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Richard Bregman, *Chief Executive Officer*

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Dear Clients and Friends:

Last week, MJB's Senior Investment Strategist, Jennie Sanders, and I attended an investment conference at which the keynote speaker was Paul Volcker, the Chairman of the Federal Reserve from 1979 to 1987. Mr. Volcker discussed a wide range of topics, from government regulation of the financial industry to the impact of currency exchange rates to the role of gold in our economic system. I found several of Mr. Volcker's observations to be particularly relevant to our current investment environment:

- *Regarding the government shutdown and negotiations over the government's debt ceiling*: Mr. Volcker reminded us that what matters most is not the amount of debt incurred by the government but rather the way in which the government puts the monies to use.
- *Regarding the Federal Reserve's statutorily-imposed "dual mandate" to maximize employment and maintain price stability*: Mr. Volcker neither endorsed nor challenged current Fed Chairman Ben Bernanke's zero interest-rate policy to stimulate the economy. Similarly, when asked about ways that Mr. Bernanke might gradually allow interest rates to rise, Mr. Volcker declined to offer any strategies.

It was interesting and refreshing to hear Mr. Volcker—a Democrat, an expert in government finance and no stranger to politics, having served as Fed Chairman during both the Carter and Reagan administrations—voice his opinions and preferences on political and economic issues without castigating members of other political parties and/or individuals who hold different views. That is a far cry from the goings on in Washington, D.C., where it is remarkable that certain members of Congress are using the debt ceiling—which is merely a formality that ordinarily is of little consequence—as part of a partisan political strategy to disrupt our government. There is no way to know what our elected legislators will do between now and February 7, 2014, their next self-imposed deadline to take action—whatever that might be—before once again shutting down the federal government and possibly leaving the U.S. to default on its debt payments. That uncertainty helped fuel a period of volatility in the markets a few months ago; we will of course be monitoring the markets as the next deadline approaches.

More troubling than the actual volatility is the fact that it arises from a source to which we typically look for stability: our government. That brings us to the Federal Reserve, a government entity statutorily charged with maintaining stability. Mr. Bernanke has indeed kept interest rates stable for the past three years and indicated that the Fed will continue to do so for the immediate future. However, the rates are being kept stable at these levels by extraordinary, artificial measures, i.e., the Fed's massive, unprecedented bond buying program.[1] Artificially-created stability creates its own uncertainty, i.e., the uncertainty over when and by how much the artificial means by which it has been created will cease. Mr. Bernanke holds the key and, as with Congress, there is no way to know what he is thinking or what he will do before his term expires in January 2014. Back in May, many investors concluded that the Fed would begin to tighten its monetary policy and allow interest rates to float upward in September. Both the bond and the stock markets reacted by dropping sharply. When September arrived, Mr. Bernanke kept rates low and the bond-buying program in place and indicated that he would continue to do so for the foreseeable future. Nevertheless, everyone, including Mr. Bernanke, got a glimpse of how the markets might react whenever Mr. Bernanke allows rates to rise, and it wasn't pretty. His decision will have potentially enormous consequences and thus has spawned what feels like endless speculation in the financial markets.

At MJB Asset Management, we prefer not to speculate. It might turn out that Mr. Bernanke's unwavering commitment to keeping short and intermediate term interest rates at historic lows for the past three years is a prescient strategy critical to the continued growth of the U.S. economy. Or it might turn out that his zero interest-rate policy is simply sowing the seeds of massive inflation. Or it might turn out to be something else altogether. We do not know and will not guess. We focus on the present. Mr. Bernanke's policies have created an environment favorable for economic growth and not surprisingly, the economy is growing.[2] With respect to investment markets, Mr. Bernanke's policies are currently favoring owners (i.e., the stock market) over borrowers (i.e., the fixed income markets). So far in 2013, in response to an improving economy and perhaps the ongoing low interest rate environment, the broad stock market indices are up 20% or more. The same improving economy and low interest rate environment have sparked fears of inflation and an increase in rates—a damaging one-two punch for bonds—and have sent the broad bond market indices into negative territory for the year. To illustrate, purchasers of common stocks can in many instances find dividends of anywhere from 3-6% per year plus the potential for capital appreciation; by contrast, savers now earn less than 1% per year in their savings accounts and conservative bond investors can earn 1.3% per year for five years or 2.5% per year for ten years on Treasury bonds with little potential for capital appreciation.

Where does that put us? For now, the stock market is going strong. Corporate earnings are good, if not uniformly great. The U.S. economy is growing, if somewhat more slowly than many would like, but growing nonetheless; Europe has begun to turn around, and offers some very compelling valuations in both equity and fixed income markets. Emerging markets are less attractive on a valuation basis, but the long-term story remains appealing. Markets always have risk, both seen and unseen. In the face of the risk posed by the actions of Congress on the debt ceiling and Mr. Bernanke on interest rates we have reduced our exposure to the bond market and, where that exposure remains, have invested in bonds that we believe are less likely to be dramatically affected should interest rates rise. We have cautiously

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[1] Generally referred to as Quantitative Easing, the Fed currently is buying $85 billion of bonds from the open market *per month*. This is in addition to the Fed's decision to keep short-term rates, known as the Fed funds rate, at close to

[2] Indeed, the Institute for Supply Management just reported that U.S. factory activity rose last quarter at the fastest pace in more than 2 ½ years.

increased exposure to the stock market to take advantage of the ongoing market rally; however, we have done so primarily by investing in funds that have hedging mechanisms in place, i.e., that will likely soften the blow should the stock market decline.

Thank you for investing with MJB Asset Management. I wish you a wonderful autumn and upcoming holiday season!

Sincerely,

Richard Bregman