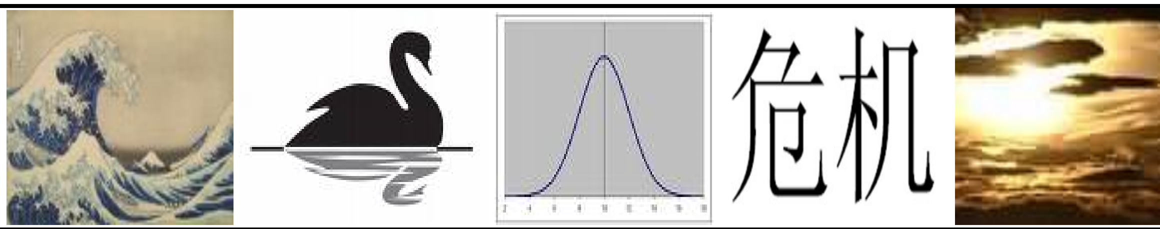

Of Growth and Gaps

MVCM Quarterly Market Outlook
May, 2009

***Nature abhors a vacuum**. While we ponder the meaning of data points suggesting that the worst of the financial meltdown may be behind us, we also have to look forward and consider what comes next. The days of heart-wrenching freefall have subsided, for the time being at least, but **for the market to embark on any kind of sustained rally will require leadership** – a combination of forces that drive economic growth and profits. Such leadership is not evident in the current environment, but it is likelier than not that its seeds are germinating somewhere in the present day landscape. The forces that propelled the bull market of the 1980s and 1990s were already unfolding in the 1970s. **There is always a period between formation and actualization**; when ideas and patterns are taking root but have yet to converge into a clear set of affirming forces to enable a macro bull market. **We call such periods "gaps", and our advice is to "mind the gap"**. Gap markets are treacherous terrain to navigate, replete with numerous false dawns and ever-shifting market bottoms. Mostly, gap markets are leaderless. **We believe we are in such a gap market today and may be for some time**. Will we eventually find our way back into a sustained growth pattern? We believe that we will. **We have faith in the ability of creative genius to express itself in economically viable ways that benefit people** – and that's what makes for sustainable leadership.*

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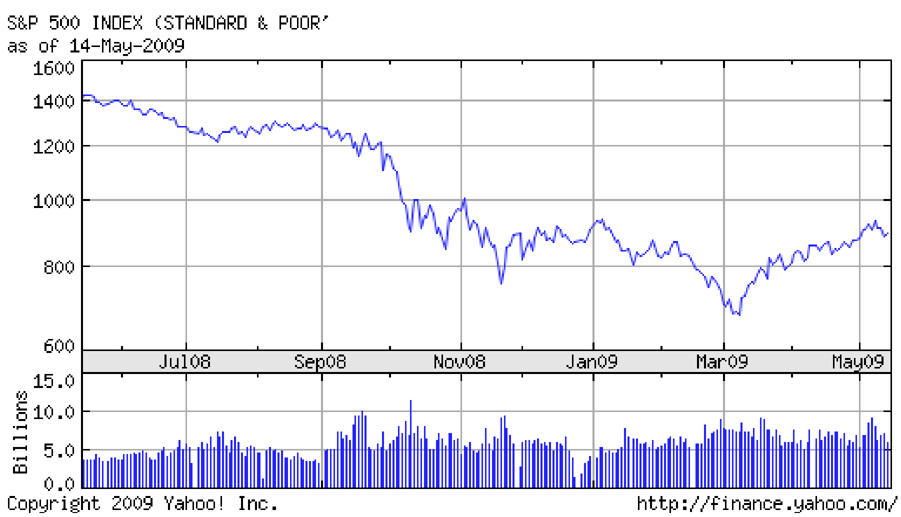
This Quarterly Commentary is a bit of a misnomer as it really does not focus specifically on the performance of investment markets between January 1 and March 31 of this year. Perhaps we should call it "Intermittent Market Outlook" to distinguish it from our Annual Market Outlook. In this document what we do is: first, to examine the case for improvement in the near-term fundamentals: the main idea being that the freefall of last fall and earlier this year has given way to a bumpy sort of bottoming out that could produce successions of short-term rallies and corrections in equity markets. As near-term conditions stabilize, performance among different asset classes has begun to diverge, creating opportunities for outperformance but also increasing the attendant risks. Today we do not enjoy the forgiving tailwinds of a secular bull market, where the pain of allocation, selection and timing mistakes is softened by double-digit returns in the broader equity indexes.

Second, we step back and take a broader look at the current market environment in the context of longer-term economic structures prevailing since the end of the Second World War. We make the argument that we have experienced two defining economic eras – both strongly growth-oriented – during this time represented by the two secular bull markets of 1949-1966 and 1982-2000/2007, with a "gap market" environment from 1966-82 and a second gap market that we would argue began at least in part in the early years of this decade but was obscured by the dramatic last gasp of the '82 bull market, leveraged on the fumes of the defining forces of that era: technology-and deregulation-aided innovation in the financial services sector. Thus a legitimate question exists as to when this present gap market actually began: 2000 or 2007? It is not a trifling question: "how much longer are we going to be stuck in the gap?" is everybody's concern, and if one were to rely on history for the average duration of gap markets we might be either two or nine years into a fifteen-or-so year cycle (of course historical averages are not a reliable predictor of future performance). We presumably will know in due time: regardless, we believe, the gap will likely persist until the contours of the third postwar economic era come into clearer definition than they are today.

Light Escapes: It's Not a Black Hole

What light through yonder window breaks? Do we dare to think, midway through the month of May, that this Mother of All Financial Crises is in its waning phase, and that those faint but still visible rays on the horizon portend the dawn of a new day? Most of us certainly hope so after the whiplash we've endured since the economic downturn metastasized into a meltdown last September. It is hard to believe that in the space of seven and a half months or so the S&P 500 has taken us on the following ride: from a post-Labor Day 2008 reading of 1277 it collapsed 41% to 752 by November 20, then scaled a wall of hope up 20% to a bit over 900 by New Year's Eve, then promptly dashed *those* hopes of an early sunrise by cascading another 25% down to 676 on March 9, and finally went on a manic tear of 37% up to graze 930 on May 8. We hope the roller coaster is over, because more vertigo is something very few stomachs are ready to take on.

