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GOOD ADVICE

Currency War

For the second quarter, the S&P 500 lost 11.5%; for the third quarter, the S&P 500 gained 11.3%.[1] August was the worst in 40 years and September was the best in 71 years.[2] By the end of September, including YTD gyrations, the S&P was up 3.9%.[3] Violent swings continue to assail the equity markets. Constant abrupt changes in outlook over short periods of time require hyper-vigilance! Balanced portfolios (60% equities, 40% bonds) underperformed strong all equity returns, as bonds were only up 2-7% for the quarter.

Markets continued to rise in October because: the Federal Reserve indicated that additional monetary stimulus was a foregone conclusion; Republican wins were anticipated in the November election; earnings topped expectations and fears of a double-dip recession dissipated. In our last letter, we said we expected markets to be range bound, that the S&P 500 would bounce back and forth between 1000 and 1200. The S&P is now at 1221. Will the rally continue on its breakout above 1200, or have markets pretty much discounted the upside news? We think the Fed has spoken loud and clear: they are not concerned about inflation or a weak dollar and they plan to flood the U.S. economy with almost a *trillion dollars* of "printed" money by next summer (this policy has been named QE2). Political gridlock following the mid-term elections greatly reduces the chances of another significant stimulus package, so the Fed knows it is the

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only game in town. If the economy does not respond, the Fed will act again (unless the dollar collapses and/or long-term interest rates climb appreciably). Near term we expect the market will remain near the top of this range, and perhaps go even higher.

Currency War

The IMF is particularly concerned about a currency war. "The global recovery remains fragile, because strong policies to foster internal rebalancing of demand from public to private sources and external rebalancing from deficit to surplus economies are not yet in place," the IMF said.[4] A recent IMF meeting of global finance leaders failed to resolve the deep differences that could lead to a full-blown currency war. Most nations would like to devalue their currencies in order to boost exports and thereby create and keep jobs during hard economic times. Economists are concerned that such efforts could trigger a repeat of the trade wars that contributed to the Great Depression of the 1930s, as country after country raises protectionist barriers to imported goods to reduce imports and capital inflow restrictions to reduce the appreciation in their currency.

The U.S. rekindled these recent tensions when the Fed announced in, late August, that it would begin another round of monetary easing before the end of the year. The QE2 news contributed to fears of a weakening dollar and complicated festering currency disputes that threaten global trade relations. The dollar did begin to weaken (5% in September) and other nations reacted by attempting to weaken their currencies. Japan led the attack by lowering interest rates and selling yen, the first currency intervention since March 2004. Other counties swiftly followed suit, for example: Brazil increased taxes on foreign holdings of domestic bonds to 8% of the value per year, Thailand introduced a 15% withholding tax and Indonesia began a one-month minimum holding period for foreign investments. Switzerland, South Korea, the Philippines, Chile, Peru, Columbia, Australia and Canada, all undertook some exchange rate measures. The dollar has since stabilized as investors reacted to the other countries currency moves. Everyone is looking to manipulate their currency to export their way out of trouble, which everyone, by definition, cannot do.

With the Fed determined to inflate the economy, the currency war can be far from over as, for every action they take to lower the dollar, other countries will react with policy changes of their own. Chicago Fed President Evans has said that the Fed should be targeting inflation above 2%, maybe as high as 4%; Federal Reserve of New York President Dudley made a similar statement. China, Brazil and Germany criticized the Fed's November 3, QE2 announcement, as an unbridled printing of dollars; and a string of east Asian central banks said they were, again, preparing means to defend their economies against large capital inflows. However, we do not expect the current saber rattling over trade issues to degenerate into a full-fledged trade war. Recent Republican victories may tone down U.S. rhetoric as well as actions. That said, Fed actions and dollar reactions will require close monitoring for signs of excessive dollar weakness. We remain long-term bearish on the dollar until it is clear our economy is out of the woods and the Fed moves from printing dollars to reducing dollars, by selling treasury bonds.

Current Economy

United States Economy

The U.S. economy expanded at a 2% annual rate in the third quarter, about half of the increase was due to inventory accumulation which will cease being a positive factor unless sales start accelerating. In the face of expected gridlock between the Executive and Legislative branches, additional fiscal stimulus is unlikely, and the Fed is left as the only entity able to respond to a weak economy. On November 03, the Federal Reserve announced that it would buy an additional $850-900 billion in Treasury securities between now and June, 2011. Once again, the Fed hopes to spur growth by flooding the economy with cash. This initiative, in effect, will be monetizing the entire federal budget deficit in the coming months. Quantitative Easing 2 (QE2) is the practice of expanding a central bank's balance sheet by buying long-term assets in an attempt to drive down long-term interest rates - something that it only has reason to do now that short-term rates are already at or close to zero. The Fed said that “household spending, while increasing gradually, remains constrained by high unemployment, modest income growth, lower housing wealth and tight credit”.

