Economic Commentary

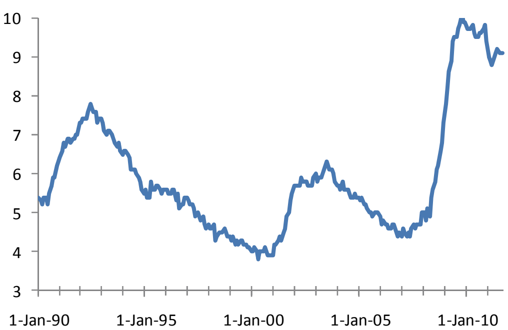
October 13, 2011

Following financial markets these days is like watching a little-tyke hockey game. The puck is in the corner so everyone runs there and buys treasury bills; now it's at center ice and everyone skates there to buy oil futures; and so on and back again. The rumors and machinations of politicians and bureaucrats around the world (particularly in Europe recently) have caused unbelievable volatility in markets. Make no mistake - the issues are very real.

One does not want to consider the consequences of the European Union falling apart, or the U.S. government not coming to grips with its weak economy and debt burden. CEO's can ruin a business, but bad politicians can ruin entire economies. It boggles the mind that the European Central Bank's stress test in July found Dexia strong and healthy, only to find Dexia unable to continue to operate on its own three months later.

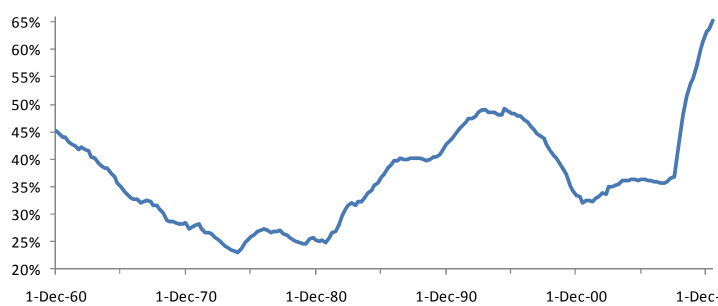
The consensus seems to be that Greece will default. For the EU, saving the banking system from that default and making sure Italy doesn't follow, will be the challenge. We assume a compromise will be found within the EU to accomplish those goals, but the sovereign debts of these countries do not disappear. They are merely set aside to be dealt with at a later date when world economies are hopefully stronger.

US Unemployment Rate



In the U.S. we see four major issues: The economy and job creation, the budget and debt burden, relations with China, and taking the uncertainty out of future tax rates and corporate regulations. The solutions to the first two are a mystery, as both easy monetary policy and significant fiscal stimulus since the financial crisis have had little effect. With republicans and democrats on absolute opposite sides of the debate, there does not appear to be a solution in sight.

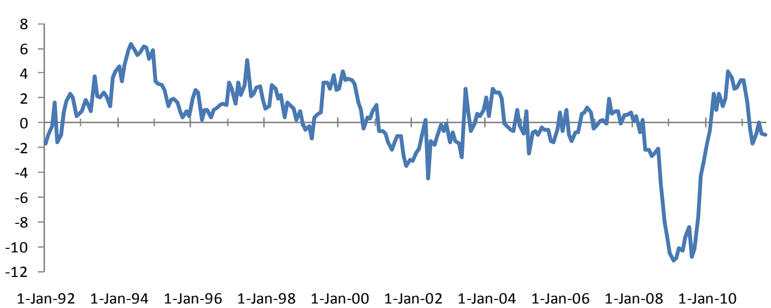
US Federal Debt as a Percent of Nominal GDP



Number three, the China question, is worsening as congress passes legislation which would threaten China with higher tariffs if the Yuan is not devalued. It doesn't seem to be good policy to get in a fight with the largest foreign holder of your debt and the fastest growing major economy.

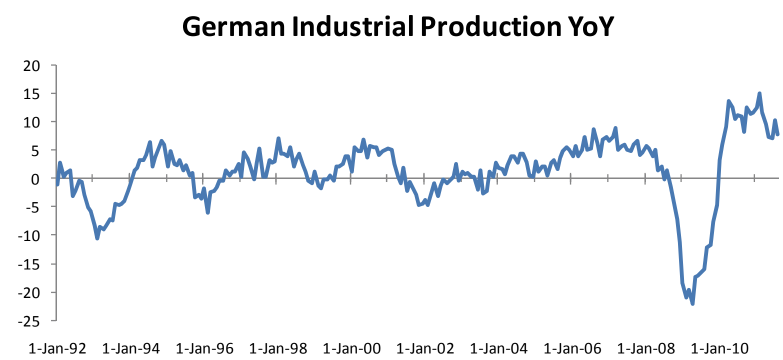
Finally, on the subject of regulations and taxes, we believe it is not possible to set the U.S. economy on a strong growth trajectory if corporations and entrepreneurs don't know the rules when they invest. The Fed has made sure the country is awash in cheap money, but the positive effects are lost when the velocity of that money is extremely weak. Banks won't lend and corporations won't spend, partially because of risk aversion, but also because it's hard to plan for the future when the rules are unclear.

UK Industrial Production YoY



And so we come to our outlook for economic growth. Markets can bob and weave around political issues, but at the end of the day, economic results will give the final answer. In our analysis, we consider the rate of change in economic numbers and market averages. As a rule, the rate of change will lead, and provide a warning of an imminent change in direction.

We are at that point (if not past it); rates of change are falling and some have even gone negative. For example, industrial production in the U.K. and Germany is declining and the U.S., the rest of Europe and even China are exhibiting this divergence to the downside. Every major world stock market exhibits similar downward trends. There are not a lot of positive indicators from our analysis. As mentioned before, it pays to be bullish when everything is negative, but we cannot find the catalyst to be positive.



Finally, two points about the stock market. Many forecasters suggest the market valuation is cheap in terms of price earnings multiples. They are correct, but we believe the earnings part of the equation is overstated. Consensus estimates for S&P 500 corporate earnings are $111 in 2012 and $123 in 2013. Given our outlook for world economies, these numbers will be revised lower. Already, downward earnings revisions have gone from 34% of total revisions in May to 50% in July and 73% in September. On the bright side, October has historically been the month when bear markets bottom and in the short term that may be correct again.

The best prediction we have is that politicians and bureaucrats will put some kind of patch on the problems of Europe and the U.S. This could lead to a seasonal rally in markets, but will be followed by the realization that world economies and corporate earnings are not supportive of higher prices. Also, these patches provide only temporary cover up of the world's debt overload. Only much stronger economic growth will solve the debt problems and we see no sign of such growth in the near future.

With our continued cautious view on the market and expectations of elevated volatility, we remain active in writing covered calls and purchasing protective puts which we believe will mitigate the downside risk of weaker markets.