

The Blue Sheets®

The Financial Advantage, Inc. Ongoing Commentary On the Global Economy and Securities Markets

AUGUST 2010



To hear The Byrds' 1965 rendition of Eccl. 3:1-8, [click here](#).

To everything there is a season... *Eccl. 3:1-8*

In this much-loved passage from the Book of Ecclesiastes, King Solomon encourages patience in the conduct of our earthly affairs. He specifically recommends an unhurried attitude toward the accumulation of wealth.

The King's 2400 year-old reflections offer timeless wisdom and practical insights for our work of managing investments for families in this hurried and hectic 21st century. I am thinking especially of Solomon's idea that there are rhythms in the affairs of men that cannot be hurried and ought not be ignored... that seasons come and go in turn, and that each is appropriate for different purposes. In this issue of the Blue Sheets we'll reflect on the natural rhythms of the credit cycle. We'll try to understand how this cycle

influences our economic behavior and its implications for investment decisions. I can almost hear a whisper from across the centuries, "There is a time for borrowing... and a time to refrain from borrowing."

SUMMARY AND CONCLUSION

Before we examine the history of debt and offer our outlook for the credit cycle, here's a summary of our economic conclusions and investment strategy for the season ahead.

Regarding the economy For the last 30 years, world economic growth has been stimulated by an accelerating use of credit in Europe, Japan and America. We believe the accumulation of both private and government debt has reached a level that is unsustainable. In the last two years there have been continuous indications in the capital markets and the political arena that a downturn in the long credit cycle is imminent. Among the more prominent signs of credit exhaustion are: the collapse of housing both here and abroad, overt and covert bailouts of lending institutions on both sides of the Atlantic, and the recent push for government austerity in Europe. If it does turn out that the pleasant tailwind of credit expansion pivots into a stubborn headwind of credit contraction, we can expect a more turbulent economic environment going forward.

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Summary (continued)

Regarding investments Despite mounting evidence of a coming credit contraction, stock and bond markets are still priced for the steady growth we experienced during the long expansion phase of the credit cycle. As the reality of a sluggish, more erratic economy becomes widely recognized, we expect a “re-pricing of risk” in world securities markets, especially in the developed countries.

There is a good possibility that a downward adjustment in securities prices might happen rather suddenly. It could be provoked by a systemic event like the 2008 liquidity crisis, or by geo-political eruptions that inject fear into the pricing equation. And since stock market activity has come to be dominated by leveraged, trend-following trading strategies, a rising market could flip into a self-reinforcing downtrend in the blink of an eye!

Our first obligation is to protect our clients’ life savings against the wide range of economic and political disruptions that always accompany a credit cycle downturn. So, we have dialed down our stock market exposure and increased our emphasis on generating a stream of cash income to accommodate our clients’ spending requirements. Near-term returns might be uninspiring, but this is not the right season for adventurism. Every economic adjustment phase eventually ushers in a new season of opportunities, often quite different from those of

the past. We have already begun to seed the portfolios with the stocks of innovative companies that can adapt to a changing environment, and we are building a shopping list and conserving capital for the season when great businesses will once more be on sale.

Capitalism’s bountiful season of credit expansion is fading fast, and a natural and restorative season of adjustment is just beginning. As a farmer gathers his crops into the barns for the winter, pays off his fertilizer loans, repairs his equipment and makes plans for next spring’s planting; so we are preparing our clients’ portfolios for a credit winter and planning for the season of opportunity that will surely follow.

OUR LONG “SUMMER” OF GROWTH: 1980-1999

Until the 19th century, the prosperity of most cultures was largely dependent on their agricultural activities. Although farming is a much smaller part of contemporary industrial economies, our well-being is influenced by economic cycles just as surely as a farmer’s work is guided by nature’s seasons. The granddaddy of all economic cycles is the credit cycle. The availability and cost of credit are the barometer and thermometer of the modern global economy; they help us anticipate changes in the financial climate. And a soaring default rate warns us when we are late in the cycle. Attention to

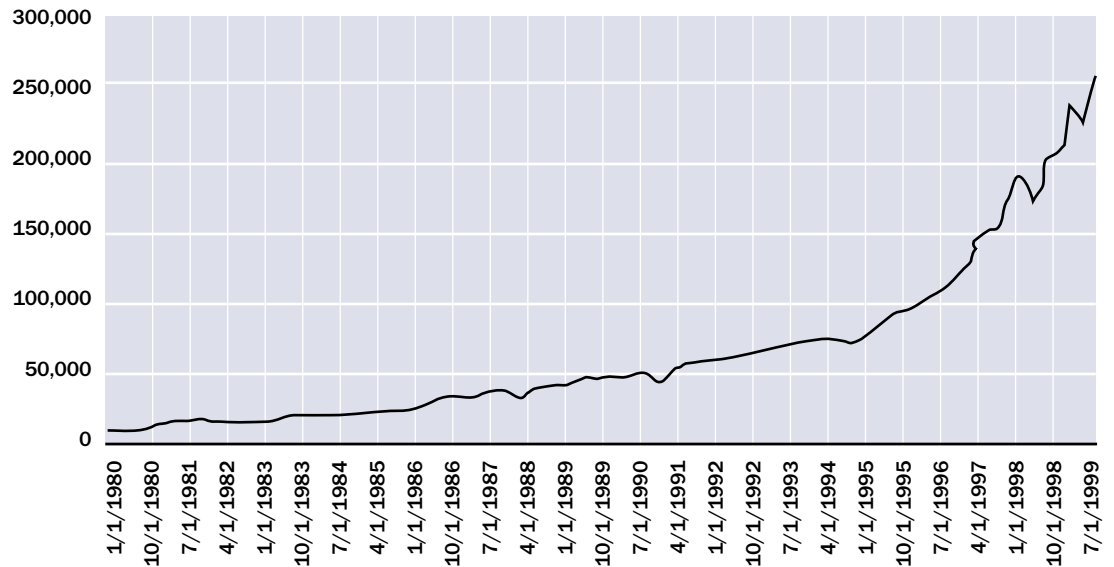
these indicators helps us design an investment strategy appropriate to the economic season.

