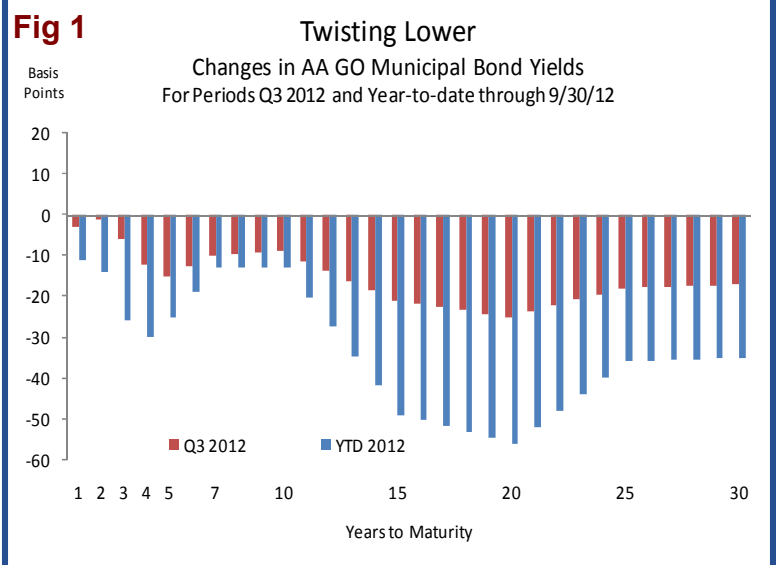




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Municipal bond yields rallied yet again during the third quarter of 2012, bringing the total number of consecutive quarters in which municipal yields have declined to **seven in a row** beginning with the fourth quarter of 2010. Referring to **Figure 7**, we can see that while yields declined modestly across the entire curve, the greatest declines occurred in the longer maturities. Given the modest changes in municipal yields year-to-date, the specific reshaping of the curves is better reflected in **Figure 1** which graphs the changes in municipal yields by each maturity for the third quarter of 2012 and for the year-to-date period through September 30, 2012. As we can see in **Figure 1**, for both periods under review the municipal yield curve underwent a “**non-parallel [uneven] downward shift**” in yields which has resulted in a modest bullish flattening of the yield curve. Specifically, for the year-to-date period ending September 30, 2012, the 2s-to-10s segment of the yield curve has flattened by 1 basis point, while the 10s-to-30s segment has flattened by 21 basis points. Despite a year-to-date flattening of the municipal yield curve by 22 basis points, overall, the municipal yield curve, at a level of 360 basis points as measured by the 2s-to-30s segment, remains historically steep. Through the first nine months of 2012, **municipal yields stand lower across the entire yield curve**, with long-term yields declining more than twice as much as short and intermediate yields. The primary driver of this uneven reshaping of the municipal yield curve has been the impact of increased institutional demand. Against this favorable backdrop of declining yields, municipal bonds as a sector have performed well thus far in 2012, particularly as compared to the Treasury sector, with longer-maturity municipal bonds outperforming shorter-maturity municipal bonds. One result of this outperformance due to municipal yields declining more than comparable Treasury yields, has been a modest decline in **municipal relative value ratios** as reflected in **Figure 8**. With the exception of the intermediate maturities (5-to-12 years), the relative value ratio of all other maturities declined slightly for the year-to-date period ended September 30, 2012. However, even after the modest declines, municipal bonds remain attractive as **relative value ratios continue to remain above 100 percent for all**



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maturities. The primary driver behind the larger decline in municipal bond yields relative to Treasury yields [and hence their outperformance] was the continued strong demand by investors who are increasingly focused on **high quality income** and **capital preservation** given the increased level of **uncertainty** in both the economy and the markets. This effect was exacerbated by a marked decrease in municipal bond issuance during the month of September.

