



The Fed Launches QE2... or is it the Titanic?

In Review

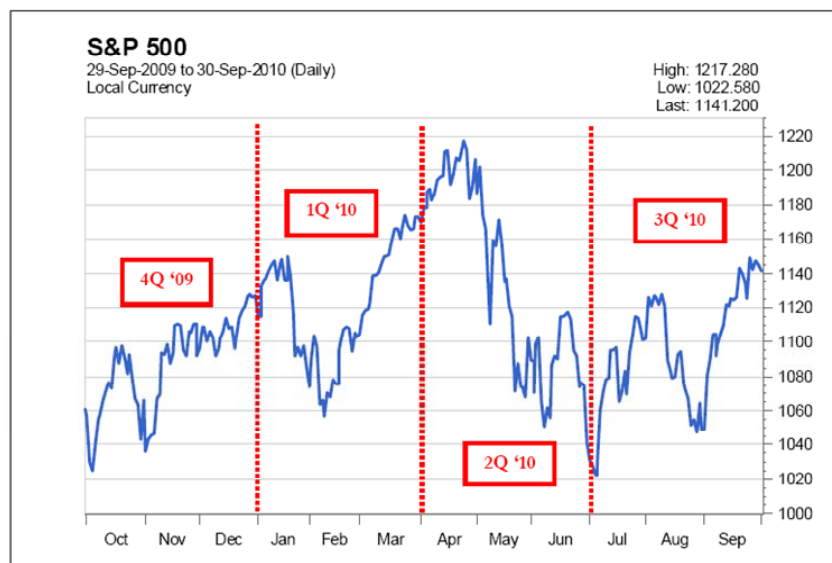
“Problems cannot be solved by the same level of thinking that created them.” **Albert Einstein**

Performance for the various indices we track for the quarter, year to date, and longer term time periods is shown in the chart below:

Benchmark Performance						
Data as of September 30, 2010						
	<u>QTR</u>	<u>YTD</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>7 Year</u>
Bardays 5 Year Muni	2.53%	5.04%	5.62%	6.74%	5.40%	4.34%
Bardays Aggregate	2.48%	7.94%	8.16%	7.42%	6.20%	5.35%
S&P 500	11.29%	3.89%	10.16%	-7.16%	0.64%	4.04%
Russell 1000	11.55%	4.41%	10.75%	-6.79%	0.86%	4.47%
Russell 2000	11.29%	9.12%	13.35%	-4.29%	1.60%	6.13%
iShares MSCI EAFE	16.48%	1.07%	3.27%	-9.51%	1.97%	7.81%
iShares MSCI Emerging Markets	18.03%	10.75%	20.22%	-1.48%	12.74%	18.94%

Source: PSN Informa

Most risk assets had a strong third quarter performance predominately driven by returns in the month of September. While historically one of the worst months for U.S. stocks, the S&P turned in its best September since 1939. The chart below shows the quarterly path of the S&P 500 since Q4 2009:



Source: Strategas

The catalyst for the movement in stocks as well as other risk assets was a speech by Chairman Bernanke in late August indicating that the Federal Reserve was considering further monetary accommodation to stimulate the economy. In that speech, the Chairman stated “Notwithstanding the fact that the policy rate is near its zero bound, the Federal Reserve retains a number of tools and strategies for additional stimulus.....The FOMC will do all that it can to ensure continuation of the economic recovery.” This is as clear a message as one can expect from the Fed, and the market’s reaction to the speech was immediate and meaningful on several fronts. The U.S. dollar as measured by the trade-weighted dollar index weakened:

