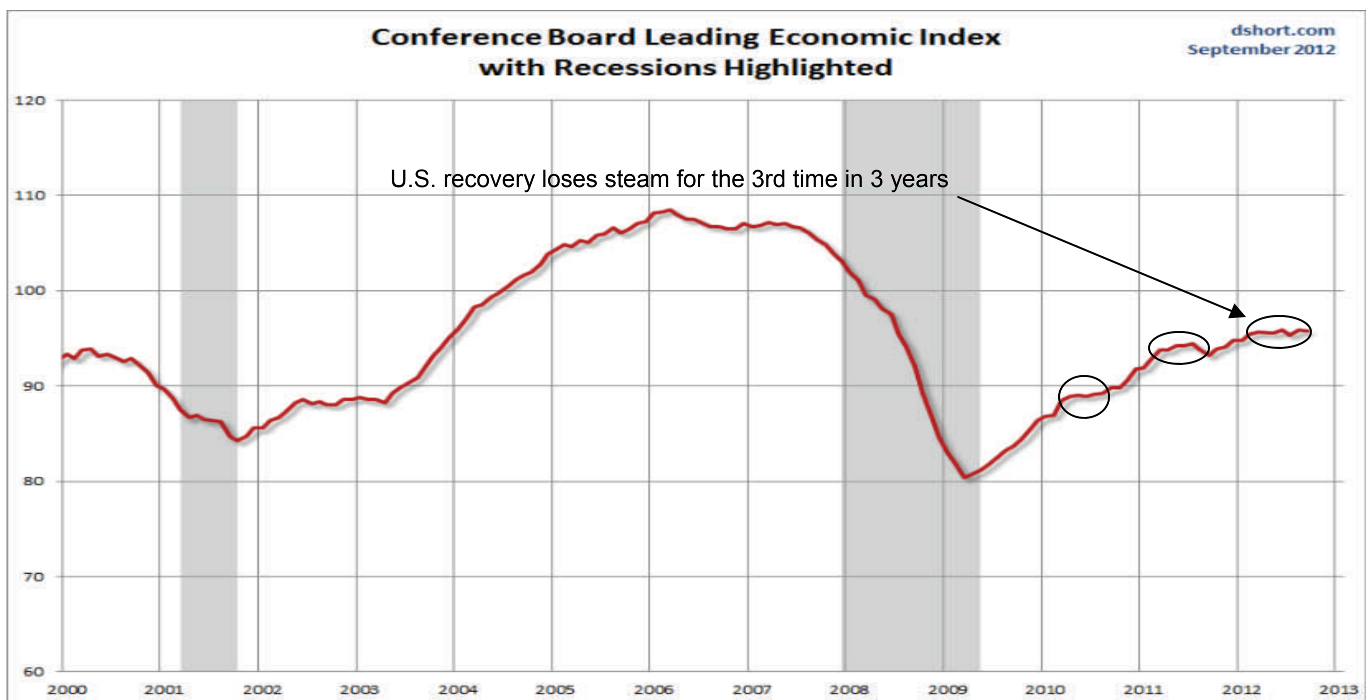
QE3 NOT A FIX FOR FISCAL ISSUES & A COUPLE OTHER TIDBITS

U.S. ECONOMIC DATA MOSTLY NEGATIVE

Whereas consumers were expected to expand their borrowings by $9.1 billion in July, borrowings actually fell by $3.3 billion in a sign that consumers have become more cautious. The aggregate size of business inventories also increased by .8% in July versus the .3% that was expected. This further suggests that demand may be waning a bit despite the fact that retail sales have recently advanced somewhat more than expected.

