



QUARTER IN REVIEW

The summer of discontent evolved into the best September since 1939 for equities as measured by the Dow Jones Industrials.

In September, investors refocused on positive possibilities, while tiring of little or no return for “playing it safe” and plunged into all sorts of risk assets. Inflation worriers plunged into gold, pushing it to over \$1,300 per ounce.

Investing is making judgments on the present value of the stream of income and future value that another investor might pay for securities. Investors make reasoned judgments of the longer-term future. However, in the short run, investment values often reflect investors’ sentiment, emotions or feelings. Sentiment improved as the summer turned into fall. We have often stated that predicting what the next 3-6 months may bring is very difficult, but we can make reasoned evaluations based upon longer-term data, such as demographics, government policies regarding taxes and spending, balance sheets of governments, businesses and individuals and their sources of potential cash flow.

Critical Areas of Concern

Jobs
Currencies
Regulation

Putting aside political and tax related uncertainties, there are three critical areas of long-term concern in the financial sector — jobs, currencies and regulation (our focus is solely on the financial sector) — that affect the outlook for financial markets and our investment decisions.

Jobs

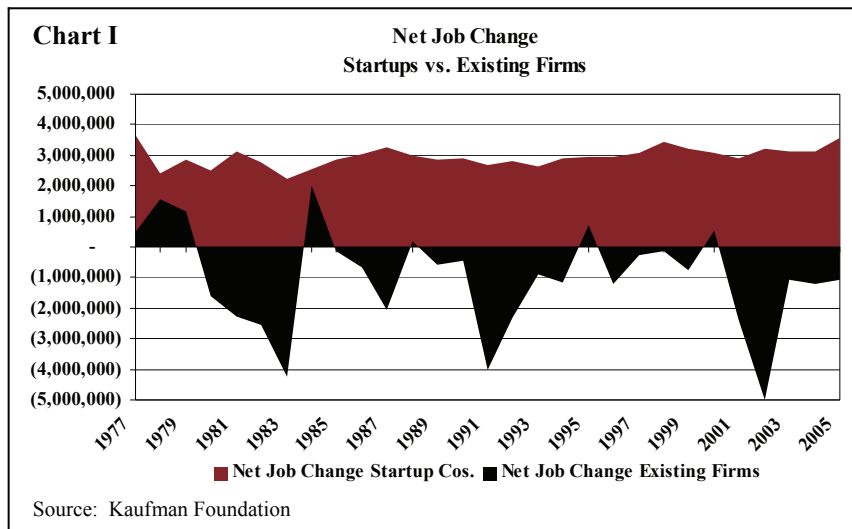
The biggest personal uncertainty for many relates to their own job security or the prospects for a new job. This is a big concern with unemployment stubbornly stuck at almost 10% and under-employment over 15%. To reduce unemployment by 1% requires Gross Domestic Product (GDP) growth of about 5% over a year. Currently, the economy is growing at about 2.5%. Unemployment is not just unhealthy for those who desire work and cannot find it, but also adds to the federal deficit at a cost to all

taxpayers because of the cost of transfer payments supporting the unemployed, as well as the lack of tax receipts from otherwise employed workers. With about 42% of the unemployed having been without a job for more than 27 weeks, unemployment appears to be more than a temporary problem related solely to the economic cycle.

According to several studies conducted by noted academic economists at the London School of Economics, MIT and the Centre for Monetary and Financial Studies in Madrid who were referenced in *The Economist* September 11th edition, middle skilled workers have lost a disproportionate amount of work in the U.S. and Europe since the mid-1980s and especially in the last two years. As stated by Jonas Prising, President of Manpower of the Americas, “the issue is not a lack of candidates but rather a talent mismatch.” Manpower, a leading global job placement firm, identified the U.S. jobs currently most in demand as skilled trades, such as mechanics, electricians and welders, sales representatives, nurses, technicians and drivers. In addition to skills, experience matters. From 2001 to 2007, one in seven jobs was filled by someone over age 55, generally more skilled workers. Since 2007, 7.4 million jobs have been lost, while older workers gained 1.7 million jobs.

A study by the Kaufman Foundation identified start-up companies as the only source of job creation since the late 1970s (see Chart I on page 2). Andy Grove, former CEO and chairman of Intel from 1987 until 2005, wrote a lengthy article for *Bloomberg Business Week* this summer that discusses his concerns about job creation in America. In Grove’s view, innovation and job creation are intertwined as new products and technology move from prototype to mass production. Therefore, he is concerned that the movement

Innovation and job creation are intertwined



offshore of manufacturing also risks the movement of design and engineering to work on the scaling up of new products on the factory floor. In his view, “without scaling, we don’t just lose jobs — we lose our hold on new technologies. Losing the ability to scale will ultimately damage our capacity to innovate.” He points to the development of lithium-ion batteries (central to laptop computers and now to electric autos) as technology that developed outside the U.S. after the U.S. abandoned battery manufacturing. One reason that Grove identifies for the shift offshore is the cost of creating U.S. technology jobs, which has grown from a few thousand dollars in the late 1950s when Hewlett Packard went public to about \$100,000 when Google went public earlier this

decade. Tied into this are not only the costs of education and training but also benefit costs that have and continue to escalate rapidly. Government policies have tended to focus on providing health care and retirement coverage along with unemployment insurance. To pay for these benefits there must be revenues generated primarily by employed workers. Will government policies change to focus on long-term job creation, not stop-gap measures?

