CLEARVIEW
INVESTMENT PARTNERS

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Tech Spotlight

If you go to the last page of this piece, you will see a pseudo definition of Technical analysis:

> "Technical analysis seeks to define the trend of various securities and/or markets, be it short-term, intermediate-term or long-term."

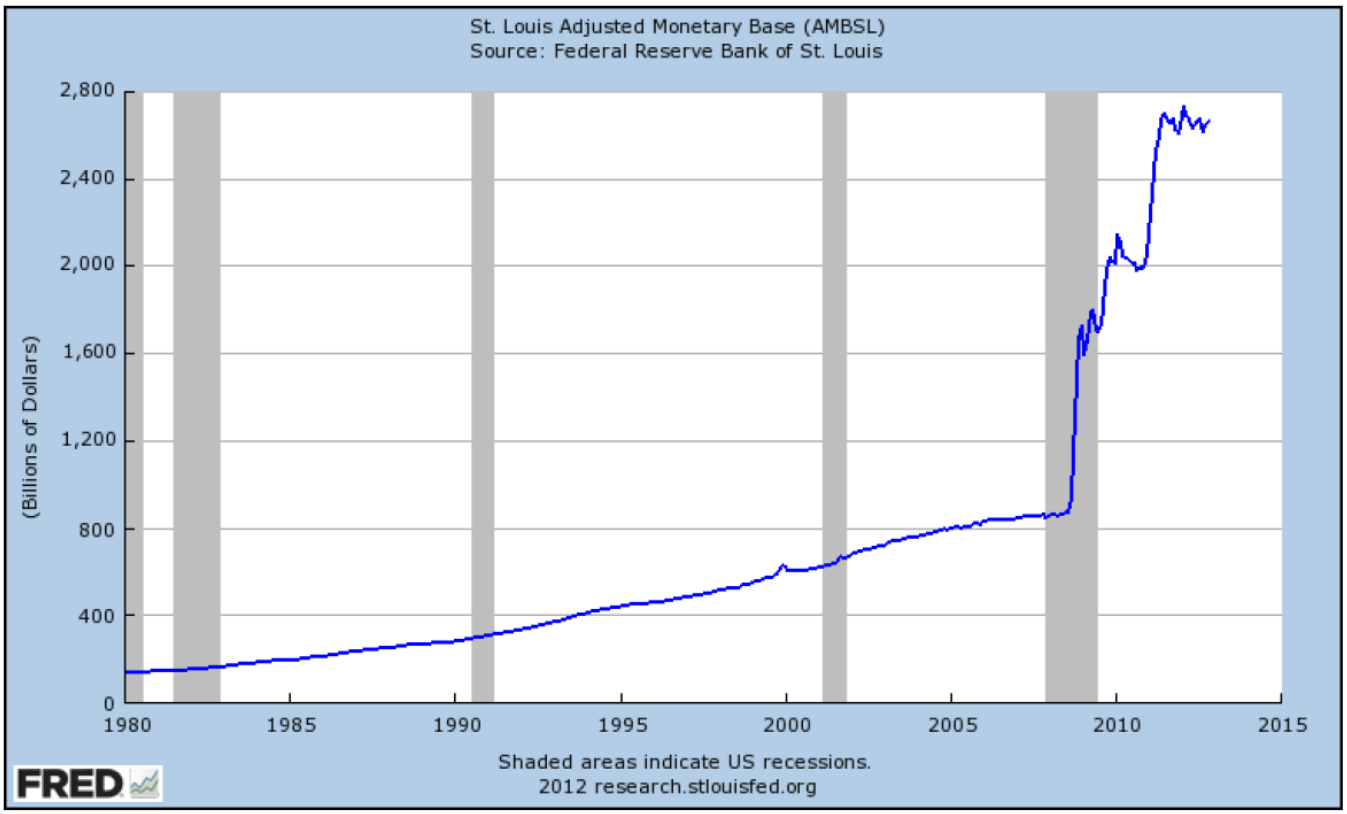
Now, while stocks, bonds and other kinds of securities can move in a certain direction for varying periods of time, ultimately the fundamentals of a security or market will take hold of investors' thinking and analysis and it is the fundamentals that will eventually drive the price of a security or market. But, in the short-term and intermediate terms, other factors (like investors' emotions) can drive prices. Which is why we look at Technical analysis, in concert with Fundamental analysis, in an effort to determine trends.

