

## **3rd Quarter 2011 Market Commentary and Outlook**

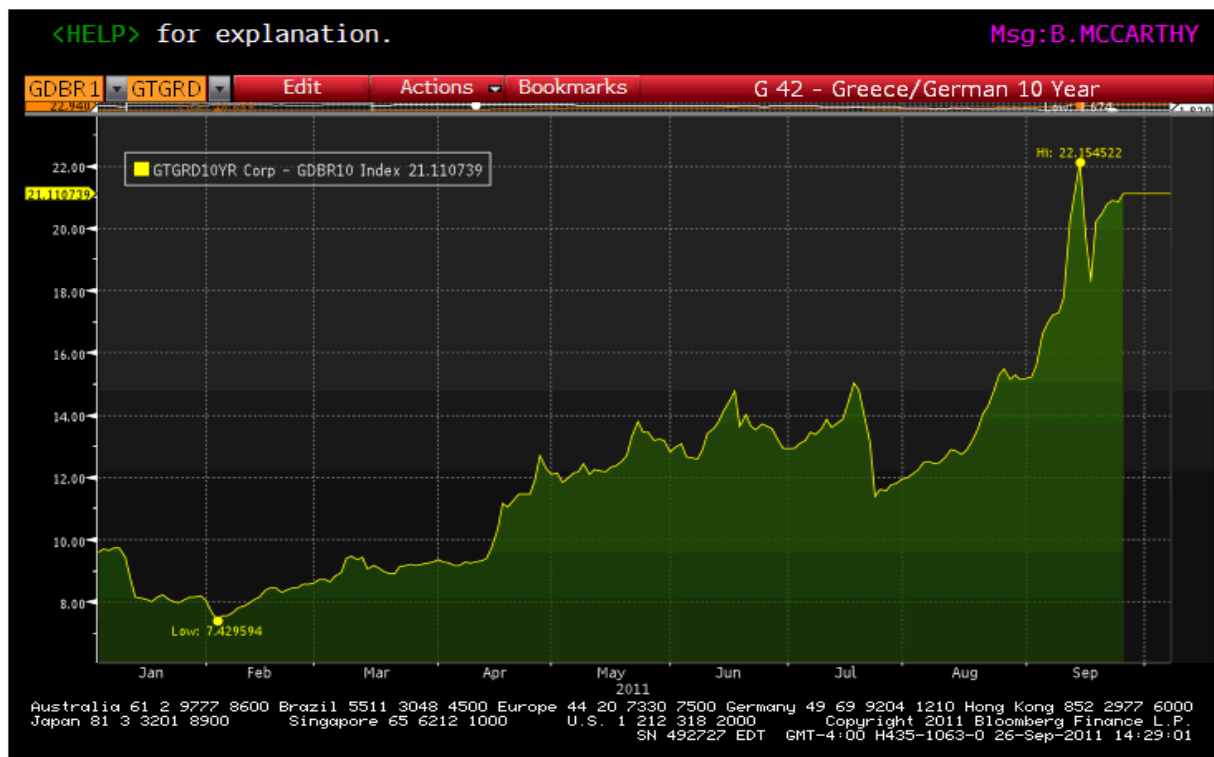
During the third quarter, global markets continued to be plagued by macroeconomic-based volatility, which originated in the 2008 financial crisis. In Thorold Barker's September 22<sup>nd</sup> Wall Street Journal article "Europe Can't Swap its Bank Problems" he says, "the market focuses on a point of weakness, politicians apply a band-aid, the financial crisis is averted and the bears retreat before moving onto the next target". In the past few quarterly letters we have discussed the "yin and yang" behavior markets have experienced as investor psychology swings back and forth from the positive micro news (company specific earnings and cash flows) to the revolving list of negative macro issues. This quarter's macro factor du jour was the European sovereign debt crisis and the significant negative implications for the European and global financial system. The S&P 500 declined 13.8% during the third quarter, making it the worst quarter since December 2008 and bringing the year to date performance to down 8.5%. As a result, we continue to be cautious in our asset allocation approach and to look for ways to protect client portfolios from the severe declines experienced in equity markets around the globe.

