

THE EXPERIENCE OF THE LAST TWO YEARS has made investors keenly aware of the role that liquidity plays in influencing the markets.

This past quarter saw a significant rebound in asset prices—largely a result of improved global liquidity. This powerful move occurred against a backdrop of soft economic numbers and rising unemployment. Despite this, the financial press, e.g., CNBC and others, continues to suggest that returns and risks are *only* driven by economic activity or by valuations. In fact, it has been acutely demonstrated that liquidity plays a critical role. Liquidity is to investors as rain is to farmers. At this point, however, it is not clear that in the *longer-run* liquidity will flow to **U.S. assets**.

Liquidity can be provided through either the private sector (the traditional or the shadow banking system) or through the public sector (through both the Fed and Congress). As we saw in 2007, when there is a glut of liquidity, much tends to be misallocated to poor investments.

When those investments don't pay as promised, deteriorating confidence and declining values cause a withdrawal of credit/liquidity because intermediaries don't have reliable collateral and their equity gets squeezed. Case in point: residential real estate.

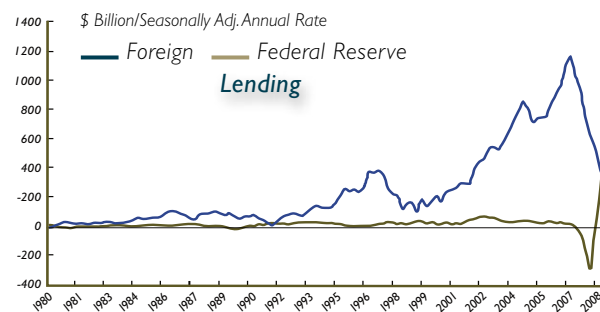
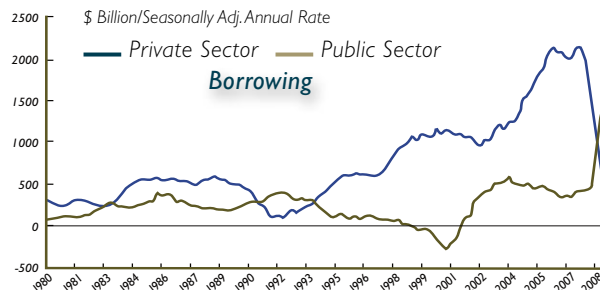
Last year's liquidity crunch had its roots in the historic low level of equity in the residential housing market. Real estate prices were juiced up to unsustainable levels by artificially low fed funds rates, the proliferation of credit derivatives, a false belief system, and excessive leverage. So as real estate prices began to naturally adjust downward, financial institutions had no choice but to withdraw credit. At that point, the federal government felt it had to step in and guarantee bank debt to mitigate the pain being felt in every asset class except Treasuries and cash.

As the Fed has now expanded its balance sheet 3-fold and Congress has added \$9 trillion in new deficits, liquidity has naturally improved. In other words, private sector deleveraging has been counterbalanced by public sector leveraging (see *graphs above*). Some of the funds have likely flowed into the equity markets as evidenced by the 60% rebound from the March lows. The follow-on effect from recovering asset markets has served to further improve liquidity because the pressure on lending institutions has abated and confidence is returning.

The overall U.S. stock market has performed admirably this year; but not just because of improved business conditions and inventory restocking. For instance, stocks of financial institutions, which still constitute a significant portion of the overall market

Public Sector Takes Borrowing Lead

While Fed Picks Up Lending Slack



Source: Federal Reserve, Flow of Funds



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capitalization, have been provided a subsidy on an unprecedented scale in the form of free money courtesy of the Federal Reserve. Obviously, loans to U.S. financial institutions with a 0% interest rate are not loans priced to reflect their true risk. But as long these loans continue to be available (which should be for the foreseeable future), banks won't terminate credit cards, mortgage programs, asset-backed loans, etc. because the government has effectively guaranteed them. It is for this reason that the outperformance of bank stocks can't be taken very seriously because it is derived from a subsidy rather than prudent banking practices.

At the same time, it is important to understand that the flooding of U.S. dollars into the global system, coupled with near-zero interest rates, has severely weakened our currency. The U.S. dollar has become the world's funding currency. What that means is that the carry trade (borrowing in the currencies of weak economic countries, i.e., the U.S. and Japan, and investing globally for higher returns) is a highly profitable game once again. Banks can borrow for next to nothing and re-lend the proceeds into the economy or use them to fund proprietary trading operations. This is tantamount to printing money, which ultimately will help Wall Street banks and certain asset markets, but is unlikely to improve broad living standards in the U.S.

A weak U.S. dollar also eventually may have a negative effect on domestic stock prices and other U.S. assets. One reason is foreign investment managers who invest in U.S. assets (and who have to report to their investors in their local currencies) will have to outperform non-dollar investments by a huge margin to offset the dollar decline. This is a risk they will be loath to take. It is for this reason that capital will naturally gravitate towards investments that are inversely correlated to the U.S. dollar such as commodities, foreign stocks and gold.