Over the last four years, though, the normal effects of a market's fundamentals on the trend in its price have been pre-empted by the Federal Reserve Board's foray into "Quantitative Easing." Over the decades, the Federal Reserve Board has affected the size of its balance sheet through monetary policy by either purchasing or selling different assets in an effort to calm markets in moments of panic or to control interest rates. This is all done in the effort to take the bumps and bruises out of the economy and fine-tuning it to run as smoothly as possible. But, the folks at the Fed are not perfect, and as a consequence of trying take away all pain, or at least minimize pain (such as a recession) in an effort to leave only growth, they experienced some unintended consequences – first a stock market bubble in 2000, a real estate bubble in 2006 and now a debt/bond bubble in 2012. Over the long haul, the net size of the Fed's balance sheet has shown growth – slow consistent growth (via the electronic "printing " of money), that is, until 2008.

The U.S. government has been running deficits for many years. The last time they didn't have an annual deficit was way back in 1957 (the best year under Clinton's presidency was in his last year when the annual deficit got down to "just" $18 billion). What is different now, and in particular over the past four years, is that there are no longer the people or institutions (aka the "markets") that are willing to lend the U.S. Government the money to fund the entirety of its annual deficits at the current low rates of interest. They were at the rates of interest that existed prior to 2008, but since then, the Fed has had to print money to cover the shortfall that

the markets are not willing to lend at the current low rates, both for the U.S. government deficits and mortgage back securities in support of the banking system. Of course, if the Fed were to stop buying assets in an effort to control interest rates and let the markets determine true lending rates, those deficits may be able to be satisfied by the markets. But the Fed has other objectives now that preclude them from letting normal market forces determine the true cost of lending and borrowing.

Consider the following chart of the U.S. monetary base – basically the base amount of cash that has either been physically or electronically printed by the U.S. Treasury:



You can see that the growth in the U.S. monetary base was fairly consistent from 1980 till the middle of 2008. And then the U.S. financial system, as well as the global financial system, literally "hit the wall", and the U.S. central bank (the Fed) and the other major central banks in the world all "printed' the equivalent of trillions of dollars, each in their own currency. At the beginning of 2008 the U.S. monetary base was $847.4 billion and the Fed's balance sheet was $927.0 billion. Today, as we are about to start out on QE4, the U.S. monetary base has grown by 214% to $2.665 trillion and the Fed's balance sheet has grown by 229% to $2.963 trillion.

And, based on the Fed's announcement of QE3 in September and QE4 in December, we expect to see each of these numbers to grow by another $1 trillion in 2013.

