



The State of the Economy

10th Annual KSGFOA Fall Professional Conference
Overland Park, Kansas
October 16, 2009



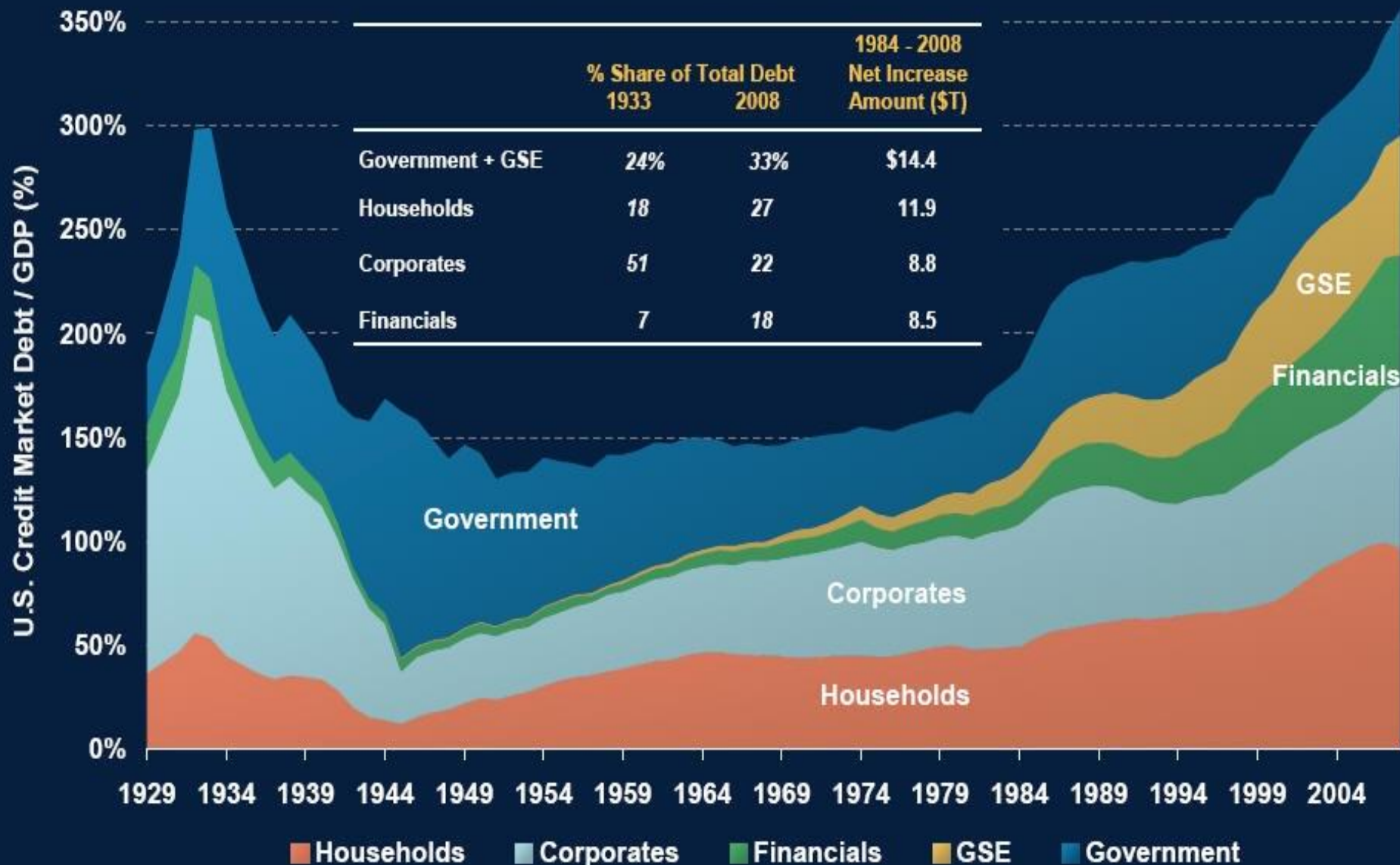
Thomas W. Laming
Sr. Vice President
Scout Investment Advisors



