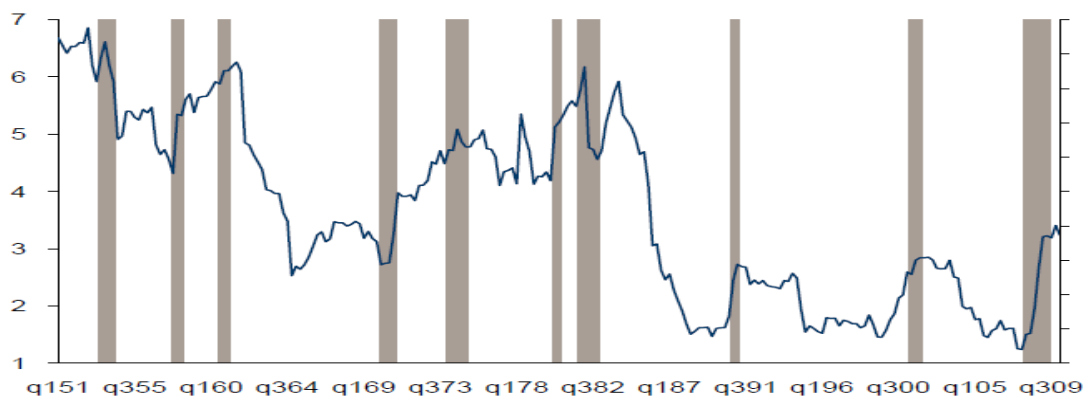


## 3rd Quarter 2010 Market Commentary and Outlook

The “Great Recession” that began in 2007 has been unusually long and severe. This pull back was very different from the brief and mild recessions experienced over the past quarter century (see Credit Suisse September Chart below – beige bars representing recessions). We agree with Neal Soss, Chief Global Economist at Credit Suisse, who points out that the alchemy of financial deregulation, innovation and engineering, with the assistance from monetary and fiscal stimulus, kept recessions rare, brief and mild. Unfortunately, we feel this “Goldilocks” (not too hot, not too cold) economic era is over. While we might be tempted to look back nostalgically at this period of economic stability, the reality is markets were anything but stable. Bubbles developed and burst in technology stocks (early 2000), real estate (late 2008), and sovereign debt (early 2010). Going forward, we expect the macroeconomic environment, especially in the developed markets, to maintain a higher level of volatility. Early indications of this can be seen as indicated by the direction of the standard deviation line in the Credit Suisse chart below. Over the next few years low capacity utilization, low operating rates, and high unemployment levels will likely make any growth slowdown feel as though we have once again been captured by the gravitational pull of the “Great Recession”. These “slow down scares”, like the one we experienced during the third quarter of 2010, may happen more frequently in a higher volatility environment. Financial “doomsday” prognosticators will take advantage of these scares, clanging the air-raid sirens, sending investors for the safety of the bunkers, and keeping risk aversion in the forefront of investor minds.

### Volatility of GDP Growth

(16-Qtr Rolling Standard Deviation of Quarterly Real GDP Growth)



Sources: BEA, Credit Suisse

### What Looks Good in the Post “Goldilocks” Era?

The short answer would be, honestly not much. However, as your investment advisor, it is our job to look at investment options in relative and reality space. Managing assets in this low growth, high volatility climate (essentially a reverse universe from the last 25 years) obviously will present ongoing challenges. In the spirit of this metaphor, it is easier to identify the things that we are most concerned about and want to avoid, and back into the assets we find attractive.

### Least Attractive

Currently, we would rank long duration government bonds (normally the lowest risk asset), the least attractive with higher risk. This is especially true in countries that are challenged with significant deficits. Tremendous amounts of private debt have been transferred to the public balance sheet in many of these countries. The unwinding of this transfer will take time and will

potentially result in significant economic pain. Some highly leveraged governments may actually be forced to run surpluses to reduce debt, based upon an increasing cost of carry. So far, historic low rates are providing the lubricant for an extended transition. However, as the markets start to price in appropriate risk (i.e. Ireland recently issued eight year bonds yielding 6.02%, up from 5.09% only 4 months ago), this could change.

