

**Cautious Exuberance**

In early October an article written by British journalist Robert Fisk titled “The Demise of the Dollar” reported that Arab governments had been meeting in secret to plot discontinuing the global practice of pricing oil in dollars. The article read like a set of Cliffs Notes on a Tom Clancy novel. The price of gold surged and currency markets, already jittery over the perceived relative fading of the U.S., dumped the dollar.

Fisk also insisted the Chinese had been suspicious that U.S. pressure kept the U.K. from adopting the Euro in the early 1990s. The author has previously dabbled in 9/11 conspiracy theories. Markets settled down after it was realized that the article was virtually unsourced, and it went down as a cheap shot on an already vulnerable U.S. dollar.

Ongoing dollar skepticism means gold is presently a hot investment, and thus deserves a mention. Below is the historical *real* price of gold, or adjusted for inflation.



Gold notched a real record in 1980 at \$2,358, during a time in which inflation

was in the double digits. Gold in 1980, on a real basis, was more than double current levels.

So is gold a good buy now? It’s nearly impossible to tell. Gold has no major uses outside of jewelry, and thus the price is determined in the short-run by what investors are willing to pay for it rather than fundamentals. In the long-run, it has historically been an inflation proxy.

As an investment, gold is speculative. Real prices are triple what they were a few years ago and the highest in real terms since the high-inflation early 1980s. And consider the extreme long-term: during the 20<sup>th</sup> century, gold modestly *underperformed* inflation.

In recent years, gold-oriented funds have multiplied, making it easier to buy than it has been historically. While this has contributed to gold’s recent rise, an exodus of speculators would magnify a decline should the metal lose its investment luster.

**Equities**

Stocks continued rebounding along with other riskier assets in the third quarter. The benchmark S&P 500 rose 15.6%, and has rallied 45% since the end of February.

In past business cycles stocks have risen into recovery, climbing a “wall of worry” as skeptics question the strength of the economic rebound and valuations. At this point equities look expensive relative to trailing and forward earnings. But this has been the case in prior trough points in the business cycle. Present

earnings reflect cyclically depressed levels rather than what would be expected in an average year.

Following the 1990-1991 recession, stocks rose 36% in 15 months, and at year-end 1991 the market was selling for 21 times what the index would earn the following year. Stocks continued rising for the next few years, and a sharp rebound in earnings brought the P/E to the historical 15 level at the end of 1994. As of mid-November, the valuation of the S&P 500 is at around 20 times 2010 earnings estimates. On other metrics the index is comparably valued to 1990, such as price relative to book value, a more stable measure.

The strength of a continued recovery in stocks will depend on the durability of the economic recovery. Markets still assume that U.S. business has reverted to a “new normal” environment in which unemployment is persistently higher and growth is slower than it has been in the past three decades. Should the new normal assumption prove excessively pessimistic, earnings will likely revert to record levels within a couple of years and stock indexes should follow suit.

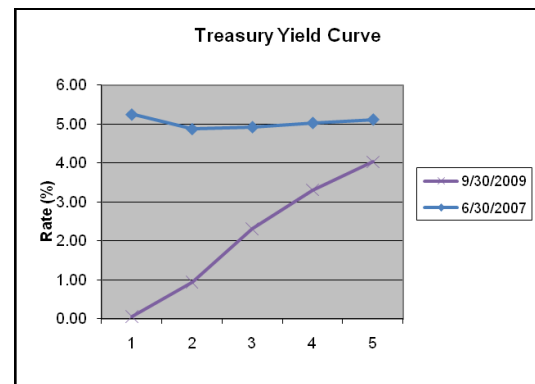
But what if the economic recovery drags? We continue to favor relatively simple businesses with strong liquidity and healthy balance sheets at low absolute valuations. Margin of safety, through low prices and low leverage, is the key to guard against the unknown. While Great Depression 2.0 may have been averted, the U.S. economy isn't out of the woods yet. Unemployment is now over 10% and consumer spending seems to primarily be driven by government programs such as cash for clunkers and

the \$8,000 homebuyer tax credit, financed of course by borrowing from private investors.

Stocks have been cheaper during other times in the past several decades. But in the other cases—namely 1974 and the early 1980's—we also had very high interest rates and inflation, which depresses prices for both stocks and bonds. In contrast, in the current environment...

### Bonds

...interest rates remain at low levels and inflation is subdued. The Federal Reserve has maintained easy money since the overnight rate was cut to 0-0.25% in late 2008 to head off the panic in financial markets.



At current rates, U.S. treasuries do not adequately compensate investors for the risk of inflation or rising interest rates, and we continue to avoid them. Higher future inflation is a reasonable possibility due to current uber-expansionary monetary policy, and low yielding, long-term treasuries would be one of the worst investments under such a scenario.

We've found value in several medium grade bond issues over the past few months, all companies with strong liquidity, big asset bases and low financial leverage. However, opportunities have vanished as investors have rapidly returned to risk, pushing down yields. Inflation protected treasuries look more attractive than straight treasuries and will hold their value if inflation rises.

### **Stock Briefs**

**Service Corp Int'l** announced the acquisition of Keystone North America, the fifth largest operator in the industry. Service Corp successfully acquired Alderwoods in late 2006, which combined with share buybacks have boosted per share earnings over the past five years. Service Corp continues to sell at a substantial discount to our long-term appraisal value.

We added **Valero**, an oil refiner and retail (gas station) operator primarily in the U.S. Retail gas demand remains depressed due to the recession. This has negatively affected the near term earnings of refiners, which operate with significant fixed costs. Valero has one of the best balance sheets and roster of assets in the industry and should be well positioned when demand realigns with industry capacity.

**Industrias Bachoco** is the largest poultry company in Mexico. The business has a strong balance sheet, entrenched market position and good profitability, and has recently been selling at a bargain valuation. In

addition, the Mexican peso is cheap relative to the dollar, and a recovery in the Peso will boost the value of the stock for U.S. holders.

We've been buying **Berkshire Hathaway** for the first time in our firm's history. Berkshire has three major components: 1) Common stock holdings, including being the largest shareholders of Coca-Cola, American Express, Wells Fargo and others; 2) Insurance operations including GEICO and 3) Wholly owned businesses including See's Candies, MidAmerican Holdings (utility), Dairy Queen, Benjamin Moore Paints and others. Berkshire recently announced the acquisition of Burlington Northern railroad. Warren Buffett began buying Berkshire "A shares" in the 1960s at around \$12, and they now trade for over \$100,000. The B shares are 1/30<sup>th</sup> of an A share. Berkshire's stock and securities holdings alone are worth over half of the current stock price, and the stock is an excellent value at the recent quotation.

Harper Asset Management, LLC is an investment advisory firm, providing clients with investment management and financial advisory services since 2001. If you are concerned about your assets' capacity to support you, please let us help you evaluate your position.

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