AR SCHMEIDLER & CO
INVESTMENT ADVISORS
A Hudson Valley Bank Company

The Outlook

Nov 10, 2009

As of 11/10/09		
Index	**Market Value**	**YTD % Change**
Dow Jones Industrials	10,246.97	16.8%
S&P 500	1,093.01	21.0%
Nasdaq Composite	2,151.08	36.4%

Sunset of the Debt-Driven Expansion Cycle—
Implications for the US Economy and Dollar

Since last December, we have described an environment in which unprecedented and coordinated stimulus initiatives by governments and central banks were required to pull the global economy out of the worst recession in 70 years and stabilize the global financial system. The massive stimulus efforts that have ensued are now both highlighting and reinforcing structural imbalances that existed prior to the crisis as well as creating new imbalances. While continuing to be mindful of the fragile global economy, central banks and governments are becoming more inwardly focused as they take the steps necessary to protect their own economic interests. Resource-rich countries such as Australia and Brazil are becoming concerned about their economies overheating, while many developed countries are still struggling to get their economies back on track.

On October 29th, the US Department of Commerce announced its estimate of annualized 3.5% gross domestic product (GDP) growth for the third quarter of 2009, which represented the first quarter of growth since the second quarter of 2008. Consumption increased as a result of the cash-for-clunkers and first-time home buyer initiatives, yet real disposable personal income decreased. A quarter of positive GDP growth would normally be viewed as positive for the US economy as it signals the likely end of recession. **However, the GDP figure masks structural challenges facing the US. Rising consumption on lower incomes is not sustainable. For 30 years, the US has financed above-trend growth through ever-increasing levels of debt. Now this cycle of debt serving as a driver of US GDP growth has come to an end.** Consumer savings rates are increasing, consumer credit outstanding is declining, and the result is muted spending and a weaker economy. US unemployment has surpassed 10%, state and local governments are facing crippling budget deficits, taxes are increasing and services are being cut.

Unlike in prior recessions, the US today is not financially capable of playing the leading role in restoring global economic growth. This Outlook focuses on the causes and implications of this important economic transformation. It will be difficult for the US to sustain its recent growth after stimulus spending begins to phase out, and many companies leveraged primarily to the US economy will struggle under these conditions. The Federal Government is now effectively the borrower and spender of last resort, as consumers and businesses are less willing or able to spend, banks are less inclined to lend, and local government budgets are strained. The stage is being set for additional stimulus. However, this comes at a time when the Federal Government is running record deficits, which, when combined with rising debt and the printing of money by the Federal Reserve, is already contributing to the decline of the dollar. The precise timing of further weakening in the US dollar is difficult to predict and there are a number of factors that could cause the dollar to rally for a period of time, as we saw late in 2008. Over the longer-term however, investors should be positioned for the preservation and growth of purchasing power in a weakening dollar environment.

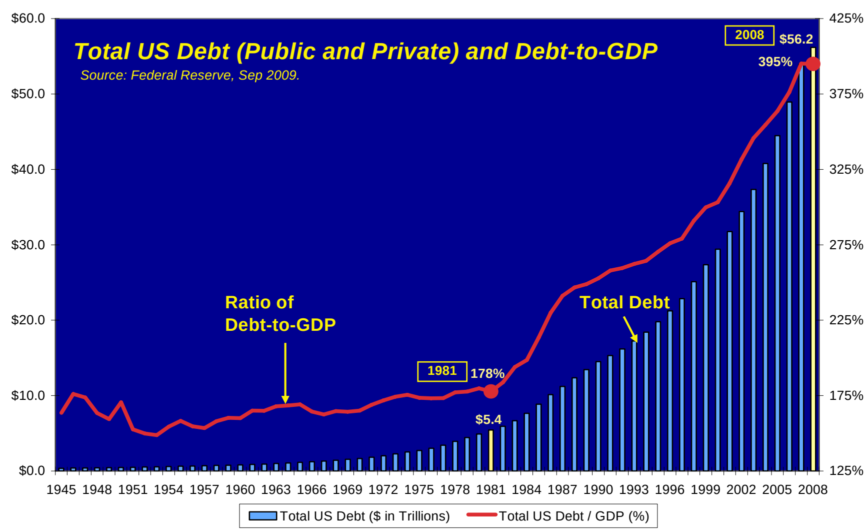
In spite of the challenges confronting the US and other developed economies, developing nations are experiencing strong secular growth resulting in rising living standards for millions of people. **We continue to be encouraged by the opportunities for companies with a high percentage of revenues tied to the rapid industrialization of developing markets. Companies that own tangible assets such as precious metals, oil, copper and iron ore should also outperform in this environment, as well as select agriculture and technology companies. Quality businesses with strong balance sheets that pay dividends and are not overly reliant upon the capital markets should also be included in investment portfolios, as well as high-quality, short-term (one to four year) corporate and government bonds.**