We find real estate the second least attractive asset class. A significant glut of properties remain on the books of financial institutions globally. In addition, large corporations continue to announce commercial lease terminations with square foot reduction as part of their continuing cost rationalization strategy. On the residential side, Freddie Mac and Fannie Mae, the two mortgage finance giants (now essentially government entities), have taken back nearly as many homes in the first half of 2010 as they did all last year. According to Nick Timiraos of The Wall Street Journal, Freddie Mac and Fannie Mae owned more than 191,000 homes at the end of June and that number will continue to grow. Fannie Mae took a \$13 billion charge in the 2<sup>nd</sup> quarter to record the carrying cost of these growing inventories. The company has publicly stated that they are trying to balance the cost of their growing inventories against the impact of slashing price and creating a downward spiral for values.

### **Attractive**

Moving into the mildly attractive category, we prefer high quality, short duration corporate bonds. Dramatically improved cash flows have resulted from corporations doing an excellent job managing their costs and improving their earnings and balance sheets. Unfortunately, corporate bonds only fall into the mildly attractive category due to their historic low yields. While much of the good news has been priced into these bonds, their short duration will allow investors to move up the yield curve as interest rates increase.

### **Most Attractive**

Crossing into the attractively ranked assets, we like internationally exposed, low volatility equities with better than market yields. Our core equity holdings have traditionally focused on this segment of the equity spectrum. We value these equities based upon free cash flow yield. We look at the relationship between cash flow and dividend yield to determine the size of their safety cushion and ability to grow that dividend over time. We believe that these low volatility equities could be a better total return vehicle in this low rate environment. They could also act as an inflation hedge due to their ability to grow the dividend faster than inflation.

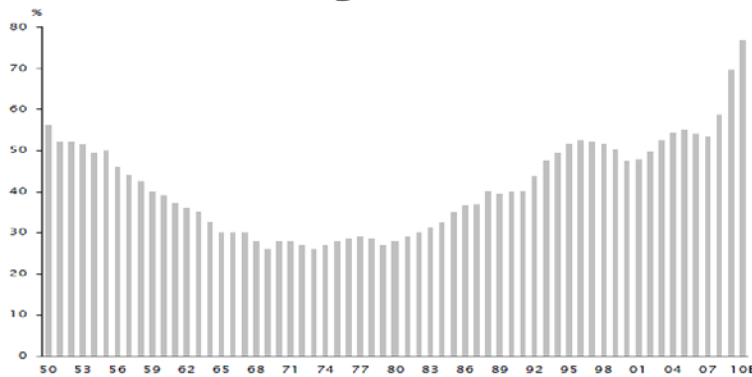
The most attractive class of assets in our allocation are the “real assets”. Included in this segment are the commodities and precious metals, with exposure to energy, soft commodities, gold and silver. Historically, this has been among the least correlated asset classes and provides direct exposure to growth in developing markets given the demand for these assets. Going forward, we like the combined inflation/falling dollar hedge and the “safety” aspect provided by this class of assets. We do anticipate inflation will appear eventually and rates will go back to more normal levels. If rates shoot up rapidly due to another financial crisis, the “flight to safety” role that these assets have historically played will dominate their returns.

Following is a discussion of the rational backing our investment preferences.

### **G -7 Leverage Limits Growth and Fiscal Options – No Double Dip**

The central issue facing the global economy is leverage (see Empirical Research Partners (ERP) September Exhibit #1 next page). ERP points out that, over the past quarter century, G-7 Government Debt as a Percentage of GDP has increased from about 25% in the mid 1970s to its current level of being approximately 75%.

