



3rd Quarter 2008 Market Commentary and Outlook

If someone told you at the beginning of the year that the several major Wall Street houses would fail and the rest would be forced into the hands of a collapsing commercial banking sector you would have thought about it for a minute, probably chuckled, and dismissed the thought. Unfortunately that is exactly what has happened. Essentially we have had a global run on “the bank”. The capital market dependent, *thirty* times leveraged, investment banking business model has been destroyed...and the resulting deleveraging has been taking down everything with it. To use a simple analogy, the U.S. banking system is the “heart” of the global economy. The monies lent by our investment and commercial banks represent the global “blood”. The blood has stopped flowing because we have had a massive heart attack – triggered by the mortgage crisis and resultant seizing of the credit markets causing banks to fail. The reason governments around the world are now doing anything they can to save our banks is because if they do not, the world’s financial system may collapse and die. Let’s now focus on what this means to investors.

Money Market Safety

First please note that Fidelity and Morgan Stanley have joined the U.S. Treasury’s Temporary Money Market Guarantee program. This program insures that any money market balance at either custodian as of September 19th, regardless of size or registration, will have the \$1 share price guaranteed by the U.S. government. This is in addition to the existing private insurance (SIPC and CAPCO) maintained by money market providers and, of course, the solvency of the funds themselves.

What Has Beaumont Been Doing?

We sold most of our remaining financial holdings (such as Bank of America) last fall and continued with the sale of the structured notes issued by Citigroup in April that was held by many clients. Last fall and early this year we significantly reduced our exposure to emerging market equities and some of the higher beta U.S. equity names. We have sold positions to raise cash and for tax loss purposes in most accounts continually since the spring. As a result, cash levels, including various short-term instruments, are much higher than “normal” in most portfolios.

In anticipation of a situation like this, Beaumont started reworking client portfolios years ago. We built and reworked solid positions in real assets (gold, silver and energy companies) and will continue to position our clients defensively for further benefit from the inevitable weakening of the dollar. We have two short-term bond funds that seek to benefit from a falling dollar. Many of our holdings are based outside the United States or are truly global companies including our core exposure to U.S. high quality consumer staple companies. All

of this was designed to avoid most of the effects of a major stock market downturn and sought to profit from it. Unfortunately, despite these defensive moves, nothing has been spared from the recent sell-off other than cash.

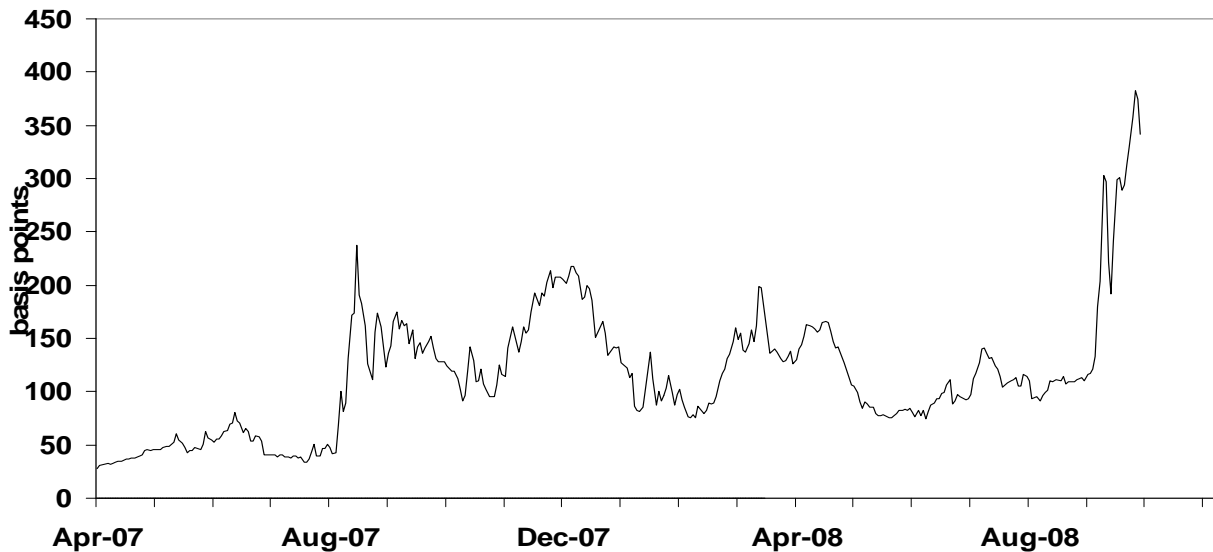
What Has Beaumont Missed?

