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MONTHLY

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EQUITIES & RECESSIONS

Introduction

The current economic situation is the weakest in many years. It hasn't been "officially" designated a recession yet by the NBER (National Bureau of Economic Research), but they are usually late in identifying the onset of recession, often after it is already over. However, the developing economic troubles have put further pressure on already-weak stock and credit markets as investors have responded negatively to each new poor data release.

If we look at the past behavior of the equity market, an interesting phenomenon is apparent: stock prices typically anticipate a downturn and the eventual recovery, rising well before the economy begins to pull out of recession. This *Monthly* addresses this fact and uses it to draw some conclusions about how long-term investors should be responding to today's weak outlook.

Recessions

A common rule of thumb in identifying a recession is two consecutive quarters of negative real GDP growth. However, this simple metric is not how recessions are dated in the US. Instead, there is an NBER business cycle dating committee, which is currently composed of eight eminent macroeconomists. The dates the committee has identified for a number of business cycle peaks and troughs are shown in Figure 1. In the chart, recession is shown by the pink shaded region from peak to trough.

The intent of the business cycle dating committee is to reflect aggregate real economic activity (i.e., something akin to real GDP), so a recession is considered to be a period of "diminishing economic activity." But, because GDP data are published only on a quarterly basis and are subject to large revisions, the NBER committee examines a number

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CURRENT TOPIC

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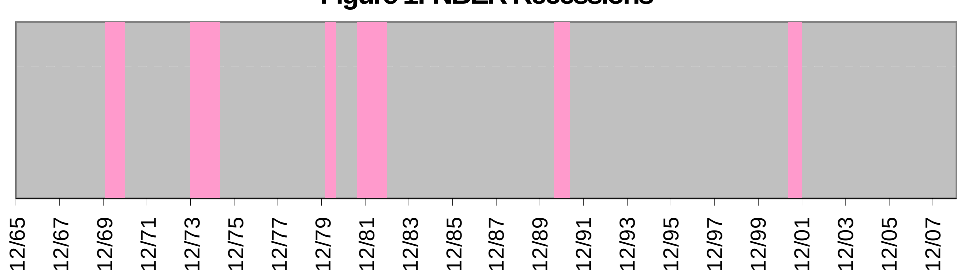
Strategy

- *We added to equities again in November, as further market declines increased our return expectations.*
- *Portfolios are overweight equities and high yield bonds.*

"A RECESSION IS CONSIDERED TO BE A PERIOD OF DIMINISHING ECONOMIC ACTIVITY"

Figure 1: NBER Recessions



Peak	Trough	Length of Contraction	Peak	Trough	Length of Contraction
Dec 1969	Nov 1970	11	Jul 1981	Nov 1982	16
Nov 1973	Mar 1975	16	Jul 1990	Mar 1991	8
Jan 1980	Jul 1980	6	Mar 2001	Nov 2001	8

Sources: NBER, Stairway Partners Note: length of contraction in months

Equities & Recessions - Cont'd

of higher frequency (monthly) data releases in making their determinations. They focus particularly on measures of real personal income, employment and manufacturing as proxies for aggregate economic activity.

Earnings & The Economy

As economic activity slows, it is reasonable to expect that companies' earnings would suffer as well. This is typically what happens, as Figure 2 clearly shows. In most cases, earnings start to weaken around the time of the peak in economic activity, as companies' costs begin to run ahead of their revenue gains. As the economy starts to soften, demand falls off and firms find that their profit margins come under pressure. Further into the recession, they adjust to the weaker outlook by shedding labor and other costs. For example, they often make aggressive cuts to investment spending.

This is exactly what is happening right now. Figure 2 shows that, although the NBER hasn't yet made the determination that the economy is in recession, profits have dropped sharply from their peak. And, the employment and spending data have been deteriorating for much of this year. It is common for profits to bottom out and start rising some time toward the end or shortly after the end of a recession.

It is also interesting to note that earnings are much more volatile than the broader economy (Figure 3). Earnings decline sharply during weakness, then rebound quickly when growth resumes.

The Stock Market

So, how has this translated into stock prices? As many of you know, the financial markets are forecasting mechanisms – notwithstanding Paul Samuelson's quip "The stock market has forecast nine of the last five recessions". (We are not trying to imply here that the stock market decline has been falsely signaling recession, just that equity markets are very sensitive to expectations about the economic outlook.)

