

Quarterly Review and Outlook – Third Quarter 2011

Think Different

On October 5, 2011, Steve Jobs died after a long battle with cancer. Two months earlier he had resigned as CEO from Apple. I generally do not get too nostalgic about the death of someone that I have never met, but for me, Steve Jobs was different. I have no idea what he was like as a person other than what I've read about his life, but as a visionary, people like Steve Jobs don't come along too often. I think Jobs' genius will continue to grow over time as people realize the numerous profound advances he made in our lives.

Jobs was essentially fired from Apple in 1985, at age 30, after a bitter power struggle with the CEO whom he hired. He managed to get by for the next 11 years (just passing time developing companies like NeXT and Pixar) before returning to Apple on December 20, 1996. On September 28, 1997, in an effort to turn the struggling computer maker around, Apple and Steve Jobs launched an ad campaign that encouraged us to "Think Different." This one ad campaign was a call to arms for Apple and began a revolution within the company. The "Think Different" campaign ran for five years, but it had a transformative effect on Apple and anyone willing to listen. The text of the original ad was as follows:

Here's to the crazy ones. The misfits. The rebels. The troublemakers. The round pegs in the square holes. The ones who see things differently. They're not fond of rules. And they have no respect for the status quo. You can quote them, disagree with them, glorify or vilify them. About the only thing you can't do is ignore them. Because they change things. They push the human race forward. While some may see them as the crazy ones, we see genius. Because the people who are crazy enough to think they can change the world, are the ones who do. - Apple Inc.

I believe many of our problems are exacerbated by an unwillingness to "Think Different," and Apple, through Steve Jobs' leadership, illustrates that thinking differently is imperative if you want to achieve transformational change. Apple transformed itself from a company that was trading for cash (in other words, investors assigned no value to the business) to the most valuable company in the world. We believe the courage to embrace different thinking is exactly what is necessary to fundamentally alter our current path.

Risk On, Risk Off

Moving on to a review of the quarter...quite simply, the third quarter was tough. The equity markets were dramatically lower with the S&P 500 down 13.9% for the quarter and down 8.7% for the year. International stocks, as measured by the EAFE, were even worse, down 19.0% and down 15.0%, respectively. The only real bright spots were treasuries and munis, which rallied as yields declined to 3-year lows. Emerging concerns about another recession here in the US, as well as the inability of the Eurozone to deal with its sovereign debt crisis, facilitated this risk off posture. Signs of a slowdown (if not hard landing) also grew in China. None of these issues have been resolved and, if anything, they have gotten worse. We believe these factors will remain primary focal points for investors and will likely result in continued market volatility. We remain very cautious.

European Sovereign Debt Crisis

The situation in Europe becomes more dire each day. As we write this letter, European leaders are struggling once again to deal with the next phase in the crisis. The issue has morphed from a fiscal crisis affecting



Greece, Ireland and Portugal, into a crisis affecting all of the members of the Eurozone and its banking system as well.

The problems are exceedingly complex and the potential solutions are unsavory to those affected. We have been of the belief that a single monetary structure without fiscal unity will create imbalances that are not able to self-correct, resulting in crisis. At some point, there will have to be a realization that long run survival requires major changes to the current structure. It will require more political unity, fiscal integration and enforceable oversight. More importantly, there needs to be a common view among Eurozone citizens as to how government should operate and their responsibility for making it work. This seems a lot to ask.

Before the launch of the Euro in 1999, Milton Friedman, the Nobel Prize winning economist, predicted that the Euro would not survive its first crisis. That crisis is here and we think he may be right.

The US Economy

The US appears to be experiencing another soft patch as the Fed-induced stimulus comes to a close. This slowdown is bringing into question the effectiveness of further monetary policy as its herculean efforts have done very little to stimulate growth. Fed officials have covertly endorsed this realization as public statements have suggested that fiscal policy needs to take the lead going forward. With the current divisiveness in Washington, and the debacle that was the debt ceiling debate, significant improvement or help from Washington seems unlikely.

