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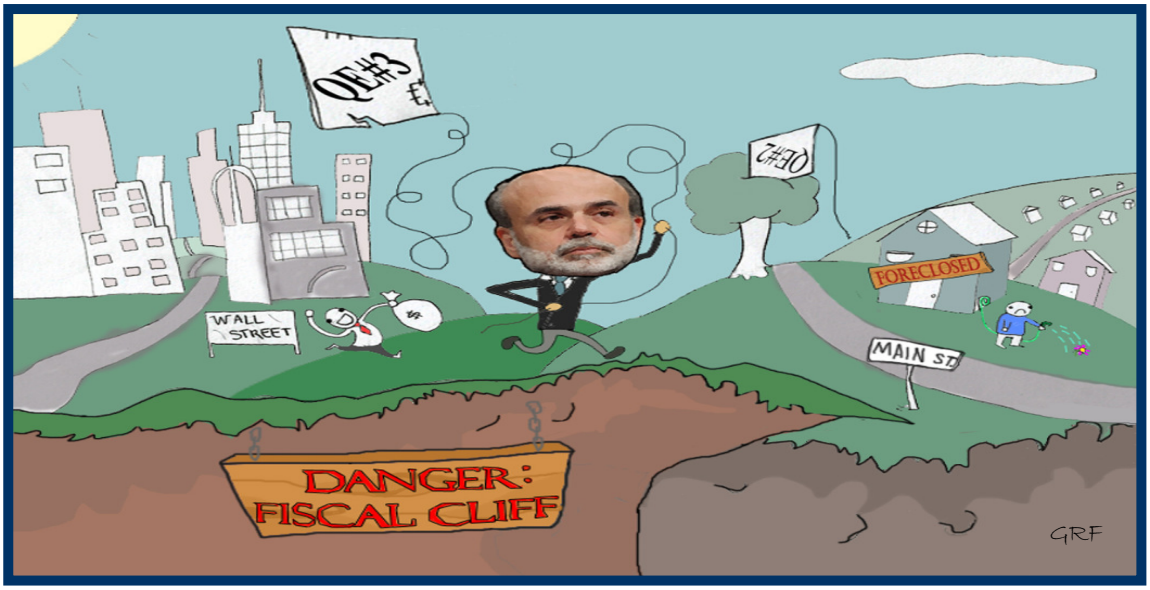
October 2012: *Rising Stock Prices Ahead of "Fiscal Cliff"?*



Will further efforts to stimulate the economy by Federal Reserve Chairman Bernanke succeed?

What's Ahead for the Markets? Longer term there will be higher stock prices. Shorter term, we wish we knew. With respect to who wins the Presidency, the market cares less than one would think, in our opinion. Expect more stock price volatility along the way.

It's fun but not terribly useful to try to discern short-term market direction by "connecting the dots" among political, economic, and financial events. U.S. stock price gains this year are partially due to earnings improvements among companies whose inventory got very low, relative to even anemic demand for company goods, so they produced more to meet demand. Demand for new toys from Apple and other tech firms also helped. In the wake of the financial crisis, some companies have learned to grow earnings without re-hiring many of their pre-crisis employees.

Anything else helping stocks? That would be the Federal Reserve's attempts to "prime the pump" with strong hints of a third "quantitative easing" (QE3 for short). This essentially amounts to "printing money" by holding on interest rates, or buying bonds for more than their worth, etc. Small businesses and homebuyers, won't see much of the easy money. It mostly flows to the big investment banks. What do they do with it? Buy stocks on the expectation that QE3 will boost stock further. Good for big investors, less good for the middle class, even less so for the under-employed and unemployed.

Respected economists say that priming the economic pump this way may be the only trick the government has left. It may work. Or, it may just buy us time until the next financial train wreck. Some argue that the current rally in stocks relies too heavily on the expectation that inflation will drive prices for company goods and services higher, as opposed to price moves based on healthy company earnings growth. Others suggest there are too few other places to invest. So, the stock market is the beneficiary by default. Still others argue that demand for goods and services will rise, even if slowly.

Most talk in Washington about the coming **fiscal cliff** is concern about the year-end expiration of the Bush era tax cuts, and related benefits. Too few in Washington are effectively addressing the other cliff–the one that lies ahead because of our frightening debt to revenue ratio, an underfunded Social Security and Medicare system, or a host of other entitlements and expenditures.

What should you be doing about this? First, avoid some costly mistakes. If you are looking for respectable earnings from bonds in order to boost your income, don't be tempted by high yield bonds while ignoring the higher risks that come with them. Be wary of falling in love, indiscriminately with all manner of dividend paying stocks. Understand that eventually, low interest rates and higher stock prices without significant company earnings growth, turns into high inflation, depressed stock prices, and worst of all, loss of purchasing power.

Next, refine your financial plan to prepare for emergencies–and opportunities. Assess how you would fare under differing scenarios for stock returns, bond yields, inflation, taxes, and life events–from a long-term care need to an inheritance from that rich relative you never heard of. Recall that investment-grade bonds–especially in an era of depressed interest rates–are primarily for dampening volatility in your portfolio. Value and dividend stocks are best suited for money you will not need to call on in the short term. Understand the downside and upside potential of different assets. Plan your affairs so you can live with whatever the markets might deliver in the years ahead.

Your allocation among stock, bond and cash markets:

If you looked over the recent account(s) statement from your custodian Trust Company of America, you probably noticed that you are holding a larger proportion in cash than usual; much more than needed to fund income requirements or near-term expenses. You will also note this fact on the pie chart in the enclosed performance report from our office. It's rare that we hold cash as long as 90 days. This is one of those times.

The cash in your accounts primarily represents the proceeds from the sale in late May, June and July of selected bond and stock funds.

Why was that done? Bonds that earn little more than cash, and at much more risk, are not we want for your portfolio. We are closely watching Washington moves to jump start the economy with low interest rates. We are holding our breath while Europe seeks to right its wrongs. So, US treasuries, foreign bonds, and other fixed income caught in the downward spiral are being replaced for now. The diversification benefits of European stock exposure versus similar US holdings are relatively unattractive at this time, especially for US investors with little desire to bet on a quick recovery in Europe or Britain. This collapse of return benefits versus diversification benefits has not occurred in a long while.

What was sold? Bond funds with the most exposure to an ailing Europe, or otherwise caught in this period of depressed interest rates; also stock funds focused in European small companies and real estate. However, our allocations to the emerging markets of China, India etc. will remain. We also continue to hold inflation-protected bond positions.

What plans do we have for the cash? The move to cash is temporary. It is being put back to work as this is written. It is being reinvested in bonds with more attractive risk/reward profiles, and with what we believe will be only a slight increase in the riskiness of your portfolio. This will be accompanied by allocations to the US Stock Market, particularly stocks with a value or dividend-oriented arenas that we have traditionally favored. Note that Europe and Britain will not be abandoned forever. Neither will US Treasuries.

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