



FAI Advisors, Inc.

# Monthly Investment Commentary

## September/October 2011

Stocks continued their slide in August and September amidst sharp volatility as investors started pricing in Europe's debt troubles and signals of slowing global growth. Large-cap U.S. stocks were down 5.5% for the month of August, while smaller-cap stocks lost 8.7%. Both developed-market and emerging-market foreign stocks dropped 8.5%.

Domestic high-quality, intermediate-

term bonds gained 1.5% for the month of August, driven by a sharp rally in Treasuries at the expense of lower-quality credits. Floating-rate loans, which we have been watching as an asset class, were down 4.4% for the month. Looking abroad, foreign bonds were up 1.9% in August, while local-currency emerging-markets bonds were flat.

### Updated Market Data

### "A Year in Review"\*

	August	YTD	7/8/11	7/8/10	% Chg	
<b>Large Cap Benchmarks</b>			<b>Consumer Rates</b>			
Vanguard SP 500	-5.50%	-1.90%	6 Month CD	0.44%	0.39%	12.82%
Russell 1000 Growth ishares	-5.30%	0.10%	30 Yr. Mortgage	4.17%	4.47%	-6.71%
Russell 1000 Value ishares	-6.20%	-4.10%	Prime Rate	3.25%	3.25%	0.00%
<b>Small Cap Benchmarks</b>			<b>Commodities</b>			
Russell 2000 Growth ishares	-8.50%	-4.60%	Gold	1794.00	1272.50	40.98%
Russell 2000 Value ishares	-8.80%	-8.60%	Crude Oil	87.96	74.57	17.96%
<b>Other Benchmarks</b>			Gasoline	3.66	2.72	34.56%
Vanguard REIT Index	-5.50%	5.80%				
Vanguard Total Intnl Stock Idx	-8.50%	-6.50%				
Vanguard Total Bond Mkt Idx	1.50%	5.60%				
Merrill Lynch High Yld Cash Pay	-3.90%	2.00%				
Citigroup World Govt Bond Idx	1.90%	8.40%				
DJ-USBCI (Commodity Futures)	1.00%	1.30%				

\* Source: JP Morgan Weekly market recap

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Year to date, we are experiencing 2008 like volatility, as the graph of the SP500 index below shows:



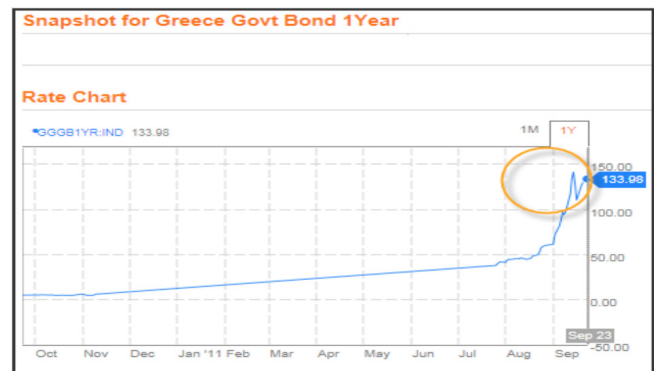
Source: [www.bigcharts.com](http://www.bigcharts.com)

With all the volatility lately, we have been asked questions recently related to what is causing the volatility. In this edition, we thought it made sense to comment on a few things: The sovereign debt situation overseas as well as the Federal Reserve here in the US.

## Global Risks to Recovery: Sovereign Debt

Certainly the world is watching the European sovereign debt crisis to see how this plays out in the short and long term. And as of this writing, the Greek one year government bond has exceeded 100% yield, meaning that bond investors are essentially saying the chance for default is for the most part certain. Whether this actually happens or not will remain to be seen, but the question does need to be asked:

how far will the systemic risk spread in Europe?



Source: [www.bigcharts.com](http://www.bigcharts.com)

A Greek default in itself shouldn't have the impact of collapsing the worldwide financial markets, but it certainly will cause fear based market reactions. If the European banking system potentially becomes unstable, it can create essentially a domino effect, the likes of which would need to be backstopped by Germany and the European Central Bank (ECB).