Table 1: S&P 500 Index Performance Last Twelve Months to 5/14/09

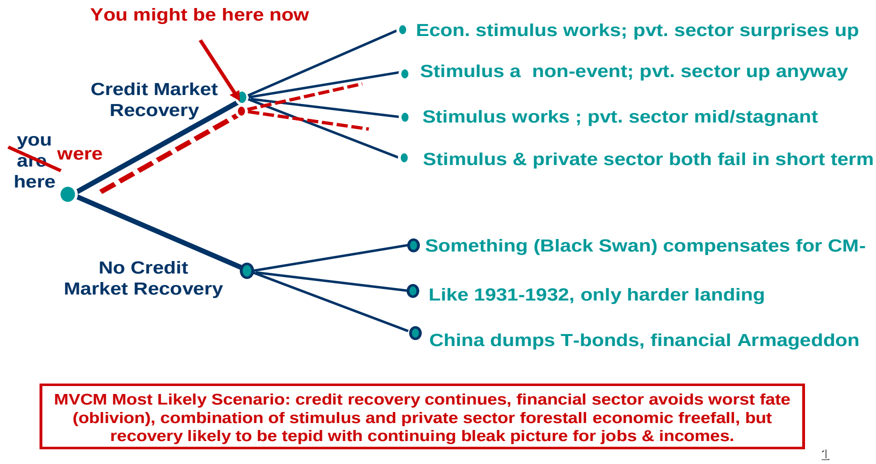


Source: Yahoo! Finance. Stock indexes are not directly investable.

The plain truth is that we do not know whether the financial meltdown component of the overall economic crisis is over or not, but *we do know that for the time being at least the worst scenario has not played out*, and that by itself increases the probability that we have passed the nadir of the financial crisis. Below is a chart that we have updated from its first use in our Annual Market Outlook earlier this year.

At the time we had posited that the most important outcome for the direction of investment market indicators was whether or not the credit markets would stabilize.

Table 2: MVCM Scenario Analysis



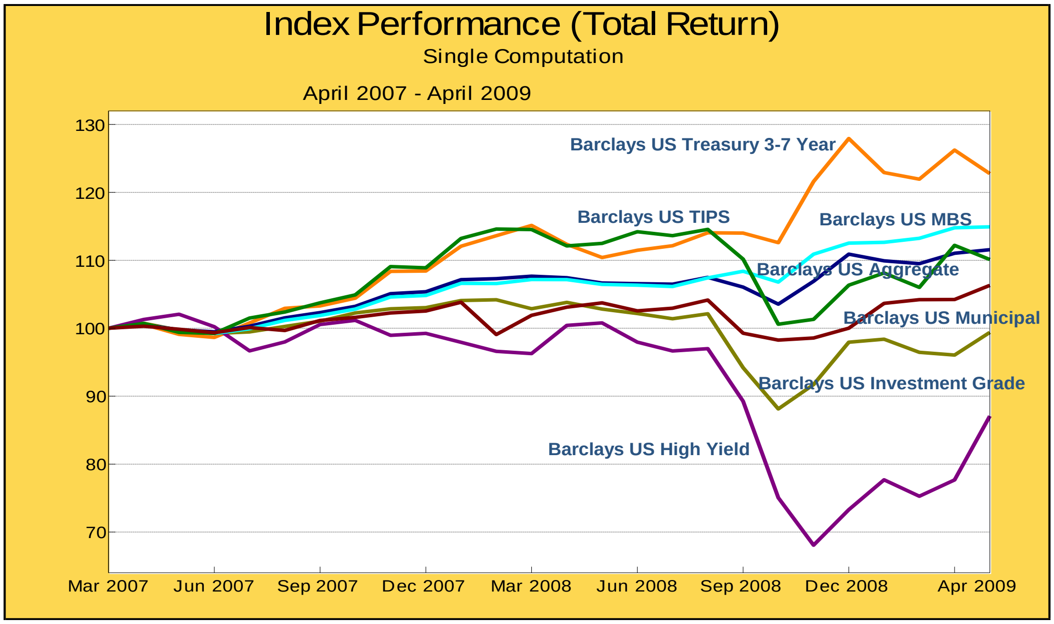
Source: MV Capital Management, Inc.

We have followed this up with an overlay (the red dotted line) and a point with a phrase worthy of Heisenberg's Uncertainty Principle for particles in quantum mechanics: you *might* be here. The credit market did not collapse under its own massive weight into a black hole. Financial institutions are still technically "solvent" – after getting some accounting-magic relief from the burdens of mark-to-market accounting, hundreds of billions of dollars from TARP, TALF and the rest of the alphabet soup of bailout relief, and effective borrowing costs of zero percent. The current phase of the stock market rally got its first impetus in March when Citibank announced that it had managed to turn a slight profit. Hooray, said the market, the banks are returning to profitability. Other voices were somewhat more skeptical. If you let a bank value its assets at something other than current notional market value (e.g. what they "might" be worth in better economics times), give that same bank billions upon billions of real-time cash dollars to spend on its day to day operations (including those famous financial sector payrolls) *and* charge the bank nothing to borrow money, which it can turn around and lend out at four or five or six percent – well, is there a person above the age of five who could somehow *not* make money under those circumstances?

But no matter that the expectations bar is so low. Solvency is solvency, and the credit markets have benefitted. 30-year mortgage rates that were grazing 6.5% at the end of last year have trended back below 5%. Six month US dollar LIBOR, which registered an eye-popping 4.5% even as Treasury yields were falling to zero last fall, has subsided to around 1.5%. The performance of fixed income asset classes appears to be reverting to more normal risk-return positions after those unlikely double-digit gains by the least risky part of the market, US Treasuries, for so many months. High yield debt led the bond market upwards in the first quarter and into April, while other non-Treasury asset classes also regained some footing. Sentiment in the investment grade market remains tempered: if the credit market recovery takes firmer hold and more corporations are able to come back to the debt financing markets at more attractive terms then we would expect to see better performance from the higher-rated end of the corporate market.

The table below shows an unusually high level of volatility in bond markets that began in the summer of 2007 when the credit market crisis began. Performance of different fixed income asset classes began to widen over this period and that trend was exacerbated when the crisis went into freefall in fall of 2008. We see some evidence of reconvergence since March, but we will feel more comfortable that the credit crisis is truly behind us when those fixed income spreads are as boring as they were before.