Biography – Tom Laming

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- **Scout Investment Advisors, Kansas City**
 - *Senior Vice President and Lead Portfolio Manager*
 - **TrendStar Advisors, LLC, Overland Park**
 - *President, Co-founder*
 - *Acquired by Scout Investment Advisors*
 - **Buffalo Mutual Funds, Overland Park**
 - *Chief Equity Strategist*
 - *Co-Lead Manager for all of equity mutual funds*
 - **Waddell and Reed, Overland Park**
 - *Technology Analyst*
 - **Lockheed Martin, Denver**
 - *Spacecraft Designer*
 - **Northrop Grumman, Redondo Beach, California & Houston, Texas**
 - *Spacecraft Designer*
 - *Shuttle Navigation Analyst*
 - **MBA, Indiana University**
 - **MS, Aeronautics and Astronautics, Massachusetts Institute of Technology**
 - **BS, Physics, University of Kansas**
 - **Senior Member, American Institute of Aeronautics and Astronautics**

U.S. Total Credit Market Debt as % of GDP, 1929 – 2008 & Sector Share Breakdown



Morgan Stanley Note: GSE (Government Sponsored Enterprises) debt includes various agency-backed mortgages; Source: Federal Reserve, Ben Wattenberg, *The Statistical History of the United States, From Colonial Times to the Present*, Morgan Stanley Research.



What Went Wrong?

- **Probably everyone agrees it started with the collapse of housing prices**
- **Artificially low interest rates**
 - *The Fed lowered interest rates to the lowest level in 50 years through 2004*
- **Heavily subsidized mortgages**
 - *Tax credits for borrowing money against a home*
 - *Fannie and Freddie buy mortgages from the original lenders, or guarantee them through the resale of MBS*
 - *F&F own or guarantee nearly 50% of all homes loans in the U.S.*
 - *about \$5 trillion dollars worth!*



What Went Wrong? (continued)

- **Wall Street created products to satisfy what became a global appetite for risk**
 - *Using financial engineering methods that would not be allowed within an engineering school – Wall Street repackaged junk mortgages with the illusion of safety*
- **Other Factors**
 - *Community Reinvestment Act (CRA)*
 - *1992 change in law required GSEs to purchase CRA loans as part of the affordable housing mandate*
 - *Homeowners using their house as an ATM*
 - *Appraisal bias*
 - *My county appraisal has never gone down*

What Form of Economic Recovery

Most recessions

V

W

1980 & 81-82

Japan

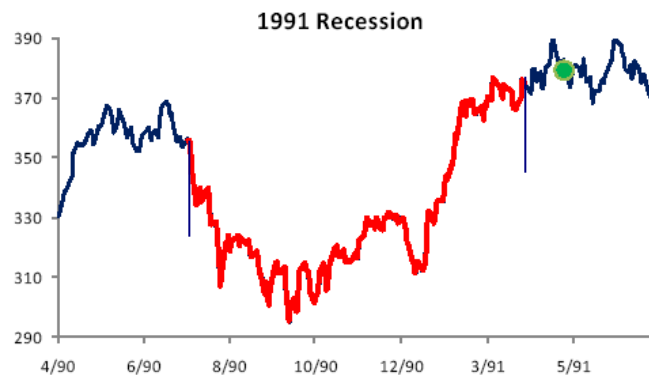
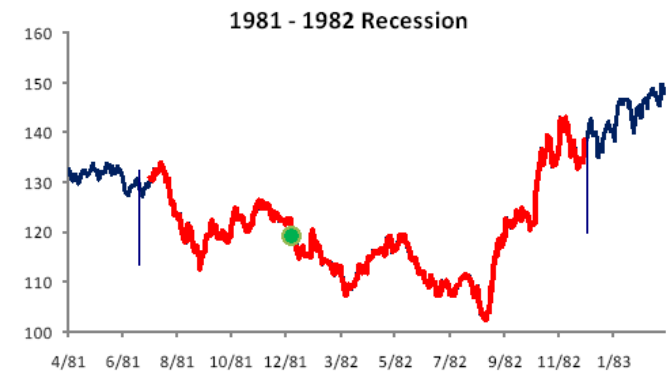
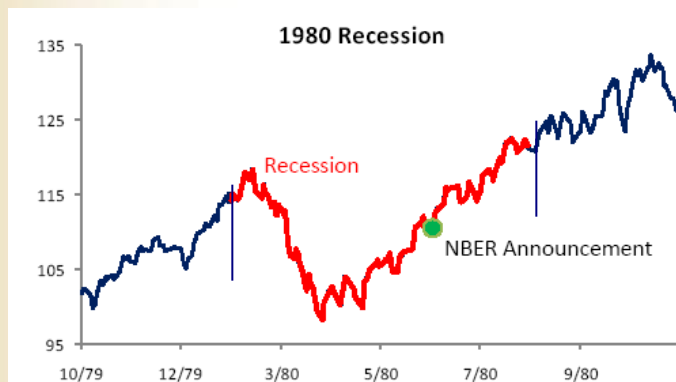
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2007-09?

