



Q4 2009 Review and Commentary

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“When it comes to unwinding their massive monetary and fiscal easing, policymakers are damned if they do and damned if they don’t.”

- Nouriel Roubini, Professor of Economics - Stern School of Business at NYU

BETWEEN A ROCK AND A HARD PLACE

The Odyssey of Monetary Policy in a Brave New World

Charles B. Atwill, CFP®

IN HOMER’S EPIC TALE, *THE ODYSSEY*, two sea monsters, Scylla and Charybdis, were described to inhabit opposite sides of the Strait of Messina between modern day Sicily and Calabria. Scylla, fixed to one spot in the ocean, would regularly eat sailors if their ship approached too closely. On the other side of the strait lay Charybdis, depicted as having a single gaping mouth that would draw in water and create giant whirlpools which destroyed any ships passing nearby.

As the myth goes, Odysseus was forced to decide which monster to challenge as he crossed the strait. He chose Scylla, reasoning that the loss of a few of his crew was preferable to the risk of losing his entire ship in a whirlpool. Fast forward a few thousand years, and we find an analogous situation in the real world circumstances faced by the Federal Reserve in 2009 and continuing into 2010.

Our Current Economic Odyssey: The Fed’s View

On one side of our economic strait we have a monster we’ll call *Inflation* (and its more nefarious extreme, *Hyperinflation*). It robs unsuspecting consumers, savers, and retirees by devaluing their dollars over time. In its “Hyper” form, this robbery can occur over a short time period as a currency rapidly collapses in value - destroying paper money

and battering the economic ship – leaving few survivors.

The other side of our strait is inhabited by the monster *Deflation*. This beast leaves in its wake declining stock markets, deflated asset bubbles, unpayable debts, failed financial institutions, and unhappy voters. In today’s economic orthodoxy, the swirling vortex of *Deflation* is likened to the whirlpool created by Charybdis, which the policymakers consider to be an existential threat to our economic survival. The Scylla-like monster, *Inflation*, according to mainstream economic theory, is considered to be the more “benign” and manageable of the two.

The Keynesian Prescription

The economist John Maynard Keynes (on whose theories much of the current economic policies are based), famously quipped, “In the long run, we are all dead.” His premise was essentially this: policymakers should take any central planning measure deemed necessary to try to “fix things” in the present and worry about the future later.

And that, in essence, is what policymakers are doing right now. On our current economic course—the policies of flooding the economy with newly created money, borrowing and spending recklessly, and providing “stimulus”—is intended, per Keynes’ prescription, to alleviate the pain temporarily, while we hope for the best when our economic future finally arrives. When it does eventually arrive (and we assume it will), what might the consequences of post-

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In this quarter’s Review & Commentary:

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poning the pain ultimately be?

Side Effects

Where we part company with the Fed’s view of these two monsters is in identifying which one poses the most fundamental danger to our longer term economic viability. While the immediate results of monetary inflation may appear to be curative, history tells us that the side effects of the supposed “cure” can end up being much worse than the disease itself.

As recently as the late 1970’s, U.S. policymakers attempted to arrest the economy from descending into a deep recession by implementing loose monetary policy and promoting enormous levels of deficit spending by the federal government. The result was a bout of *stagflation* (stagnant growth coupled with crippling inflation and high interest rates), which brought the country’s economy to its knees. Only after painful monetary tightening by Paul Volcker at the Federal Reserve—and the occurrence of a severe recession that the government had attempted to prevent—did the economy recover, and indeed, flourish.

Therein lies the quandary facing our monetary policy-makers: should we risk going through the whirlpool of *Deflation* by allowing the economy to contract to a sustainable (and more stable) size *or* do we try to inflate our way back to health and risk an entrenched stagflationary episode from which we may recover only at very high cost?