In response to sagging demand, industrial activity disappointed forecasters by declining 1.2% during August instead of increasing .1%. While the "core" Consumer Price Index, which excludes food and energy costs due to their inherent volatility, increased by only .1% during August, the "everything included" CPI figure that most folks care more about rose by a much more substantial .6%. This resulted in the largest monthly CPI increase in three years. As is the case with declines in consumer borrowing, large cost-of-living increases also sap consumer buying power as necessities such as food and fuel command a greater share of consumers' collective wallet. The number of workers filing initial unemployment claims was also slightly higher (worse) than expected. At 8.1%, the national unemployment rate is still about the same as it was at the beginning of the year and earnings estimates for 2013 continue to suffer downward revisions. Because the U.S. population is growing,



the U.S. economy must consistently add jobs just to maintain a stable unemployment rate. Maintaining the status quo, however, is simply not good enough and the Federal Reserve understands this.

FED RESPONDS WITH "QE3"

On September 13th, Ben Bernanke and team responded with its third round of so-called quantitative easing. Although the term has become somewhat ubiquitous over the past several years, quantitative easing is a form of stimulus that somewhat differs from the Fed's more traditional "open market operations" where the Fed buys existing government bonds on the open market using newly created funds. With quantitative easing, the Fed purchases various types of assets of varying terms *directly* from commercial banks and other financial institutions. This allows the Fed to more directly influence (i.e., lower) the level of interest rates on those forms of credit the Fed considers to be most crucial to aiding the U.S. economy.

INTENT OF QE3

The Fed's latest quantitative easing effort is an open-ended program whereby it plans to purchase around $40 billion worth of mortgage-backed securities (mortgage loans that have been packaged into securities that investors can trade) per month — for as long as it thinks it's necessary. The Fed intends to hold short-term interest rates at "exceptionally low levels" (i.e., close to 0%) through at least the middle of 2015 and has indicated it might keep interest rates low for an extended period even if economic growth does rebound.

QE3 is designed to directly increase the prices and decrease the yields associated with mortgage-backed securities (MBSs). Those higher prices will help the balance sheets of the financial institutions that hold this type of asset look better. Lower mortgage yields will help make homes more affordable to those people who do not already own one and encourage those people who already do have homes to refinance them which will then leave them with more money to spend in other ways. Since mortgage rates are already so low, many economists figure that this latest round of Fed stimulus will have only a minor positive impact on the housing market. This view is premised on the belief that the main obstacle to increased home ownership has more at this point to do with the high unemployment rate and limited incomes and savings than high mortgage rates. Nonetheless, lower mortgage rates will enlarge the pool of home buyers and support real estate prices to at least some extent.

As the Fed pursues quantitative easing, financial institutions will accumulate excess funds which may induce them to relax their lending standards. Since quantitative easing will generally result in banks being more flush with cash, their incremental lending efforts will tend to cause rates to fall on all types of loans and deposits. All of this encourages economic expansion.

IMPACT ON SAVERS ... POTENTIAL FOR ASSET BUBBLES

While further Fed easing is likely to stimulate the economy, there could be some negative consequences. First, monetary stimulus aids debtors at the expense of savers who will find it even more difficult to earn a meaningful return on their spare cash. The reality for those virtuous enough to have worked hard over the years to accumulate capital to lend to others is an intentional diminution of their earning power by Fed decree as it continues to tilt the playing field to favor those who have been less economically virtuous (i.e., debtors). A natural consequence of this game tilting is that investors will increasingly turn to riskier asset classes to recapture some of the return that would ordinarily have been available through traditional deposit vehicles. As investors gravitate toward riskier asset classes, the potential for pricing or asset bubbles increases. Of course, investors enjoy rising asset prices until the bubble bursts. In truth, asset bubbles wreak havoc on markets and investors' psyches.

U.S. FISCAL DETERIORATION ... A LITTLE PERSPECTIVE

As Chairman Bernanke noted in his remarks about the Fed's latest round of stimulus, quantitative easing is only one component of economic policy. He and the rest of the U.S. are still waiting for elected officials to address the severe budget reductions that are scheduled to occur automatically on January 1st. However, it's unlikely that Congress will act until after the November election. The stakes are high and investors are likely to become increasingly nervous as the draconian budget cuts of 2013 approach. To the extent these automatic cuts are allowed to occur, the shock to the U.S. economy would almost assuredly be large enough to trigger another recession.