Last quarter, we devoted our Market Review to addressing the question "**why should I own municipal bonds?**" To this we concluded that "*municipal bonds are the choice par excellence for building par value and preserving wealth.*" This quarter we would like to broaden that discussion by introducing the concept of maintaining the **nominal purchasing power of a portfolio** as an important component of wealth preservation. As we stated last quarter, we believe that the cornerstone of wealth management should be **capital preservation** not capital appreciation. This, we believe, is particularly true during periods of **great uncertainty**. According to "**Pascal's Wager**" [named after the 17th century French mathematician and philosopher Blaise Pascal], for decisions made under conditions of uncertainty, the severity of the consequences, not the probability of occurrence, should drive the decision. And as we have stubbornly maintained for many years in our 'Economic and Market Reviews', the current economic and market conditions consisting of unrivaled structural distortions, unparalleled malinvestments and unprecedented intervention and central planning, have resulted in the greatest period of systemic risk and uncertainty in nearly a century. As such, the goal of capital preservation has never been more important than it is today. The efficacy of this position was underscored in a recent quote by Kyle Bass, Founder of the hedge fund Hayman Capital; "***As a fiduciary, given what we see coming, our job is not to lose money.***"

Under the mandate of capital preservation, we believe that **building par value** is the primary long-term goal of conservative asset management. As we discussed last quarter, we believe that certain unique characteristics of municipal bonds make them ideally suited for this task and as such, should play a key role in a strategy of wealth preservation. However another equally important yet oft neglected facet of preserving wealth, involves maintaining the **nominal purchasing power of the portfolio** by protecting the par value of the portfolio against the debilitating impact of inflation. Given that Mr. Bernanke says that inflation is both **moderate and transitory**, is it still important to hedge a managed municipal portfolio against inflation? For the answer we need to begin by **defining inflation**. According to Mr. Bernanke and the consensus of economic and market sycophants, inflation is an increase in the consumer price index or CPI. However long before the advent of the Bureau of Labor Statistics or Lord Keynes 'General Theory', inflation was and remains properly defined as **an increase in the quantity of money and credit un-backed by savings**. This is the old and traditional definition of inflation found in practically every book on economics and money written prior to the publishing of Keynes 'General Theory' in 1936. Any resulting increase in the **price of commodities or assets**, is merely a **consequence** of the underlying monetary inflation, not inflation itself. Unfortunately one of the casualties of the Keynesian Revolution, whose primary objective was to provide intellectual cover for **interventionism** and **inflationism**, was the proper definition of inflation. Ironically it was the modern day **father of inflationism**, Lord Keynes himself, who, writing in an earlier book 'The Economic Consequences of Peace' published in 1919, offers us perhaps the most vivid and striking commentary on the insidious and destructive nature of inflation as properly defined: "***By a continuing process of inflation [of the money supply], governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.***"

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It is this "secret and unobserved confiscation of wealth" with which we are most concerned. How does this happen? The simple answer is through the **devaluation of the US dollar**. Briefly, by investing the Federal Reserve with an unconstitutional monopoly on the production of money, coupled with the passage of the Sixteenth Amendment which established the power of Congress to tax incomes (both occurred in 1913), and the illegal confiscation and subsequent demonetization of gold (1933 and 1971), the US government was effectively freed to pursue any level of **credit inflation** required to support the unbridled growth of the **new welfare state** launched under the guise of the "New Deal". This is amply illustrated by **Figure's 2 and 3** which traces the history of the growth of **US public debt** since 1870 and **total government spending** as a percentage of US GDP since the country's founding. As we can see, subsequent to the establishment of the Fed, the authority to tax incomes, and the abandonment of gold, both **US public debt** and its corollary, **federal spending**, soared without restraint as inflation became the preferred policy of the welfare state. The result of this long-running **policy of inflation**, as reflected in **Figure 4**, has been anything but *moderate and transitory*. It has instead resulted in a massive debasement of the purchasing power of the dollar. Contrary to the soothing dogma of a *modest rise in prices*, this is what **real inflation** looks like.

