

The financial markets rallied strongly in the third quarter, probably due to the Fed, which is expected to soon begin another series of easing steps designed to kick start our flagging economy. And, that these new efforts will be successful. But will they be?

Past recoveries have had soft patches that didn't lead to double dip recessions. In fact, dropping back into another recession is quite rare. But the current recovery has some unusually poor signals. Long term unemployment statistics (chart one) are exceptionally high. Consumer confidence is poor. The NFIB small business optimism index is extremely low, due in part to a

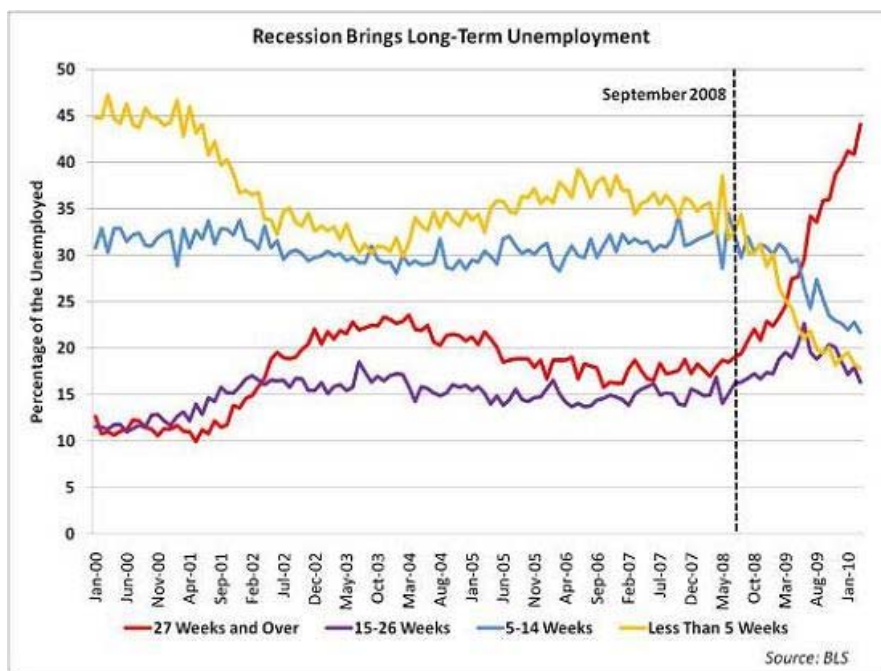


Chart One. Long Term Unemployment

reluctance "to add permanent employees, citing regulatory uncertainty," according to Fed chief Ben Bernanke. After a brief rebound, new home prices have rolled back. And, the global economy is facing a record fiscal drag next year as past stimulus programs wane and, in some places, austerity measures take their place.

Of course there are many indications the economy *is* recovering. Corporate profits, up

65% from last year's lows, is certainly an important one for investors. Unemployment claims, while still high, have improved. Consumer spending is better. Construction pending has also been much stronger. But something else is different about this recovery.

When the Fed lowers interest rates it does so to stimulate demand, because lowering interest rates has the same effect as lowering prices. They lower the cost of the item bought on credit, which should drive up demand. In the current recovery, however, despite higher profits and very low interest rates, consumers and businesses alike have decided to significantly pay down debt rather than use those funds for consumption. Charts two and three show the reduction in commercial loans and consumer credit. It seems hardly certain that modestly lower rates would change this behavior.

Some thoughts discussed by Bridgewater Associates during the last recession may be helpful to understand where we now are. To Bridgewater, a recession isn't just an economic contraction as most define it. Rather, "a recession is a managed contraction in real GDP, brought on by a tight central bank policy that ends when the bank eases." This definition explains every US recession in the post-WWII era, except, maybe, the current one. It may be that if the Fed could be accommodative enough that it would spur demand. A measure called the Taylor Rule attempts to target where the Fed's interest rates should be by looking at inflation, unemployment, and economic activity. Today, according to the Bloomberg estimate, the Taylor rule is at -1.5%, meaning the fed should lower their target to a negative interest rate. Not an easy thing to do. Recognizing this, some Fed governors have recently called for a policy that would increase inflation so our low interest rates will become an effective stimulant.

