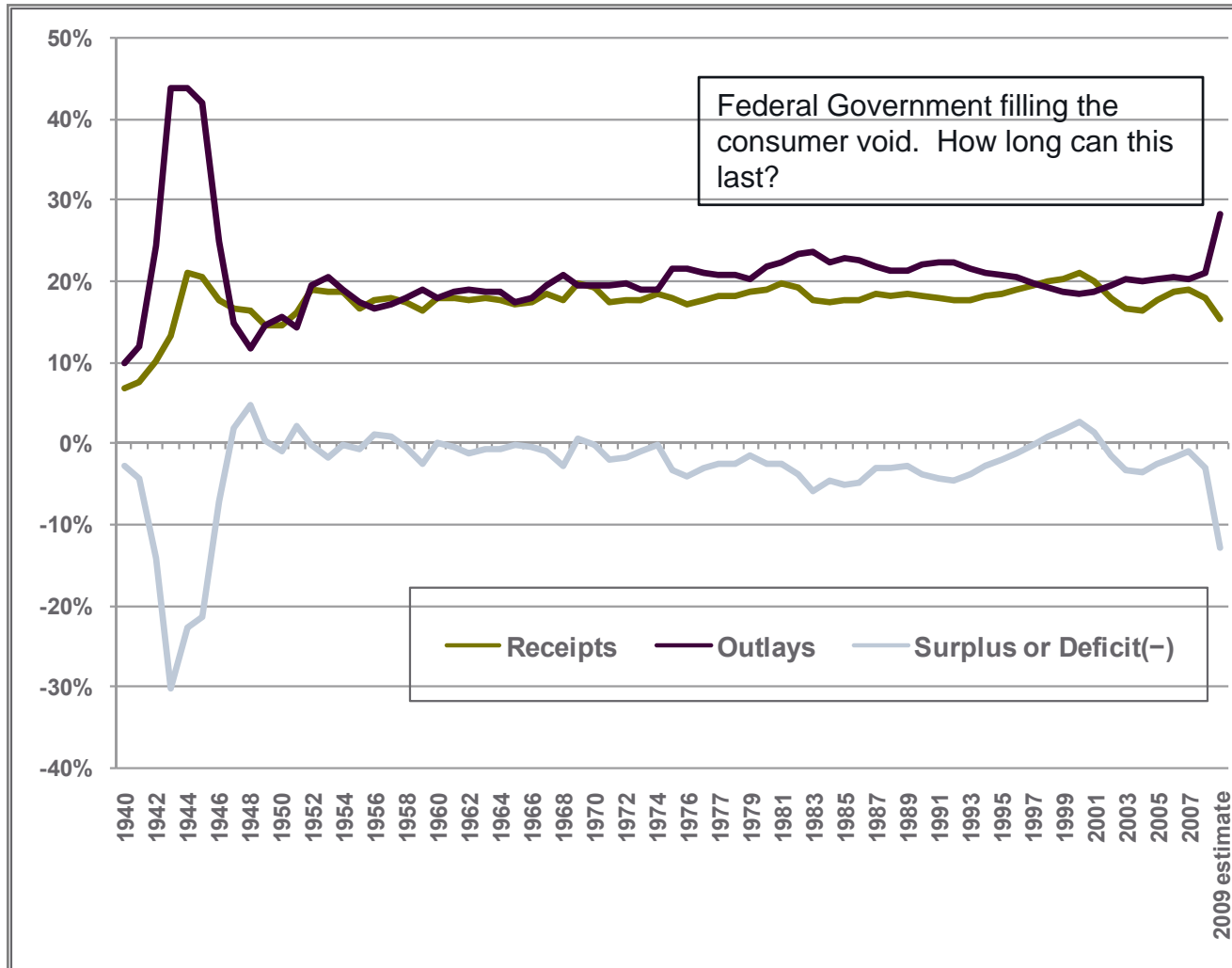


- Potential to return to long term average of 9-10%
- Fell in August and October 2009 due to Cash for Clunkers and Home Buyer Credit programs



