

JUNE CLIENT INVESTMENT REVIEW

GOLD OUTSHINES BOND YIELDS AS DEFLATION LOOMS

Question: How prepared are most investors and regulators for deflation? *Answer:* Barely. Bloated balance sheets have left governments with little flexibility — and 10-year government bond yields in Japan (1.07%), Germany (2.57%), Switzerland (1.46%), and Sweden (2.66%) show that US bond yields have plenty of room to decline.

Historically, while the bull market in bonds started in late 1981, it was only a year ago that deleveraging entered the cycle. According to McKinsey Global Institute, deleveraging has followed all financial crises, lasting 4-7 years on average. This time, though, the crisis's global nature will prolong US instability, postponing the cycle as governments continue to adopt liquidity-driven policies prescribing more debt. The problems are strictly structural: solvency, with misleading accounting masking conditions that will force the politics of austerity. Governments — so lacking in decision-making up until now — will be forced into fiscal-belt tightening, higher taxes, and consumer retrenchment.

All this is tied to US real GDP, marked down again for the first quarter to 2.7% despite expectations that 70% of the \$850 billion of fiscal stimulus will have been implemented by summer's end — and with little to show for it. Entitlement programs (Social Security, Medicare, and Medicaid) along with interest and debt service on public debt amount to 65% of government spending (88% if you add in defense) — and none of it easy to reverse. Tax increases tied to the growth decline in GDP are of course inevitable. That, coupled with a lack of labor mobility (home valuations), and excess capacity all imply one thing: deflationary pressure dominating over the next few years.

In June, the financial markets' gross performance shown below (unadjusted for taxes, risk or inflation/deflation) continued reacting to the advent of deflation. The bright spot was, of course, gold, which continued to out-perform all sectors for both month and year-to-date. Meanwhile, bond yields, led by US Treasuries, edged lower while the stock market ended its worst month and quarter since late 2008.

Total Return	June 2010	YTD
DJIA	-3.42	-4.98
S&P 500	-5.23	-6.64
NASDAQ Composite	-6.49	-6.61
BCGC*	1.80	5.49
BCMB*	0.06	3.31
COMEX Gold Spot \$/oz. (% chg.)	2.14	13.25

*BCGC: Barclays Capital Government/Credit Index, BCMB: Barclays Capital Municipal Bond Index

TAXABLES

US Treasuries were resilient in June, with demand rising significantly, along with the flare-up in sovereign debt; borrowing costs soared across all of Europe, putting pressure on US corporations as well. Credit sectors unilaterally retrenched as signs of credit stress again arose everywhere. US Treasury bond prices jumped as yields fell. The 10-year note yielded 2.95% at quarter-end, down from 3.29% a month ago and 3.84% at the start of it. The two-year note yielded 0.62% at month-end, down from 0.77% a month ago and down from 1.03% at the start of the quarter. These interest-rate changes have flattened the yield curve as the 2-10 year spread differential has dropped from 281 basis points at the outset of the quarter to close out June at a spread of 233 basis points. This occurred despite a flood of new Treasury supply throughout the quarter, totaling some \$300 billion in new debt.

Performance of various taxable fixed-income sectors was also very positive, as shown in the table below. However, we continue to point out that they share a common element with interest rates at current levels. The dominant variable of total return is price; of course, this is further accentuated by the shortness of a monthly timeframe. During the month, we added to US Treasuries and extended maturities where possible. Considering our outlook on deflation and the positive yield curve, we will continue to favor Treasuries and seek opportunities, particularly those with the longest possible maturities permitted by client investment guidelines in each of our product strategies.

Barclays Taxable Indices	Price (%)	Coupon (%)	Tot. Ret. 6/10 (%)
Aggregate	1.27	0.30	1.57
Government/Credit	1.48	0.32	1.80
US Governments	1.46	0.25	1.71
US Treasuries	1.61	0.24	1.86
US Agencies	0.85	0.26	1.11
TIPS	1.26	0.16	1.43
Credit	1.52	0.44	1.96
Corporate	1.67	0.46	2.13
Credit Aaa	0.99	0.27	1.26
Credit Baa	1.44	0.50	1.94

GOLD

Commodity-wise, gold distinguished itself last month, not only within the precious metal sector but also within the broader grouping of commodities overall. As shown under Market Highlights on the next page, gold enjoyed greater acceptance as a reserve currency, as demonstrated by its superior performance (gaining 2.14%) relative to the CRB Commodity Index (up just 1.46% for the month). Late in the month, it achieved a new nominal high, unadjusted-for-inflation, of \$1,267/oz. We continue with gold as one of our ongoing recommendations for portfolio allocations.