Zacks Research recently analyzed how the fiscal condition of the U.S. economy has deteriorated since 2000. In real terms (i.e., in terms *not* skewed by inflation), output of the U.S. economy has grown at an average rate of about 2% per year while tax receipts have grown at about 3% per year. In isolation, these two trends would have combined for a significantly *improved* fiscal situation were it not for the fact that government spending and transfer payments (i.e., entitlements) grew at an average annual rate of approximately 8%. Bear in mind that these figures are annual averages. Over longer periods of

time, the magic of compounding will transform even relatively small annual percentage differences into astoundingly large absolute differences.

To put this into perspective, a 2% average annual rate of economic growth over an 11½ year period (from January 1, 2000 through June 30, 2012) translates into an overall increase of about 26%. That is, economic output of the U.S. was roughly 26% higher in the middle of 2012 than it was in 2000. Since tax federal collections have grown at about 3% per year over this same period, they are now about 40% higher than they were in 2000. Clearly, tax collections have *more than* kept pace with the growth of the U.S. economy, so the level of tax collections is not what ails the U.S.

BIG GOVERNMENT & THE ENTITLEMENT NOOSE

That leaves a big arrow pointing at government spending and entitlement programs. The fact that these expenditures have increased by about 8% per year since 2000 equates to an overall increase of over 140%! Despite the fact that tax revenues have grown substantially faster than the U.S. economy as a whole, uncontrolled growth in government spending and the size of entitlement programs has dwarfed the 40% increase in tax receipts by a factor of 3½ to 1. Not only has the soundness of the U.S. fiscal condition already been negatively impacted (recall that the U.S. lost its AAA credit rating a while ago), this trend is simply not sustainable.

Although the Bush-era tax cuts are set to expire at the end of this year, the U.S. fiscal situation is not solvable by tax increases (favored by democrats) or a repeal of Obamacare (favored by republicans). Instead, the solution must address reductions in the size of government itself and the relative generosity of entitlement programs such as Social Security, Medicare, Medicaid, and unemployment benefits. Financial physics denies the possibility of a free lunch and acting otherwise will not make it so. Politicians and the electorate have finally started to own up to this reality, but an actionable plan is still lacking. While the presidential contenders bicker over distracting minutiae, the huge issue of how to remedy the fiscal imbalances that plague the U.S. are mostly being ignored. While some maintain that the U.S. might improve its fiscal situation by growing its economy, reducing the size of government and entitlement spending would seem to represent a far more direct and plausible approach.

FISCAL DISCIPLINE AN EVENTUAL CERTAINTY

Despite the fact that the United States' public debt has ballooned over the past decade, the cost of

servicing that debt has actually increased at a lesser rate due to the low absolute level of interest rates. While the U.S. certainly does have severe fiscal problems, they're not as severe as those facing some other developed nations. In drinking terms, the U.S. is essentially the least drunk, drunk at a bar of developed nations. At some point, however, creditor nations will grow suspicious of the U.S.' ability to service its debt. When that point is reached, they will impose higher borrowing costs on the U.S. and those higher rates will trickle down to every single economic unit within the U.S. Accordingly, economic activity would contract sharply and investors would be negatively impacted.

To the extent the U.S. is unable to muster the political courage to reign in its entitlement spending, there will eventually come a point where fiscal discipline is imposed upon the U.S. by creditor countries much the way they have imposed discipline on the peripheral countries of Europe. Whether that discipline is imposed soon, or eventually and whether it's imposed voluntarily, or by external forces, economic contraction is certain to be the result. Here's why. A reduction in the size of entitlement payments will not only reduce government expenditures, it will also reduce consumer buying power. In essence, a significant portion of economic activity will be lopped off and demand will fall. Like an algae bloom that occurs as a result of concentrated waste rather than naturally occurring agents, the resulting algae is just as real. Likewise, it matters not that a large chunk of U.S. economic activity has been allowed to develop as a result of public financing. When this chunk of activity eventually does disappear, it is certain to create a material economic void.