From 1980 through 1999, America enjoyed an unusually long “summer” of abundance during which our economy grew at about a 6% (nominal) annual rate with only two manageable recessions. Following, as it did, the stagflation of the 1970s, this era of steady, low-inflation growth was enormously refreshing for investors! The accompanying bull market was the most powerful in history! Even government bonds delivered double-digit annual total returns as Treasury bond interest rates declined steadily from 13% to 4%, driving up the market price of older bonds.

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GROWTH OF \$10,000 (1980-1999 S&P 500 TOTAL RETURN)

Including dividends and price appreciation, a \$10,000 investment grew to \$250,000 in just 20 years! That's a compound annual return of 17.5%, produced by an economy growing at just 6.2%!



It seemed like the miracle of free market capitalism was really hitting its stride and that this could go on forever! Perhaps that's why price/earnings ratios hit record highs of 40X and even more. The chart above shows what our long summer of prosperity looked like through the lens of the stock market.

That 20-year stretch of almost uninterrupted growth has commonly been attributed to lower tax rates (true), productivity gains (true) and technological innovation (also true). But looked at from the perspective of the nation's balance sheet a somewhat different explanation offers itself for consideration... a credit explosion. It shouldn't surprise us that as credit became cheaper it grew more popular! We citizens kept borrowing more and more money to spend on the good life! After all, with easy access to loans a family could buy a bigger house, a nicer car and a more memorable vacation; those temptations were apparently hard to resist!

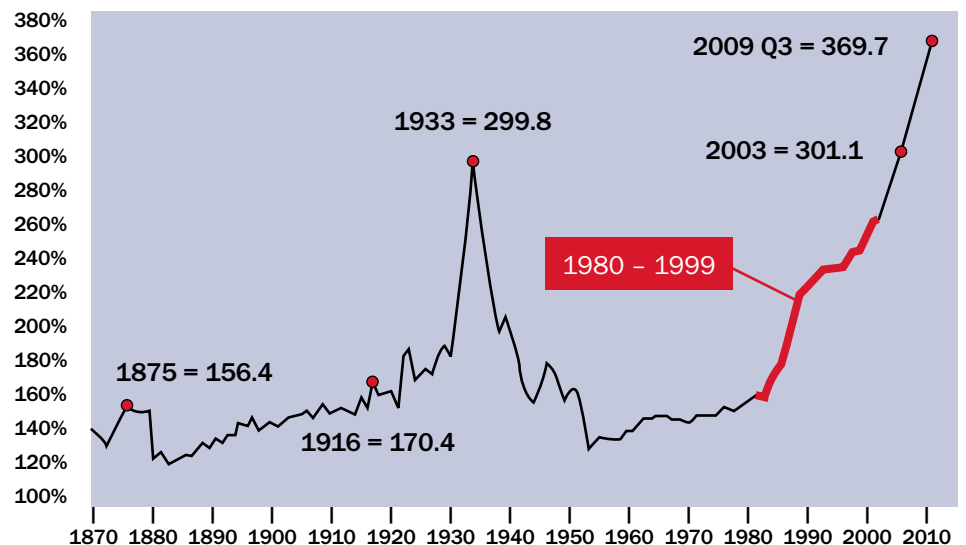
In the 20 years from 1980 through 1999, total debt outstanding

in the US exploded from 160% of GDP to about 270%, which goes a long way toward explaining the wonderful economic vitality of that era. Easy credit helped consumer spending grow a bit faster than the overall economy. But household debt during the same 20 years grew 30% faster than the economy! Household

debt surged from 67% of consumers' after-tax annual income to 91% in 1999! But, as we'll see shortly, the borrowers and the lenders were just warming up for the credit binge that lay ahead in the next ten years!

Here's what our long summer of economic growth looked like through the lens of the credit cycle:

TOTAL U.S. DEBT AS A % OF GDP (ANNUAL)



SOURCES: Bureau of Economic Analysis, Federal Reserve, Census Bureau: Historical Statistics of the United States Colonial Times to 1970. Through Q3, 2009.

LATE-CYCLE CREDIT SURGE: 2000-2009

If total credit market debt had flattened out around the 270% of GDP level it reached in 1999, there's a good chance America might have "grown into" those obligations. But instead, an unlikely troika of government agencies, big banks and eager consumers collaborated in taking the nation's financial leverage to unheard of heights at 370% of GDP. Reduced to its essentials, here's how it happened:

- **Government** manipulated monetary policy so that credit remained cheap, and encouraged (some would even say "mandated") access to mortgage loans by people who ordinarily would not have qualified. (All parties took comfort in the thesis that future house price appreciation would make the debts manageable).

- **Big Banks** and investment bankers, aided by financial engineers and rating agencies, created a \$7.5 Trillion market for "Mortgage-Backed Securities" (more than half of all home mortgages). This allowed banks to earn big fees by making loans that they could immediately sell into publicly-traded pools and never have to worry about defaults. Funny how the credit underwriting process tends to get a little sloppy when lenders know somebody else will be stuck with any of the loans that go bad!

