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2012 Third Quarter Review
"QE to Infinity….and Beyond!"

Now that the first Presidential debate has taken place, we can all amuse ourselves by watching as various parties furiously put their spin on every nuance, tic, and utterance between now and the election. Political pundits will understandably chew on every new development, but many economic pundits too will expend enormous amounts of time and energy trying to decide which candidate is going to win and how that will affect financial markets. It is more often said that a Romney victory would be beneficial for stocks since he is considered more "business friendly" and the stock-owning class stands to gain the most from reduced tax rates. Specific industries such as coal and oil might benefit from reduced regulation. Others claim that certain healthcare stocks would benefit by an Obama victory and the implementation of "Obamacare." Unfortunately, we can't know the outcome until the announcement of the winner after November 6th. However it may very well be that the September 13th announcement of the third round of "quantitative easing" (dubbed QE3) by Mr. Bernanke and the Federal Reserve was more important to the short-term fate of the financial markets than the outcome of the presidential election. For the first time, the Fed has taken that stand that they will continue to "intervene" in the markets by buying securities (specifically mortgage-backed bonds) and they will do so with no constraints as to time or amount. Thus, the operation has come to be called "QE Infinity" by many, especially those who like the idea of markets finding their price levels without being propped up by a government program. If this intervention doesn't get the economy moving, Mr. Bernanke may have to call on Buzz Lightyear to launch "QE3 to Infinity and Beyond!" Whatever the long-term costs may be (staglation?), the short-term affect of QE3 has been to pump money into the system and to encourage buyers of stock.

As we often need to remind ourselves, financial markets tend to move ahead of events. Thus, stocks often bottom several months before the data arrives signaling the end of a recession and often begin to decline in a similar fashion ahead of the data on economic downturns. Although the second quarter was a tough one for stocks, the market started to rally in early June and continued through the end of September, producing a 5.75% quarterly gain for the S&P and the best quarter for stocks in some time. In hindsight, the move appears to have anticipated a surprisingly accommodative change in the Federal Reserve's policy. By the end of September, the Dow Jones Industrials had gained 9.98% for the year while the bond market, as represented by the Barclay's 20-Year Treasury Bond ETF had gained only 2.45%. It has been our opinion that, given the predilections of the current Federal Reserve Board, stocks would be a better place to invest than bonds, and the recent performance seems to be confirming that theory.

One economic pundit that you may have heard of is Dr. Nouriel Roubini. He famously forecast the beginning of the financial crisis in 2007-2008. He also almost-as-famously forecast that the stock market would collapse in March of 2009, even though it promptly began a historic rally. His views have been so dour that he is now also known as "Dr. Doom." Although he has been repeatedly wrong on his forecasts of the markets' direction, he recently made an interesting observation regarding the state of the world's economies and why the Fed may have instituted QE3:

We're in the process of very painful deleveraging in advanced economies. We started the crisis with too much private debt and now we have too much public debt and deficits. Research suggests that usually a deleveraging cycle can last up to a decade. The crisis began in 2007, now we are in 2012 and therefore the process of deleveraging in the United States, in the euro zone, in the U.K. and Japan is barely mid-stream. In the U.S. we postponed the deleveraging of the public sector and the housing sector, and therefore, economic growth is anemic. Therefore, the only thing we can do, given we don't have the fiscal tool, is use the monetary policy.

Translation: "Quantitative easing (creating money) is the only trick they have left and they're going to use it for all it's worth."

We have only two realistic choices for President, and the Fed may be down to one choice on policy, but we are fortunate to have a very wide number of candidates to choose from when making investments. Our thesis has been that high-quality, high-yielding stocks would pay better than bonds or money markets, that equities of large-multinational corporations would be safer than the "sovereign debt" of many countries, and that, if the economies of the world weakened, the U.S. markets would still be "the best house in a bad neighborhood." So far, that has been working out reasonably well. Recently we have seen value in a number of new investments that we hope to hold for years and for large gains, including Corning Glass, Avon Products, and AIG. All three, and particularly the last two, are companies whose stocks look cheap because of investor skepticism. While most amateur investors clamor to own the currently popular companies, Jim Grant explains why that may not be good investment practice:

Pride goeth before a fall -- also publicity, handshakes and celebrity. The biblical injunction about the first and the last trading places often has literal truth. Thus, stocks and bonds, which fared poorly in the inflationary 1970s, excelled in the disinflationary 1980s. The country's most admired companies (as listed annually in the glossy business magazines) are frequently on their way to becoming among the country's least admired investments. When a cynical investor hears that there are too many optimists in the market, he will begin to worry. By the same token, an over-abundance of pessimists will give him courage. After all, he may ask, if everyone is already bearish, who is left to sell?

General pessimism toward an investment can create the opportunity to buy cheaply, popularity can buoy an investment, and euphoria often presents an excellent time to sell. We will continue to monitor the mindset of "Mr. Market" through the price changes and try to take advantage of his "mood swings" for our benefit.

Enclosed are your account reports and statements. Please review them at your leisure and give us a call with any questions or suggestions you may have. Good luck to us all on Nov. 6th!

Best regards,

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