Debt has Artificially Inflated US GDP Growth

The total outstanding balance of US federal, state, municipal, corporate and household debt has grown at a compound annual rate of 9% since 1981 compared with a growth rate of 6% for GDP. During that time, total US debt rose from $5 trillion to $56 trillion.

As a percentage of GDP, debt swelled from 178% to 395%—the highest in modern US history, with most of this rise coming from private debt (financial, mortgage and credit card).

Assuming an average rate of 5%, the interest alone on $56 trillion of debt would cost $2.8 trillion per year, or 20% of GDP.



For a while, consistently higher borrowing allowed consumption and capital expenditures to continue rising despite a growing debt-service burden. But the US was effectively required to borrow more each year in order to maintain its growth. An example of this phenomenon was the stimulus provided by mortgage equity withdrawal earlier in this decade. From 2001 to 2006, US consumers withdrew over $2.5 trillion of home mortgage equity for one-time expenditures, providing a nearly 3% annual lift to GDP. Credit card debt also expanded rapidly during this period. However, once home prices began to decline and excess credit availability was no longer available—the fuel driving consumption was gone and all that remained was a higher debt service burden.

Deleveraging—The Paradox of Thrift

Keynes' paradox of thrift states that if everyone tries to save more money during times of recession, then aggregate demand and economic growth will decline, in turn paradoxically making it more difficult to save. Banks, corporations and households today are focused on repairing their finances and husbanding cash and want neither to lend nor to borrow. Consumer credit declined at a 9.1% annual rate in July, the steepest rate since records began in 1945. In essence, capital is being directed away from goods and services and toward savings or the repayment of debt. This process can continue for quite some time. During the Depression, the US experienced a 13-year deleveraging cycle that reduced private sector debt from 160% of GDP to 60%.[*] Moreover, deleveraging's stifling impact on GDP is self-reinforcing—as the economy contracts, employment, incomes and tax receipts decline, making existing debt more burdensome and increasing the need to boost savings and further reduce consumption and investment.

Risk of a "Double Dip" Recession

We are also concerned that the recent return to US GDP growth will prove difficult to sustain. In particular, there are eight obstacles that need to be considered:

> First, the **Federal stimulus program is expected to peak in the first half of 2010**. Outlays in 2011 will shrink to approximately $125 billion from $425 billion in 2010, which equates to a greater than 2% headwind to real GDP.
>
> Second, the **banking system remains impaired** and the FDIC continues to close banks resulting in heavy assessments for surviving institutions ($45 billion at last estimate), which is further restricting lending.
>
> Third, GDP is currently benefitting from an **inventory rebuilding cycle** that may be largely completed by the middle of 2010.
>
> Fourth, **state and local governments are budget-constrained**, preventing them from serving as a source of stimulus. In fact, they are laying off workers, cutting services and raising taxes to balance their budgets.
>
> Fifth, the potential for higher exports helps, but **exports account only for approximately 15% of US GDP** and are dependent in part on the fiscal policies of trading partners. Exporting nations are helping to restore balance to US trade relations by taking steps to stimulate internal consumption, but such efforts take time.
>
> Sixth, **consumption will remain constrained** by continued deleveraging and high unemployment, as well as higher state, local and possibly federal taxes.

