ARKY&MILLER
FINANCIAL GROUP, LLC
PLANNING MEANINGFUL FUTURES

3Q2010 Portfolio Review: Quantitative Pleasing

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Planning Meaningful Futures

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"The ability to foresee that some things cannot be foreseen is a very important quality."

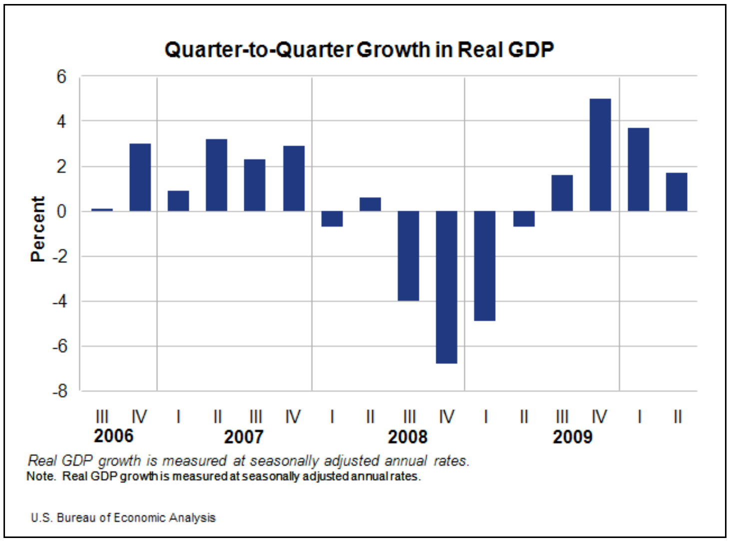
Jean Jacques Rosseau

The Economy – Private Sector Demand Still MIA

The constant hope, obfuscation, and spin surrounding the reporting and analysis of economic data since early 2009 has been consistent and amusing. The powers-that-be have a vested interest in maintaining the status quo, and their game plan seems to depend upon convincing the populace that things are better than they actually are. They would make terrible lifeguards. They see a man drowning in the ocean and tell him to just relax and enjoy the sunny day. Make no mistake. The economy remains quite weak and is greatly lagging the typical post-recession recovery path.

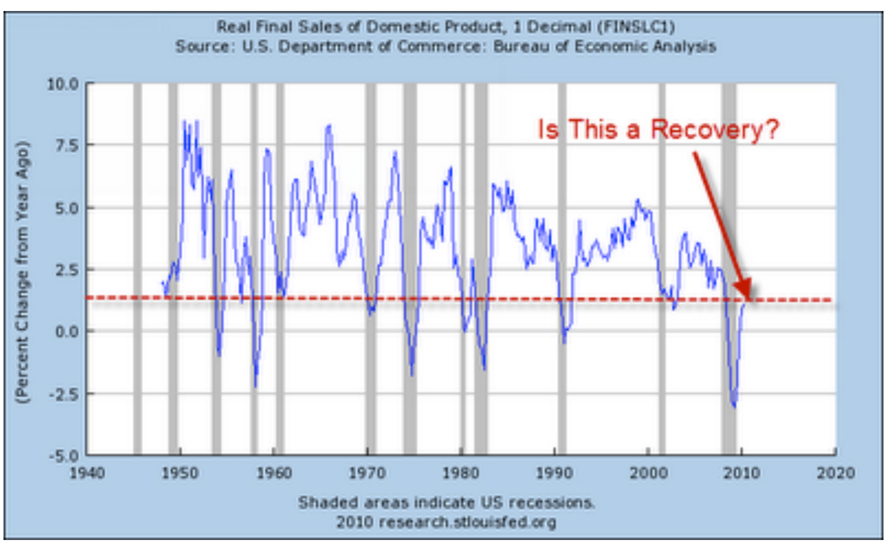
One of the themes we've been banging on for the past 15 months or so is that this much-hyped economic recovery was not real and would not last. It was not real in the sense that it was almost completely dependent upon government stimulus, the occasional boost from exports thanks to a weak dollar, and inventory replenishing.

