

## MARKET COMMENTARY

*Summer, 2011*

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### *Iceberg Spotting*

Dear Client:

In the midst of a robust economy, it is tempting to speak of the “good” and “better” ways to invest. The seemingly good ways make money and the better ways make even more. Cash is safe and most everything else appreciates.

During times of economic stress, the conversation is often couched in terms of “bad” and “less bad” investments. Loss of principal, worrisome market volatility and inflation undermine the former prosperity of all asset classes. Investors focus more keenly on ways simply to preserve wealth. Hopes for outsized gains are downsized to aspirations for nominal returns that just might pay a few bills.

With 14 million displaced workers confronting anemic jobs growth and with home prices having continued to fall for eight consecutive months, the “bad - less bad” terminology appears to hold sway.

The average stock investor, if he stayed in the market through thick and thin, has enjoyed an 88% recovery of his portfolio since the lows of 2009.\*

\*March 9, 2009 Dow Jones Industrial Average low of 6,440 through June 14, 2011 closing of 12,076.

### *The Economy*

For investors, the hot news in the financial press is the pending June 30 conclusion of the Federal Reserves’ QE2 program. QE2 is the Fed’s second attempt to stimulate the business environment through quantitative easing, or a loosening of the money supply. The program potentially deserves credit for having redirected the economy so as to avert a collision with an iceberg. Regrettably, however, despite the vigorous nudge, the nation’s engines are still stalled and the economy is simply adrift in a new direction. Whether we are merely headed for another hazard on a new vector remains to be seen. We will know for sure when we are upon it. Such is the utility of iceberg spotters.

In its apparently failed effort to ignite a fire, the Federal Reserve assumed an uncharacteristically active role. It became the buyer of last resort of mortgage-backed securities taking the sick issues (among other varieties) off of banks’ balance sheets and sacrificially placing them onto its own.

The 1.8 trillion dollars spent for these purchases was of the proverbial “printed money” variety. Those are the inflationary kind of dollars. The non-inflationary type could only have been if Congress had raised taxes to pay for the purchases, thereby keeping the money supply unchanged. The Fed’s course pumped more spendable paper into circulation.

The unanswered question, then, is, what will happen once the Fed stops its purchases? The Fed is estimated to have acquired 85% of the Treasury’s securities offerings in the past eight months.

Arguably interest rates are at historic lows *because* of the buying, and there are no obvious bidders who would or could take up the slack. China is searching for ways to diversify out of its U.S. debt holdings. Japan which purchased \$130 billion of U.S. Treasuries in 2010 now confronts \$300 billion of tsunami damage and is repatriating its cash. The oil exporting countries have slowed their purchases of U.S. bonds. Those located in the Middle East have domestic issues to solve. And U.S. investors? Tellingly, the PIMCO Total Return Fund, the world’s largest bond fund, is so adamant that U.S. interest rates may soon rise that it has eliminated 100% of U.S. government bonds from its portfolio.

So now the economy appears to be lumbering through nighttime waters without engines or lights. We know only that the effect of the QE2 program’s injection of new dollars into the system and the pending easing of that intervention (some call it bond market manipulation) seem destined to have ramifications. The most likely seem to be that rising inflation could be a side effect of the QE2 drug and rising interest rates may be its withdrawal symptom.

Ominously, with the housing market still on life support, a rise in rates could knock a shaky foundation out from under it.

In short, the economic act to unfold over the remainder of 2011 starts with a good deal of suspense.

### ***A New Glossary Term for the Times: “Financial Repression”***

Financial Repression describes an environment in which a heavily indebted government sustains interest rates below the rate of inflation. That mechanism eventually diminishes the value of the outstanding debt without the need for raising taxes. An implicit tax, of course, is borne by holders of the currency and fixed-income securities who suffer negative real interest rates.

To help ensure perpetuation of an inversion of the inflation rate and available interest rates, governments compel institutions to hold presumably safe assets in the form of government obligations.

University of Maryland economist Carmen Reinhart explains the typical progression into financial repression:

First, governments encourage credit expansion by the financial sector. As a result, a mountain of bad debt is piled up [*subprime lending*]. Then, at some point, comes panic. At this stage, governments nationalise the liabilities of their financial sector [*TARP and the Fed's Quantitative Easing programs of buying distressed securities*] and, more important, find their revenues collapsing, along with the economy. Huge fiscal deficits then emerge and public debt starts to soar.