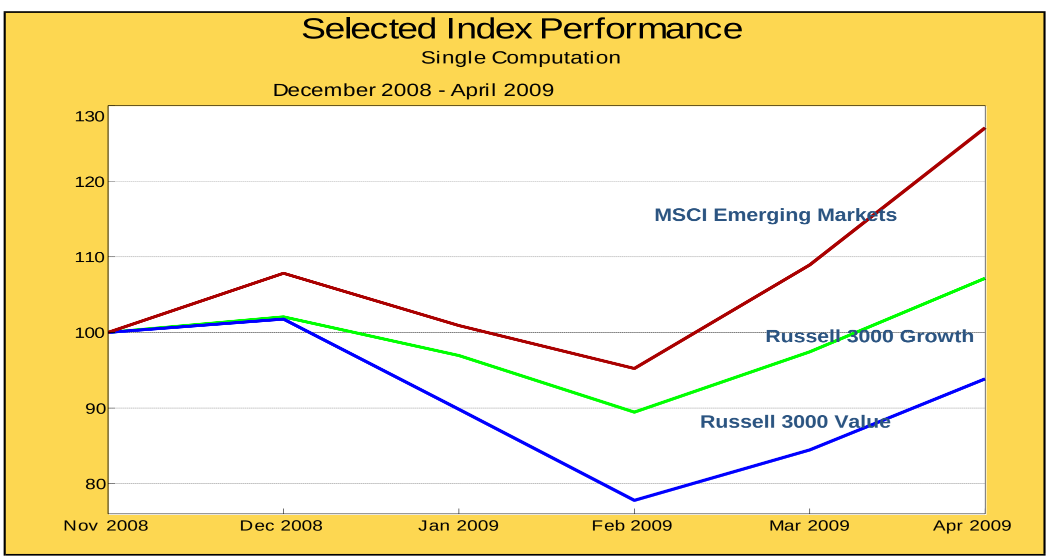
Table 3: Fixed Income Performance Last Three Years to 4/30/09



Source: Zephyr & Associates LLC. Indexes are not directly investable and performance does not reflect fees and expenses customarily associated with actual portfolio investments.

Equity asset classes also show divergence. During the freefall last autumn it was impossible to discern performance along traditional style or location lines: all performed terribly and correlations shot radically up. Over the first four months of this year we see divergence to potentially enable active portfolio tactics.

Table 4: Selected Equities Performance Year to Date



Source: Zephyr & Associates LLC. Indexes are not directly investable and performance does not reflect fees and expenses customarily associated with actual portfolio investments.

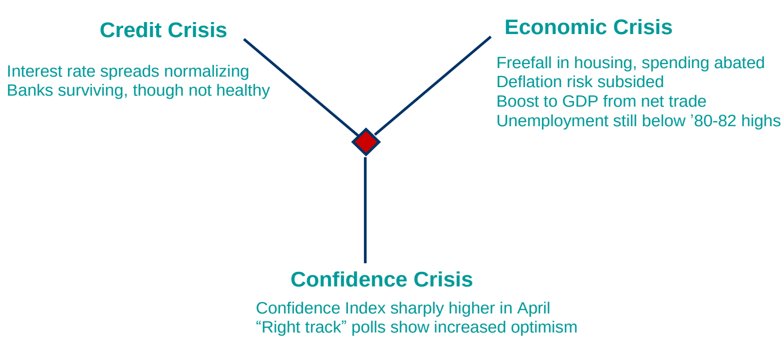
Such tactics do not come without heightened risks, however. Market timing is a fool's game in the best of times, but in a bull market the general upward drift is very forgiving to timing bets gone wrong. The topography of a bear market is much more forbidding, with shorter cycles between intermediate-term rallies and corrections, as we shall see in more detail later in this paper. Consider, for example, the divergence between U.S. value and growth stocks as represented in the above chart. Technology stocks, a major component of growth equity portfolios, have performed relatively better than other sectors in the past several months, though we believe more of that has to do with the financial and homebuilding sectors – key components of value equity indices – performing significantly worse than the market overall.

On several occasions during the first quarter we looked at the value-growth question (our target allocation guidelines have been roughly 50/50 during this period). Each time we came to the conclusion that the risks of a tactical move towards growth outweighed the benefits. Our reasoning, which was a major theme in our Annual Market Outlook published earlier this year, was that if the stock market really is going to embark on a sustained near-term rally it would be on the back of gains in the financial sector first of all, with homebuilding and possibly energy stocks/commodities also firming up as harbingers of an economic turnaround, however modest. In other words, if the market is going to move significantly higher we would expect much of that additional performance to come from the value side of the market and thus find ourselves somewhere not too far from value-growth parity, which is what our allocations suggest. However, we also think that the likeliest outcome of all will be an overall sideways pattern with periodic mini-rallies and corrections – a pattern we think lends itself rather poorly to tactical style bets in general, and affirms our current style-neutral, defensive positioning.

The Tripartite Economy

If indeed the credit market has successfully turned away from the event horizon that threatened its annihilation then we still have to contend with the other two pillars of the platform on which our markets operate: the "real" economy; and the confidence of its participants from consumers to industrial purchasers, from average-Joe taxpayers to hedge fund managers. Markets need these three things: credit to facilitate allocation of capital to its most productive uses; a well-functioning system for the provision and consumption of real goods and services (i.e. the real economy); and the collective confidence of everybody who participates in the system to keep entrusting their stores of value (their savings, their time, their unique human assets that can contribute something worthwhile to the greater economic good).

