3rd Quarter Newsletter, October 2010

"Hope Is a Dangerous Thing"

In The Fed We Trust?

U.S Federal Reserve

The above title, from the motion picture "Shawshank Redemption," is arguably one of the greatest movie quotes of all time. For several reasons, I am reminded of this quote as we decipher the recent economic data. The weekend of October 9th, the Financial Times ran with this headline: *Weak Jobs Data Help Propel Dow Above 11,000 points.* Jobs create income. Income creates spending. The US consumer spending drives 70% of US GDP (Gross Domestic Product) and 17% global GDP. GDP must equal GDI (Gross Domestic Income) of which 11% is comprised of corporate profits. When you invest in equities (stocks) an investor is supposedly buying a stream of profits from a given company. Right? Right.

There have been several other articles like this over the last couple of weeks which point to this "Hope." Saturday New York Times: *Faith in Fed Pushes Dow Past 11,000.* Financial Times: *Equities Fired Up for Fed Easing.* Front page article: *Jobs Data Point to Fresh Stimulus.* All of these articles state that the primary reason the stock market is advancing is that

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there was a terrible employment report. A fellow colleague insightfully pointed out on CNBC recently, that "softer" economic data was actually a good thing; It would mean a more aggressive attempt by our Federal Reserve Chairman, Ben Bernanke to pump more quantitative easing (QE2), for the second time, into the system to limit the looming problem of deflation.

Still Buyers!

Investors were buying into the stock market over the last few weeks in the face of a pretty bad employment report and a soft ISM report (Institute Supply Management). The ISM report tells you that the manufacturing cycle of inventory replenishment is coming to an end. This inventory cycle was responsible for about two-thirds of the rebound in real GDP from the middle of 2009.

The market is completely based on "Hope." Let's just take all the investment fundamentals and throw them out. Right now it appears to be "all about the Federal Reserve." Can the Fed manage to inflate asset prices now that fiscal policy has tested its limits with the general public?

Hey Fed… What Have You Done For Me Lately?:

Remember the below is what the Fed has done as well

- The Fed took interest rates from (fed funds rate) 5.5% to practically 0%.
- The Fed tripled the size of its balance sheet from its first QE1 (first quantitative easing).
- The Fed said that the housing/mortgage crisis would stay 'contained" back in 2007.
- The Fed said just six months ago that it was "contemplating its exit strategy."
- The Fed said it "Believed it could start to shrink its balance sheet" last spring.
- The Fed trimmed its forecast not once, not twice but 3x in the past four months.
- The Fed passively tightened policy with a 25 basis point hike in the discount rate to .75% in February.

If the primary goal of the Federal Reserve was to re-ignite a new credit cycle then it was a failure. If the goal was to bring down mortgage rates then it was a success. Notwithstanding, the Fed

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has helped to divert certain catastrophic disasters. It's the unforeseen consequences we are just beginning to see.

Can Interest Rates Go Lower?

Many believe the Fed will be successful in bringing interest rates down even more. So what if they do? Perhaps rates on mortgages and auto loans will come down another 50 basis points (1/2%) or so. These rates are already at all time lows. Additional rate decreases will not likely accomplish anything. The real story today is household debt relative to both asset and income is still closer to record highs. We likely need another \$5-\$6 trillion of deleveraging to bring household debt ratios back to healthy levels prior to the real estate bubble.

Asset Prices

All the talk has been about the Fed's actions to boost asset values (asset inflation). The New York Fed stressed the need for the US Federal Reserve to bolster asset inflation in order to boost the wealth effect on spending. It is not such a good thing to run the economy off of asset-dependent increases. The Fed is aiming to generate another asset bubble as a means to correct the massive amount of debt on household balance sheets. The goal here is to correct the debt/asset ratio on individuals balance sheets, by inflating the asset as opposed to having people deal with the pain of reducing their excess debt burden.

What May Happen From Here?

The Fed is typically successful in creating asset bubbles; The "tech bubble" in the late 1990's and the recent housing bubble are evidence of this. Asset bubbles don't typically end well. Here we are again, at the beginning of a potential asset reflation cycle. The Economist recently indicated that the next re-leveraging cycle is unlikely to commence until US households have rebuilt their balance sheets. We still have a ways to go to repair our financial health. Asset reflation will grease the wheels quicker, but with what consequences?

Hope can be a good thing … maybe the best of things. However, let's put the right resources to work that can ultimately create a long lasting recovery. We believe this recovery will take time to develop and it is not "off to the races" into a new economic expansion in the next several quarters.

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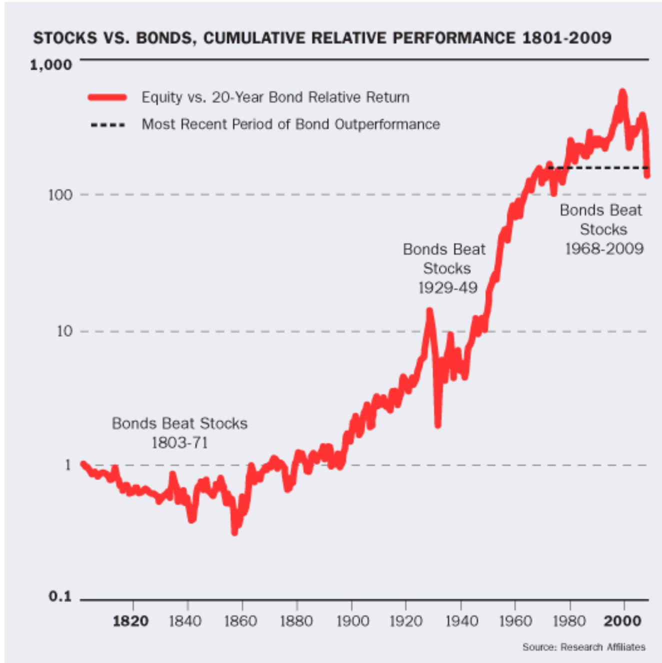

Reflective of these concerns, our portfolios continue to maintain their conservative posture overweight fixed income and underweight equities. For most of the third quarter, bonds outperformed stocks which translated into modest gains for our portfolios. In the last few weeks of September, stocks began to rally (while bonds maintained their value) to further add to our gains. As you can see from the above chart, the reason why we have maintained our conservative posture is that bonds outperform stocks for a substantial period of time after severe financial shocks.

We feel that we have the proper balance right now in our portfolios to achieve modest upside returns while reducing down side risk. The gloomy economic clouds have not yet cleared and we think the patient and prudent investor will be rewarded in the end.

Respectfully,

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President & CEO

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