We maintain our view that improvement in unemployment/underemployment and housing are key to a sustainable recovery. Those areas have stopped getting dramatically worse, but no one has demonstrated ideas to start turning them around. We are desperate to see some real leadership emerge on these issues, but thus far, very few have embraced the “Think Different” approach.

I have watched a couple of the Republican debates over the last few weeks where the potential candidates have shared their best ideas. With the economy so weak, it should be guaranteed that Obama becomes a one-term President, but the Republicans don’t get THE issues. Republicans are so fixated on taxes that it appears that is all they have to offer. I applaud Herman Cain for his bold 9-9-9 plan, but is now the time to rewrite 100 years of an incentive based tax system with no possible way to anticipate the unintended consequences? In my view, political economic discussions should focus on housing, unemployment and our finances, recognizing that the triple threat of entitlement spending is out of control. It is a shame that you can’t get elected if you tell people the truth about what we cannot afford and what we must do to solve these problems.

Our View On The Outlook

The heart of the issue is that we live in a world with too much debt and too little income to support it. We have seen this reality result in one crisis after another and all have been predicated on one thing...confidence. Confidence in our financial system is essential for proper functioning and, once lost, it is difficult to get back. Making matters worse, investors are losing confidence in the ability of policymakers to effectively deal with our problems. This will undoubtedly make matters worse if changes don’t happen soon. We are not all that optimistic.

The following chart illustrates how dramatically we have levered our economy since 1980. Increasing the level of debt relative to our economic output has been the way we have run our fiscal and monetary policy for far too long. We have become a society in which we can’t stand anything negative in the short-term so

we have asked our policymakers to fix it now so we can continue to enjoy prosperity. This has led to a mountain of debt on both public and private balance sheets. This chart is for the US, but the relationship is similar to much of the developed world. This phenomenon could only continue for so long and the trigger point for a reversal is the eroding confidence in our financial system that began a decade ago.

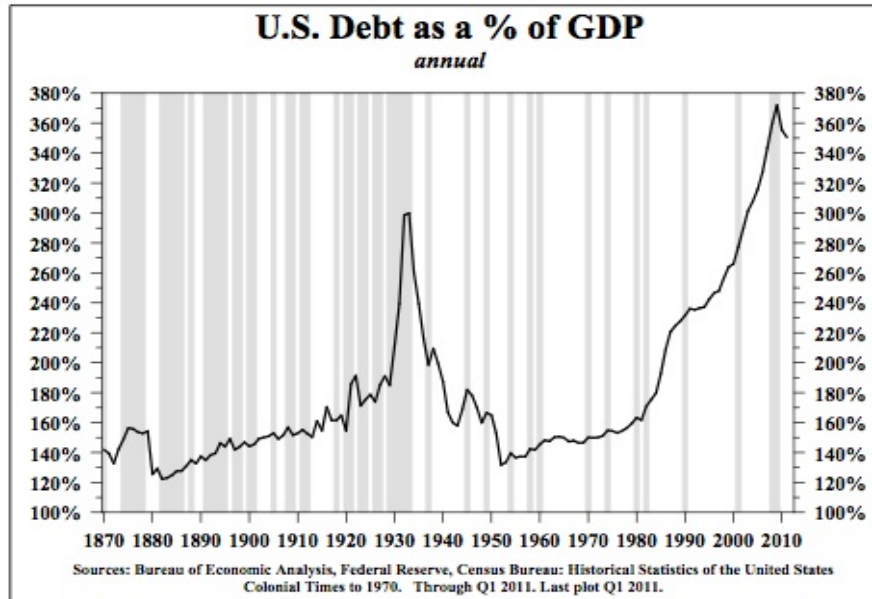


Chart 1

In our view, our policymakers are wired to resist these negative adjustments through further stimulus measures (which we believe will come), but the half-life of such measures have seemingly grown very short. We believe that the best policy response should be to manage the current debt deleveraging cycle to help moderate its impact, but it should be allowed to run its course. Ludwig von Mises, the Austrian economist once said about the endgame for a credit expansion:

There is no means of avoiding a final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of voluntary abandonment of further credit expansion, or later a final and total catastrophe of the currency system involved.

Which seems the better option?

