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Greetings,

The most hated bull market in recent history continues to chug along. Despite all the bad news (second quarter GDP was just revised down to 1.3% which means we are about as close to being in a recession without being in one) this market refuses to go down. With the market melting up over the past several months, many of the talking heads/strategists (who were talking the market down early in the year) are now becoming optimistic. However, the retail/individual investor is still on the sidelines, missing out on this powerful market. The individual investor continues to be like a deer in the headlights. Despite this strong market, there have actually been net outflows of $ 50 billion this year from equity mutual funds and the proceeds have gone into over priced bond funds. There is no new cash coming into this market as so many people still sting from the post Lehman financial meltdown. I don't want to minimize the carnage from the financial meltdown in any way. However, Lehman folded 4 years and two weeks ago! It is time to get over it. Despite the lousy economy, there is money to be made in this stock market. There certainly isn't a heck of a lot of money to be made in the Treasury bond market with the ten year bond yielding 1.7%. If you want the safety of the bank with zero risk of loss, they will be happy to give you a 2% annual guaranteed return, before taxes that is. Of course you will have to keep your money there for at least 2 years. Money market funds will give you a return of ¼ of 1% but you can have access to your money at any time.

I wrote in my April 1, 2012 investment letter that one of the reasons I was optimistic about the stock market was because of all the stock buyback programs. Large public corporations are as flush with cash as they have ever been. While the retail investor is too scared to put cash to work, corporations are putting their cash to good use by purchasing their own shares. In my view, that is one of the reasons for the recent stock market rally. I will also point out that when a company buys back its own stock, it benefits because purchasing its own stock decreases its share count which given the same net income, will lead to a higher earnings per share. Another reason for the stock market rally has been short covering. Hedge funds have been huge underperformers this year. The last that I have heard, the average hedge fund is only up 2.3% this year. One of the reasons that they are doing so poorly is because they have big short positions which means that they are betting that the market will go down. Many of the hedge funds recently have been throwing in the towel and covering their short positions. Speaking of past investment letters; I want to bring up that column from the NY Times that I wrote about last quarter. That column applauded the retail investor who was fleeing cheap stocks for expensive bonds. Well, how smart is that columnist looking now? This is an excellent example of how columnists in any newspaper (not just the NY Times) should stay away from giving investment advice.

By far and away the biggest reason for this market rally has been QE3. QE stands for quantitative easing. Quantitative easing is a euphemism for the Federal Reserve "printing money" and using the liquidity to purchase Treasury bonds and mortgage backed securities. The stock market has been anticipating this QE for at least the last three months and has shrugged off all the bad news with the economy. I call this a major sugar high for the stock market. As I have written in the past, the stock market has a very short time frame. Three and a half years ago, when things were a disaster with the economy and stocks were much cheaper than they are now, very few people (other than myself) wanted to look a year or two down the road and take advantage of some once in a lifetime buying opportunities. Now, people in the market are simply looking at all of this liquidity coming into the market creating this sugar high. What is important to realize is that while sugar (or candy) tastes great at the time you eat it, if you eat too much of it you will get rotten teeth, among other things. Some people think that inflation will be an unintended consequence from QE3. I am not in that camp. I don't think that inflation will be a problem for a long time. There is simply too much capacity in this economy, never mind the horrific labor market which will keep wages down. I do think that the Fed is creating conditions for the ultimate Treasury bond bubble. Eventually (I don't know when), the economy will pick up. When that happens, long term interest rates will go up, despite all of this Fed intervention. When that happens, there will be less fear among bond market traders and since the bond market traders will be less fearful because of the improving economic conditions, that will create even less demand for Treasury bonds. When there is less demand, then the prices of Treasury bonds will continue to go down. I won't even get into the effects of all the additional supply of Treasury bonds coming into the market because of these $ trillion+ deficits for as far as the eye can see. At the same time, the Federal Reserve with its huge several trillion dollar balance sheet will have to unwind its position or else it will be stuck with assets whose prices are plummeting. Can you imagine the effect on the Treasury market when the Fed is forced into selling hundreds of billions of dollars of Treasury bonds at the same time that financial institutions are also selling those same Treasury bonds, while the government is issuing Treasury bonds to fund $ trillion deficits during a time of falling prices?? Do you remember the word crash?? My call before this all happens is that we are looking at the biggest crash in the history of the Treasury market. Another investment adviser I know asked me not that long ago if I thought the entire bond market was in a bubble? My response was no, just the Treasury bond market. The problem I see is that even if other bonds are expensive but not in a bubble, there could be such emotion out there so when the Treasury bond market does crash and burn, it will most likely take the rest of the bond market with it. My first year as a professional investor was 1994. During 1994, the Mexican Peso collapsed, partially as a result of rapidly rising long term interest rates and it was the worst year for the entire bond market (including municipal bonds) other than 2008 in the last 30 years. Fortunately in 1994, the stock market held up. That is why I am not overly concerned about the stock market getting clobbered when (notice I said when, not if) the bond market crashes. All of that money fleeing the bond market will have to go somewhere and in a growing economy, it would make sense for some of the proceeds from the bond sales to flow into the stock market.

Now, you might be asking, why the heck is the Fed doing all of this if it will cause all of this collateral damage down the road? My answer is that the people at the Fed will vigorously state that they will be able to unwind its balance sheet without causing a bond market panic. I don't know how they will but I will look forward to seeing them try. The

Fed's logic behind all of this isn't just to keep long term interest rates low. That is what they say is the reason that they are doing this. Long term interest rates are already at all time lows and all the QE won't bring them down any lower. What they are looking to do in reality is to keep interest rates so low so that the public will eventually have no choice but to put money into the stock market. Interest rates have been at historic lows for nearly four years now. Stocks are as under owned as a percentage of assets for as long as I can remember. It used to be that many people would have an asset allocation of say 60% stocks, 30% bonds and 10% cash. Now, it is more like 60% bonds, 30% stocks (if that high) and 10% cash. I just don't have confidence that people will now all of a sudden start flocking into the stock market because of QE3. I don't agree with the Fed's logic. I am trying to explain it so that you understand what is going on now and why. The Fed feels that if the stock market continues to go up, that it will create a wealth effect similar to the 1990's. Then they reason that if people feel wealthier, they will spend more. Since consumer spending accounts for 70% of GDP, the Fed figures that if GDP increases, that will lead to more hiring and then reduced unemployment. Sorry again, but I simply don't buy their logic other than the fact that all of this liquidity will create a floor under the market which is frequently referred to as the Bernanke put.

If you have any questions or items that you want to discuss, then please either call me or email me.