VIEWPOINTS

3RD QUARTER 2012	*ADVISORY NEWSLETTER*

MARKET COMMENTARY FREDRIC W. WILLIAMS

Afraid Of The Dark…

"It might be scary, Til your eyes adjust, Don't fear the shadows, Me you can trust"
Robert Cray – "Don't Be Afraid Of The Dark" 1988

As children our fear of the dark is typically a fear of the unknown – if we can't see into or through it, then we don't know what may lurk in the murky gloom. The power of suggestion (primarily driven by our older relatives who delight in telling us spooky stories about the dark to scare the bejeezus out of us) then takes over and we presume all variety of bad stuff is present - which then prevents us from sleeping, requires we leave all the lights on in the house, request flashlights be left in every room, and generally frustrate our parents to no end.

Similarly, investors possess a fear of the unknown, whereby the inability of their eyes to see into the shadows of the future makes them reluctant to commit any of their hard earned cash to the supposed vagaries of the equity markets. Combine this with the retail investor's innate "ability" to extrapolate the past indefinitely into the future and the foundation is laid for a compelling contrarian case that could be the basis for positive equity performance going forward.

As noted below in our equity commentary, this is not to say that near term headwinds won't present themselves, but our longer term view is focusing on the dynamics of behavioral finance and how these same retail investors are lopsidedly voting with their buy/sell orders. We can understand that after a decade-plus that included a tech/internet bubble, Enron/Worldcom imploding, a housing bubble, and a global financial crisis (along with a side order of Madoff and Stanford thrown in just for the heck of it) that there is sufficient support for a bit of skepticism relative to the prospects of the stock market, but as value investors we always consider emotional extremes to lay the groundwork for longer term opportunities.

Additional fuel for this fear of the dark can be found in the uncertainty surrounding the upcoming elections, continued partisan gridlock in Washington, as well as with the so–called fiscal cliff and all its iterations and outcomes…to say nothing of the continuing euro-debt drama. Taken together one can understand how these unknowns obfuscate any attempt at discerning policy clarity over the next 3-6 months, something which is constraining business investment and consumer activity, both of which are negatives for any significant pick up in GDP growth over the near term.

Countering, and we think ultimately trumping, this Chicken Little-like view of the world and its investing landscape are some macro themes that we see as supportive of our more positive view of a longer term time horizon. From money flows, to excess reserves, relative valuations and viable alternatives, there is the beginning of a backdrop that could provide a significant "bid" for equity prices into the future.

- *Money Fund Flows:*

  Retail investors have been voting with their feet and exiting stock mutual funds for the last 5 years – something that reverses decades within which equity funds (and now ETFs) exceeded the fund flows into fixed income alternatives by a wide margin. Between 2007 and the middle of 2012 nearly $1 trillion has gone into taxable and municipal bond funds, while $222 billion has been *withdrawn* from stock funds. This year alone a net withdrawal of approximately $50 billion has come *out* of a combination of stock mutual funds and ETFs while more than $270 billion has gone into bond funds and ETFs.

  After a decade plus of sub par returns from equity funds, decisions are now being made based solely on the rear view mirror of performance, not understanding that when interest rates begin to normalize and start rising that bond funds will no longer perform as they have in the past, and will in fact go down in value. We see this eventual exodus from the bond bubble as being fuel that will support higher equity prices in the future.

- *Valuations & Alternatives:*

  We see valuation metrics as compelling on their own, but particularly so when viewed within the context of what the alternatives are on the investing landscape. The aforementioned data on money fund flows is testament to the level of investor pessimism relative to equities as an asset class. And although the indices may have struggled over the last decade, many individual companies have continued to pay dividends and accumulate cash on their balance sheet that will have to be deployed somewhere – most likely via share buy-backs and dividend increases. Investor skepticism, as an example, has pushed the MSCI Europe Index down to the point where its dividend yield is near 4% - almost twice the amount for the Dow and S&P.

  Stocks are cheaper than their historic averages, something which can't be said about other asset classes, and therefore can offer an attractive entry point. Back in the early 1980's, companies on average were paying out over half their income in dividends, compared with only 30% today – leaving more accumulating on their balance sheets. In a slow growth economy, expanding capital expenditures can't be profitable quickly enough, which therefore leaves faster dividend increases and share repurchases, or acquisitions that are accretive to earnings – all of which are good for shareholders.

- *Fed Excess Reserves:*

  Although an arcane corner of our banking system, reserves play a significant role in how the Fed monitors the condition of banks, as well as how it might impact the money supply – the central bank's primary tool to influence the economy.