So how can you protect the nominal purchasing power of your municipal portfolio? Or stated differently, how can you hedge your portfolio against dollar devaluation? Here we must return to a discussion of the **visible consequences of inflation**, i.e., a measured increase in prices. While a full discussion of the inherent flaws of the Consumer Price Index (CPI) and its ability to accurately measure the **effects of inflation** on prices is beyond the scope of this Review, suffice it to say that most

Fig 2 Without Restraint: The Law of Accelerating Issue
US Public Debt Since 1870

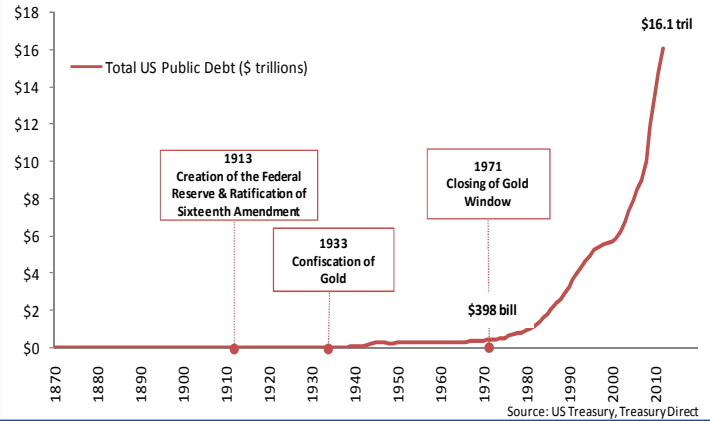


Fig 3 The Growth of the Welfare State
Federal Govt Spending as % of GDP

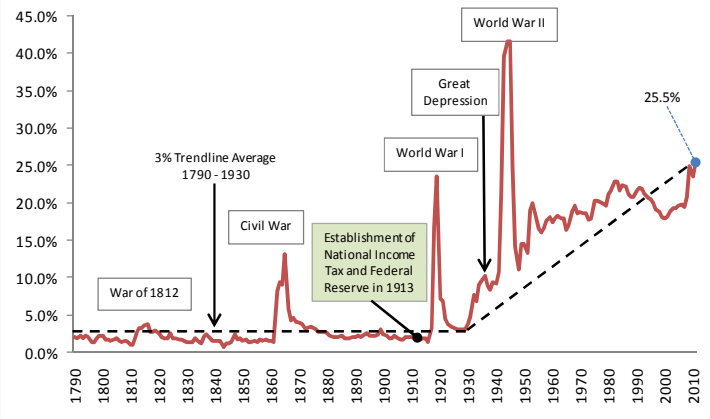
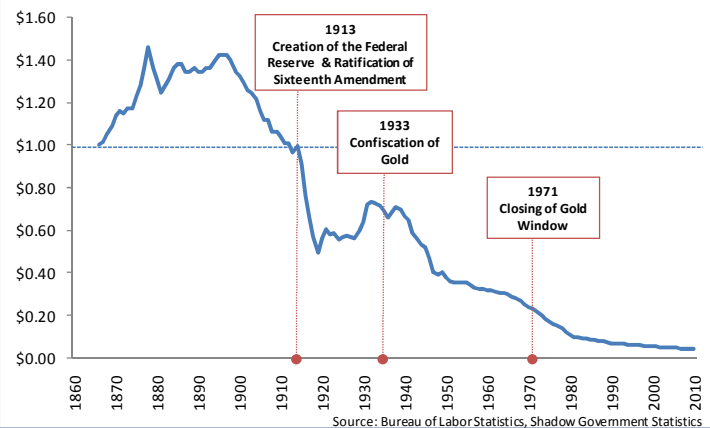


Fig 4 The Resulting Debasement of the Currency
The Value of the US Dollar back to 1860