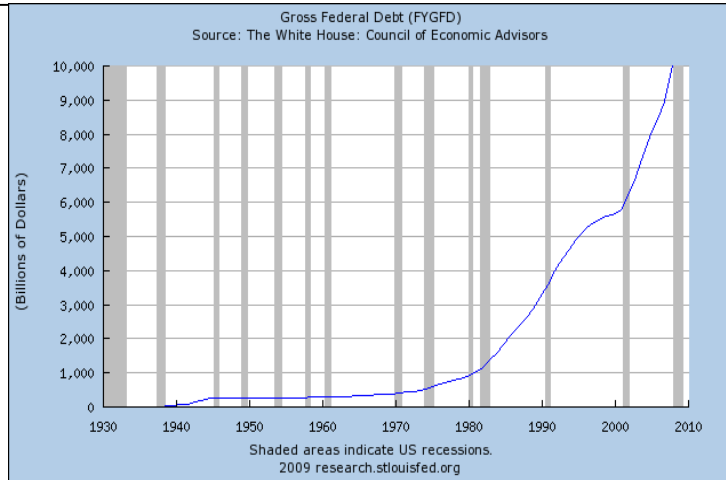
We’re From the Government - We’re Here to Help

Another character, *Homo Politicus*, may, in fact, have the last word in all of this. *Homo Politicus*, who happens to be chronically nearsighted (seeing no further than the next election), cannot stand the thought of campaign contributors and certain constituent groups facing *any* kind of temporary hardship. *Homo Politicus* would much rather take the chance of navigating past the Scylla, *Inflation*, even if it means the possible destruction of the entire crew and ship, rather than taking the path of immediate (but nevertheless *survivable*) pain associated with permitting a protracted economic contraction to bring systemic debt excesses back into balance (**see chart below**). Short of a fiscal and monetary policy “sea change”, we don’t see the latter happening anytime soon.

Climbing the Wall of Debt

Current U.S. Federal Debt:	\$12.3 Trillion
<u>Projected 2010 Federal Deficit:</u>	<u>+\$1.4 Trillion</u>
Projected FYE 2010 Federal Debt:	\$13.7 Trillion
Projected FYE 2015 Federal Debt:	\$20.0 Trillion

Source: White House Office of Management and Budget



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.
- The **Explore** element focuses on capital appreciation, providing scalable exposure to more growth-oriented assets.

AFCG Absolute Return Models January 2010

		Target Allocations by Model		
Asset Class		Growth	Balanced	Conservative
Core	Cash / Money Market	5%	15%	40%
	Gold / Silver Bullion Fund	15%	15%	15%
	World Bonds	7%	15%	20%
	Allocation Funds	8%	15%	20%
	Rising Rates Fund	15%	10%	5%
	Subtotal	50%	70%	100%
Explore	Global Resource Equities	50%	30%	0%
	Energy Equities			
	Gold Mining Equities			
	Global Agriculture Equities			
Subtotal	50%	30%	0%	
Total	100%	100%	100%	

Economic and Capital Markets Outlook

Justin D. Harris, AAMS®

IN REVIEWING THE SIGNIFICANT ECONOMIC EVENTS that occurred in 2009, we are again struck by the extreme nature and generational scale of actions taken by policymakers to continue intervening in the ailing global financial system. The official justification given for the unprecedented intrusion into the capital markets by central bankers, led by the U.S. Federal Reserve, was that a further extension of the “too big to fail” doctrine was desperately needed to backstop the collapsing financial, real estate, and automotive sectors as serious problems spilled over from 2008.

By mid March, the Fed announced that it would expand its balance sheet via an admitted “experimental” policy of “quantitative easing” (i.e., printing money out of thin air) to act as the buyer of last resort for ballooning U.S. treasury debt and toxic mortgage-backed securities festering in the banking system. Bloomberg.com described the Fed’s plan to further distort interest rates this way:

‘Rambo Fed’ Will Buy Treasuries to Combat Crisis

March 19 (Bloomberg) -- By committing to buy Treasuries and double his purchases of mortgage debt, Federal Reserve Chairman Ben S. Bernanke signaled his determination to avoid a repeat of the Great Depression and his willingness to pump as much cash into the economy as needed to end the crisis. U.S. central bankers decided yesterday to buy as much as \$300 billion of long-term Treasuries and more than double mortgage-debt purchases to \$1.45 trillion, aiming to lower home-loan and other interest rates. The Fed kept its main rate at almost zero and may keep it there.

