

## AFGHAN SURGE, DUBAI, AND NEGATIVE INTEREST RATES

November was another volatile month, with significant off-year electoral messages for the current Administration as it prepares for the 2010 mid-term elections. While attempting to address the financial recession with a variety of fiscal stimuli, a mountain of ambitious legislative initiatives in healthcare, emissions, financial regulatory reform, and an Afghan surge are also in play. Searching for government solutions to all of these business/economic problems is ironic, especially in light of the recent Chapter 9 bankruptcy filing of the New York City Off-Track Betting Corporation (NYC OTB). Most signs of economic improvement during the month were not organic but a function of globally coordinated stimulus efforts.

This stimulus washing through the system has benefitted the financial industry by enabling carry trades emanating from the US. This has created asset and currency valuation problems globally. Acknowledgment of these problems is evidenced by exchange controls and tightened tariff regulations being imposed and accepted by the IMF and the World Bank. None of this is expansive for global trade and has helped to foster the rise in the price of gold in all currencies, not just the dollar. As the Renminbi (China) is tied to the US dollar, the rest of Asia, Europe, and Brazil have had to deal with an unfavorable strengthening of their currencies as the US dollar weakened.

Near month-end, it was announced that the state-controlled Dubai World was seeking to reschedule payments on some \$20 billion of debt. This is a tripwire of vulnerability for the European Economic Community (EEC). The euro currency is supported solely by the concept of implied sister-country credit support and has been exploited by the Portuguese, Greek, Italian, Spanish, and UK debt-level exposures. Dubai and the arm's-length posturing of Abu Dhabi to Dubai are, of course, analogous to the weak versus hard countries within the euro; i.e., Germany and Scandinavia versus the above-mentioned nations.

As shown below, November was marked again by the rising price of gold, which had its best monthly performance in a decade. While all financial sectors were positive last month, we have continued to focus on the year-to-date and the 12-month numbers to keep perspective on the changing trends among sectors.

	NOV. 2009	YTD	12 MOS.
<b>Total Return</b>			
DJIA	6.92	21.54	21.06
S&P 500	6.00	24.08	25.38
NASDAQ Composite	5.05	37.30	41.13
BCGC	1.35	6.41	11.22
BCMB	0.83	12.53	14.17
% chg. COMEX Gold Spot \$ per oz.	12.84	33.73	44.20

## TAXABLES

Since July, every Treasury offering (including \$44 billion this past month) has been over-subscribed, regardless of whether it was a new or reopened issue. This can be seen in the bid-to-cover ratio, running close to three-to-one or better as well as the indirect bidder percentages, a proxy for foreign participation, averaging 45-60% of each issue. In our view, this results from the national deleveraging demonstrated in the Federal Reserve's Flow of Funds statistics. The current third quarter report will be released on December 10. Curve-wise, yields at the short and long end remained the same, with a yield spread of 414 basis points. However, the largest declines were in the 3-7 year maturities, which dropped almost 30 basis points (bps).

Led by TIPS, Treasuries were the strongest performing sector among the total returns shown below. These returns were followed by the credit sectors, most especially the lowest investment-grade sector: BAA. Within the BAA quality bucket, utilities and industrials have continued to be very strong groups as sector yield spreads over US Treasuries have narrowed sharply. We continue to look for corporate opportunity in the utility and Canadian banking sectors as well as refraining from the US broad financial sectors. This is so because the balance-sheet transparency required to make appropriate credit-risk assessments is sorely lacking. We continue to favor Build America Bonds (BABs) from large issuers of vital services as well as general obligation bonds (GOs). We remain willing to assume duration risk in all product lines as we approach the new year, with a view that deflation is the greater risk, and if the Federal Reserve should disagree, short rates remain far more exposed to price risk than long rates, starting with a two-year yielding 0.89%.

Barclays Taxable Indices	PRICE (%)	CPN (%)	TOT. RET. 11/09 (%)
Aggregate	0.96	0.33	1.29
Government/Credit	1.01	0.34	1.35
US Governments	1.01	0.26	1.28
US Treasuries	1.13	0.26	1.39
US Agencies	0.68	0.27	0.95
TIPS	2.61	0.17	2.78
Credit	1.01	0.46	1.47
Corporate	0.96	0.47	1.43
Credit Aaa	0.98	0.29	1.26
Credit Baa	1.41	0.52	1.93

## TAX-EXEMPT/MUNICIPALS

While the slope of the overall municipal yield curve from short to long steepened somewhat, the short intermediate area (3-7 years) rallied 30 bps on average. When this is coupled with the sell-off in Treasuries of these same maturities, municipal yields as a percentage of Treasuries have now completely returned to their pre-crisis relationship of approximately 80% for these maturities.

