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AR SCHMEIDLER & CO
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THE OUTLOOK

In this issue of THE OUTLOOK. . .

The Forces of Currency Devaluation and the Impact on Investment Strategy

The recent International Monetary Fund meeting may have marked another lost opportunity for global coordination by governments to rebalance and stimulate the world economy. Leading nations are focusing on their economic and political self interests rather than cooperating to maximize the best outcome for all. Over the past two years, the divergences between the surplus and deficit nations have grown and accelerated given the dramatically different profiles of the developing and developed economies. Since our inception, A.R. Schmeidler (ARS) has focused a significant amount of research effort around the study of global capital flows recognizing that capital always flows to the highest rate of return. At the core of global capital flows are currencies which serve as the transmission mechanism of the global economy.

For perspective, the global economy is experiencing two powerful secular forces that will continue for years if not decades. The first is the deleveraging of most developed economies after more than 20 years of easy money and excessive indebtedness. The second is the rapid industrialization of the emerging economies that is creating dynamic shifts in the demand for the necessities required to support their rapid growth. The result of these forces has been the massive transfer of wealth from West to East, as we have written about previously. The efforts to stimulate the global economy after the financial crisis have accelerated these divergences. We believe that consistent focus on these enduring trends will enable serious investors to position their portfolios in the attractive companies that are beneficiaries of these dynamic periods while avoiding those companies that will be negatively impacted. This Outlook will focus on the impact of continuing currency creation by central banks against a backdrop of an unprecedented global financial environment.

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GDP Growth, Fiat Currency and Reserve Currency Defined

Fundamental to understanding the dynamics of the Outlook is an appreciation of the sources of Gross Domestic Product (GDP) growth as well as the meaning of fiat currency and reserve currency. The components of GDP growth for any country are consumption, business investment, government spending and net exports. Fiat currency, according to Deardorff's Glossary of International Economics, is "money whose value is not derived from any intrinsic value or guarantee that it can be converted into a valuable commodity (such as gold). Instead, it has value only by government order (fiat). Usually, the government declares the fiat currency (typically notes and coins from a central bank, such as the Federal Reserve System in the U.S.) to be legal tender, making it unlawful to not accept the fiat currency as a means of repayment for all debts, public and private." The main functions of money are as a medium of exchange and as a store of value.

A reserve currency, or anchor currency, is a currency which is held in significant quantities by governments and institutions as part of their foreign exchange holdings because of its perceived importance, stability and liquidity. It also is the international pricing currency for products traded on global markets such as oil, gold, non-ferrous metals, grains and other commodities. The U.S. dollar has enjoyed the status of being the world's reserve currency since the Bretton Woods agreements of July 1944. From that time and continuing up to the mid-1980's, the U.S. was the largest creditor nation and the fastest-growing economy in the world. This contrasts sharply with its current position as the largest debtor nation with the largest deficits and sub-par growth.

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The Challenge for the Developed Economies

The developed world, with the exception of a select group of resource-rich and export-driven countries, has been experiencing a deficit and debt problem that has created a heightened risk of eventual sovereign-debt default. The need to deleverage is siphoning capital away from productive uses toward debt pay-down, resulting in a muted growth outlook and high levels of unemployment. Compounding the problem of weak growth in the developed economies is that longer-term debt concerns and government obligations have bolstered the case for fiscal austerity. Governments have taken the view that further borrowing is to be avoided, thus removing the support for public spending at a time when private demand remains weak. This is the wrong time for fiscal austerity because it now places the entire burden for growth on the central banks. The conventional tool of central banks to stimulate growth is through lowering interest rates. At a time when interest rates are already near zero, some central banks are expected to soon implement additional rounds of what is known as quantitative easing ("QE"), whereby they create money to purchase assets, typically treasury bonds. The stated goal of QE is to drive down longer-term interest rates in order to stimulate business activity. Two additional potential benefits of QE are to help the Treasury finance deficits and to weaken a nation's currency through increasing money in circulation. A weaker currency serves as a stimulant for exports, until such time as other countries depreciate their currencies in response. Under this scenario of competitive devaluation, no export-dependent country can afford a strong currency, and since there is no backing for any currency, there is no limit to how much money a central bank may decide to print.