The evidence of slowing growth became all but impossible to ignore during the past quarter. As you can see in the following chart, GDP growth accelerated nicely from the fourth quarter of 2008 through the fourth quarter of 2009. This shouldn't have surprised anyone given the trillions in stimulus thrown at the economy. The only surprise is just how small the response to such a massive mobilization actually was. So far in 2010 we're seeing a rapid moderation in economic growth. Again, this should not have surprised anyone, as the wearing off of the stimulus was sure to prove a drag.



Furthermore, the impact of inventory rebuilding is no longer boosting the official numbers. When inventory is rebuilt following a slowdown, that increased inventory adds to GDP. Following the crisis in 2008-9, firms were desperate to slash inventory as demand collapsed. This dragged GDP growth down during early 2009 but set the stage for a rebound in late 2009 and 2010. This goosing has effectively run its course.

Because of the variability of inventory in the GDP report, it's very important to keep an eye on real final sales (see the following chart), which strips away the impact of inventory to provide a better view of real activity. Real final sales never fell as steeply as GDP in late in late 2008 / early 2009 nor rose as strongly over the last year. In a typical recovery, we would be seeing real final sales growth at or above 5%. We haven't come close to those levels.



With consumption accounting for roughly 70% of economic activity, a real unemployment rate of 17%, a looming tax increase, and a still massive debt overhang, we're unlikely to experience strong and sustained economic growth for some time still. Without question, the last thing we need to see is a rebound in economic growth being driven by increased borrowing at any level.

<u>The Return of Quantitative Easing (QE)</u>

Quantitative easing. We just love the term. It sounds so official and important and academic and mathematic and scientific yet gentle and zen-like. How can you not like quantitative easing? Everyone these days seems to love it. At some point the world will become aware of just how counterproductive and destructive quantitative easing is - although it does not appear that we are there quite yet.

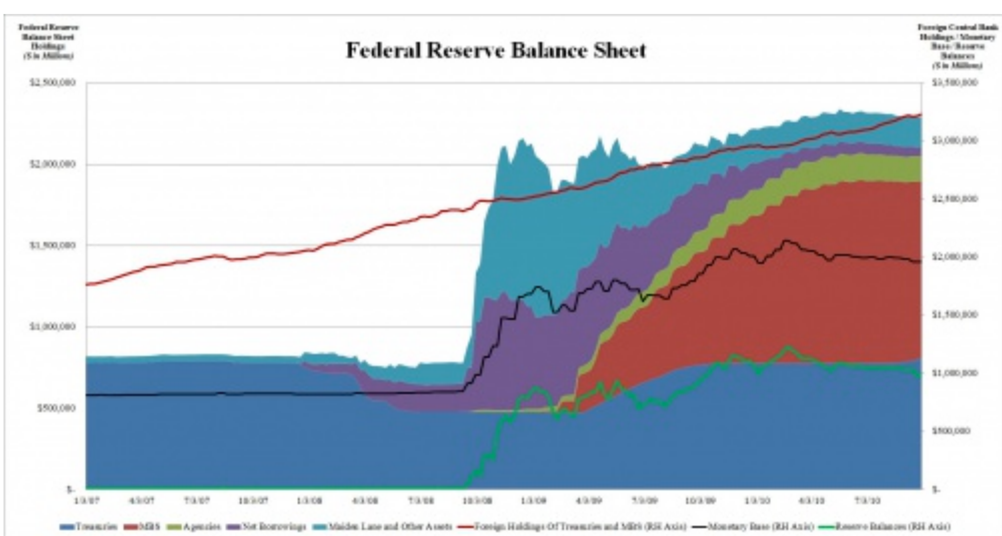
Washington loves to come up with names for bills and policies that make them sound wonderful, and quantitative easing is no different. Quantitative easing is nothing more than monetary inflation and dollar devaluation. Note how the actual descriptive terms sound so much more negative. No one could get away with coming out and saying, “We’re about to embark on a new policy of monetary inflation and dollar destruction.” But, call it “quantitative easing” and the crowd roars for more.