Previous 10 Recessions Lasted An Average of 10 Months

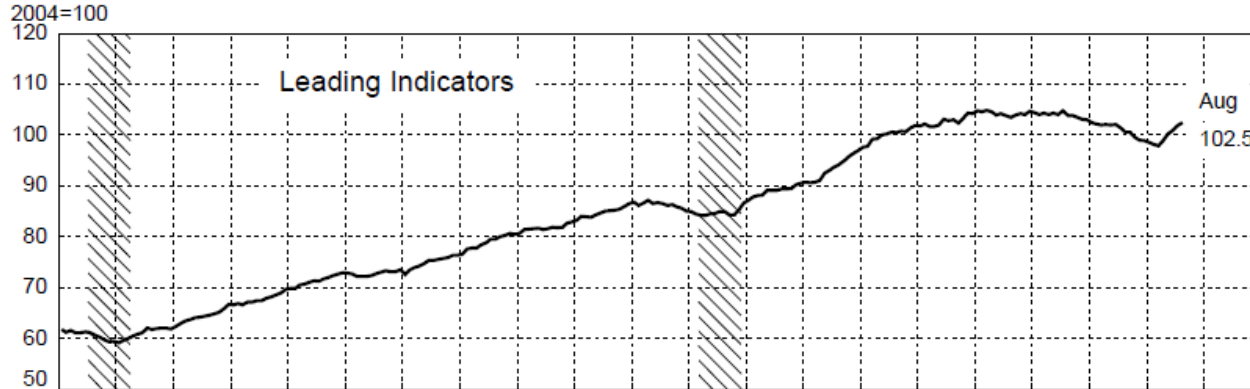
- **On December 1, 2008 the National Bureau of Economic Research declared that the current recession began in December 2007**
 - *Stock market reaches bottom before the recession ends*
 - *Recognition of recession sometimes occurs after it is over*





Leading Economic Indicators Suggest Recession Has Probably Ended

COMPOSITE INDEXES Seasonally Adjusted



Source: The Conference Board.

Diffusion index



Source: Institute for Supply Management.

