



ECONOMIC OUTLOOK

bounty management
unique investment insight

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THE FED LIGHTS A BONFIRE OF CURRENCIES

During the third quarter of 2010, developed world economies began to stall with debt turmoil and continued deleveraging in the financial, consumer, and real estate areas. The inventory recovery of the past two years peaked in the 3rd quarter as the September Institute for Supply Management (ISM) survey showed record inventory levels. Trade also began to crest as the 2009-2010 inventory cycle faded. Developed world governments began new programs of bond buying and money printing to counter sluggish economies. The hope is that the new programs will lower interest rates, stimulate buying, and provide a trade advantage. Historically, economies which have experienced financial crisis-induced recessions have stabilized largely through lower currency values. The Federal Reserve and the Treasury are aware of the issue as is evident from the recent G-20 statement that a competitive devaluation of currencies is not in any countries' interest. If all countries become more defensive and are dragged into bond buying and money printing, there will be more market turmoil, lower currency values, and little overall economic effect.

Second quarter U.S. growth was at a 1.7% annual rate, above our target, due to inventory and trade effects. Real final demand (demand excluding inventory and trade) was at a 0.9% annual rate, the slowest in a year. Due to further unwanted inventory growth and a large push from an unusual increase in auto production, 3rd quarter growth will be 2.5% with real final demand 1 to 1.5%, still near stall speed. Regional Fed surveys have generally shown activity in this quarter weakening into its close.

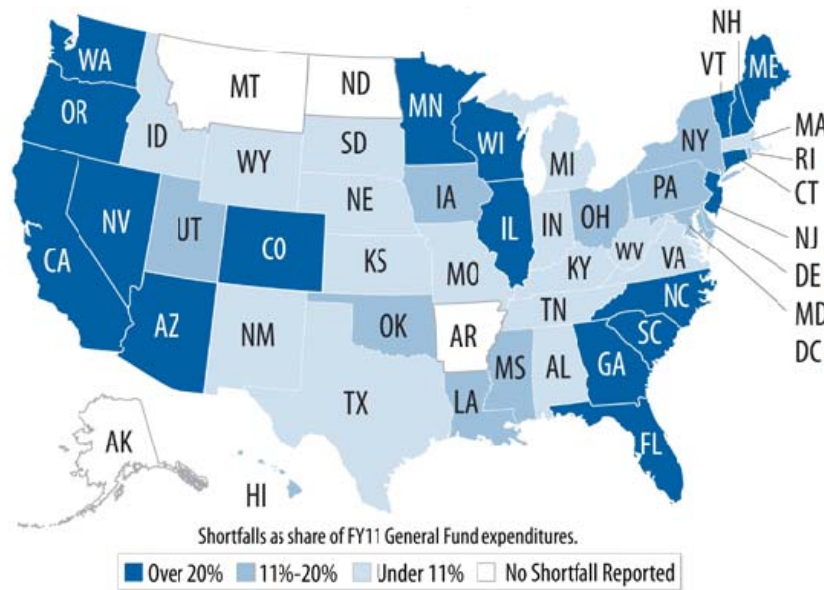
Consumer

The largest GDP sector, the consumer, continues to struggle. A net of 250,000 jobs were lost in the 3rd quarter according to the Bureau of Labor Statistics. The workweek remains mired at a low 34.2 hours. The rate of underemployed workers ticked up to over 17% in September. Consumer confidence remains at historically low levels. Real estate has shown no recovery with traffic low and inventory high. Auto sales still struggle in the range of 11.4 million - 11.8 million per year. Retail sales in the quarter were higher primarily due to state sales tax holidays in half of the states.

State and Local Government

The state and local government sector is likely high on the Fed's list of concerns. Tax revenues are down 30% year over year and fiscal year 2011's projected deficit is \$121 billion nation-wide. States are resorting to hitting their pension and health care funds to fill the portion of their deficits not covered by Federal aid. At the same time, their collective pension funds are underfunded by over \$1 trillion. State and local government may be forced to lay off 500,000 workers (or 8.6%) by the end of 2011. In September, 80,000 workers were laid off. This directly hits Main Street in the same the way that the downturn and lack of recovery has affected small business.

Many state budget shortfalls exceed 20%:



Source: CBPP survey.