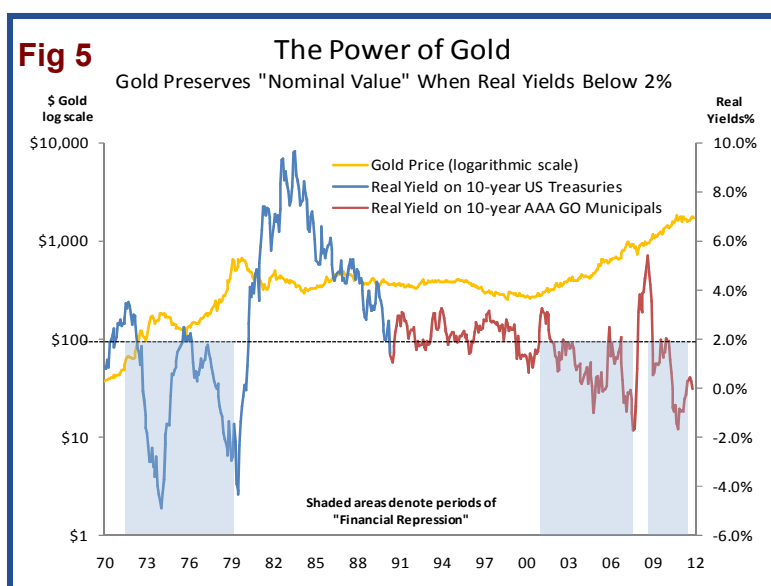
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people who purchase food, gas and health care are well aware of its shortcomings. At best, a price index provides an inaccurate picture of the **impact of inflation on prices**. Due to the arbitrary and subjective nature of the construction of a price index, it is simply not possible to capture the full impact of the confiscation of wealth through the devaluation of the dollar brought about by inflation. Many aspects of inflation are either unaccounted for, such as **asset price bubbles**, or mitigated, as is the case with our Faustian trade-off of manufacturing jobs for **lower import price inflation**. The bottom line is that CPI, as currently constructed, **understates** the true level of the impact of inflation on prices. Nevertheless it is still the most objective measure we can use to *estimate* the loss of purchasing power in a portfolio.

One way of visualizing the impact of the loss of purchasing power in a bond portfolio is by adjusting nominal market yields by the annual percentage change in prices as measured by the CPI. This is presented in **Figure 5** where we have graphed **real** or CPI-adjusted bond yields since 1970. [Note: Due to the limited availability of reliable municipal yields for the period between 1970 and 1990, we have utilized 10-year US Treasury yields for that period] We have also included

the dollar price of gold measured on a **logarithmic scale** for the same time period. [A logarithmic scale more accurately portrays the rate of change in a variable across large values] What is readily apparent is that when **real yields decline below 2 percent** for extended periods of time [horizontal line], the **price of gold appreciates markedly**. Those periods are denoted by the blue shaded areas in **Figure 5** and are referred to as periods of "**Financial Repression**", a term recently reintroduced into the economic lexicon by economists Carmen and Vincent Reinhart and Kenneth Rogoff in a recent series of important studies on sovereign debt overhangs. Essentially **financial repression** refers to the **subtle form of debt restructuring** resorted to by governments to reduce



rollover debt risk and curb rising interest costs in light of massive and growing sovereign debts. Among the means utilized by governments under financial repression, the manipulation of interest rates is foremost with the primary result being an **artificial lowering of real yields to investors** resulting in a **subtle confiscation of wealth**.

Currently, real yields on 10-year AAA municipal bonds are approximately zero. Referring again to **Figure 5**, we can see since the onset of the Great Recession in late 2007, the real yield on municipal bonds has been **consistently below the historical 2 percent threshold** and it has been **negative about 50 percent of the time**. As indicated in the chart, the price of gold has been rising markedly throughout this most recent period of financial repression. During those periods of financial repression, when real yields are low and falling as they are today, the investment is actually **losing purchasing power** regardless of what nominal interest rate the investment is actually paying. At these times, the strategic addition of gold to a municipal bond portfolio can act as a hedge to preserve the purchasing power of the bond portfolio.

