CLEARVIEW
INVESTMENT PARTNERS, LLC

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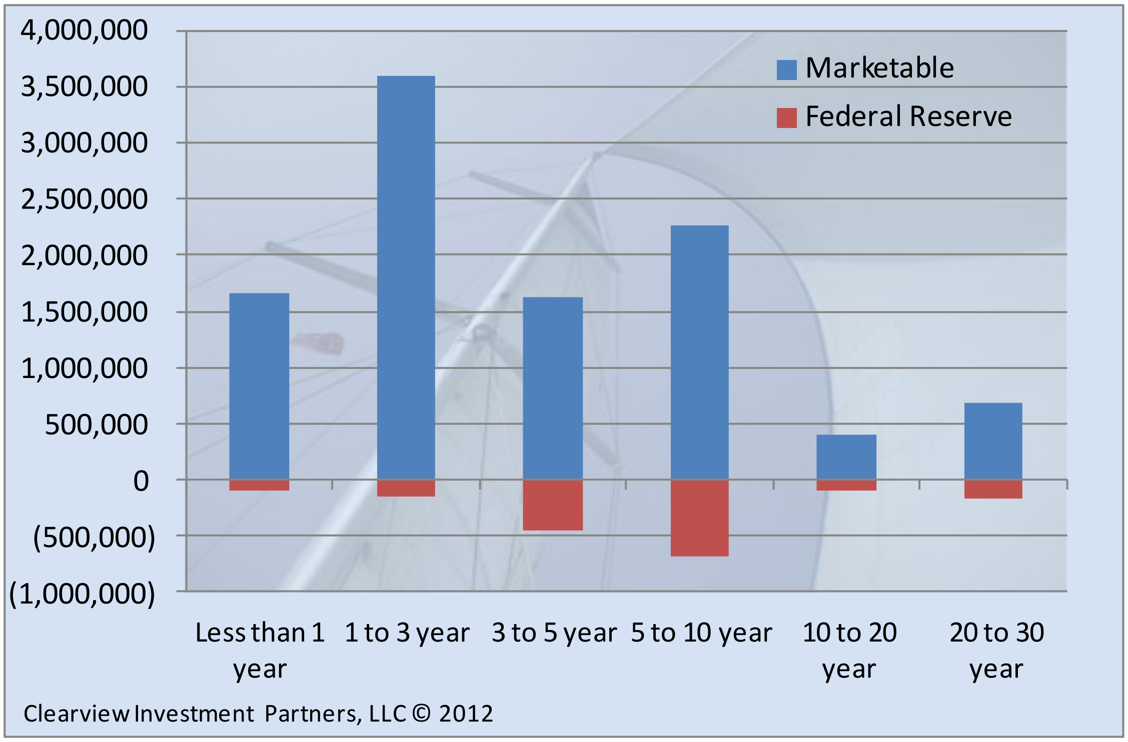
"You've got to get yourself together, you're stuck in a moment and now you can't get out if it.
Don't say that later will be better, now that you're stuck in a moment and you can't get out of it."
- U2- Bono & The Edge

Ben Bernanke & Co. may want to make the U2 hit 'You're Stuck In A Moment You Can't Get Out Of' their theme song. Since the Great Recession of 2008 the Federal Reserve has moved swiftly and decisively to a "moment". That moment has been punctuated by a zero percent interest rate policy (ZIRP) and two rounds of asset purchases dubbed QE1 and QE2. A third easing policy move, aptly named 'Operation Twist', sought to lengthen the average maturity of the assets the Federal Reserve held by selling short term securities and buying longer dated securities. This was meant to lower long term interest rates. Through all this the economy has barely managed to get a proper toehold and has sputtered to about 2% growth in GDP. Now the question is, "can the Fed get out of it"? They are clearly "stuck in a moment" and after 4 years of unprecedented easing, I'm not so sure "later will be better" as the song says. A big part of the issue in removing the Fed's accommodation can be seen in the chart below. The Fed is holding a large amount of the longer dated bonds in its portfolio. Lower long term interest rates reflect this. Investors term preferences for treasury securities may have shifted as the abundant policy accommodation has lead to fears of future inflation, thus forcing buyers to recon-