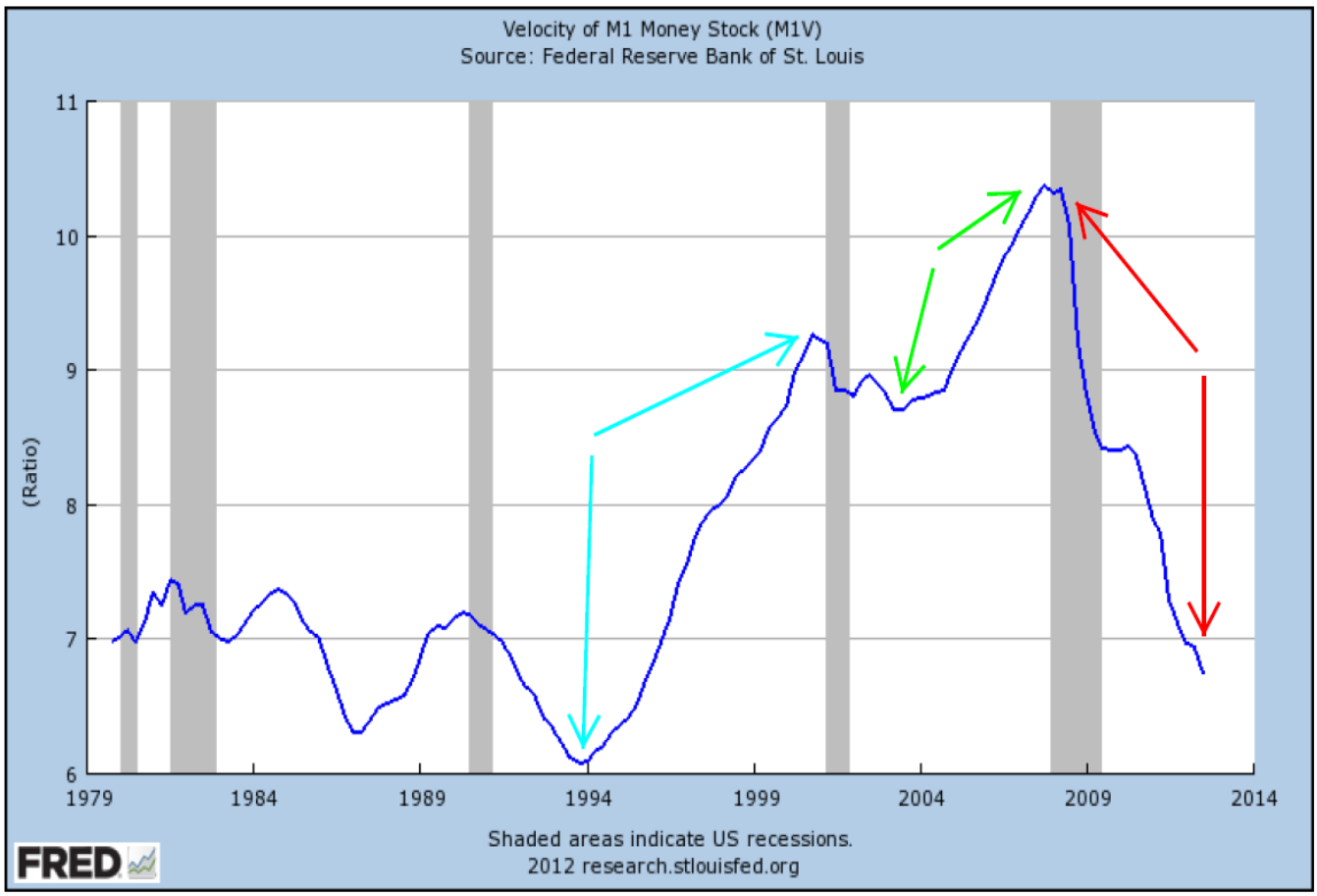
At the beginning of 2008, the cumulative U.S. federal debt stood at roughly $9.1 trillion dollars. Today it is now approximately $16.1 trillion. The last five years saw the Federal government outspend itself by almost $7 trillion! That's equivalent to about 43% of our country's GDP.

So, what does the U.S. have to show for all the governmental deficit spending, borrowing and money printing? And how come with all this extra money sloshing around is inflation so tame (well, at least as it is calculated by the Bureau of Labor Statistics)?

The Fed sets its monetary policy in an effort to control inflation and keep unemployment down – which is another way of saying, as I did earlier, to "fine-tune" the economy. So let's look at the economy in terms of the growth of U.S. GDP in both nominal and real terms over the past five years (since the beginning of 2008). Annualized growth in GDP nominally has been 2.2% per year. Annualized growth in GDP in real terms (that is, adjusted for inflation) has been 0.5% per year. That's not great growth by any means, but remember, there was a pretty severe recession during that time. The Fed, and any number of politicians, will tell you that without all the Fed's monetary intervention and the government's deficit spending we would most likely be in a depression. And they would be correct. The problem is, at some point we will not be able to create the deficits we are and maintain a slow-growth economy. (For comparison's sake, the average annualized GDP growth numbers from 1960 to the present are 6.7% nominally and 3.0% real.)

Now to inflation – why has inflation been so subdued? And this is a very important question. Why? Because the Fed is more comfortable with their quantitative easing efforts as long as inflation remains low. Inflation is low because the velocity of money (VOM) has fallen as dramatically as the size of the monetary base and the Fed's balance sheet has grown (red arrows on the chart on the next page). While the amount of money available in the economy to spend has risen, the rate at which people and institutions spend and/or lend that money has fallen off, virtually canceling each other out. The Fed is in the position of trying to hold the economy together (via low interest rates and lower unemployment) while Congress and the president try to figure out how to solve the "mystery" of the fiscal cliff. I think the Hardy Boys or Nancy Drew could have solved this mystery long ago. The problem for the Fed will be when the velocity of

money eventually starts to rise – if they are unable to effectively and efficiently lower the size of their balance sheet and the monetary base we could see significantly higher inflation.