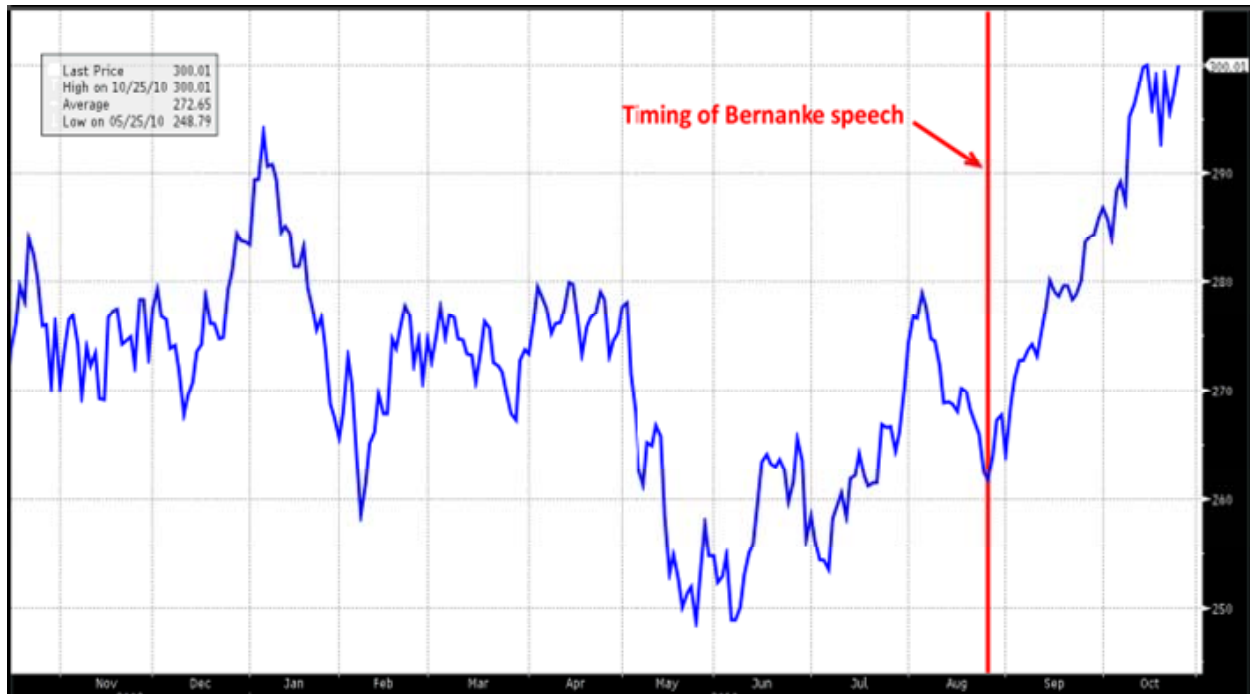
Trade Weighted Dollar Index



Source: Bloomberg/CWA

Commodities, as measured by the Reuters/Jeffries equal weight commodity Index, began to climb as investors sought hedges against the falling dollar:

Reuters/Jeffries Commodity Index



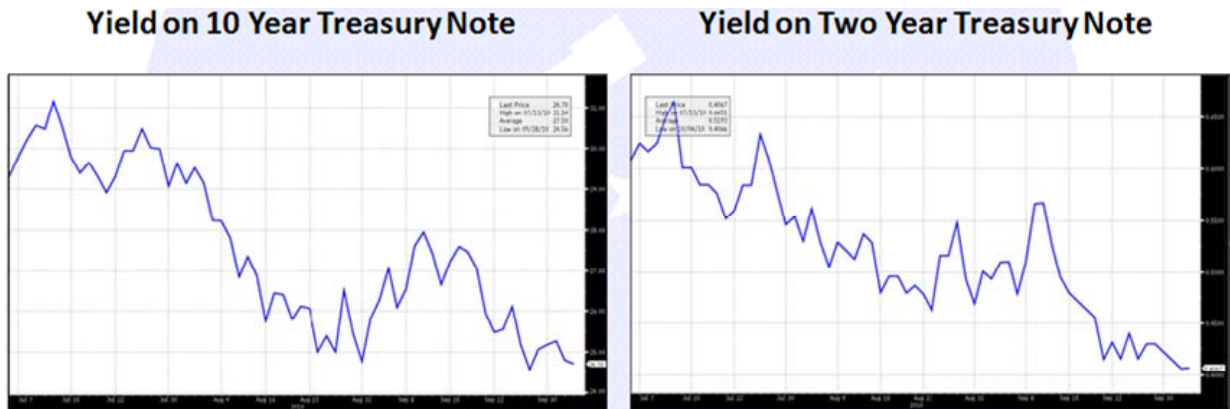
Source: Bloomberg/CWA

The price of gold hit an all time high on a nominal basis at over \$1,300 per ounce, but not on an inflation adjusted basis as seen below:



Source: Goldman Sachs

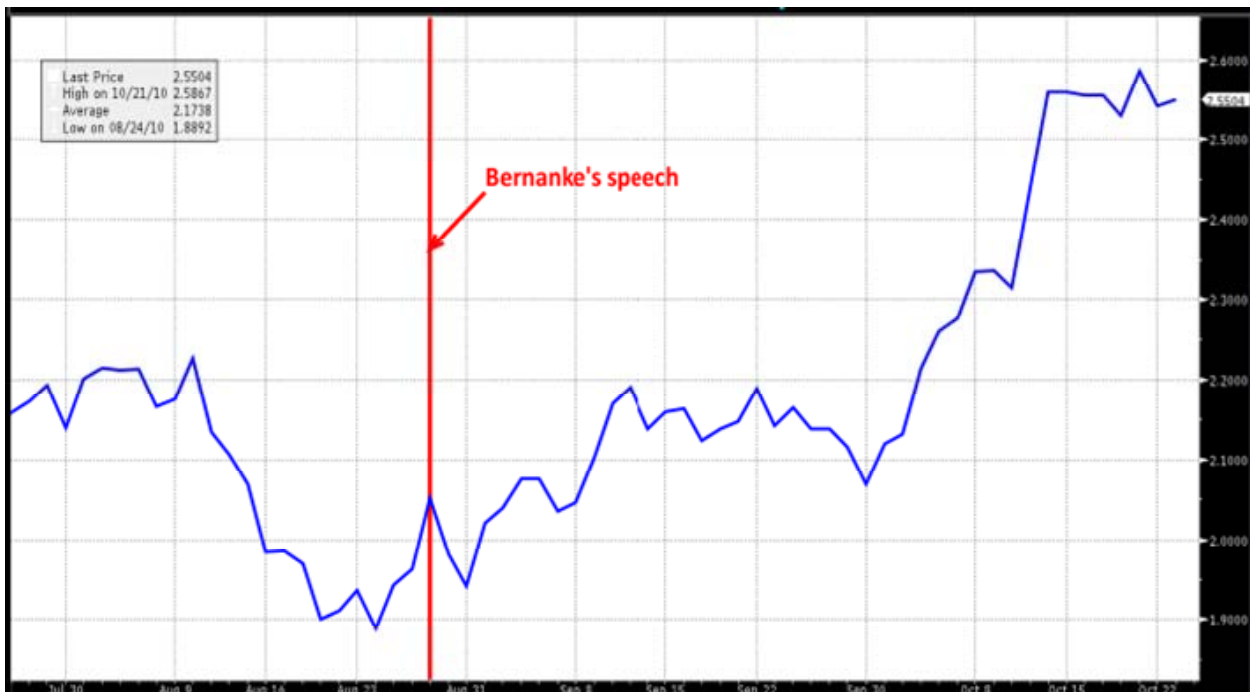
And the yields on treasuries dropped from already low levels across the curve as investors rushed to front-run anticipated Fed purchases (the 10 year was recently quoted at 2.50% and the 2 year at a near record low 0.36%):



Source: Bloomberg/CWA

Investors' long term inflation expectations increased as well; those expectations are expressed in the marketplace through the yield differential between nominal treasuries and their commensurate maturity TIP issue. Below is the 30 year breakeven or the yield differential between the 30 year nominal treasury and the 30 year TIP:

30 Year Breakeven



Source: Bloomberg/CWA

Within just a few weeks time expectations rose from roughly 1.89% to over 2.50%, a stunning move. On a related note, the yield on the 5 year TIP went into negative territory indicating a

willingness of investors to potentially lose money over a five year time period if their inflation expectations were incorrect:

5 Year TIP Yield



Source: Bloomberg/CWA

The market's reaction to the Chairman's speech was not surprising given the expectation of further monetary accommodation. Unfortunately, it may end up resulting in a massive misallocation of capital as the Fed's intervention distorts the marketplace. Most disconcerting, is by increasing the size of their balance sheet, the Fed decreases the odds that they will be able to manage their exit strategy smoothly.