Bill Gross, founder and CIO of PIMCO, stated in his most recent letter to clients:

There are no double-digit investment returns anywhere in sight for owners of financial assets. Bonds, stocks and real estate are in fact overvalued because of near zero percent interest rates and a developed world growth rate closer to 0 than the 3-4% historical norms. There is only a New Normal economy at best and a global recession at worst to look forward to in future years.

Gross sums up our view quite nicely. While equity valuations have improved during the third quarter, we are uncertain whether we have built up enough margin of safety if the global economy falters. We would

suggest it does not. With respect to bonds, our emphasis on quality gives us comfort that we will be paid back but the outlook for attractive returns from them is modest. If our view is correct, and we face a high probability of a recession, then bonds can continue to rally as yields go even lower.

Below we have updated a chart we included in our first quarter letter earlier this year. In April, GMO's analysis was suggesting that both stocks and bonds were expensive. As you will notice, equities have become much more attractive due to the negative returns in the third quarter but US stocks still remain below the 6.5% long-term historical equity return. More dramatically, US and International bonds have become much more expensive and give us concern about their return potential in portfolios.

GMO 7-Year Asset Class Return Forecasts*

	March 2009	February 2011	September 2011
U.S. Equities (large cap)	7.5%	-0.1%	3.1%
U.S. Equities (small cap)	7.4%	-2.7%	1.5%
Intl. Equities (large cap)	10.0%	1.8%	7.2%
Intl. Equities (small cap)	10.8%	-0.6%	6.0%
Emerging Mkts. (equities)	8.5%	4.7%	7.2%
U.S. Bonds (gov't.)	0.2%	0.6%	-1.2%
Int'l. Bonds (gov't.)	0.5%	-0.5%	-2.4%
Emerging Mkts. (bonds)	3.4%	1.9%	1.9%
TIPS	0.9%	0.3%	-1.1%
Cash	0.2%	-0.7%	-0.8%

*The chart represents real return forecasts. Long-term inflation assumption of 2.5% per year. Returns are annualized.

In our view, we believe that there are attractive opportunities in equities, especially in the area of high quality dividend paying companies. Bonds don't offer much in the way of yield but they do mitigate volatility and help us preserve capital in the portfolios. We continue to want to maintain a significant allocation to bonds despite these low yields.

Our view on inflation is key to this allocation. Inflation has perked up in goods and services, but much of the economy remains quite deflationary. We continue to believe that, over the short term, deflation is a bigger concern than inflation. But the potential for unwelcome levels of inflation is high if the deflationary forces moderate. This is exactly what the Federal Reserve is hoping to foster. A little inflation would likely be very welcomed. As each day passes, it becomes more evident that many developed countries are looking more and more like Japan.



We believe that maintaining our cautious stance is the most appropriate course of action. The issues that our global economy faces are significant. We strongly believe that the imbalances created over the last 30 years need to be resolved. The necessary prescriptions for fixing what ails us include further deleveraging of the imbedded debt levels of the global economy through regional austerity, changed tax policies and a realization that there is no more money left to give. None of these prescriptions are positive for risk assets. Let us all hope our policymakers have the courage to make these difficult decisions and lead.

I just finished reading *Boomerang* by Michael Lewis and I recommend it to anyone wanting to gain insight into the causes of the crisis we face in Europe. It is, essentially, a compilation of articles he wrote for Vanity Fair, but he pulls it together nicely. Having said that, after finishing, I felt that he did not leave me with a sense of urgency or seriousness of what we face going forward. After talking about the book with a friend about the need for a conclusion, I recommend reading the book then rereading the preface to tie a nice little bow around the story. To me, the preface with Kyle Bass is the best part of the story. Kyle Bass is certainly willing to “Think Different.”

Finally, on October 25th, 2011, we will host our third annual Fall Investment Conference focused on “Uncovering Opportunities.” This year we are pleased to have Joe Wade, the Chief Investment Officer of Centennial Partners, and Michael Drury, Chief Economist of McVean Trading, join us for a discussion of the markets and the issues we discuss in this letter. We look forward to seeing many of you at the conference.

Please let us know if you have questions.

Best regards,

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