**Exhibit 1: The G-7 Economies'  
Net Government Debt as a Percentage of GDP  
1950 Through 2010E**



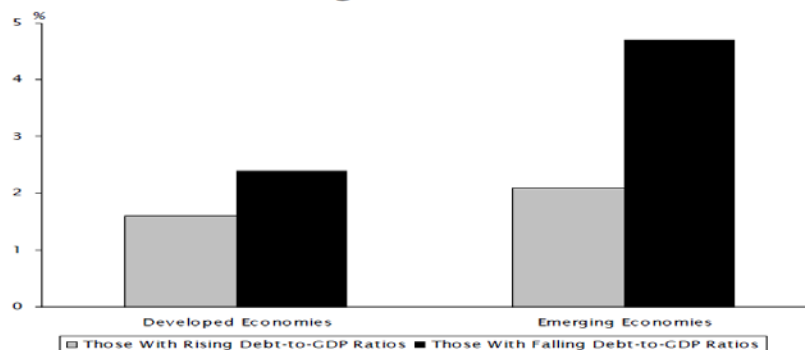
Source: Cottarelli, C. and Andrea Schaechter, 2010. "Long-Term Trends in Public Finances in the G-7 Economies," *IMF Staff Position Note* SPN/10/13.

<sup>1</sup>The U.S., the U.K., Germany, France, Italy, Canada and Japan.

Source: ERP

High levels of leverage can create a problem in that, countries which run large deficits tend to grow more slowly. As one can see from the chart below (September ERP Exhibit #10), heavily indebted developed economies with rising debt ratios have grown (over the subsequent five years) on average about 1% slower than those with falling leverage ratios. This negative growth spread is even more dramatic in emerging economies. Fortunately, the major leverage issues are predominantly in the developed economies.

**Exhibit 10: Developed and Emerging Economies'  
Countries with Debt-to-GDP Ratios Above 60%<sup>2</sup>  
Real-GDP Per Capita Growth Rates  
Over Five-Year Windows  
1970 Through 2007**



Source: Kumar, M. and Jaejoon Woo, 2010. "Public Debt and Growth," *IMF Working Paper*.

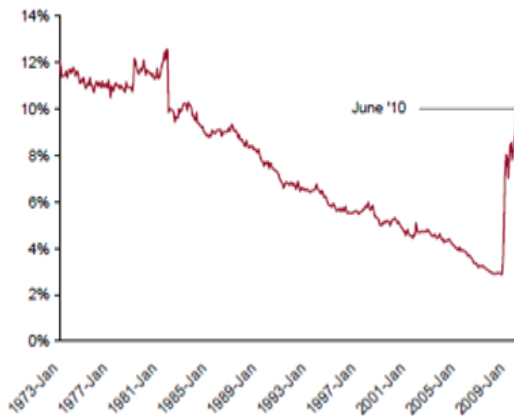
Source: ERP

As such, we believe growth, as indicated by aggregate demand, will continue to be constrained by the deleveraging of America and the European "periphery". Despite this moderation, we do not expect a true "double dip" (as defined by an outright decline in the level of business activity accompanied by higher job loss and the urge to destock inventory and hoard additional cash). Corporations have already taken these precautionary steps. Cash levels at corporations and banks are already near historic levels (See September Credit Suisse Chart on the following page). In addition, corporate inventories have been taken down to historic low levels relative to sales. While differentiating between the slow growth, volatile environment that we envision versus an outright double dip may seem like semantics, we do feel that this is an important distinction to make at this point in the recovery. Corporations' desire to hold cash remains powerful and will act as a brake as it prevents inventory building, aggressive hiring, and a consumption pick up. While these cash balances may act as a brake on growth, they also provide an important cushion

