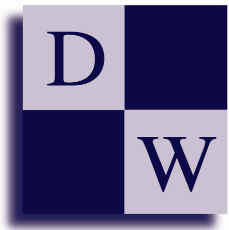

Dunn Warren Investment Advisors, LLC

The Portfolio Reporter

Mike Carr, CMT
James Cornehlsen, CFA
6143 S. Willow Dr. Ste.102
Greenwood Village, CO 80111
Phone: 800-793-4866
www.dunnwarren.com

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Printing Money - Benefit or Drag

The day after the election, Wednesday, November 3rd, the Federal Reserve (The Fed) announced the purchase of $600 billion long-term treasury securities (U.S. government bonds.) Since the market started moving higher in August when rumors began to circulate that this would occur, we thought we would detail out the implications. First, we will discuss what The Fed's purchase means (this purchase is also known as the QE2 or the second round of quantitative easing). Second, we will discuss the overall implications of the QE2 to the economy and business cycle. Third, we will discuss changes to the portfolios.

The Fed's announcement in November did not cause us to change our investment selection. However, the announcement did confirm what we had already been seeing in our economic market indicator: that the government would need to increase money supply in hopes of energizing the economy to grow more quickly. Specifically, more money acts like adding oil to a bicycle chain - it loosens everything up to move more smoothly through the gears. Therefore, it reaffirmed our decision to take the hedge off in August by selling inverse funds[1] in accounts we could hold them in, and buying more emerging market securities at this time.

The Fed is now targeting 10-year government bonds to keep broader interest rates lower. The implication is that housing and small business loans have a lower interest rate. However, this will also help lower the demand for the US dollar, which results in a lower price for the US dollar. If the price of the US dollar falls, then the total cost of exports, goods that are sold to other countries, may look more attractive.

The US government is trying all it can to make sure banks have all the money they want, so they will lend. If banks lend, then people may be interested in doing more with the money at their disposal. However, the problem in the US is not liquidity. The problem is we need to pay down excess debt that has accumulated over 30 years. Second, prices for homes, property, bonds, and equities need to fall to a level that is worth buying. At current prices, the future returns over 10 years are not going to benefit investors to take on additional risk.

Given the higher level of risk in the stock market, investors are settling for the relative safety of government bonds. This means that investors want less risk and will settle for 1-2% returns for the foreseeable future.

The Fed has overstepped its usefulness. The Fed acts as a stopgap in scary times to provide liquidity when no one else is willing to take action. However, over the last 50 years the government has injected more money into the system without taking money out of the economy when times are better. This means more money chasing after few things. Another way to look at it is slicing up a pizza. If you have a large pizza, you can slice it into 8 slices or 16 slices. Either way, you have the same amount of pizza, just different sized slices. Overall, you are not any better off for having more slices. In this manner, each additional US dollar represents less real tangible assets per US dollar.

Previously the money in circulation represented a fixed amount of something. Historically, this could be any number of things but normally was backed by gold. The US last went off the gold standard in 1973. The impetus to do this was the belief that the government could print more money when the economy slowed down or went into a recession. But government officials were not willing to turn off the tap. They continued

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to print more money.

So the tap has continued to run. We keep slicing the pizza into smaller slices, but we aren't making any more pizza.

Why have we taken the time to explain all of this? Because the Fed's actions are an effort to keep bond, home, and stock prices higher. However, without underlying demand, prices are only artificially propped higher and risk a decline when the tap runs dry. Once it is revealed that behind the money supply curtain there is no real underlying demand or growth driver, prices will fall to a normal level. In this case the stock market is overvalued by 20-30% based on the current price of the S&P 500 (an index representing some of the largest companies in the United states) relative to the average earnings over the last 10 years, or the q ratio, which represents the price of the total stock market (think Wilshire 5000) divided by the price to replace an existing good, car, factory, etcetera.

In history when prices have gotten too high, it has taken years for the underlying growth of the economy and subsequent earnings to catch up to the market. It also historically caused a correction in the price of the market to align with the rewards and risk people were willing to take to make a new investment.

For a better discussion of this, you can read *The Little Book of Sideways Markets: How to Make Money in Markets that Go Nowhere*, by *Vitaliy Katsenelson*. Specifically, he notes that sideways markets, such as we have had since 1998, are a result of prices that are just too high, and it takes years to grow out of them (or as he explains, for the market to correct into them.)

As for the positioning of the portfolios, we like international investments. First, if the US government wants to debase (lower the value of our currency) then we will invest in countries where there is real growth, where a. the currency is increasing, and b. there is real demand and growth for infrastructure. Specifically, emerging markets such as Singapore, Malaysia and Turkey provide relatively low valuations, good economic growth and a solid foundation of expanding infrastructure.

Currently, we see a secular outlook that includes growth at a low pace. If however our economic indicator has slower growth or goes negative, this would result in us changing our portfolio position to become more conservative, meaning we would take market risk out of the portfolios. While we can't say when this will happen, we certainly need to be concerned that a slowdown in the trajectory of the economy has its impact on the stock market.

Notes

1) Inverse funds move in the opposite direction of the market or underlying securities they represent. If the underlying security increases in value, the inverse fund decreases in value, and vice versa.

Please feel free to pass "The Portfolio Reporter" to interested friends and family members. For more information about your investments, please contact your financial professional.

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MONTHLY CONFERENCE CALL

Our next monthly conference call will occur Thursday, December 16th at 11 a.m. Mountain Time (1 p.m. EST).

Phone Number: 866-740-1260

Access Code: 4682824

To view slides on the internet during the call, go to www.readytalk.com **and enter 4682824 under "Join a Meeting".**

HOLIDAY BUSINESS HOURS

We will have limited business hours of 8:30 a.m. – 12:30 p.m. Mountain Time (10:30 a.m.–2:30 p.m. EST) from Monday, December 27 – Friday, December 31. If you need assistance during this time, please contact our office at 303-468-2824 or Toll Free at 877-491-7514.