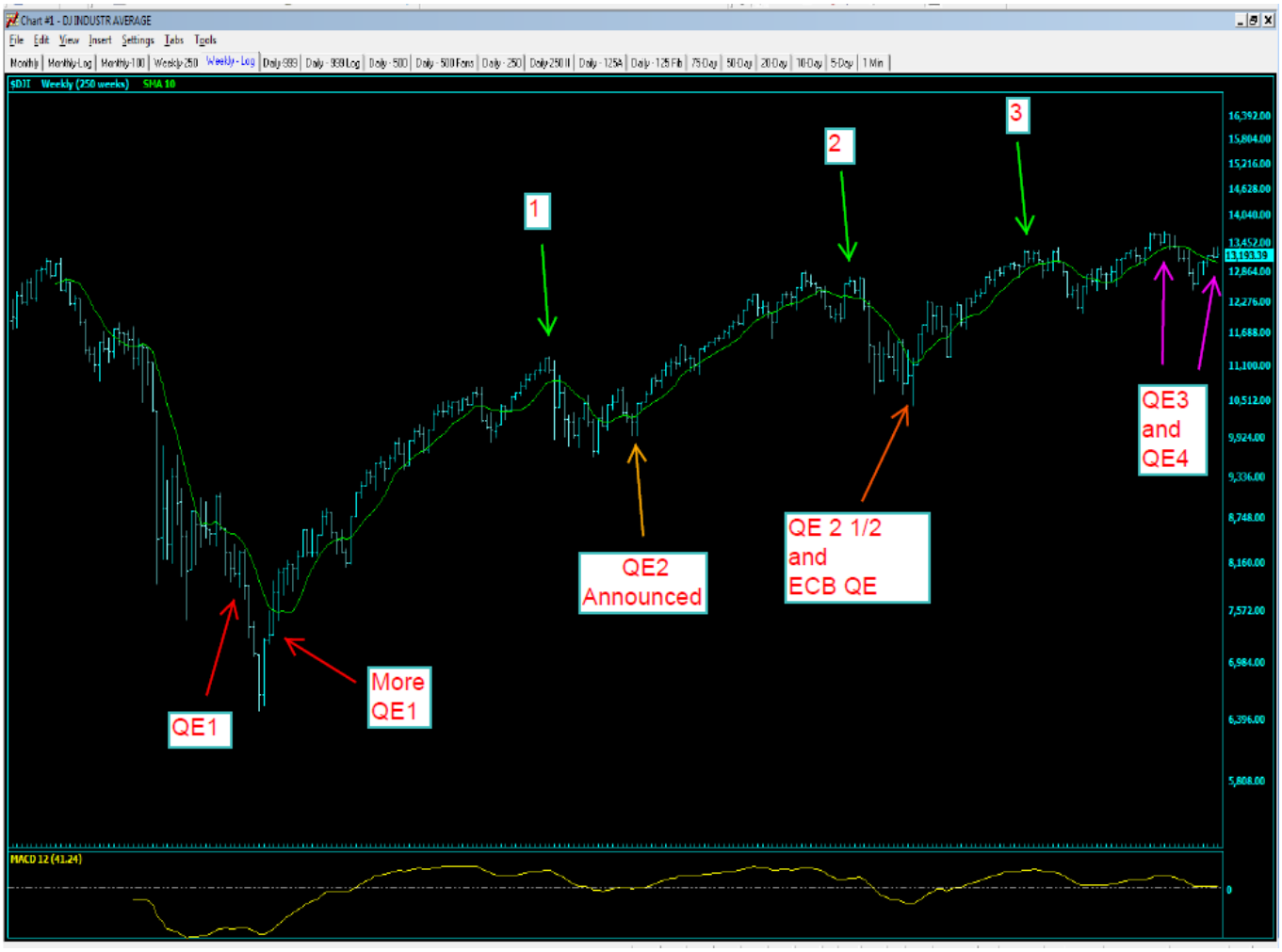
As an example of the effects of the velocity of money rising quickly, just take another look at the above chart. The light blue arrows show a 50% rise in the VOM from 1994 to about 2000 which corresponds to the tech bubble and then its bursting in late 2000. After coming out of the recession in 2001 we see the VOM begin another significant rise from still elevated levels (the green arrows) – which corresponds to the dramatic rise in the home prices with its bursting announced in 2007 with the subprime crisis.