By way of explanation, banks must maintain a certain level of required reserves in the form of vault cash or balances at the Fed as a percentage of their deposits in order to provide adequate liquidity. Reserves over and above those required are referred to as excess reserves. Normally these "deposits" at the Fed earned no interest and if a bank wanted to generate addition income they might lend some of their balances to other banks via the federal funds market. That changed in October 2008 when the Fed decided to pay interest on both required and excess reserves – which has been fixed at a rate of 0.25% since December 17, 2008.

Starting at only a few billion dollars in early 2008, excess reserves ballooned to nearly $800 billion by the end of the year, continuing to grow to over $1 trillion by the end of 2009 and then spiking again to over $1.6 trillion during the first half of 2011. The most recent Fed data indicates the level has pulled back a bit to just over $1.4 trillion. The obvious observation is that banks were preferring to take a safe 0.25% from the Fed rather than make any type of loan – risky or otherwise – in the US economy.

A cynic, which we resemble from time to time, might argue that interest on reserves was a back-door strategy by the Feb to help recapitalize the banks during perilous times in our nation's economy. But it's possible that the old law-of-unintended-consequences may be biting our derriere to the extent that these dollars have remained on deposit at the Fed rather than being circulated through our economy in an attempt to boost our weak GDP. As you can imagine, we consider it a good thing to hear that the Fed is considering a revision to its policy of paying interest on reserves – something which may occur sooner rather than later.

Although we don't suggest that everything is going to be hunky-dory immediately, we do think that it's time for investors to expand their time horizons and reflect on some of the macro forces that are developing in the background. That exercise could then shed some light on the extent of the recent level of equity-aversion and show it for what it may be – an emotionally extreme reaction that could be a significant contrarian indicator, and opportunity, for patient longer term investors.

EQUITY MARKET OVERVIEW — J. FOSTER & F. WILLIAMS

Back On The Up Escalator…

Reversing course from the previous quarter's "risk-off" stock-price declines, the 3rd quarter of 2012 saw global equity markets rise in the face of a whiff of further central bank easing, as well as the absence of any abysmally bad news. The "sell in May and go away" crowd ended up leaving 2-3% on the table since the first of May, while the domestic equity markets posted even better numbers during Q3. The vast majority of global bourses followed suit as the summer of 2012 saw the Europeans actually develop more definitive action plans for addressing the continent's debt crisis – in contrast to the last 2 years where they appeared to blithely take the summer off from a policy adoption perspective.

Equity Indices			
US	*Closing Level*	*Percentage Change For Quarter*	*Percentage Change Year-to-Date*
DJIA	13437.13	4.98%	9.98%
S&P 500	1440.67	5.76%	14.56%
Nasdaq	3116.23	6.17%	19.62%
Europe/Asia			
FTSE - London	5742.07	3.07%	3.05%
DAX - Frankfurt	7216.15	12.47%	22.34%
CAC - Paris	3354.82	4.95%	6.17%
Nikkei - Tokyo	8870.16	-1.52%	4.91%
Emerging Markets			
Bovespa - Sao Paulo	59559.31	8.87%	4.27%
MICEX - Moscow	1458.26	5.10%	4%
SENSEX - Mumbai	18762.74	7.65%	21.40%
SSE - Shanghai	2086.17	-6.26%	-5.15%

In addition to accommodative central banks adding liquidity to a questionably growing global economy, there were a number of other factors that were supportive of equity prices during the quarter. Despite ongoing investor skepticism, stocks benefited from "cross-over buying" of dividend paying stocks by bond investors who found unappealing the continuing, and declining, low yields available in the fixed income market. In addition, hedge funds expecting another weak summer were caught off guard with the June rebound and have been aggressively repositioning to be net long, while sovereign wealth funds and other international investors continued to use the U.S. stock market as a safe haven.

The more significant macro trends that patient investors need to factor into their longer term calculations are developments with dividend payments and stock repurchases. As corporations wrestle with how to deploy the expanding piles of cash on their balance sheets, increasing dividends and share buy-backs will be supportive of stock prices and beneficial to shareholders. August saw a record $34 billion paid out from S&P 500 companies – much of which gets reinvested back in the same equities. Additionally, these same companies are on track to repurchase $429 billion of their shares in 2012, down a bit from the $555 billion in 2011 but on par with 2008 and up from levels seen in 2009 and 2010. Although not in and of themselves a reason to rally, they both are shareholder friendly and can help put a longer term floor under share prices.

