

October 1, 2009

Dear Valued Client:

September proved to be another positive month for the markets as indices made modest advances. Year-to-date, the S&P, Dow, & the Nasdaq are up 19.26%, 13.49%, and 33.46%, respectively. Since hitting a bear market closing low of 677 on March 9, 2009, the S&P 500 has gained 56.14% (not counting the impact of reinvested dividends). The average gain of the S&P 500 for the one year following a bear market closing low for the eight bear markets of the past 50 years is 36.5% (Source: BTN Research). The magnitude of the rally has once again reinforced the investment wisdom of a quote from Warren Buffett: "Be fearful when others are greedy, and be greedy when others are fearful". During this month's investment letter, we will address a topic of discussion that several of our clients have raised recently, which is the subject of inflation.

Although there are not many tangible signs that inflation is prevalent today, it is the *expectation* of inflation in the years to come that is causing many investors to worry about it today. Most market participants recognize that the fiscal responsibility of our government is lacking, which is causing our debt and deficits to grow at a rapid pace. Although the recent pace of debt expansion will be detrimental to our economy if sustained long-term, many economists deem it necessary to stabilize the economy and offset the significant deleveraging that is currently occurring within the private sector. In a recent report by the Federal Reserve, consumer credit fell \$12 billion in August, or at a 5.8% seasonally adjusted annual rate. This marks the 7th straight month of declines, which is the longest stretch since 1991, and illustrates how both lenders and consumers are scaling back. Contrast that with the increase in public debt, which is expected to increase at a rate of 27.8% in 2009 (Source: The Economist). Further evidence of investor anxiety over inflation can be seen through the price of gold, which broke through \$1,000 per ounce last month, the highest level it's been in many years.

Ultimately, our ability to finance these debts is in the hands of both the Federal Reserve and foreign purchasers of our debt, like China and Japan. If our debt continue to grow at such rapid rates, it's not unreasonable for foreign purchasers and the Federal Reserve to slow the pace at which they purchase our treasury securities, which could cause interest rates and inflation expectations to rise. The Federal Reserve has a difficult balancing act because if they allow interest rates to stay too low for too long, they will inadvertently create another asset bubble and ignite inflation and if they raise interest rates too fast, it could cause the economy to slip back into recession.

One of the more interesting articles we read recently was an editorial written by James Grant in the Wall Street Journal, where he suggests the possibility that the economic recovery could be stronger than what many economists are expecting. "In the post World War II era, the government has attacked recessions with an average fiscal stimulus of 2.6% of GDP and an average monetary stimulus of 0.3% of GDP, for a combined countercyclical lift of 2.9%. This time out, the fiscal stimulus is likely to measure 10% of GDP, monetary stimulus 9.5% of GDP, for a combined pick-me-up equivalent to 19.5% of GDP. Our Great Recession would be marked for greatness if for no other reason than by the outpouring of federal dollars to repress it," writes Grant.



Despite the significant monetary and fiscal stimulus within our financial system, we still believe that inflation will be benign and contained at least in the near term as the economy digs its way out of recession. High un-employment (9.8%), low factory utilization (69.6%), and declining consumer credit all suggest that there is significant slack in the economy that can be reversed through recovery without inflation becoming a near-term issue. Of course, when and if inflation does become a serious issue, we believe that ownership of high quality, durable businesses with pricing power will prove effective within an inflationary environment.

As always, we thank you for your trust and support.

The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stocks weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance.

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