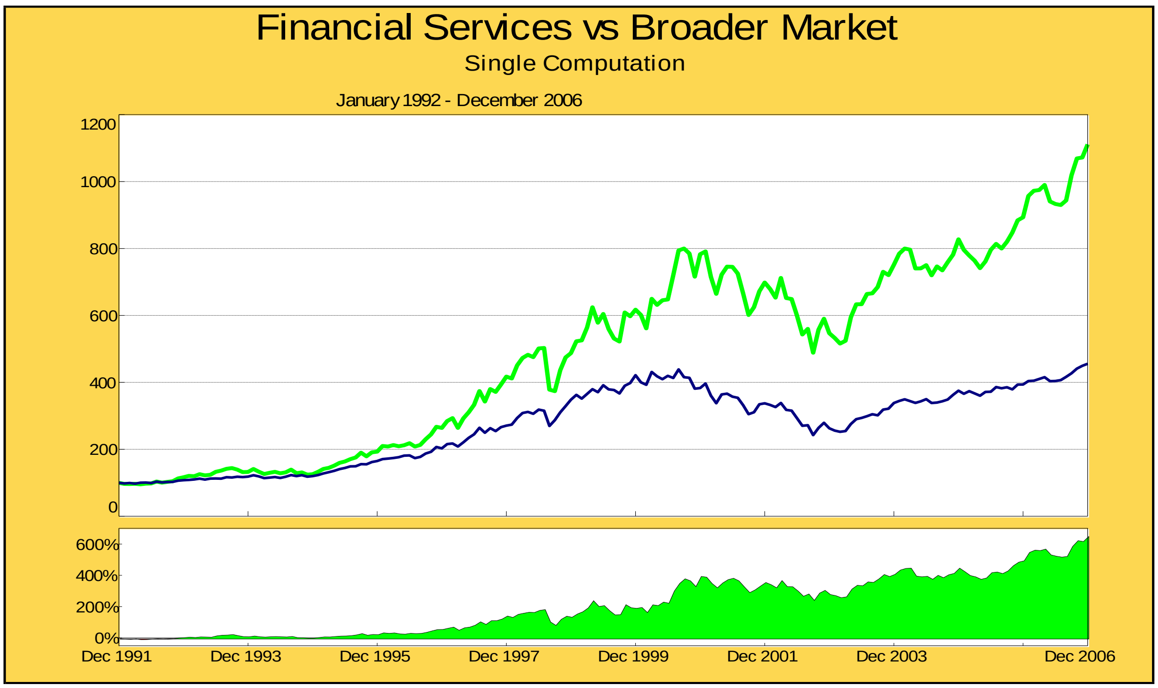
Table 5: Components of Economic Crisis



Source: MV Capital Management, Inc.

For much of our post-World War II economic history the credit markets played a predictable, if somewhat unglamorous role: banks lent money to businesses, which invested in capital assets to produce goods and services people wanted to buy, which caused the businesses to grow, creating employment and income opportunities for more people, who saved some of that income and spent the rest, and so on in a virtuous spiral – a positive feedback loop. The relationship between the credit market and the real economy was fairly stable and predictable. Starting in the 1980s that began to change; and the change accelerated into hyperdrive in the early part of the 2000s. Namely: the credit sector mutated into the dominant sector of the real economy per se. In 1980 financial institutions – broadly defined to include deposit-taking institutions (banks and savings & loan institutions), investment banks, brokerage houses, insurance companies and asset managers – accounted for roughly 16% of the total operating profits of the S&P 500 constituent companies. By 2007 that number had risen to 44% and included a whole range of new types of finance companies under the rubric “non-bank financial institutions”, commonly referred to as the “shadow” banking system. This muscled-up new financial order thus accounted for nearly half the profits in the total economy. Even that figure is understated, because many other industries ranging from homebuilders to consumer discretionary goods derived a large part of their own profit growth from financial sector innovations that continually discovered new ways to provide people with the means to borrow ever-greater sums of money.

Table 6: Performance of Dow Jones USA Financial Sector Index vs. S&P 500, 1992-2006



Source: Zephyr & Associates LLC. Dow US A Financial Index in green; S&P 500 in blue. Shaded green area on bottom chart indicates excess return (of Dow Financials over S&P 500). Indexes are not directly investable.

That the financial system dwarfed the rest of the economy can be seen in numerous ways: one that never ceases to astound us was the growth of the credit default swap (CDS) market, which had a global aggregate notional value of over $62 trillion by 2007. That’s not a typo: $62 *trillion*. By comparison the total size of the U.S. Gross Domestic Product (GDP) was about $15.5 trillion in 2007. The growth of finance and its many service industry tributaries kept the overall economy on the uptick for many years, obscuring some growing organic problems in other sectors and, more importantly, a growing inability of household income to keep pace with inflation. Consumer spending, the economy’s *primum mobile*, grew on the back of increased household debt, not rising incomes. Not surprisingly, then, when the financial sector bubble finally burst it was a long, hard and vertical descent ending with a shock that will reverberate for years to come.

The Great Deleveraging is now underway as households try to unburden themselves of the unprecedented debt pile-up of the past 10 years and restore the integrity of their household balance sheets. Household savings in the U.S. rose to 3.6% in April this year (it was negative in 2007); expect it to rise further. It's not a question of choice, as some media commentators with a persistent hangover of Bubble Economy Syndrome like to profess (usually ending with some silly exhortation to spend as a display of "patriotism"). Households simply will have to save more. Real incomes are no longer even flat – they are in decline and credit lines are tapped out.

This does not mean that we will necessarily see continually declining retail spending every month from here on out. But it does mean that the whole consumer spending equation will likely change. First, people will likely increase the percentage of things they buy with debit cards as opposed to credit cards. Second, because those debit cards are directly related to the here and now – the amount of cash in the checking account today as opposed to the credit balance owed in one month or 12 months from now – the breadth and depth of discretionary and even staple goods choices that people make will contract. Patience will become a virtue again. Plasma TVs and Italian terracotta patios will still be purchased – but not necessarily in the same month or even year. Third, financial institutions will come to play a less active role in this whole consumer equation. All they will have to do is operate checking and savings accounts and issue debit cards – in other words, do what banks used to do before they became high-powered salespeople hawking seemingly (and actually) too-good-to-be-true retail borrowing tools.