[*] *Source: ISI International Strategy & Investment.*

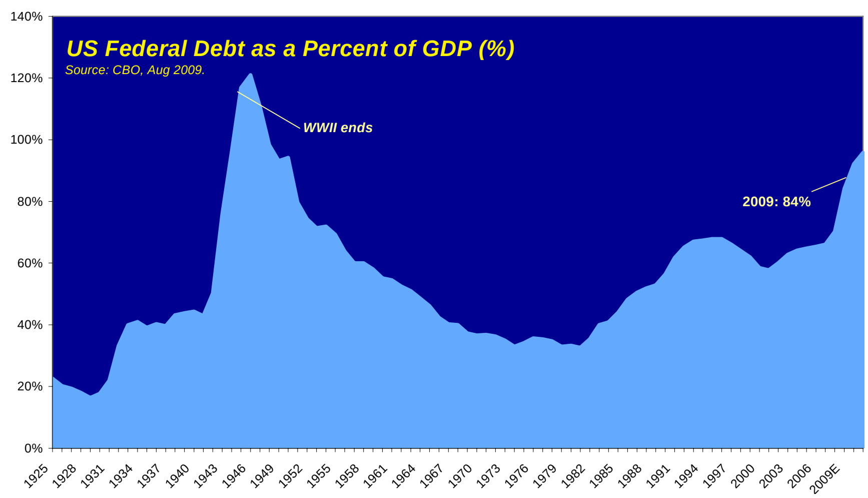
Seventh, there is a potential risk of **rising interest rates** now that the Federal Reserve has completed its purchase of Treasury and Agency debt.

Finally, **demographic trends are becoming an economic headwind**. The "baby boom" generation has passed its peak spending years and is approaching retirement age. The greatest generation of consumers is becoming a generation of asset sellers, including second homes, cars and securities. Also the number of US workers per retiree is expected to decline from five-to-one to four-to-one over the next decade.

The Financial Health of the US Government

As a result of the factors discussed above, the Federal Government is using deficit spending to offset the gaps in private sector demand. Although helpful, **we do not expect the Federal Government's substitution spending to be sufficient to sustain robust economic growth in this cycle. The impairment to private sector demand is simply too great, and as discussed below, the Federal balance sheet is too strained.**

Current US Federal Debt as a percent of GDP has reached 84% and is expected to grow to 96% by the end of 2010—a level not seen since World War II. After the war, the US debt burden fell rapidly as the economy grew and spending declined. Today in contrast, the Congressional Budget Office (CBO) projects that US debt-to-GDP will grow for the foreseeable future fueled by ongoing deficit spending.



The CBO's projections call for total new debt issuance of $7 trillion over the next 10 years. The White House Office of Management and Budget, using more conservative assumptions (including that some of the Bush Tax Cuts are extended) projects total deficit spending of $9 trillion over the next 10 years, or $900 billion per year. Rising deficits increase the likelihood that Treasury rates will need to rise in order to continue attracting demand, which could derail the nascent economic recovery by increasing private sector borrowing costs. An additional concern is the cycle that could be ignited by higher government borrowing rates—the average maturity of government debt is at a 26-year low of just 49 months at an average interest rate of 3.4%, well below the average borrowing costs that prevailed over the last 40 years. If debt continues growing as projected and average interest rates were to rise to just 5%, by 2014 annual gross interest expense would approach $1 trillion, or 22% of the annual Federal budget, up from approximately 10% today.

Fiscal Policy, Monetary Policy and Currency

Recent policy actions by the US government and Fed arguably are both increasing supply of and decreasing demand for the US dollar. By March 2010, the Fed will have completed $1.55 trillion of open market purchases of US Treasury and Agency Securities, such as mortgage-backed bonds issued by Fannie Mae and Freddie Mac. To date, these purchases have financed virtually the entire 2009 budged deficit of $1.4 trillion with newly-created money, and have expanded the US monetary base by over 70%. The increase in the US money supply has thus far been largely soaked up by the banks in the form of excess reserves. However, once bank lending eventually re-accelerates, the US is likely to see a significant increase in money in circulation.