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As part of our ongoing mandate to preserve client wealth while building par value, we have been strategically adding and actively managing gold in those portfolios where the client desires to hedge his portfolio against a **loss of purchasing power**. For all of the reasons we outlined in our last quarterly Municipal Review, municipal bonds are uniquely qualified as the conservative asset par excellence for building par value and preserving client wealth. However all investment assets are negatively impacted by the devaluation of the dollar and suffer a commensurate loss of purchasing power. Gold has historically been the preferred vehicle for hedging investments against the insidious effects of inflation. Unfortunately the high costs associated with purchasing and holding physical gold have made the implementation of this hedge costly and inefficient. For this reason, we prefer to utilize an investment in a closed end management investment company called the **Central Fund of Canada** for a client's strategic allocation to gold. The Central Fund is an **exchange tradable bullion proxy**. The sole holding of the Central Fund is gold and silver bullion held in physical form on an **allocated and fully segregated basis** in the underground vaults of the Canadian Imperial Bank of Commerce. The Central Fund's bullion may not be loaned, subjected to options or otherwise **encumbered** in any way. And unlike other forms of investment in physical gold and silver, there are no direct ownership costs associated with holding this investment. And because Central Fund's Class A shares trade on the NYSE Amex, the allocation to gold within client portfolios may be actively and efficiently managed.

Referring to **Figure 6**, we can see that since the stabilizers embarked on an unprecedented policy of money production (QEs), the price of gold has risen in nearly lock-step with the increase in the monetary base. Given the monetary authority's public commitment to a policy of zero interest rates (ZIRP) until **late 2015** and the recently announced policy of open-ended money printing referred to as **QE•ternity** aimed at keeping long-term interest rates low, we believe that **financial repression** will remain the policy of choice and as such, **real bond yields will remain artificially low or negative** for some time to come. Under these conditions of increased uncertainty and unprecedented money production, we believe that the strategic addition of gold to actively managed municipal bond portfolios is a **good fit** and offers investors the best opportunity to preserve the nominal purchasing power of their investment portfolios.

