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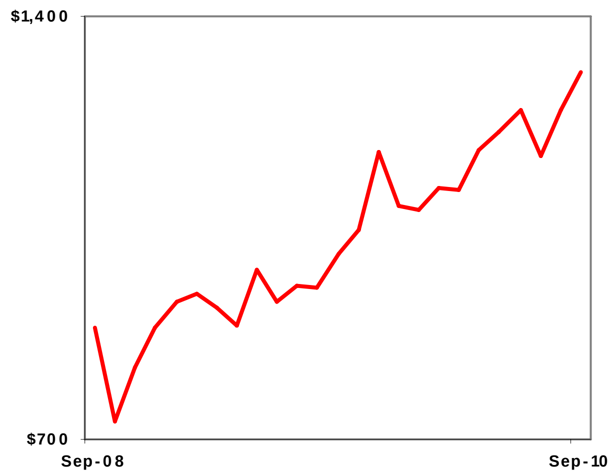
Investment Matters

For the quarter ended September 30, 2010

The Great Reflation

Will the Great Recession, as the recent economic malaise has been called, be followed by the Great Reflation? Gold which recently surpassed $1,300 an ounce is shouting, yes. Now the gold bugs are joined by the Federal Reserve, which recently stated that inflation is too low, and inconsistent with their mandate of maximum employment and price stability. Perhaps, in our efforts to stave off deflation we could lurch into an inflationary morass.



THE PRICE OF GOLD HAS BEEN RISING FAST EVER SINCE THE FED BEGAN PUMPING UP THE MONEY SUPPLY

Inflation is commonly viewed as a rise in prices, but it is actually a decline in the real value of money. For two years, beginning in September, 2008, the Federal Reserve has acted to depress the value of the dollar. First, they pumped reserves into the banking system, doubling the so-called base money supply, an unprecedented increase. The hope was that excess money in the banking system would eventually be loaned out and would serve to stimulate the economy and prevent a devastating deflation of asset prices like the one which sank the economy in the 1930's.

Then, in March, 2009, with bank lending still weak, the Fed announced a program of quantitative easing (QE). Under this program the Federal Reserve purchased massive quantities of bonds with newly created money. This new money, delivered directly into the hands of large financial institutions, appeared to do the trick. The stock market went up immediately and the economy soon followed.

"Inflation is ... a decline in the real value of money"

Recently the Fed has hinted it may institute a second round of QE to further stimulate growth and to bring inflation into line with their higher target. The best guess is that this will be delayed until after the November election so as to avoid any political implications. Concern about the possible inflationary effects of this program has contributed to the recent surge in the price of gold.

Here is the problem. With massive reserves in the banking system and with the Fed's balance sheet swollen with bonds, how can the Fed unwind their programs slowly enough to avoid a double dip recession but rapidly enough to prevent letting the inflation genie out of the bottle. Nothing like this has ever been done before, much less attempted. The risks are high and our prosperity depends on its success.

Macro Driven Market

Wall Street professionals have a tendency to characterize the stock market by what types of stocks are 'working'. Thus the late 1990's were often referred to as 'tech driven' or sometimes as 'large cap driven' since it was stocks with one or both of theses characteristics which were outperforming the general market.

Today the market is referred to as 'macro driven'. This implies that stock prices are primarily dependent on news and forecasts about the broad economy, the macro-economy. The opposite situation, often referred to as a 'stock pickers market', occurs when news and forecasts about individual companies or industries have more impact on stock prices than general economic news.

In a macro driven market, stock price movements tend to be highly correlated, meaning they move together like a school of fish. When a particular economic report turns out a little better than expected, or when the Federal Reserve Chairman suggests that he may further boost the money supply, stocks move higher in unison. Conversely, weak economic news or negative economic forecasts cause stocks to fall. With economic news varying from good to bad on a daily basis, this has resulted in high stock market volatility but not much

Continued on page 2.

Macro: continued

direction.

Although stock traders react to daily economic reports, investors are better advised to take a long term view, and focus on anticipating changes in government policies which affect business. If signs suggest that government tax, monetary, regulatory and trade policies may begin to move in a direction which improves the climate for business, investors can anticipate higher stock prices and better economic news down the road. If the trend in government policies implies higher taxes, a weaker dollar, more restrictions on business activity and added obstacles to free trade, the market and the economy will continue to disappoint.

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The cumulative national debt is now $42,000 for every single U.S. citizen.

We're (not) Turning Japanese

The Japanese economy has been in a deflationary funk since 1990, and many people have warned that the U.S. may be on the same sad path. But a recent report by Andrew Garthwaite of Credit Suisse, an international financial services group, highlights significant differences between the Japanese experience and ours, and concludes that we will avoid structural deflation:

1. U.S. policy makers are more proactive. While Japan maintained tight money conditions for ten years after their asset bubble burst and even after deflation had taken hold, the U.S. boosted the money supply at the first sign of trouble.

2. In Japan, where layoffs are discouraged, wages have been falling since 1997. U.S. jobs were lost but wage growth in the U.S. is stable.

3. Stocks and housing prices in Japan had declined more than twice as much as in the U.S. by this point because they were far more overvalued at the top.

4. Japanese bank losses were substantially larger than the U.S. and they were reluctant to take writedowns for many years. U.S. banks have already written down 85% of their losses.

5. Japan has an aging population and with immigration discouraged, labor force growth is weak. Labor force growth in the U.S. is much stronger.

6. Deflation has become socially acceptable in Japan where 55% of household wealth is invested in low interest savings accounts. As consumer prices fall, the purchasing power of these savings rise. Thus Japanese voters put little pressure on their government to stop deflation.

7. Japanese corporations have little incentive to maximize return on equity. Most of their capital is raised based on cozy relationships with banks and other corporations rather than from independent investors. In the U.S., corporate managers who continue to hold unproductive assets are punished in the marketplace.

8. Worker productivity in Japan is low and is not improving. Structural rigidities and lack of deregulation are blamed for this poor performance. The U.S. is the world leader in productivity growth.

9. Japan relies on exports much more than the U.S. and China is winning over their customers.

A recent poll reveals that 53% of Americans think free trade agreements hurt the U.S., up from 32% in 1999.

The Bottom Line: 9/30/2010

Market Indicator	**Current Value**	**One Year Change**
Large company stocks *(S&P 500 Index)*	1141	10.2%
Small company stocks *(S&P Small Cap Index)*	359	14.1%
Short term interest rates *(3 Month T-Bill Yield)*	0.2%	No change
Long term interest rates *(10 Year T-Bond Yield)*	2.5%	From 3.3%
Inflation *(Consumer Price Index)*	218.2	1.2%
Energy *(West Texas Intermediate Crude Oil)*	80.03bbl.	13.3%
The economy *(Inflation adjusted GDP)*	14.6trillion	3.0%

QUOTABLE

"Successful investing is anticipating the anticipations of others."

John Maynard Keynes

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