- **Consumers** didn't need a lot of coaxing to buy homes they had only dreamed of and to borrow against their rising home values for every imaginable sort of expenditure without regard to the long-term consequences of the debt. For a million reasons, home prices began to weaken in 2006, defaults rose

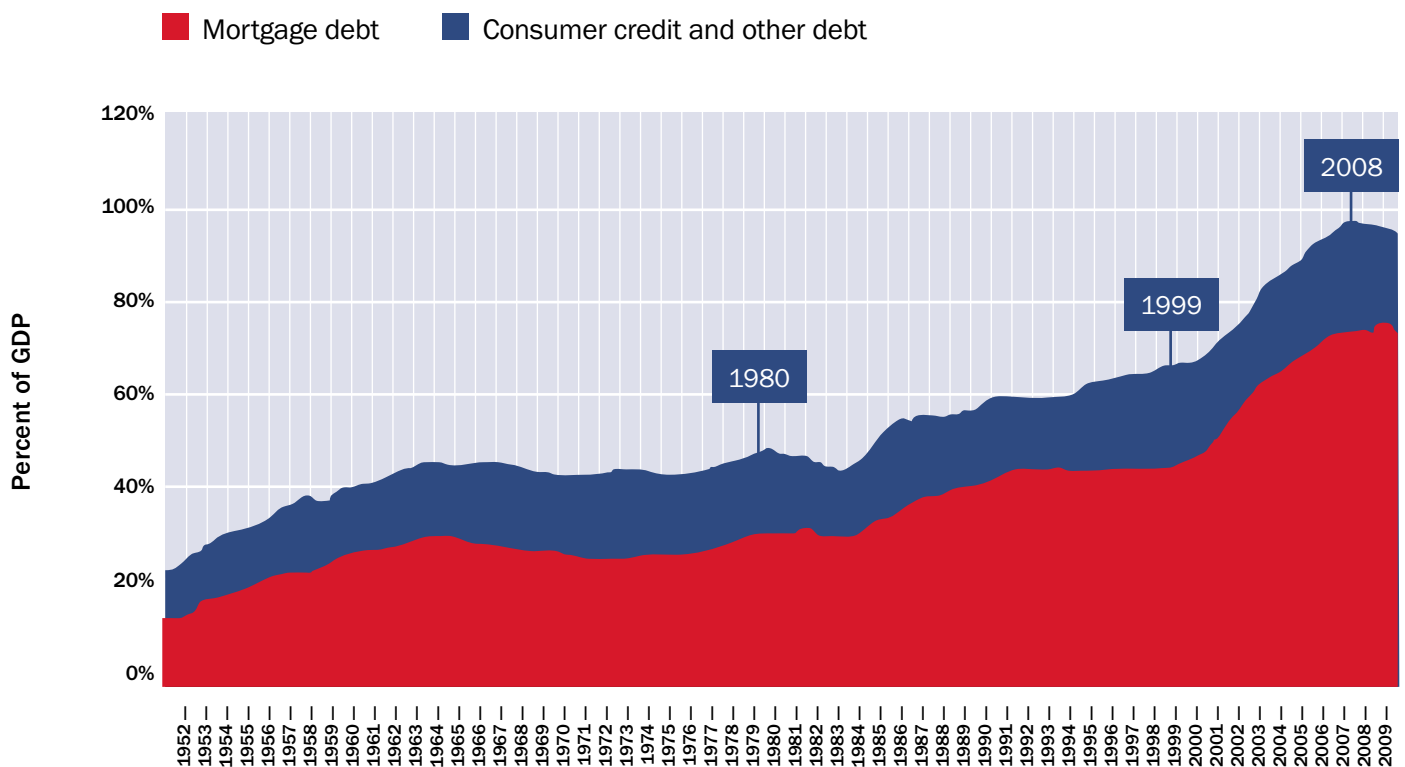
and the wheels began to come off the whole lending machine in 2008.

Lately, the headlines have been about "sovereign" debt (which we'll get to), but during the first 28 years of our 30-year credit boom the most aggressive borrowers were not governments but financial institutions and consumers.

Financial company debt spurted from 20% of GDP in 1980 to 70% by 1999 and to a stunning 121% last year! The credit industry increased its debt at twice the speed of the economy for 30 years! And consumers certainly did their part, as you can see in the following chart, increasing their indebtedness from 48% of GDP in 1980 to 64% by 1999, and then to 97% of GDP in 2008! That's 44% faster than the economy grew!

Almost the entire consumer debt increase since 1980 has been in *mortgage debt*; that is why the

HOUSEHOLD DEBT AS PERCENT OF GDP



SOURCE: BEA and Federal Reserve Flow of Funds report

The long credit cycle is near exhaustion, and a season of remediation is at hand.

great decline in home values since 2006 is causing such havoc in terms of defaults and write-offs, the collapse of the building industries, stubbornly high unemployment and flat-lining of consumer spending. And it is why Fannie and Freddie are in receivership and car sales are down about 40%. And it is why the political class, who fear losing their powerful jobs if the economy contracts, seem bent on stimulating end demand with nary a thought for the effect on the buying power of our currency or the future health of the private sector that, at the end of the day, has to pay all the bills!

CREDIT CYCLE EXHAUSTION

With everyone “helping out” by borrowing and spending, America’s economy did keep growing in the 10 years from 2000 to 2009. But with two recessions in eight years, GDP progress was noticeably slower than before; nominal growth averaged 4.3% a year in the latest decade, down from a 6.2% pace in the prior 20 years. The credit-supported growth kept unemployment under control and profits reached an all-time high in 2006. **But nobody noticed or cared that the law of diminishing returns was at work.** We think this is compelling evidence that the credit cycle is very long in the tooth. Here is a table we’ve published before showing that as our economy’s debt burden grew it took bigger and bigger loans to produce even a little GDP growth.