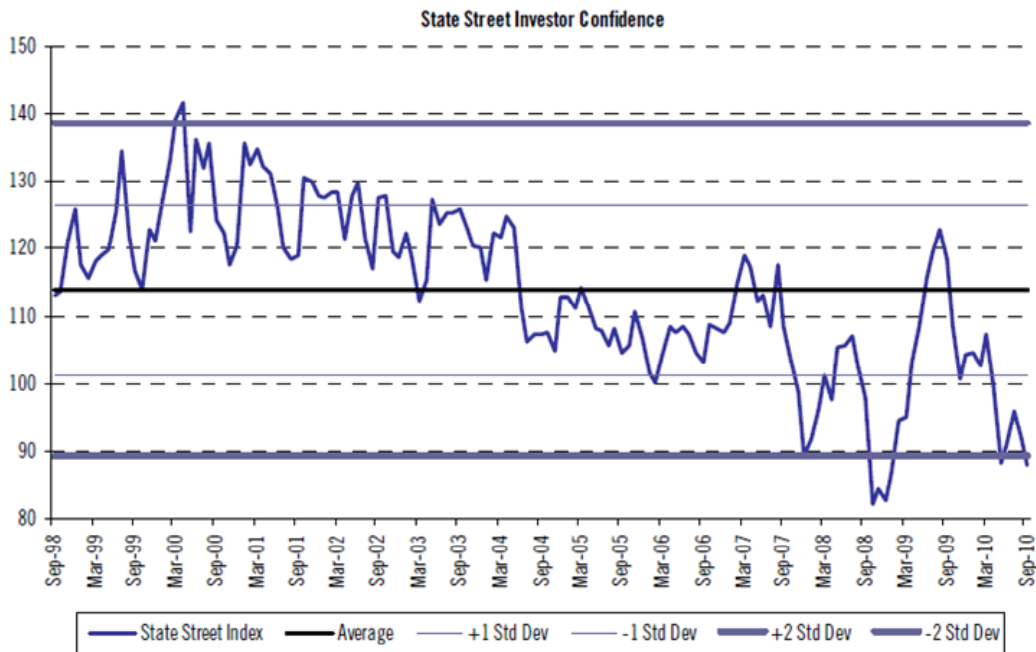
Outlook

"Human beings who are almost unique in having the ability to learn from the experience of others are also remarkable for their apparent disinclination to do so." **Douglas Adams, Author**

The Federal Reserve will likely announce its decision about the amount and timing of further "quantitative easing" after the next Fed meeting on November 3rd. To review, quantitative easing is a euphemism for printing money; and is effectuated by having the Fed purchase treasuries or other securities, using new money to do so (i.e. the Fed creates the computer entry in its own account, then uses the money for asset purchases). These are uncharted waters and even Chairman Bernanke, in a bout of unusual Fed transparency and frankness, admitted that "we have much less experience in judging the economic effects of this policy instrument, which makes it challenging to determine the appropriate quantity and pace of purchases and to communicate this policy response to the public." (Bernanke October 12th, 2010). Despite the Chairman's hesitance to continue to aggressively deploy this policy tool, and the fact that several members of the FOMC are either against it outright (Hoenig) or have expressed reservations (Bullard,

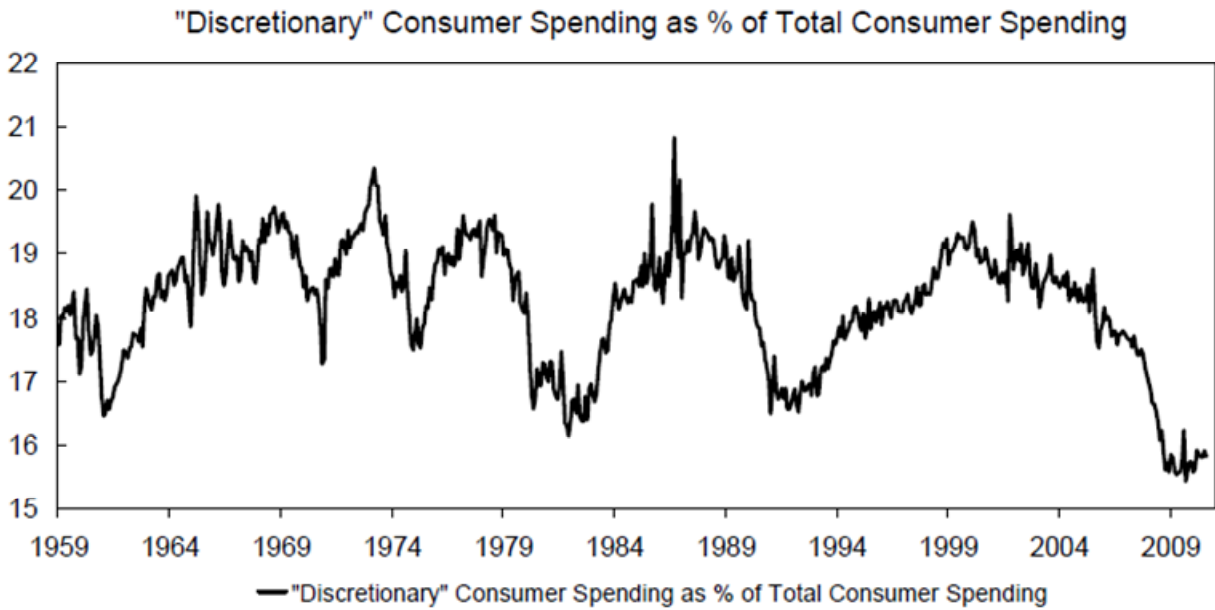
Kocherlakota and Fisher), the markets appear to have discounted a fairly significant purchasing program as illustrated by the charts at the beginning of this letter. This appears to have set up a potential for disappointment when the details of the program are released, and if so, the potential for a partial reversal of the recent moves that began in late August. We will have to wait to see.

