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Q3 2010 Review and Commentary

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"All the perplexities, confusion, and distress in America arise, not from defects in their constitution or confederation, not from want of honor or virtue, so much as from the downright ignorance of the nature of coin, credit, and circulation." - John Adams (1735-1826), second President of the United States

Printing Our Way to Prosperity

Surviving the Brave New World of Perpetual QE

Charles B. Atwill, CFP®

DON'T LET THE COMPLICATED jargon fool you. Quantitative easing ("QE") is not some newly invented monetary panacea. It has been tried again and again by spendthrift nations throughout history. The past is littered with defunct paper currency systems of countries that employed QE schemes as a last resort to fund deficit spending.

While the details of how the Federal Reserve Bank of New York implements its electronic QE (through the primary dealer system) are somewhat arcane, the end result is very simple to understand. QE is an *increase* in the *quantity* of dollars that *devalues* our currency. More supply of dollars = less purchasing power. And despite what the central planners at the Fed intend, there is nothing "orderly" about the devaluation process in the real world. It is fraught with enormous economic, social, and geo-political risks.

On August 10th and November 3rd, the Federal Reserve commenced its second round of QE operations--dubbed "QE2 Lite" and "QE2"--ostensibly done to drive interest rates lower, fund excessive deficits, and stimulate the deteriorating economy through the "wealth effect" (inflating asset prices). The Fed's stated objective is to inject nearly **$900 billion** more into our economy through June 2011 (an estimated $250 billion in proceeds from maturing securities acquired during the inaugural round of QE that ended March 31, 2010, plus $600 billion in freshly printed dollars from QE2) by buying U.S. Treasury debt.

This benign façade of "stimulating the economy" via debt monetization masks what more global investors are now waking up to: **the United States is functionally bankrupt.**

The only entity that will buy the bulk of our sovereign debt at current (artificially) low interest rates is our own central bank--the Federal Reserve--using money printed out of thin air.

This is a MAJOR negative turning point for the United States as the world's superpower tasked with managing the international value of the global reserve currency. We cannot emphasize the significance of this event enough!

In a world where annual multi-trillion dollar federal budget deficits seem to draw far less attention than the latest episode of *Dancing with the Stars*, it's no surprise that we've come to this point. The collective mind of the body politic is numbed by the complexity and sheer size of the fiscal problems we now face as a nation. Yet, the incomprehensibility and intractable nature of these problems does not make them go away or make the economic effects any less material to our daily lives.

Our goal in writing about this serious topic each quarter and having frank planning discussions with clients is not to shout "Fire!" in a crowded theater. Rather, our guiding mandate as an investment advisory firm is to protect and grow our clients' standard of living in "real" (inflation-adjusted) terms through changing market cycles over time.

No single global macroeconomic factor that we have identified poses a more clear and present danger to U.S. savers, consumers, retirees, and investors than the ongoing devaluation of the U.S. dollar. A continuation of monetary

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and fiscal policies designed to keep kicking an underlying debt problem down the road appears to be leading us directly towards a perpetual state of QE. What we need is a system-wide restructuring of our entire debt-based service economy. What we are getting is more of the same fiscal irresponsibility that got us here in the first place.

As we have emphasized in our past commentaries, global investors are demonstrating an increasing loss of confidence in the integrity of the U.S. dollar as a currency. We are now seeing things start to become even more unstable in the plumbing of the banking system and financial markets that we monitor on a daily basis—particularly in the $2.8 trillion U.S. municipal bond market.

Based on our research and analysis, we consider QE2 to be a clear warning signal that we are being ushered as a sovereign nation into a more perilous phase of the global financial crisis.

Our Concerns

A currency (such as the U.S. dollar) that is used as money in an economic system is supposed to serve as:

1. a medium of exchange;
2. a unit of account; and
3. a store of value

When the currency ceases to adequately perform any one of these critical functions, its value to the holder diminishes. Prices and interest rates used to make economic decisions regarding production and consumption become distorted.