From 1980 through 1999, it took \$3 of new debt to a produce \$1 of GDP growth. But in the most recent 10 years, borrowing our way to growth got more and more

expensive. Since 2000, it has taken \$6 of new debt to squeak out an extra \$1 of GDP; we may as well just print dollar bills and hand them out! The ineffectiveness of debt is **a clear sign that the long credit cycle is near exhaustion, and a season of remediation is near.**

Debt had long been used by monarchs as well as elected governments to finance wars and infrastructure such as ports and roads. But the uses of sovereign debt vaulted to a whole new level after the 1936 publication of John Maynard Keynes’ “The

DIMINISHING RETURNS FROM ALL THAT DEBT...

DECADE	\$ NEW DEBT PER \$1 GDP GROWTH
Dec. '49 to Dec. '59	1.36 to 1.00
Dec. '59 to Dec. '69	1.53 to 1.00
Dec. '69 to Dec. '79	1.68 to 1.00
Dec. '79 to Dec. '89	2.93 to 1.00
Dec. '89 to Dec. '99	3.12 to 1.00
Dec. '99 to Dec. '09	6.02 to 1.00

While banks and consumers have actually started reducing their leverage, at least a tiny bit, our elected officials seem to feel duty-bound to keep the GDP engine from stalling by a combination of federal spending and outright transfers to state governments and to individual citizens. All this largess is funded with non-existent revenues, resulting in trillion-dollar annual deficits projected as far as the eye can see. There is no serious talk of ever coming to terms with our government debt obligations. Not surprisingly, securities markets seem to be getting more nervous about the end game.

General Theory of Employment, Interest and Money.” In his classic thesis, Keynes promoted an expanded economic role for government. His Theory included the idea of running government deficits during recessions to fuel the economic engine and thus prevent cyclical layoffs and the sort of depressionary spirals that had been a dark characteristic of the industrial revolution. His idea was enormously popular with the political class, and deficit spending became standard operating procedure for governments in Europe and America throughout the post-WWII period.



In his defense, Keynes had actually envisioned governments operating at a surplus and retiring debts during economic expansions, but

somehow this temperate aspect of the Theory never got much traction in the hallowed halls! If it had, perhaps the financial crises of the last 3 years may have been avoided.

Reasonable people may disagree, but it is our opinion that federal, state and local governments have been borrowing irresponsibly, especially in the past few years, in a futile effort to extend the full-employment economic growth experience of 1980-1999. The weak impact of massive federal deficit spending in the US, and the sovereign debt crisis that surfaced in Europe this year, strongly suggest that Keynesianism has run smack into the practical limits of government debt. Though you wouldn't know it from the miniscule interest rates on new government bonds, the clock is surely ticking on the sovereign debt phase of our long credit expansion.

WHAT TO EXPECT NEXT

Trees don't grow to the sky. And someplace between earth and sky there is also a limit to the amount of debt a society can carry without buckling under its weight.

Now that those extra-nice vacations are stored in our photo files, and most of the cars we bought with home-equity cash are starting to rattle a bit, those pesky debts are still there, with their annoying monthly payments! And although consumer debts outstanding are beginning to shrink, governments are trying to re-create the past by

piling up more obligations, but with very little stimulative effect. Despite warnings from the markets, America (and Europe, and Japan) have refused to learn from history; so it seems we are about to get a contemporary lesson in the consequences of too much debt. A season of cold reality is slowly settling over the fruited plain. If the long credit expansion is indeed history, what happens next?

Despite massive government deficit spending, America's GDP has stalled at the \$14.5 trillion level, little changed in three years; actually, at June 30, 2010, we're still 1% below the peak of three years ago. This "recovery" has been much slower than previous editions, and it seems to be running out of steam much earlier. Unemployment is stuck at 9.5% of the workforce, and it may get worse next year as state and local governments are forced to follow New Jersey's lead back to budget reality.

Home values have already plunged by 32%, leaving 23% of the owners of mortgaged homes owing more than their homes are worth! Absent a miracle recovery in housing demand, that statistic cannot bode too well for banks' lending prospects. Banks have been reporting improved earnings so far this year, buoyed by accounting artifices; but many are experiencing declining revenues from their core banking and trading activities, which is consistent with the sluggish economic outlook we have in mind.

Non-financial corporations have also experienced strong profits improvement so far in 2010, and consensus earnings forecasts for the S&P 500 companies call for a 40% full-year gain to \$79.51. (The previous peak was \$87 in 2006.) Average guesses for 2011: an 18% increase to a record-setting \$94... which we believe is fast becoming an untenable forecast.