Currency demand is impacted by many factors, including the financial health of the nation issuing the currency. Much of the dollars held by US trading partners are invested in the form of Treasury purchases. If US credit quality or the value of the dollar is perceived to be at risk of further decline, demand for the dollar could continue to fall. The US government depends on foreign buyers for at least one-third of its debt issuance and unfortunately, the US relationship with its foreign lenders is showing signs of strain. This is clear from recent calls by China to move away from the dollar as the world's reserve currency. These calls are largely just "shots across the bow", as there is no near-term viable alternative to the dollar as the global reserve currency. However, with the amount of deficit spending needing to be funded through year-end 2010, it is not too early for the US to begin taking the concerns of its lenders seriously.

The Devaluation "Solution"

There are three potential benefits that would explain the apparent willingness of the administration and Fed to tolerate or even encourage a decline in the dollar. First, exporters become more competitive when pricing their goods in the international markets. Second, debt can be repaid with cheaper dollars. Third, foreign investors are incentivized to invest capital in the US where they get more for their currency. Moreover, even if the administration or the Fed wanted to support the dollar, the traditional tools they would use such as raising interest rates or controlling deficits through tax increases or spending cuts have the negative side effect of being contractionary. Such initiatives would be economically unsound and deeply unpopular.

Although there are pro-growth alternatives for stimulating the economy that might be more supportive of the dollar (such as targeted tax cuts and more liberalized regulatory policies), these proposals are not in sync with the administration's approach. With unemployment nearing a 30-year high and an election year in 2010, Congress and the administration are understandably reluctant to pursue any policy that would be contractionary and appear willing to risk the ire of foreign lenders in order to continue deficit-funded stimulus spending.

It is important to note that devaluation does not occur in isolation and also leads to a reduction in purchasing power. There is the risk that any benefits will be offset by other countries engaging in competitive devaluations for similar economic purposes. On the other hand, China is facing pressure to appreciate the yuan against the dollar due to its stronger economy, which would be inflationary for imports and result in an effective purchasing power tax on the US populace.

Gold Demand is Increasing

As discussed in recent Outlooks, monetary creation is likely to continue and this has not been lost on investors and indeed countries that are sensitive to protecting purchasing power. There are no currencies today that are backed by tangible assets, and governments can produce whatever quantities are needed. Gold in contrast is durable and in limited supply—the total amount of gold poured throughout history is less than the amount of steel poured globally in an hour—and gold carries no default risk. Because of this, gold has been a proven store of value for over 5,000 years, which was recently reaffirmed by India's announced purchase of 200 tons of gold from the International Monetary Fund (IMF) at a cost of $6.7 billion or $1,046 per ounce. This purchase allowed India to diversify its currency reserves and lower its dollar exposure. Even following India's recent purchase, India and China between them have just $50 billion in gold versus over $3 trillion in paper currency reserves. We expect to see other large holders of dollar reserves purchase gold from the IMF, and we anticipate investment demand will persist for as long as major trading countries continue to print money.

Investment Implications

The challenges facing investors are clear, but equally clear are the compelling opportunities available. The investment Outlook calls for a balanced approach to investment portfolios, recognizing both the opportunities emanating from developing market growth and a weaker dollar, as well as the risks of muted economic growth in the developed world. **Investors should be positioned for the preservation and growth of purchasing power in a weakening dollar environment through investments in precious metals producers as well as companies that own, produce and distribute the increasingly rare commodities needed for developing market growth and infrastructure development, such as oil, copper and iron ore. We also favor companies with significant global sales exposure, particularly in the areas of technology and agriculture.** After making record job cuts, companies will need to be as productive as possible, which makes investment in technology a necessity.

Investors also need to be prepared for the possibility of a double-dip recession in the developed economies, which could be discounted by the stock markets several months before tangible signs of a slowdown emerge. **Blue chip, dividend-paying companies with strong balance sheets that are not reliant on capital markets for growth can benefit in a weak economy from opportunistic acquisitions or market share gains, while dividends are increasingly attractive in a low interest rate environment. Balanced accounts should also include high-quality debt with an emphasis on shorter-term maturities (primarily one to four years), allowing for principal to be re-invested at higher rates should interest rates increase in the years ahead.**