With regard to our view of what the nearer term peek over the horizon might have in store, we think the recent run up in the indices may face some head winds in the current quarter as some macro uncertainties have yet to be resolved or clarified. Although our longer term view of the capital markets is constructive, given our expectations for an eventual, and gradual, global recovery from the excesses of the financial crisis, we think election year drama and continued partisan gridlock domestically may impede further advances in the indices. We therefore will continue to focus on select income oriented and value opportunities as initial entry points for our longer term perspective.

BOND MARKET OVERVIEW **J. FLOWER & F. WILLIAMS**

QE-forever?…

Bolstered by continuing concern about global growth and the ongoing European debt-drama, the bond market continued its rally – the longest since 2008 – although tempered by the combination of the 2nd half of the quarter's actions from both the ECB and the Fed. Once again this quarter Treasury yields hit record lows prior to backing up in response to further stimulus as central bankers announced plans to inject further liquidity into lethargic economies around the globe.

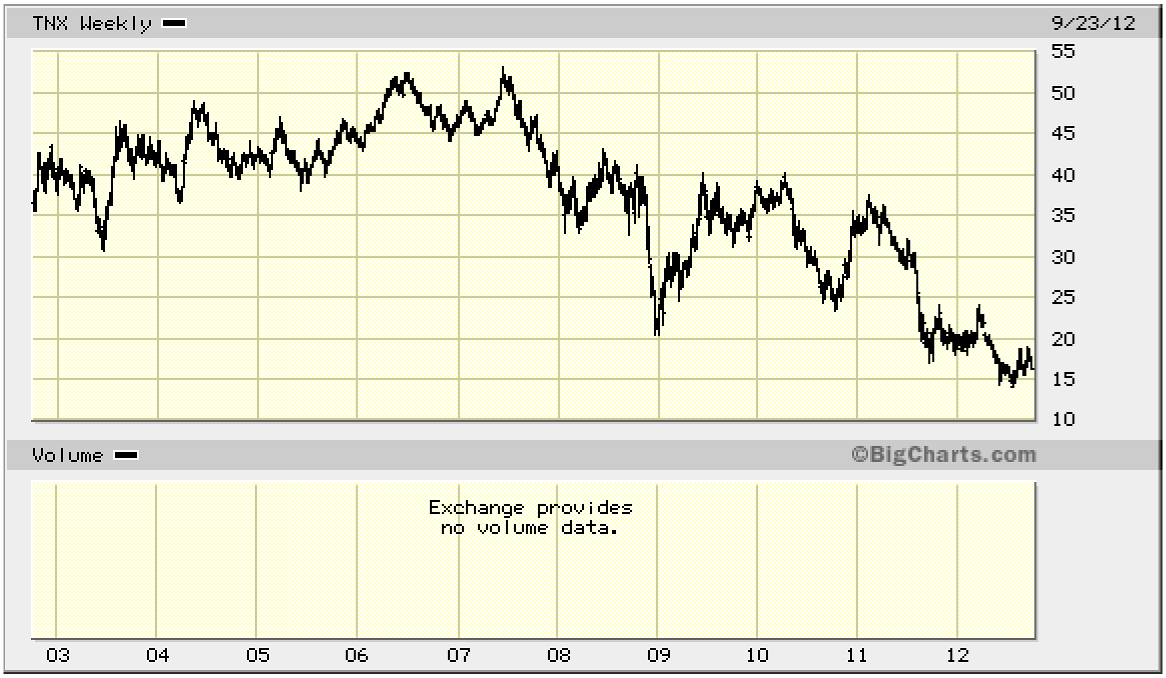
Following up European Central Bank President Mario Draghi's July pledge to do "whatever it takes" to save the euro, the ECB formally adopted in September what it termed Outright Monetary Transactions (OMT) as a mechanism to intervene in secondary sovereign bond markets and buy short-maturity government paper to force interest rates lower.

The Federal Reserve then joined the party a few days later with its unveiling of QE3 – announcing that it would begin buying $40 billion each month of agency mortgage-backed securities on an open-ended basis and indicating that it could extend those purchases by buying additional assets if the jobs market doesn't improve. The Fed also said it would continue the program know as Operation Twist, under which the central bank has been selling short-term bonds and using the proceeds to buy longer-term bonds. Taken together, the Fed will be purchasing $85 billion of longer-term securities per month through the end of the year. Fed officials also said they expect to keep short-term interest rates near zero until at least mid-2015, beyond their previous estimate of late 2014.