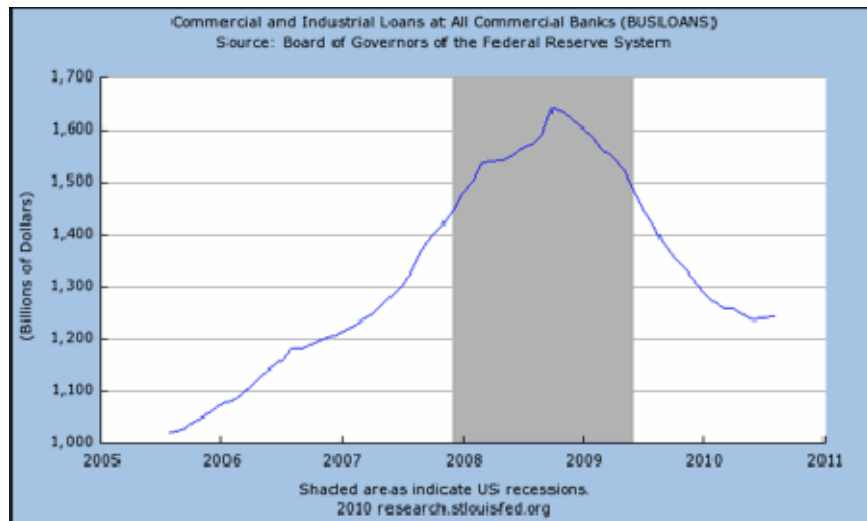


Chart Two. Commercial & Industrial Loans

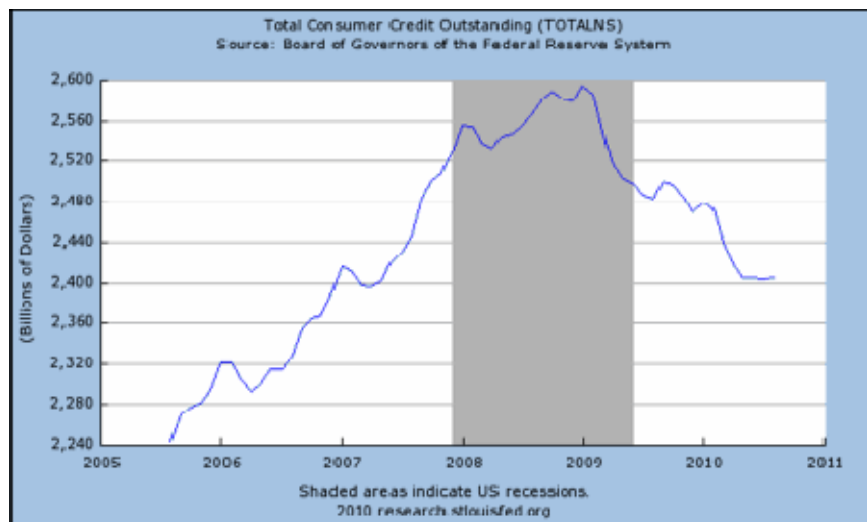


Chart Three. Total Consumer Credit Outstanding

It may be that we are in what Bridgewater calls a "deflationary depression." This is "an *UN*-managed economic contraction in which monetary policy ceases to work because interest rates have fallen close to 0% making *meaningful* interest rate cuts impossible." (emphasis mine) "The key is that a depression is not the same as a long and large recession, but is rather a different phenomenon entirely. Normal economic linkages are maintained in recession, but breakdown in depressions." The 1930s was the last time our economy suffered a depression but that is probably not the form we should expect. It seems more probable that we are facing something akin to Japan whose economy has languished for years. Chart four shows Japan's GDP for the past fifteen years. Despite huge government spending programs trying to stimulate

growth, which has brought their national debt to more than 200% of GDP, there has been no growth for the entire period.