As shown below, New York out-performed both the national as well as California indices, which merely represents the relative image of more functional government. Maturity-wise, 5 years out to 12 years out-performed the other maturity sectors.

As money has poured into mutual funds, the demand has surged for lower-rated housing and hospital issues. This should not continue. In short-duration accounts, a need to roll out to the longer maturities is in order, particularly with sensitivity to rising Fed rates having a much heavier impact on the front part of the yield curve.

Barclays Tax-Exempt Indices	PRICE (%)	CPN (%)	TOT. RET. 11/09 (%)
Municipal Bond	0.44	0.39	0.83
10-Year Municipal	1.17	0.38	1.55
California Exempt	-0.19	0.39	0.20
New York Exempt	0.72	0.39	1.10

## OUTLOOK

As we approach the new year, we believe the unmasking of insolvency will be the largest risk in global finance. Signs of this have been Dubai World and the 130<sup>th</sup> bank closing by the Federal Deposit Insurance Corp. (FDIC), with no respite in sight. This is a global problem, as discussed above. The decline of the sovereign credits of Greece, Spain, Italy, and Belgium, to name a few, may well challenge the euro's strength at its current levels. More importantly, currency diversification also will be challenged. Playing defense in 2010 will be the only successful investor playbook. This is so as private-sector deleveraging continues, especially in the consumer sector, and joblessness remains high (we have had job losses now for 23 consecutive months). In addition, the new Afghan surge must be paid for, and the major legislative rearranging of more than 40% of the economy (healthcare, finance, and autos) in an election year will not be a recipe for capital expenditures by corporations.

As such, a return to a higher Treasury emphasis, along with gold, is in order. Maturity for short to intermediate accounts will be barbelled whereas core portfolios will be focused on the 20-year part of the curve.

Corporates remain more attractive than mortgages, particularly in areas such as mining, metals, forest products and paper, and consumer goods. In municipals, we will remain true to ongoing emphasis on vital-service revenue issues and look to upgrade credits where possible. Our maturity emphasis remains in the long intermediate part of the curve (15 to 20 years). An anticipated rising tax environment, coupled with the decline of tax-free municipal issuance because of BABs, augurs a good ongoing demand-favored environment. This will go a long way to offset the credit environment that municipals face going forward.

## MARKET HIGHLIGHTS\*

Foreign Money & Bond Markets	10/31/09	11/30/09	US \$ Tot. Ret. (%)
3-mo. LIBOR BP Fixing	0.59125	0.61188	N/A
ML UK Gilt 10+ Index	4.04	3.99	0.63
3-mo. LIBOR Yen Fixing	0.32563	0.29875	N/A
ML Japanese 10+ Index	1.97	1.80	6.81
Currencies	% Change		
British Pound (US \$ per pound)	1.6453	1.6440	-0.08
Japanese Yen (yen per US \$)	90.09	86.41	-4.09
Euro (US \$ per euro)	1.4719	1.5005	1.94
Commodities			
Gold Comex Spot (\$ per oz.)	1,045.40	1,179.60	12.84
CRB Future Com Pr. Index	270.38	277.40	2.60
W. Tex. Int. Crude (\$ per bbl)	77.00	77.28	0.36
Equities	US \$ Tot. Ret. (%)		
S&P 500	1,036.19	1,095.63	6.00
DJIA w/ Income	9,713.00	10,345.00	6.92
NASDAQ	2,045.11	2,144.60	5.05
NIKKEI (TOKYO)	10,034.74	9,345.55	-2.88

\*Source: Bloomberg

Disclaimer: This publication contains the current opinions of the manager and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This publication is distributed for education purposes only. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Forecasts are based on propriety research and should not be interpreted as an offer or solicitation, nor the purchase or sale of any financial instrument. No part of this publication may be reproduced in any form, or referred to in any publication, without the express written permission of Smith Affiliated Capital Corp.

Smith Affiliated Capital:  
800 Third Avenue, New York, NY 10022  
TEL: 212-644-9440 FAX: 212-644-1979  
www.smithcapital.com