Recession may have ended in the July to October period

> 50 implies we are probably out of recession

10.1.09

Total Return After End of Recession 1927-1958

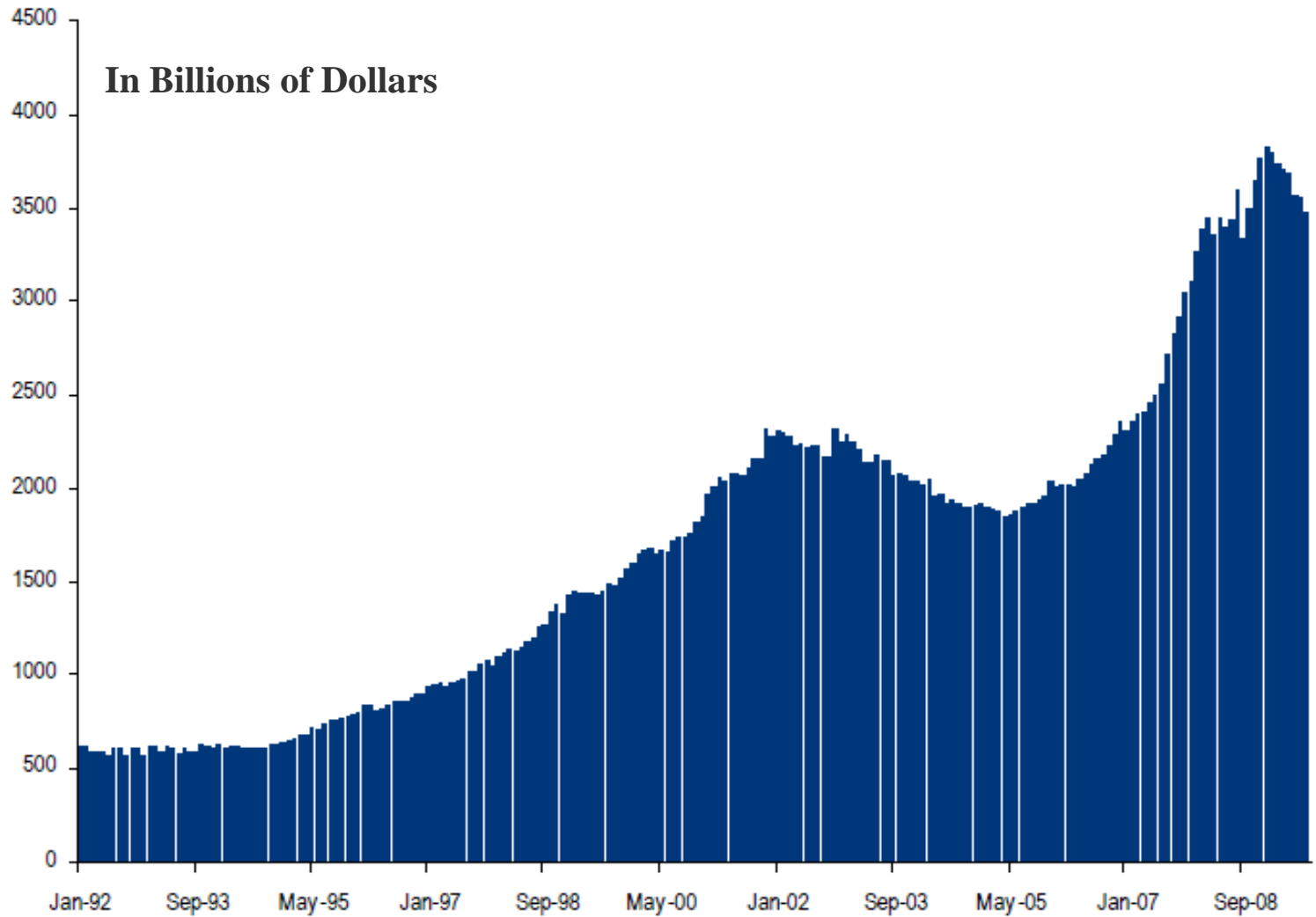
Recession End Month	1-Year Total Return			3-Year Total Return		
	Small Cap	Large Cap	LT Govt Bonds	Small Cap	Large Cap	LT Govt Bonds
Nov 27	51.9 %	46.9 %	0.8 %	-50.9 %	9.3 %	9.8 %
Mar 33	257.0 %	91.9 %	5.6 %	511.0 %	192.0 %	18.5 %
Jun 38	-15.4 %	-1.9 %	7.6 %	16.2 %	0.9 %	16.3 %
Oct 45	-1.8 %	-7.3 %	2.2 %	10.7 %	15.3 %	2.5 %
Oct 49	31.4 %	31.5 %	0.3 %	54.9 %	88.0 %	-1.1 %
May 54	51.1 %	35.9 %	1.3 %	81.2 %	83.8 %	-3.1 %
April 58	53.5 %	37.3 %	-9.5 %	94.5 %	66.3 %	3.0 %
Average	61.1 %	33.5 %	1.2 %	102.5 %	65.1 %	6.6 %