Currencies

Corporations have accumulated large stockpiles of cash and borrowing power to use for acquisitions, dividends, share buybacks and, perhaps, new investment; their balance sheets are strong. Consumers are reducing their leverage by paying down debt and/or as a result of loan modifications and restructuring in order to improve their balance sheets. On the other hand, the government’s balance sheet would not get a high rating since all of its cash flow is from borrowing.

The deterioration in the Federal government’s balance sheet has contributed to global currency arbitrage and concern about how the U.S. and other developed market countries will address the imbalances between spending, taxes and other sources of revenue.

During the third quarter, China surpassed Japan in terms of GDP and also in accumulated currency reserves; China’s foreign currency reserves currently approach \$2.5 trillion. There are only three currencies that have enough trading volume available to use for investment of reserves: the dollar, euro and yen. The problem with a weak currency is that it becomes unattractive as an investment. Chinese concern about the decline in the U.S. dollar since 2002, briefly interrupted by a flight to the dollar during the financial crisis, led them to diversify into euro, but just before the Southern European debt crisis produced a sharp drop in the euro. In the latest quarter, the Chinese have been aggressive buyers of

yen, pushing its value to the highest level in 15 years relative to the U.S. dollar. This prompted the first Japanese government currency intervention since 1994. The yen has been the least attractive developed country currency because of the low interest rates on its government bonds. However, the difference has narrowed as shown in Table I below.

Table I	10-Year Government Bond Yields %		
	Japan	U.S.	Euro
12/31/1999	1.7	6.4	5.4
12/31/2002	0.9	3.8	4.2
12/31/2007	1.5	4.0	4.3
03/31/2009	1.4	2.7	3.0
09/30/2010	0.9	2.5	2.3

Source: Bloomberg

A weak dollar may help U.S. exports, but it will either be inflationary or, as appears to be the case so far, compress margins. To avoid loss of market share, sellers of imported goods often do not raise prices to reflect higher costs caused by currency weakness. But, the last time the dollar was very weak, the Chinese stockpiled oil, which is priced in dollars, and drove up prices for all buyers.

Congress is calling on the Administration to label China a currency manipulator and China is telling Americans to spend less if we want smaller deficits. Tensions surrounding trade and currencies are mounting, raising the specter of competitive devaluations, protectionist measures and trade wars, none of which are good for financial markets and will not solve trade and federal deficits.

Regulation

To get a sense of the sweeping nature of recent regulatory developments and their potential impact on investors and the market, consider four important areas of uncertainty:

- 1) Under Frank-Dodd legislation, which was designed to address the problems in the financial system that led to the crisis, the SEC is required to conduct 17 studies and issue 95 new or modified rules. No timetable has been set and the SEC lacks the personnel and financial resources to tackle all of these tasks.
- 2) Frank-Dodd appears to have created concern among the leading bankers who contribute their expertise on the Federal Reserve Board. In question is their continued ability to serve in this role because of prohibitions regarding conflicts of interest and new fiduciary standards. Loss of their expertise could be detrimental to the smooth operation of the key Federal Open Market Committee that conducts day-to-day monetary policy for the Fed.
- 3) The newly created Consumer Financial Protection Bureau (CFPB) will operate within the Federal Reserve but have its own budget and virtually no oversight. While appointment of the director requires Senate consent, the director can only be removed for cause. Rather than endure an anticipated political fight with the Senate, the President appointed Elizabeth Warren as interim head which allows the CFPB's rule making to begin.
- 4) The FDIC announced on September 27 that it will defer issuing its rules for the orderly unwinding of large, systemically important financial institutions in order to coordinate its rules with other agencies.

Regulation from outside U.S. adds to uncertainty

In order to reduce the possibility of another global financial system crisis, financial regulators and political leaders from around the world agreed to the Basel III rules for capital

adequacy of global financial institutions. At this meeting, they agreed to forestall the deadlines for implementation until 2015-19.

Most major U.S. financial institutions actually already meet the less stringent-than-expected requirements. European members pressured the commission for leniency because some of their major financial institutions are more challenged and need time to raise capital and improve operations. We do not know to what extent the new rules will affect bank profitability, only that more capital/less leverage will reduce it.

There are also important issues winding their way through the judicial system that could have important consequences for investors and markets. The courts are currently coping with questions surrounding personal bankruptcy and loan modifications. Until financial institutions and consumers are able to discern the value of housing related loans and assets on their balance sheets, neither bank lending to consumers nor consumer spending are likely to recover.