Corporate Cash Holdings % Assets



Bank Cash Holdings % Assets

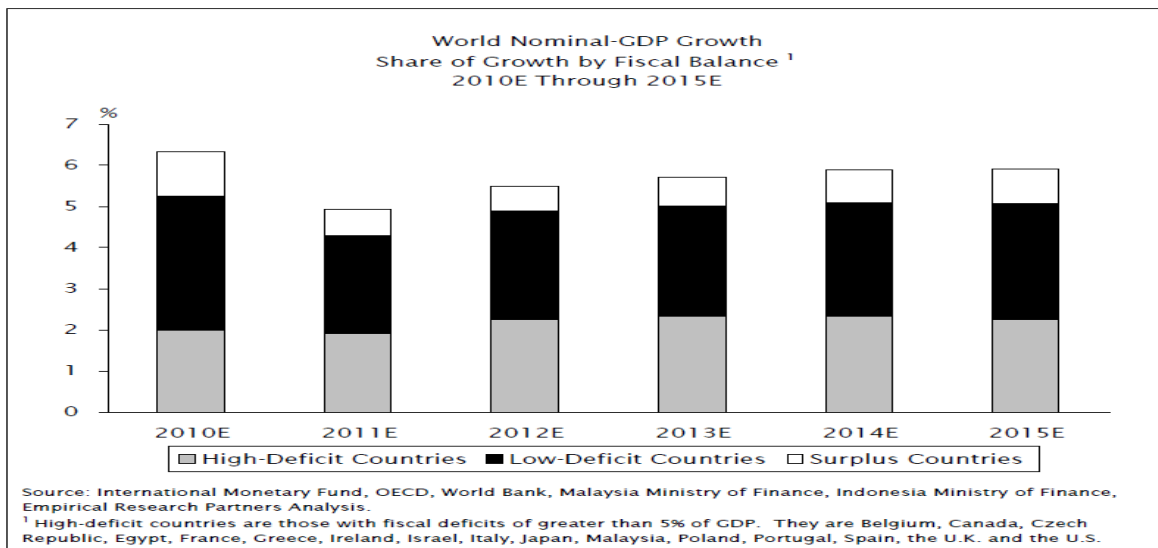


Source: Credit Suisse

against further dramatic downside. Acknowledging this reality has helped us to avoid overreacting to the 10%-20% macro based swings that the market has experienced this year. Our conservative allocation has positioned us to take advantage of these swings and we are now starting to see these as buying opportunities rather than the start of another financial meltdown.

**Excess Leverage is an Issue; However that is Not the Case in Many Growth Economies**

While high levels of fiscal retrenchment are needed globally, and most Central Bank's balance sheets have already been enlarged, important pockets of reasonable leverage still exist. As one can see from the ERP chart below, countries with fiscal deficits greater than 5% of GDP (Belgium, Canada, Czech Republic, Egypt, France, Greece, Ireland, Israel, Italy, Japan, Malaysia, Poland, Portugal, Spain, U.K.), are expected to source only about 40% of global growth over the next five years. While some very large countries (U.S., U.K., France and Spain) have deficit problems, others that are poised to grow more rapidly (Brazil, India and China) do not. The point being, we could have respectable overall GDP growth even with mediocre results in much of the developed world.