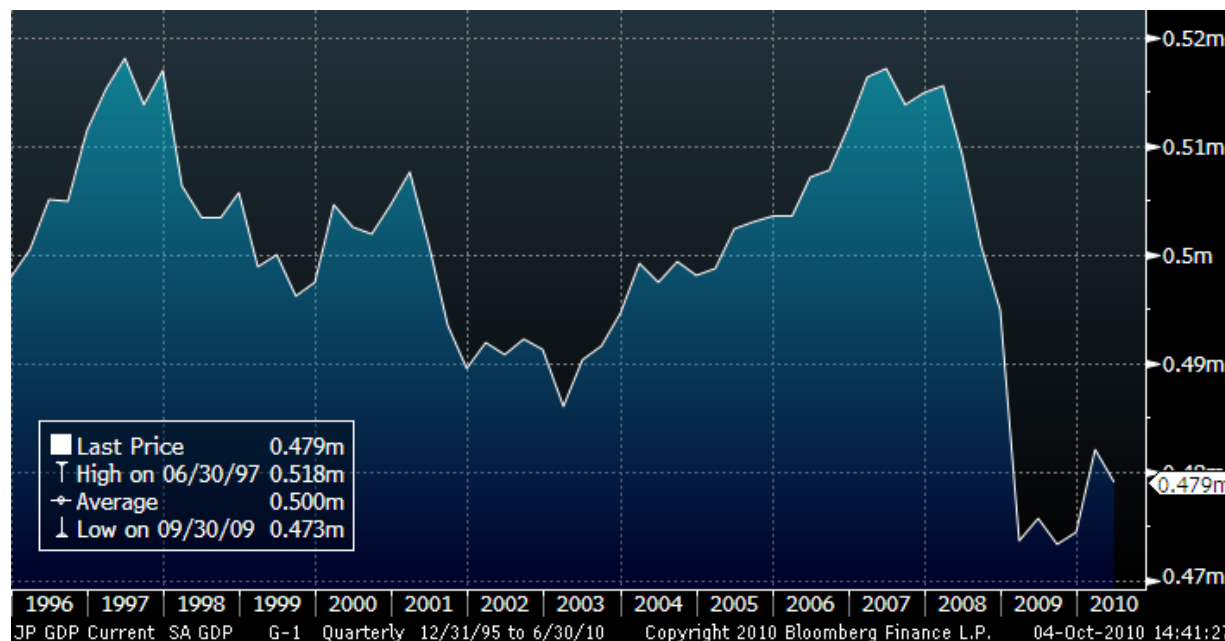


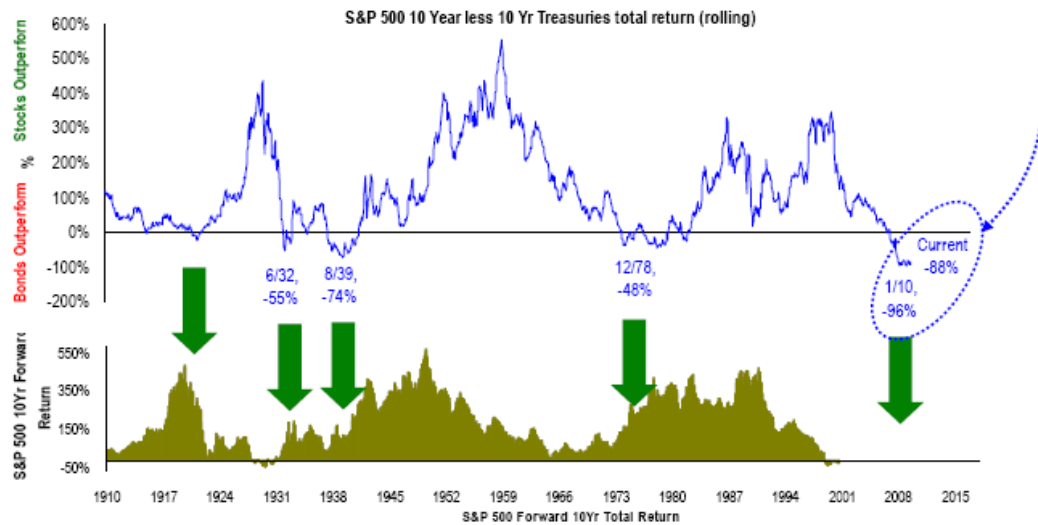
Chart Four. GDP of Japan, 1996-2010

A common theme between Japan and the US now, and the US in the 1930s, is too much debt relative to the amount of liquidity in the system. Bernanke seemed to recognize this following the Lehman debacle in 2008 when he nearly tripled the Fed balance sheet almost overnight. A huge injection of liquidity in 1933 also brought on a recovery, without creating a lot of inflation. A lot of debt had been written off or paid down by the 1933 injection and, as we saw in charts two and three, debt is declining here now as well, at least in the private economy. Conversely, Japan has found itself unable to rid itself of its bad debt. Perhaps debt has been reduced enough so that a bold action by the Fed will be enough to get growth going again.

We have been shifting the focus of our equity investments away from the cyclical sectors which behaved very nicely last year and into the first third of this year in favor of more defensive sectors. We have begun introducing positions in the consumer staples and utility sectors while increasing holdings in the healthcare sector. We have also bought positions in gold mining companies. One might think, given the above discussion about the possibility of a depressionary period, that we would want to stay away from equities altogether. However, the long term returns for equities may be quite bright.

At the bottom of the market, as represented by the S&P 500 index, last year stocks had fallen to levels seen during the mid-1990s. Even now, after the rebound of the past year and a half, we are at levels first seen twelve years ago. That's a long time for an asset class to have performed so poorly. During that time bonds have had a remarkable run. Chart five shows that bonds have outperformed stocks by 88% over the last ten years. The current period is the worst under-performance by stocks relative to bonds in more than a hundred years. The bottom part of the chart shows the ten year forward total return for stocks. The worst ten year forward performance for stocks following a period like we have experienced was about 150%.

Figure 1: S&P 500 Relative Total Return (Trailing 10 Years) vs. S&P 500 Forward 10-Year Return
 Monthly Data since 1900



Source: J.P. Morgan and Shiller. S&P 500 total return includes dividend and the return for US Treasuries assumes bonds will be held until maturity. Note: Past performance is not indicative of future results.

Chart Five. S&P 500 10 Year less 10 Year Treasuries Total Return

Our investment process singles out companies that generate a lot of cash. With yields so low on bonds, dividend yields more attractive for income generation, and valuations for many stocks quite attractive, we think it is prudent for long term investors to maintain their equity allocations at this time. We continue to search for opportunities in the fixed income markets but with yields as low as I have ever seen, it's a real challenge.