It is not difficult to think about why the stock market is considered to be forward-looking: equity ownership provides the investor with a stream of cash flows from future earnings. So what

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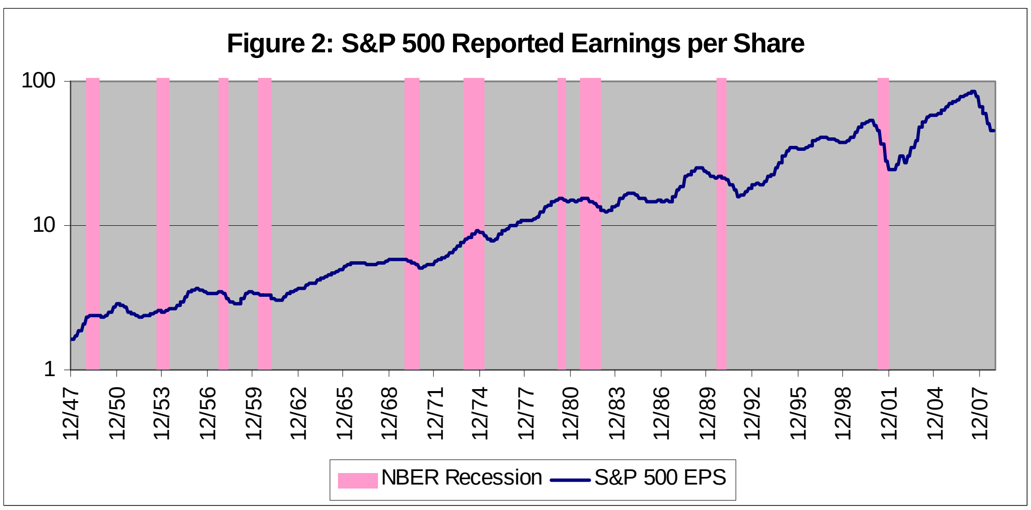
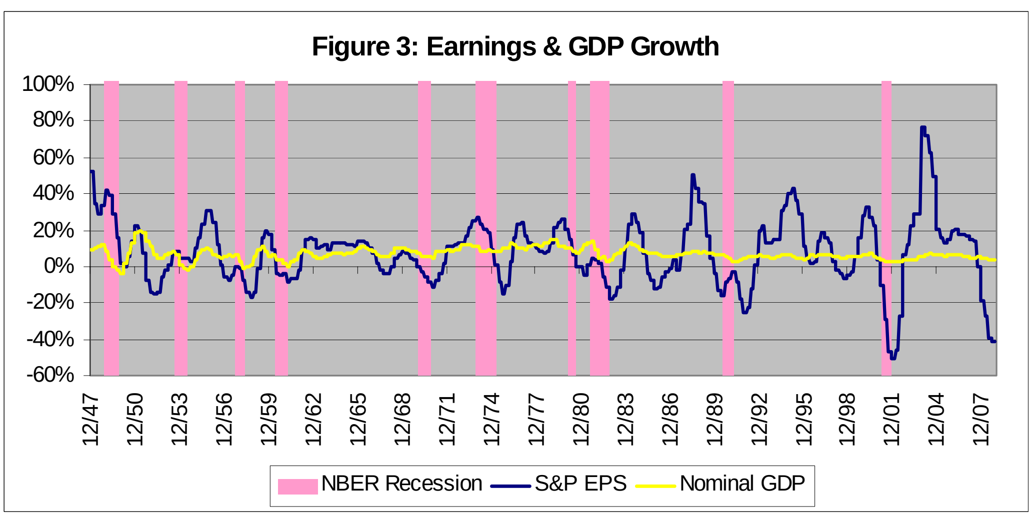




Sources: NBER, S&P, BEA

Note: growth rates are 4 quarters over prior 4 quarters

"Earnings are much more volatile than the broader economy. Earnings decline sharply during weakness, then rebound quickly when growth resumes."

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.

should be important is the *long-run* level and growth rate of earnings, not necessarily what is happening now or next quarter. In Figure 4, it is clear that the stock market has usually started its descent in advance of any downturn in economic activity. And, importantly for today's environment, in most recessions stock prices turn up before the economy hits bottom and a recovery is evident.

Investment Strategy

While we cannot forecast the duration or depth of the current economic decline, we can use the information presented here to say something about investment strategy. It is almost universally accepted that the US economy is in recession, given what has happened to profits, employment, output, and financial markets. Furthermore, the economy is well into the slowdown, as the environment has been deteriorating for many months.