Our expectation is that US economic activity will flatten out or perhaps even decline a bit over the next 18 months. Disappointing sales and intensifying price competition will lead analysts' to start cutting corporate earnings estimates, possibly as early as the third quarter reporting season. The main reason? Well, as everyone is tired of hearing, consumer spending now accounts for 70% of GDP, and anything more than a 1% real increase in spending next year is hard to imagine in light of the multiple headwinds confronting consumers. Among the formidable obstacles to increased consumption are:

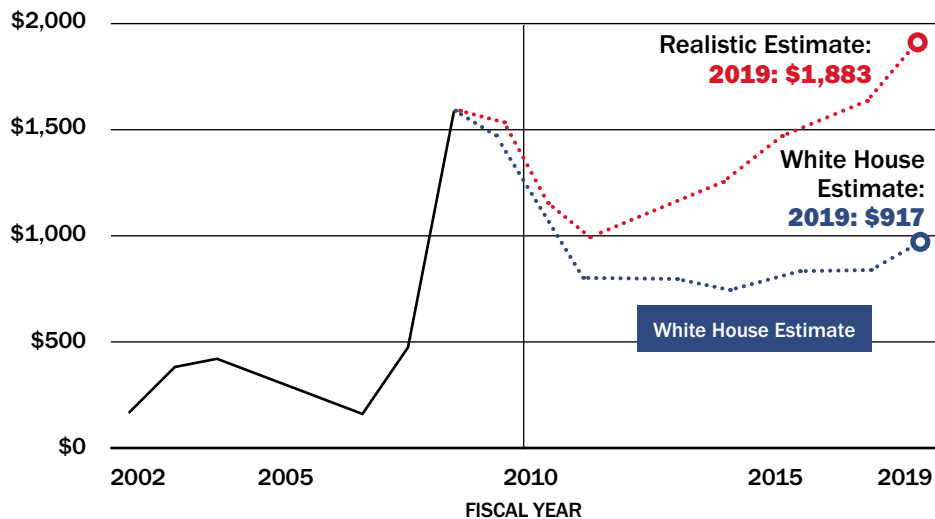
- Continued household de-leveraging
- Greater instinct to rebuild savings
- Homes worth less than their mortgages
- Stubbornly high unemployment and flat wages
- Further layoffs and furloughs in state & local governments
- An increasing pace of retirements from the workforce
- Out-of-date skill sets for many unemployed
- Taxes rising on upper income citizens. (The top 20% of earners account for 40% of spending, and their outlays are volatile and highly sensitive to stock price performance.)

Keynesianism has run smack into the practical limits of government debt.



Obama Budget Agenda Would Bring Annual Budget Deficits to Nearly \$2 Trillion

Budget Deficit in Billions of Dollars



SOURCE: Heritage Foundation calculations based on data from the Congressional Budget Office and U.S. Office of Management and Budget.

Total debt owed by strapped consumers has started to shrink modestly, in large part because lenders have been more aggressive in writing off loans they know will never be collected. Bankers also remain concerned about coming defaults in their commercial real estate portfolios, which partly explains their reluctance to ramp up small business lending.

In the past year, the consumer savings rate has popped somewhat erratically from zero to 6.5% of disposable income; that's still less than the 10% that people routinely squirreled away back in 1980. We think it makes sense to expect a continuation of the recent savings and de-leveraging trends as long as consumer confidence remains at recent low survey levels. Paying down debt and saving more are healthy, of course, in the long run, but in the short run they imply more cautious consumption patterns. A slowdown does not seem to be factored into consensus earnings forecasts... yet.

As to employment prospects, almost every state is struggling to even draft a balanced budget for fiscal 2011 ending next July. One policy group's forecast sees state spending next year 22% below the level of 2009! That could lead to 2 million job losses! And the nation's continuing jobless claims are testimony to the listlessness of private employment. Overall, jobs are unlikely to improve until consumer spending perks up.

The current administration is convinced that enough deficit spending will eventually stimulate consumption. But the weakness of the recovery so far and the data on the diminishing effectiveness of debt lead us to a less optimistic conclusion about stimulus. Nevertheless, continuing trillion-dollar federal deficits and increased government borrowing are political realities for now. By early next year gross federal debt alone is projected to exceed 100% of GDP, and it is growing by nearly 10% a year! And, of course, there is a risk that a decline

in economic activity could actually shrink federal revenues further, exacerbating the operating deficit and the borrowing needs.

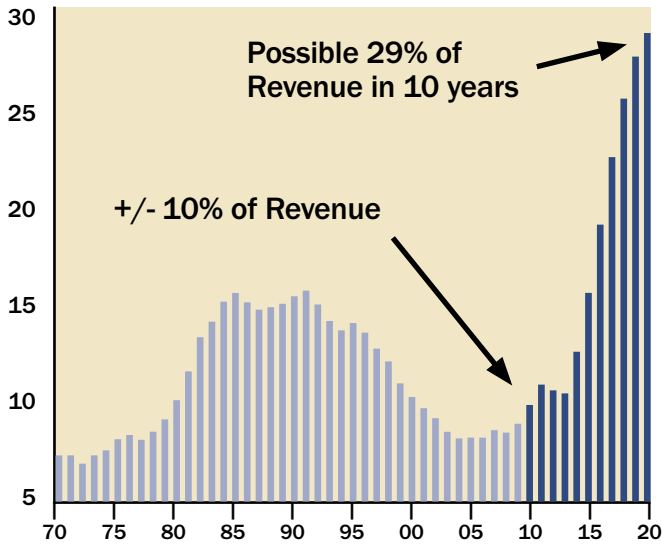
To the left is a chart of the projected budget deficits the next 9 years (Heritage House adaptation of CBO & OMB forecasts).

Even the optimistic "White House estimate" of deficits would raise gross federal debt some 60% by 2019. Using the "realistic" projection demonstrated by the red line, federal debt would more than double! In our Summary & Conclusion we mentioned that total debt in the US has reached a level that is unsustainable. John Mauldin, a widely-respected observer of things economic, says it this way: "Talk about unsustainable. This chart shows something that cannot be! The US cannot borrow \$15 trillion in the next ten years. It's just not there. Long before that, the bond market will simply rebel, rates will rise, and the aftermath will make the last crisis seem like a cakewalk."