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Central banks and governments continue to face difficult choices in dealing with increased social, economic and political challenges. The recent efforts to implement austerity programs by European governments are undermining the social order. High unemployment rates, worker strikes and political backlash against incumbent leaders continue to dominate the headlines, particularly with respect to France, Greece, Poland, Spain and Portugal. Consequently, opposition to further fiscal stimulus initiatives leaves countries more dependent on export growth. To achieve this, these developed countries' currencies must be devalued. Japan, which is export-driven, recently took steps to weaken the yen to protect the competitiveness of its exports. However, Japan's efforts to weaken the yen are being hindered by the specter of further QE by the U.S. Federal Reserve (Fed), which is widely expected to be implemented at the next FOMC meeting in November (dubbed "QE2" by the financial press). This prospect is weakening the U.S. dollar versus the yen. Japan's experience highlights the interconnectivity of the global economy and foreshadows the risks of a currency war as other countries continue to take steps to devalue their currencies or implement capital controls. Brazil and Thailand recently introduced tax increases to slow the flow of capital into their economies for fear of overheating and making their exports more expensive. Capital inflows have the effect of pushing up the value of a currency making exports more expensive and less competitive.

In the U.S., the headwinds from high unemployment levels, low interest rates and the need to bring state and local budgets into balance leave this economy in a state of disequilibrium. The U.S. can no longer count on an over-leveraged consumer to drive GDP growth, and in light of this the current administration has made doubling exports over the next five years a priority. This makes a cheaper U.S. dollar a necessity. Unfortunately for the world's central bankers, currency moves do not occur in isolation. Further complicating the global currency picture is China's currency policy. China is a leading exporter, the largest creditor to the U.S., the owner of the largest currency reserve and one of the fastest growing economies that has pegged its currency to the dollar. So a weakening U.S. dollar pulls down the Chinese yuan (or renminbi) putting further pressure on other nations' exports as their currencies effectively appreciate against the yuan. Consequently those countries risk losing market share to the Chinese until they devalue their own currencies.

We are in a period of competitive currency devaluations as nations are forced to act and react to one another's policies. Attempts to manage currencies in this fashion are short-term oriented and merely postpone the hard decisions ultimately required for structural change. At some point, coordinated action by governments will be required.

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The Fed Dilemma

The responsibility of the Board of Governors of the Fed as mandated by The Full Employment and Balanced Growth Act, more commonly known as the Humphrey-Hawkins Act, is to establish a monetary policy that fosters maximum employment and promotes price stability. Now over 21 months after the global financial crisis, the U.S. has neither stable prices nor full employment. With stubbornly high unemployment and a core Consumer Price Index (CPI) significantly below the 2% level that the Fed has defined as healthy for price stability, the pressure on the Fed to act has increased.

The Fed is faced with a difficult choice. The Fed may continue and accelerate its efforts to stimulate the economy or let the economy deflate which would certainly lead to a deep recession. Both choices have a cost. The Fed has come out in favor of further quantitative easing to attempt to stimulate the economy. This could devalue the dollar and benefit exports but at the expense of potentially generating high inflation in the future and lowering the U.S. standard of living. If the Fed does not act it would be out of compliance with its mandate, and the economy would likely decline further unless the government embarked on well-targeted stimulus programs. After recent comments by several Fed officials, the Fed appears likely to move ahead with QE after the November 2nd mid-term elections, although the amount and timing of implementation are less certain. The scale of central bank monetary creation and intervention that is reportedly being considered is without precedent. We would not be surprised if the total amount of QE ultimately viewed to be required over the next few years is in excess of $2 trillion or approximately twice the size of the Federal Reserve's balance sheet.