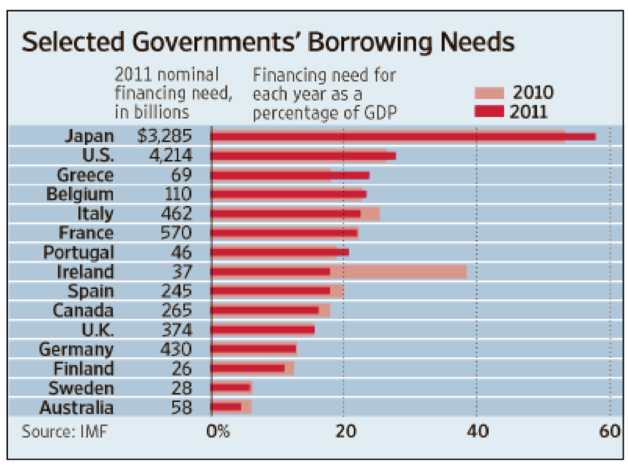
The more "benign" form of currency depreciation manifests itself in the *gradual* rise in prices of goods and services over time, as has been the case with the U.S. dollar. When confidence in a currency's utility as a store of value is lost quickly, it can translate into a more vicious inflationary spiral with collapsing bond markets and spiking interest rates. Historically, these events have been associated with hyperinflations in less developed countries of Africa, Eastern Europe, and Latin America. **This year we are witnessing the same basic economic dynamic begin to unfold concurrently in Japan, the U.K., Iceland, Portugal, Italy, Ireland, Greece, Spain, and now...the United States.**

What many people find confusing is that housing prices and wages may be *falling*, while prices for basic necessities like food and energy are *rising*. This is largely due to the fact that what we import costs us more and commodities are being sought for capital preservation on a global basis as the dollar weakens. QE has the effect of undermining the "store of value" component of a currency. This currency induced phenomenon is also known as "cost-push inflation". We believe this is something we will all be experiencing much more of in the near future, particularly for those who buy food, use electricity, and fuel their cars.

With no end in sight to state and federal budget deficits, bank failures, and mortgage/real estate market problems (i.e., "Foreclosuregate") requiring even *more* QE, it's not a stretch to think that major holders of the U.S. dollar might, *en masse*, seek refuge in a better store of value. The U.S is, in fact, now "borrowing" heavily from the privilege of being the issuer of the world's reserve currency.

Far from being a U.S.-only occurrence, money-printing is accelerating globally at a frightening pace in Europe, the U.K, and Japan. With literally nothing backing any of these currencies other than declining "faith and confidence" amidst worsening fiscal conditions, it's no surprise that the market values of scarce physical assets like gold, silver, and oil, are rising relative to devalued paper ones.

According to the **Wall Street Journal**, the 15 major developed countries will need to borrow a combined **$10.2 trillion in 2011** to repay maturing debt and fund deficits:



When we start to see global protests demanding a *return* to fiscal sanity through radical austerity measures rather than current popular outrage *against* austerity, we will adapt our strategy accordingly. Until then, we will continue to invest for the brave new world of deficit spending, perpetual QE, and the economic consequences.

The *AFCG Absolute Return Models* are based on a "Core and Explore" strategy employing a tactical asset allocation.

- The **Core** element functions as the more stable, income-oriented foundation of the portfolio with inflation protection.
- The **Explore** element focuses on capital appreciation, providing scalable exposure to more growth-oriented assets.

AFCG Absolute Return Models November 2010

		Target Allocations by Model		
	Asset Class	Pre-Retirement	Balanced	Retirement
Core	Cash / Money Market	23%	10%	15%
	Gold / Silver Bullion Fund	18%	18%	23%
	World Bonds	0%	15%	30%
	Allocation Funds	0%	15%	25%
	Rising Rates Fund	15%	10%	7%
	Subtotal	*56%*	*68%*	*100%*
Explore	Global Resource Equities Global Energy Equities Gold Mining Equities Global Agriculture Equities	44%	32%	0%
	Subtotal	*44%*	*32%*	*0%*
	Total	**100%**	**100%**	**100%**

Economic and Capital Markets Outlook

Justin D. Harris, AAMS®

In our **Q2 2010 Review and Commentary**, we expressed concern that the Federal Reserve would likely be forced to initiate a second round of QE to continue to bail out the ailing U.S. financial system. On November 3rd, this extraordinary monetary policy action of printing money to monetize U.S. Treasury debt was formally unleashed on the markets.