The outcome of these changes in regulation may have a disproportionate effect on the financial sector and markets

overall. Financial sector profits grew to almost 40% of total corporate profits at the peak and are in the process of recovering to perhaps 20% of the total. Future profit growth will likely come from other sectors. Because financial institutions face heightened uncertainty surrounding future operating costs, managements are reviewing business lines to decide where to focus, what to divest and perhaps what to acquire. As examples, Citigroup recently announced the sale of its student loan business to Discover and a number of large, regional bank holding companies are acquiring all or parts of other banks. Out of adversity often comes investment opportunity.

Strategy Considerations

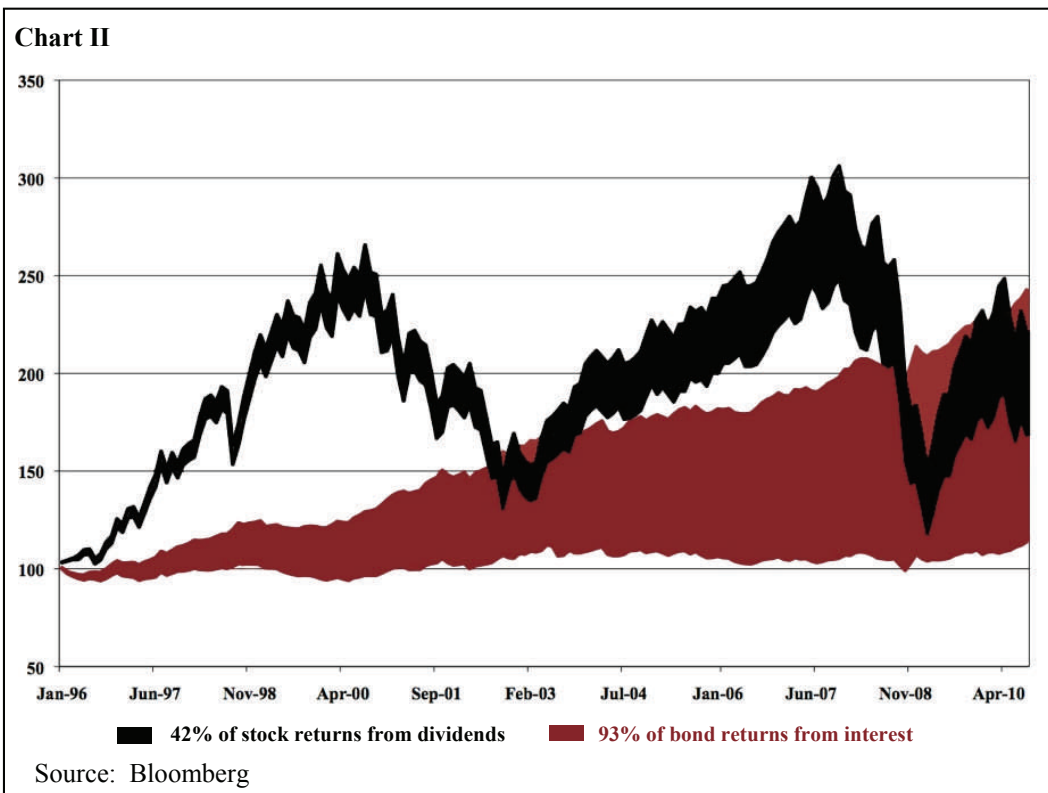
The three central long-term policy issues discussed above affect the federal budget, the cost of capital for government and the private sector, and the valuation of the dollar and of financial assets. Unless federal spending (25% of GDP) can be brought down and revenues (20% of GDP) increased, the value of the U.S. dollar may be in a long-term decline. Eventually this will lead to higher interest rates as foreign investors demand a higher return to compensate for currency depreciation.

Yes, the U.S. dollar remains the reserve currency, but that will only continue if the rest of the world believes we can and will put our fiscal situation back in order, even if it takes a decade to do so. The prospect of higher interest rates in the future and all of the near- and long-term economic and government policy uncertainties is not an envi-

ronment that leads to higher price/earnings ratios (P/Es). The best we should expect from stocks is the return from dividends and price appreciation in-line with earnings growth.

Current return in the form of income has always been central to total return, not only for bonds but also for stocks, as shown in Chart II below. In our view, current income remains essential today. This leads us to consider higher yielding corporate, municipal and foreign bonds rather than U.S. government bonds, and to higher yielding common stocks, some with better yields than those of bonds and with the prospect of increasing dividends.

Because we wish to preserve principal, as well as earn a return on it, investment management is as important as ever. We focus attention on funds and managers with extensive internal research and a commitment to a philosophy and process with proven success. As always, portfolio management requires discipline, the agility to respond to ever changing circumstances and a long-term orientation to make reasonable judgments about today's prices and tomorrow's values.



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