After posting record low yields (1.379% for the 10-yr and 2.4405% for the 30-yr) in late July, Treasuries dropped in price and rose in yield as the risk-on trade gained favor for the balance of the quarter, although year-to-date yields are still lower.

Fixed Income				
US Treasury Yields		*Yield To Maturity*	*Basis Point Change For Quarter*	*Basis Point Change Year-to-Date*
	5 Year Note	0.63%	-0.099	-0.2
	10 Year Note	1.64%	-0.022	-0.234
	30 Year Bond	2.83%	0.067	-0.059

The 10-year Treasury note at 1.64% is in the mid-range for the quarter, but as the 10-year chart shows, we are still at all-time lows and way off the 5.25% levels we became accustomed to in the summer of 2007. It is important to note, however, that spreads between the 10-year and BBB-corporate bonds with similar maturities did tighten rather consistently throughout the quarter as the risk-on theme seemed to gather momentum. At the end of June investors were receiving an additional 250 basis points of yield to own high yield bonds over Treasuries and as of quarter's end the spread has narrowed to just 200 bps.



As economic forecasting scorecards have shown over the years, the ability for even the most intelligent, experienced, educated, or, in last year's case, the most "famous" bond manager to predict with any meaningful accuracy the direction of interest rates is unimpressive to say the least. With that being said, it is hard to construct a convincing argument for rates to increase dramatically over the next year or two. With three rounds of stimulus in the books or pending, GDP continuing to expand at an anemic rate, non-farm payrolls growing at a clip that could take 5 years to recover to '07 levels, a housing market that, while showing encouraging signs, still requires significant inventory reduction, and possibly the largest inhibitor of economic expansion on our plates - the European slowdown/recession - it is likely that this low-rate environment will linger for a while. But, then again, who would have believed anyone saying in late '07 that the 10-year note would be below 2% in 5 years?

As noted last quarter, once un-tethered by Fed policy we would expect rates to be pulled upward as a result of the increasing monetary aggregate and its inflationary dynamics, so we continue to favor TIPS, floaters and select coupon credits in the intermediate maturity range, as we feel they offer reasonable opportunities in the fixed income arena.

FIDUCIARY CORNER — STEPHEN L. EDDY

Apples to Apples???…

A plan sponsor of a participant-directed retirement plan has a fiduciary responsibility to the participants to make decisions in the best interests of the participants. The sponsor's goal is to put the best platform, the best funds, and the best education process in place. Of course, very few plan sponsors are well-versed in ERISA and/or fiduciary accountability so they hire someone who has that expertise to do the work for them. The real issue is whether the "expert" they hired is truly an expert, or an advisor/broker that has outsourced all of the fiduciary legwork in the name of a product sale and a commissioned "finder's fee" payment to convert the plan to another platform.

With all of the recent legislation regarding fee disclosure and the attempt to create a universal fiduciary standard, the successful advisor/broker uses a sales pitch that includes a liberal dosage of the terms "fee transparency" and "fiduciary". It all sounds good to the plan sponsor when they are looking at glossy marketing materials and spreadsheet after spreadsheet as to why their current funds and platform are too expensive and need to be replaced. But do they really need to be replaced? Here are a couple of not-so-obvious marketing tricks to be on the lookout for that advisors/brokers use when they are trying to convince plan sponsors that change is necessary:

Comparing Funds to the Incorrect Peer Group – A fund should be compared to funds in its specific peer group. The Morningstar Category Average, which is the default average for most of the outsourced scorecard materials that advisors/brokers use, is ***the average of all share classes of all of the funds in the category***. That means that funds with multiple share classes that have multiple fee levels are all lumped into the average, boosting the average numbers higher (thus making the averages easier to "beat"). If a plan sponsor is being shown a proposal for a new platform with funds that don't have 12b-1 fees, then the correct peer group for comparative purposes would be funds in the category that **don't have 12b-1 fees**. In the large cap growth category for example, the peer group comparison would change from an "all funds" peer group with 1800+ funds charging an average fee of 1.30% to a "no 12b-1 fee" peer group of 357 funds with an average fee of .88%. Relating them to anything else is a misleading expense and performance comparison. Should make a plan sponsor think twice about the large cap growth fund charging 1.1% that "beats its category average", shouldn't it?

PLAN SPONSOR SOLUTION: ASK FOR A COMPARISON TO A "LIKE" PEER GROUP FROM A 12B-1 DISTRIBUTION EXPENSE STANDPOINT.