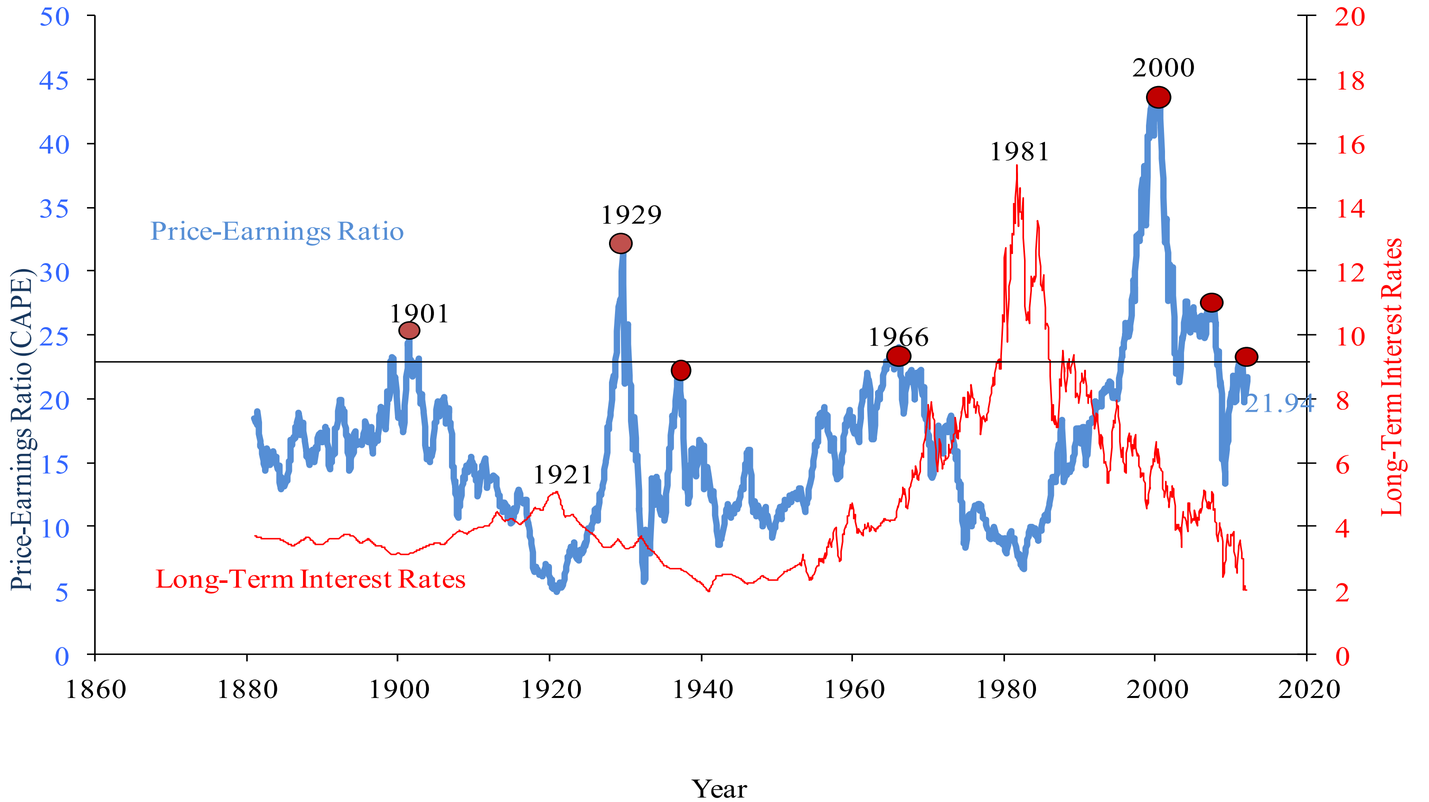


sider their longer term preferences for shorter dated bonds. If the natural buyers are reluctant at a 2% ten-year bond, then at what interest rate level will they be enticed to reenter the market? Additional consideration for the Fed's continued involvement is the fact that we are running over $1 trillion a year in fiscal deficits at the Federal level that need funding. If investors prefer short dated maturities because of uncertainty, most new issuance will have to be 1-3 years or less to be adequately absorbed by the market. This *shortens* the average life of treasury issuance and puts our country at greater risk of spiking short term interest rates and our ability to pay interest on our debt obligations in the event of rising rates (inflation). Of course, the Treasury can just print more money to buy the bonds themselves so the U.S. is not likely to default in the typical sense of not paying on its obligations. A more likely scenario is a pseudo default through much higher inflation, thus rendering the bond payment streams nearly worthless. This danger grows every day, not necessarily by the Fed's actions alone, but coupled with the lack of fiscal action to remedy the U.S.'s overspending habit. Natural 10-year treasury yields might be closer to 3 or 3.5% without continued Federal Reserve involvement, a yield level which would be anathema to bond investors (see The Year Ahead from February).

Market Signals 'Under Construction Ahead' Signs

The last time general market levels caused a more heightened concern for us was back during March through May of last year. At that time we felt there was about 5-8% upside versus a market selloff risk in the 10-15% area. Our concerns were justified as the general market declined approximately 15% by August. Our antennae have been called to alert once again with advancing market levels driven by fewer stocks and low volume, large amounts of insider selling and stretched valuations as measured by the Shiller smoothed 10-year earnings P/E ratio (see chart on next page). Particularly troublesome in the recent run-up in stock prices is the fact that almost *all* assets have moved up in tandem, with correlations moving decidedly higher. We observed this phenomena back in 2006 and 2007 leading up to the 2008 decline. Although we don't expect a correction of the magnitude of 2008, it pays to be cautious as we look to deploy clients' cash reserves to more productive uses. The current market configuration suggests a 4.1% annual compound rate of return over the next ten years for the S & P 500. Until the risk premium in stocks gets a whole lot better we will view any advances with a skeptical eye. This is not to say that stocks cannot advance further from here, but the risk to principal is too great for the potential reward. Proceed with caution!

As you can see in Dr. Shiller's chart below, we've been at or above a P/E of 22-23 (horizontal black line) only 7 times in the past 132 years. The persistence of those instances has only lasted



