Lassus Wherley ...a view from the top
Building Better Futures
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A Really Bad Month All Around………..

Looking Back and Moving Forward…..

It has been a really bad third quarter in many ways. The weather has been crazy and so many people have been hurt by hurricanes and earthquakes on the East Coast, and the drought and horrible fires out west. The financial markets have only added to this pain with pretty ugly performance over the entire period.

The positive performers for the month of September were dominated by the bond funds. Many of our bond funds managed to squeak by with a positive return but not all. The international bond funds were hurt by the performance of bonds in Europe and in the Emerging Markets. The worst performance which comes as no surprise was the Emerging Market asset class which pretty much got hammered with the "risk-off" mind set we will talk about later in this newsletter. The only true shining light last month was Hussman Strategic Growth (one of our Hedge Strategies Funds) which had an amazing 4% plus return for the month. This fund is still slightly negative for the 12 months but John Hussman definitely redeemed himself in September.

The bottom line is that performance for September, even for well-diversified portfolios, took a serious hit, and opening statements will not be a pleasant experience for anyone. So……..now that I have that bad news out of the way, we will spend the rest of the newsletter discussing what we believe is happening in the current investment environment.

We discussed some of these topics in our ***For Clients Only: Breaking News*** publication that was released on September 23, 2011, but decided to cover more detail on the economics in this issue. It may sound like a broken record, but we do expect that we will continue to muddle through with a slowly growing economy and not go back into recession. However, we do recognize that Europe, and specifically Greece, are important pieces of the global economy and could continue to negatively impact what is happening in the US.

What's Driving Financial Markets?

Macro issues continue to dominate the markets today. The fiscal situation in Greece remains the top story. Greece is effectively running out of money to pay its bills. Because the country is going broke, they are attempting to stay on the good side of the stronger members of the euro-zone, hoping that they will be willing to bail them out.

On July 21, 2011, European leaders hammered out a second, €109-billion bailout for Greece. This package also included an expansion of the EFSF (European Financial Stability Facility) bailout fund to €440 billion ($592 million) from €250 billion.

Voting is taking place this month on the expansion of the EFSF, as well as three other changes. These changes would 1) allow the fund to buy bonds of any euro-zone country to keep the rates on their debt at manageable levels, 2) provide financing to recapitalize banks and 3) enable the fund to lend money to countries that don't yet have bailout programs in order to head off problems. The vote must be passed unanimously by the parliaments of the 17 euro-zone countries. The final vote is expected to take place in Slovakia by October 17th. The European Union (EU) is in a hurry to get the expansion and the other changes ratified so that they can ring-fence (circle the wagons around) Greece in the event of a default.

The German parliament voted their approval on September 29th. This vote was crucial given Germany's leadership role in Europe. Until now, euro-zone officials have been prevented from taking more forceful and dramatic action by their focus on their own domestic politics and a fear that being too lenient with the weaker countries would be encouraging bad behavior. That needs to change for them to move forward.

At recent meetings in Washington, DC, the International Monetary Fund (IMF) has told the EU that they have approximately 5 weeks to protect themselves against the default of Greece and the aftershocks that would occur. Euro-zone officials promised to develop a comprehensive plan to "maximize the impact" of the EFSF. This plan is to be ready to be presented by a November meeting of the group of 20 major economic powers.

It is assumed that up to 50% of the value of Greece's $470-billion debt could be effectively written down. Before this occurs, however the EU is trying to come up with a strategy that will prevent the contagion from spreading to the rest of the euro-zone. Expansion of the EFSF is part of this.

The other part would involve the European Union issuing some kind of Euro Bonds to replace the Greek debt. The idea behind the EFSF is to lower the borrowing costs of financially-troubled countries. If the EU borrows as a collective unit, it can get better rates than an individual-troubled country and can subsequently pass these more favorable rates on to the country in question.

If Euro Bonds were issued to replace the Greek debt, then Greece would owe the European Union and the European Union would owe the bondholders. In order for the EU to get paid back the funds advanced to Greece, however, the EU would have to show some leniency towards Greece because without growth in the Greek economy, they could not service the debt.