### **Macro Dominance - No Safe Harbor with Correlations Pushing Record Levels**

During periods such as this, when macro factors dominate investment psychology, there are few safe harbors. The past quarter was no exception as macro issues (the solvency of European countries and fears of a global economic slowdown), overshadowed fundamental differences among companies. As a consequence, many stocks and assets have moved in the same direction, indicating a high degree of correlation. According to an August 29<sup>th</sup> Wall Street Journal article "Traders Seek Salvation From Correlation" by John Jannarone, the S&P 500 Index itself had a correlation of 80% during the month of August. This level is even higher than the 73% record correlation reached during the financial crisis in late 2008. Historically, diversification across geography, sectors and asset classes was a powerful tool for portfolio risk control. We believe correlation levels will remain elevated making diversification more difficult. This high correlation among asset classes, combined with the interconnected nature of today's global financial markets, is making it more difficult to shield client assets from market volatility due to macro issues.

### **European Sovereign Debt Crisis – "Too Interconnected to Fail"**

While the U.S. experienced plenty of drama this summer around the politically charged debt ceiling debate and the subsequent ratings downgrade from Standard and Poors, the U.S. economy, and hence our debt markets, are perceived as "too big to fail". In a bizarre twist of fate, U.S. long term interest rates actually declined a half percent due to a flight to safety after the early August loss of the top-tier AAA rating. Unfortunately for many of the periphery European economies that are struggling under the weight of outsized debt burdens (see Chart at the top of the following page - Bloomberg Greek/German Year to Date Interest Rate Spreads showing high Greek rates), an appropriate description might read "too interconnected to fail". This tongue in cheek comment refers to the fact that while countries including Greece, Ireland and Portugal represent a small fraction of the GDP of Europe, they do represent the lion's share of the troubled assets held by European financial institutions. This summer's Committee of European Banking Supervisors (CEBS) "Stress Test", which was undertaken in an attempt to



calm investors, seems instead to have raised further concerns that the European Banking industry was undercapitalized. Only 7 of the 91 European banks that underwent stress tests failed and were required to raise additional capital. However, according to Simon Nixon's September 15<sup>th</sup> Wall Street Journal article "Euro-Zone Banks Face Capital Conundrum", disclosures resulting from this exercise showed an 80 billion Euro capital shortfall for European financial institutions if Greek, Irish, Portuguese, Spanish, and Italian sovereign debt was "marked to market". Furthermore, that number would more than double to 200 billion Euros if their capital ratio were increased to reflect the deteriorating fiscal picture in many of these countries. As Nixon points out in his article, the bigger incalculable risk would be a proverbial "run on the bank". If the markets perceive a lack of commitment from the EU to support peripheral (PIIGS) country assets and especially their sovereign debt, the result could topple the banking system due to deposit flight. Because the global fractional banking system is based upon confidence, should depositors demand funds, the cash is not actually sitting in the banks. The risk of this wider "crisis of confidence" is why the Euro zone's current official policy is that there will be no sovereign defaults beyond Greece.

### Preventing a Run on European Banks

Midway through the third quarter we witnessed how such a "bank run" might start. Over the course of the summer, EU politicians sent mixed signals around their commitment to support periphery (PIIGS) debt. As a result, U.S. investors, specifically large money market funds, started to reduce their short term dollar-based deposits with European banks. In the Barker article quoted above, the author also noted that European banks were struggling with access to dollar funding and that the duration of available funding was getting shorter. When this happened, the world's leading Central Banks were forced to extend existing credit lines with the Federal Reserve to allow the European domestic banks to access dollar funding. This response helped neutralize (apply a band-aid to) investor concerns over a liquidity crisis for the European Banking system. By acting in concert, Central Banks signaled the ability to quickly coordinate a response at a high level. Unfortunately, markets were more spooked than calmed by *the need* for this cooperation. While this coordinated move bought time and smoothed the funding market in Europe, European bank credit default-swap spreads (see following Bloomberg chart) tripled during the quarter. The jump in the cost to protect against default by this major French bank tells



us that the real confidence challenge facing the European financial system persists and a permanent credible solution to the European sovereign debt crisis remains elusive.