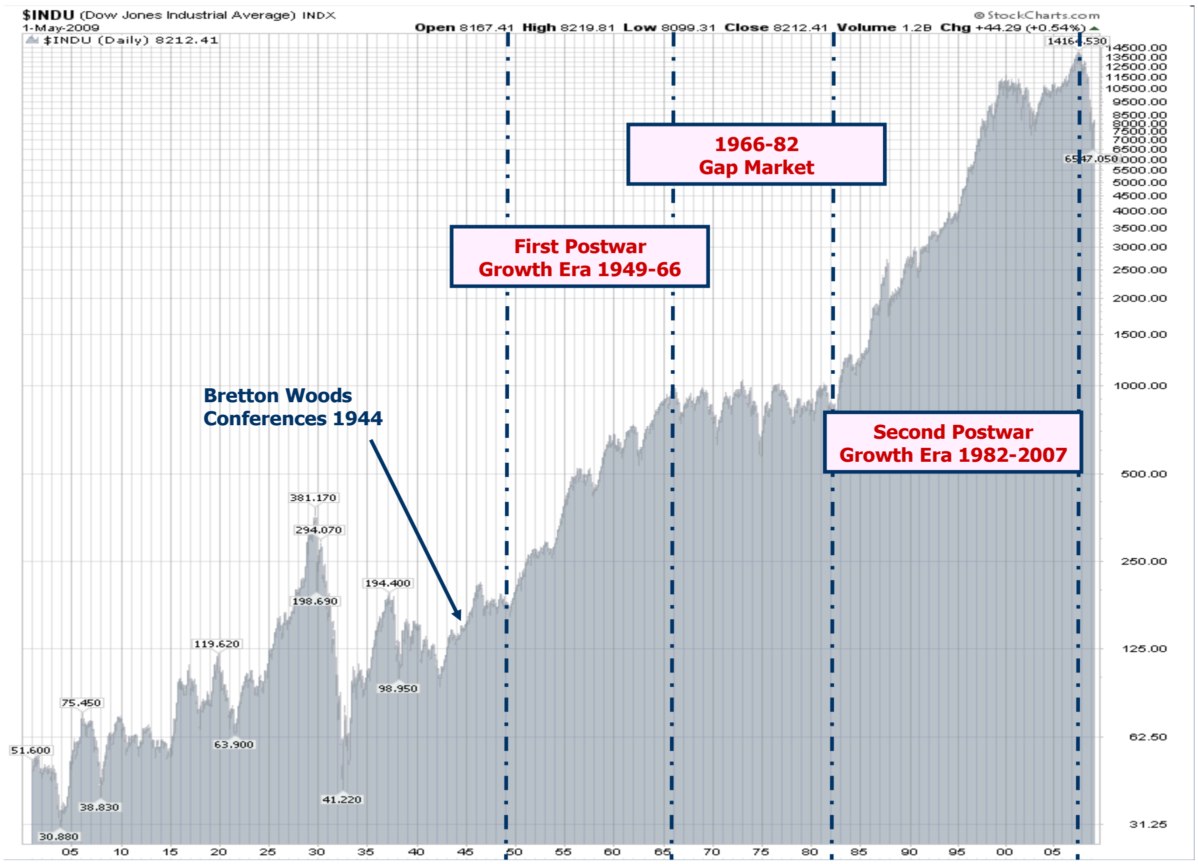
All of this matters because, as we never seem to tire of saying, consumer spending has accounted for over 70% of our GDP for the past handful of years, and so fundamental changes to consumer spending and saving patterns will matter greatly. We would take that comment one step further. The twin engines of finance and consumption powered the economy for most of the past 25 years. Finance, aided by the forces of technology, deregulation and globalization, was the driver: without the relentless pace of innovation in the financial sector that managed to turn shopping into the hyperleveraged 24/7 pastime it became, consumer spending would never have grown from its long-term stable level of 65% to 72% of GDP. The macro bull market of 1982-2000/2007 is the most visible testament to this economic era. That bull market had a last, overreaching gasp from 2003-2007 before it finally expired for once and for all.

We believe that we are at the beginning of the third defining economic era since the end of World War II. To appreciate what this potentially means for the investment markets it is worth our looking at the preceding eras – not because history repeats itself but because there are instructive lessons in how markets absorbed change, adjusted to new information and eventually found the next trajectory for growth.

The Third Postwar Economic Era

The day-to-day movements of the stock market say very little about fundamental economic trends. But looking at more than 40 years of stock market performance does tell a story – the creation of wealth and its periodic disappearance, stagnation and re-creation. When some perky newscaster chirps that the "market rose today on lower jobless claims" that is on its face a silly statement: the market rises or falls on any given day for a variety of reasons that cannot be crushed into the bland confines of evening news soundbites. But it is *not* silly to say that "the economic institutions created by the victorious nations of the Second World War provided a foundation for economic strength that powered a long secular bull market through the 1950s and first half of the 1960s". With that in mind, let us consider the following chart, showing the performance of the Dow Jones Industrial Average from 1900 through 2009.

Table 7: Dow Jones Industrial Average Historical Performance 1900-2009



Source: StockCharts.com. DJIA results represent price performance. Dividends are not taken into account. Price performance (capital appreciation) and dividends are the two sources of returns available to equity investors, so price performance alone does not represent total return.

The point of this discussion is not a history lesson for its own sake. Nor is it to go back in time, find a particular market cycle and claim that market cycle is now repeating itself. No two economic cycles are ever the same. But in a larger macro sense this picture tells us a lot about what happens during sustained growth periods and during gap markets. There are few similarities between the growth era of 1949-66 and that of 1982-2000/2007. But what they both did have in common were compelling forces that converged into a powerful rationale to buy stocks – secular forces that were strong enough to weather cyclical downturns and keep the upside momentum going so that when the market corrected by, say, 10% it would easily succeed in returning to its previous high point. What that gap market of the 1970s lacked was a compelling rationale that could hold up over shorter-term cycles. That is in no small part because, as we shall see, it was a time of tremendous change: when the forces that would power the 1980s and beyond came into being but had yet to actualize in a meaningful way and be recognized as such.

The First Growth Economy 1949-1966: Institutions for the Greater Good

It would be very difficult for most of us to imagine the mindset of the latter days of World War II. The first 45 years of the 20th century were witness to the dissolution of centuries-old empires and monarchies in Europe and Near Asia, global economic depression and the two most bloody, brutal wars ever waged.

As the Allied powers saw victory coming within sight in 1944 they convened a series of meetings in a small mountain resort center in Bretton Woods, New Hampshire. At these meetings the finance ministers of the United States, Great Britain, France and other nations hammered out the framework of a postwar New World Order to rebuild devastated economies and implement a workable system of international trade and finance. Out of the Bretton Woods conferences came the creation of the International Monetary Fund, the World Bank and the International Development Bank as supranational institutions to promote economic growth, provide the capital to finance this growth and lift the world's poorest nations out of poverty. The United States was the leading light in this new order, and the U.S. dollar was to serve as the world's reserve currency. International trade was to be encouraged, but on clear, fixed terms: the currencies of other nations would be fixed in their rate of convertibility to U.S. dollars, and the dollar itself was pegged to the value of gold at the rate of $35 per ounce.

