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WHERE GOES THE DOLLAR?

BY DOUGLAS KREPS, CFA

(CONTINUED)

As with gold, futures trading can impact the value of a currency, even one as widely traded as the dollar. Given leverage, speculative futures bets on any currency can whipsaw investors quickly. Then think about long-term holders of dollar-based assets. A country like Switzerland (number 10 on the list) may have vastly different goals for its dollar holdings (stability) than Brazil (trade). And don't forget the concept of Purchasing Power Parity. As Japan illustrated in the meteoric rise in the yen, at some point a McDonald's cheeseburger shouldn't cost five times more there than it does here. In the long-term, currencies reflect the growth in population and productivity of that population (rising real GDP). In the short-term, it's anybody's guess.

So how should investors respond? Our investment philosophy is that investors should own productive assets. By itself, owning gold does little, other than allowing one to speculate on the value of a commodity which is subject to the whims of the crowd. Sure, if you like a piece of jewelry, it provides value to you beyond the underlying value of the metal. But other than that, it just sits there. And consider

the trading costs involved with futures trading, or the storage costs associated with physically owning gold. This "friction" is not represented on the daily price charts we see on television.

BY ITSELF, OWNING GOLD DOES LITTLE, OTHER THAN ALLOWING ONE TO SPECULATE ON THE VALUE OF A COMMODITY WHICH IS SUBJECT TO THE WHIMS OF THE CROWD.

With regard to the dollar, we believe investors can protect themselves by owning world class American companies that derive revenue from non-dollar sources, like IBM or GE, or by owning stocks of foreign companies. The latter can easily be accomplished through ownership in mutual funds that focus on foreign stocks. If one can re-focus on long-term goals, the short-term fluctuations of both gold and the dollar can be recognized for what they are - noise.



QUARTERLY REVIEW

BY: DENNY BAISH

The major equity indices followed up an impressive second quarter with double digit gains in the third quarter (see accompanying chart). This is the second straight quarter of double digit gains for both the domestic and international indices. Emerging market countries, represented by the S&P/IFCI Emerging Composite, once again outpaced the other major averages gaining 21%. The closely followed Dow Jones Industrial Average finished up 16%.

THIS IS THE SECOND STRAIGHT QUARTER OF DOUBLE DIGIT GAINS FOR BOTH THE DOMESTIC AND INTERNATIONAL INDICES

Investors, economists and policymakers continued to be more optimistic about the state of the economy. Although rising unemployment, consumer debt and record deficits remain a concern, most areas of the economy have stabilized or shown improvement. The Federal Reserve also stated their belief that the economy was stabilizing. During the quarter, the Fed left interest rates unchanged and indicated it planned to do so for the foreseeable future.

Double digit returns were common across the board for all market capitalizations in the third quarter. Small- and mid-caps once again led the way. Mid-cap companies gained slightly more than small-caps, with both gaining about 20%.

Large-caps failed to keep up, but still posted a solid return of 16%. The difference between value and growth was on display again this quarter. Growth trailed value across all market caps. Large value gained 4% more than large growth, while small value and mid value returned 6% more than their growth counterparts.

The international markets moved right along side the domestic markets and posted big gains for the quarter. Emerging markets gained slightly more than the developed markets. The S&P/IFCI Emerging Composite Index is now up 67% year-to-date and 93% from the stock market low in March.

All the major fixed income areas posted positive returns for the third quarter. Building on strength from the previous quarter, High Yield bonds were up another 14%. World government bonds added 7%, while corporates gained 3%. After losing money last quarter as investors rotated out of conservative investments, domestic government bonds bounced back this quarter with a return of about 2%. The Barclays Capital Aggregate Bond Index, a proxy for the overall fixed income market, finished the quarter up almost 4%.

BENCHMARK INDEXES	
INDEX	SECOND QUARTER RETURN
DJIA	15.82%
S&P 500	15.61%
S&P MID-CAP 400	19.98%
RUSSELL 2000	19.28%
MSCI EAFE	19.47%
BARCAP AGG. BOND	3.74%



THE EYE OF THE NEEDLE

BY CHARLIE SMITH

As we discussed in our previous newsletter, massive reflation efforts on the part of the Federal Reserve and U.S. Treasury have put a floor under the economy and financial markets. We are not going back to the dicey days of March 2009; policymakers will see to it. This doesn't mean our ultimate fiscal destination is a serene one, however. Markets, after recovering nicely over the past two quarters, continue to scale a wall of worry over widely disparate potential future outcomes. Is hyperinflation in our future as a result of all the money printing? Or will deflation return to grind away at debt and asset values? Or can our leaders "thread the needle" between the two? Our message this quarter touches on these key economic questions.