The move sparked the biggest drop in 10-year Treasury yields since 1962, rallies in the stock market and gold and a plunge in the dollar against the Euro...with the purchases of Treasuries and housing debt, Bernanke is effectively using the Fed’s power to print money and aim it where he and other officials believe it will have the greatest impact in lowering borrowing costs.

As if the Fed’s official policy of devaluing the dollar by printing money wasn’t enough, the Financial Accounting Standards Board (FASB)—the designated private sector organization responsible for establishing standards of financial accounting governing the preparation of corporate financial statements—was strong-armed by Congress and financial institutions to give banks more accounting “leeway” in valuing toxic assets infecting their balance sheets:

FASB Eases Fair-Value Rules Amid Lawmaker Pressure

April 2 (Bloomberg) -- The Financial Accounting Standards Board, pressured by U.S. lawmakers and financial companies, voted to relax fair-value accounting rules that Citigroup Inc. and Wells Fargo & Co. say don’t work when markets are inactive.

Changes to fair-value, or mark-to-market accounting, approved by FASB today allow companies to use “significant” judgment in gauging prices of some investments on their books, including mortgage-backed securities. Analysts say the measure may reduce banks’ writedowns and boost net income. Firms could apply the changes to first-quarter results.

The accounting change enacted by FASB was *unofficially* termed by astute investors and pundits as “Extend and Pretend” to more accurately describe the coordinated effort of “too big to fail” banks, federal regulators, and Congress to officially sanction kicking the economy’s structural debt problem down the road into 2010 and beyond.

Essentially, FASB allowed financial institutions to “extend” (modify) the terms of existing troubled loans to try to preempt rising defaults and then “pretend” that real estate assets and mortgage-backed securities they owned were valued according to “significant judgment” (their own internal financial models) rather than lower market prices; thus helping them magically avoid having to recognize immediate losses.

Key Point: In 2009, enormous financial losses that should have been borne by the financial entities responsible for creating them were, instead, transferred to the U.S. government’s balance sheet and socialized among taxpayers, savers, dollar holders, and small businesses throughout the U.S. economy. Crucial price discovery necessary to cleanse the system of bad debts and overvalued assets and return the economy to a sustainable path forward was forestalled by more of the same monetary shenanigans that directly contributed to the crisis in the first place.

This official policy – the shifting of financial losses from “too big to fail” businesses to U.S. taxpayers and dollar holders around the world – is creating very elevated currency, interest rate, and geo-political risks in the global capital markets. As we wrote throughout 2009, economic policies emanating from the Fed and U.S. government are causing investors on a global scale to increasingly question the value and integrity of the world’s reserve currency—the U.S. dollar. This will continue to be a primary risk management focal point for the AFCG investment strategy in 2010.

Economic Lessons from 2009

From an investment standpoint, 2009 provided some very instructive examples of the real-world “cause and effect” relationship regarding the government’s unprecedented fiscal and monetary policies and how global market participants respond to them in order to protect themselves, financially.

This dynamic typically unfolds as follows: 1) the Fed prints money in reactionary crisis mode to keep interest rates arti-

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Economic and Capital Markets Outlook (continued)

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ficially low and serves as the lender of last resort to the banking system (the “cause”) and 2) global investors react by shunning riskier long-term U.S. treasury bonds and mortgage-backed securities causing interest rates to rise. At the same time, major dollar holders like China diversify out of paper dollars by purchasing tangible stores of wealth (hard assets) such as gold, silver, oil, copper, iron ore, and other critical natural resources causing prices to rise on the global markets (collectively, the “effect”).