As one would expect, the global response to QE2 from our trading partners awash in devalued U.S. dollars and U.S. bonds has not been encouraging. Debt monetization is a very dangerous path for any central bank to follow. It has been attempted repeatedly over the course of history by insolvent empires and third world countries with disastrous economic results.

The well-documented consequences of debt monetization include:

- Global monetary instability
- Competitive currency devaluations among trading partners ("beggar-thy-neighbor" policy)
- Trade wars via tariffs and legislated protectionism
- Extreme volatility across global financial markets being chronically distorted by QE
- Collapsing bond markets and rising interest rates
- Cost-push inflation in prices of essential goods
- Global flights of capital into hard assets and tangible goods for safety and wealth preservation
- Hyperinflation as central banks and policymakers become trapped in a downward spiral of QE
- Geo-political tensions between debtor nations and creditor nations

If QE2 is starting to sound like very bad monetary policy, it's because it is. And we are by no means alone in our assessment (**see following pages**). Fortunately, we have been preparing client portfolios over the past few years for this significant monetary tipping point.

AFCG's Investment Strategy

Our core strategy to protect client accounts from growing financial market and monetary instability has been to accumulate and blend investments in the following six asset classes within our asset allocation models (as appropriate for each client):

1. Global Hard Asset Stocks through select sector mutual funds and shares of individual companies engaged in the mining, exploration/development, and/or production of gold, silver, oil, natural gas, coal, uranium, energy services, agricultural resources, and key industrial metals including rare earth elements.

Our general approach to investing in equities as an asset class is to concentrate in smaller market cap stocks (and mutual funds that pursue an "all-cap" objective) in order

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Economic and Capital Markets Outlook *(continued)*

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to "buy down the food chain" and own attractive acquisition targets. Large, multi-national companies and our foreign creditors (e.g., China) flush with cash continue to strategically acquire smaller, undervalued companies around the world that own assets in resource-rich regions including Africa, Australia, Canada, and Latin America.

These larger companies and sovereign entities have been paying hefty premiums to market values in order to ensure current and future access to in-ground reserves and production streams of critical natural resources. We continue to implement this approach as our preferred way to invest in equity sectors that benefit most from fundamental tailwinds generated by the declining U.S. dollar trend.

2. World Bond Funds with an unconstrained, "go-anywhere" total return mandate to invest broadly outside of the U.S. bond market for higher yields, manage interest rate risk with short to intermediate-term bond portfolios, and use tactical non-dollar currency exposure for protection against the devaluation of the U.S. dollar.

3. Allocation Funds with an absolute return objective to actively manage market volatility and invest globally across multiple assets classes (stocks, bonds, currencies, and commodities) for varied sources of capital appreciation, income, and inflation protection.

4. Rising Interest Rates Fund for protection against growing geo-political risk negatively affecting the U.S. bond market and a potential spike in interest rates on long-term U.S. Treasury bonds.

5. Cash/Cash Equivalents for liquidity, periodic rebalancing, and additional portfolio stability.

6. Precious Metals Bullion Fund that owns physical gold/silver (currently in a 50/50 ratio) on an insured, audited, allocated, and segregated basis in an underground vault in a major Canadian bank.

Overall, we continue to rely on our tactical asset allocation strategy for clients to 1) mitigate extreme portfolio volatility and 2) provide diversified sources of total return potential from the primary trend we are positioned for--an inflationary decline of the U.S. dollar.

We anticipate an escalation of this trend as currency induced cost-push inflation continues to develop into a global occurrence. We plan to maintain our focus on managing heightened financial risks through our asset allocation strategy into 2011.

Unless we begin to see a 180-degree change in currently entrenched monetary, fiscal, geo-political, and demographic trends, we believe that market forces will continue to exert significant downward pressure on the value of the U.S. dollar. This is a very *bullish* factor for select non-U.S. investments and inflation-sensitive hard assets. It is a very *bearish* factor for cash, bonds, and other fixed income securities denominated in U.S. dollars earning negative interest rates when adjusted for a real-world inflation rate.