In last quarter’s review, we wrote the following:

> *Ben will increasingly feel the heat in the coming months as evidence of a slowing becomes even clearer. Ben is going to feel immense pressure once again to “help” the economy by further easing monetary policy. We would be very surprised to see Ben sit on his hands at this point while the economy weakens and risk spreads widen.*

It didn’t take long. The clear weakening of economic activity in recent months gave the Fed the cover it needed to initiate its next round of stimulus, billed as QE Lite. With this, the Fed is reinvesting the interest and maturities (principal) from its securities portfolio back into Treasury notes and bonds. Merely weeks ago, the Fed was publicly discussing its exit strategy, but that talk is now off the table. Instead, the Fed has telegraphed that it’s likely to resort to another bout of massive (at least another $1 trillion) monetary inflation and dollar devaluation (we’re sorry -- quantitative easing) should the economy weaken. Well, the economy has been weakening, and the market has zipped ahead in the expectation that this stimulus is imminent.

You can see below that the Fed massively increased the size of its balance sheet when the crisis first hit. This was QE 1. It could be argued reasonably that this was necessary to address the liquidity crisis which existed at the time. Today, however, there is no liquidity crisis. There is plenty of cash and credit in the system relative to demand. The issue we face is one of solvency, not liquidity. Sound monetary policy would call for removing the liquidity that was added to the system and letting interest rates rise back to market levels, but the Fed hasn’t practiced sound monetary policy for a long time. Instead, we’re very likely to soon see the slope of the following chart jump yet again as the Fed conjures new money to buy even more assets from the private sector.



The Fed is resorting to blatant money printing because it is rapidly running out of tools to manipulate monetary policy. Short-term interest rates have already been driven to zero. Now, they hope to drive longer-term rates down. They would have us believe that their goal is to get banks to lend, thereby spurring the economy. Well, Ben is either lying or he's stupid. In this particular instance, we're going with lying. We believe the Fed knows that consumers are generally unwilling, unable, and/or unqualified to borrow more. The Fed also knows that the banks are generally much more concerned with rebuilding their capital (safety cushion) than growing their loan portfolios. The data proving this comes from the Fed itself.

So, the Fed's primary concern is not really with spurring the economy by lowering rates. This is just the spin being used to deflect and distract from its real intent, which is twofold. First, they aim to boost asset prices in order to rebuild confidence and encourage increased spending due to the wealth effect. Second, they want to devalue the dollar in order to make American goods and services more affordable internationally.

This current policy of quantitative easing is pure desperation. The Fed is once again pursuing a faulty and short-term focused policy which will create massive imbalances and dislocations. The Fed is playing a dangerous game of manipulating asset prices, exactly as they did prior to the internet bubble and housing bubble. In recent years, the Fed has managed to stoke bubble after bubble by keeping interest rates too low and money too readily available. The Fed has been an abysmal failure in spotting bubbles but a tremendous success in creating and fostering them. This time is no different. Sadly, it will end very badly yet again.

Competitive Devaluation

One of the other major risks we've been discussing for some time is that of competitive devaluation. This issue has recently become front-page news across the globe with everyone including Japan, Brazil, Thailand, Peru, Switzerland, South Africa, China, Korea, Colombia, and Russia taking steps to actively devalue and/or talk down their currencies. We've now moved well beyond the cute bickering between the U.S. and China which has been the focus of currency disputes in recent years.

In a world with ample demand and strong balance sheets, this wouldn't be such a heated issue. The fact that countries are climbing over one another to reduce the value of their currency is powerful evidence that global demand remains subpar. With an excess of manufacturing capacity and labor and insufficient domestic demand in much of the world, hopes for growth are being pinned on increasing exports.