1-2 years at best with the exception of our most recent past. You will also notice that the eventual P/E was close to 10 before the cycle was reversed. The simple average P/E over the long period is 16.4 (skewed up by the internet and tech bubble of 2000). A quick move to that average would put the S&P 500 at about 1018, or a 27% decline; caution indeed! There are arguments for higher prices yet and those arguments generally include an improving economy, sustained high corporate profit margins, continued Federal Reserve stimulus and large quantities of underutilized cash. One of the most important of these is the Federal Reserve's use of stimulative actions. This cannot be underestimated and is the one area we just cannot be sure of. Although these actions tend to magnify returns, we are very concerned about their eventual exit from these programs as we've mentioned at the start of this letter.

Complexity Science?

All of the aforementioned issues, and many others we have not discussed, can be accurately described in terms of a complex system. Maybe more accurately, in the academic sense, what would be termed a Complex Adaptive Mess (CAM). By definition the condition for the existence of which is an unstable, unpredictable and intractably intertwined system that has problems that are not easily resolved. Our current economic system is one such animal. In normal times the system is robust because of the built-in mechanism to purge itself when it over indulges and becomes sick (recession). This rids it of its excess and disease (malinvestment). In an effort to try to simplify the system and avoid some of the pain of the disease we've introduced easy money to buffer the system when it is in its purge cycle. This has actually made the system more complex. It is now subject to the **butterfly effect,** where small (and seemingly unimportant) changes in the system can result in large, unforeseen and sudden perturbations in other parts of the system. Both the political apparatus and the Federal Reserve are now in a 'sense and respond' mode to deal with incoming data on the economy. This is a highly unstable environment. The cure, or problem resolution, is far from clear. Important to understand is that there is no one certain action that will correct the problems we now face. Resolutions come in the form of decision trees, corrective paths, trial and error and **seeding** (nurturing emerging solutions that show promise of working).

I mention these things to focus our clients and friends on the fact that a simple policy solution or election will not likely alter the landscape of difficult decision making. Of course, a change of policy makers can have an impact, but they too will have to embark into uncharted territory to set us on a sustainable fiscal path. This seems a lot like Dr. Suess' 'Go Dog Go' in reverse. We had the party, you liked my hat, now we have to climb down the tree and find our way home!

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