QE2 and the Global Response

We are aware that the direct tone of our quarterly commentary may strike some readers as hyperbole. We feel it is important to share a collection of comments made recently by some of the most respected minds in the economics profession and investment business regarding QE and the U.S. fiscal predicament (**see below and following pages**).

We have to make daily asset allocation and investment decisions based on the reality of the financial situation as it now stands. Decades of shortsighted (and bi-partisan) governmental policies have compounded into a global economic crisis now confronting the U.S. dollar fiat currency regime in effect since 1971. Our judgment is that the dollar standard has reached its terminal phase. To us, managing investments for this overriding financial risk factor is a top priority. Also, we believe it is our job to include and disseminate important economic information that we routinely collect, and trust that it helps shed additional light on the extreme nature of ongoing monetary events.

First, we turn to the manager of the world's largest bond fund and PIMCO's bond expert, Bill Gross, who recently (and shockingly) wrote the following about QE in his November outlook entitled **"Run Turkey, Run"**:

> "**Checkwriting in the trillions in not a bondholder's friend; it is in fact inflationary, and, if truth be told, somewhat of a Ponzi scheme. Public debt, actually, has always had a Ponzi-like characteristic…**
>
> One and one-half trillion in checks were written in 2009, and trillions more lie ahead. The Fed, in effect, is telling the markets not to worry about our fiscal deficits, it will be the buyer of first and perhaps last resort. There is no need - as with Charles Ponzi - to find an increasing amount of future gullibles, they will just write the check themselves. I ask you: Has there ever been a Ponzi scheme so brazen? There has not. This one is so unique that it requires a new name. I call it a Sammy scheme, in honor of Uncle Sam and the politicians (as well as its citizens) who have brought us to this critical moment in time. It is not a Bernanke scheme, because this is his only alternative and he shares no responsibility for its origin. It is a Sammy scheme - you and I, and the politicians that we elect every two years - deserve all the blame. "

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Economic and Capital Markets Outlook (continued)

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Next, in the same spirit of not beating around the bush when describing the U.S. financial situation, esteemed Boston University economics professor, deficit expert, and author of *The Coming Generational Storm*, Laurence Kotlikoff, wrote the following in a column for Bloomberg:

U.S. Is Bankrupt and We Don't Even Know It

August 10 (Bloomberg)--"Let's get real. The U.S. is bankrupt. Neither spending more nor taxing less will help the country pay its bills. What it can and must do is radically simplify its tax, health-care, retirement and financial systems, each of which is a complete mess. But this is the good news. It means they can each be redesigned to achieve their legitimate purposes at much lower cost and, in the process, revitalize the economy."

John Hathaway, a managing director of Tocqueville Asset Management LP in New York and manager of the $2.4 billion Tocqueville Gold Fund (a mutual fund we use in our investment models), provides expert commentary regarding the declining dollar:

Gold Will Outlive Dollar Once Slaughter Comes

October 28 (Bloomberg)--"The world's monetary system is in the process of melting down. We have entered the endgame for the dollar as the dominant reserve currency, but most investors and policy makers are unaware of the implications.

The only questions are how long the denouement of the dollar reserve system will last, and how much more damage will be inflicted by new rounds of quantitative easing or more radical monetary measures to prop up the system.

Whether prolonged or sudden, the transition to a stable monetary system will become possible only when the shortcomings of the status quo become unbearable. Such a transition is, by definition, nonlinear. So central-bank soothsaying based on the extrapolation of historical data and the repetition of conventional wisdom offers no guidance on what lies ahead.

It's amazing that there is no intelligent discourse among policy leaders on the subject of monetary rot and its implications for the future economic and political landscape. Until there is fundamental monetary reform on an international scale, most economic forecasts aren't worth the paper on which they are written."