The "Apples to Oranges" Spreadsheet Indicating the New Platform is Less Expensive – Typically, the advisor/broker will present this in one of two ways. Either way, the next step for them is to "cherry pick" a new fund lineup that is (wait for it…) – less expensive!

- Scenario 1) add up the expenses of all of the plans current funds, then divide by the total number of funds to get an average expense for the current plan without regard for which funds hold what assets. Since two or three funds can skew the result, it is pretty easy for the advisor/broker to find funds that are less expensive than the original lineup and that have tolerable fund performance. Selecting index funds to replace high cost managed funds in the growth or value category is one trick I see utilized in this situation.

- Scenario 2) add up the actual expenses for the current funds based on the actual participant dollars invested in each fund, then calculate the total "cost" for the plan by adding up the corresponding expense dollars. Usually, in their projection the advisor/broker will use lower cost funds to replace existing options, and higher cost funds for new options. Since there are no assets in the new funds, they have zero impact on the fee calculation. Also, they will factor in any platform charges to the total, making it less of a true fund expense comparison and more of a total expense analysis. If a plan sponsor is fortunate enough to have a Vanguard or Spartan (Fidelity) index fund in their current platform, it can be quite entertaining watching an advisor/broker try to justify a 60 basis-point charge for the new index fund versus the 6 basis points on the Vanguard fund.

PLAN SPONSOR SOLUTION: ASK FOR A SIDE-BY-SIDE COMPARISON OF EACH FUND FROM THE CURRENT PLATFORM AND THE PROPOSED PLATFORM, BY CATEGORY. THEN GET AN EXPLANATION AS TO WHY THE PROPOSED FUNDS ARE BETTER THAN YOUR CURRENT FUNDS.

At IMCG, we work with and negotiate with any platform, compare funds to their true peer group, define that peer group for our clients, and work hard to educate our clients. Sometimes the best change for a plan is no change at all.

WEALTH MANAGEMENT UPDATE **TRACY W. ROGERS**

Inflation and Retirement: Strategies to Hedge Against It

Inflation is defined as a sustained increase in the cost of goods and services. Almost all goods and services increase in value over time, regardless of demand or the value of a currency. Most people understand inflation in terms of what they pay for an item now compared to what they paid for it years ago. For example, people in their 70s and 80s paid more for their current car than they did for their first house. People in their 50s paid more for one year of a child's college tuition than was paid for four years of their own education.

Inflation occurs naturally as the government prints more money and issues more bonds, and businesses slowly raise prices over time. But it can also happen because too many dollars are chasing too few goods and services. This is basic supply and demand. The higher demand becomes, the lower supplies become, which results in prices increasing. A rise in prices can also occur when a currency loses its strength. As the dollar loses strength against other currencies due to a weak US economy, high debt, and high unemployment, it takes more dollars to buy other currencies, goods, and services.

Inflation is one the most difficult components of retirement planning to adjust for, and can really eat away at the nest egg you have saved. For example, assume a retired couple draws an annual retirement income of $60,000 in today’s dollars during retirement. With a 3% inflation rate that $60k is only worth $33k in future dollars in 20 years, quite a reduction in purchasing power or the “value” of their money. That same couple would need an annual income of $108,000 20 years from now to match the current purchasing power of $60,000.

Below are some common inflation-hedging investment strategies, several of which we utilize:

- ***Dividend Paying Companies*** **-** Companies that pay dividends provide investors with an effective inflation hedge as their revenues and net income are positively affected by increases in the overall prices paid by consumers for the goods and services they provide. Some companies, however, are more suited to paying reliable dividends than others. Think banking, pharmaceutical, food, and telecommunication industries as typically producing the most reliable dividends.

- ***Treasury Inflation-Protected Securities (TIPS)*** **-** Treasury inflated-protected securities are bonds that are backed by the US Government. TIPS pay a fixed rate, but the principal is adjusted twice a year to reflect changes in inflation based on the CPI. These bonds tend to do very well a) when inflation is expected to rise and b) in the actual inflationary period.

- ***Commodities*** **-** Commodities prices usually rise with inflation. As demand for goods and services increase, the price for these goods and services usually increases too, as does the price for commodities to produce these goods and services. There are what seems an unlimited number of ways to invest in commodities, whether through stocks, ETF's fund or managed futures. In general think energy, agriculture, precious and non- precious metals, and timber.

- ***Emerging Markets*** **-** Though more volatile, diversifying abroad is another strategy, as emerging markets are often exporters of in-demand commodities (see above) and not perfectly linked with our domestic economy. The emerging markets can also offer a hedge on currency as a weak dollar makes their products cost more.

