DouglasBradley LLC – 3rd Quarter 2010
Quarterly Economic and Market Assessment

DOMESTIC ECONOMY
- The Federal Reserve, having already lowered rates as low as possible, has resorted to buying bonds in the open market to artificially drive down interest rates in the hopes of stimulating the economy.
- Unemployment remains stubbornly high - job losses have slowed but the economy has yet to see increases.
- Recent announcments from the government show that economic growth is clearly lower than the projections; suggesting that jobs and tax revenue will also come in below expectations.
- The prospect of an announcement in early November that additional stimulus dollars will be pumped into the economy has been driving the price of all assets, including stocks and commodities, meaningfully higher.
- House prices remain depressed and the outlook for gains remains discouraging as there is more than 10 months of inventory currently for sale.

INTERNATIONAL ECONOMY
- The G-20, a group of central bankers representing the world's twenty largest economies, met recently to address global financial weakness, but came away with no consequential solutions.
- Despite fears that a collapse of real estate prices in China may drag their economy down, they seemed to have temporarily addressed their problems and kept economic growth at a rate greater than 5% annually..
- England, Ireland, Germany and other European countries have implemented strict austerity programs to reduce their unsustainable levels of debt; with the unwelcome effect of rising unemployment and slowing economies.

DOMESTIC STOCK MARKET
- The historically strong stock market rally that started in March 2009 continues through to the present, with the market experiencing its best September in decades.
- US stocks remain overvalued given expected corporate growth rates and a still weak economy..
- High levels of optimism and expectations for a future round of government stimulus are supporting stock prices in spite of a weak business and economic environment.
- Mutual funds focused on US stocks continue to see large monthly outflows as investors leave equities in search of the perceived safety and income offered by bonds and bond mutual funds.

INTERNATIONAL STOCK MARKETS
- World stock markets, as well as markets for commodities, have become increasingly correlated.
- Global prices for raw materials such as cotton, sugar, metals, etc. surged during the 3rd quarter in large part due to investors' preference to hold hard assets vs. currencies subject to devaluation.
- China's stock market, which often leads the US stock market, is struggling to beat highs set in November 2009.

FIXED INCOME (BOND) MARKET
- Short-term and long-term interest rates remain at historically low levels due to the Fed's decision to stimulate the economy by creating new money and injecting it into the economy, lingering concerns about deflation and a second recession in 2011, and the increasing preference of investors to hold bonds instead of stocks.
- Japan's failed policy of using very low interest rates to spur economic growth was derided by US leaders at the time – yet when faced with the same situation 20 years later they are following the same roadmap.
- Historically, the price of gold starts to rise 10 months before interest rates also start to rise (and bond prices fall); interestingly, it has now been 100 months since gold started its climb with no corresponding rise in rates.
- For those that can qualify for a loan, long-term mortgage rates are hitting all-time lows.

DouglasBradley's View Looking Ahead
- The US government, through the Federal Reserve and the US Treasury, continues to keep interest rates artificially low to spur growth. We expect long-term rates to follow short-term rates lower a bit longer.
- Despite the claim that the US economy will return to 4% annual growth shortly, we believe economic growth will remain markedly below the long-term trend and probably be in the range of 2% for the foreseeable future.
- We expect (sadly) chronically high unemployment and depressed housing prices for several more years.
- We expect a stock market correction in the range of 15-20% from the April highs over the coming six months. The current rally suggests investors are too optimistic about corporate growth rates and a turnaround in business conditions, employment, and housing.
- The challenging investment climate will continue for another 5-7 years. Nevertheless, emerging Asia, Brazil and India will provide some of the greatest investment opportunities in the future.

DouglasBradley
Personal Financial Advisors

Mr. Douglas O. Robinson
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October 29, 2010

Dear Doug:

It seems like things have coalesced in the last thirty days in terms of what has been driving the financial world for the last eighteen months – Quantitative Easing (QE). We talked about it in our last MoneyWise, but for those who missed it we offer another opportunity to get acquainted with it. Think it doesn't impact you (or us as your investment advisor)? It's directly responsible for the performance in your portfolio over the last year. And will continue to be the driver for the foreseeable future.

From MoneyWise:

> Quantitative Easing can be described as the US Federal Reserve Board (the Fed) printing new money for the purpose of injecting it into the economy. You see, unlike you and me, the Fed has the ability to print money "out of thin air". If you tried to do this at home - printing $100 bills on your computer - you'd go to jail for counterfeiting. But the government calls it Quantitative Easing. They literally create new money from nothing - it's not borrowed from anyone. It is simply a debit entry on the country's balance sheet.
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> The Fed injects this money into the economy by purchasing large amounts of financial assets (debt instruments such as government bonds, mortgage-backed securities and corporate bonds) from big banks and other financial institutions. The formal Fed process of buying all this debt is referred to as Open Market Operations. You may also read the phrase, "monetizing debt." What happens is that a bank sells the Fed its bond(s) and now the bank has additional cash to spend or lend - or as they've been doing - buy stocks.
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> You might ask yourself: Why does the Fed have to get involved in this? Why can't the owners of the bond find someone else to sell to in the bond market? The answer: Because these are the "toxic assets". This is the stuff no one will buy except at drastically reduced prices. They just sit on bank balance sheets because the banks don't want to realize the loss and admit how little they're worth. So instead, the Fed comes in and buys them on the "open market" at ridiculously inflated prices. So it's not really an open market - it's an artificial market.
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> The hope is that the injection(s) of this newly created money will spur spending and economic growth. But because of the risks associated with QE, it is often only employed after all other efforts to restore an economy have failed.