At this point, desperate governments look for ways to force institutions to hold their bonds, willy nilly. This is the point at which financial repression begins: banks are forced to hold government bonds, for “liquidity”; pension funds are forced to hold government bonds, for “safety”; interest rate ceilings are imposed on private lending; to prevent “usury”; and, if all else fails, exchange controls are imposed, to ensure nobody can easily escape from such regulations.

While frequently associated with the economies of lesser developed countries, the U.K. successfully implemented mild financial repression from 1946 through 1979 in an effort pay down its wartime debt.

Although it has not been implemented as an explicit policy objective or by coercive means, U.S. investors have been enduring the same consequence as financial repression. Over the past 12 months, inflation has run at a 3.2% rate, well above the 0.2% to be earned on a one-year U.S. Treasury bill. A \$100,000 cash deposit is now worth just \$97,000 in last year's dollars. As we all know, proof is as close as the grocery store.

For the time being, it has been investor fear of more volatile assets (rather than governmental arm twisting) that has led to an acceptance of negative real interest rates. And, if the Federal Reserve can maintain that rate environment, it might well suit national financial interests, if not those of investors. The national debt becomes increasingly more manageable while those with cash deposits and bonds suffer the consequence.

Robin Hood was never so debt.

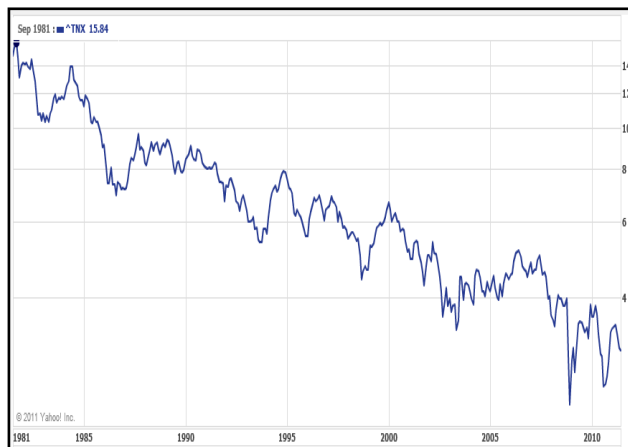
### ***Bonds, Wealth Preservation & Misguided Conventional Wisdom***

So, while media attention has focused largely on the volatility of the stock market, the real story might lie with the bond market. Some observers claim that, without the compulsory elements of financial repression, such low interest rates cannot persist indefinitely.

That would seem to be particularly likely with the conclusion of the Fed's bond buying programs. It is believed by many, therefore, that the bond market may represent the world's greatest asset bubble now primed for implosion.

Because of its seemingly increasing relevance, let me reiterate observations from an earlier market letter.

The following graph charts the 30-year decline in the interest rate of the 10-year U.S. Treasury note since it peaked in 1981.



This long-term trend of falling rates may be responsible for why conventional wisdom tends to place inordinate faith in the presumed safety of bonds.

Many, perhaps most, of today's investors have had no direct experience with the bond market of the 1970s when rates spiraled upwards:



Just as falling interest rates lift bond prices, rising rates would be expected to cause investor losses.

Three decades of favorable winds for bond owners may have badly skewed investors' perception of their safety. Or, to look at it another way: If a volcano has been quiescent in all memory, it may be tempting to build a house on its slopes in order to get a good view. The view realized may not be the one intended.

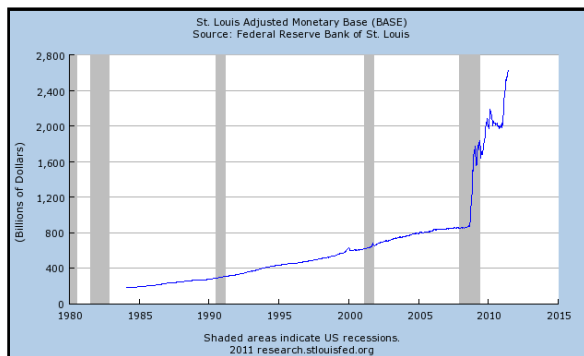


***A Picture for Amusement  
...and One More Troubling***

To illustrate the consequences of the worst-of-the-worst type inflation (referred to as hyper-inflation), the following is a picture of a 100 trillion dollar Zimbabwean note that I keep in a small collection of such currencies. (I am not Bill Gates. I purchased it on eBay for a few dollars.) If the Federal Reserve would print just one such bill, it could pay off the national debt seven times over.



