From: Arthur McKee <art@mckeeinvestments.com>
Subject: **Update May 13, 2011 - A little harvesting**
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Dear Clients,

The markets, both domestic and international, have been doing quite well in the past 2 1/2 years. It has been nearly a year since we have had a market downswing of more than just a couple of percentage points. In the US, the S&P 500 sits about 15% below the level it reached in 2007 (the all time high). At that time, unemployment was effectively 0% because everyone who wanted a job had one, and people were quitting their jobs to flip houses. Construction was booming, banks were making money hand over fist, and we were fat and happy with a seemingly unlimited supply of utopia-flavored kool-aid. Right now, the markets are pricing stocks (in the aggregate), at just 15% lower than they were at the irrationally exuberant high of our recent past. How quickly we forget....

Why are stocks so high? I would argue that there is a solid case for international stocks to be at the heights we find them. Many international economies, especially in Asia and Latin America, Germany and Sweden of Europe, are on quite solid footing and have good fiscal foundations underlying. Contrast that with US stocks, and particularly the US economy, which has benefited from another trip to the makeup artist, where a new layer of lipstick eagerly awaited. We were spending too much money to begin with (negative net savings rate in the US) and when we stopped, our government stepped into the picture and replaced private spending with public spending. Have you heard our government tell us that what we need is for the "banks to start lending again"? How do you have an intelligent conversation with someone like that???

Quick backdrop of economic theory:
John Maynard Keynes is credited as being the "father of modern macro-economics". Keynes economic theories were first adopted during the depression and the tangible result was the government spending programs that, along with the war, were credited for getting the US economy out of the great depression. Keynes main idea was that the government should save up money during the economic "boom" times and then spend that money (deficit spending) during the economic "bust" times. While that can sound like a good idea, the whole mindset is based upon an idea that the government should play the key role in managing the economy. This is the theory that the US has embraced. Currently, we have borrowed and spent $14 TRILLION. We don't have any savings.

Back to Today:
Since the banks weren't lending, the Treasury and the Fed have used every trick in the playbook to get money flowing again. That spigot of easy money will close tightly in the near future, starting in July. Borrowing and/or printing money without runaway inflation are unsustainable and the private sector may not be able to keep up the circular flow of money in the absence of government spending. Ben Bernanke's Quantitative Easing 2 "QE2" will end in late June. QE2 was basically a heavy printing run of $600 billion dollars to continue to try and keep interest rates low and stock prices high. Interest rates were pushed down because the Treasury bought bonds with the newly minted money (we lent it to ourselves) and competed with other potential lenders. I cannot imagine that our Fed would taunt the world by doing this again, especially because the international community is our largest lender and we have already done this twice in a year, hence the "2" of QE2. When our government prints money, it devalues the US dollars that already existed in the hands of others.

Our population is aging, our currency is still artificially high (I've previously written about oil and the dollar), our government has just about tapped out its credit line, and private households can not leverage up again like they did before. I'm sorry, but 2 years of private households actually living within their means did not make us lean, mean financial machines. Quite to the contrary, the US population has gotten used to an array of government services that we can't continue to afford. We have been fat and happy, and now it is getting to the time we have to get back into shape. Just like starting an exercise program after years of "couch-potato-ness", it won't be pretty, especially at the beginning of our financial workout.

Is Bernanke on a secret mission?
However, there is a part of me that thinks Bernanke is playing the role of "evil genius." A weak dollar will provide the US with the backdrop we need to restart manufacturing and get REAL jobs back within our borders. A weaker dollar will allow us to shift from a service and consumption economy to one that has a healthy balance of manufacturing and exports. This is not rocket science and Bernanke is a smart fellow. However, Bernanke can't announce this because it is bad politics and other countries don't want to hear this for 2 reasons: First, other countries hold a huge amount of US dollars and lend those dollars back to us. The other countries don't want to hear that we PLAN to devalue our dollar and then pay them back with paper that is worth half of what it was.....that's just not good dinner conversation for our State Department diplomats. Second, a weaker dollar means that our products and services become more affordable for consumers in other countries (for example Orlando Disney World vacations and Ford cars become more affordable for foreigners.) As far as the bad politics part, this is due to the fact that the financial pain involved with devaluation of the US dollar will most acutely impact the poor.

So, the stuff we buy now will get more expensive because, currently, nothing we buy is made in the USA. So, the transition is going to be tough and we will have to make adjustments. If it goes slowly it will be most bearable. If it happens too fast, then everyone gets hammered. Bernanke, if he is the evil genius, would want to bring the value down slowly, like landing an airplane. You have probably heard the term "soft landing" in some terms of economics. Well, that soft landing would be just what the doctor ordered for the value of the US dollar. The problem is that this plane could look like an elephant with the wings of a gnat. We will have to wait and see.

Recent sells:
By this point, you should understand why we have recently done a little bit of harvesting of the portfolios. The recent sales resulted from the macro-economic risks I laid out above, combined with the fact that we could take some gains when they were good for the taking. We still like the mutual funds and many of the stocks we sold, but at current prices, didn't see enough potential for rational upward movements and protecting from the downward risk became the more important driver. The sales were an attempt to protect our portfolios; to take some risk out of the equation. The proceeds will be mostly invested in an international, short-term bond fund where we can earn more interest than in the money market and also keep away from holding too much US dollars.

If the US market makes a significant downward move, the international markets will inevitably follow and that is why we sold some international investments as well. When the next round of panic and fear sets in, we expect to find great investments selling at cheap prices and be in the position to capitalize on it. For now, real estate looks really attractive as an investment (bought with cash from a bank - already foreclosed).

Have a great weekend.

Best Regards,

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