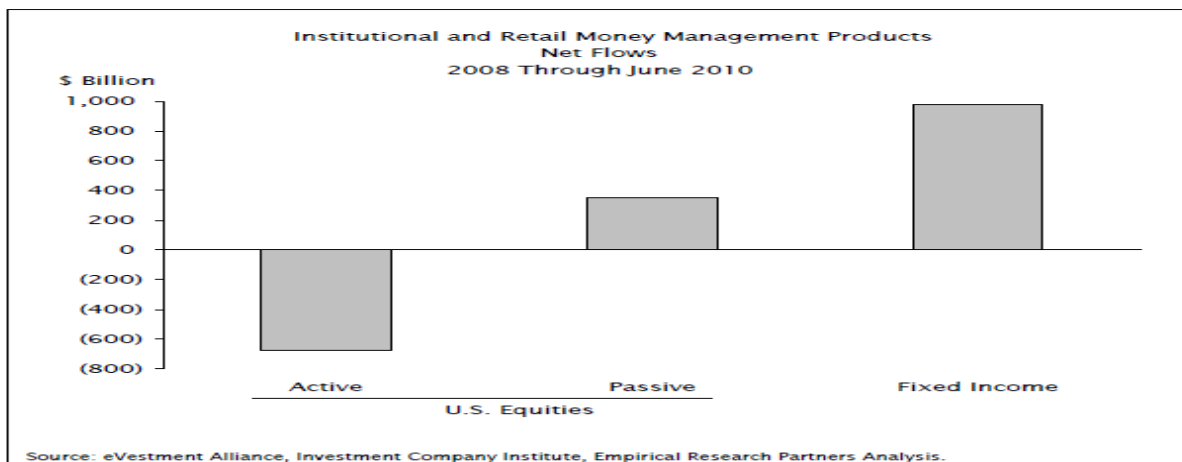


Source: ERP

**Bonds - Are We Seeing the Formation of a Third Bubble?**

A very productive investment and business strategy over the last quarter century has been to identify the needs, desires and fears of the “baby-boom” generation. If you anticipated the 1990’s equity culture, which culminated in the tech/internet bubble, the real estate – home

ownership craze that peaked in 2007, and now what seems to be an over-allocation to fixed income, your performance would have been stellar. However, this would only have been the case if you were prescient enough to get out in time. The problem with bubbles (and the herd mentality that creates them) is the tendency to follow the leader over the edge. Paper gains and losses in the millions were made and lost in these bubbles, and only those that diversified away from the gains retained the wealth created. With this in mind, we and many others are wondering “are we seeing the formation of a third bubble?” Mentally, I would paint the picture of everyone running from one side of the boat to the other. The following chart does an excellent job of demonstrating this visually. If we draw a line down the center of the page, it would have the two equity bars - U.S. Equities Active and Passive (which includes diversified indexes and ETFs) to the left and Fixed Income to the right. As ERP points out, since early 2008, institutional and retail investors have shifted nearly \$1trillion dollars into the hands of bond managers, pulling approximately \$750 billion from active equity managers. Bond bulls defend this shift as secular, based upon the following: demographically, “baby boomers” have moved beyond the “save and invest” phase of their investment cycle into “retire and spend”. Practically speaking, with rates so low, retirees need more of their assets in fixed income to produce enough cash flow to cover living expenses. Finally, after the bursting of the tech and real estate bubbles, the damage done to the “boomers “ risk psyche is not recoverable in their remaining investment horizon. While these are valid and popular opinions, a contrarian may predict that “boomers” could quickly shift to cyclical exit strategies when they start to experience principal loss on bonds as rates move up.



Source: ERP

### **Warning – U.S. Interest Rates Have Gone in the Wrong Direction**

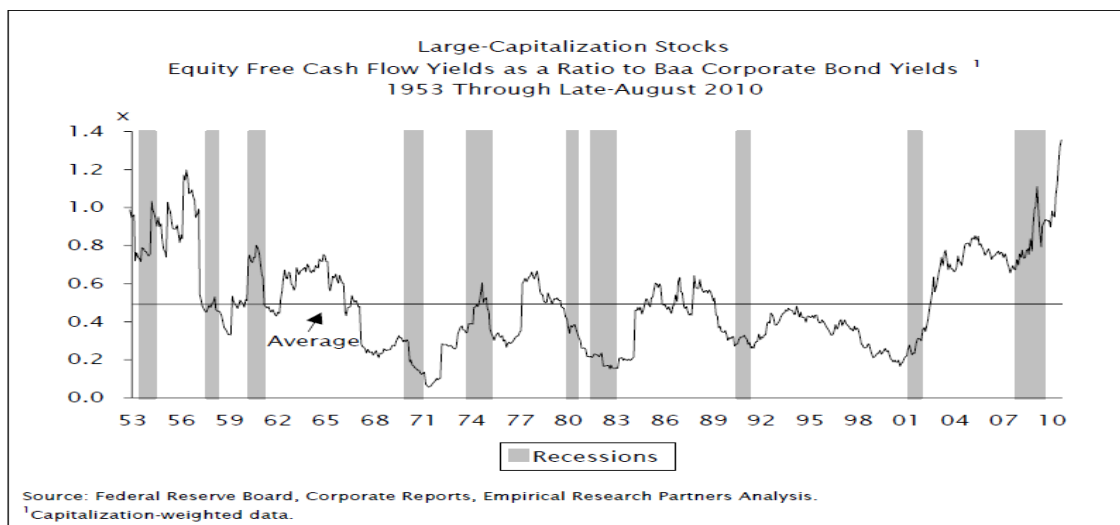
Generally, economic studies suggest that as a country’s structural deficit increases, the cost of their long term funding costs also goes up – each whole percent increase in the deficit could result in an additional 20-30 basis points increase in long term interest rates (such as a 30 Year U.S. Treasury bond). Over the past three years, the U.S. structural deficit has increased 4-5% (currently the 2011 deficit as a percentage of our GDP is projected at 11-12%). Hence, based upon the historic experience outlined above, this should have translated into approximately an additional 100+ basis point increase in the cost of long term U.S. funding. Amazingly, U.S. rates have actually gone in the opposite direction, falling by about that same amount. This anomaly supports our aversion to long duration bonds, and specifically U.S. government bonds. Buying long bonds yielding less than 3% in this setting may prove to be a much riskier strategy than anyone buying these bonds could ever imagine. This summer, the combined fear of deflation and a less than normal recovery growth rate, has once again dramatically lowered interest rates. Our fear is, with any indication of better than expected economic growth, the move up in rates could be swift and violent, with a devastating impact to the value of bonds with longer term maturities.