Data Source: Ibbotson

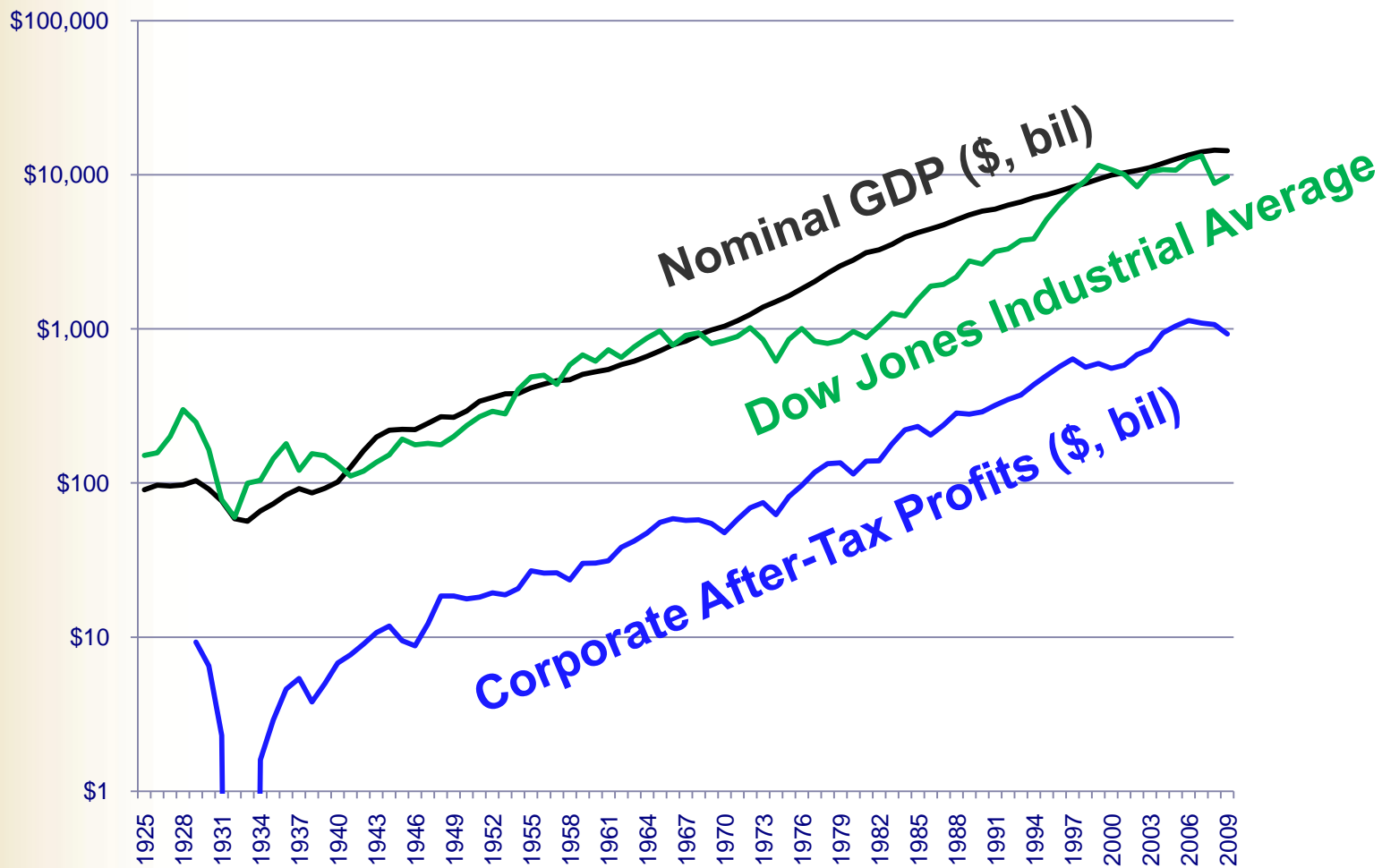
Total Return After End of Recession 1961-2001