Whether the market is disappointed or not in the short term, the more relevant question is what effect the additional money will have on the economic landscape beyond this calendar year. Our fear is that the second round of QE will result in only further debasement of the U.S. dollar, driving up the cost of food, energy and other commodities while leaving little pricing power in the remaining areas of the economy. The Fed therefore has unwittingly added to the overall level of uncertainty which already is weighing on broad confidence levels. Business confidence is lacking due to the uncertainty over taxation, regulatory restrictions, health care costs and the volatility of global currency exchange rates. In turn, consumer confidence remains low due mostly to the employment situation which hinges on business regaining clarity on some of the aforementioned topics. Below is a chart of overall investor confidence demonstrating readings well below desirable levels and only slightly better than those registered at the market bottom in 2008:



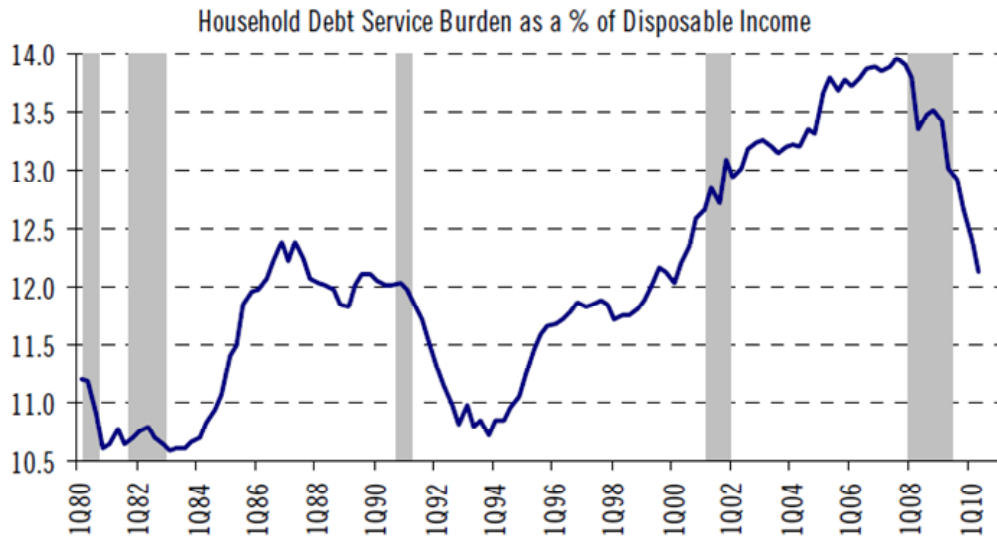
Source: Citigroup

Consumers are reacting to this uncertainty by repairing their balance sheets; spending less on discretionary items. The reported data lump both government and consumer spending on health care into discretionary spending and if that distortion is removed, we can see that true discretionary spending is at a 50 year low:



Source: Citigroup

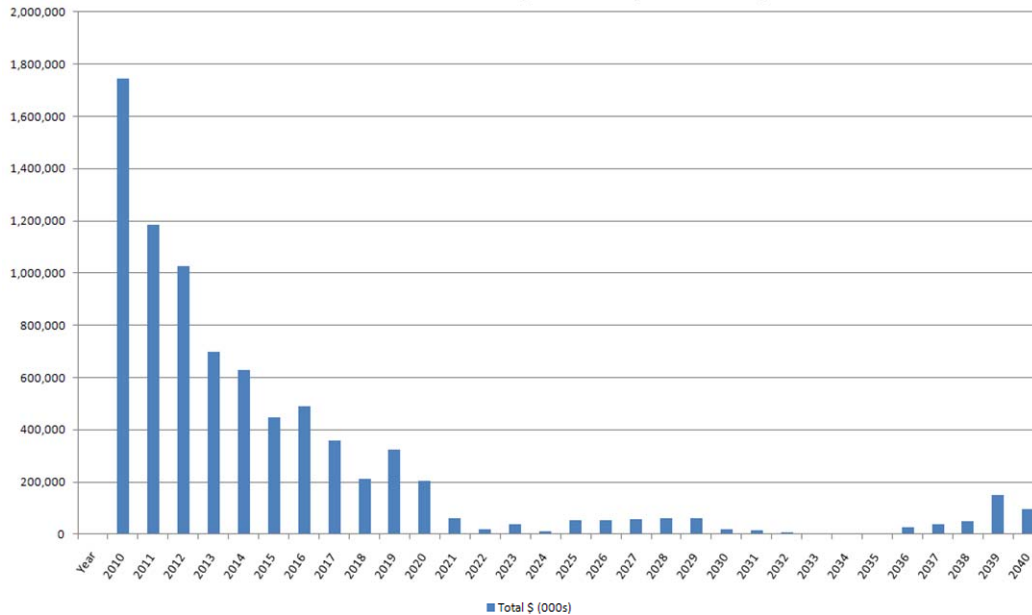
This newfound propensity to save, coupled with the decline in debt service costs (shown below) due to the rapid decline in interest rates could potentially pave the way for the next recovery in spending to take place. However, it will take some time:



Source: Citigroup

Meanwhile, the government is intent on propping up the economy until things recover. With the federal debt growing, it is paramount that Congress addresses the deficit before debt levels reach their tipping point (Greece showed us what happens when the market loses confidence first). It would be helpful if the Treasury could avail themselves of record low interest rates by moving more of their borrowing “out on the curve”. The chart below shows that over 60% of the almost \$9 trillion in outstanding debt has a maturity of less than 3 years (there is an additional \$5 trillion in intra-agency debt, i.e. debt owed to ourselves mostly due to Social Security obligations):

U.S. Treasury Debt by Maturity



Source: U.S. Treasury /CWA

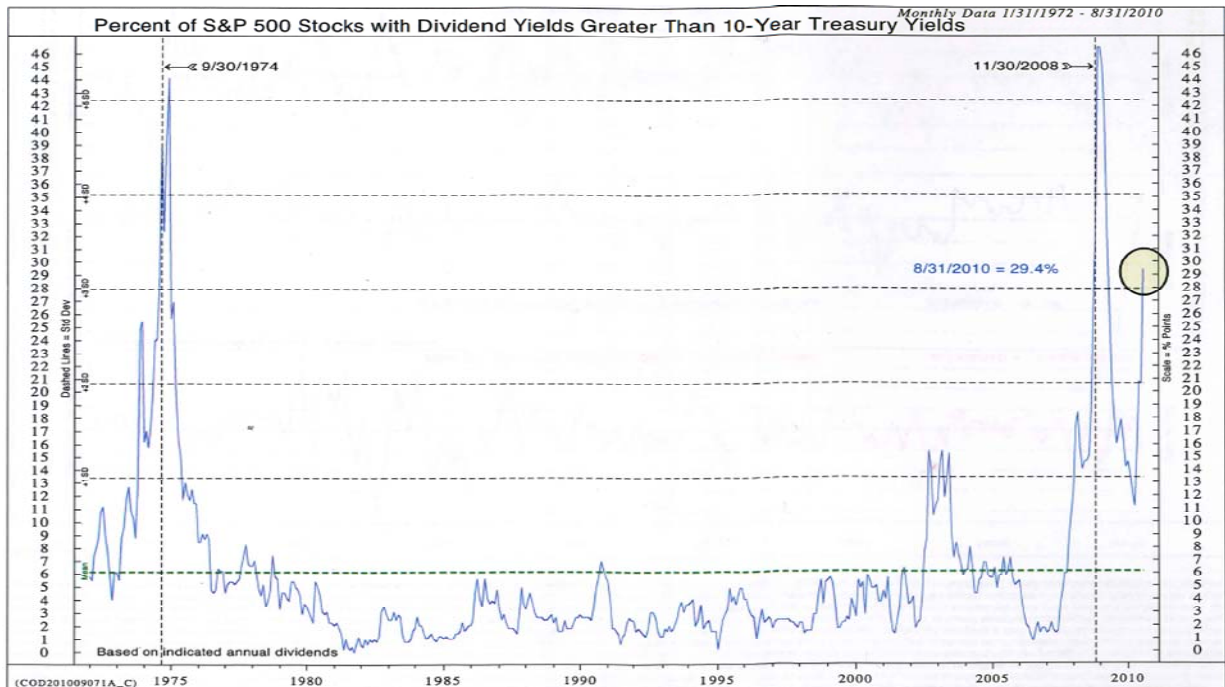
So if the Fed gets their wish and creates inflation, or if large foreign purchasers demand more return, higher bond yields will result, causing further budget pressures as the short term debt matures and is reissued at higher interest expense to taxpayers.

