J.J. BURNS & COMPANY, LLC

3rd Quarter Newsletter, October 2011

MOOD SWINGS

The financial markets for most of the year, and especially in the third quarter, have been displaying "split personality disorder." The markets rally when the "risk on" trade occurs (markets are in an upswing) and likewise decline when the "risk off" trade (when investors become anxious) takes hold. In the third week of September, for example, equity markets declined in dramatic fashion because of worries about the global economy. Then in the fourth week, they initially rebounded on hopes that Europe's political leaders may be coming up with a plan for their debt crisis. Last year other "Club Med" countries were "prepared" to bailout Greece with $220 billion Euros. This plan never came to fruition. Today the needs exceed this initial bailout by more than double, as many banks in Greece need to be re-capitalized. Here is the problem: Currently, Euro-banks are looking to leverage assets on their balance sheet by as much as a 4:1 ratio. In other words, solve the debt crisis by adding on more debt to the system. The markets are smarter. The market will know a good plan when they see it and until that time lawmakers are in denial about fixing the problem the correct way. This sent the stock market into a downward trend.

We have been told the latest strategy to save Europe is "The Plan." To date we have no details but one simple fact in that, "they have a plan." Fed Policymakers had a "Plan" too. The U.S. Government spent trillions of dollars, through all the complex myriad of stimuli, including TARP, quantitative easing (QE1 & QE2) programs to save the housing market, the banks and the economy. However, to this day, residential real estate is dead. Banks are dysfunctional and will continue to be this way. Policy makers have done little to help, except increase unemployment benefits, and yet unemployment and a lack of job creation persist. Interestingly, a CEO of an employment agency reported, "When the White House decided to extend unemployment benefits, his agency that day had numerous cancellations of appointments for job interviews. The European "Plan" is smaller than our "Plan" that produced mixed results. Even today, U.S. policymakers continue to add stimulus to the economy in hopes of keeping the economy from stalling.

Operation Twist: "Lets Twist Again"

During the third quarter of this year The Federal Reserve unveiled Operation

Twist. Operation Twist is an attempt to keep interest rates low. On September 21st the Fed began selling short term Treasury bonds and utilizing the proceeds to buy longer term debt. Interest rates on the 10 year Treasury decreased to an all time low of just less than 1.7% breaking the 2% threshold. This was a significant and unprecedented rally in the price of the 10 year bond.

Operation Twist is an old policy from the 1960's. The policy involves selling $400 billion in short-term Treasuries in exchange for the same amount of longer-term bonds, starting in October and ending in June 2012. While the move does not mean the Fed will pump additional money into the economy, it is designed to lower yields on long-term bonds, while keeping short-term rates little changed. The intent is to thereby push down interest rates on everything from mortgages to business loans, giving consumers and companies an additional incentive to borrow and spend money. According to the Fed, "This program should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative." Our collective team at JJ Burns and Company questions the effectiveness of this program. Interest rates have already been at record lows since 2008, and that has yet to entice consumers to take out loans. Our bond traders confirm what CEO's at local banks and credit unions are saying, "loan demand has not increased, after all, no one is walking into their loan office saying, 'I really want to buy that house but interest rates are too high". Bond traders are doing more business with banks, as banks may borrow money from the Federal Reserve at nearly 0% and invest the proceeds higher, reaping the difference with no risk. In short, lower interest rates have not stimulated the consumer. Granted, it has helped to lower and consolidate debt. Our concern over the long run for the Federal Reserve is that if inflation outpaces interest rates over time, it could cut into the returns on bonds.

Many economists today view the policy as a failure, arguing that it may have been too small to have a significant impact. Totaling $8.8 billion, the original Operation Twist was roughly equal to 1.7% of the total U.S. economy in the early 1960's. Relating this figure to today's economy, the impact may be 2.7% to the U.S. economy.