	1-Year Total Return			3-Year Total Return		
Recession End Month	Small Cap	Large Cap	LT Govt Bonds	Small Cap	Large Cap	LT Govt Bonds
Feb 61	18.0 %	13.6 %	0.9 %	32.5 %	35.1 %	8.0 %
Nov 70	12.1 %	11.2 %	11.8 %	-9.7 %	20.6 %	18.3 %
Mar 75	58.1 %	28.3 %	11.8 %	142.0 %	22.0 %	24.3 %
July 80	45.1 %	12.9 %	-11.1 %	149.0 %	55.9 %	29.8 %
Nov 82	43.6 %	25.4 %	4.4 %	57.3 %	67.2 %	48.9 %
Mar 91	27.5 %	11.0 %	12.7 %	69.8 %	29.8 %	40.6 %
Nov 01	-3.3 %	-16.5 %	10.1 %	68.4 %	8.4 %	24.2 %
Average	28.7 %	12.3 %	5.8 %	72.8 %	34.1 %	27.7 %

Assets in Money Market Funds



Stock Market Performance is (ultimately) Bounded by Economic Growth



Subsequent 10-year returns (green) After Negative 10-Year Periods (red)

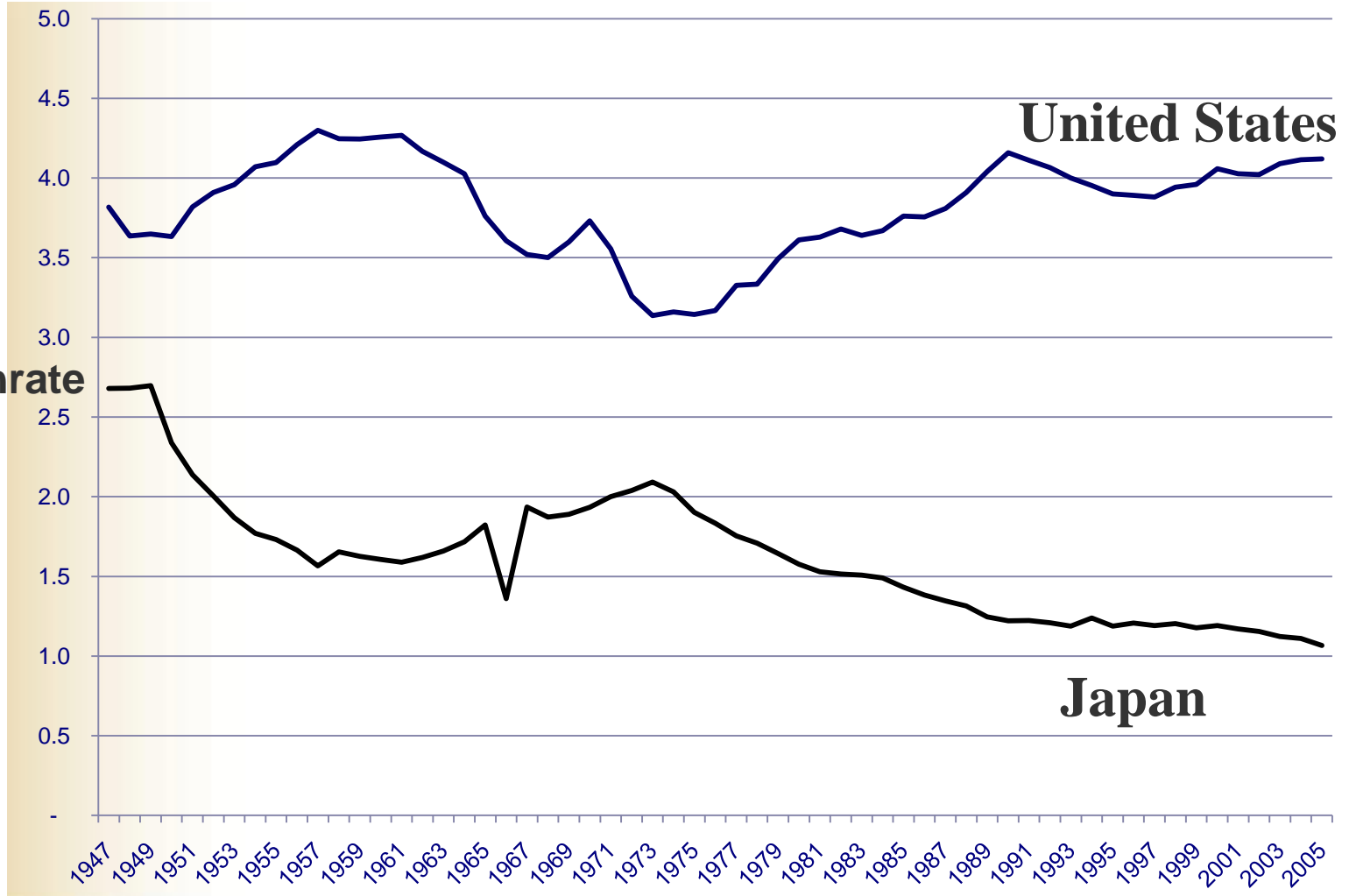
Distribution of 10-year Annualized Real Returns: 74 Ten-Year Periods Since 1926