We underestimated the willingness, speed and breadth of actions taken by the U.S. and other governments. The old adage “don’t fight the Fed” grew exponentially as our government used every means at its disposal to stop the fall of the dollar, stop the global commodity boom (part of saving the dollar) and save our failing financial institutions. For instance, not one vote was taken and not one word of new legislation was written when Fannie Mae and Freddie Mac were nationalized. In terms of dollars, this was the world’s largest nationalization ever...larger than anything under communism...and fascism.

It is one thing to predict major losses for the financials but quite another to predict their demise. The failure of these institutions has had many effects we did not foresee. For instance, one of our electronically traded funds (ETFs) had AIG as the counterparty to its holdings. The holdings were fine but the losses mounted quickly as the counterparty suddenly bordered on bankruptcy. We sold the ETF, but did so too late for the unforeseen counterparty risk. Energy, and indeed all commodities, have suffered along with every other asset class. First, the speculators were knocked out. Next, the deleveraging of many hedge and mutual funds took hold and finally, there has been a dearth of futures buying due to fear and the lack of cash to do so. The lack of cash over the past few weeks has been due to the fact that every financial institution has been hoarding liquidity. This unwillingness to lend or spend means that the velocity of money is at or near zero. Without the free flow of money, investment instruments, most companies and the world economies are literally frozen. This means that several of our stocks have become illiquid as the market to sell them in has disproportionately “dried up”.

Despite the weakness of the dollar over the last several years, it continues to be the most liquid financial instrument in our system. The liquidity need has driven the demand for dollars through the roof in recent weeks resulting in the dollar having as much as a 15% bounce. Joanna Slater’s recent article in the Wall Street Journal pointed out that “many foreign banks have engaged in short-term borrowing in dollars to fund various activities in recent years”. According to Barron’s October 13 issue, there are ten trillion of foreign borrowings denominated in U.S. dollars. Unfortunately those various activities include the buying of “toxic” U.S. financial products tied to our mortgage/housing crisis. Foreign banks had relied on U.S. banks as the normal channel for getting those funds due to the lack of depth of their capital markets. As we all now know from the daily headlines, lending by U.S. banks has come to a screeching halt as they attempt to buttress their balance sheets against losses and credit issues. The near term effect has essentially been like a “dollar short squeeze”. This effect can be seen in the chart below of LIBOR spreads relative to U.S. Treasury securities. The size of this spread indicates the banks willingness-- or lack thereof -- to lend to one another. The spike upward in this chart also shows the *massive fear* amongst the banks themselves as they are afraid to lend, even overnight, lest they not get the money back.

3-month Cash TED Spread



“(London Inter-Bank Offer Rate. The interest rate that the banks charge each other for loans (usually in Eurodollars). This rate is applicable to the short-term international interbank market, and applies to very large loans borrowed for anywhere from one day to five years)”

Another reason we believe that this move in the dollar is only technical and hence a short-term reaction is that banks world-wide are looking to reduce their overall leverage or borrowing as part of their attempt to clean up their balance sheets. In doing so they will eliminate many U.S. dollar denominated assets and liabilities. Long term, the trend toward selling dollar denominated assets and repaying dollar denominated liabilities will not be a plus for dollar demand. It may seem counterintuitive, however, (as the dust settles and the panic level declines) that the dollar is in demand now but will be spurned going forward.

Dollar Bounce Near Term Ripple Effects...

For Beaumont, the ripple effects of the bounce in the dollar have been widespread. First, a stronger dollar reduces the expectations for global demand for commodities which are priced in dollars. In addition, several large hedge funds which had taken short positions in the dollar (or borrowed in low rate countries including the U.S and Japan) and invested in global commodities and other non-dollar denominated assets have been forced to unwind their highly leveraged business model. This has added to the already dramatic selling pressure in the space. Fears of slowing global economic growth have contributed to declining commodity prices; this can be seen most clearly in the headline price of oil which is now down over 16% YTD and over 50% since its peak. These price declines have reduced fears regarding global inflation, which has contributed to the selling frenzy impacting gold which declined to under \$800 per oz during the quarter. Recently, we have seen gold and precious metals rebound due to fear and a flight to safety. In general, all commodities are now selling off on fear rather than fundamentals just like most other equities.

Is The U.S. The Mother Of All Banana Republics?!