TAX-EXEMPT/MUNICIPALS

Municipals unadjusted for taxes underperformed Treasuries in June, a casualty of the already-mentioned flight to quality brought on by the European sovereign crisis and deteriorating US economic reports. Mutual fund flows have slowed and retail investors have been bombarded by negative municipal credit stories and widening spreads, especially for longer maturities. Issuance plunged in response to the market turmoil, with total volume down 30.4% for the month (\$30.5 billion vs. \$43.8 billion in 2009). Tax-exempt issuance fell 44.7% to \$19.5 billion from \$35.3 billion last year. YTD issuance is now only 1.8% higher than 2009 (\$200.1 billion vs. \$196.55 billion), with tax-exempts down 21.7% \$132.9 billion from \$169.8 billion.

Consistent with the June flight to quality, California underperformed for the month, reversing the YTD trend. The New York index outperformed slightly for the month, quarter, and YTD. Additionally, AAA credits outperformed BBB, and the 5- and 10-year maturities sector outperformed the rest of the curve. In this environment, vital service revenue issues continue to remain the most attractive area of the municipal market as the demand for tax-free income increases, driven by rising tax expectations at all levels of government.

Barclays Tax-Exempt Indices	Price (%)	Coupon (%)	Tot. Ret. 6/10 (%)
Municipal Aggregate Bond	-0.32	0.38	0.06
5-Yr. Municipal	-0.05	0.36	0.31
10-Yr. Municipal	-0.06	0.37	0.31
20-Yr. Municipal	-0.65	0.39	-0.25
Aaa-Rated	-0.16	0.36	0.20
Baa-Rated	-0.72	0.43	-0.29
California-Exempt	-0.56	0.39	-0.17
New York-Exempt	-0.23	0.38	0.15

OUTLOOK

Just as we suspected: the most important driver of bond yields isn't the supply of bonds — it's the direction in which inflation is moving. Contrary to popular thought, the yield curve is normalizing in our opinion, with falling long-term rates as opposed to rising short-term ones. The dovishness of the Federal Reserve's press statement on June 23 implied a prolonged near-zero-rate policy, treating cash as little more than a tactical asset.

This is what makes capital preservation strategies with low correlation to the equity market so vital. To successfully preserve capital, you need income, and a core holding of gold (wherever guidelines permit) to be able to achieve that in a deflationary market. It certainly leaves little cause for US bullishness when it comes to equity prospects.

Our deflation playbook of liquidity, income and risk management (as opposed to asset allocation) continues to drive the makeup of our portfolios. Since risk management drives balance-sheet research, supporting income production must be the focus of our playbook. In a year of unusually disparate economic forecasts, we've observed a flattening of the bell

curve and a widening of the statistical tails of error. This has led to the observation that once-rare "black swans" now seem to be coming in flocks.

What does this mean for you? Simply to watch your step. Not all consensus opinions lead to greater performance. There are many bond firms, but not all are created equal. Consider the more popular consensus versions — about inflation, a weak-dollar, 10-year interest rates of 5% or better by year-end, and the optimism for emerging markets and sovereign debt — none of which we supported. It's one of the reasons we outperformed our peers in 2010, and why we're so confident in our outlook assessment calling for a deflation playbook to succeed.

MARKET HIGHLIGHTS*

Foreign Money & Bond Markets	5/31/10	6/30/10	US \$ Tot. Ret. (%)
3-mo. LIBOR BP Fixing	0.71063	0.73031	N/A
ML UK Gilt 10+ Index	4.15	4.01	5.18
3-mo. LIBOR Yen Fixing	0.24563	0.24438	N/A
ML Japanese 10+ Index	1.85	1.64	6.15
Currencies	% Change		
British Pound (US \$ per pound)	1.4538	1.4945	2.80
Japanese Yen (yen per US \$)	91.26	88.43	-3.10
Euro (US \$ per euro)	1.2306	1.2238	-0.55
Commodities			
Gold Comex Spot (\$ per oz.)	1,216.20	1,242.25	2.14
CRB Future Com Pr. Index	254.80	258.52	1.46
W. Tex. Int. Crude (\$ per bbl)	73.97	73.97	0.00
Equities	US \$ Tot. Ret. (%)		
S&P 500	1,089.41	1,030.71	-3.42
DJIA w/ Income	10,137.00	9,774.00	-5.23
NASDAQ	2,257.04	2,109.24	-6.49
NIKKEI (TOKYO)	9,768.70	9,382.64	-1.14

*Source: Bloomberg

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