Will QE2 work? Yes, at the margin. Over the short term, it will support growth by lowering interest rates and the devaluing the dollar. Most economists put the gains from this stimulus at .2% to .4% of GDP.[5] Even though the Fed is very powerful, it's not all-powerful, just as the United States is not all-powerful when it comes to its own financial affairs. The Fed has to worry not only about the U.S. economy, but also about debasing the dollar too much, too quickly, lest it spook the foreigners who finance the U.S. trade and federal budget deficit. If foreigners lose faith in the U.S. dollar, it could run interest rates up sharply and abort any recovery. Even with the QE2 stimulus, we think the economy will muddle through 2011, at less than a 2% growth rate.

World Economy

According to the IMF, global activity is forecast to expand by 4.8% in 2010 and 4.2% in 2011. They project that output for emerging economies will expand at rates of 7.1% and 6.4% respectively, in 2010 and 2011. In advanced economies, however, growth is projected at only 2.7% and 2.2%[6]. Slack will remain substantial and unemployment persistently high. Inflation is expected to stay low, amid continued excess capacity and high unemployment, with few exceptions among the emerging economies. The probability of a sharp global slowdown, including stagnation or contraction in advanced economies, still appears low.[7]

Asset Allocation

U.S. Bonds and Stocks

For the third quarter, up until the November 3 announcement, expectations about QE2 succeeded in pushing down interest rates and boosting bond prices. We think the Fed will succeed in keeping interest rates low. Intermediate corporate, municipal and BAB bonds, bond funds and ETFs are attractive at current prices. Yields are low and will remain low because private credit demand is weak, inflation is low, the Fed has pegged short rates at zero, and the economic and financial meltdown of 2007-09 has left investors risk averse and distrustful of equities. For these reasons, investors should avoid long term bonds because eventually inflation and a weak dollar will force long term interst rates higher and bond prices lower. We would also avoid Treasury inflation-protected bonds (TIPS). Despite the Fed's intention to print money and the potential inflation impact, TIPS are not attractively priced at this time.

The U.S. stock market appears to have broken out of its recent trading range to the upside. The Fed is determined to avoid deflation, opting for price and asset inflation, which includes equities. Equities are a much better value than other assets in this environment. The earnings yield on the S&P 500 (earnings divided by price) stands at 5.7%, while investment grade corporate bond yields average 3.7%.[8] Another way to think about it; IBM just issued 3 year bonds with a yield of 1%; while shareholders earn a higher dividend yield of 1.7% and dividends are expected to increase. Stocks are supported by historically low borrowing costs, a continual slide in the dollar (bolstering domestic and international earnings) and subdued wage pressures. For the year, the best sectors have been those benefiting from a weak dollar: such as industrials, selected technology and materials. During the week of the upside breakout, the best performers were the financials, energy, materials and industrials. We like industrials, materials, energy and high technology and would add financials as a catch-up sector given the push from the Fed. We like big caps over small caps and favor high yielding stocks versus stocks with little or no yield.

International Stocks

Selected international equities should be over weighted in portfolios. We think the shift in capital flows from developed to emerging markets, which began in 2003, will persist due to expectations of superior economic performance, and because capital allocations to emerging markets remain well below their current and anticipated share of global output. On the other hand, we are concerned that it is becoming consensus that developed markets are a thing of the past and that emerging markets are the only place to be. So have they become overpriced? While emerging markets are not as cheap as they were in 2003, they are definitely not at an irrational level. The forward P/E ratio is 11.5 and multiples for normalized earnings are 17.3. In the early 1990s, the forward P/E reached 20 and normalized earnings topped out at 39.[9] Bottom line, emerging market equities are not excessively valued and the economic, monetary and financial backdrop for this asset class is positive.

Natural Resources and Energy

Assuming continuing global growth, and domestic QE2 coupled with a weakening dollar, we continue to recommend over weighting natural resources, energy, and commodities. Portfolios should also have gold bullion and gold stocks. Why be bullish on gold when it has already appreciated from $253 in 1999 to today's $1393, a gain of 450%? Are we not in the midst of a gold mania, similar to the late 70s? Gold has appreciated considerably on an absolute basis and relative to U.S. stock indices but we do not believe there is a gold mania yet. In fact there are reasons to think that there is plenty of upside left: First, gold is increasingly a currency alternative to the fiat money being printed by the world's central bankers. Second, central banks will continue to be net gold buyers (after having been net sellers from 1975 to 2008). Third, institutional and retail investors are looking for alternative investment assets, given the recent dismal returns of traditional equity and bond "buy and hold" strategies. Fourth, it is much easier for investors to build gold exposure via ETFs, such as GLD. Fifth, emerging market demand for jewelry could surprise to the upside, as strong middle and upper class wealth creation occurs. Sixth, investors on a global basis are underinvested in gold, with less than a 0.5% allocation, well below than the 2.8% held in 1980.[10]

Real Estate

Bolstered by QE2 expectations, REITs have continued to do well YTD. Declining bond yields have made real estate yields relatively more attractive. Real estate fundamentals are recovering, but at a slow pace. However, given the recovery in REIT prices that has already occurred, we believe that other asset classes offer superior returns, and prefer to under weight this area.

Summary

The Fed is determined to inflate its way out of the current economic malaise by driving investors away from short term assets like money market funds, CDs and treasury bills and toward riskier assets like long bonds and equities. Lower rates lead to a weaker dollar, so it makes sense for investors to favor investments that benefit from dollar weakness: materials, industrials, technology, commodities, energy, gold and international equities.

Dave

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