Longer term, EU policymakers may find that saving the EU demands that it become more tightly integrated. This would also indicate that it is in the best interests of the richer euro counties, such as Germany, to support the weaker ones, such as Greece. This will not happen easily as Europeans identify much more with their individual countries than with Europe as a whole. Another complicating factor is that the EU was created as a monetary union with no fiscal powers.

Investors are watching closely to see if the EU can get it together in the short term to ring-fence Greece and to provide the funding that would enable the country to grow again. The longer this takes, the more damaging the outcome will be for both the European and the US economies.

Given their ineffectual conduct over the past

year, investors are afraid that EU leaders will be unable to respond swiftly and decisively in Europe. We hope the current high level of fear will **finally** prompt more aggressive action on their part.

The situation in Europe has become pretty bleak but there is still a safety valve. That is the ECB. The ECB is the European Central Bank, similar to our Federal Reserve. The ECB could increase government bond purchases, as it did in the summer of 2010. This strategy has one big risk, however, and that is the prospect of rising inflation. The ECB has one primary mandate and that is to maintain price stability. The ECB would have to tread very carefully here. In spite of this caveat, the ECB could and would provide liquidity and fiscal support as a backstop against a deterioration of the European political system and economy.

We have heard from a few of you with some great questions. Please keep them coming. Our goal is to provide information for you in a form that helps you understand what we are doing and why. Your questions help us make sure we are doing that.

Question: *How much has the possibility of a Greek default been discounted by the markets?* **Answer:** Credit Suisse estimates that by early September, roughly 80% of a potential 30% write-off on Greek debt was already reflected in 5-year Greek credit default swaps (CDS).

Empirical Research Partners estimates that all 90 stress-tested European banks could see losses of more than €250 billion, which would cause large write-downs. For perspective, European banks took write-offs of around €700 billion during the 2008-2009 financial crisis. We expect to see continued volatility in global financial markets over the near-term as EU leaders deal with the challenge of greater integration.

Question: *What is this Operation Twist that I keep hearing about?* **Answer:** On September 21st, the FOMC (Federal Open Market Committee) issued its customary post-meeting announcement. The announcement was greeted by a dramatic sell-off. Investors were reacting to the fact that the Fed felt compelled to take any action at this point, when they have already said they will be keeping their Fed Funds target rate at 0%-0.25% through mid-2013. The Fed's statement that "there are significant downside risks to the economic outlook, including strains in global financial markets" exacerbated the sell-off in stocks and other riskier assets globally.

Operation Twist had been expected for some time, and it did not vary far from expectations. In essence, the FOMC announced that it would buy $400 billion of Treasuries due from 6 to 30 years and sell an equal amount of notes due in 3 years or less. The goal is to extend the average maturity of its portfolio. Investors were fearful that this indicated that the central bank expects the economy to grow even weaker. They were also not convinced that this measure would have any real impact on the slow-growing economy as rates are already so low.

The FOMC's post-meeting announcement also indicated that it will resume purchases of agency mortgage-backed securities (MBS) as these mature rather than using the proceeds from maturities of MBS to buy Treasuries. This makes sense since rates on Treasuries have come down more than rates on mortgages.

In fact, Operation Twist may end up having more of an impact than investors initially gave it credit for. Although it hasn't even begun to

be implemented, it is already causing long-term interest rates to come down and has encouraged bond investors to buy somewhat more risky fixed-income securities like mortgage-backed securities and corporate bonds.

Question: *I keep hearing the terms "risk on and risk off" – what do they mean?* **Answer:** The market has been dominated for some time by the macroeconomic news (big-picture) rather than by microeconomic news (company fundamentals). The macro issues that have dominated the news have been the sovereign debt crisis in Europe and the debate over the debt ceiling in the US. These big-picture issues have caused what is referred to as the "risk-on" or "risk-off" trade to dominate the markets and the news.