Clients continue to barrage us with concerns about the likelihood of hyperinflation and a collapsing dollar, and with good reason. Over the past 12 months, the Federal Reserve has been busy buying up U.S. Treasury bonds, mortgages and other private sector debts (often of dubious quality), creating over \$1 trillion in new cash in the process. There are also nascent signs of improvement in the housing market. Home prices (as measured by the Case-Shiller index) have risen for three consecutive months since May. Seasonal forces may account for some of this improvement, but the beginnings of a bottom are evident in housing. Median home prices may continue to drift sideways over the next several years, but we're past the moment of maximum price decline.

We have yet to see an increase in the demand for credit, however. If anything, the forces of moderate deflation continue to hold sway in the economy. Even with the aggressive Fed money creation mentioned above, bank lending has failed to reignite, and has actually trended lower over the past several months. Cash is simply not finding its way into the economy via the banking system. Instead, major banks continue to build reserves against expected future loan defaults. In the meantime, a heavy debt burden constrains activity in the commercial real estate market. Regional and community banks expect further losses in this still highly-troubled loan category.



All these factors combine with a moribund housing market to set a deflationary tone for the broader U.S. economy.

At some point entrepreneurial zeal and risk-taking will revive.

When they do, it will be the responsibility of the Fed to be sure credit is priced appropriately. Interest rates will need to rise, perhaps abruptly. In order to deny inflation a foothold, policymakers will need to vacuum up the excess liquidity created over the past twelve months. If the unemployment rate remains painfully high at that time, the political pressure on the Fed to keep interest rates low will be immense. Only then will we learn how good Ben Bernanke is at his job. In the meantime, we are closely monitoring the velocity of money as a proxy for animal spirits within the economy. As yet there is little sign of any revival. Bottom line: inflation is not a problem, and is unlikely to be for at least the next twelve months.

So, unlike the inflationistas and rabid dollar bears roaring so loudly in today's financial press, our choice of outcomes for the domestic economy tends toward the middle of the road, with a minor bias towards deflation. Certainly, policymakers face a daunting set of choices over the next several months. Because banks are still so concerned about the quality of their loan portfolios (and therefore reticent to lend), further efforts on the part of the Fed to shovel cash their way may not produce much in the way of new lending. On the other hand, recent strength in key coincident indicators such as the stock and corporate bond markets may indicate a new economic up-cycle is already upon us. In this case, the Fed might need to begin to pull the punchbowl away immediately. It is these decisions regarding the timing and abruptness of monetary tightening which will determine not only the character of the recovery, but the likelihood of inflation further down the road. Mr. Bernanke and company will need to be just as adroit at monetary contraction as they were at expansion if we are to safely navigate the eye of the economic needle.

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Given recent movements in the U.S. dollar and gold, we have been asked what is the future of each. Since many commodities are priced in dollars, the natural question is whether it is gold strength, dollar weakness or a combination of each. While we will likely not know the answer in the immediate future, it is important to understand the relationship between the two asset classes, and then maybe gain some insight to the future.

Let's start with gold. The largest consumer of gold is the individual consumer, specifically with regard to jewelry. For illustration, over 70% of gold demand is for jewelry, 11% goes to industrial purposes, and the remainder is held for investment – institutional and retail demand for gold bars, coins, etc. However, consumer (jewelry) purchases of gold do not have a proportionate affect on the price of gold. If the price of gold rises 5% in a couple of days, the gold bracelet at the local mall is not likely to go up commensurately. Something else must be happening.

This is where the remaining 20% can dramatically swing the price of gold. Because gold is perceived as a hedge against both inflation and deflation, current prices can and do move quickly based on investor sentiment. Additionally, we have to layer on the impact of gold futures trading, where speculative bets are being made daily all over the world. Much like the oil price spike of 2008, bets on futures can pull or push the underlying value of gold without regard to true demand.

Before we return to the relationship between the U.S. dollar and gold, we should consider other factors that affect the value of the dollar. Of course, the dollar has become the reserve currency of the world. As a result, the current value of the dollar is determined not only by the U.S., but by all the foreign holders of dollar-denominated assets. When we think of who owns dollars (as measured by holders of Treasury debt), we know the easy answers listed by the media – China and Japan. But then we find the U.K., the combined oil states and then Brazil, Hong Kong and Russia.

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