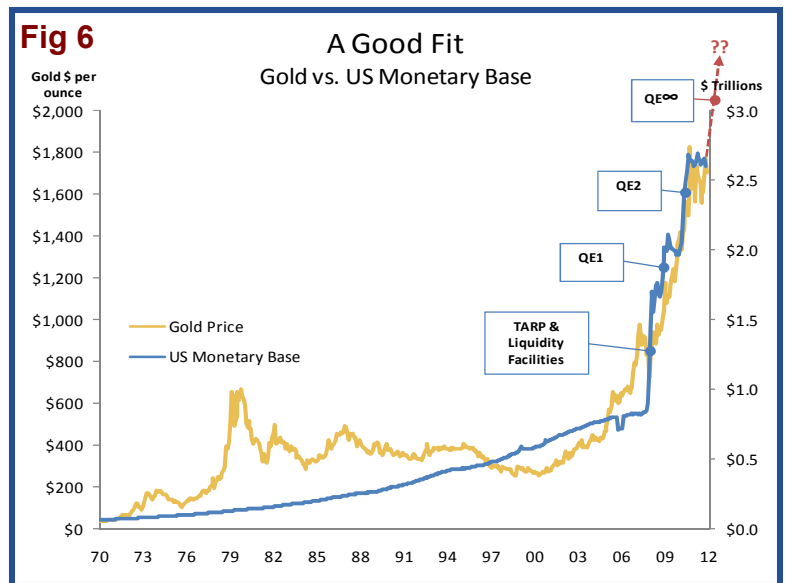


Fig 7

AA General Market Yields

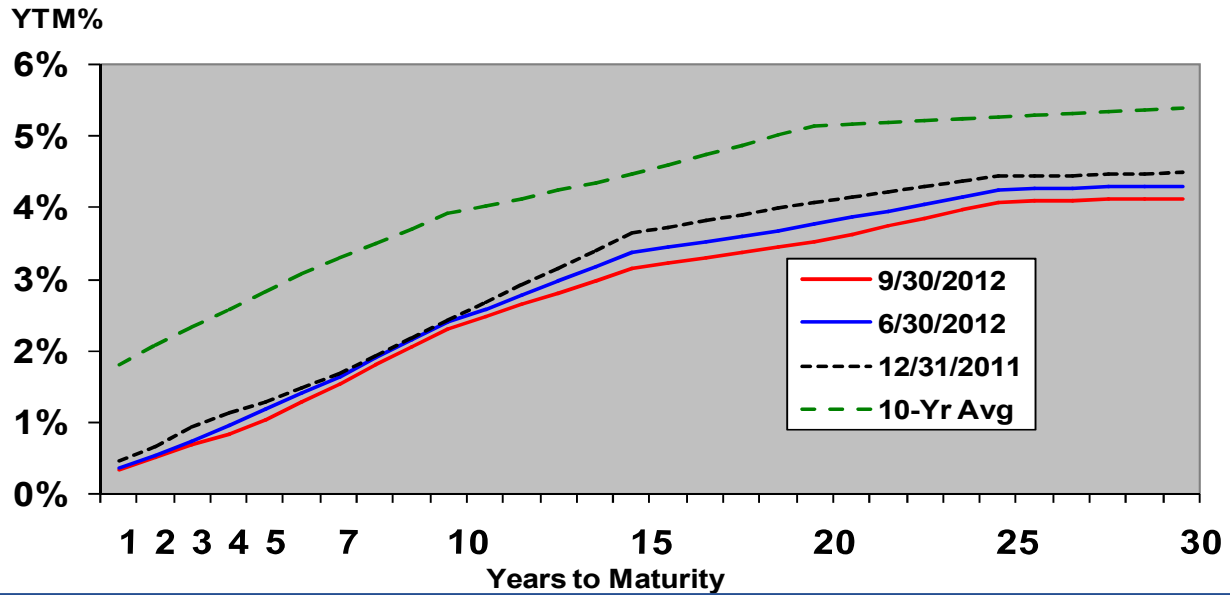
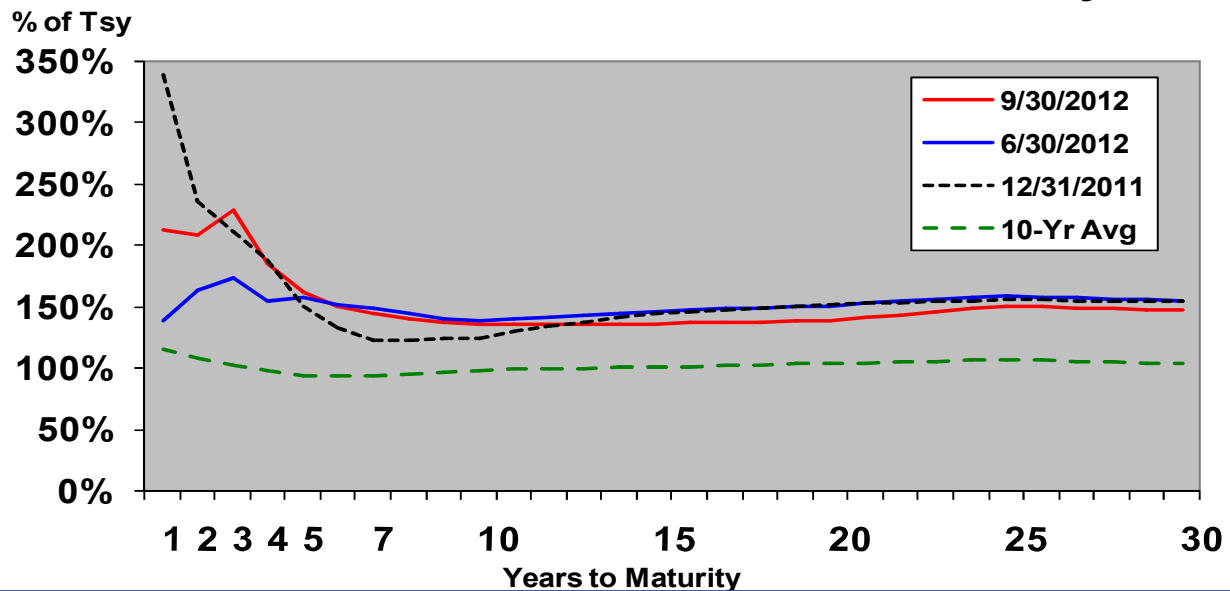


Fig 8

AA General Market Yields as % of Treasury



	10 Yr Avg	6/30/2011	9/30/2012
2-Year AA Municipal	107%	162%	208%
5-Year AA Municipal	93%	157%	161%
10-Year AA Municipal	97%	137%	135%
25-Year AA Municipal	106%	158%	150%