The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

"*In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could.*" - Rüdiger "Rudi" Dornbusch

Twisted Reality

In yet another attempt to fuel the economy and eventually address the main problem facing the U.S. economy (unemployment) the U.S. Federal Reserve announced on September 21st what pundits came to call Operation Twist: basically the purchase of US$ 400 billion worth of longer-term bonds and sale of an equal amount of short-term bonds, maintaining its balance sheet but putting downward pressure on longer-term interest rates.

On September 22nd irrationality in financial markets was painted on the screens: the Dow Jones Industrial Average fell almost 3.5 percent (along with almost every single market in the world) and the ten-year Treasury yield hit 1940s levels dropping to a record low of 1.67 percent, while the U.S. dollar surged as investors clamored for "safe" assets.

We are talking about the same U.S. dollar that has been under fire for quite a long time and the same debt that has been under scrutiny and even downgraded in a bold move by S&P widely covered by the media.

But like all madnesses, even this one has its own logic.

In his popular book "*Extraordinary Popular Delusions and the Madness of Crowds*" Scottish journalist Charles Mackay wrote in 1841: "Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."

Despite the fact that at the current level of debt and deficit the U.S. government needs the use of Financial Repression (see our June 2011 update for more on this), the U.S. dollar is still widely considered a reserve currency. Millions of people around the world still look at the "greenback" as the ticket to a secure place. Like little kids who dare to explore new territories and grow, most will feel the urge to run to daddy every time the perception of higher risk becomes present. We can see through market movements that in the financial world "daddy" is represented by the U.S. government.

According to a recent release by the International Monetary Fund almost half (47 percent) of the US$14.7 trillion U.S. federal government debt is held by the Federal Reserve and the government itself, such as the Social Security trust fund. Another 22 percent is held by foreign Central Banks. That means that almost 70 percent of the debt of the U.S. government is held by non-market/non-profit oriented investors and the largest portion of that by the very same U.S. nation.

The problem with obsessing about debt is that it ignores that there are two sides to any accounting ledger, and that someone's debt is somebody else's asset.

This problem will have to be resolved and somebody will end up paying the cost of its resolution, but financial markets are cognizant that the U.S. economy is still the largest in the world and that the U.S. debt problem (albeit very serious) is still manageable in a controlled way.

For long-term investors attempting to manage investment portfolios for retirement or wealth transfer to the next generation or other mid to long term goals, the harsh reality is that you can't be bullet-proof from macro events. But by understanding the difference between risk and uncertainty and putting the proper strategies in place, we can control much better how to respond.

Based on valuations, fundamentals and long-term history there is a clear indication that stocks (that represent an interest in real companies that produce and sell services and products that have and will have demand) offer value especially compared to Fixed-Income instruments and cash. The dividend yield for companies in the S&P 500 is now about 2.5 percent compared to the ten-year Treasury yield of 1.67 percent. The last time the dividend yield was higher than the ten-year Treasury yield for any prolonged period of time was in the 1950s.

As we write this the S&P 500 is trading at 11.5x current year earnings estimates and 10.3x next year earnings. Valuations usually do not indicate market bottoms but these P/E levels are nearing the panic trough levels of 2008-2009 which were 10.2x current year estimates and 9.0x next year estimates.

We concur with academic studies that show that the risk of damaging long-term returns by moving to cash and potentially staying on the sidelines in uptrend markets, once valuations come back to their historical averages, is higher than the risk perceived as a consequence of higher levels of uncertainty reflected in increased levels of volatility.

We think that once some level of uncertainty is removed from the market, one by one market participants will slowly recover their senses.