### **The Best Chance For The Survival Of The Euro: Fear of Unknown Risk**

Perhaps the only thing holding the EU together at this point is the near impossibility of breaking it up, and the devastating reaction that its collapse could have. There are many political obstacles facing Euro zone leaders as they battle to save the single currency. Unlike the United States, where we have a common culture and national identity, the Euro collective does not have that common cultural or national mindset. Currently, the EU is faced with the reality that Greece cannot shrink its operating deficit let alone run surpluses fast enough to reduce the balance of outstanding debt. The math does not work for leverage trapped economies like Greece where the market demands interest rates above 20% to hold their long term debt. According to RDQ Economics late September estimates ***“using IMF numbers, Greece has debt-to-GDP at 166% and deficit-to-GDP at 8% for 2011. The IMF has Greece running deficits of 5% of GDP in 2012 and 3% of GDP in 2013, leaving debt-to-GDP at 188% by 2013. If we use the IMF’s estimates for GDP, if Greece wanted to maintain a 166% debt/GDP through 2016, it would have to run surpluses averaging over 7% through 2016. This is obviously not possible. Greece cannot grow its way out of its debt problem and it cannot cut its way out of this mess. Greece is too far gone. The only solution for Greece is an orderly default to get debt/GDP back down to levels that are manageable.”***

The challenge facing the EU will be to allow such “unrecoverables” to fail while minimizing the ripple effects across the Europe and other global financial systems. This will require governments and banks to do everything they can to strengthen their balance sheets. This, combined with the establishment of a more flexible, robust common fund, referred to as the European Financial Stability Facility (EFSF) will be required to present a plausible solution. Recent changes to the EFSF voted upon by the 17 EU members include allowing the fund to provide capital directly to banks and to buy government bonds in the open market. The stability fund will help European governments that are already under political pressure over existing bailouts. Governments will find it very difficult to continue to “write blank checks” to countries that fail to keep their fiscal promises. In the coming months, there is likely to be much more political drama driving European markets as the EU members work through these structural challenges and make the case for a deck clearing Greek default.

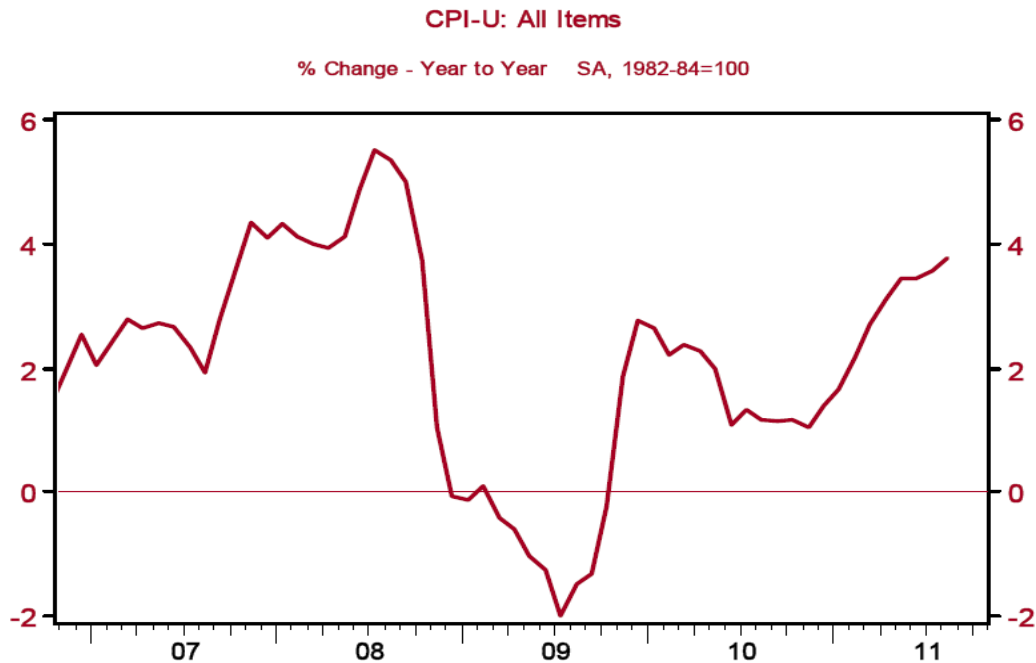
## **The Global Leverage Problem – Is There a Long Term Solution?**

The market continues to return to a common macro theme. From the European perspective, the global economy has significantly over-leveraged itself over the past decade and, in so doing, has borrowed from future growth. Artificially low rates have allowed lending to those without the capacity to repay. We have talked about this phenomenon from many sides, including the U.S. perspective, specifically as it is tied to the U.S. housing bubble. The Greek and Euro periphery (PIIGS) situation is a very similar story. With the advent of the common currency over a decade ago, less credit worthy countries like Greece, Ireland, and Portugal were allowed to borrow funds at rates available to much bigger, better capitalized economies like Germany and France. Greed combined with a significant misallocation of capital is the root of the current debt problem. How does this proverbial “pig in a python” get resolved?