Hedge funds, in particular, have traded in this fashion. For example, when investors are concerned about Greek and European sovereign debt, then all risky assets tend to trade down together in price. When there is news that indicates there could be a solution to the sovereign debt crisis, then all risky assets tend to rise in price. This phenomenon has been weakening to some extent over the past few months as corporate and high-yield bonds, which fall into the "risky assets" category, have declined in value well before stocks. Several asset classes are now diverging and not trading in lock-step as they seemed to do earlier in the year.

Question: *How do you see the markets right now?* **Answer:** As far as the economic backdrop goes, we see the global economy slowing but still growing, although risks of a recession have been rising in both the US and in Europe; and the wild swings in global markets have not helped. The risk is higher in Europe than in the US, although the bigger risk in the US is that we talk ourselves into a recession.

Economists are estimating that there is about a 1 in 4 chance that the US economy will fall back into recession over the next 12 months. The most likely scenario still seems to be one of very weak economic growth with a slight rise in the unemployment rate. The forecast rise in unemployment will be as a result of the spending cuts which are being enacted in order to slow the growth in the deficit. The global economy is still expected to post growth of about 4% both this year and next. We have been seeing a rebound in Japanese production, and growth in the emerging markets is still expected to come in above 6% both in 2011 and 2012.

That being said, there are still plenty of worries, especially in Europe, and plenty of uncertainty, as witnessed by the dismal performance of global stock markets in the third quarter just ended. Barring a cataclysmic decline in global output and a concurrent downdraft in earnings, which we do not foresee, stocks still look cheaper than bonds. The 10-year US Treasury is selling at an extremely low 2% which is equal to the current core rate of inflation. This is the lowest real rate on Treasuries in 31 years.

Companies in the S&P 500 are expected to earn $98/share in 2011 and $111/share in 2012, although estimates are still being revised downward. Using the September 30th close on the S&P 500 of 1131.42, and a blend of this year's $98/share estimate and next year's $111/share estimate, we derive a price/earnings ratio (p/e) on the S&P 500 of 11 times. This is a lower p/e than we have seen in any quarter end going back 21 years. We know that stocks could stay cheap and even get cheaper in the short term. We also know that most stock market bottoms occur when valuations are compelling and sentiment is extremely bearish.

We are getting there on both accounts but may well see some more downside in the markets before we see a turn.

As we have written previously, we have been taking steps for months to reduce risk in portfolios through tactical actions. These have included close monitoring of cash levels, reduction of allocations to International Large Cap and US Large Cap in favor of Hedge Strategies, and a reduction in global fixed income investment in Europe.

In this uncertain market, we are keeping our focus on preservation of capital as much as on growth of capital. We believe that keeping balanced and diversified is more important than ever. For long-term investors (those with a time horizon of 3-5 years), the current volatility is creating opportunities as painful as the market may feel today. Sticking with our theme of the importance of balance, we continue to maintain an allocation to fixed income in all portfolios. It is important to have an allocation here as diversified fixed-income assets can help cushion portfolios from market volatility.

If the issue in Europe is resolved through an expanded EFSF or bank recapitalization, we would expect European stocks to respond positively, especially since there has been indiscriminate selling of European equities in the past few months. We are continuing to hold our underweight allocations in both International Large Cap and Emerging Markets because we believe Europe is likely to continue to experience volatility for some time.

The bottom line is that we are concerned about what the leaders in the US and Europe are going to do next. We are prepared to take additional tactical actions should they fail to act in a positive way to resolve the issues in Greece and in the US to prevent further pressure on the global economy.

As always, please let us know if you will be needing cash for any unusual or unanticipated need as soon as possible. This makes it easier for us to plan for how and when we will raise the cash to cover that need.

Hope you find time to turn off the TV and enjoy the Autumn!

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On a Personal Note: I would like to express my deep appreciation for your thoughts and prayers after the loss of my youngest brother Jimmy (James H. Dial, Jr.) on September 6th. He was only 51 and an incredibly bright and loving individual and we really miss him. For those who have asked about organizations for contributions, we are supporting the American Foundation for the Suicide Prevention (www.afsp.org). *Diahann*

Compliance Disclosure

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