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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

When is this rally going to end? That is what a lot of investors want to know. After all, the recent spike in stock prices has been a little, shall we say, surprising. If the economy is so weak the Federal Reserve feels the need to dump another couple hundred billion onto the fire, why then are investors so keen to buy equities? In a simpler time, this might not make sense; however, this is not a simple time.

Frankly, they don't teach this type of stuff in business school; at least they didn't when I was coming along. Maybe they will when my children are in graduate school; if they go.

Unfortunately, as the case may be, the answer to that very simple question, when is the rally going to end, is not as scientific as folks would like. Everyone wants a number, a chart, a date, or some form of technical analysis that boldly predicts: "THIS IS THE TIME AND THIS IS THE PRICE!" Instead, the message is decidedly mixed. Some folks are predicting financial Armageddon, and others are saying the good times are here to stay. Well, which is it?

As with the most things in life, the truth is almost always somewhere in the middle; meaning the stock market likely won't fall apart just because, but it probably shouldn't keep going up at its current pace for, well, ever. But that is a soft answer, isn't it? Almost a little too dull and predictable.

So, let me counter with a question of my own: "what else are investors supposed to do with their money? After all, the Fed is goading us to do something, anything, with our money."

Here are some facts: 1) the 3-Month Treasury Bill, a proxy for cash and money market investments, has a current yield to maturity of around 0.10%. Obviously, that isn't a lot, and; 2) the 10-Year US Treasury, a proxy for fixed income securities, has a yield of about 1.75%. That isn't a lot either. 3) the Federal Reserve has all but guaranteed it doesn't plan on raising the overnight lending target for at least a couple of years.

So, where is the return in cash? It isn't there. Where is the absolute return in bonds? It isn't there either. I mean, if inflation averages just 2% per year for the next 10 years, you will have effectively lost money by "locking in" at these interest rates, and these levels. In short, bond and cash returns are relatively easy to predict over time, and, right now, those predictions aren't much.

Invest in traditionally non-risky asset classes, and lose money to inflation. Or you can do something else. Which do you want? The rock or the hard place?

Oh, I guess there are other things you can buy: real estate, private equity, and, heck, collectibles like baseball cards and anything from the Franklin Mint. People are simply scrambling for something, anything, which has either appreciation potential or a decent income stream. Leaving the money in cash, waiting for all hell to break loose, doesn't pay the light bill over the long haul.

That is where we are. That is what is going on here.

People are shifting out of CDs and short-term bond funds into short-term fixed income funds. Investors are moving out of short-term bond funds, and into stocks. In essence, people, investors, are taking on risk they didn't necessarily want, but feel compelled to do. In a lot of instances, they didn't

Inside this issue:

"Well, what the [heck] are we supposed to do, ya moron?

Stork (Animal House)

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really have much of a choice. While everyone wants the return OF capital, at some point the return ON capital is also important. When inflation is stealthily eating into principal, well, investors know what to do.

So, if the talking heads on the television really want to find out the story behind the recent rally, instead of interviewing a bunch of academics and other people with sophisticated opinions, including yours truly, they should simply ask a retired couple what they plan on doing with CDs rolling off into something paying 1% or less. They should ask the employee at XYZ firm, who hasn't seen a raise in a three years, what they plan on doing in their 401K plan. These are the people that know the truth behind the stock market's incredible run this year; not Paul Krugman.

They have to do something, anything, to keep up with the rate of inflation. Hey, in the past, when stocks got pricey, it was an easy decision to sell some, and invest the proceeds in a bond paying 5% or even a CD yielding 3-4%. You took a little risk off the table, and were still able to make an absolute rate of return which kept up with inflation. These days, you can't, meaning investors, whether they like it or not, or know it or not, have increased their tolerance for risk BECAUSE that is what the Fed's monetary policy is forcing them to do.

Why is AT&T up as much as it is this year? I mean, revenue is flat, and earnings growth, while positive, isn't necessarily through the roof. Why then? I would submit because John Doe and Suzie Queue understand what the company does AND it pays a fat dividend. There is comfort in AT&T. The same could be said for other companies like Altria or Phillip Morris International and others. Shoot, you could find a bunch more names, with higher growth prospects, cheaper valuations, and cleaner balance sheets. But, you know, Altria makes cigarettes and pays a fat dividend. John and Suzie understand cigarettes, and they understand dividends. Does that make sense? I wish it could be more complicated than that, but, sometimes, you know, it isn't.

While institutional money managers, analysts, and the entire industry twist in knots trying to generate things like Alpha and relative return, individual investors simply want….a return on their money.

Then there is the question of gold: how much longer can it continue its dizzying run? Who would have thunk it? $1,700+ per ounce? Where does it stop?