- ***Real Estate*** **-** Real estate investment trusts (REIT's) have historically offered good protection against inflation because inflation lifts the rents these trusts collect and pay to shareholders as dividends. REIT's vary in type by the underlying holdings - apartments, commercial real estate, strip malls or self-storage are examples. The premise is that long term there is a chance for price appreciation in the real estate and an increase in rental income for cash flow.

- ***Gold*** **-** Gold is known as one of the most common inflation hedges and one of the most volatile as well. Over the past few years it has been used more as a "crisis hedge" than an inflation hedge.

At IMCG, we are continually looking for ways to hedge against inflation in our clients' portfolios and protect them from losing purchasing power over the long term. We continue to evaluate inflation-hedging alternatives and how they may fit our investment discipline.

PLANNING CONCEPTS

Quantitative Easing (QE): Goals & Impact — *John Warme*

After August's jobs report undershot just about every economist's consensus, the Federal Reserve's hand was significantly tipped toward more accommodation. Thus, on September 13, the Fed announced an extension of its 0 - .25% fed funds target rate "at least through

2015" and more notably, a third round of quantitative easing. The Fed over-delivered market expectations regarding the so-called QE3 by committing to an *open-ended* monthly purchase of $40 billion of agency mortgage-backed securities. This level of accommodation proves the Fed's commitment to economic recovery via monetary policy action but with it come questions of standalone effectiveness and unintended consequences.

Quantitative easing is implemented by central banks when economic conditions have deteriorated to the point that traditional methods of buying short-term treasuries in open market operations have become ineffective due to zero-bound interest rates. It is a process of increasing liquidity in the economy by buying longer-term bonds; effectively flattening the yield curve and increasing the money supply. Lower treasury yields drive investors into higher yielding, riskier assets like stocks. Dually, this yield suppression is designed to keep mortgage rates low in an attempt to substantiate a housing recovery. Ideally, this begins a virtuous cycle by catalyzing hiring and thus minimizing unemployment, one half of the Fed's dual mandate of a) *promoting maximum employment* and b) *price stability*.

Elevated levels of unemployment have unequivocally had the most negative drag on this protracted recovery. The crisis has embedded itself in the structure of the economy leaving many long-term unemployed increasingly unemployable by the day. Unfortunately, monetary policy effectiveness can be limited by fiscal inaction. The fiscal uncertainly in Washington has left many corporations that would otherwise be creating jobs, on the sidelines awaiting policy certainty. All this while the Fed continues to "print money", leveraging its other mandate, price stability, in an attempt to get Americans back to work.

US inflation has remained relatively low and stable in spite of extraordinary market conditions and an extremely accommodative Fed. QE1, announced in November 2008, saw disinflationary and deflationary environments, finally followed by reflation to its conclusion in March of 2010. The inflation rate settled to roughly 1% until an inflection point in November of 2010 when QE2 was announced and begun. This program continued through June 2011, after which time the inflation rate lowered to the current rate of 1.7%. Throughout, we have seen a regression to the short-term mean of roughly 2% . . . the Fed's target.

It is reasonable to believe that the liquidity pumped into the economy will end up catching up with us. The Fed's September 13th press release states "the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens." The operative word here is "after". It is believed that the Fed is targeting an unemployment rate of 5.5% which is a considerable spread from 8.1%. This is sure to be a long-term commitment and once this liquidity starts to gain velocity in the economy, it is conceivable that there will be considerable inflationary pressures. It appears that the Fed will cross that bridge when it gets there as it seems to be squarely focused on the unemployment half of their dual mandate. We will continue to monitor this situation and remain vigilant in constructing our client portfolios in accordance with our Investment Policy Committee's economic forecast.

Facts About Income Needed at Retirement ***Ben Daigle***

"How much annual income will I need after I retire?" is a question that we get in one form or another from many of our clients. The industry standard suggests that retirees will need 80%

of their pre-retirement income to live at their pre-retirement standard of living. This means that someone living on an annual gross income of $200,000 when working should be able to live the same lifestyle on an annual income of $160,000 when in retirement. Your retirement income will usually come from some mix of retirement plan, IRA, and pension distributions, social security payments, portfolio withdrawals and other less common income sources.

The 80% number is arrived at as a universally accepted benchmark based on the fact that our typical client has put away between 10-15% per year for retirement, which is no longer necessary once in retirement. Also, once retired, you will no longer be paying FICA, Medicare and Social Security tax. This amounts to another "savings" of 7.65%. Combined, that's roughly 17%-22% less of gross income needed before expenses and taxes, hence the 80% rule-of-thumb.