### **Equity Micro Fundamentals Still Attractive**

Heading into the third quarter reporting period, corporate earnings and cash flow are estimated to improve at a low double digit pace. Low single digit global growth has allowed corporations to continue to leverage cost cutting initiatives implemented in 2009. Consensus earnings expectations for 2011 have stabilized at up 16% year over year 2010 to 2011 according to Thompson Reuters Baseline. Upward earnings revisions essentially peaked in April coincident with the 2010 market top. Fortunately, the 3<sup>rd</sup> quarter “come to confession” period (September has historically been the worst month of the year due to this seasonal factor), as often defined by a wave of pre-announcements and negative earnings revisions, has not materialized. While most market indices were down in August in anticipation of the possibility of these pre-announcements and downward revisions, indices actually rallied in September as the general economic news was not as bad as anticipated.

### **Equity Valuation Very Attractive on a Relative Basis**

Doubts regarding corporation’s ability to sustain their earnings and cash flow at current levels are best seen in the September ERP chart below. This chart demonstrates the relationship between the free cash flow yields of large capitalization stocks relative to investment grade corporate bond yields. At a 30% premium, this relationship has rarely been this favorable to equities, providing an important contrarian signal that we feel should be capitalized upon. This allocation driver is especially true when one understand the underlying contributing factors. First, the rush into bonds as outlined earlier, has depressed yields to historic lows. Second, investors fear that the recovery of the past two plus years is failing and we are about to enter a Japan-like extended period of no growth. In reality, corporations have never been better positioned to manage their businesses. Unions, which historically dominated industries such as the auto industry, have essentially been neutralized in the recent downturn. Cash balances on corporate balance sheets are at historic high levels and recent refinancing opportunities have created a significant reduction in corporate interest expense. U.S. corporations are well positioned to return capital in the form of dividends or share buy backs to shareholders. Our core equity holdings are positioned to participate in this sharing, focusing on companies that are growing their cash flow.



Source: ERP

To date, the largest challenge in the unfolding equity story had been the perception of an anti-business agenda from the Obama Administration and Congress (i.e. health care and financial services reform). This perception, combined with the fear of significantly higher taxes, put significant pressure on large U.S. corporations early in the year. With the heightened sense of uncertainty created by these policies and concerns about the impact of higher taxes on the consumer, many U.S. corporations implemented what we will call “hiring strikes”. In addition,