Albeit at a more measured pace, our own U.S. money supply has grown smartly since the start of the financial crisis:



The full impact of how this growth in the monetary base may eventually translate into an expansion in higher level measures of the money supply cannot yet be known. And any inflationary impact would likely show up most profoundly once the economy recovers and banks begin to lend more freely again.

But, as investors, we can probably be relatively assured that there are threatening icebergs about, and we should be in a vessel that is likely capable of withstanding an impact, because there is, regrettably, no certainty of being able to avoid them.

***The Less Bad: Dividend Stocks***

The antidote to market volatility is to hold cash instead of stocks; and the antidote to inflation is ownership of assets for which their *replacement values* increase *because* of inflation. In the financial securities markets, that tends to mean common stocks.

During our ongoing financial crisis, investors, therefore, have been left with a stark choice:

- (a) For the safety of their principal, accept the anemic interest rates offered on cash deposits, bank CDs, and high-quality bonds... but suffer a likely permanent erosion of their purchasing power, or

(b) Attempt to protect the purchasing power of their savings with common stocks, yet endure the extreme stock market volatility and the uncertainty of not knowing *if* they will earn a return, *when* it might be earned, and *how much* it might be.

Dividend stocks may offer something of a middle ground for those investors wanting to try to protect their principal’s purchasing power from inflation but who may not wish to experience the likely greater volatility of growth stocks along with the greater inconsistency in the *timing* and *amounts* of the potential returns.

A portfolio of stocks selected for their high dividend yields, above-average quality and at least average growth potential, might be expected to produce a dividend yield of about 3.5%. The dividend offers a consistency of return while the portfolio still might be expected to have capital appreciation potential. Noteworthy, also, unlike the fixed rates paid on bonds and bank certificates of deposit, companies that pay dividends tend to raise them over time.

No stock, however, allows its investors to escape the discomfort of volatility. Even so, those that pay higher dividends might be expected to fluctuate somewhat less in value than growth stocks. And, of course, unlike

bank CDs or U.S. government bonds, stocks offer no guarantees. Stock prices can go down and stay down, and companies can reduce or eliminate the dividends. A diversified list of dividend stocks with a high-quality bias, however, seems apt to help diminish the likelihood—or mitigate the consequences—of such events.

Below is a sampling of a number of better-known dividend stocks with average or higher growth and quality rankings.\*

Company	Industry	Value Line Growth Rating	S&P Quality Ranking	Recent Price*	Approx. Yield
AT & T	Telecommunication	3	B+	30.79	5.6%
Atmos Energy	Natural Gas	3	A-	31.66	4.3
Chevron	Petroleum	1	A-	100.60	3.1
ConAgra	Food Processing	2	A-	24.40	3.8
Heinz (H. J.)	Food Processing	3	B+	53.71	3.6
Johnson & Johnson	Medical Products	3	A+	67.10	3.4
Kraft Foods	Food Processing	3	A-	34.26	3.4
Mattel	Toys & Games	2	A-	25.77	3.6
McDonald’s	Restaurant Chain	3	A	81.47	3.0
Waste Management	Pollution Control	3	B+	36.84	3.7
*as of 6-14-11				Average	3.8%

Not straying from our roots, over time we would anticipate that growth stock portfolio owners might enjoy much higher total returns than those with dividend stock portfolios.

However, if confronting the choice between holding a low-yielding fixed-income asset versus a higher-yielding dividend stock portfolio that might protect against an inflation iceberg, the latter could prove to be the “less bad” option. Or even, with a shred of optimism, potentially quite a good investment choice.

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As always, I am most grateful for your confidence, and I wish you an enjoyable start to your summer season.

Most sincerely,



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