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Unless we see significant structural changes, we anticipate that the U.S. will continue to have a weak currency and a lackluster economy due to overcapacity, high unemployment and tapped-out consumers. But, the U.S. does not equal the world, and there is encouraging economic development overseas. It is interesting to note that despite the global contraction, neither China nor India went into recession.

We think of our clients as global citizens rather than U.S. citizens, and position portfolios to tackle the challenges we anticipate here in the U.S. while also capitalizing on global dynamics. Given our concerns of a weaker dollar and overall price inflation, we want to own assets that should perform well in that environment. We also want investment exposure to countries that are experiencing rising economic prosperity.

Liquidity is both a blessing and a curse. While it creates higher asset prices in the short-term, these same inflationary forces can negate paper gains over the long term. We believe a key part of our job is to use liquidity to our advantage, while also protecting clients from its downside. ■

MARKETPOINT

AS MENTIONED IN OUR WINTER NEWSLETTER, we have added a few new communication channels to provide our clients with more frequent market updates.

One of these is our **Monthly Investment Commentary** which is posted on the “Client Access” section of our website. These pieces are designed to complement our quarterly newsletters, and provide the opportunity to dive deeper into current market dynamics and our investment perspective. You do need a login and password to access these postings; please call the office if you need this information.

The title of our most recent issue was, “Inflation or Deflation?” This edition seemed to have particular resonance with several clients and so we wanted to share a summary of the article more broadly.

September 2009: Inflation or Deflation?

People most often equate inflation with a general increase in the level of consumer prices. The actual definition of inflation is an **increase in the quantity of money and credit**. When the quantity of money increases, prices rise as more and more funds chase assets and consumables—so rising prices are a **symptom** of inflation. The symptom can manifest itself in different ways such as through higher prices of commodities, houses and real estate, stocks, insurance contracts, education, or in wages and consumer prices. Furthermore, different areas of the economy can become inflated at different points in time (think tech, housing, etc.)

The reason the “inflation or deflation” debate is raging currently is that we are in a situation where the government is increasing its fiscal deficit to inject cash and credit into the system **to offset** the withdrawal of credit by the private sector.

This environment is challenging for investors as the whole point of investing is to increase your **real** wealth through time. That means holding investments which should increase in value at a greater rate than money and credit is expanding. The difficult part is to know into which assets the expanding money supply will flow.

As an example, since December 2008, in the wake of what most would argue was a global deflationary shock, oil traded from \$32 to \$70, but natural gas traded from \$6 to \$3. During this same time period different economic forces were at work—crude oil is priced globally, and natural gas is priced by supply/demand mostly in the U.S.

The debate of inflation vs. deflation will continue because there are some credible arguments for both sides. However, it is our view that inflationary forces will ultimately prevail...

To protect clients from anticipated inflation, we want to avoid investment in industries that have too much capacity (i.e., auto manufacturing, hotel and leisure, financial services, and real estate), and overweight industries where there is likely to be constrained capacity in the future (i.e., energy production, electricity generation and distribution, agricultural production and healthcare). And in the context of an inflationary environment, we believe that over the next ten years stocks will perform better than cash and bonds and recommend for one's long-term investments maintaining exposure to equities despite near-term challenges. ■



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OBERMEYER NEWS



WE ARE EXCITED TO SHARE THE NEWS that Wally Obermeyer was named by *Barron's* magazine as one of the nation's top independent advisors.

The *Barron's* 2009 list of "Top 100 Independent Advisors" was published in the magazine's August 31st edition. The list of distinguished advisors, culled from more than 500 nominations, is based on assets under management, revenues the advisors generate for their firms and the quality of their practices. *Barron's*, one of Wall Street's most well-regarded publications,

publishes its list to identify elite practitioners in the field and highlight the investing practices that are protecting and growing the wealth of investors.

This year marks Wally's third consecutive appearance on the list, and our firm is the only advisor in Colorado to be included in this year's survey.

Upon hearing the news, Wally quickly highlighted that this distinction should be celebrated as a group success. Borrowing a quote given to a local paper: "To be in *Barron's* "Top 100 Independent Advisors" demonstrates the level of excellence that the team delivers to our loyal clients. Without these important partnerships, this recognition would not have been possible."

Following the publication of our ranking, several clients have asked whether we are taking on new relationships. We are interested in working with new families, but selectively as we want to make sure every client is a good fit. Our first priority is to deliver intelligent investment management to our existing clients as it is their partnership that has made us successful; however, we are interested in growing our business and do have capacity to do so. If you do have a friend, family member, or know of an institution who you believe would benefit from our services, please contact us and we are happy to explore whether we can be of value. Our team is always greatly complimented by the referral of family or friends.

Thank you for your continued confidence and support! ■



Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels.

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