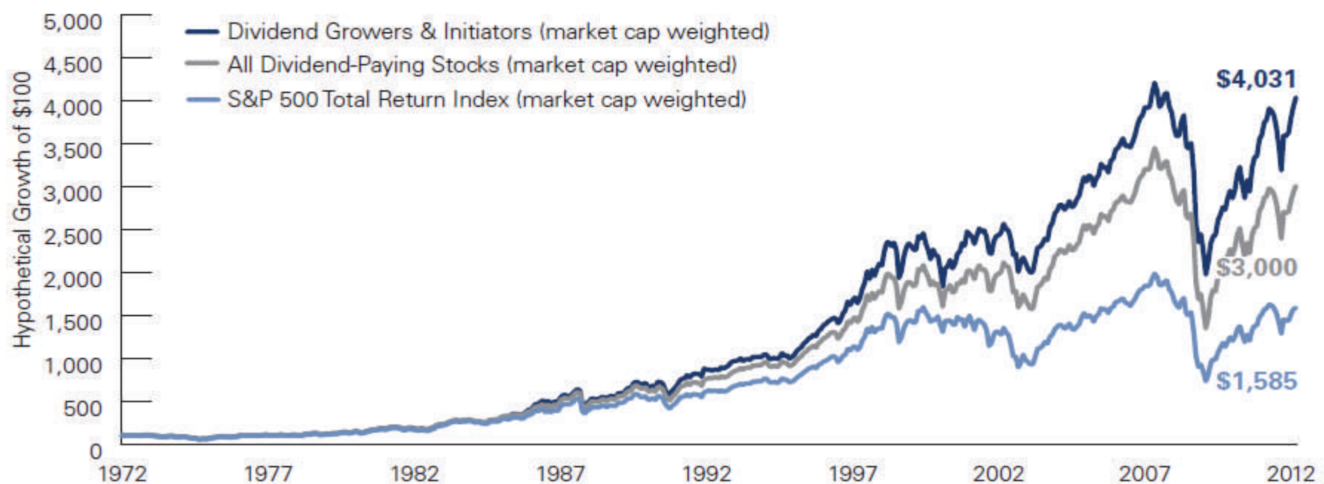
SURVIVING CONSUMER PRIORITIZATION

Since some measure of consumptive austerity seems to be in store for the U.S. at some point, it would seem to make sense to favor companies that offer goods and services that consumers value relatively more than others. That is, as consumers are forced to prioritize their purchases, it would make sense to favor those companies that produce the goods and services that are expected to survive this eventual prioritization. Of course, the devil is in the details, but it's difficult to execute those details without having the larger view in mind.

WHY DIVIDENDS MATTER

In my last letter to you, I showed how the dividend rates on many of the stocks we hold had changed over the previous decade and how, for the most part, they had increased at a rate that far outpaced inflation. This time, I'd like to discuss some other positive aspects associated with owning shares of

companies that reward shareholders through a growing dividend. Because a material portion of the return of a dividend-paying stock can more or less be relied upon, it makes intuitive sense that dividend-paying stocks have tended to be less volatile than their non-dividend-paying counterparts. What may be surprising is that dividend-paying stocks have outperformed non-dividend-paying equities over the past several decades and companies that have been able to increase their dividend payments have performed even better.