It should be obvious, however, that everyone can't increase exports at the same time. Some countries have to import. For decades now, the U.S. has been the chief global importer, but our growth has slowed, and we can no longer increase our consumption through borrowing. Further, the administration has made it clear that one of its goals is to double exports over 5 years (not going to happen barring serious dollar devaluation). So, even the world's chief importer wants to increase exports.

There is one extremely easy way to boost your exports in the short-term – devalue your currency. If one or two countries do this, it can work for them. When everyone wants a weaker currency, however, the stage is set for resurgent inflation and trade wars. Countries will simply take turns devaluing their currencies to give a short-term boost to their economies. This has the potential to spiral out of control.

The U.S., which possesses the world's reserve currency, is the big dog in this fight. If we are determined to boost exports through dollar destruction, it will happen. The only thing that the Fed has successfully done consistently since its founding in 1913 is destroy the value of the dollar. The value of the dollar has plummeted 95% in that time. We think the Fed does a horrendous job when it comes to most of its functions, but we never doubt for a moment its ability to manufacture inflation and dollar devaluation. There are tremendous risks out there today which could wreak havoc upon the global economy and markets. This one has to be near the top of the list.

<u>The End Game</u>

We have a weakening economy, an expectation for further massive monetary stimulus, a tremendous debt bubble, and the very real prospect of a currency war. The boring market environment we've been hoping for isn't likely to arrive for a while.

The stock market had been following the improving economy higher throughout the final three quarters of 2009. Again, this was largely due to the massive stimulus provided by the administration, the Congress, and the Fed. It probably isn't a coincidence that the market has largely been meandering in 2010 given that economic growth has been declining steadily in the face of still high debt levels and unemployment. The stimulus provided a short-term boost (at a substantial long-term cost), but it didn't address the underlying issue of debt. In fact, it exacerbated the debt problem and prolonged the time it will take to adjust back to a truly healthy economy.

With the economy weakening, we're once again facing a massive intervention on the part of the Fed. Interestingly, we seem to be in a phase in which all news is good news. Good (or not as bad as expected) news sends risky assets (stock markets) higher, and bad news increases the odds of more quantitative easing which sends risky assets higher.

The current rally in risky assets is clearly tied directly to the implementation of QE Lite and the rhetoric surrounding and expected enactment of the next massive round of quantitative easing. The market isn't rallying because the economy is improving and healthy. It's rallying precisely because the economy is deteriorating, which will compel the Fed to print money.

We can't stress strongly enough just how dangerous the environment is becoming yet again. Our stock market is being driven by computer algorithms trying to scalp pennies on millions of trades rather than by long-term fundamental investors. Volume has been declining in the market over the past year, insiders are again selling hand over fist, and we've seen cash outflows from equity mutual funds consistently for 6 months. The economy is weak, unemployment remains high, housing is still a mess, valuation is unattractive, we still have a massive debt bubble, demographics are a major headwind, public pensions are massively underfunded, and we may be on the cusp of a trade war. Aside from that, it's a terrific time to buy financial assets!

Here's what we don't know. We don't know how long this easing/stimulus will serve to boost risky assets. We don't know if the markets are about to top out again or if we're off to the races one more time. Clearly, to some degree, the market has priced in some substantial easing on the part of the Fed already. In fact, we may well see a sell-off once the Fed formally announces the program. We simply don't know. No one does.

Here's what we do know. We do know that we don't care about what we don't know. We have zero intention of gambling on the markets and chasing the hot money around the globe. We don't care if the markets get silly or stupid and run up despite unattractive valuation and fundamentals. We do know that the Fed is doing nothing to actually address the underlying problems. We do know that we're not getting paid to load up on risk in the current environment. We do know that we have no desire or intention of getting blown up once this latest misplaced euphoria wears off. We do know that the markets will soon come to the realization that the Fed cannot save us. We do know that balance sheets need to be repaired. We do know that we plan to sell more of our long positions should the markets keep climbing. We do know that money printing and a trade war are very bullish for our precious metals positions.

