



North American Management

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Political Paralysis

The S&P 500 index fell 14% during the third quarter, its worst performance since Lehman collapsed in 2008. While significant and painful, the US declined far less than other markets: Germany (DAX) and France (CAC 40) each tumbled 25%, Italy (MIB) dropped 26%, and the MSCI Emerging Market Index fell 23% in the same period. The Dow Jones UBS Commodity Index declined 15% in September alone, and even Canada (TSX), home to some of the world's healthiest banks, dropped 12% on the quarter as expectations for global growth were upended.

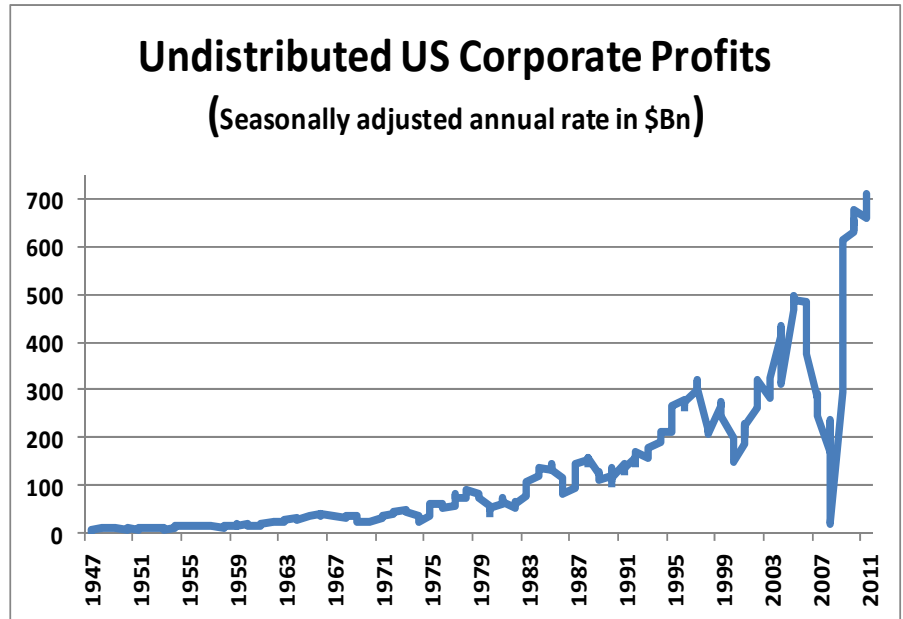
The causes are well known, some uncomfortably reminiscent of 2008: stalling US growth, political gridlock, debt downgrades here and in Europe, frozen credit markets and renewed fears of a systemic banking crisis. First stocks, then commodities - including gold - fell sharply as the consensus investment strategy (modest recovery, paid for with inflation) came undone. Cyclical stocks levered to recovery declined the most, including banks, commodity producers and transportation companies, many falling 40% or more. Enter the Fed with Operation Twist, a program to sell short term Treasuries and buy long term Treasuries with the proceeds, ostensibly an effort to help homeowners refinance or buy houses at very favorable rates. Any form of stimulus directly targeted at consumers is welcome, especially at a time when politicians are too busy posturing and campaigning to produce their own. However, in this recession, low rates have had little effect on credit creation; we note that banks are currently holding \$1.6 Trillion in reserves at the Fed.

It should be clear by now that this is not a normal recovery, corporate profits notwithstanding. Economic policy (or lack thereof) dominates news flow on a daily basis to the point where it feels like we are living in a planned economy - except no one can agree on a plan. Asset allocation decisions are made much more difficult, and are fraught with political risk. The penalties for bad choices are severe. We see three paths ahead for highly indebted economies: they can attempt to grow at a rate fast enough to meet their projections for pensions and other entitlements, they can default the easy way through inflation and devalued debt obligations, or they can push austerity, risking deflation, civil unrest, and hard defaults. Each of these outcomes is now, to varying degrees, in the hands of politicians and central bankers, and the third quarter showed us how painful their mulish timetables and misguided rhetoric can be. We assumed, along with many investors, that recovery would be some combination of the first two paths, that politicians would choose to preserve as much of the status quo (read: incumbency) as possible. They still might, but we are less confident.

We became much more defensive during the quarter, raising cash to levels approaching our targets of 2008 and placing even greater emphasis on solid dividend payers within our equity portfolios. They offer positive benefits in the current interest rate environment where there is a real cost to owning "risk free" assets. We crowed about low multiples and high dividend yields in our previous letter and, unfortunately, they subsequently

became lower and higher still. We are working to minimize client realized gains for 2011 by taking offsetting losses before year end.

For now, corporate balance sheets are swollen with cash from retained profits, as executives restrict hiring and minimize capital expenditures (see graph). It's another measure of uncertainty that the pursuit of market share through mergers and acquisitions has largely been put on hold, though such high cash components, and low interest rates, would surely lessen the risk of a bad acquisition. Finally, consumers are borrowing less, increasing their savings in order to protect their own household balance sheets. Judging from the paltry yields on US



government debt and the low multiples placed on corporate earnings by the stock market, most savings are in cash or US Treasuries. This behavior does not bring about productive capital allocation. It's more about safety, self-insurance, and lack of direction from our "central planners."

We expect to retain a defensive posture until we see indications that Europe can deal with their sovereign debt overhang and its impact on the banking system. On this, half measures will not suffice. Next month, we will also hear from the US "super committee" about taxes, entitlements and cost cuts, with the prospect of mandated cuts should they fail to reach an agreement. Grinding along in the background we have a Presidential election cycle, which the market will begin to discount at some point. Further clarity on taxes, entitlements and nascent credit creation are all on our radar as potential release valves for the stupendous amounts of stranded capital in the system. We are also anticipating that tightening cycles in many emerging markets may end soon. If so, they appear attractive relative to the highly indebted Western world.

While we never want to underestimate the ingenuity of the American people, our leaders have thus far disappointed. If they were asleep before the credit crisis, they appear catatonic now.

Source of graph: Strategas Research Partners
Source of data: Bloomberg

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