The Bretton Woods institutions proved to be durable, and the global economy enjoyed a sustained period of growth. The Dow Jones Industrial Average, which had languished below 200 until the end of 1949, was approaching 1000 by 1966. However the institutions that governed world trade proved to be too successful for their own good. Countries were growing at different rates of growth but the system of fixed exchange rates constrained the ability of individual countries to manage their own economic destinies, and trade balances and national accounts fell out of whack as a result. Domestic financial markets were tightly controlled, with regulatory caps on interest rates that hindered the ability of many growing but not yet top-rated companies to raise external capital to finance their growth. The Eurodollar market, the forerunner of what was to become the largest component of the global fixed income market, got its start in the early 1960s as an offshore means for U.S. companies to raise dollar-denominated debt outside the regulatory confines of the U.S. domestic market.

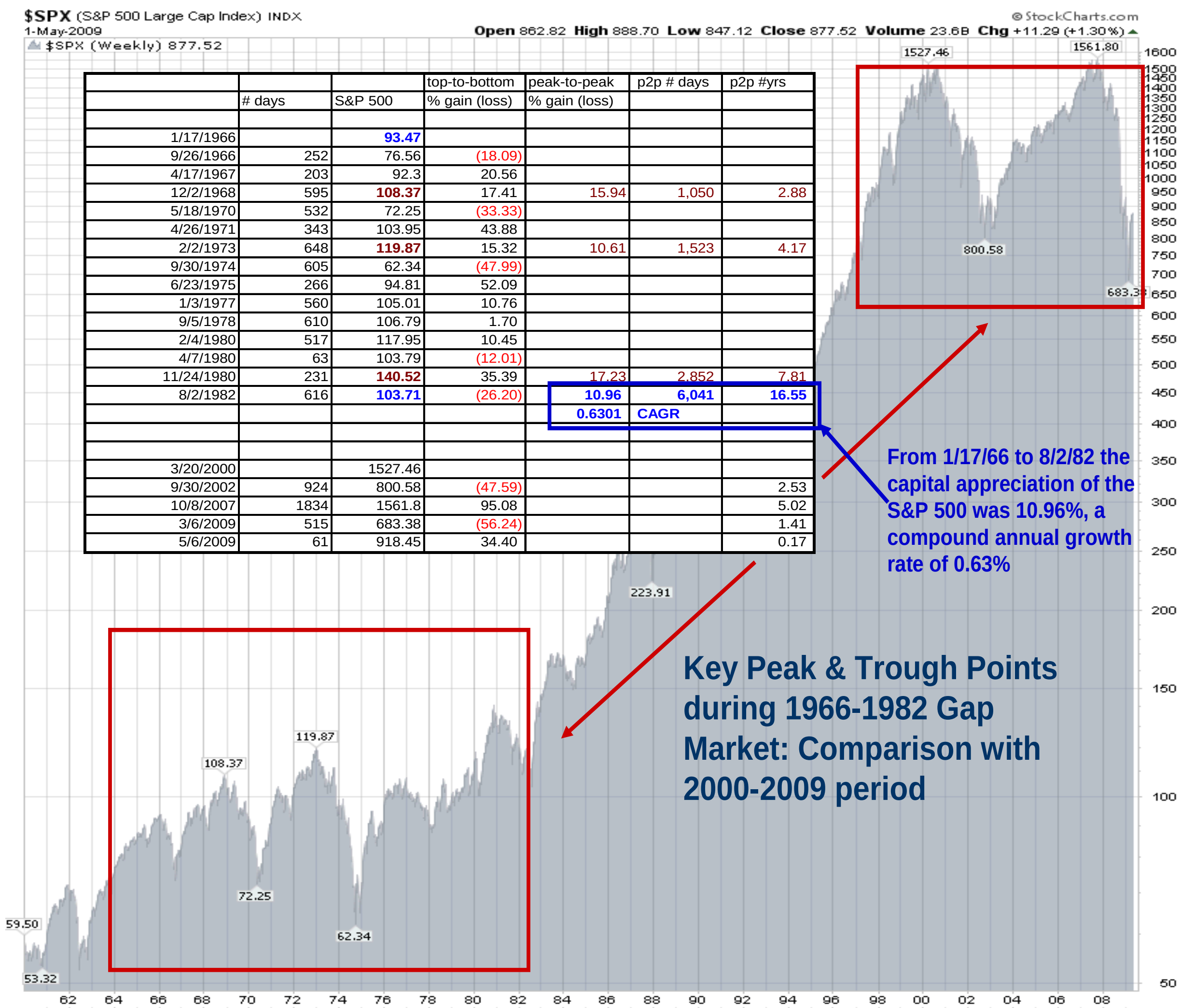
In other words, the great and good institutions of Bretton Woods could not handle the growth they had engendered, and the system began to fall apart. By the dawn of the 1970s the system was unsustainable and in August 1971 U.S. President Nixon announced that the U.S. dollar would no longer be pegged to gold – the dissolution of the fixed exchange rate system was the death knell for Bretton Woods.

The First Gap Market 1966-1982: A String of Bad Hair Days

The stock market, as always a leading indicator of economic direction, started its downward trend in 1966, five years before Bretton Woods was officially pronounced dead. What ensued for the next 16 years was a directionless, though far from inert, sideways market. Throughout the 1970s stocks consistently underperformed bonds, though in comparison with the escalation of inflation over the course of the decade neither stocks nor bonds were particularly appealing on real terms – it was a decade where real-value assets like crude oil and gold were the most attractive investment categories.

Directionless though it was over the course of the whole period, the equity markets of the 1970s were characterized by continual intermediate-term bear market rallies and corrections. The following chart illustrates the major peaks and troughs of the S&P 500 over this period.