Margin of Change

Back in the 1980's, Arthur Zeikel a former and well known president of Merrill Lynch Asset Management wrote a report, "On Thinking." It illustrated that change occurs at the margin. Dave Rosenberg (Rosey) a former Chief Economist wrote to me on this same subject, that supply and demand at the margin in the real estate market consists of those who have "For Sale" signs on the lawn and those who are actively looking to buy. The price of the entire market is in their hands, not in the hands of those who are confidently sitting tight. This is important because it was the action at the margin that took prices parabolic, and all homeowners benefited during the bubble. Everyone, except the 30% that rent, felt the wealth loss as house price gains reversed course, even those with no mortgage debt outstanding. More sellers plus fewer

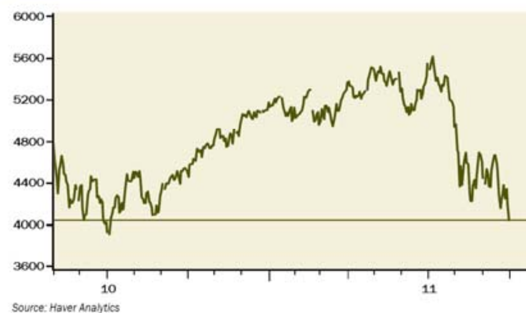
buyers equals home price deflation, and that is still the excess supply backdrop prevailing today, more than four years following the initial detonation in residential real estate.

At the margin there are still many more sellers and fewer buyers. Homeowners will very likely continue to experience the effects of home price deflation in many urban areas. Yet because home prices are such an emotional topic, most economists are afraid to consider what a sustained depreciation in housing prices will do to their forecasts. I recently attended an investment conference where I met with two well known chief economists, from separate brokerage firms, which I will purposely not name. Their opinion of the current market volatility was that they considered it "a buying opportunity". It's not a surprise to us that no matter how dire the market predictions, events occurring, or subsequent consequences, it's likely a rare day to ever see an economist who is representative of a company whose products may be in marketing "stocks" advising you to sell your holdings and invest in another asset class.

Interestingly these economists operate from a position of "the economy is in a terrible place but the market has already discounted the worst case scenario, therefore, based on that premise stocks are still undervalued "relatively." I love when economists use the word "relatively." Relative to what? The reality is: the recession has not gone away, nor will it. At this stage in the world economies it's all about containing contagion risks. In the U.S., inventory backlogs, orders and customer inventories are behaving as they did at the tail end of the last recession in 2009. Remember, the S&P 500 peaked not at a time of any particular Eurozone event, but within 24 hours of the extremely poor Q1 U.S. GDP (Gross Domestic Product) data coupled with all the revisions showing the downturn to have been deeper and the recovery shallower that previously thought. IT'S THE ECONOMY!

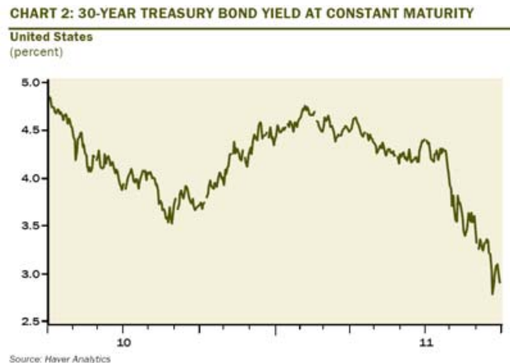
Looking Ahead

With respect to these economists, we need to keep in mind that most stock fund managers went into this market volatility and downdraft being fully invested and with very thin cash levels. The Dow Transportation index (a helpful economic indicator), has reverted back to July 2010 levels of recent, even when energy prices are heading lower. This is a signal that economic contraction is coming down the pike.



Bond markets are rallying and consolidating in the U.S. after the yield declined as the longer term U.S. Treasury or long bond yield declined to 2.77% which is where the 10 year Treasury was just two months ago. For the last two years we at JJBCo., have been calling for lower interest rates and, of recent, a decline under 2% on the 10 Year U.S. Treasury. If you think the U.S. 10 year Treasury yields can't go

any lower, consider that comparables are 0.97% in Japan, 0.83% in Switzerland and 1.60% in Sweden.