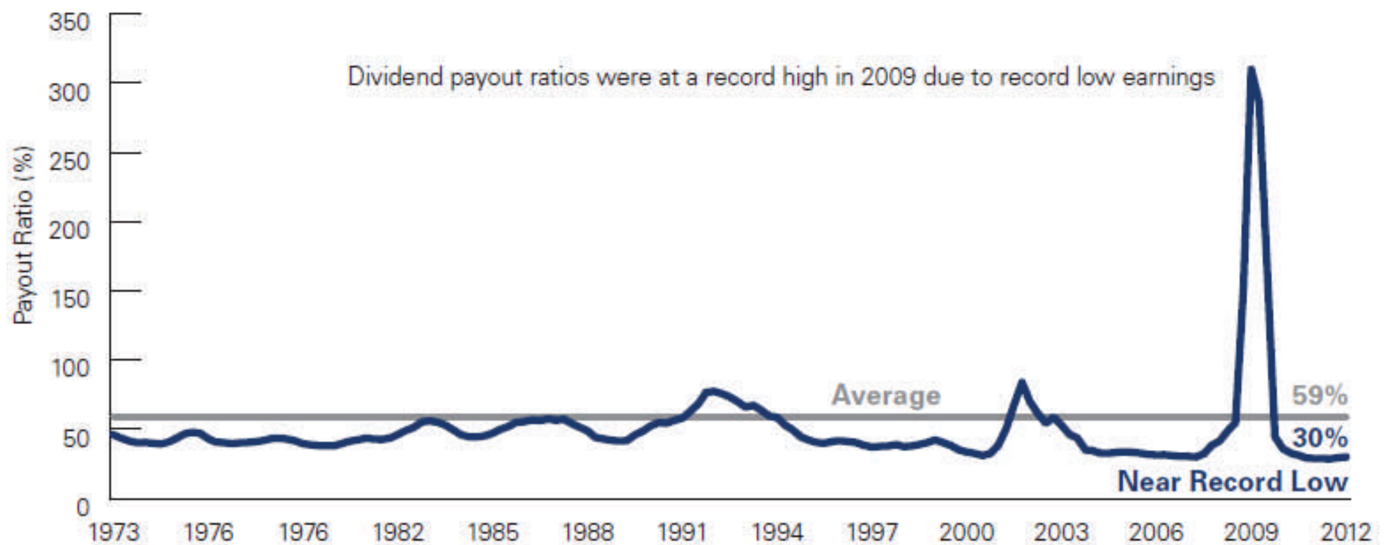


Of course, a growing dividend equates to an increasing income stream which is exactly what most retirees want and need from their investment portfolios. The table below shows how large a dividend that starts at 3% would grow over a five-year period based on various rates of growth.

	Dividend Growth						
Years	0%	5%	10%	15%	20%	25%	30%
1	3.0%	3.2%	3.3%	3.5%	3.6%	3.8%	3.9%
2	3.0%	3.3%	3.6%	4.0%	4.3%	4.7%	5.1%
3	3.0%	3.5%	4.0%	4.6%	5.2%	5.9%	6.6%
4	3.0%	3.6%	4.4%	5.2%	6.2%	7.3%	8.6%
5	3.0%	3.8%	4.8%	6.0%	7.5%	9.2%	11.1%

In practice, dividend yields of over 5% are relatively rare — not because dividend rates are static, but because the share prices of stocks that have undergone dividend increases have tended to rise. As a stock's price rises, its dividend yield falls ... to the *next* investor. From the perspective of the investor who already owns the shares, the yield rises, but that's not the way it's reported in the media.

The dividend payout ratio relates the dividends paid by a company to its earnings. Very often, companies will target a specific payout ratio or range of payout ratios. When a company's earnings rise, its payout ratio will fall unless it also increases its dividend. Relatively low payout ratios suggest that companies have more *headroom* to boost future dividend rates.



The chart above indicates that dividend payout ratios are now significantly below the long-term average. This is due to the confluence of strong corporate earnings and the fact that many companies have raised their dividends somewhat more slowly than they otherwise might have. (In response to the financial shock of 2008-9 and lingering economic uncertainty, many companies have hoarded cash and have paid more attention to fortifying their financial staying power.)

The chart below compares the investment performance of stocks that do not pay dividends to those that do and to those that have tended to increase their dividend rates since 1972. Regardless of the inflationary environment, "dividend growers" have performed better.