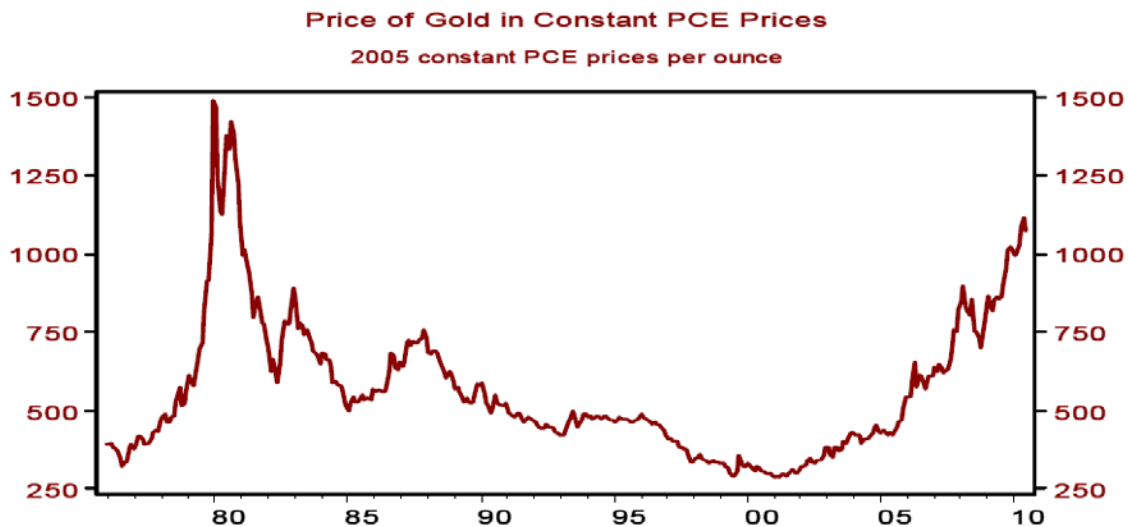
during July and August, many U.S. corporate managements utilized their quarterly earnings conference calls as an opportunity to voice their concerns as we head into the upcoming mid-term elections. The impact has been swift and dramatic heading into the contentious mid-term elections as the message regarding the importance of corporate support in turning the economy around, and specifically, improving the critical employment picture, has been delivered to all politicians across the country.

### **Real Assets March On – Commodities Hit Record Levels in the Face of Deflation Fears**

As can be seen from the following September RDQ Economics charts, gold and other commodities (as measured by the CRB Spot Commodity Price index) continued to march higher. Ironically, commodity prices are hitting record levels in the face of ongoing global growth fears and a Federal Reserve which recently justified a second round of quantitative easing based on deflation concerns. Clearly real asset investors are not buying the deflation scenario, at least not over the long run. This Federal Reserve decision also hints at the continuation of their indirect policy to debase the U.S. dollar versus other currencies, further enhancing the appeal of commodities. With balance sheets stretched in the U.S., a skeptic would note that the Federal Reserve, and hence the U.S., literally cannot afford to have rates go up. Globally, Central Bank's ultra-easy monetary policies will attempt to keep rates low for as long as possible. This will allow over-leveraged governments to "kick the proverbial can down the road", providing them the time they need to grow their way out of this financial mess. The paradox is clear that low rates extended over the past 25 year "Goldilocks" period is what brought us into this massive debt situation. This begs one obvious question, "what will the future price be for these artificially low rates?" Our response, "significant inflation is one very likely answer".

