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MONTHLY

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CYCLES & EXTRAPOLATION

Introduction

Earnings have weakened considerably since peaking in the middle of 2007. The consensus outlook remains bleak. The same is also true in the broader economy. Economic data have been very weak for the last year, and many observers believe this trend will continue for some time. As often happens, the stock market started moving lower in advance of the bad news. Poor equity market returns - a 40% loss in the US and even worse elsewhere - have caused many investors to lose hope that there will ever be a recovery in the economy, in earnings, and ultimately in the markets.

In this *Monthly,* we look at the current poor environment in the context of the longer-term picture. We believe the historical relationships among earnings, the economy and the equity market provide valuable perspective in this difficult time.

Historical Data

It is widely accepted that the economy is cyclical. Figure 1 illustrates the variability in the year-over-year growth rate in real GDP. Although the growth rate varies substantially, the *path* of GDP over the long term is much smoother, as can also be seen in this figure.

We have noted a number of times in the past that earnings tend to be even more cyclical than economic output. Profitability is quite sensitive to the economic cycle, so that when the economy is strong, profits accelerate even more rapidly, and when the economy weakens, profit growth reverses sharply.

Figure 2 provides evidence of this notion that earnings are more cyclical than GDP. It is apparent from this figure that changes in economic output and S&P earnings have been reasonably well correlated over time. When

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CURRENT TOPIC

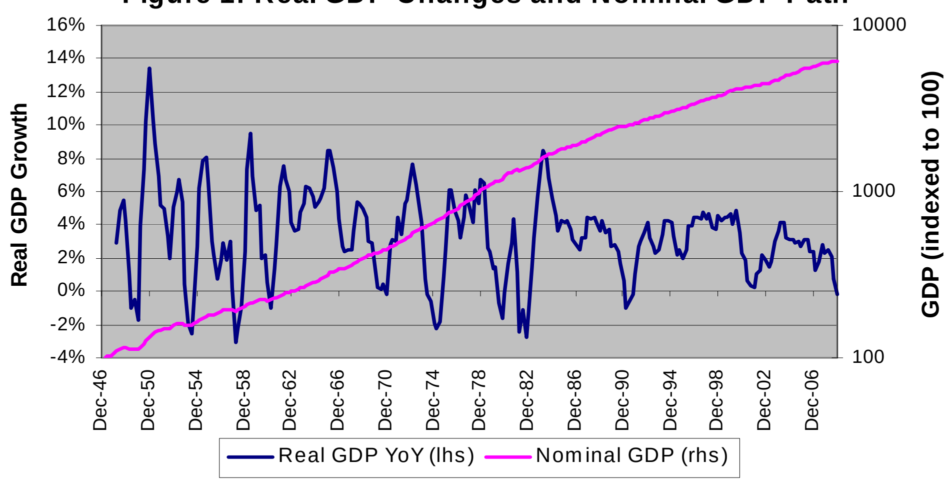
Cycles & Valuation

- *Introduction*
- *Historical Data*
- *Extrapolation*
- *Examples*
- *Conclusion*

Strategy

- *There were no strategy changes during the month of January*
- *Portfolio strategies remain overweight developed equity markets and high yield bonds*

Figure 1: Real GDP Changes and Nominal GDP Path



Sources: Haver Analytics, Stairway Partners

"ALTHOUGH THE GROWTH RATE VARIES SUBSTANTIALLY, THE PATH OF GDP OVER THE LONG TERM IS MUCH SMOOTHER"

CYCLES AND EXTRAPOLATION - CONT'D

GDP growth has been strong, earnings growth has also tended to be strong, and when GDP growth has been weak or negative, earnings have declined sharply. The important point to note in Figure 2 is the sizes of the two y-axis scales - fluctuations in earnings growth are much greater than changes in GDP growth.

Despite the different levels of volatility in the GDP and earnings growth rates, over time the two series should track each other. This is simply due to the fact that increases in earnings ultimately depend on increases in output and spending.

Because earnings in the long run reflect the fundamentals of the economy, and stock prices are strongly related to the level and growth rate of earnings, the equity market should in turn be similarly related to GDP. Figure 3 illustrates the increase in GDP, earnings and the S&P 500 Index over the last six decades. If we ignore their disparate degrees of cyclicality, we see that all three series have indeed risen to roughly similar levels over the long run, as expected.

Extrapolation

As we have addressed in past *Monthly* publications, equity market participants often expect the current trend, whether positive or negative, to continue. When optimism reigns, investors typically feel that risk has disappeared, growth will continue unabated, and returns will remain high. When investors are pessimistic, the opposite is true and even good news fails to improve expectations.