Inflationary Environment	Y/Y % Change in CPI*	Total Return Non-Dividend Payers (%)	Total Return Dividend Payers (%)	Total Return Dividend Growers (%)
Low to Moderate	0%-2%	0.55	9.67	10.80
Elevated	2%-4%	5.81	11.17	12.09
High	4%-6%	-20.15	-5.16	-2.62

SELECTED EMERGING MARKETS QUOTES & DATA FROM CAPITAL ECONOMICS

Healthy fundamentals and plenty of scope for policy stimulus mean that **Asia** looks better placed than most emerging regions to withstand the impact of weak global growth over the next couple of years. A lackluster policy response to the economic slowdown has set **China**'s economy up for the mildest of rebounds over the coming quarters. The economies of **Latin America** are set to slow in 2013, as both local and external headwinds build. As the region most exposed to the euro-zone crisis, the outlook for **Emerging Europe** is the weakest in the emerging world. Overall, weaker **Emerging Markets** growth is likely to be a permanent feature.

— Glenn Wessel

% y/y	Share of World[2]	GDP				Inflation[3]			
		2011	2012f	2013f	2014f	2011	2012f	2013f	2014f
Emerging Asia[1]	**28.3**	**7.4**	**6.0**	**6.3**	**6.0**	**6.2**	**4.0**	**4.0**	**3.8**
China	14.3	9.3	7.6	8.0	7.5	5.4	3.0	3.3	3.0
India	5.7	7.8	5.0	5.0	5.0	8.6	7.3	6.5	6.0
South Korea	2.0	3.6	2.5	3.5	4.0	4.0	2.3	3.0	3.0
Latin America	**8.1**	**4.5**	**3.0**	**2.5**	**3.5**	**7.0**	**7.5**	**8.0**	**7.5**
Brazil	2.9	2.7	1.7	3.5	3.8	6.6	5.5	5.3	4.5
Mexico	2.1	3.9	3.8	3.2	4.0	3.4	4.0	3.5	3.0
Argentina[4]	0.9	8.9	0.0	-2.0	1.0	9.8	25.0	28.0	30.0
Emerging Europe	**7.3**	**4.8**	**2.5**	**1.5**	**2.5**	**6.5**	**5.0**	**4.5**	**4.0**
Russia	3.0	4.3	3.8	2.5	2.5	8.5	5.0	6.0	5.0
Turkey	1.4	8.5	2.5	2.0	4.5	6.5	8.5	6.0	5.0
Poland	1.0	4.3	2.0	1.8	3.0	4.3	3.8	2.5	2.5
Mid. East & N. Africa	**5.0**	**5.0**	**3.8**	**3.5**	**4.3**	**5.3**	**5.0**	**5.0**	**5.3**
Saudi Arabia	0.9	7.1	4.5	3.3	3.8	5.0	4.5	4.0	4.5
Egypt	0.7	-0.8	1.5	4.0	5.5	10.1	8.0	8.0	8.5
Sub-Saharan Africa	**2.4**	**4.9**	**4.5**	**4.5**	**5.5**	**8.6**	**8.5**	**7.0**	**7.0**
South Africa	0.7	3.1	2.3	2.5	3.5	5.0	5.5	5.0	5.0
Emerging Markets	49.4	6.3	4.8	4.5	5.0	6.4	5.0	5.0	4.5
G4 Countries									
US	19.7	1.7	2.0	2.0	2.5	3.1	1.9	1.8	1.7
Euro-zone	14.6	-0.7	-0.7	-2.5	-1.0	2.7	2.5	1.2	0.5
Japan	5.8	1.5	1.5	1.0	0.8	-0.3	0.0	0.0	0.5
UK	2.9	-0.5	-0.5	0.5	1.5	4.5	2.6	1.8	1.4

(1) Incl. China. (2) %, 2011, PPP terms. (3) % y/y annual avg. (4) Historical data are official figures, forecasts are for CE proxies.