Common sense tells us that the financial issues in Europe and in the US didn't begin during the financial crisis in 2008; the unsustainable government spending and fiscal irresponsibility began well before then. The problem only became evident during and after the crisis. Furthermore, common sense also tells us that the Greek bailouts in spring

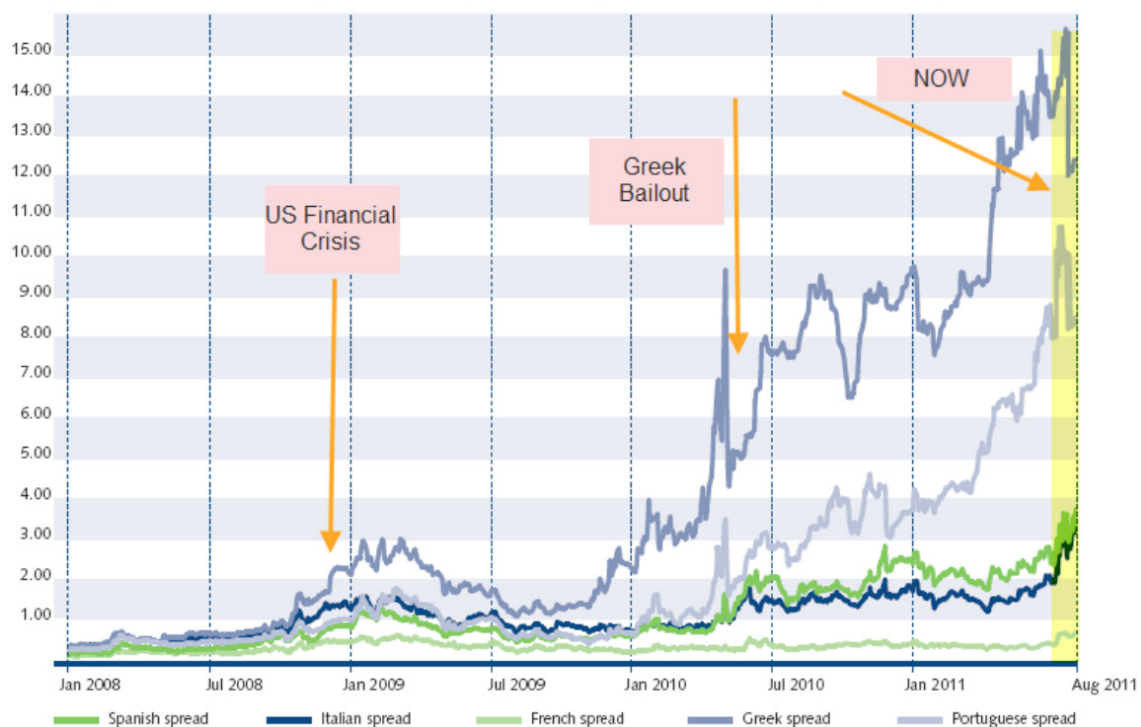
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2010 didn't solve the problem either. The bond investment markets have a unique way of telling us whether or not there should be concern in the Euro zone, in both the health of the local governments and the relative health of the banking system. The graph below shows this method, called the "yield spread". In this graph, 10 year government bond yields of many of the EUR countries are compared. Since Germany is considered the most financially healthy, it is used as the baseline to which other government bond yields can be compared, the difference being called the Yield Spread. The larger the yield

difference as compared to Germany (the wider the "yield spread"), the higher the perception of risk being reflected. For investors to buy a Greek government bond, they require a huge "risk premium" as reflected in the graph.

An interesting point: Even though the media and the public felt that crisis was averted in March of 2010 with the Greek bailout, the bond markets have been showing something quite different. The increasing risk, a reflection of how bond investors feel, is evidenced by the yield spreads widening since the bailout. If risk was subsiding, the spread would narrow

European government bond yield spread relationships to German government bonds – ten years maturity



Source: Advisor Intelligence

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over time.

So what is the real problem here? Can't Greece just cut their budgets, raise taxes, and get a bailout from Germany and France? Well, sort of. That has been the first step in tackling the challenges, but the core issue is more complicated. Austerity, the recent buzz word coming out of the Europe crisis, is the drastic reduction of government spending, and it is not an immediate solution. It will take years to move from the massive government safety net culture to one of austerity. Drastic change primarily results in large cuts in economic activity, which is the very thing that is needed to increase government revenue to pull them back from the brink of collapse. We as Americans are hearing about this now, the delicate balance between fiscal responsibility and "draconian" cuts, as they are called.

Furthermore, as we are seeing in the US, sustained unemployment has a devastating and long lasting impact on the future of the regional labor pool, especially younger generations. Without these generations moving toward present and future productivity, the retirement benefits for older citizens leaving the workforce are in serious jeopardy. In Greece, this is especially damaging due to the historically

young normal retirement age, before age 60.