That's great, you say, but what if you want to travel? Buy a second home? Give money to children, grandchildren and favorite charities? Pick up an expensive new hobby? The list of potential new expenses is endless. Some new expenses aren't so pleasant: rising medical costs, the effect of inflation on spending. Maybe you're lucky enough to offset some of these new expenses by not having to save for a child's college expenses any more. Maybe you can downsize your home and/or payoff your existing mortgage. The fact is there are a lot of ways to get where you need to go. If you haven't reviewed your plans for retirement recently, please give us a call. We're here to help.

INSIDE THE MARKETS — FRANCIS J. DAVIES, III

The Liquidity Trap

> *"And my tires were slashed and I almost crashed, but the Lord had mercy And my machine, she's a dud, out stuck in the mud somewhere in the swamps of Jersey."* *Bruce Springsteen, "Rosalita"*

The US economy remained stubbornly resistant to all efforts to restart its progress in the third quarter. Like a muscle car sunk in mud, the harder one stands on the gas pedal, the deeper it sinks. Even a '69 Chevy with a 396, Fuelie heads and a Hurst on the floor is going to spin its wheels until it is sunk to the floor boards. Under normal circumstances, the government would use the twin tools of fiscal policy and monetary policy to gain traction and get the economy rolling again. But these are far from normal conditions. Economics being the dismal science, there is a term for the current state of affairs: a "Liquidity Trap".

A liquidity trap is one of the possible outcomes after the bursting of a credit and/or asset bubble (they usually arrive together). The resulting damage to balance sheets leads to a frenzy of deleveraging as consumers, banks and industry lower their debt levels. The decrease in borrowing and spending dries up demand, while the excess capacity built up during the bubble overhangs the economy. The slowdown becomes a liquidity trap when interest rates approach zero without an increase in credit demand.

Now, when conditions are most challenging, desire for austerity suddenly gains currency. Unemployment and underemployment increase sharply. In March, former PIMCO managing director Paul McCulley wrote a report that discussed the current liquidity trap and the adoption of a fiscal policy of austerity in Europe: "Fiscal austerity does not work in a liquidity trap and makes as much sense as putting an anorexic on a diet."

Fiscal policy is a longer-term fix as it involves changing taxing and spending plans at the federal level. Tax cuts and spending bills come out of Congress, which would entail the Senate and the House agreeing on something. In the best of times, this is not a timely remedy: by the time a bill is passed, the time would also have passed. This is usually only attempted in times of dire emergency when consensus is forced on the legislature. The tax cuts in 1981-82 and the stimulus in 2008-09 are examples.

The usual course is to use monetary policy to influence the economy. The Federal Reserve adjusts interest rates and money supply to either slow or revive growth. It has the benefit of being implemented immediately after the central bank proposes it. In times of expansion, this would mean raising rates and decreasing the money supply, Times of slow growth, like today, would call for the opposite – lower rates and increased money supply. This is where it gets complicated.

In December of 2008, the Fed dropped its target for the federal funds rate to between 0.0% and 0.25%, where it has remained since. For nearly 4 years, America has had a zero interest rate policy – or ZIRP for you acronym aficionados. Rates are said to have a zero lower bound, meaning yields cannot go lower than zero which seems fairly obvious. Perversely, this is not the case. Rates actually can go below zero. Returns on bonds issued by the stronger European countries (including Germany, the Netherlands, Switzerland and Denmark) have been in and out of negative territory since late summer - in essence charging for holding funds. Negative yields are not just an overseas occurrence. At the September auction, the US Treasury sold $13 billion of 10-year inflation protected securities, or TIPS, with a yield of negative 0.75%. Negative rates are thought to be unsettling to markets over time; however, September was the fifth consecutive TIPS auction that resulted in negative yields. Investors perceive risk to be so prevalent that they will pay to guarantee to protect their funds; their priority is now “return of capital” rather than “return on capital”.

These conditions – rates close to zero and negligible economic growth, remove the Fed’s latitude to decrease rates. This leaves the Fed to try and influence the money supply through quantitative easing, which entails the use of open market operations to purchase Treasury debt from financial institutions. These purchases increase the quantity of reserves in the system, hence the name. This tactic has less impact with Treasury rates at or near zero, so the Fed is trying something different this time. In September it announced that it would purchase $40 billion of mortgage-backed debt every month in an open-ended policy aimed at lowering mortgage rates and stimulating further recovery in the housing market.

