

OCTOBER 2011 QUARTERLY NEWSLETTER

TEETER-TOTTER TIME

Germany's Merkel



France's Sarkozy



JOEL FRAMSON &
ERIC BRUCK,
PRINCIPALS

Since our most recent letter that we distributed shortly after the third quarter ended, we have observed continued volatility in the equity markets and in most risk assets. This will be a much shorter letter and is intended to bring our clients up to date and to accompany our third quarter performance reports.



An Invitation to *Women's Circle*

Women's Circle provides an opportunity for women to talk, learn, and share about money.

We will explore the powerful money questions with other women in a confidential and supportive environment. Let's talk to each other about what truly matters to us and learn the best from sharing our own stories and experiences!

When: 5:15pm - 7:00 pm

Last Tuesday of each month

Where: 10866 Wilshire Blvd, Suite 1270. Los Angeles, CA 90024

Refreshment will be served. Please RSVP at 310.207.4800 or email to lcao@silveroakwa.com

Silver Oak Wealth Advisors, LLC
10866 Wilshire Blvd., Ste 1270

Los Angeles, CA 90024

Phone: (310) 207-4800

Fax: (310) 943-0398

www.SilverOakwa.com

The Chart below displays the stock market gyrations for three different stock market indices over the past 30 days as the third quarter ended and the 4th quarter began. The **brown** line reflects the S&P 500, the **blue** line indicates large company foreign developed markets stocks as represented by the EAFE index, and the somewhat more volatile **orange** line reflects the emerging market stock index.



Notice two aspects in this chart. First, all three indices are more or less moving in the same direction over this 30 day period. Second, notice how the lines converge almost on top of each other over the last few trading sessions.

While there is never just one factor that causes such volatility, our interpretation of current events brings us to focus on one primary protagonist – Europe. Every market around the globe has tuned into the daily discussions, meetings, and deliberations happening in Europe. On days when the news emanating from discussions between German Chancellor Merkel and French President Sarkozy are cordial and appear to be leading to positive economic results, the markets all rise in tandem. Too often, however, the news headlines point out the frictions developing between the ideologies and politics of these two world leaders (not to mention raising doubts regarding the efficacy of any real solution to the problems), causing the markets to decline.

Not that we want to oversimplify the serious nature of the work needing to be done in Europe, but we also

can't help ourselves. As we see it, the world economy is teetering. The European leaders need to create a viable plan to accomplish a number of objectives including:

1. How do deal with debt issued by Greece that is approaching becoming worthless.
2. The high debt levels of Italy, Spain, Ireland, and a number of other countries.
3. Since the major European banks all own significant bonds in these countries that are bordering on becoming insolvent if these sovereign bonds are written down to their actual values, can countries agree to contribute enough in Billions of Euros to stabilize their banks.
4. Concurrent with these issues, Europe is on the verge of a recession.

While the fundamentals of the U.S. economy are showing some positive signs, it is quite likely that a European recession would get imported to our shores causing at best a slowdown in our GDP growth, or at worst another domestic recession.

IMPLICATIONS FOR PORTFOLIO DESIGN

Planning portfolio construction in a world environment whose landscape changes as fast as a Hollywood movie set backdrop poses immense challenges. As Europe debates building a large stabilization fund designed to support the capital requirements of their key banks, the tensions have been mounting between the leaders of Germany, France, and Italy. For example, as highlighted in a Wall Street Journal article, Italy's Berlusconi issued a statement saying, "No one in the Union can appoint themselves as administrator and speak in the name of governments elected by and made of the people of Europe."

It is important to remember that Europe's "union" is only a monetary union fused together by their common currency and presided over by a European Central Bank that relies on each member country for funding. They lack a political union. There is no central elected body to enforce the economic policy requirements placed on each member.

During this week and extending into November, European leaders will attempt to create a unified economic policy to solve their member nations and banks debt problems. Any agreement will need sufficient incentives and consequences to convince the world that the Euro zone countries and their sovereign debt remain stable. Additionally, they need significant monetary contributions, possibly an additional \$1 Trillion Euros, to recapitalize their banks. This is all required concurrent with the backdrop of signs of an economic slowdown in every country other than Germany.

While the graph in Chart 1 depicts the positively correlated movements of three equity asset classes, we have observed several other asset classes moving in tandem. They rise on optimism about a solution to Europe's debt crisis and fall in times of heightened fear. Domestic stocks, for example, have moved in tandem with Treasury yields. In terms of gold which should move opposite to the strength of the dollar, we have observed it also moving in concert with the strength of the dollar.

MACRO ECONOMIC SCENARIO MODELING

In our efforts to better control portfolio risk, we have added a new software tool to assist us in modeling macro economic scenarios to determine the impact on various investments. We believe that the single factor moving all markets over the next few weeks will be the success or failure of the Euro-zone leaders. To the extent that they are not able to rise above their individual political pressures and begin to convince the world that the Euro has continuing viability, we expect to see a stronger dollar than we have seen in years. However, if they succeed and the Euro strengthens, a completely different set of asset classes will benefit.

Complicating this picture further, there is growing anticipation of additional liquidity being forced into our monetary system by the Fed – a possible QE3, as this series of quantitative easing has been dubbed. A likely outcome of such a move will be a weakening of the US dollar. In the meantime, we have made some signifi-

cant adjustments in each of our asset allocation "buckets" to anticipate the possible outcomes from these talks. We feel that since each outcome has a certain probability of occurring, we need to include a number of asset classes in our portfolio models that will perform well under a range of probabilities.

We know that this continues to be an unsettling period for many of our clients. Our efforts in buying and selling various positions are focused on creating stability and growth in your portfolios. At any time should you have questions about our thinking or desire an explanation of why we made a specific trade, we encourage you to call us to chat. We are eager to hear your concerns, and equally eager to share our thinking and perspective.

Sincerely,

Joel Framson

President