The endgame is coming, though the timing is uncertain. The Fed is not bigger than the market in the long-term. At some point, we will have our Greek moment when the bond market realizes that our bankrupt government will only be able to pay its bond obligations with inflated (devalued) dollars. This is likely to be when the debt death spiral will begin unless we address it voluntarily first. The debt burden here and throughout much of the developed world is far too great to withstand higher interest rates. Until that time, the current low interest rates are actually encouraging governments to put off addressing serious debt reduction efforts. We have the subprime lending crisis occurring at the sovereign level. This is Ponzi finance of the highest order.

If we remain on our current path, there will be massive economic blowback in the form of rising interest rates, rising interest expense, massive budget pressures, and ultimately an acceleration in the debasement of the dollar and monetization of the federal debt as the Fed and Treasury move beyond their current gentle petting to full-on relations. There is still time to preach and practice abstinence, but the Fed's urges are growing stronger, and we may not be able to hold Big Ben back much longer. The game is over once the market finally demands higher interest rates as compensation for increased credit and inflation risk.

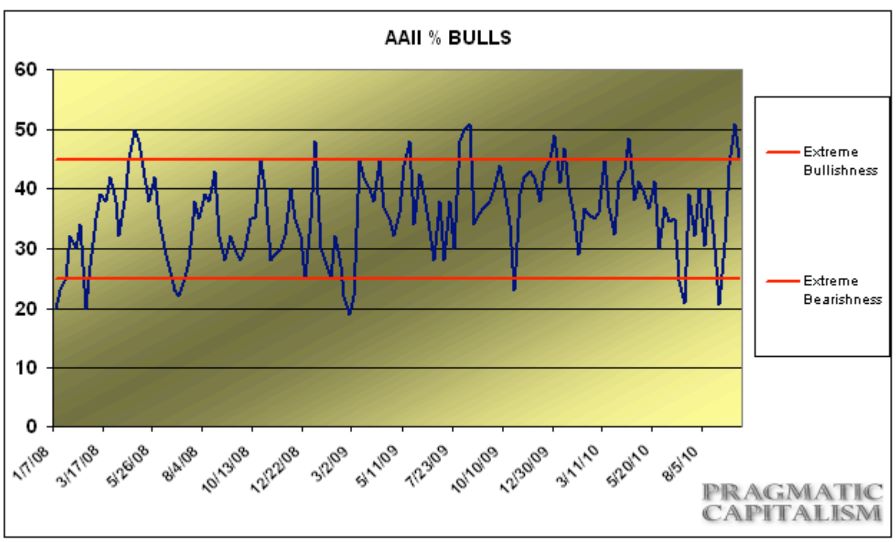
There is an important question which the bulls struggle to answer. If everything is so wonderful and risks are truly low, why does gold keep making new highs? If the economy and debt bubble were truly on the mend and if monetary and fiscal policy were sound, we would see gold plummeting. Ignore the pundits. Ignore the press. Ignore the politicians. Ignore the Fed. Watch gold.

Let us re-emphasize what we wrote last quarter:

> *Another massive round of quantitative easing will mean further debasement of our currency. This will continue to send false pricing signals throughout the economy and result in a further misallocation of capital as well as rolling asset bubbles. The only good news is that the value of gold should be even more appreciated in such a world.*

Performance

It was risk-on and full steam ahead last quarter for virtually every asset class except the U.S. dollar. When we left off at the end of the second quarter, the markets were at their lows for the year and concern was growing that the market could fall sharply. You can see in the following two charts that sentiment was quite bearish at the end of the second quarter, and few stocks were trading above their 50-day moving average. These often contrarian measures effectively called a short-term bottom in the market. Today, both of these measures are pointing to excessive bullishness. We'll see if they mark a short-term top in the markets.