Unfortunately the issue confronting residential real estate is not mortgage rate levels but rather loan approval rates. A survey by Ellie Mae Inc., a software company whose products are used by many lenders, showed that in August, the average FICO credit score on new loans closed was 750, or 9 points higher than a year earlier. Less than 20% of American consumers carry a credit rating at 750 or above. The survey also notes that lenders are demanding higher down payments, lower debt-to-income ratios and after the applicant has cleared all those hurdles, the approval process now takes an average of 49 days. That is 9 days longer than just a year ago.

So it seems that no matter how much liquidity the Fed pumps into the system, cash is hoarded rather than invested or lent. The demand for money is so responsive, or elastic, that it completely consumes all the additional money, without helping to boost the economy. For QE to work, banks need to shift funds to riskier assets like corporate bonds, real estate securities, and loans, not stack it up like firewood.

It is not just banks increasing reserves; industry is holding record levels of cash (one of the reasons for weak credit demand). The absolute size of the money supply increases but the cash remains dormant. Eventually the savers, the people that need to live off their cash, are forced to find higher yields in riskier assets. With low returns and the likelihood of higher rates in the future, bonds are not a good choice. This leaves the riskier option of investing in the equity markets. This consequence intended or not, raises the question of whether the Federal Reserve should be pushing people into the stock market.

During a liquidity trap, the economy does not act like normal times. McCulley (as well as many other economists) feel only unconventional policy will work. The political reality is that any course that is viewed perceived as risky will never be pushed when career safety depends on remaining conventional. Many feel the Federal Reserve needs to increase inflationary expectations. If the Fed accomplishes this, regardless of the real or nominal interest rate, households and businesses will be willing to spend their money now, rather than see its value eroded by inflation. Recent economic reports have been mildly encouraging. There has been a small rise in commercial bank lending and the GDP is showing small, but measurable growth. While the evidence is not overwhelming, it is this type of positive momentum that can gradually add to consumer confidence, increase aggregate demand and bring all the money being held on the sidelines back into the economy.

IMCG NEWS

In the event you missed our continuing growth last quarter while we were expanding into our new space, IMCG was pleased to announce the following additions our team of professionals:

***JASON FOSTER* –** Has joined us as a Vice President and Portfolio Manager. Jason began his investment career at the regional firm of Legg Mason Wood Walker (now Morgan Stanley Smith Barney) as a financial advisor in 1998, works with both individuals and retirement plans and is a member of the firm's Investment Policy Committee. Jason has served on the University of Maine Farmington Advisory Board and is a past volunteer and educator with the Junior Achievement program. He is a Maine native, having grown up in the Lakes Region in the Bridgton/Naples area. He currently resides in Gorham with his wife Kristin and two young children Hadley and Braden.

***JAY FLOWER* –** Has also joined IMCG as a Vice President and Portfolio Manager. Starting his career in the investment management industry while living in Boston, Jay joined Legg Mason when he and his wife returned to Maine in 2005. Jay works with both individuals and retirement plans as well, and is a member of the firm's Investment Policy Committee. He currently serves on the Board of Trustees at North Yarmouth Academy and is also a native of Maine having grown up in Brunswick and Boothbay Harbor. He graduated from Hobart College in 1998 and now lives in South Freeport with his wife Julie and their two young daughters Liza and Kate.

> *"We're heartened by the surprisingly quick, and significant, vote of confidence that we've received from our clients as they've followed us while we move forward in our careers. IMCG's entire team has been welcoming and accommodating to both us and our clients as we continue to migrate to the boutique side of the business. We look forward to meeting with you in our new offices as we begin the year end planning process!"* *Jason & Jay*

WEB SITE UPDATE – We recently revamped our web site (www.imcgrp.com) so do drop by and pay us a "visit". We can also be followed on Linkedin (www.bitly.com/theimcgrp) and Facebook (www.facebook.com/imcgrp). Our heartfelt thanks go out to Huard Marketing (www.huardmarketing.com) and Gnosis Studios (www.gnosisstudios.com) for all their help with these projects over the last several months.

NEW OFFICES – We completed our expansion to larger space in late August as the renovations to our new location were finished just prior to Labor Day. Our new offices, the 2nd floor at 130 Middle Street in downtown Portland are only three blocks from our previous Exchange Street address, which is shown below. As in the past we will continue to provide access to a parking garage (The Custom House Garage at 25 Pearl Street) just steps away from our building. Directions to both the new offices and the adjacent parking can be found on our web page.