It's no coincidence that the stock market recovery began immediately after the Fed started its Open Market Operations. After exhausting all other means, this strategy was their last hope of reversing the ongoing weakening in the US and global economy. As illustrated in the following chart, stocks (represented by the S&P 500 in purple) started their 18-month rise once the Fed, under the direction of Chairman Ben Bernanke, started flooding the economy with newly printed money in March 2009.

Surprisingly, the Fed has made no secret of their attempts to manipulate the markets. Earlier this month Brian Sack, Chief of the NY Fed's open market group stated unapologetically that actions by the Fed, "**add to household wealth by keeping asset prices higher than they otherwise would be**." The blatant market manipulation illustrates the incredible arrogance of our government and financial leaders and the degree to which they will go to protect their jobs and the wealthy class of this country. To burden current and future taxpayers with the repercussions of their actions is incredibly reckless in our opinion.

It is no wonder that so many experienced, prudent and disciplined investors (as we consider ourselves at DouglasBradley) have been left behind during the recent rally. The rally wasn't based on increased corporate earnings. Nor was it based on improving economic fundamentals or attractive stock valuations. That would be "old school." No, the new financial wiz-kids that brought the economic collapse to our doorstep are resorting again to their financial wizardry to float the market higher on a sea of newly printed money (aka, increasing the money supply, monetary easing, etc.).

Too much of a good thing (printing US dollars in the Fed's case) will certainly have serious and unintended consequences – and we are already starting to experience them.

All this new money can't be printed without adding to the Federal deficit. And, under normal circumstances, an increasing deficit leads to inflation and higher interest rates/yields on bonds. But this isn't being allowed to happen. The Fed is using their newly issued money to purchase US Treasury bonds and bundles of impaired mortgages owned by banks. This artificial demand is driving up bond prices and driving down interest rates. At the same time, they are systematically shifting the losses suffered on the mortgage-backed bonds from private banks to the taxpayer/uninformed public. Refer again to the chart to see the decline in interest rates (blue line) during a period of increasing Federal deficits – particularly the period starting in June 2010 when the Fed stepped up bond purchases.

Another serious consequence is that the excess money will result in the devaluation of the US dollar against foreign currencies. This lowers every Americans' purchasing power.

What we are left with is an unprecedented period where: 1) stock prices are up based on artificially inflated stock prices; 2) bond prices are up (interest rates are down) based on artificial bond demand by the Fed; and, 3) gold prices are up as investors attempt to protect their purchasing power because of 1) and 2). These three asset classes historically don't move in lock step with one another. At least they don't when they're left alone. But the Fed's actions have created an artificial Utopia.

Unfortunately for everyone, the Utopia cannot continue. Notably, the growing spread between stock prices and interest rates (refer again to the chart to see the divergence that started June 2010) must revert to normal patterns where stock prices and interest rates move together as they did from 2007 – 2009. We absolutely cannot borrow our way back to prosperity no matter much our leaders' would like it to be so. This obviously means that stock prices must either fall and/or interest rates must rise.

As many of you know we've successfully invested in and profited from falling stock prices in the past, but we only do that in extreme conditions. This is not one of those times as it is clear the Fed will do everything within their broad power to artificially inflate asset/stock prices. Instead, we've elected to focus on the investment theme of rising interest rates. We've done this through the purchase of the ProShares UltraShort 20+ Year Treasury fund (symbol: TBT). This exchange traded fund (ETF) tracks the movement of the 20 year Treasury yield and will rise in value as interest rates go up. As you have no doubt noted in your statements, in retrospect we've invested entirely too early in this strategy. No one doubts that interest rates must rise, but what we certainly couldn't foresee (and few foresaw) was the aggressiveness with which the Fed would use QE to drive interest rates down.

So here we are: our gold stock positions are going through the roof and our TBT is sitting at a sizable paper loss. It's understandable to look at TBT and scream "Sell!". But is that really a wise course of action at this point? How long can the Fed fight the laws of nature? At some point interest rates will have to rise – either at the Fed's hand or because the market demands it. We bought the position knowing three things: we were buying early; pricing could be volatile in the near term; and we intend to hold for years (not months) as the trend develops over time. So while no one likes to lose money on an investment, we don't see any fundamental reason to change our view of TBT's future prospects.

As we said at the start of the letter – things seem to have coalesced in the last couple of months. And it has reinforced our view that for the foreseeable future, the three main investing opportunities remain gold/precious metals/commodities, the stock of companies in emerging countries and rising interest rates. We're already investing with two of these themes and we continue to wait diligently for an opportunity to buy into those emerging economies at a reasonable price.

I daresay we are as frustrated as you are that the performance of the accounts over the last year wasn't higher. We purposefully stayed out of the emerging markets stocks because we feared how clients would react to the short-term volatility that comes with them. In retrospect, we would have been better off to "bite the bullet" and invest. But hind sight is always 20/20. We never expected we'd have to sit on the sidelines this long. We will enter the market – but it will be on our terms. And when we do, we'll all have to steel ourselves to the volatility in portfolio values from month to month as we let the emerging market trend continue to develop over time. Our belief is that this area represents one of the best opportunities for growth over the next decade.

As we're fond of saying, "a letter is never a substitute for a conversation," so we strongly encourage you to give us a call to ask any questions you may have or even to share your point-of-view. We would like nothing more than to have a dialogue about this letter or any other matter that may be on your mind.

DouglasBradley LLC

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