The markets have been moving in a monolithic fashion with risky assets rising and falling in tandem. This is neither normal nor healthy. Traditional diversification does little to mitigate risk in this type of market. Money is either flowing into risky assets or fleeing for safety en masse. There isn't much middle ground for the time being.

In a rising and risk-hungry market, the most volatile asset classes tend to perform best, and this is what we saw in the third quarter. Commodities and emerging markets led the way with very strong double digit returns. The dollar was a huge laggard, dropping nearly 9%. For the year, the real standout has been gold, which has climbed 19%, continuing its 10-year bull market.

Index/Market	3Q10	2010
S&P 500	10.72%	2.34%
DJIA	10.37%	3.45%
Nasdaq	12.30%	4.38%
Vanguard Total Stock Market (VTI)	11.05%	3.55%
Vanguard International Stock Index (VGTSX)	17.90%	3.75%
China - Shanghai A Share Index	10.65%	-19.07%
Wisdom Tree India Earnings (EPI)	15.91%	19.48%
Emerging Markets (VWO)	19.66%	10.88%
iShares Aggregate Bond (AGG)	1.31%	5.29%
Dow Jones Commodity Index (DJP)	12.33%	0.05%
DPDR Gold Trust (GLD)	5.12%	19.20%
Oil	5.29%	1.37%
U.S. Dollar (UUP)	-8.86%	-1.04%

Strategy and Outlook

Trying to predict short-term moves in the markets is a silly game. The truth is we have no idea what the markets will do in the short-term Frankly, if we knew in advance what every economic release would say and exactly what the Fed would do, we still couldn't tell you how the markets would react over a short period of time.

It should be clear that we have no intention of drinking the Kool-Aid should the markets continue to run on hopes of the magical QE 2 saving the day. One of the key tenets of our investment management practice is a focus on absolute returns and preserving wealth. Over the short term (less than 10 years) we have very little concern for what any particular benchmark or market is doing. Our focus is on taking appropriate and attractive risks – not trying to mimic the market. We don't do stupid with our money, and we don't do stupid with yours.

So, if the 22-year-old physics Ph.D.'s with their fancy Frisbees and new math which drive today's market decide that their 1's and 0's are aligned for a move still higher, we will gratefully and gradually sell more of our long positions to them. After that, we will very likely start to beef up the short/put side of our portfolios if things really get carried away. Frankly, if it weren't for the near-term uncertainty created by QE, we would be more defensively positioned already.

Warren Buffet has become a bit of shill for Wall Street and the administration of late, but he has offered some timeless wisdom over the years. One of our favorite passages is the following:

> *"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his."*

This is very much how we view market quotes. We can argue until we're blue in the face about how real or manipulated any market move may be, but what really matters is the price (and of course valuation) at which we can buy and sell specific securities. If Mr. Market gets a little too greedy, we stand ready to sell. When Mr. Market is a little overly upset and depressed, we will happily buy his shares.

In general, we will maintain a heavy precious metals position so long as the global authorities insist on debasing currencies and increasing debt. We'll rotate between mining securities opportunistically, and we may also shift our emphasis periodically between the mining stocks and the commodities (gold and silver) themselves. We'll pare back our exposure as it grows too large and boost it again on the inevitable pullbacks.

Otherwise, we'll take advantage of the opportunities Mr. Market provides and keep an eye out for more special situations. Our hedge position will grow as valuations expand, and it will shrink as the market become more attractive. In other words, we'll keep doing what we've been doing with an eye towards managing overall portfolio risk effectively. In addition, you should expect to see some tax-loss selling during the fourth quarter in taxable accounts. In particular, we'll be repositioning our hedge positions to capture the unrealized losses which have accrued.

Recall our last Bulletin on secular bear markets. This current rally is hardly out of the ordinary, and it will almost certainly reverse. We will again swing from an environment of optimism and hope to fear and concern.

Best,

Arky & Miller Financial Group Investment Committee
Joe Miller
George Arky
Ken Bell

10/19/2010