# Federal Government Spending Filling the Consumer Void

## U.S. Federal Budget, Receipts, and Outlays (1940 – 2009)

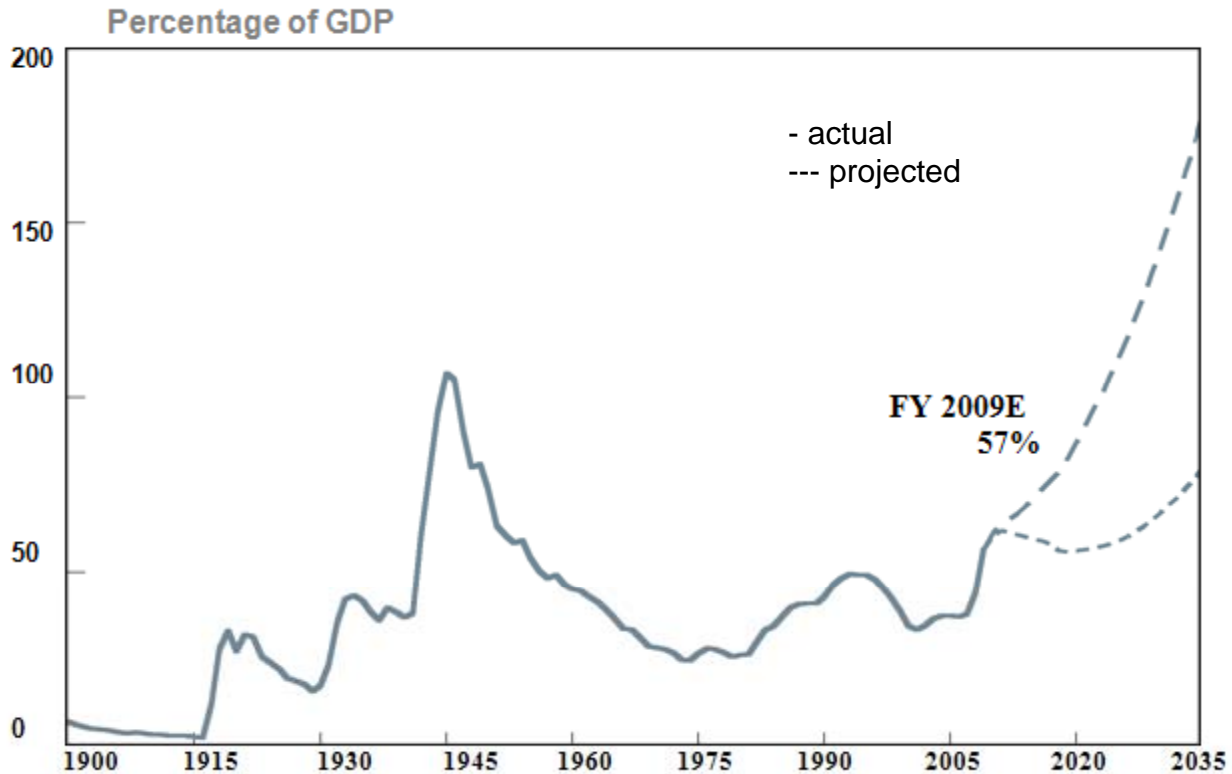


Source: Office of Management and Budget via GPO Access ([www.gpoaccess.gov](http://www.gpoaccess.gov))