One of the most significant market events in 2009 that aptly demonstrated this “cause and effect” occurred when the central bank of India upstaged China by purchasing half of the International Monetary Fund’s (IMF) gold sale at market prices averaging about \$1,045 per ounce:

India Buys IMF Gold to Boost Reserves as Dollar Drops

November 3 (Bloomberg) -- India, the world’s biggest gold consumer bought 200 metric tons from the International Monetary Fund for \$6.7 billion as central banks show increased interest in diversifying their holdings to protect against a slumping dollar...“the fall in the U.S. dollar seems to be pushing all the central banks to strengthen their portfolio with gold,” said N.R. Bhanumurthy, professor at the National Institute of Public Finance and Policy in New Delhi. “Gold is a safe store of value compared to the U.S. dollar”.

Importantly, China continued its decades-long natural resources buying spree by recycling its hoard of U.S. dollars from our trade deficit back into strategic purchases of undervalued energy and resource projects around the world.

Not only is China taking future world oil supply off of the market and diverting it to its own economy, it is exacerbating an already tenuous financial relationship with the U.S.— the world’s largest daily consumer of oil.

Two additional news headlines from 2009 offer telling insights regarding this growing geo-political trend as demand increases from emerging countries for a limited supply of global resources. As reported by Bloomberg.com:

PetroChina Agrees Biggest North America Acquisition

September 1 (Bloomberg) -- PetroChina Co. has agreed to pay C\$1.9 billion (US\$1.7 billion) for a stake in a Canadian oil sands project in its biggest North American acquisition, widening the search for energy resources overseas. China’s largest oil company will buy 60 percent of Athabasca Oil Sands Corp.’s Mackay River and Dover oil-sands projects, the Canadian company said in a statement yesterday...the transaction is part of the “long-term, strategic development of the company” PetroChina spokesman Mao Zefeng said today. The purchase is also the first time PetroChina has invested in an oil sands project in the continent.

China Railway Construction, Tongling in Corriente Bid

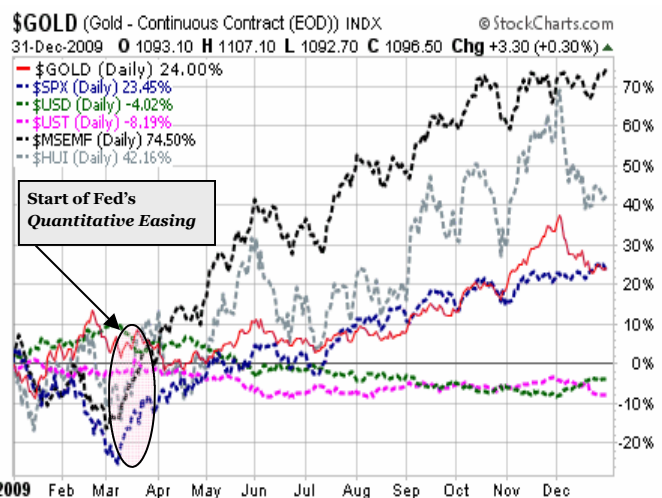
December 29 (Bloomberg): China Railway Construction Corp. and Tongling Nonferrous Metals Group Holdings Co. offered C\$679 million (\$653 million) for Canada’s Corriente Resources Inc. to gain copper resources in South America...China has been looking to secure raw materials to sustain the world’s fastest growing major economy, buying assets from iron-ore mines in Brazil to oil fields in Canada the past year. Overseas investment by Chinese companies surges almost threefold to \$20.5 billion in the third quarter from a year earlier, according to Ministry of Commerce. “It’s a trend for Chinese companies to acquire metal resources abroad to meet domestic demand,” Li Jingyuan, an analyst at Haitong Futures Co., said from Shanghai today. “Tongling needs copper raw materials because of its giant capacity and almost zero self-sufficiency.”