While all this is true of Greece, Spain, Portugal, Italy and Ireland, the US faces much of the same dilemma. Any level of fiscal responsibility at the Government level has typically been something to be addressed later, much like Social Security and Medicare. Politicians don't offer solutions that relate to the most appropriate actions for the long term, their timeframe is the length of the next election cycle. Historically, serious actions don't usually occur until there is a crisis event, resulting in reactionary, short sighted and often misdirected responses.

## **The Fed and Interest Rates**

Finally, the markets are paying close attention to the Fed and their interest rate policy. It is helpful to gain insight about their level of concern of the direction of the economy by reading what they release in their committee minutes, as the excerpt from the Federal Reserve August 2011 press release shows ([www.federalreserve.gov](http://www.federalreserve.gov)):

*.....Information received since the Federal Open Market Committee met in June indicates that economic growth so far this year has been considerably slower than the Committee had expected. Indicators suggest a deterioration in overall labor market conditions in recent months, and the unemployment rate has moved*

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*up. Household spending has flattened out, investment in nonresidential structures is still weak, and the housing sector remains depressed. However, business investment in equipment and software continues to expand. Temporary factors, including the dampening effect of higher food and energy prices on consumer purchasing power and spending as well as supply chain disruptions associated with the tragic events in Japan, appear to account for only some of the recent weakness in economic activity.....*

*.....To promote the ongoing economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent. The Committee currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.....*

In the latest update on September 21st, the Fed Open Market Committee (FOMC) announced that they:

*.....intend to purchase, by the end of June 2012, \$400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less.*

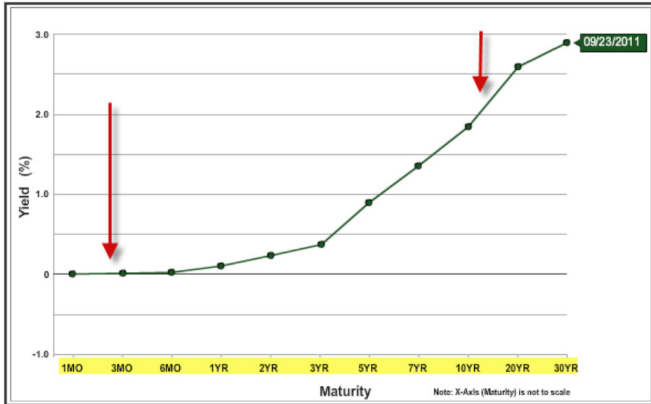
This program, referred to as Operation Twist, is designed to put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative. i.e.: to support the housing market once again by

spurring refinance activity and home buying. Will this work to spur this type of activity? It didn't work when it was tried in the 1960's, at least to any great extent.

The problem is that 30 year mortgage rates are already close to 4%, and have been trending down since the mortgage crisis began in 2007. Some believe mortgage rates have little impact on consumer decisions when their confidence is low and in an economy with 9%+ unemployment. In addition, an argument can be made that homeowners won't use this as an opportunity to refinance because they already know the Fed (through its own August press release) has decided to hold short term rates at zero until 2013. These homeowners may just wait another year or so since there is no reason to hurry, especially because so many homeowners need property values to recover a bit before they can refinance.

But, nonetheless, Bernanke and his Board of Governors are still trying to support the economy out of the slow down by pushing rates down because it's the only tool they have left. We must always remember the constant battle that wages on: Economic cycles (long term) vs. Political cycles (short term).

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Source: [www.ustreasury.gov](http://www.ustreasury.gov)

## Dual Mandate

The Fed states its statutory dual mandate as it relates to the economy: Full employment and price stability. They attempt to achieve these two mandates through controlling interest rates. The recent actions of the Fed: The commitment to leave short term rates at zero

until 2013, and finally the purchasing of \$400 billion of long term treasury and mortgage debt and mortgage securities until June 2012, provide evidence that the Fed is very concerned about this recovery. Furthermore, the \$600 billion of Treasury purchases (called QE2) essentially did nothing to help meet the employment mandate. According to Data360.org, the national unemployment rate has gone from 9.6% to 9.1%, from November 2010 to August 2011. September is expected to be relatively unchanged. It created a stock market run, a commodity run, basically a run in risk assets. Really, it potentially creates a longer term inflation problem, an environment of price instability, the opposite of their mandate. We live in interesting times, no doubt. It is likely to get even more interesting. We truly appreciate the trust you have placed in us. Thank you.

FAI Advisors, Inc.

Portfolio Sterling Committee October 2011

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