Over short periods of time, stock prices tend to reflect current conditions rather than long-term fundamentals. Why might this occur?

While we do not profess to have all the answers to this question, we believe part of the explanation centers on investors' expectations that good and bad times will continue. When the economy is

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Figure 2: GDP Growth and S&P Earnings Growth

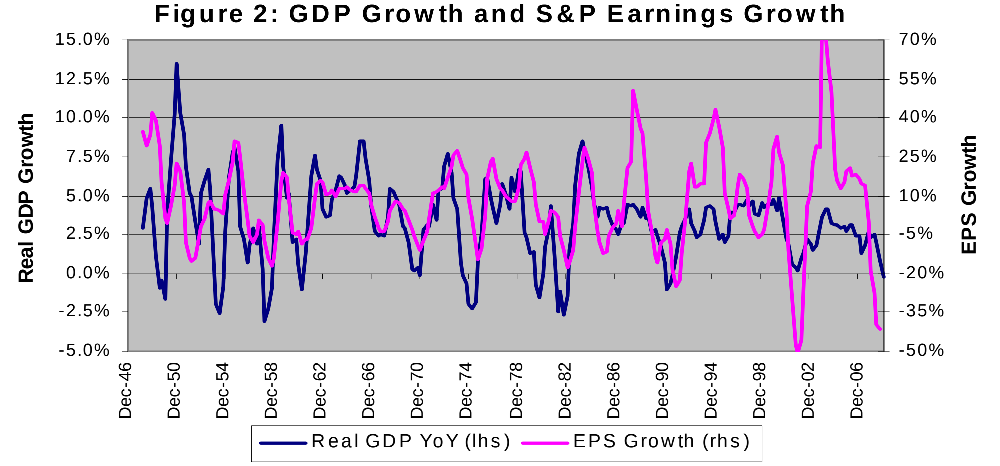
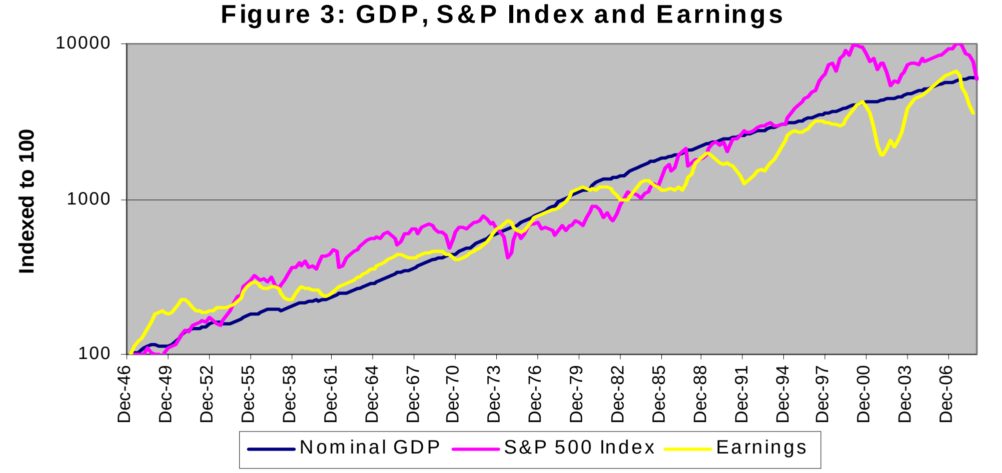


Figure 3: GDP, S&P Index and Earnings



Sources: S&P, Haver, Stairway Partners

Note: Earnings are rolling sum of 4 quarters

"EARNINGS TEND TO BE EVEN MORE CYCLICAL THAN ECONOMIC OUTPUT"

"FLUCTUATIONS IN EARNINGS GROWTH ARE MUCH GREATER THAN CHANGES IN GDP"

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"IF WE INGNORE THEIR DISPARATE DEGREES OF CYCLICALITY, ALL THREE SERIES HAVE RISEN TO ROUGHLY SIMILAR LEVELS OVER THE LONG RUN"

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

good, say with real growth in excess of 3%, earnings tend to rise at an even faster pace. This leads many investors to form unrealistically optimistic long-term expectations about future earnings growth - witness the positive outlook for earnings during 2007.

The reverse is true when the economy is weak. Earnings tend to drop significantly and many investors believe that the near-term weakness will continue more or less unbroken. Unrealistic expectations, both good and bad, can cause investors to buy or sell at the wrong time.

It is common for investors to be reactive in response to this cyclicality. They buy when the environment is good and sell when things get bad. Despite all that has been written about this counter-productive investor behavior, the same mistake seems to be made repeatedly - buying high in good times and selling low in bad times.