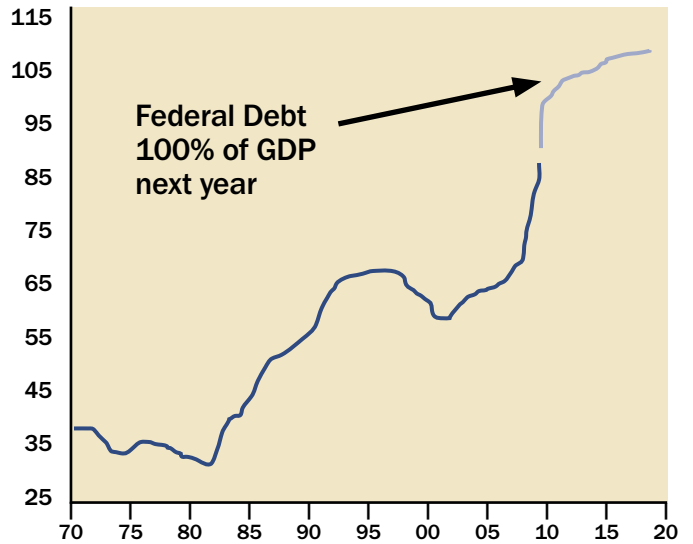
Which brings up another important issue... government's debt service cost is being held artificially low by two things: a near-zero Fed funds rate, and a purposeful concentration of maturities in the less expensive 1-3 year range. When credit markets eventually demand realistic rates on US government debts, the annual interest payments on government debt will rise dramatically from about 10% of federal spending to between 20% and 30% in just 9 years! All things being equal, that alone could catapult the annual Federal deficit to \$2 trillion! An enormous increase in the annual interest tab (see chart on next page) could happen quickly because more than half the outstanding government debt matures in less than one year, and must be continually refinanced. All of this helps a person understand why

UNITED STATES: GOVERNMENT FINANCES (PERCENT)

Interest Payments as a share of Total Revenue



Debt as a share of GDP



Shaded bars and dotted lines represent estimates (interest payments/total revenue estimates by Gluskin Sheff and debt/GDP estimates by the OMB)

Source: OECD, U.S. Office of Management and Budget (OMB)

Moody's has publicly suggested that over time Treasury bonds are at risk of a credit downgrade.

The unmanageable burden of debt at each level of our society makes the restoration of a steadily growing economy very hard to imagine without first picturing an extended breather period to rationalize our credit and pension funding obligations. A rationalization is going to take place one way or another, through some combination of repayment, default and/or currency debasement. None of these is stock-market friendly, which we're going to talk about. But there's more to the risk story than just domestic debt and economic stagnation.

GEO-POLITICAL RISKS, TOO

During the 30 years of our credit upswing, as we all now know, another completely different cycle

was underway... Globalization! Most economies of the world have been profoundly influenced by the emergence of a modern export economy in China and other parts of the world that had never been successfully developed. Not only are these emerging economies not in debt, but many of them are major creditors of the US, Europe and Japan. And a credit contraction in the West is starting to create some tensions in global trade relationships. As if there wasn't already enough tension in the world from terrorists and saber-rattling

dictators with nuclear ambitions, the balance of economic power is rapidly shifting east.

US citizens all across the income spectrum are feeling insecure, and it is showing up in lackluster retail sales and a revived preference for savings. Businesses, especially those small businesses that have historically created the lion's share of new jobs, can feel the tax noose tightening and regulatory costs mounting. And they are beginning to doubt that a heavily indebted, highly taxed nation can compete effectively in a globalized economy, or that domestic

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...stock and bond prices are out of sync with the sober realities of near-term economic and geo-political risks...

demand will be brisk enough to warrant any investment in expansion. Corporations are hanging onto their cash.

Employees who are planning to retire from government service or from large corporations look at the woefully inadequate pension funding, and they wonder if their benefits will be restructured. The same goes for Social Security & Medicare with unfunded future benefits exceeding (are you ready for this?) \$100 Trillion! And now that we have two wide-ranging 2,500-page new laws regulating healthcare and finance, concerns about unintended consequences are getting a lot of ink and airtime. The electorate is confused about who is telling them the truth and whether anyone in charge knows what they're doing!

Since our government is spending a stunning 62% more than its annual revenue, we shouldn't be surprised to learn they're planning to shrink the defense budget over the next several years. If you regularly watch the evening news, defense cuts are probably not going to make you more confident about the future. Troubling stories emerge every day not only from the obvious war zones in Iraq and Afghanistan, but from Iran, Korea, Venezuela, Pakistan, Russia, and at our own southern border with Mexico. New troubling international alliances are emerging (Turkey- Brazil- Iran is one of the more surprising!) and the UN's impotence hardly inspires visions of world peace.