Implications of an Extended Low Rate Environment

One of the first tools central bankers used coming out of the financial crisis was to lower interest rates. For the U.S., rates have been lowered to a target of 0.0-0.25% on the short end. The 2-year treasury recently hit 0.33% while the 10-year treasury reached a new low of 2.38%. Given the challenges facing the economy, interest rates are likely to stay low for a very long time. This has serious implications for important segments of the U.S. Low rates have a dramatic impact on those who rely on a fixed income and social security, which is not providing a cost-of-living adjustment for the second year in a row. At the same time, food, energy and health care costs continue to rise. In addition defined benefit pension plans require higher rates to meet their target return assumptions and have been severely impacted by the current rate environment. Furthermore, money market funds, which have played an important role in providing funding for the commercial paper market, have been impacted as low rates have placed fees under pressure leading to fee waivers that have reduced profitability. This has led some sponsoring institutions to reconsider the viability of staying in the money market fund business. At the same time investors are seeking higher-yielding

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Importantly, low rates have benefited many corporations by allowing them to strengthen their balance sheets, increase share repurchases, fund mergers and acquisitions and raise dividends. Many companies' shares yield more than the interest they pay on their bonds. This valuation disparity cannot endure and we expect it to be reconciled through the continuing flow of capital into high-quality equities with attractive and growing dividends.

The Role of the U.S. Dollar as a Store of Value

The current fiscal budget deficit exceeds $1.3 trillion, or nearly 10% of GDP. According to the Congressional Budget Office (CBO), the U.S. national debt is expected to grow from the current level of approximately $13.5 trillion to more than $18 trillion by 2015. This is likely to be significantly more than 100% of GDP. With deficits stuck at high levels and the national debt climbing dramatically, this structural imbalance will be with us for an extended period unless fundamental changes are undertaken for which there does not appear to be the political will. Further complicating the problem is the mid-term elections for Congress which is creating policy paralysis around taxes, additional stimulus programs and trade. With the burden for U.S. growth increasingly falling on the Federal Reserve, and the Fed's resolve to bolster employment and avoid deflation at all cost, secular pressures on the buying power of the dollar continue to rise. The U.S. dollar remains a medium of exchange, but increasingly it is losing its status as a store of value.

This trend is leading to a shift in demand from fiat currencies toward hard assets, as reflected by the actions in recent years of various countries with surplus foreign reserves. Countries such as Russia, China, India, among others have been diversifying their foreign reserves into developing market currencies, as well as fixed and strategic assets and commodities, including oil and gas companies and projects, iron ore and copper mines as well as gold, among others.

Portfolio Strategy

Our Outlook remains consistent with our writings over the past two years. There are many opportunities in U.S. companies and select ADR's that we expect to be beneficiaries of the current environment. As the emerging economies continue to grow bringing hundreds of millions of people higher living standards, there will be continued demand for the products and services of leading multinational companies. We also remain focused on the preservation of purchasing power for client portfolios given the global pursuit of competitive currency devaluation to maintain export competitiveness, combat deflation and promote growth. If central banks are successful at

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debasing the values of fiat currencies over the longer term, the prices of vital goods and services that are traded internationally will tend to rise in terms of the currencies being devalued. Some of the primary beneficiaries of competitive devaluation and quantitative easing, as well as the industrialization of developing economies, are the producers of gold, silver, energy, iron ore, copper, steel and agricultural commodities.

In addition, in the environment of low interest rates that we expect to persist for some time, those companies with secure and rising dividends will continue to attract interest as investors seek higher returns. Leading pharmaceutical, consumer staples and even technology companies currently offer attractive and growing dividend yields and should be among the primary beneficiaries. These companies also enjoy strong balance sheets and significant revenue growth from the developing markets.

Fixed income security selection is focused on relative-value income opportunities with a short to intermediate duration. With regard to credit selection, we favor companies whose balance sheets are stable or strengthening. With the severe budget constraints facing states and municipalities, we are particularly cautious with regard to the municipal bond market. Given continuing economic and sovereign debt challenges, there is a high probability that demand for U.S. Treasury debt will remain strong keeping the rate structure at low levels.

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Consistent with our 40 year history, ARS continues to focus on select undervalued businesses that are positioned to benefit from important secular trends. While investors continue to express concerns about investing in the broad market, ARS believes that this remains a time for opportunistic and thoughtful security selection as we continue to expect to see separation and outperformance for those companies that are well-positioned to benefit from the global divergences and imbalances described above.