Additionally, **twenty-three** leading economists, research analysts, political experts, and investment managers, jointly stated the following concerns in a letter published in The Wall Street Journal on November 15 regarding QE:

Open Letter to Ben Bernanke

"We believe the Federal Reserve's large-scale asset purchase plan (so-called "quantitative easing") should be reconsidered and discontinued. We do not believe such a plan is necessary or advisable under current circumstances. The planned asset purchases risk currency debasement and inflation, and we do not think they will achieve the Fed's objective of promoting employment.

We subscribe to your statement in the Washington Post on November 4 that "the Federal Reserve cannot solve all the economy's problems on its own." In this case, we think improvements in tax, spending and regulatory policies must take precedence in a national growth program, not further monetary stimulus.

We disagree with the view that inflation needs to be pushed higher, and worry that another round of asset purchases, with interest rates still near zero over a year into the recovery, will distort financial markets and greatly complicate future Fed efforts to normalize monetary policy.

The Fed's purchase program has also met broad opposition from other central banks and we share their concerns that quantitative easing by the Fed is neither warranted nor helpful in addressing either U.S. or global economic problems."

As the letter above appropriately concludes, global opposition to U.S. fiscal policy is growing. This further demonstrates the basic principle that no free lunch is obtainable by the Fed printing money:

Fed Global Backlash Grows

November 7 (The Wall Street Journal)—"Global controversy mounted over the Federal Reserve's decision to pump billions of dollars into the U.S. economy, with President Barack Obama defending the move as China, Russia and the euro zone added to a chorus of criticism.

Mr. Obama returned fire in the growing confrontation over trade and currencies Monday in a joint news conference with Indian Prime Minister Manmohan Singh, taking the unusual step of publicly backing the Fed's decision to buy $600 billion in U.S. Treasury bonds—a move that has come under withering international criticism for weakening the U.S. dollar."

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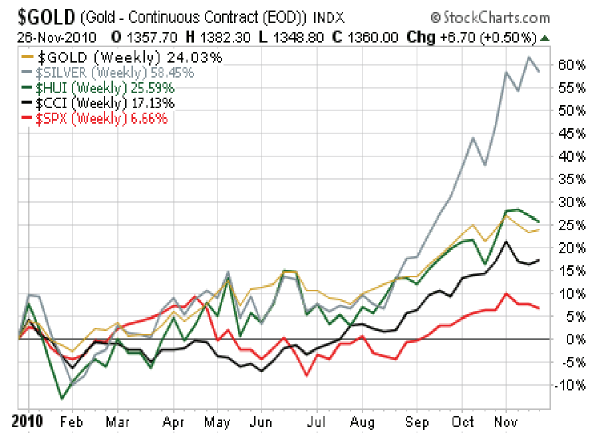
Our Conclusion

Our conclusion is straightforward. Money-printing is inherently inflationary and the values of real, tangible assets of more limited supply are rising to reflect this timeless economic law. The U.S. and other developed Western nations are on an unsustainable fiscal path and the economic chickens of thirty plus years of debt-based profligacy are now coming home to roost.

Below we include a snapshot of the year-to-date outperformance of gold, silver, gold/silver mining stocks, and commodities relative to the broad U.S. stock market.

Chart Symbol	*YTD Return (1/1 - 11/26)
Gold ($GOLD)	+ 24.03%
Silver ($Silver)	+ 58.45%
NYSE Arca Gold Stock Index ($HUI)	+ 25.59%
Continuous Commodity Index ($CCI)	+ 17.13%
S&P 500 Large Cap U.S. Stock Index ($SPX)	+ 6.66%

**Price only, excludes dividends*



Our view is that the fundamental forces driving the outperformance of hard assets as shown above are strongly intact going into the 2011-13 time period. These forces include currency devaluations via QE, deficit spending, geopolitical tensions, and negative real interest rates on U.S. debt instruments.

It appears that policymakers have once again opted for short-term remedies at the U.S. dollar's expense. As appropriate, we will continue to favor hard assets and select non-U.S. investments in more economically sound regions.

Sources:

1. Bloomberg (www.bloomberg.com)
2. Stockcharts (www.stockcharts.com)
3. The Wall Street Journal (www.online.wsj.com)
4. The Federal Reserve (www.federalreserve.gov)

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