# How Long Can the Federal Government Fill the Consumer Demand Void?

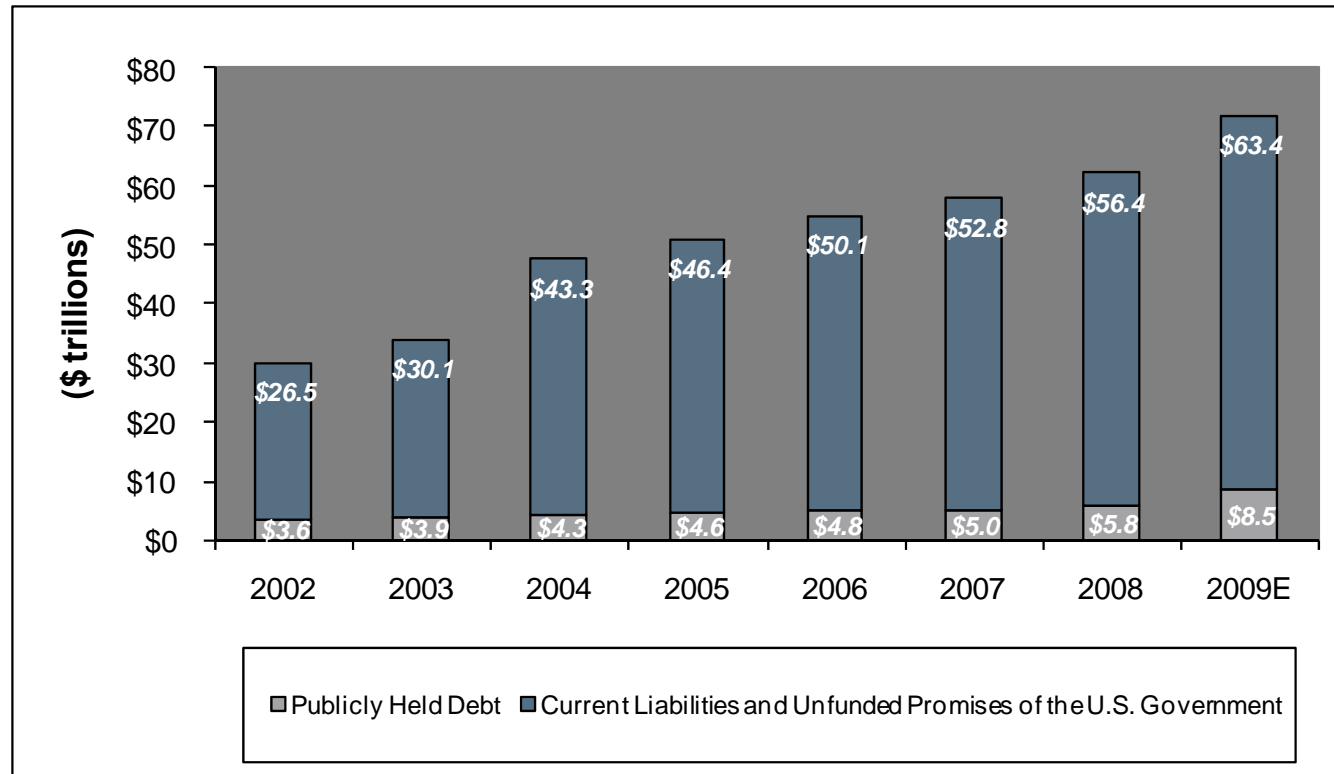
Federal Debt Held by Public as a Percentage of U.S. Gross Domestic Product



Note: The CBO makes two budget projections: an estimate of future spending, revenues and balances based on the President's budget proposal (the top dotted line) and a baseline estimate (bottom dotted line). The baseline assumes no policy changes in the future.



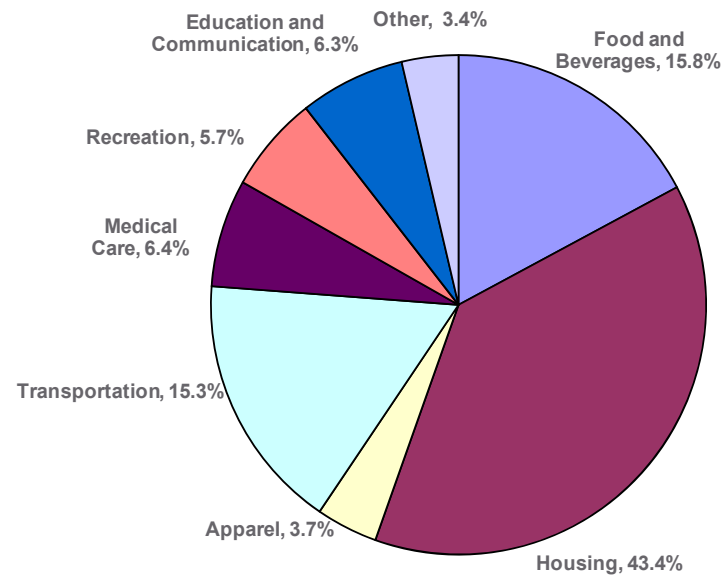
## Current Liabilities and Unfunded Promises of the United States Government