Ultimately, our job is not to opine on policy but instead to allocate capital based on the most likely outcomes and find assets that may be mispriced for coming economic conditions. All of the uncertainty, as well as potential bad policy decisions near term, create opportunity. There will be clear winners and losers as the aftermath of the crisis unfolds, and the Fed's course of action and other government uncertainties are resolved.

Recommendations

In the current landscape it is more efficient from a risk/reward standpoint to generate income in risk assets than to stretch to increase yield in a bond portfolio. Seeking risk assets that provide more income has the added benefit of reducing volatility in the overall portfolio.

- To that end, we continue to recommend dividend oriented equities for all of the reasons we have stated in previous letters. Fortunately, the opportunity set for dividend investing has not been this attractive in decades; according to data published by Ned Davis Research, over 29% of companies in the S&P currently yield more than the 10 year treasury. Other than a momentary blip at the bottom of the market in 2008, this is the highest number by far since the bottom of the bear market of 1973-4 as shown below:



Source: Ned Davis Research

Since the 1920's dividends have represented almost half of the total return on equities. With record cash on corporate balance sheets and companies seeing a limited need for investment, we expect payouts to continue to grow.

- As for equities in general, the S&P 500 is currently trading at roughly 14x earnings for 2010 which consensus forecasts at slightly over \$84. The chart below shows where multiples generally reside in different inflation scenarios, and suggests that stocks should be trading at closer to 18x:

Inflation	Average S&P 500 P/E
Less than 2.5%	18.6 x
2.5% - 3.5%	17.6
3.5% - 4.5%	12.1
4.5% - 5.5%	14.2
5.5% - 6.5%	12.8
6.5% - 7.5%	10.0
Greater than 7.5%	8.6

Source: Goldman Sachs

Of course there are many reasons for stocks to trade at a discount and perhaps one of those is the Fed's desire to increase inflation. We reiterate our belief that domestic equities will remain somewhat range bound but that the opportunity exists to make money.

- Emerging markets are attractive for the long term investor but this has become a bit of a crowded trade. For 2010, the developing economies represent roughly 35% of global GDP on a spot currency price basis (it is sometimes quoted on a purchasing power parity basis

which can be misleading) and a greater percentage of global growth. Most investors are underweight these markets in their equity portfolios and need to adjust from what has been a geocentric mindset. We would use any meaningful weakness to average into these markets as growth prospects and federal balance sheets compare favorably to developed nations. Additionally, this is the first cycle in which central banks in the emerging areas have raised interest rates ahead of the Fed. As a result, the currency appreciation versus the dollar could persist, adding to any capital gain in equities.

- Following up on the income theme, we also recommend yield-oriented real estate, specifically the multifamily/apartment space. We believe that the combination of attractive pricing, low cost financing, tax-preferenced yields in excess of corporate bonds and favorable demographics will allow for very attractive rates of return.
- We remain positive on the hedge fund space as economic uncertainty, coupled with increased policy intervention, make for volatile capital markets. In this environment, we believe that long/short strategies and global macro funds will be countenanced with a large opportunity set on a consistent basis to provide very favorable risk-adjusted rates of return.
- Fixed income remains a very difficult place to invest capital. With rates moving lower ahead of the expected Fed intervention, plus the Fed openly stating their desire to increase the rate of inflation, it remains a poor risk/reward trade off. The best bet is to keep ladders and barbells weighted toward the short end of the curve and wait for the Fed to get their way. By structuring the portfolio in this manner, cash will be available to invest in the higher rates when inflation eventually arrives.

As always, we appreciate your trust and confidence. Please feel free to contact us with any questions or comments.

A copy of Constellation's Form ADV Part II is available upon request by calling Philip Frank at (212) 697-2500 or e-mail philip@constellationwa.com.

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