

January 7, 2011

2010 Fourth Quarter Review
“Thank you for sailing with the QE2!”

The big news of the fourth quarter was the launching of “QE2” (quantitative easing version 2.0). The effect on the stock market was as refreshing as a Caribbean cruise is to a vacationer after a tough year. Investors now seem to be all tanned and rested, walking off the ship with leis around our necks, and thinking about having one more pina colada before going home. We always hope that vacation feeling will last longer this time, but those of us with experience know that it may wear off sooner than we expect.

To review the entire year, the stock market rallied in the early part of 2010 through April, sold off sharply into July 2nd, and muddled along during the summer and into August. By the end of August, the stock market was in the doldrums based on fears of a “double-dip recession.” US government bonds had rallied sharply to that point. However, everything changed on September 1st. As monetary easing began to be expected, stocks starting marching up and bonds began to get whacked. The trend continued largely unabated into the end of the year. We had mentioned our aversion to long term government bonds in last quarter’s letter. Thankfully, we stayed away from that investment as the iShares Barclays 20+ year US Bond ETF fell by 15% from September 1st to December 31st, 2010, giving back most of its gains for the year. In the aftermath of the fourth-quarter rally prompted by “QE2”, the Dow Jones Industrials finished the year up 11% and the S&P 500 up 12.8%. Long term US Government bonds (as represented by the iShares ETF) advanced 4.7% for the year.

The monetary easing that goosed the market did its job by creating some of the short-term benefits that were its objectives: a stock market rally, increased consumer and business confidence, and at least a temporary uptick in employment. The Fed’s idea is that the “easing” would set the economy up for smooth sailing and a self-sustaining recovery. Recent economic data has been decidedly positive. However, the market is a discounting mechanism (prices reflect expectations of the future) and the rally in prices already reflects the anticipation of an improving economy. We still have to be wary of “those pesky unintended consequences” that we mentioned last quarter. We’ve already seen one of those with the drubbing that US government bonds have taken. We will have to be on the lookout for others as the effects of the “cruise” wear off.

Doug Kass of Seabreeze Partners said it well in a recent article:

There remains an unresolved tension between the short-term tailwinds of monetary stimulation and the longer-term headwinds of fiscal imbalances (local, state, federal and non-U.S.), a reluctance to move on the domestic deficit, the inevitability of higher marginal taxes, the [screwflation](#) of the middle class and other nontraditional factors. More immediate, a still-moribund housing market, vulnerable corporate profit margins, and rising food, energy and interest rate costs are causes for concern.

We must add to those cautionary factors the higher level of speculation and the bullish sentiment held by most investors currently. Those are often “contrary indicators” of future market performance. Investors always become more confident after a rally in stocks, precisely when prices are higher and risk (other things being equal) would be greater. The current market has been called a “no fear” market because of the high levels of confidence and optimism that are currently reflected in polls of investor sentiment (that

always become more confident after a rally in stocks, precisely when prices are higher and risk (other things being equal) would be greater. The current market has been called a “no fear” market because of the high levels of confidence and optimism that are currently reflected in polls of investor sentiment (that good old vacation feeling). One bearish prognosticator points to the following as reasons for caution: investor psychology is one-sidedly bullish now, mutual fund cash-to-asset ratios are at record lows, option speculation is near record highs (10-day put/call ratio at levels last seen at April 2010 peak) and breadth (S&P 500 advance/decline ratio) is falling and diverging against rising prices. We take these into account and prepare to be opportunistic by adding to positions when fear is a greater component of investors’ expectations. We very well may get our chance in the next few months.

With the Federal Reserve keeping short term interest rates near zero, investors are starved for income and are understandably tempted to “reach for yield.” We are continually adding to positions that we believe have capital gains potential while paying us a reasonable income while we wait. We just don’t want to be like Wiley Coyote and walk out on that risky plank concentrating only on getting the prize, only to find that there’s not much under us but air. We’ve seen investors holding those “Yikes!” signs before and we don’t want to be one of them.

Gold has been much in the news and on investors’ minds recently. Having been through this kind of thing before (I started on Wall Street as a commodities trader during the late 1970’s when the Hunt brothers of Texas tried to corner the silver market), I know that even strong bull markets can “correct” harshly when they become too popular. Sharp contra-trend declines are common in most long term cycles. We should not be surprised if this happens with precious metals this year, considering how far prices have moved recently. We are entering what has often been a seasonally weak period of the year for gold, and we should remind ourselves that “no tree grows to the sky.” If we are prepared for the possibility of such a decline, we will more likely be able to profit from it.

Weakness in gold would likely include a rally in the dollar. Charts of the stock market and the dollar look like mirror images of each other over recent decades. A surprisingly strong dollar might actually provide a headwind to the stock market and give us the opportunity to invest more and at better prices in some areas that we want more exposure to (commodities, inflation hedges, income-oriented securities). At any rate, we plan to use our knowledge of “bubblenomics” to take advantage of the after-effects of QE2.

On an administrative note, we have lately had several instances where we have not received emails that were sent to us. If you send an email and don’t hear from us, please give us a call. We pride ourselves in following up with every inquiry, so be sure to contact us again if you don’t hear from us very soon after you make a request.

Enclosed you will find your statements and reports for the full year of 2010, as well as capital gains reports for any taxable account. In closing this letter as well as the year, we want to thank you again for the opportunity to work with you on your investments. We will do all we can to make 2011 a prosperous one for you.

Sincerely,

Claude Carmichael CFA