- Explicit guarantees are \$12.2 trillion at the end of 2008
- Major unfunded components are Medicare (\$36.3 trillion) and Social Security (\$6.6 trillion)
- Medicare and Social Security are listed in net present value as of January, 2008



## CPI: Relative Importance of Components

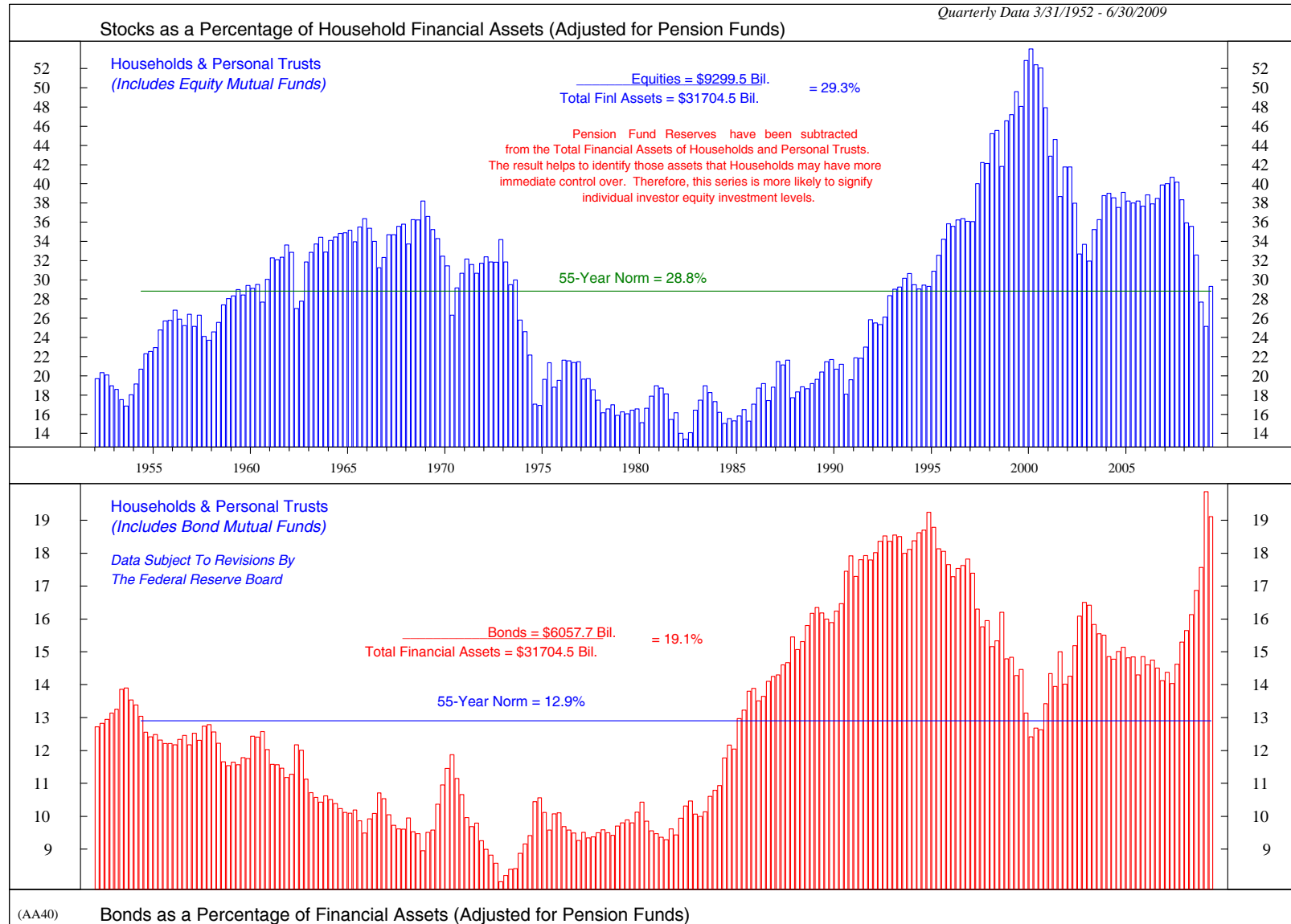


Transportation includes all new and used motor vehicles, motor fuel, motor vehicle parts and equipment, motor vehicle maintenance and repair, motor vehicle insurance, motor vehicle fees, public transportation

