

# HEADWATER INVESTMENT CONSULTING, INC.

Registered Investment Advisor

## INVESTING WITH DISCIPLINE

DECEMBER 31, 2009

### TRANSITIONS

By Brian Lawrence, CFA

The year 2009 saw markets and emotions span a wide range, starting with great fear and trepidation as the capital markets shuddered under the weight of a collapsing financial system. Fear gave way to hope as markets began to recover and the economy exited recession. Since the calendar has rolled over to a new year, hope and optimism has been replaced by a realization that the world has changed in some difficult ways. How we save, invest, consume, and view our place in the world is changing. By definition the future is unknown, but it's interesting to consider some of the transitions taking place.

First, the geopolitical and economic centers of gravity no longer reside wholly in the USA. The G7 has become the G20. Globalization has led 100's of millions out of poverty and into the middle class, in turn lifting a host of developing nations to the cusp of being "developed." The newly empowered nations now demand a voice in the world's major institutions. They demand a say in global trade negotiations and other decision making. And from the standpoint of global prosperity, the continued growth of Asia, India, and Brazil could be equally or more important than U.S. or European success. China alone is the #1 importer of many commodities and recently passed Germany as the world's #1 exporter. China will soon pass Japan as the world's second largest economy. While a large swath of American society was worried about McMansions and SUVs and shopping malls (non-productive assets), Asia invested in roads, factories, and schools (productive assets). The center of gravity has dispersed. The U.S. is unlikely to regain its stature of the last two decades. We are in a transition, from the world's lone superpower to a world where other nations are economic and political counterweights.

### WELCOME!

*We would like to introduce Amy Woodard,  
the newest member to the Headwater Investments team.*

*Amy earned her B.A. in Finance & Religious Studies from Linfield College in 2007. She has worked the past several years for a retirement management company as a financial analyst. Amy is joining our firm as an Associate Portfolio Manager. Amy is looking forward to meeting you.  
Stop by or call to say "Hello!"*

### INDEX SCORE-CARD

	QUARTERLY RETURNS	
	3 <sup>rd</sup>	4 <sup>th</sup>
US Large Cap:	15.6%	6.0%
US Small Cap:	19.3%	3.9%
International Stocks:	19.5%	2.2%
Emerging Markets:	20.1%	8.3%
US Bonds:	3.7%	0.2%
Foreign Bonds:	6.8%	-1.3%
REITs:	33.3%	9.4%
Commodities:	4.2%	9.0%
TIPS:	3.1%	1.8%
Treasury Bills:	0.04%	0.02%

3<sup>rd</sup> Quarter for the period ending  
9/30/09

4<sup>th</sup> Quarter for the period ending  
12/31/09

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## TRANSITIONS (CONTINUED)

Besides these macro level changes, the U.S. economy and culture are undergoing other transitions. Perhaps the most immediate concern is the shift from government spending, as a crutch for the economy, to private spending and investment. Since the beginning of the crisis in 2008, government spending has skyrocketed to offset plummeting private sector demand. It is self evident that this is not sustainable. The question and concern is – how does the government exit from the extraordinary programs that have so far propped up the economy? This transition is just begun and is already fraught with potential problems.

The U.S. housing market is a prime example of this challenge. The Federal Reserve has purchased billions of dollars of mortgages to both keep the market for these securities from locking up and hold down interest rates on future loans. The Fed cannot keep printing money to buy mortgages. They recognize the danger of inflation and have signaled their intention to phase out of their programs over the coming months.

Complicating the situation, the housing market crash has shaken confidence in one leg of the American Dream – homeownership. A friend of mine has sworn it off, determined to rent and maintain greater financial freedom and flexibility. His point of view may sound extreme, but many laid-off auto workers in Detroit might share his perspective. Once they lost jobs, their choices became very limited and unattractive. Stay in a high unemployment area and try to scrape by, or declare bankruptcy, lose their house and try to start over elsewhere. Arguably, the rising rate of homeownership in this country has slowly chipped away at one of our great economic strengths – a flexible and mobile labor force.

Thus, attitudes may be shifting. Homeownership will likely always be viewed as part of the American dream, and rightly so. There are many benefits. However, a small shift in perception and the homeownership rate would magnify existing problems in the housing market – more sellers than buyers, a flood of foreclosures, and a persistent need for government support. The government would like to stop some of its most explicit subsidies to homeowners, such as the new home buyer tax credit. When the subsidies run out, the housing

market must make a tough transition to standing on its own two feet.

Challenges persist at the individual level as well. The most obvious source of concern is unemployment. Over 7 million jobs have been lost since early 2008. The unemployment rate has risen from around 5% just a few years ago to 10% nationally. If employment growth returned to pre-recession levels, it's estimated that it would take us 5 to 7 years to replace those 7 million lost jobs. Thus, we are likely in a period of structurally higher unemployment.

If there is a silver lining, it may be that economic uncertainty is driving the average American back to old fashioned financial values. The Great Depression created a generation of fiscally conservative citizens. Our Great Recession has similar potential, but on a smaller scale. Data indicates we are changing from a credit card and debt driven society to one where people are more fiscally responsible. The savings rate (the amount saved as a percent of after tax dollars) has risen to levels not seen for a decade. However, this transition is not easy. Restrained spending and renewed savings create a paradox. The economy needs spending in the short term, but our long term prospects are enhanced by personal and systemic stability brought on by more savings.

The transitions that are happening on a global and local level are double-edged, but ultimately should move us towards a reality that is more balanced than in the past. The world cannot indefinitely ride the back of the U.S. consumer. Developing economies represent important new engines of growth and indicate a positive step towards more balanced global trade. At home, our economy will achieve greater balance as the Fed and Treasury withdraw subsidies and phase out extraordinary market interventions. Individuals saving more and spending less will eventually reduce their debt burdens. The future is uncertain, as always, and some of the current transitions are unpleasant. The only guarantee is that market volatility will closely follow daily developments. Patience, perseverance, and perspective are necessary for all investors at all times, especially now.

**INDEX LIST**

**US Large Cap:** S&P 500.

**US Small Cap:** Russell 2000.

**International Stock:** MSCI EAFE.

**Emerging Markets:** MSCI Emerging Markets Index.

**US Bonds:** Barclays Capital Aggregate Bond Index.

**Foreign Bonds:** Barclays Capital Global Aggregate Bond Index.

**REITs:** FTSE NAREIT Composite Index.

**Commodities:** Dow Jones UBS Commodity Index.

**TIPS:** Barclays Capital US Treasury Inflation Protected Securities Index.

**Treasury Bills:** Short-term government issued securities with maturities less than 90 days.

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