From: Arthur McKee <art@mckeeinvestments.com>
Subject: Operation Twist - Global Panic - Negative Interest Rates in US
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Dear Clients,

Today caps off a very volatile week in the global financial markets with the US market down about 7% for the week and while the markets are still open at the time of this writing, we have seen swings of about 2% today. In the US, stocks are very close to the lows of the year.

"Maturity Extension Program and Agency Security Reinvestments", AKA "Operation Twist"
On Wednesday, Ben Bernanke announced that the Fed would embark on "Operation Twist" which does in fact get its name from the famed dance, "the twist". Let's explain what the intent is and how it is done. First, let's look at how it is done. The Federal Reserve will sell $400 billion worth of short-term Treasury bills and bonds, and use the proceeds to buy long-term Treasury bonds, with about $120 billion of those bonds to be in the 20-30 year maturity range.

What for? What's the intended outcome? According to the Federal Reserve's policy statement, I offer you the following quote:

"By reducing the supply of longer-term Treasury securities in the market, this action should put downward pressure on longer-term interest rates, including rates on financial assets that investors consider to be close substitutes for longer-term Treasury securities. The reduction in longer-term interest rates, in turn, will contribute to a broad easing in financial market conditions that will provide additional stimulus to support the economic recovery."

In a nutshell, Bernanke is trying to further reduce long-term interest rates in an effort to make it more attractive for people and businesses to borrow money. The Fed is "twisting" the yield curve by manipulating the supply and demand for short-term and long-term treasuries.

Two days into the implementation of Operation Twist, it appears to be effective as the 10 year treasury bond is now yielding just 1.77%, the 30 year bond brings just 2.83%, and if you want to lend money to the US government for less than a year, be prepared to give the government more money than you expect to get back because the short term yield is actually NEGATIVE right now. The market is telling us that we should consider it such privilege to lend money to the US government that we have to lose money to do so. Completely illogical, but utterly true.

I would argue that the problem isn't that interest rates are too high, but that we, as a nation, have too much debt already. Bernanke is acting like it is a credit "supply" issue when it is clearly a credit demand issue. We don't need it and don't want it. But again, I am not telling Ben anything he doesn't know. I continue to believe that Ben is the evil genius/mad scientist that is working on his long-term plan to devalue the US dollar to get us competitive again in the world manufacturing market. I have to believe this because the alternative is to believe that Ben is just plain stupid, and when given the choice, my internal optimist chooses the evil genius explanation. In either case, the results are the same with the dollar losing value over time and eventually getting to a point where our exports are competitive on the world market. If you want jobs, especially manufacturing jobs, devalue your currency.

Global Panic
The Fed's report, along with outlining "Operation Twist", noticed that the US economy has entered into a period of economic softness and that seemed to add fuel to a European worry fire. The head of the International Monetary Fund, Christine Lagarde recently said that there is a "negative feedback loop" that is working against markets, especially Greece.

The price of gold has come down quite significantly over the past few weeks with gold prices dropping to $1,632 and ounce, down from over $1,900. The only asset that has made money in the past month or so is the long-term Treasury bond that the Fed manipulated with the Twist. The long term treasury bond would be the last thing that I would want in my portfolio (well maybe Greek bonds would be worse), but it would

Currency
There has been a global "fast money" rush to long treasury bonds and consequently to US dollars in the last few weeks. That has caused the US dollar to appreciate significantly, in several cases, over 10% versus other countries' currencies. As you know, we have positioned our investments to benefit from a falling US dollar, and the rising dollar has hurt recent performance. However, with the Fed effectively lowering interest rates again this week, our budget deficit still running high and an economy that grows at 3% when times are good, I do not see the uptick in the value of the US dollar as being sustainable and believe this to be a short term anomaly. I believe the US dollar will resume it's decline verses other currency and that will bode well for our investments.

While Ben Bernanke and Tim Geithner say that they support a strong and stable US dollar, every policy action undertaken thus far has a weakening affect on the dollar. The dollar appreciates sharply when markets get scared, but this appreciation quickly unwinds as the crisis passes and we return to rational thinking to determine value. This has impacted the value of our short-term international bond fund, but the fund manager is using it as an opportunity to put more cash to work in a distressed environment.

Equities
Opportunities are beginning to emerge in stocks and while I have yet to begin buying, I do believe that there are some great companies selling for good prices. Much to my surprise, there are a handful of US based companies that I have on my radar screen for possible purchase. All of the companies have extensive overseas operations, but are still American nonetheless. My tendency is to be early on the buy side so I am still monitoring the Greek situation for signs of collateral damage and waiting for a clearer picture on that before we start buying. I have my eyes on another couple of companies that have very little to no debt and a strong product line.

Apple
As our single largest holding, I have to at least mention Apple. One thing for sure is that Apple hasn't presented another really great buying opportunity. Now the largest company in the United States by market value, Apple has really helped our returns this year and is over $400 per share even when the "market" is down. We are supposed to see the new iPhone 5 in October and the roll out of iCloud concurrent with IOS5 (operating system upgrade). We will get to see Tim Cook take the lead in his role as CEO at the iPhone 5 intro. Thus far, the stock price is still lagging behind the actual financial performance of the company. I know that may be hard to believe, but the math is the math. Apple is opening just it's 5th store in China tomorrow. Contrast that with the fact that I have 5 Apple stores within a 2 hour drive from my house. The opportunities are still out there, and for Apple, the opportunities are abundant.

Thanks for allowing me to serve you and I hope you have a great weekend.

Best Regards,

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