2009 Asset Class Performance

Global stock markets and most asset classes – with the notable exceptions of the U.S. dollar and longer term U.S. Treasury bonds – responded positively by May 2009 to money printing by the Fed and a flight to non-dollar assets and commodities (see charts below and on Page 5):

Asset Class (Chart Symbol)	*2009 Return
Gold (\$GOLD)	+ 24 %
S&P 500 Large Cap U.S. Stock Index (\$SPX)	+ 23%
U.S. Dollar Index (\$USD)	- 4%
10-Year U.S. Treasury Note (\$UST)	- 8%
Emerging Markets Stock Index (\$MSEMF)	+ 75%
NYSE Arca Gold Stock Index (\$HUI)	+ 42%

*Price only, excludes dividends

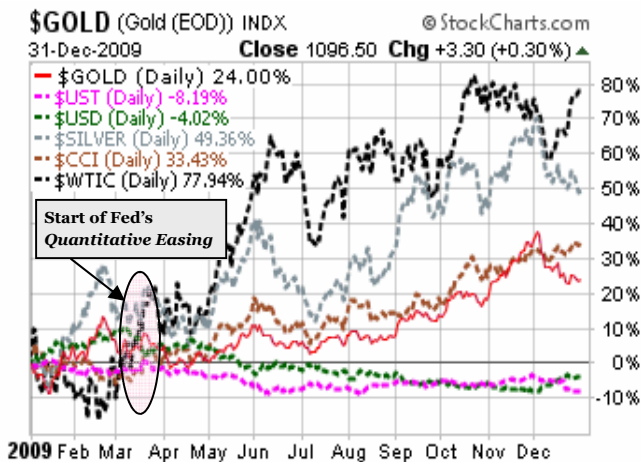


Economic and Capital Markets Outlook (continued)

If we take a more detailed look at gold, silver, oil, and a broad commodity index relative to the U.S. Dollar Index and the 10-Year U.S. Treasury note price, the inflationary effects of the Fed's actions become even more evident:

Asset Class (Chart Symbol)	*2009 Return
Gold (\$GOLD)	+ 24 %
10-Year U.S. Treasury Note (\$UST)	- 8%
U.S. Dollar Index (\$USD)	- 4%
Silver (\$SILVER)	+ 49%
Crude Oil (\$WTIC)	+ 78%
Continuous Commodity Index (\$CCI)	+ 33%

*Price only, excludes dividends



Capping off 2009 by Removing the Cap

In another *major* regulatory decision (released on Christmas Eve when many U.S. taxpayers were doing something other than thinking about being put on the hook for billions more in mortgage losses), the U.S. Treasury Department committed unlimited bailout funds to the government-sponsored enterprises and mortgage giants, Fannie Mae and Freddie Mac:

U.S. Treasury Ends Cap on Fannie, Freddie Lifeline for 3 Years

December 25 (Bloomberg) -- The U.S. Treasury Department will remove the caps on aid to Fannie Mae and Freddie Mac for the next three years, to allay investor concerns that the companies will exhaust the available government assistance. The two companies, the largest source of mortgage financing in the U.S., are currently under government conservatorship and have caps of \$200 billion each on backstop capital from the Treasury. Under a new agreement announced yesterday, these limits can rise as needed to

cover net worth losses through 2012. The Obama Administration is "beginning to realize it's not getting better and it's not likely to get better" soon in the housing market, said Julian Mann, who helps oversee \$5.5 billion in bonds as a vice president at First Pacific Advisors LLC in Los Angeles. **"They don't want the foreclosures now, so they're saying, we'll pay whatever it takes to continue to kick the can down the road."**

We could not have summarized it more precisely than Mr. Mann. "Kicking the can down the road" is a patently unsustainable strategy. The crux of the problem is this:

- Fannie Mae and Freddie Mac own or guarantee about \$5 trillion in mortgages—nearly half of the \$12+ trillion in home mortgages outstanding
- Between 2010 and 2012, a second wave of over \$1 trillion in Prime, Alt-A, and Option-ARM adjustable rate home mortgages originated during the housing bubble years are scheduled to re-set
- The Fed is supposed to be *ending* its initial round of \$1.45 trillion in purchases of mortgage-backed securities at the end of March 2010

Clearly, the U.S. Treasury Department views (as we certainly do) the looming mortgage re-sets as a tsunami of problem loans that will likely require billions more in taxpayer funded assistance due to losses. In fact, the Fed—despite talking about an exit strategy—may be forced to do the exact opposite and extend its mortgage purchase program beyond March 31, 2010, as conditions deteriorate.

