THE RUDD COMMENTARY

{ SEPTEMBER 2010 }

We are excited to publish this edition of *The Rudd Commentary*, which is a periodic publication designed to bring you a professional opinion on the current investment environment and some developing trends. Since we are in the business of managing investments for our clients, we will focus on information and events that we feel are material to that end. We will not comment on opportunities or challenges relating to specific securities as this would undermine the value we provide for our private clients. Please feel free to forward *The Rudd Commentary* to family, friends, and business associates who might find this information valuable.

DEFLATION, THE DOLLAR AND A DOUBLE DIP

The letter "D" gets a bum rap in the English language. Country western singers and college students alike have had fun at the expense of the fourth letter of the English alphabet, but lately, politicians and the media have been the instigators. The talking heads on the evening news have been droning on about the worst financial crisis since the great *Depression*, record *Deficits*, consumer and municipal *Defaults*, and more recently, the falling *Dollar*, *Deflation*, and a possible *Double Dip* recession. This has prompted many questions from our private clients about all these "D"'s, specifically the concerns over deflation, the falling dollar and the possibility of a double dip recession. Let's take a look at these last three to see if they really deserve all the recent attention.

DEFLATION »

The word "deflation" simply refers to falling prices. While this may seem like a great thing for young consumers saving for their first home, car or their next gaming console, deflation is often accompanied by some very undesirable consequences. First, if prices for goods and services fall for an extended period of time it will have a large impact on corporate profits. In a deflationary environment, corporate executives will look for ways to cut costs which will eventually have a negative impact on jobs. In our current environment with over 9% unemployment, we would like these high paid decision makers focused on new products and innovation rather than cutting expenses. Second, if prices continue to fall, consumers may sit on cash waiting to purchase their goods at a later time and a lower price. This creates a deflationary spiral in which the waiting consumer forces businesses to mark down prices further to match demand, in turn forcing firms to cut expenses to stay profitable, which will increase unemployment leading to less purchases...you get the picture. The final problem with deflation is that it presents a very challenging environment for the Federal Reserve Bank or "Fed" to stimulate the economy using monetary policy. To state this simply, the Fed could normally lower short-term interest rates in a bad economic environment to encourage borrowing and investment. However, if wages and prices are falling, businesses and consumers are less concerned with low borrowing costs and more focused on fortifying their falling income. In summary, deflation can be a very bad thing.

So, is there a risk of deflation? The answer is yes. In fact, in late 2008 through mid 2009 we did experience a short period of deflation overall driven primarily by falling energy prices. Since then, we have been hovering in positive territory, but just barely. We appear to be at a very fragile point in the U.S. economy, but despite the doom and gloom from the media, a long deflationary period is definitely avoidable. Housing troubles and the unemployment problem have continued to weigh on economists minds, but consumers are still spending on things they want and are willing to pay higher prices for shiny new products whether they need them or not (iPad). At the end of the day, our expectations and habits have a big influence on price levels.

In the meantime, let's look at how to deal with deflation if it actually occurs. Treasury bonds should provide the best and possibly only positive return if they realize their primary objective of preserving capital and income. However, this is a risky bet given the current interest rate environment and the Fed's unique predicament mentioned above. If prices become inflationary and the Fed has to raise rates, you will be trampled by the crowded market in Treasury bonds as everyone runs for the exit. Other assets could provide some form of deflationary protection as long as they have fixed and collateralized income and are not tied to falling asset prices. So, if you have recently purchased a vineyard or distillery, you might find your stock rising in a deflationary environment despite any economic woes...at least among your friends.

THE DOLLAR »

I have been receiving questions about the falling dollar pretty consistently over my career. Since the mid 1980's the greenback has been in a decline except for a resurgence in the late 1990's that lasted for about 6 years. Most of the questions have centered on the strength of the U.S. in the world economy and not so much the stability of the currency itself. A country's currency is affected by many things including interest rates (which have been falling in the U.S. on average over the same period), inflation expectations, national debt, and trade, in addition to the strength of the country's economy.

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In general, we should not let a temporary fall in our currency concern us as this has the benefit of making all the commercial aircraft and heavy equipment we export more competitive in the world marketplace. However, a prolonged decline in the dollar could be a reminder that our largest export is actually our debt, which could have a much more negative effect in the long-term than just increasing the cost of our travel abroad during retirement.

A DOUBLE DIP »

The latest media craze has been to talk about the possibility of a double dip recession. "Double dip" simply means entering into another recessionary period in the U.S. economy shortly after the completion of one. In this case, it would mean economic output in the U.S. would contract again shortly after getting back to growth in the third quarter of 2009. This would probably result in further unemployment and a falling stock market. Clearly this is a bad thing with unemployment already at 9.6% and interest rates near zero, which gives the Fed little ammunition to stimulate the economy. But before we run into the streets like Chicken Little, let's take a look at the situation.

On August 27th, the Bureau of Economic Analysis (BEA) released its revised gross domestic product (GDP) numbers for the second quarter and reported that the U.S. economy grew at an annualized growth rate of 1.6% versus first quarter growth of 3.7%. This tells us that the economy is still moving forward, but we are coasting right now and not accelerating as we should. This lack of robust acceleration is getting attention because historically, our economy has come out of deep recessions with roaring growth rates of 6% or higher on average. This makes sense when we stop to think about it. As businesses cope with a recession, they lay off workers, cut costs and let inventories dwindle. Then when economic conditions improve, these same businesses are forced to ramp up quickly to meet demand. The problem this time around is that demand is weak. Businesses have pulled their share of the weight by rebuilding their inventories and spending money on new equipment, but the consumer, who drives about two thirds of GDP, is still dealing with credit problems and not spending. All this has led to businesses that are reluctant to rehire and many paranoid financial institutions trying to figure out who is going to pay all these mortgages and credit card bills outstanding.

The good news is a double dip recession is certainly possible, but not probable. As the recent GDP and manufacturing data suggest, our economy is growing, just not as fast as it has in past recoveries. The slower recovery speed is likely a result of the unique credit issues of our time and possibly related to the overly burdensome costs associated with the loads of new legislation passed in haste within the last year. Ironically, the magnitude of our politicians meddling seems to move in inverse proportion to our recent growth in GDP, but only time will tell.

"D" IS FOR DIPLOMA »

Regardless of which "D" we choose to discuss, we seem to come right back to consumers and their confidence in the financial system. This doesn't just include confidence in the stock market, but more simply the framework available for Americans to go to work, earn a living for their own families, pay limited taxes, and decide for themselves what to do with their surplus. Right now, investors around the world are using the letter "D" to grade stock markets by accepting record low bond yields instead of taking advantage of historically low stock prices. Maybe we are all just tired of sitting in our uncomfortable chair looking at the same index numbers on the board for the last 10 years and are now willing to just get by. In college, this attitude was called "D is for Diploma" and it never worked out very well for those who adopted it as a strategy. With that in mind, now is not the time to sit by on Treasuries and corporate bond funds because the Dow Jones Industrial Average is still around 10,000. The best approach is to improve your investment strategy with some good old-fashioned ideas that make sense. Many stocks today are at good valuations and are even paying dividend yields higher than corporate bonds in some cases, which can provide an attractive income while investors wait for the economy to begin accelerating again. Let's not worry about all those self proclaimed experts that are satisfied using the "D"s to just get by. It's time for us to stop watching T.V. and start doing our homework.

Invest Long and Prosper,

Josh Rudd

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