These short term (cyclical) trends aside, as the world comes to grip with the fact that the U.S. banking/financial industry essentially has been nationalized and the “toxic” liabilities from commercial banks have been transferred to the balance sheet of the U.S. government, our status as a financial “Banana Republic” will be confirmed. The one “ace” that the U.S. still holds is that our debt is denominated in dollars. Why is that important? Because it means that we still control our own destiny. Our Government can continue to print dollars ad infinitum. To this point, in the last four weeks, the Federal Reserve has increased its balance sheet from \$883 billion to \$1.551 trillion—literally creating \$668 billion “from thin air”. By flooding the global financial system with dollars, we will pay back our liabilities with dollars that are diluted and worth much less. As a result, the dollar will be debased not only from inflation, but from the literal printing of money as well.

Was D.R. Triffin Right? In 1960, Yale University Professor Robert Triffin exposed a gaping flaw in the Bretton-Woods monetary system. He predicted that any reserve currency issued by a single country or region is doomed to fail. Adoption as the reserve currency means that demand to hold the currency is very high outside the country or region of issue. This strong demand pushes the value of that currency higher relative to the currency of other countries, making business in the issuing country less competitive on a global scale. Unless the reserve issuing country is willing to live with the attendant economic weakness and unemployment engendered by the high valuation of its currency, the issuing country will be tempted to meet the high demand for its currency by issuing large amounts of debt to pay for goods and services from abroad. This will lead to larger and larger trade and current account deficits. The sheer weight of the currencies success essentially sews the seeds of its own demise. This is exactly what has happened.

If we look at the Federal Reserve’s Z.1 report, which is a summation of debt outstanding and its rate of growth, we can see that non-financial debt in the U.S. has been growing at more than \$2 trillion per year since 2005. Unfortunately these claims are growing three times faster than the combined output and savings of the U.S. Essentially our government is issuing more claim checks than it can cover. Once the world realizes that the U.S. government has 1) diluted the dollar by printing hundreds of billions of new money, 2) taken on hundreds of billions of assets of “questionable value” as part of the bailout and 3) the removal of the temporary demand for liquidity in the dollar, it becomes not a question of “if” but rather “when” the slide in the dollar will continue.

1st Half Recap

In our Q1 letter we outlined the extreme levels of total debt in our economy and how this has risen so dramatically over the past twenty years. Essentially we identified this as the crux of the current issue facing the U.S. and global financial system. There is just too much debt outstanding, and the underlying assets that have been purchased with this leverage (homes, etc.) have all declined in value and can no longer be liquidated to repay the loans. The U.S. essentially is becoming one big tag sale from coast to coast. What has become more apparent over the course of this year is that the financing of this massive debt load has cemented the global linkage of financial institutions around the world. Our problem (as the debtor) has become the world’s problem (as the creditor) in this unholy relationship.

In our Q 2 letter we talked about the weakness in the dollar and the first stage of an inflationary spiral that had been kicked off by its decline. While the politicians are busy trying to point fingers in an election year, basically nothing constructive has been getting done in Washington. We also discussed the real possibility of revisiting the 1970's era economy which faced a slowing economy in the face of inflation, hence the term "stagflation".

Will The 1970's Economy Return?

Most likely, stagflation will return but for very different reasons. The largest differences between the U.S. in the 1970's and the U.S. today are that in the 1970's we were the world's largest creditor with low debt to gross domestic product and a high savings rate. Today we are the world's largest debtor with a negative savings rate and we have the highest debt to gross domestic product in our history. This meant that in the 1970's inflation was the enemy as the world owed us and we didn't want to get paid back in the future with dollars whose purchasing power had been inflated away. Now the opposite is true...*deflation* is the enemy and we will do everything we can to prevent it...including stoking inflation by printing dollars and living with large trade and budget deficits.

Looking Forward

While we do feel strongly about our outlook for the dollar and the inflationary pressure that will result due to its continued decline (and the benefits that will accrue to "real assets"), managing your money is not strictly an academic exercise. We have been and continue to be cognizant that markets are not always rational and that many variables including deleveraging and panic are currently driving investors. As noted above, we have significantly increased the cash holdings in client accounts for principal protection and as a result have down shifted the volatility factor in doing so. Tax loss selling has been aggressive and active during the quarter.

The short term gyrations in the market will likely continue. Beaumont is seeking to balance the near term reality of sheer fear and panic with the long-term opportunities that the market is creating. For each client that balance is different and we look forward to continuing communication with you as we work our way through these tough times. We will stay the course with the current asset allocation which includes significant inflation protection and non-dollar denominated exposure, larger than normal cash positions allowing for principal protection, and opportunistic asset purchases.

If you have any questions or comments please contact us at 781-237-7170 or e-mail me at mstack@bfparkers.com.

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