Global Strife			Dismal to Poor			Nominal to Good			Wonderful World		
					75-84						
					76-85						
					77-86						
					93-02		58-67	45-54			
					33-42		84-93	46-55			
					96-05		85-94	53-62	52-61		
					63-72		27-36	83-92	90-99		
			74-83	38-47	35-44	26-35	92-01	80-89	91-00		
	70-79		30-39	34-43	97-06	94-03	79-88	43-52	54-63		
	73-82		28-37	62-71	32-41	78-87	44-53	87-96	48-57		
69-78	72-81	67-76	64-73	40-49	36-43	59-68	95-04	42-51	88-97	50-59	
65-74	66-75	71-80	39-48	31-40	60-69	57-66	56-65	55-64	51-60	89-98	
99-08	68-77	37-46	29-38	98-07	61-70	41-50	81-90	86-95	82-91	47-56	49-58
< -3 %	-3 -- -1	-1 -- +1	1 - 3	3 - 5	5 - 7	7 - 9	9 - 11	11 - 13	13 - 15	15 - 17	> 17 %

Distribution of large company one decade holding periods returns, measured from the beginning of the first year to the end of the second year. Returns were computed as the compounded annual inflation-adjusted return over each 10-year period. The large company geometric real (inflation-adjusted) return for the entire 1926-2008 period is 6.4%.

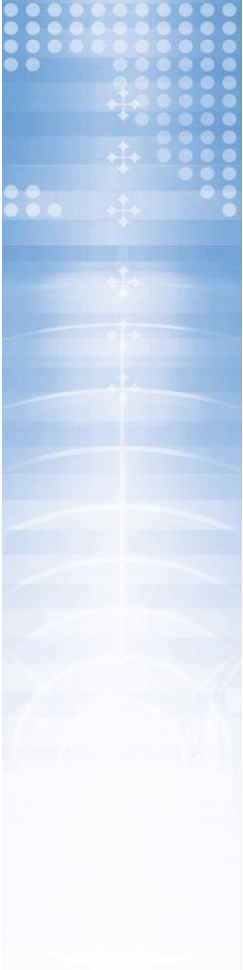
Source: Ibbotson Associates, TrendStar Advisors.

Japan's Falling Birthrate has Led to the Second Oldest Nation in the World





Future Sources of Demand & Intellectual Capital Supply



	Population Change 2008-2050
India	57%
United States	44%
China	7%
United Kingdom	5%
Germany	-7%
Italy	-13%
Russia	-22%
Japan	-26%

We Have Run Out of Oil (in forecasts) Many Times Before

<i>Year</i>	<i>Prediction</i>	<i>Source</i>
1914	Oil would last a decade	Bureau of Mines (U.S.)
1920	20 billion barrels - total oil remaining in the world	U.S. Geological Survey
1922	US only has energy oil supply to last 20 years.	U.S. Geological Survey
1926	4.5 billion barrels remain	Federal Oil Conservation Board (U.S.)
1932	10 billion barrels of oil remain	Federal Oil Conservation Board (U.S.)
1939	13 years supply	Interior Department (U.S.)
1944	20 billion barrels of oil remain	Petroleum Administrator for War (U.S.)
1950	world oil reserves are at 100 billion barrels	American Petroleum Institute
1951	13 years supply	Interior Department (U.S.)
1977	'could use up all of the proven reserves of oil in the entire world by the end of the next decade'	U.S. President Jimmy Carter