The declines in world markets have been breathtaking during the 3rd quarter. A total of $10 trillion of equity wealth has vanished globally in the past three months and 37 of 45 countries that make up the MSCI World index are down 20% or more from their recent peaks, so this is now considered a bear market.

We at JJ Burns and Company have been significantly underweight stocks in most of our portfolios and overweight bonds and defensive issues such as alternatives and diversified hard assets. Asset allocation and regular rebalancing have helped to minimize the significance of the downturn in the 3rd quarter for our clients.

It's equally important to note, that despite the U.S.'s continued structural problems, demand for the investment in the U.S. dollar has increased because there is simply nowhere else to hide. Equally, the Treasury bond market offers a level of liquidity that no one else can match, with yields higher than that of other developed nations even as low as they may "appear" to be.

The Frontier of Frugality

In early October, the Wall Street Journal ran an article entitled "Frontier of Frugality" which has been a theme of previous JJBCo., newsletters. The share of consumers switching to private brands and shopping more at bulk food stores is on the rise. Recently we received data which we are not sure what to make of, but spending on diapers is now contracting.

This era of frugality is a pervasive theme which is growing larger and larger. The number of farmers markets operating in the U.S. has soared 64%. American shoppers redeemed 3.3 billion coupons in 2009, a 27% year over year increase. In addition, cell phones, cable and internet services, have emerged as the essential item people cannot live without.

Spending patterns are shifting:

Spending on games, sporting goods, and hobbies is up. Outlays on expensive boats and foreign made cars are down. Do it yourself home projects are up. Expenditures on theme parks and sporting events have declined. TV watching has increased. Overseas travel is down. Interestingly, one night stays at hotels and motels is up. Lipstick and nail polish sales are up, but other more expensive facial products and perfumes are down and declining.

Lessons in Portfolio Management

1. In 1980, the inflation imbalance was not resolved from the 1980

recession. Therefore, in 1982 we had another economic downturn which ultimately had the correction required to expunge the problem. Currently, we had nearly two decades of excessive debt globally which was never rectified in the last recession, therefore, another downturn like 1982 is likely.

2. Bonds were and are still attractive: Bonds go farther and are more predictable in pricing in a recession. Stocks are vulnerable to earnings revisions. Expect downward earnings revisions. The market has not fully discounted this as yet.

3. No bear market ever bottomed ahead of a recession. Usually 30% of the down move occurs by the time the contraction has arrived.

4. Dividend yields are approx. 2%. The 10 Year Treasury is at approx. 2%. Investors may need to consider more of a preservation of principal perspective.

5. Opportunities are available to the well informed: Alternative investing will likely have real trend growth while still benefitting of down trends as well. Hard assets such as gold and even gold mining stocks are likely beneficiaries.

6. There is a lag in the financial economy and the real economy. This usually takes 4-6 months. Therefore, expect the reports on GDP to be more bearish in November. Its takes time to see bad data show up because of this "lag."

7. Inflation remains in check. Real returns in bonds, defensive and dividend paying stocks may do well (still keeping underweight).

8. Economic growth will eventually happen and may likely occur when the personal savings rate hits 8%. Investors are on their way, but have a long way to go.

9. Bull markets are born from a process of wringing out the excesses. After many years of easy credit which formed this "Debt Bubble," it will take more than a year or two to wring out this excess. This is happening globally.

Our well diversified portfolio with regular and consistent rebalancing, albeit stocks underweight, has helped us to maintain and preserve principal while collecting some yield. We continue to maintain this stance while the current economic uncertainty runs its course.

As always if you have any questions regarding our macro views or specifically within your portfolio please feel free to contact anyone on our team.

Sincerely,

J.J. Burns
President/CEO

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