Table 8: S&P 500 Price Performance 1962-2009



	# days	S&P 500	top-to-bottom % gain (loss)	peak-to-peak % gain (loss)	p2p # days	p2p #yrs
1/17/1966		93.47				
9/26/1966	252	76.56	(18.09)			
4/17/1967	203	92.3	20.56			
12/2/1968	595	108.37	17.41	15.94	1,050	2.88
5/18/1970	532	72.25	(33.33)			
4/26/1971	343	103.95	43.88			
2/2/1973	648	119.87	15.32	10.61	1,523	4.17
9/30/1974	605	62.34	(47.99)			
6/23/1975	266	94.81	52.09			
1/3/1977	560	105.01	10.76			
9/5/1978	610	106.79	1.70			
2/4/1980	517	117.95	10.45			
4/7/1980	63	103.79	(12.01)			
11/24/1980	231	140.52	35.39	17.23	2,852	7.81
8/2/1982	616	103.71	(26.20)	10.96	6,041	16.55
				0.6301	CAGR	
3/20/2000		1527.46				
9/30/2002	924	800.58	(47.59)			2.53
10/8/2007	1834	1561.8	95.08			5.02
3/6/2009	515	683.38	(56.24)			1.41
5/6/2009	61	918.45	34.40			0.17

Source: StockCharts.com. S&P 500 shown on price performance basis and is non-inclusive of dividend returns.

We call the market of the 1970s a gap market because we see it as a sort of No Man's Land in between two defining economic stories (the first we have already described; the second we will get to shortly). What reason was there to invest in equities in the 1970s? Of course it is easy to say that 30 years hence, when we have the luxury of hindsight, but during the period itself it was not all that clear. Markets can rally in the short term on any combination of economic data points, momentum, gut instinct or whatever else moves the spirit. But those rallies tend to fizzle out when investors fail to be convinced that anything fundamental is afoot and cash out their paper profits.

In fact secular bear markets and bull markets don't look anything like each other. Bull markets are driven by positive fundamental forces over a substantial multi-year time period. Bear markets – at least the bear markets we have experienced since the beginning of the 20th century – are not driven by some mirror image set of negative forces, at least over the duration of the secular period. Rather, what usually happens is one or more tightly compressed periods where the market seems to come to a collective realization that the good times are over and crumbles (e.g. 1929-1932, 1971-1973, 2008-2009). But apart from those periodic shocks the market is driven only by the *lack* of a compelling positive story, rather than the existence of a compelling negative story. Look at the shape of the S&P 500 from 1982-2000. There is not one single example, over any time period of five or more consecutive years, of a bear market that mirrors this performance. Hence the term "gap market" rather than "anti-growth market". The first definable postwar economic era lasted from the late 1940s until the late 1960s. The second definable era began in 1982. This period in between was definable only by its lack of definition – a gap market.

The Second Growth Economy 1982-2000: Greed Is Good

In fact the 1970s gap market was a combustible period of tremendous change. Innovations, discoveries and ways of doing business that would become the rocket fuel of the 1980s and beyond had their genesis in the 1970s. But there was a considerable period between formation and actualization. In the 1970s Apple was just one company out there trying to establish a foothold in this relatively exotic, largely unknown new market of computer technology. Ditto Microsoft and its two Harvard dropout founders of Bill Gates and Paul Allen. The field of technology was growing by leaps and bounds in the 1970s as Moore's Law enabled more information to be squeezed into ever-smaller transistors at ever-cheaper costs. Electronic gadgets became more affordable and more interesting. Many of them bore the stamp "Made in Japan", or "Made in Taiwan", and imports from those and other Asian countries started to grow.

Technology was also having an impact on financial markets. The Eurodollar market of the 1960s evolved into the rapidly growing Eurobond market of the 1970-80s, and the advent of technology helped enable traders and bankers sitting at remote locations to trade and deal with each other. While the Eurobond market was pushing the boundaries of the still largely regulated world of capital markets, the New York Stock Exchange abandoned its system of fixed commissions on May 1, 1975, one of the first acknowledgments by the Establishment that the days of deregulation were approaching. In 1976 an article appeared in the *Journal of Financial Economics* by an academician named Michael Jensen. Called "Theory of the firm: Managerial behavior, agency costs and ownership structure", the article identified structural weaknesses in the ownership and management structure of American corporations. Five years later, that article served as the intellectual blueprint for a takeover of the Gibson Greeting Cards company by a group of private equity investors with the help of a substantial amount of bank financing to support the investors' relatively modest equity contribution – the first noteworthy leveraged buyout (LBO).

All of the events we have cited in the previous two paragraphs flashed up at some point during that '70s gap market, but it was not until the 1980s that they started to converge into the kind of compelling meta-story that powers bull markets. Whereas the First Growth Era was a creature of men and the deliberative institutions they built, the Second Growth Era arose from more primal forces of nature: globalization and deregulation, enabled by the rapid growth of information and communications technology. These forces enjoyed political support in Ronald Reagan's America and Margaret Thatcher's Great Britain.

By far the greatest beneficiary of these forces was the financial system. Deregulation opened many areas of the financial markets that had long been the province of regulated commercial banks, and their more aggressive cousins the investment banks and securities dealers – and later the non-bank finance companies – moved quickly and decisively. Over the 1980s and 1990s the pace of innovation in the financial sector was relentless and quickly spread out to cover the globe. Innovation occurred at the institutional level – a wider range of financial instruments and strategies for a broad spectrum of large and small corporations to raise money and a segmentation of investors into identifiable niches of specific risk and return objectives – and also at the retail level as banks and non-bank finance companies pioneered the widespread adoption of retail credit instruments from credit cards to durable goods financing plans, money market accounts, creative mortgage financing schemes and all the rest with which we are so familiar today.

Part of the sustainability of this market was of course due to events that, when they happened, served to breathe fresh life into trends already underway. The collapse of the Warsaw Pact nations of Eastern Europe, followed by the demise of the Soviet Union, gave fresh impetus to the globalization imperative. The commercialization of the Internet in the mid-1990s unleashed a whole new succession of technology innovations. Persistently low commodity prices had the effect of keeping inflation in check and interest rate levels below historical averages, helping to sustain high levels of activity in the capital markets.

The Second Gap Market 2000/2007-present: What Next?

As we noted earlier there is a lingering question as to when the second gap market started: was it in 2000 or 2007? Are we closer to or farther away from the end of the gap market and the resumption of growth? In truth, looking to the duration of past gap markets is helpful but not predictive. Time cycles vary notably over long periods, and it may well be that we cycle through this current gap in a greatly reduced span of time as emergent forces become known and captivate the investor class. We don't know – and so we are comfortable to simply let that question sit unresolved and open to different opinions.