Source: Lyn Martin, "Are We Running Out of Oil?", 27th Australasian Transport Research Forum, Adelaide, 29 September – 1 October 2004

■ For Perspective

- Current world consumption is 31 billion barrels per year
- Current proven reserves are 1,340 billion barrels



Market Bottom – Friday, July 8, 1932



■ Dow at 41

- *GDP declined 46% from the 1929 peak*
 - ▶ It would take until 1941 to return to the 1929 level
- *The steel industry was operating at 12% of capacity and at the same level as 1900*
- *P&G's soap prices were at 17 year lows*
 - ▶ Deflation during 1932 was 10.3%
- *Unemployment was nearly 25%*
- *Calls for “socialized capitalism” made the front page of the wall street journal on July 22, 1932.*

■ Turning point?

- *On the day the market bottomed, the Lausanne Accord was struck, effectively ending German war reparations*
 - ▶ Replaced the Young Plan that had Germany making payments until 1988

- **5-year annualized return June 30, 1932 – June 30, 1937:**
34.8%



Market Bottom – Tuesday, April 28, 1942



■ Dow at 93

- *1939,40,41 three year sequence of down years for the market*
 - ▶ Germany invades Poland on September 1, 1939
 - ▶ France surrenders to Germany on June 22, 1940
 - ▶ U.S. declares war on Japan, Germany, Italy December 1941
- *Real GDP expands 37% from 1938 to 1941*
 - ▶ Economic expansion was overshadowed by rising risk of world war
- *Inflation accelerates in 1941 and 1942 to nearly 10%*
- *Japanese expansion reaches peak in Pacific*
- *End of World War II over 3 years away*

■ Turning point?

- *Ten days prior to the bottom—Jimmy Doolittle's raid on Tokyo, April 18, 1942*

■ **5-year annualized return Apr 30, 1942 – Apr 30, 1947: 19.6%**



Market Bottom – Friday, December 6, 1974

■ Dow at 578

- *Cease-fire between U.S. and Vietnam announced January 23, 1973*
- *Oil prices had skyrocketed from \$3 in 1972 to \$12 by the end of 1974*
- *Oil embargo begins Oct 17, 1973....ends March 18, 1974*
- *Inflation rises to over 12% during 1974*
- *President Nixon resigns August 8, 1974*
- *Ford Pardons Nixon October 17, 1974*

■ Turning point?

- *Constitutional crisis averted*
- *Sharp drop in inflation during early 1975*

■ 5-year annualized return Nov 30, 1974 – Nov 30, 1979: 14.0%



Near Term Outlook

- **Consumers will focus on debt reduction**
 - *Consequently, consumer spending and overall GDP growth could be below long-term trend for several years*
- **Government inadvertently adding disincentives to hire**
 - *Higher payroll taxes, taxes on healthcare, pro-union environment, pro-plaintiff attorney environment*
 - *Persistent high unemployment or “jobless recovery”*
 - *Should see prolonged period of capital for labor substitution*
 - *Likely to favor technology and certain industrial companies*
- **Government stimulus (both fiscal and monetary) will ultimately put upward pressure on inflation**
 - *Governments worldwide will have the incentive to inflate out of their own debt problems*
 - *For now, inflation is tame because banks are not lending*



Summary



■ Technological progress to accelerate

- *Rate of change of technological progress doubling every 10 years (Kurzweil, 2001)*
- *The equivalent of the past 100 years of progress will take place over the next 20-25 years*

■ Great promise leads to great expectations and excessive enthusiasm...which creates stock prices bubbles

- *Rail stocks during 1860s*
- *Radio and auto stocks in the 1920s*
- *Electronics stocks in the early 1960s*
- *Personal Computers in the early 1980s*
- *Internet stocks in the late 1990s*
- *Housing and Commodity stocks in the mid 2000s*

■ Change = Opportunity

- *New winners and losers – destruction of old wealth, creation of new*