### **Gold – Realizing its Store of Value Role on an Inflation Adjusted Basis**

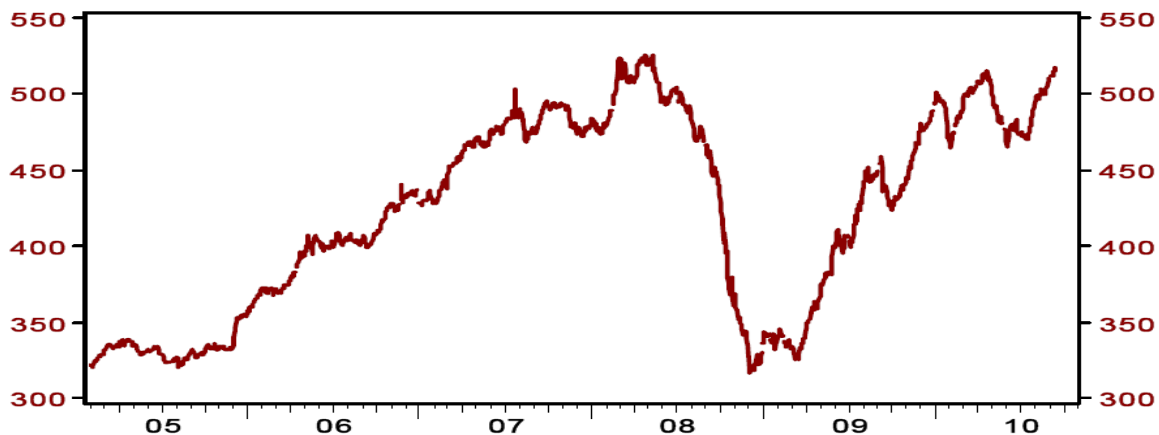
Unlike equities or bonds, gold has no inherent valuation metric such as P/E or yield. However, since it is essentially a store of value, we can look at it in constant purchasing power terms to obtain some perspective on its current price. As can be seen below, RDQ Economics has taken a look at the price of gold compared to its prior peak, in inflation adjusted dollars. The current (as of 9/30/10) nominal price of gold that would match the January 1980 peak, in real terms, would be \$1,650 an ounce. This is 30%+ above the \$1191 actual average price recorded in the month of July 2010. While there is nothing special about the prior peak price (other than it was the prior peak), this calculation shows that gold has yet to fully realize its store of wealth potential. Our expectation, based upon the current ultra-easy monetary policy and aggressive quantitative easing espoused by our government, is that in time gold will appreciate much more as the dollar and other global currencies are devalued by governments printing of more money (i.e. currency debasement).



Source: RDQ Economics

### CRB Spot Commodity Price Index: Raw Industrials

1967=100



Source: RDQ Economics

#### **SUMMARY**

As we have outlined, in this post “Goldilocks” era many of the traditional investment standards and relationships of the past 30 years will be challenged. Uncertainty and volatility combined with lower rates of growth, and hence returns, will make for a difficult investment environment. Our investment approach will continue to prioritize asset classes based upon fundamentals as we have in this letter. We will continue to implement your individualized asset allocation based upon opportunities provided by the market’s emotional reaction to positive and negative macroeconomic news flow. Client portfolios remain positioned for cautious optimism, with principle protection a high priority. However, it is important to note that we have made an important mental shift, seeing our conservative allocation as an offensive weapon rather than strictly a defensive tool. That being said, you may start to see us proactively populate exposure to emerging markets and other appropriate equities on market pull backs. We look forward to guiding you through these challenging times and, as always, we thank you for your trust and confidence. If you have not done so recently, please review your portfolios with your relationship manager. In the meantime, if you have any questions or comments please feel free to contact us at 781-237-7170 or e-mail me at [mstack@bfpartners.com](mailto:mstack@bfpartners.com).

Michael P. Stack, CFA

Disclosure:

Diversification does not ensure a profit or guarantee against loss.

Sector investments concentrate in a particular industry and the investments' performance could depend heavily on the performance of that industry and be more volatile than the performance of less concentrated investment options and the market as a whole.

The information presented in this reports is based on data obtained from third party sources. Although it is believed to be accurate, no representation or warranty is made as to its accuracy or completeness.

The information provided herein may not be suitable for all investors and is intended for the recipient only. Not for further distribution.

This material is provided for informational purposes only and does not in any sense constitute a solicitation or offer for the purchase or sale of securities nor does it constitute investment advice for any person.

The material may contain forward or backward-looking statements regarding intent, beliefs regarding current or past expectations. The views expressed are also subject to change based on market and other conditions.

Past performance is no guarantee of future results