THE COMING RE-PRICING OF RISK

So, the de-leveraging phase of the credit cycle will dampen

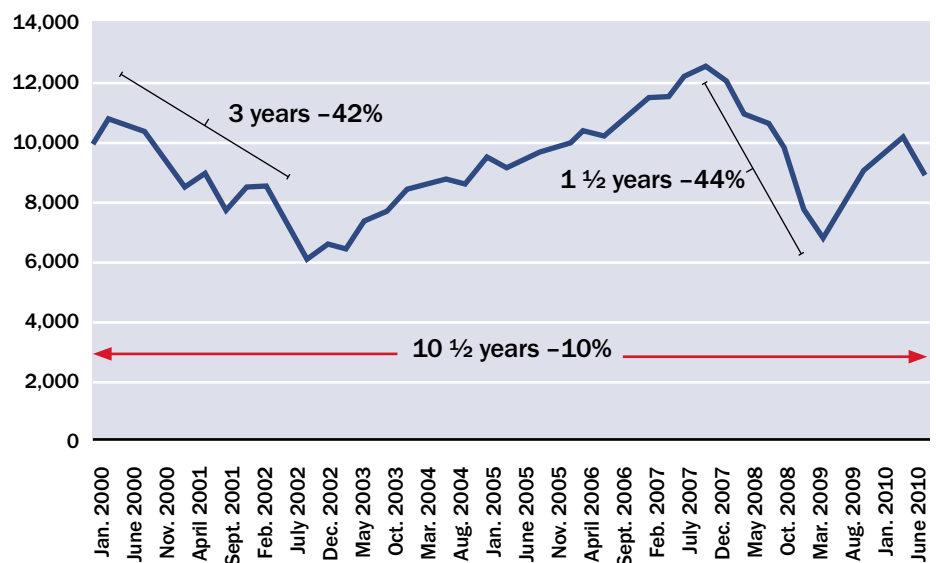
consumption in developed countries in nearby years. It will also kick into gear the famous Creative Destruction cycle described by economist Joseph Schumpeter (Capitalism, Socialism and Democracy, 1942). During this phase the industrial base is right-sized and re-conditioned for the next season of growth. Our government, which has no bottom line to discipline its activity, is bleeding red ink and getting deeper in debt to our wealthy Asian trading partners! Adding to investor angst, geo-political tensions are teeming with unpleasant and even violent possibilities. Yet, with all that uncertainty, bonds are priced as though there was neither default risk nor inflation risk in sight, and the P/E ratio for stocks hovers slightly above its average for the go-go years of credit-supported growth.

We have concluded that stock and bond prices are out of sync with the sober realities of near-term economic and geo-political risks. But before designing a portfolios to cope with an eventual adjustment in securities prices, we wanted to test our thesis by asking ourselves how such a pricing disparity could exist in a market awash with information; how could the stock and bond markets possibly ignore the unsettling evidence? There is always the human tendency to see the future through the prism of the familiar; that could be the whole story. But some additional satisfying explanations occurred to us.

FIRST WITH RESPECT TO STOCKS:

- a) The public's faith in stocks took a drubbing during the "lost decade" that followed the dot.

GROWTH OF \$10,000 INVESTED IN THE S&P 500 2000-2010



— S&P 500 Composite Total Return

com bust. They are not eager to get back into the market. Here's what 10 years of disillusionment looks like: Fed up with losses, individual investors are voting with their feet. They've been withdrawing their savings from equity mutual funds all year. They've staunchly resisted each market head fake to the upside, and kept moving money into bond funds. Individual investors read the news, and it's been making them uneasy. They have been personally burned by the housing collapse, they see in their own families the pain of unemployment, and the political polls highlight their concerns about federal deficits, government intrusions, rising taxes and redistributionist policies.

b) If the individual investor is sidelined, that leaves the professionals; mutual fund managers and traders. Some 95% of mutual funds are special-purpose funds with a mandate to "outperform" a particular benchmark. Only 5% of funds are hybrids, or what we call "go-anywhere" funds whose allocations can be adjusted to reflect the manager's economic outlook; most hybrids are already bearish, waiting for prices to adjust to reality. The other 95% of funds are excused from losing money for their investors as long as they do less badly than others in their special niche (small caps, growth, emerging markets etc.). They pretty much have to invest clients' money within a narrow class of securities. We have met a number of these style-specific managers

lately who are very worried about the outlook but remain fully invested in stocks. So, the fact that mutual funds are not selling stocks does not mean that their professional managers think the outlook is rosy!

c) Statisticians who make it their business to know these things say that at least 75% of daily stock trading volumes originate with quantitative trading strategies, many of which are leveraged with lots of borrowed money. A similar situation existed in 1998 when Long Term Capital Management, a hedge fund run by acknowledged geniuses, collapsed under its 40-1 leverage and brought the global banking system to its knees!

Traders tend to use some version of trend following/momentum strategies that have nothing to do with economic or geopolitical fundamentals except in the very shortest time frames. If the market turns south, traders can hasten its trip to the bottom by flipping from long positions to shorts! Their portfolio positions make no statement about the market outlook beyond a day or a week.

In some ways this market environment feels a lot like 1999 when there was no fundamental basis for stocks of untested internet companies to sell at huge multiples of book value; nor any good explanation for shares of solid "old economy" businesses going begging at 8 times earnings. Over the following 3 years fundamentals

did prevail... the S&P 500 fell 42% and NASDAQ plunged nearly 80%, while traditional "value funds" prospered. The lesson: business and economic fundamentals are powerful indicators of actual value... but unfortunately, they're not at all helpful in timing!

Our concern going forward is that the contraction phase of the credit cycle will precipitate weaker corporate earnings, and that waning investor optimism about the future will be reflected in a gradually shrinking Price/Earnings ratio. This is what we call the "double Whammy" risk... declining earnings AND a declining price/earnings multiple. Using Shiller's 10-year adjusted P/E benchmark, the market is currently valued a little above its historic mean multiple, which was established during the economy's heyday in the rising part of the credit cycle. It seems very natural to us that a few years of economic tumult would take the market's mean P/E down a peg or two. Or more!

We have written often about secular bull and secular bear markets; these are market trends that tend to last 15-20 years and their main feature is the multi-year increase or decrease in the market's P/E ratio as optimism waxes or wanes. Because of the unavoidable economy-dampening effects of the pending contraction phase of the credit cycle, it is quite conceivable, even likely, that the secular bear market that began in 2000 still has some work to do.