Our best judgment—based on the facts, data, and research we have available—is that the above-described cap removal marks the end of the first phase of the financial crisis and signals the beginning of the second phase. As we witnessed in 2009, what is unfolding is not likely to be friendly to the value of the U.S. dollar over the next few years.

Investment Implications for 2010

We anticipate 2010 to be yet another year of economic consequences from the bursting real estate/credit bubble. Investors in the global stock, bond, and currency markets must again deal with the uncertainty caused by haphazard government intervention in the markets and highly experimental monetary policy being conducted by central banks.

As a result, we see two primary risks in the year ahead as the second phase of the crisis gets under way:

1. **Rising Interest Rate Risk.** After a year of record fiscal deficits in 2009, the outstanding U.S. public debt now stands at record \$12,319,326,469,724.43 as of

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January 15, 2010. The U.S. Treasury must issue over \$2 trillion in new debt to fund projected deficits for fiscal 2010 and refinance short-term treasury debt coming due over the next 12 months. Where is this money going to come from? Due to the overwhelming supply of new debt amidst waning global demand from natural buyers in the market, interest rate must eventually rise to reflect the reality of enormous supply/demand imbalances.

- 2. Inflation Risk.** Prices for daily necessities including food, healthcare, and energy continue to rise as a result of the declining U.S. dollar and rising global demand—particularly from emerging nations such as Brazil, India, and China. The more money the Fed is forced to print and the more the production of real goods declines due to the ongoing recession/credit crunch, the more prices will rise for an increasingly limited supplies of critical goods and resources.

Given these two risk factors, our overall investment strategy remains relatively unchanged from 2009. We continue to implement the following risk management strategies for client accounts:

- **Diversifying across the six asset classes** we currently use in our tactical asset allocation: Cash, Gold/Silver Bullion, World Bonds, Allocation Funds, Rising Rates Fund, and Global Equities.

- **Maintaining core exposure to a closed-end Gold/Silver Bullion Fund** for wealth insurance and protection against fiat currency debasement.
- **Limiting exposure to rising interest rates** by owning income-oriented World Bond funds that emphasize shorter term (low duration) bonds and allocate capital to bonds of non-U.S. issuers denominated in dollars and non-dollar currencies for diversification.
- **Accumulating additional exposure to Global Equities in the Energy, Agriculture, Mining, and Natural Resource** sectors—emphasizing small and mid cap companies—using individual stocks, mutual funds, and exchange-traded funds (ETFs).
- **Maintaining core exposure to a Rising Rates Fund** designed to go up in value as interest rates rise (bond prices fall) on long-term U.S. Treasury bonds.
- **Utilizing select actively managed Asset Allocation Funds** for diversifying sources of volatility management and total return potential (capital gains + income) within our model portfolios.

On a final note, we continue to update our web site www.afcglc.com and have added a number of links to other informative web sites and reference material posted on our “[Resources](#)” web page. We encourage readers to visit the site. We wish everyone the very best in 2010.

Sources:

1. Bloomberg (www.bloomberg.com)
2. Financial Times (www.ft.com)
3. Stockcharts (www.stockcharts.com)
4. Wall Street Journal (www.online.wsj.com)
5. Weiss Research (www.moneyandmarkets.com)
6. St. Louis Fed (www.stlouisfed.org)
7. Treasury Direct (www.treasurydirect.gov)

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Our Services

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- ◆ Qualified Retirement Plans
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For more information, please contact us for our brochure.

Contact Us

2924 Emerywood Parkway
Suite 100
Richmond, VA 23294

T: (804) 672-0040
Toll-free (888) 300-2517
F: (804) 672-2006
E-mail: info@afcglc.com
Web: www.afcglc.com