What we do know, though, is that the Dow and the S&P 500 both recovered from the 2000-2002 downturn to surpass their previous high points in 2006 and 2007 respectively. Moreover the financial sector, the great beneficiary of the Second Growth Era, had its strongest performance ever from 2003-2007. Yes, but…the sector was running on the fumes of sky-high leverage, not viable fundamentals. We would argue that the equities markets of this decade to date were not powered by a fundamentally compelling story but by the artifice of an unsustainable bubble in which a variety of decision agents took actions that were reckless at best, criminal at worst and drove up the price of practically every identifiable risk asset class to levels well beyond their fundamental values. When the music stopped in 2007 it did not come as a major surprise to many market observers (ourselves included), though the cataclysmic and unprecedented collapse of the stock market a year later did have the element of surprise, to say the least.

So here we are in the gap market, trying to navigate the treacheries of false dawns and shifting tectonic plates while searching for the affirmation of whichever emerging trends and discoveries will be the grist for the Third Growth Era, whenever that will be. We don't mean identifying one single stock – say some embryonic developer of solar technology or green waste management – and saying "this is it, this one is going to the moon". It's always nice to armchair-quarterback and speculate how it would have been possible to pick out Steve Jobs and Apple from the pack of aspiring technology companies back in the mid-1970s and make gazillions – and some people did, but that's more the purview of Lady Luck than the foundation of a disciplined strategy.

However we see a handful of broad themes that in our considered opinion may provide the fertile soil for the next convergence of forces to spur economic growth. We periodically address some of these themes in more detail in our periodic research commentaries and e-updates.

For example, one theme which in our opinion bears giving some thought to is *where the next vortex of technology-business convergence will be*. As we have described in this paper, although the effect of technology has been felt across a wide range of industries the sector that arguably benefitted the most from the late 1970s onwards was the financial sector: technology facilitated the total transformation of how Wall Street works, from enabling remote dealer quotation markets like Nasdaq to automated depository and clearing systems that gave rise to stock-futures arbitrage, portfolio insurance program trading and eventually the colossal hedge funds that came to dominate the capital markets landscape in the 1990s and the present decade. Compare this to the role of technology in, say, the field of health care. If an American from 1975 were magically transported into 2008 and went to a doctor's office for a check-up she would not feel unduly out of her element: her medical records would be pieces of paper in a manila folder with her name written in magic marker. If she switched caregivers her records would have to follow her physically, not as packets of data coursing through bandwidth highways from one provider's local area network to another. What is the potential upside – the value creation – from a more intensive convergence of technology with health care – or public utilities, or management of the environment? These are examples of broad themes where we believe "the truth is out there" – and that will figure into our thought process about what that Third Economic Growth Era will look like.

Whatever is going to power that Third Era is happening somewhere today, we are quite convinced. Moreover, many of those emergent phenomena are likely happening somewhere outside the U.S. The world economy has had two distinct appearances during the First and Second Growth Eras. Global Economy 1.0, during the Bretton Woods era of the 1950s and 1960s, was a story of the ascendancy of the U.S. to dominance of world economic trade. The age of globalization – Global Economy 2.0 in the 1980s and 1990s – saw the opening and growth of new markets and the division of the world into the "developed" economies of North America, Western Europe and Japan on the one hand and the "emerging" markets of Latin America, Asia and Central & Eastern Europe on the other.

As we first described in a 2006 research paper "Emerged Markets", that developed/emerging paradigm has run its course of usefulness and, we believe, is no longer useful as a guideline for allocation of global wealth. In Global Economy 3.0, rather than blandly looking at the world through the traditional prism of developed/emerging markets we think it makes more sense to view the entire world from the standpoint of three primary economic components: capital (or finance) markets, production (of goods and services) markets and consumer markets. Traditionally the locus of capital markets has been the axis of New York and London (perhaps to a lesser extent Tokyo). As the economy deleverages we see an emerging Cash Triangle rising to challenge the longstanding supremacy of New York and London. That triangle extends from the Gulf Cooperation Council countries of the Middle East, to Shanghai, Seoul and Tokyo in northern Asia and south to Singapore, Kuala Lumpur and the growing markets of southern Asia. This triangle contains a vast store of the world's net cash savings. The instruments and practices of Islamic finance, a $1 trillion industry, manage a growing amount of the wealth within this triangle. Even in a world where finance is contracting, Islamic finance continues to grow at annual rates of 15-20%.

Beyond the Cash Triangle we see the Asia Pacific region growing in its global importance in all three economic components: capital, production and consumer markets. If this emergent trend metastasizes into a key propelling force of the Third Economic Era then a traditional portfolio allocation – say 5% "emerging markets" of which 2.5% might be related to Asian equities – will most likely be in the position to dramatically underperform. An entirely new way of thinking about global asset allocation is required.

Conclusions

Gap markets are defined by their lack of definition: there is no compelling story to provide the undercurrents of a consistent growth trend, i.e. an overall upward drift through shorter term market cycles. We can argue about whether the current gap market started in 2000 or 2007 – but we are of the opinion that the 2003-2007 rally served as the final dramatic swan song for the macro trends that dominated the bull market of 1982-2000. In any event we believe the current gap market environment will persist for some time yet before a more defined picture of the Third Growth Era emerges. The previous gap market of 1966-1982 was characterized by a succession of false dawns and corrections, and we think this serves as a warning for those who would blindly rush in each time we experience the kind of short-term rally we had at the end of 2008 and again from March to May of this year.

We have maintained a defensive position in our portfolios for over a year now, and will continue to focus full attention on principal protection at the core allocation exposure level. At the same time, we believe that gap markets do present particular opportunities as emergent trends that appear today may be the drivers of sustained performance tomorrow, and we will seek to capitalize on these opportunities wherever possible. Gap markets are a reflection of what the Chinese have long called “interesting times”. Interesting times are not necessarily for the faint of heart. But tumultuous times beget the opportunity for healthy change. The system that collapsed in 2008 had grown unhealthy in many ways: not just financially but also ethically, as the seemingly never-ending fallout of scandals from that period come to light on a regular basis. We are excited about the possibilities that the Third Growth Era may bring, and we would like nothing more than to see our clients benefit from these possibilities.

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