Bob Farrell, legendary market strategist at Merrill Lynch, maintained that bear markets have three stages: i) sharp decline, ii) reflexive rebound and iii) a drawn out fundamental downtrend. The dot.com bust gave us the initial sharp decline, a clear break from the 20 year bull market. The complete rebound in 2007 made a good stage

two. And the uncovering of ugly credit problems in the fall of 2008 showed that the fundamentals are ripe for a classic drawn-out stage 3.

AND WITH RESPECT TO BONDS:

The yield on a 10-year Treasury bond has declined from 13% in the early 1980s to 2.6% this week. The 2-year treasury yields a half of 1%! Recently, IBM sold 3-year bonds with a 1% coupon! One has to wonder whether a growing investor appetite for bonds is creating a bubble in this largest of asset classes.

The individual investors and hybrid managers who've been abandoning stocks have been pouring cash into bonds and bond funds in a "search for yield" and a "flight to safety." Their demand has pushed up bond prices and lowered yields dramatically, especially on Treasuries. Most traditional bond fund managers are in much the same position as stock fund managers... when new cash comes into the fund they have to buy bonds. Some managers can actively manage their allocations by credit quality and maturity, and many of those more adaptable funds are holding large cash positions and bonds that mature in a year or two, because they, like us, are concerned that default and inflation risks are a lot more serious than today's low interest rates imply.

We can't work up a lot of enthusiasm for making a 10-year loan to a government that is destroying its balance sheet while printing money, endorsing accounting cosmetics and making no game plan for mending its spendthrift ways... while we're being paid only 2.6% (taxable!) interest for putting our money at risk. Buying bonds, even government bonds, is no longer a safe investment that provides adequate income for retirement. There is serious principal risk in bonds, especially longer-term bonds.

OUR PORTFOLIO STRATEGY FOR THE SEASON OF CREDIT ADJUSTMENT

Now here is where theory meets reality. Bob and Sally spent 40 years accumulating a nest egg to support them through a comfortable retirement that could last almost as long as their working years. Before they came to Financial Advantage, they looked around at their investment choices. They saw that bank deposits and money market funds pay virtually nothing, and a 5-year Treasury Note yields just 1.5%. Heck, inflation has averaged 3% over their lifetime, they thought, and with the government running permanent trillion-dollar deficits, they couldn't imagine that future inflation is going to be less. If Financial Advantage is correct about the sluggish economic outlook and pressure on stock prices, they asked us, what ideas do we have for their situation?

It happens that we manage retirement portfolios for a lot of people in just this situation. In the past two years, as we've become convinced that the downturn in the credit cycle is not just a short-term challenge, our professionals have poured probably 20,000 hours into research and debate, designing strategies, then tweaking and re-designing them. We will be writing more about the details of our current retirement portfolio strategies, but for now I'll just mention the four foundational principles of our approach to managing retirement portfolios in this rather extraordinary time in history.

I. Emphasize cash income

throughout the portfolio. When cash income from interest & dividends meets withdrawal needs, investors can take a longer view of price fluctuations.

- i. Diversify the sources of income widely; feature growing dividends.
- ii. Stress quality and sustainability of income.
- iii. Minimize bond price risk: shorter maturities, yield advantage & adjustable rates.

II. Reduce stock market risk

until values come more in line with earnings prospects; even excellent stocks get cheaper in a weak market.

- i. Keep equity exposure at the low end of the range in each of our risk profiles.
- ii. Business will be highly competitive; invest in companies with competitive advantages: a strong balance sheet, low cost position, brand dominance, innovative management.
- iii. Diversify equities by theme, sector, & economic drivers; feature emerging mkts.

III. Defend against inflation

which ultimately threatens the buying power of a portfolio.

- i. Currently, deflationary pressures are palpable, favoring bonds in the short run. But absent a public policy change, the longer-term inflation threat is very high.
- ii. Gold is a legitimate defense against currency debasement. Energy and industrial materials can be, too, but they're also influenced by shifts in economic activity.
- iii. In the long run, stocks are a better inflation defense than bonds because well-managed businesses can adapt to an inflationary environment.

IV. Find advantages in market volatility;

it may be with us for an extended time.

- i. Watch for anomalies that can set up low-risk paired trade opportunities.
- ii. Make small investments in diversified tactical positions; use tactical managers.
- iii. Be alert to rebalancing opportunities created by large price swings.

In summary...

We think it is clear that the long season of credit expansion is winding down; even the government is probably in the last stages of its vain effort to forestall the inevitable transition to the contractionary phase.

America and the rest of the developed world will spend at least a few years rationalizing their debt burdens through some combination of repayments, defaults and/or currency debasement. The credit downturn will keep economic growth well below the pace we've been used to, and most businesses will be more intensely competitive until imprudent loans and excess capacity have been dealt with.

We believe that Wall Street's earnings expectations are unrealistically high for such a transition season, and that the shares of even our best businesses will trade at more attractive prices in the future— possibly even in the near future.

An economic transition of this magnitude will undoubtedly be bumpy. Even the political environment, both at home and abroad, promises to be a little raucous. But capital will continue to be in demand because business is the natural activity of free people intent on improving the quality of life for their families. Investors will need to be a little sharper, a little more demanding and a good deal more careful while the world works off the excesses of the past.

We have designed the Financial Advantage investment strategy specifically to keep our clients' capital safe and productive in the transition and beyond.

FOR THE INVESTMENT COMMITTEE:

J. Michael Martin, J.D., CFP

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DJIA 10,150 | S&P 500 1064 | NASDAQ 2153 | Gold \$1,235 | 30-yr Treasury 3.69%