There are only three ways to ultimately resolve the current global leverage overhang. First you can pay it off, second you can default on the debt, and third you can try to print or inflate your way out of the mess. Paying it off would be the most constructive solution. However, in the current slow growth/austerity-driven economic environment, most governments and individuals cannot afford this option. The second option of default would lead to massive economic dislocations accompanied by tremendous global political and even social unrest. Ripple effects have the potential to collapse banking systems globally. Finally, the third option, the most politically appealing, and the option that we believe most likely to be applied, will be an attempt to print or inflate your way out of the problem. Printing and flooding the global financial markets with fiat currency provides the liquidity (economic grease) to continue to “kick the can down the road”. Injecting that liquidity or printing depresses the real value of fiat currencies, allowing the over leveraged to repay liabilities with significantly depreciated nominal dollars or Euros. We believe the actions taken by the Federal Reserve in the form of Quantitative Easing 1 and 2 (QE1 and QE2) started the global economy down this path and now the ESFS based actions of the European Central Bank (ECB) indicate that they have joined in this growing debasement strategy.

## **With Inflation Approaching 4%,What Will It Look Like When We Exit the Current Slow Growth Environment?**

While there has always been debate around the validity of our Consumer Price Index (CPI), it is our most frequently quoted measure of inflation (see September RDQ Economics Chart at top of the next page). In August, the U.S. CPI came in higher than expected with a year over year 3.8% run rate, a significant uptick from the 2009 recession bottom. The most important perspective is not the current inflation level relative to a depressed base observation, but rather: how high will inflation be in the future when the economy comes out of its current high unemployment and depressed capacity utilization rate? The market’s recent focus has been on anything but inflation. During the third quarter, the market was worried about a deflationary reaction resulting from another liquidity driven disruption (this time European based) in the global economic recovery. It is very possible that the market will swing back to the other side of the boat (too much growth and inflation) in a matter of quarters. This could be a result from the massive liquidity injections that politically driven Central Banks and governments have and will continue to provide as their preferred solution to the global debt problem outlined above. These actions should calm current deflation fears and bring back some investor confidence. Unfortunately these manic swings, between inflation and deflation or “risk on - risk off” will likely continue for an extended period due to the pervasiveness of the global excess leverage challenge outlined above.



Our challenge will be to protect our clients from the ongoing volatility in the market and our long term concern of an inflation-based debasement of their wealth. Our answer has been, and continues to be, a significant exposure to real assets, in particular, physical gold. Gold, like many other real assets, is no one's liability and cannot be produced via a printing press. While gold recently pulled back from its highs during the worst of the European sovereign crisis, we see this as a buying opportunity as we believe that the ongoing liquidity response by Central Banks will continue to drive gold prices higher over time.

### **SUMMARY**

In an attempt to minimize short term principal damage to our client's portfolios in these tumultuous markets, we will continue to emphasize a conservative asset allocation with additional cash held above your appropriate risk profile balances. In addition, at the core of the portfolio, we will continue to hold relatively low volatility, well managed, multi-national equities with favorable cash flows that are paying and growing their dividend. Our bond holdings continue to emphasize high quality and, in many cases, inflation protected securities. While we will continue to maintain our long term investment thesis and investment horizon, we may utilize mid and small cap ETF's (baskets of stocks) to opportunistically increase and decrease the cash cushion as we roll through these ongoing emotional market swings. As always, we look forward to guiding you through these challenging times and 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 email me at [mstack@bfpartners.com](mailto:mstack@bfpartners.com).

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**Definitions:**

CPI - A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.  
Read more: <http://www.investopedia.com/terms/c/consumerpriceindex.asp#ixzz1amjFCJX1>

S&P 500 - An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.  
Read more: <http://www.investopedia.com/terms/s/sp500.asp#ixzz1amjcOZgd>