EQUITY INVESTMENT OUTLOOK

October 18, 2010

Money for Nothing

During the second quarter our economy began to experience some growth headwinds, and many feared that we were headed back into recession while others felt it was merely a soft patch. Now that the third quarter is over, a mixed bag of data and surveys indicate to us that the path forward is not considerably clearer. Roosevelt Investments continues to believe that in the coming months the economy will grow at a slow, plodding rate, below what is likely to be needed for meaningful job creation but on balance providing an environment which is positive for capital markets.

The most important economic event of the third quarter may have been the Federal Reserve's annual retreat in Jackson Hole, Wyoming. It was at this meeting that Fed Chairman Ben Bernanke first hinted that further large scale quantitative easing was on the table if the economy continued to falter. (Quantitative easing involves expanding the money supply and using those dollars to buy very large quantities of Treasury bonds and agency mortgage-backed securities. This tool was first used by the Fed in March 2009 to stabilize the economy and helped kick-start the recovery that began last spring. The anticipated second round of quantitative easing has been referred to in the press as "QE2".) It remains a question whether the Fed will actually pull the trigger on QE2 at its next meeting in early November, but the odds seem to be pointing in that direction. It could be argued that the possibility of QE2 is responsible for the stock market's nearly 9% surge last month, the strongest September performance since WWII. The bond market has also been strong lately, perhaps helped by the view that the Fed will be engaging in large-scale bond purchases in the near future.

Our investment committee reviewed the presentations made by a group of economists at the Jackson Hole retreat, and among them was an analysis of financial crises during the past century to assist in determining what may lie ahead for our economy. The analysis pointed to an average post-crisis period encompassing a decade during which economic growth is slower and unemployment higher than the period leading up to the crisis. It appears that the US economy may be headed down a similar path. This sobering outlook contrasts with the prospects for many developing economies which are experiencing much higher growth rates. For example, China has experienced annual GDP growth averaging above 8% for the last 20 years, while our economy has averaged growth closer to 2% over that time. This dovetails with our Asian Exposure theme, which incorporates our belief that companies deriving meaningful revenue exposure to non-Japan Asia should outperform because their economies are likely to grow at faster rates than the US.

Currency values are also impacted by QE2, and changes in relative value have implications for trade. The dollar has already lost 9% of its value against a basket of other currencies since the Jackson Hole conference. If the Fed's actions increase the supply of dollars relative to the supply of Yen or Euros, then the US dollar may continue to lose value relative to other currencies. A weaker dollar is beneficial to exporters in the US, since it makes their goods cheaper relative to competing goods in other countries. Those countries however, do not want their export sector to be at a competitive disadvantage. The result is today's environment where at least a half dozen countries are engaging in either QE (Japan) or policies which attempt to stem the appreciation of their currency relative to a US dollar that seems to be on a path toward losing value (Brazil, China). If many countries are engaging in QE at the same time, then there is likely to be a lot more liquidity sloshing around the global economy. While controversial, QE2 should be positive for our market over the next several quarters.

The inflationary impact of this easing activity may be significant, and we are already seeing investors respond to this by bidding up the value of gold and other precious and non-precious metals, as well as many other hard assets, and even art, wine, and other assets that are believed to hold their value. The risk is that this excess liquidity will have unintended effects that may be difficult to manage. We have selectively increased our exposure to certain commodities in the belief that they are likely to outperform because of this liquidity dynamic. Furthermore, in an environment with weak demand and low inflation in developed markets coupled with rising commodity prices, we expect companies with pricing power to be rewarded by the market, especially where pricing power is increasing relative to the prior cycle. This can occur where consolidation activity produces a more concentrated industry structure. As a result we have added a pricing power theme during the quarter and have taken positions in the airline, specialty chemical, and waste disposal industries based on this notion.

It is remarkable that many companies and consumers are paying record low rates to borrow money, and yet so far this has not stimulated much economic activity. Banks are borrowing at near zero rates – they are essentially getting money for nothing. Buyers of Treasury bonds and other high-quality bonds today also seem to be getting nothing for their money. The recent 10-year benchmark T-note yield of 2.4% hardly seems enough to compensate for the potential risk of inflation and speaks to the possibility of a bond bubble aided by the potential for QE2. Low returns have negative implications for consumer spending derived from individuals who rely upon fixed income investments for income,

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and are also a negative factor for pension funds since they may need to make extra contributions as a result. While these low rate dynamics persist, companies in the utility sector will likely benefit from attractive borrowing costs and their dividend-paying equities are likely to be perceived as attractive by investors seeking better yields. We have added some utilities to the portfolio recently to take advantage of this.

While economic data has been mixed and growth remains slow, there have also been some positive reports. Capital goods orders rose in August more than expected, and non-military capital goods orders increased 5.1%, the biggest gain since March. Third quarter earnings season has just begun, and it will provide us with a great deal of information about the economy and how management teams are feeling about the future. In mid-September, the heads of both General Electric and Berkshire Hathaway both offered a preview and commented that looking across their portfolio of businesses they see the world getting better and believe the odds of a double-dip are low. On the other hand, Duke University's quarterly CFO survey indicates that optimism has fallen back to recession levels among CFOs and as a group they foresee minimal increases in expected hiring and weak consumer demand. September's reading from the Philadelphia Fed survey indicates that growth stalled over the August-September period, and recent data from the Chicago, Dallas, and Richmond Fed regions have also been disappointing. In aggregate, our reading of recent data points to more uncertainty ahead and is in line with last month's 'stall speed' outlook.

Another headwind to our economy's growth is the rising trend towards austerity budgets as governments around the world try to repair their balance sheets. This is more of an issue for some of the weaker governments in Europe, but it appears likely that the upcoming elections in this country will herald a new, more austere fiscal environment in the U.S. Many states are also cutting spending as part of their requirements to submit balanced budgets for next year. While getting budgets in line is an important factor for the long-term health of many national economies, the IMF has warned that such actions will likely cut growth and increase unemployment in the short run. As many countries look to cut deficits at the same time, the economic costs could be severe.

Roosevelt Investments
Please visit our new website at <u>www.rooseveltinvestments.com</u>

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