Examples

Relatively recent events can serve to illustrate this behavior.

The "Tech Bubble" of the late 1990s was a time when investors believed in a new era of investing in equities. Strong earnings growth, explained by productivity-boosting technology, caused many to throw away conventional ideas about future growth and risk. As seen in Figure 4, investors bid up equity prices near the end of a strong earnings cycle.

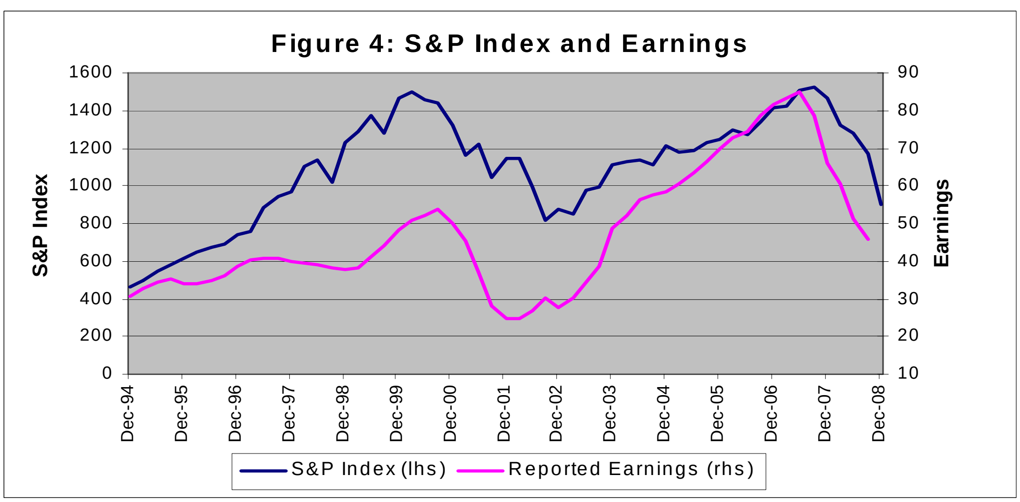
After the "Tech Bubble" burst, earnings dropped by 54% and the S&P 500 declined 49%. Investors were devastated and many thought the economy was in a period of deflation and earnings would not turn around. As Figure 4 also shows, this caused investors to drive down the price of equities as earnings were reaching their trough and about to turn strongly upward.

The common thread in these examples is the extrapolation by market participants of recent news or current trends, thus justifying the market's pricing *toward the end* of the bull or bear move. This is in contrast to pricing assets off of longer-term and ultimately more sustainable trends.

Conclusion

Today's equity market poses some exceptional challenges. The current trend is poor and many expect it to get worse. At the same time, equity markets have recently endured some of the worst returns recorded.

Many of the past economic and market cycles have produced investor behavior that involves buying high and selling low. We believe that investors would be better off if they instead looked beyond the current trend and focused on longer-term fundamentals.



Sources: S&P, Haver, Stairway Partners   Note: Earnings are rolling sum of 4 quarters

"AFTER THE TECH BUBBLE BURST … MANY THOUGHT THAT WE WERE IN A PERIOD OF DEFLATION AND EARNINGS WOULD NOT TURN AROUND"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	29.0%	5.9%	over	Exposure increased above benchmark weight due to improved pricing
Non-US Developed			over	Asset class has become more attractive as markets have fallen
Eurozone	33.0%	6.5%		
Japan	22.2%	4.5%		
UK	27.6%	6.7%		
Emerging	28.1%	11.4%	neutral	Price declines have made asset class attractive
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors priced better
2-Year	0.6%	2.7%		
5-Year	0.2%	3.4%		
10-Year	0.3%	4.1%		
30-Year	-0.7%	4.6%		
US Municipal Bonds			under	Longer-term maturities have become more attractive
2-Year	1.3%	2.4%		
5-Year	1.7%	2.9%		
10-Year	3.1%	3.6%		
30-Year	9.5%	4.6%		
US High Yield	21.1%	4.4%	over	Sector is attractive relative to its risk
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	1.6%	4.2%		
Japan 10-Year	-0.4%	1.9%		
UK 10-Year	1.8%	4.7%		
Emerging Markets Debt	7.2%	4.7%	under	Although sector is priced attractively, other asset classes offer better value
Cash	2.7%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-4.1%	28.8%	-2.5%	Euro is moderately overpriced
Japanese yen	-4.7%	17.5%	-5.1%	Yen is expensive
UK pound	3.3%	30.9%	5.2%	Pound is slightly underpriced

Notes: **As of: January 31, 2009**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.

The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).

The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.

Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.