- **All commodities – 39.6%**
- Gasoline – 8.4%
  - Gas as motor fuels- 3.0%
  - Gas used for household energy- 4.2%
  - Utility (piped) gas service – 1.2%



# Household Investments: Potential Catalyst for Equities



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1. Government spending will continue to stabilize economic data in short run:
  - Housing market should continue to stabilize if interest rates remain low
  - Government programs should continue to stimulate consumer spending
  - 3Q through 1<sup>st</sup> half 2010: should see +3-5% growth off of terrible 2008 and 2009 data
2. Economic growth will be restrained by consumer savings rate increasing to ~10%
  - Low nominal growth environment is here for the next 3-7 years
3. Demographic trends and low growth will keep unemployment high at ~10% for 3-7 years
4. Inflation is not an immediate concern because demand for goods and services < supply; but medium-term inflation risk is high because ***rising deficits = dollar devaluation***
5. Government cannot afford to run \$1.0-\$2.0 trillion deficits for more than 1-3 years:
  - Raise taxes??
  - Freeze spending??
  - Legislate benefit cuts??
  - Tax cuts end automatically beginning in 2011
  - Bi-partisan commission being discussed
  - Political suicide but inevitable



## A. Domestic Equities:

### 1. Exposure to faster growing emerging markets allows multi-national companies to prosper:

<u>Company</u>	<u>US Revenues</u>	<u>Rest of World Revenues</u>
Apple Inc.	44%	56%
Abbot Labs	49%	51%
Corn Products International	30%	70%
FMC Corp.	34%	66%
HPQ	31%	69%
IBM	35%	65%
Johnson & Johnson	50%	50%
McDonald's	34%	66%
PepsiCo	52%	48%
Procter & Gamble	39%	61%
Reinsurance Group of Amer.	55%	45%

### 2. Strong balance sheets and market leadership allows the strong to become stronger by:

- lowering pricing to gain market share: *Best Buy, Kohl's, McDonald's, Wal-Mart*
- acquiring weaker competitors or complimentary business lines: *Cisco, Hewlett Packard, Intel, Microsoft*
- providing capital and liquidity in markets where it is scarce: *Goldman Sachs, JP Morgan, RGA*

### 3. Low cost products, delivery systems, and business models:

- generic drugs: *Teva Pharmaceuticals*
- drug delivery: *Pharmaceutical Benefit Management companies*
- low cost domestic natural gas: *Equitable Resources*
- imported liquefied natural gas: *Sempra Energy*
- consumers desire to save: *CVS Pharmacy, Kohl's, McDonalds, Wal-Mart*



### **B. International Equities:**

1. Focus on countries with:
  - Strong workforce population growth resulting in rising middle class
  - Low levels of consumer and government debt
  - Manufacturing based and commodity rich economies
  
2. Candidates: Brazil, Mexico, Korea, Indonesia, Turkey, South Africa, Malaysia, Philippines, India

### **C. Food Based Commodities:**

1. Worldwide inventories of grain are at record lows compared to consumption
2. Consider exchange traded funds focused on food: Powershares DBA
3. Consider individual equities that benefit from increased demand for food and water

### **D. Tax-Preferred Investments Become More Valuable as Tax Rates Increase:**

1. Roth IRA conversion a huge potential opportunity (pay some now; save huge later)
2. Municipal bonds tax preference becomes more valuable
3. Appropriate real estate income generating investments with offsetting depreciation

### **E. Alternative Investments:**

1. True total return strategies should be focused on now!
2. Liquidity will become more valuable: give it up only if you get paid.