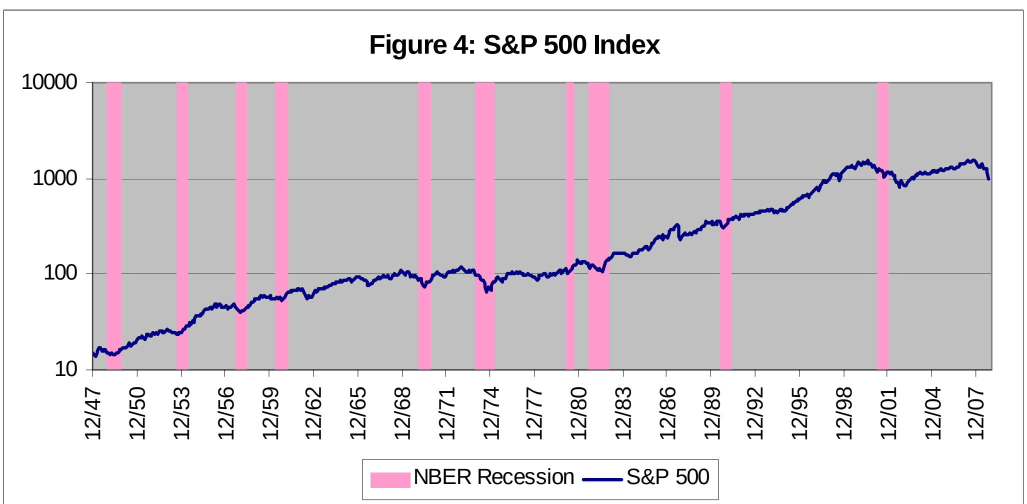
At some point, which we won't know until after the fact, the economy will begin on a path to recovery. With the resumption of positive economic growth, profits will start to rebound. However, it is very likely that, when this turning point is reached, the financial markets will already have "discounted" the improvement into prices – the stock market will have rebounded strongly. This is because equity investors will have gone back to focusing on longer-term fundamentals rather than near-term weakness.

If investors wait for clear signs from the economic data or earnings that the picture is improving, they will most likely miss out on a good deal of the gains in prices. As is clear from our strategy changes during the last two months, our investment process leads us to buy when others are selling – during times of overwhelming pessimism about the future when panic and fear have set in.

Conclusion

Economic growth is cyclical. Periods of solid growth and optimism are punctuated by episodes of declining economic activity and pessimism. Earnings tend to follow the economic cycle, but also tend to be considerably more volatile.

Because financial markets – and equity markets more specifically – over time will look forward, discounting the future stream of cash flows, prices will tend to lead changes in the economic and profits environment. In order for an investment program to be successful, investors must be willing to sell when others are buying at high prices and buy when others are selling at the lows. Unfortunately, it is only known with hindsight.



Sources: NBER, S&P, Stairway Partners

> "If investors wait for clear signs that the picture is improving, they will most likely miss out on a good deal of the gains in prices"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	26.8%	6.7%	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	30.1%	7.4%		
Japan	20.1%	4.8%		
UK	26.4%	7.5%		
Emerging	27.8%	12.3%	neutral	Price declines have made asset class attractive
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors priced better
2-Year	0.7%	2.8%		
5-Year	0.3%	3.5%		
10-Year	0.2%	4.1%		
30-Year	-1.2%	4.5%		
US Municipal Bonds			under	Longer-term maturities have become more attractive
2-Year	2.1%	2.7%		
5-Year	2.9%	3.3%		
10-Year	4.6%	4.0%		
30-Year	10.5%	4.7%		
US High Yield	26.9%	5.2%	over	Sector is pricing for deteriorating fundamentals
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	1.4%	4.2%		
Japan 10-Year	-0.1%	1.9%		
UK 10-Year	2.2%	4.7%		
Emerging Markets Debt	10.6%	5.4%	under	Although sector is priced attractively, other asset classes offer better value
Cash	3.3%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-2.4%	27.7%	-1.0%	Euro is near fair value
Japanese yen	-1.0%	19.2%	-1.0%	Yen is close to fair value
UK pound	2.8%	29.2%	5.0%	Pound is near fair value

Notes: **As of: November 30, 2008**

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.