Here is the story behind gold: it makes people feel safe. That is about it. There are limited commercial applications. It doesn't have any earnings, let alone pay a dividend. In fact, gold is basically a shiny metal. Put a 1 oz. bar of it on your kitchen table: what does it do? Can you call your parents with it? Check your email? Send a text? Surf the web? Of course not, again, it is a shiny metal, and little else. Why gold? The technical charts look awful, and there is really no valid reason to own it other that….it makes people feel safe.

With much of the world's central banks doing everything they can to inflate and debase, gold is an attractive alternative. When government balance sheets are upside down from stem to stern, and the world is awash in fiscal imprudence, gold is a known entity, and is much harder to mine than paper money is to print, isn't it? Go ask the proverbial Widow Jones whether she understands what the Fed is up to with its quantitative easing shenanigans. The chances are she probably won't, as is the case with virtually everybody else. Then ask her if she understands gold. If you do, she might look at you funny, and ask: "what is there not to understand?" Voila, eureka, and all of that.

Where the rubber meets the road, the sophisticated arguments on the television help to explain the short-term, daily fluctuations in the markets. Why is the market up 100 points after the FOMC meeting? Well, the statement said thus and so, and the implication is the Fed is going to do something in the future to goose the economy a little. That's well and good. However, why is the market up over an extended time period? Well, it is because the end investor, not the institutional variety, the end investor, has to do something with their money. They want to do something that generates a positive return, preferably something they understand.

Then there are other questions like: when do you sell Apple? Or, how much more can Apple go up? I mean, it is over $700/share! Well, the reason why analysts love Apple is because the company: 1) has the best brand in the world, and; 2) is the market leader, and; 3) continues to innovate and grow, and; 4) has a pristine balance sheet, etc. There are a number of reasons why Wall Street likes Apple. But why do individual investors?

Let's think about it. How many other companies have people literally camping out for their products? Or where you have

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to make an appointment, that's right, to service your product or talk to a technician? Or where the retail outlets are full of customers literally every minute they are open? All of this makes individual investors feel safe. So, when you add the anecdotal and quantitative analysis, yes, Apple has gone up like a rocket this year, but why would you sell it? To do what with it exactly? Other than pay a hefty capital gains tax?

In so many ways, it is riskier to sell Apple at this juncture than to simply keep it, just as it is riskier for many people to keep their money in investments that aren't paying anything as opposed to taking on a little additional risk.

In the end, the reason behind the recent rally isn't all that complicated, and you can find it buried in that paragraph just above: "to do what with it exactly?" Yep, that is about it, even if the folks in the money management industry want to make it seem more complicated than that.

Do you want an inflation-adjusted, absolute rate of return? Right now, your best chance for that is in the stock market. Period. Gold? Sure, if you want a little semblance of safety while the world's central bankers bend over backwards trying to inflate the global economy.

So, the answer to the initial question: when is the rally going to end? Well, when investors determine the potential for absolute returns have declined to a point where losing money, in an inflation-adjusted sense, in cash and bonds is the more attractive alternative.

Yes, it could come to that, and might very possibly. We could see this happen before the end of the year or in 2013, but it is out there. This means, while we can enjoy this nice rally, at Oakworth Capital, we aren't getting too carried away with it, and will have our sell tickets ready to go when the time is right.

Important Economic Releases

Release	Survey	Actual	Prior	Comments
Current Account Balance (2Q)	-$125.0B	-$117.4B	-$133.6B	There isn't a lot to say about these numbers. They aren't what I would call good, but they aren't quite bad either.
Housing Starts (Aug)	767K	750K	733K	
Existing Home Sales (Aug)	4.56M	4.82M	4.47M	
Initial Jobless Claims	375K	382K	385K	
Philadelphia Fed (Sep)	-4.5	-1.9	-7.1	
Leading Indicators (Aug)	-0.1%	-0.1%	0.5%	

Tables & Data Points

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
8/30/12	13,000.71	1,399.48	3,048.71	808.64	8,983.78	2,403.80
9/6/12	13,292.00	1,432.12	3,135.81	837.95	8,680.57	2,524.95
9/13/12	13,539.86	1,459.99	3,155.83	856.12	8,995.15	2,543.22
9/20/12	13,596.93	1,460.26	3,175.96	851.51	9,086.98	2,553.03

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
8/30/12	0.10	0.13	0.26	0.66	1.62	2.75
9/6/12	0.10	0.13	0.26	0.68	1.68	2.80
9/13/12	0.10	0.12	0.24	0.64	1.72	2.93
9/20/12	0.11	0.14	0.26	0.69	1.77	2.95

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil—WIT/brl.	$/Euro	JPY/$	$/GBP	CAD/$
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
8/30/12	3.25	0.25	0.42	1,654.80	94.62	1.251	78.63	1.579	0.993
9/6/12	3.25	0.25	0.41	1,703.20	95.53	1.263	78.86	1.593	0.983
9/13/12	3.25	0.25	0.39	1,769.50	98.31	1.299	77.48	1.616	0.968
9/20/12	3.25	0.25	0.37	1,767.80	91.87	1.297	78.24	1.622	0.977

Disclosure