



## U.S. Market Update

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Two events occurred during the first week of November that are likely to have a substantial impact on the U.S. economy and the stock market in the year ahead: The mid-term elections gave the Republicans control of the House of Representatives and a big increase in power in the Senate; second, the Federal Reserve announced a new plan to purchase \$600 billion in treasury securities through June 2011. While both of these outcomes were fairly widely anticipated, we think the impact of these events is underappreciated.

**We believe that the upside potential in business growth and stock prices is very significant during the quarters ahead and don't see the potential for a material pullback in prices until perhaps mid-year. In the meantime, we remain very Bullish.**

The election results are in many ways analogous to what occurred in the 1994 mid-term elections and we think the effects could be similar as well. You may recall that President Clinton was elected in 1992 along with a Democratic majority in the Congress. However, he faced popular opposition to his healthcare, tax and spending programs in much the same way that Obama has during the past year, and in 1994 the Republicans took over Congress. A major impact of that election was that the fiscal conservatism of the Republicans led to a downward spiral in government spending so that by the end of 1998 federal spending was rising at a rate of only 1.5% year-over-year. Federal debt as a percent of GDP, which peaked at 49% in 1994, began to fall rapidly and hit a low of only 32% just prior to the events of 9-11. The Republicans who just captured the big gains in this election ran on a policy of fiscal conservatism and spending control much as they did in 1994.

It is also important to differentiate between spending control and budget control. There reportedly have been voices in the Obama administration that have been pushing for a VAT tax, which currently doesn't exist in the US, in order to raise revenues and reduce the budget deficit. Furthermore, the Bush tax cuts of 2001 and 2003 are set to expire at the end of this year. Obama has publicly stated that, while he would consider extending the tax cuts for lower wage earners, he would like to allow the income tax rates on incomes above \$250,000 to rise. In contrast, the Republicans oppose a VAT tax and want all of the Bush tax cuts to be extended in order to help growth. This is now more likely because of the election results.

The Republican's policy goals, with regard to the budget, are focused almost exclusively on spending restraint. And in this we believe they will be successful. The best way to restart business growth and promote job creation is by reducing the drag on the private sector that occurs because of government spending. Such spending must be paid for through taxation or borrowing, i.e., budget deficits. By either method, government spending results in a reduction of resources available to the private sector. The Japanese, for example, for nearly a generation have been trying to reignite growth through Keynesian "pump-priming." The Japanese government spent huge sums of money and drove the level of government debt to nearly 200% of GDP despite initiating a VAT tax. But all that government spending and new taxation acted like a millstone around the neck of the Japanese consumer and industry. This is not expected to be the fate of the U.S.

Our reaction to the Fed's decision to purchase an additional \$600 billion of treasury securities is mixed. The Fed has observed that there is a great deal of unused industrial capacity and labor in the U.S. and would like to "stimulate" growth in order to take up this slack. Some economists think that this program will have little effect because interest rates are so low that any further decrease will not be sufficient to stimulate spending. We think this analysis is wrong. The purchase of \$600 billion in treasury securities by the Fed, absent a decrease in lending by the banking system, will result in a \$600 billion expansion in the money supply. People have been hoarding money and the velocity (turnover) of money has been declining. But it is almost certain that a substantial portion of this new money will be spent or find its way into the stock market or other securities. This, in turn, can become self reinforcing because as stock prices rise people feel more wealthy and the velocity of money will likely accelerate. Indeed, there has been very high correlation between the year-over-year change in the S&P 500 and M2 velocity. So at least in the quarters ahead, we expect to see higher levels of spending and rising asset prices. This is all well and good, but like too much wine at a party, there is risk of a hangover.

Nominal GDP growth, which was down at a year-over-year rate of 3.0% as of the June 2009 quarter, grew at a 4.4% rate as of the third quarter of 2010. Nominal spending growth at a rate between 4% and 5% is consistent with inflation of 1% to 2% if you think the U.S still has the potential to grow at its historical real rate of about 3%. Therefore, we see little reason at this point why the Fed should be creating money in order to stimulate spending. If spending were to accelerate beyond a 5% rate for an extended period of time, there is a real risk of inflation further down the road. Therefore, while we think the Fed's new program will be good for the economy and the stock market in the quarters ahead, we have real concerns about what lies in the years ahead.

Our strategy at FVCM is known as growth at a reasonable price (GARP). F&V constantly searches for individual stocks which are expected to experience upward earnings momentum and earnings estimate revisions. However, overpaying, even for a great company, is not a strategy for investment success. Valuation is always an important factor. Right now we see great opportunities in several areas of the markets, including the materials, energy and industrial sectors, all of which will benefit from an acceleration in growth, as well as the weak dollar. German investors can purchase our Luxembourg-based mutual fund which is invested in North American equities using our GARP strategy. More information about our mutual fund is available on our website at [www.fvcm.us](http://www.fvcm.us). Also, please feel free to give us a call in New York at 1-212-326-9533. One of our German or Swiss advisors would be glad to help you.

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