Now the question to ask is, "how has all of this intervention by the Fed affected the stock markets?" Please look at the following chart on the next page – a chart of the Dow Jones Industrial Average from mid 2008 to the present. The bottom line message is that each round

of QE has a lesser effect. And to make matters worse, the markets' reaction to the announcement of QE3 in September was to immediately begin to correct down.

As the market was falling down in late 2008, the Fed came out and announced QE1 in November of 2008 (first red arrow) and then announced an expansion of QE1 in latter part of March 2009 (the second red arrow). QE1 ran out in the middle of April 2010 (first green arrow). The corresponding rise in the DJIA from the market bottom in March 2009 to when QE1 ran out was 69%.

Within two weeks of topping out with the end of QE1 in April, the DJIA corrected down about 14% and then Fed Chairman Bernanke made an announcement of the high probability of QE2 and the markets took off in late August 2010 (the light orange arrow). QE2 ran out (2nd green arrow) in June 2011 with the DJIA running up 28.3%. It only took a few weeks, though, and the DJIA began to correct down almost 19%.



In early October, with the DJIA down 19%, the Fed announced QE2 ½ and the European Central Bank (ECB) announced their version of a very hefty quantitative easing (about one trillion euros - $1.3 trillion U.S.) for bailing out European banks. The markets immediately bounced up and ground out a 27.5% gain over the next 6 months. When the ECB's QE ran out, the markets soon began to correct down (3rd green arrow) and it wasn't long before the Fed began talking about QE3 which was eventually announced in September (just 3 months ago). This time, there was no upward effect, and the markets began to correct down within four trading hours of the Fed's announcement.

And then just last week, the Fed announced QE4 (the second purple arrow). QE3 represents an average monthly purchase of $45 billion of mortgage backed securities to assist the banks and the mortgage market. This time there is no dollar limit or end date for QE3 – it is open ended as is QE4 which will represent the purchase of an average $40 billion a month of longer-term U.S. Treasuries. Between QE3 and QE4, that represents about $1 trillion dollars of security purchases per year. The hope was that this would buoy the stock markets and help with peoples' confidence in the economy. But now, Congress is bickering over the "fiscal cliff" and the markets are stalled waiting to see what happens. The decisions, or lack of decisions, will affect peoples' perceptions of the fundamentals for the economy and thus their spending habits. It is most difficult to discern a security's price trend, or its fundamentals, when the fate of the economy lies in the hands of politicians who seem more fixated on "winning" a political battle versus working on fixing a country's balance sheet.

We wish you the happiest of Holidays and a healthy and prosperous New Year!

Kenneth G. Hobbs III
Managing Partner

TECHNICAL ANALYSIS

Seeks to define the trend of various securities and/or markets, be it short-term, intermediate-term or long-term.

Remember, markets never move straight up or straight down, they move more like the ocean tides, surging (trending) up or surging (trending) down until the tide changes direction. We use various chart time horizons to give us an idea of how far a wave will move within a tide. Our intent is to keep clients apprised of changes in the various markets' movements in the months and years ahead.

Technical Analysis operates under three Basic Premises:

1. Market Action discounts everything. Or …

   Supply Versus Demand governs market action.

2. Prices move in trends. And …

   Trends stay intact until broken.

3. History often (but not always) repeats itself. Or …

   At the very least, it sure seems to rhyme.

The study of charts is based on the evaluation of past events to determine future probability. We seek a stock, or other asset or financial instrument, forming a particular pattern. We note that this pattern resembles that which typically precedes an asset's upward or downward move. In this way we are able to use our knowledge of the way a particular asset has acted in the past to estimate this particular asset's most probable future move. There will be a rational, logical and fundamental explanation for a particular chart formation usually following a given move in price.