Quantitative Easing

With fiscal policy continuing to show \$1.5 trillion deficits per year in an election year, economic support operations have been pushed to a worried Fed. Their September minutes set the pretext for further quantitative easing (purchases of financial assets such as government bonds) to support asset markets, reduce interest rates, and lower the dollar for trade reasons. This program could amount to \$500 billion to \$1.5 trillion over the next year and is an example of money printing debasement. We may find that by next July the Fed has fully funded the Treasury's whole deficit for 2011; the government will have funded itself by selling to itself. The dollar's implicit value will suffer in this process.

World Economies

Japan: Partly in response to U.S. action, Japan has also launched a quantitative buying program of about \$500 billion to purchase real estate, corporate bonds, and especially the yen which they feel is far too high in value and constraining trade. Trade is their only growth area: consumers are generally aging and unwilling to buy in an economy still deflating 1% a year after 20 years of the same. Corporations do not want to invest

in capital expenditures when the yen is so high. The government, constrained by a high debt/GDP ratio of over 200%, is still willing to throw \$500 billion on the currency bonfire in a likely futile attempt to increase trade.

Europe: Europe has a different problem. The core Franco-German countries have been economically strong, as they are not inherently over-leveraged and trade well with Asia. The many peripheral nations, for example, Greece, Ireland, Portugal, Spain, E. Europe, and the U.K., are all quite weak economically and are all over-leveraged. Most of the banking system of Europe, with cross border/interlocking sovereign debt, are very weak. Ireland has been the victim this past quarter; the European banks are exposed to both Irish sovereign and bank debt to the extent of 5 times Irish GDP. British and German banks are highly exposed with over \$225 billion each. Irish bank bailouts have been \$68 billion to date this year or 33% of national GDP. Next on the list to have crises after Ireland are Portugal, U.K., and Spain. The European quantitative easing method has been for the European Central Bank to buy up all bonds in sovereign auctions which might not be spoken for by private buyers. As the Euro rises in relative value, it will also be intervened against, to stimulate foreign trade, as this is a main German pillar of growth.

Emerging Markets: Finally, we come to the emerging world, the 25% of world GDP which is producing 75% of the world's growth rate of 3 to 3.5%. Emerging economies and markets have been profoundly strong due to: 1) developing indigenous strength, 2) trade advantage, 3) resource supplies, and 4) the tendency of investment dollars to flow to areas of S. America, the Middle East, Africa, and Asia. The growth in these countries has led to inflation, especially in food prices, and many emerging nations have had to raise interest rates repeatedly. At the same time, in the 3rd quarter of 2010, countries intervened in currency markets to hold their own currencies down, relative to the dollar, to retain terms of trade. By intervening, more currency is thrown into the bonfire, but without hurting economic activity too much in the emerging world. The Asian Development Bank expects 8.2% GDP growth in 2010 from Asia-ex Japan. China will be +10%. Other emerging nations are growing 5 to 7%. These high growth rates only slightly boost the overall world growth rate since they comprise ¼ of world GDP.

Investment Expectations

So much money printing, quantitative easing, and currency intervention - there is paper everywhere! As the renowned investor Murray Pollitt said recently, *“Only in the Anglo-American world do investors consider money stable and things volatile.”* Cash has no yield and no purchasing power protection. Bonds have little yield, no purchasing power protection and lots of potential price risk (the 5 yr Treasury note yields 1.10%!) Investors will seek hard assets as safe havens. Commodities are stores of value; one broad commodity index has gained back 85% of the losses from the very high levels of '07-'08. All commodities have participated, soft and hard. Cotton is up over 50% year/year and at its highest price since 1870. Gold is over \$1,300. Oil is about \$80 / barrel. Grains have soared on emerging market demand. Quality equities, especially those with a yield and with a high fixed asset replacement cost, are a way of gaining protection against debasement. In order of our preference, we consider gold and gold equities, energy, agriculture, manufacturing, other basic materials, transportation, telephone and some drug issues to be relevant to the task at hand. Treasury Inflation Protected securities are also appropriate. Quality, yield, and well-run

businesses all matter in a tough investment world. Finally, as stated above and in previous updates, investors need a hard asset hedge in a world where pure paper values could be debased at any time. We remain vigilant.

September 30, 2010

DJIA: 10,788.05

S&P 500: 1,141.20

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. For nearly 40 years, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

We believe that:

- Global macroeconomic analysis of world-wide trends is valuable
- Security and sector selection add alpha
- Unique business models and good management teams generate better returns
- A valuation discipline can help avoid mistakes

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at <http://www.bountymanagement.com>.

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