

## ECONOMIC HALLOWEEN

Zombie banks are merely taking deposits but making no loans. The death toll at the FDIC mortuary has now reached 115 banks for the year to date. Personal income has declined 0.2%; consumer spending fell 0.5%; and the savings rate rose to 3.3% vs. 2.8% in September. When this is coupled with the continued high unemployment rate, it pretty much negates holiday season expectations. The 3Q09 gross domestic product (GDP) mirage of 3.5% was mostly full of tricks and no treats. This was a response to the auto cash for clunkers, the housing first-time buyer credit, inventory re-building, and the use of savings to participate in the government programs. Clearly, things are not what they appear to be. The waning stimulus will run its course and contraction will occur in the fourth quarter, with stagnation worsening in the first half of next year.

Internationally, surging violence in Pakistan and the worst-ever month-end death toll (59 US soldiers; 76 total for the coalition) in October in Afghanistan highlights the indecision of the Administration. Gubernatorial election results in New Jersey and Virginia indicate clear shifts from blue to red, reflecting all of the conditions discussed above.

Led by the rising price of gold, October also marked the first month of decline for the S&P 500 since February. Again, as shown below, the longer 12-month picture is important for perspective as emphasis continues to shift among sectors.

Total Return	OCT. 2009	YTD	12 MOS.
DJIA	0.14	13.68	7.72
S&P 500	-1.86	17.06	9.80
NASDAQ Composite	-3.61	30.70	20.09
BCGC	0.24	4.99	14.60
BCMB	-2.10	11.61	13.60
% chg. COMEX Gold Spot \$ per oz.	3.70	18.50	44.30

## TAXABLES

Many different visions of the future exist because of the concern over the Administration's ballooning deficit. The heavily over-subscribed auctions of \$123 billion of Treasury debt last week and the rise in the price of gold, closing at \$1,045/oz. at month-end (now higher), would indicate deliberate asset-allocation decisions being made to increase portfolio protection. The demand for Treasuries has come from US households, foreign central banks, and domestic commercial banks. The foreign participation also has served to strengthen the dollar, somewhat offsetting its longer secular downward trend. It is important to remember that up until the recent financial crisis, almost no Treasury securities were held by US households, banks, insurance companies, and pension funds. In an era of private sector deleveraging, which creates a decline in income-producing assets, all of the above buyers must gravitate to the sector, creating income-producing assets to satisfy their operating portfolio needs.

The Treasury yield curve became more positive during the month, with the 30-year maturity rising 18 bps and the 3-month T-bill declining 6 bps. The rest of the curve registered minimal change. As shown below, sector performance during the month was led by US Treasury Inflation-Protected Securities (TIPS), followed by corporates, with nominal US Treasuries getting the poorest results.

Our portfolio investment activity during the month consisted of adding longer maturity Treasuries, and, where permissible, significantly and opportunistically adding to our gold-sector allocation and to taxable municipals – mostly BABs (Build America Bonds).

Barclays Taxable Indices	PRICE (%)	CPN (%)	TOT. RET. 10/09 (%)
Aggregate	0.14	0.35	0.49
Government/Credit	-0.11	0.35	0.24
US Governments	-0.26	0.27	0.02
US Treasuries	-0.32	0.27	-0.05
US Agencies	-0.08	0.28	0.20
TIPS	1.05	0.18	1.23
Credit	0.12	0.46	0.58
Corporate	0.23	0.47	0.70
Credit Aaa	-0.02	0.29	0.27
Credit Baa	0.09	0.52	0.61

## TAX-EXEMPT/MUNICIPALS

In October, municipal curves steepened; spreads widened and yields rose as supply increased; bond-fund inflows slowed; and dealer desks cut back capital commitment in anticipation of year-end. In spite of continued long-duration taxable BAB issuance, the longer maturity sector of the tax-exempt market performed the worst in price terms, while large new issues required substantial discounts to get placed. Municipal new issuance increased 93% in October (\$42.3 billion vs. \$21.9 billion), when compared to last year at the height of the credit crisis. Taxable new issues made up almost 37% of the total – a record \$15.6 billion. Refundings also surged over 115% to \$8.4 billion YTD volume is now only down 3.3% (\$331.6 billion vs. \$342.8 billion), and will most likely exceed 2008 by year-end.

The California index under-performed the national index as multibillion-dollar deals came to market, longer duration took its toll, and credit spreads widened – while New York performed in line. YTD however, all three indices are within 20 basis points of each other. The main area of value now remains with vital service revenue issues in the long intermediate part of the yield curve (15-20 years), where we continue to add to our portfolios, primarily with new issues.

Barclays Tax-Exempt Indices	PRICE (%)	CPN (%)	TOT. RET. 10/09 (%)
Municipal Bond	-2.48	0.38	-2.10
10-Year Municipal	-2.83	0.37	-2.46
California Exempt	-3.34	0.38	-2.96
New York Exempt	-2.48	0.38	-2.10

## OUTLOOK

There are many potentially disastrous things on the US economic radar that point to a “Japan-ization” of our environment: dysfunctional government at every level, where “change we can believe in” has morphed into the status quo; the rise of the US carry-trade, weakening the long-term outlook for the dollar; an inability to service old debt or incur new debt without facing heavy high-yield refinancing cycles; and the high level of toxic (bad) debt off balance sheet in all major financial institutions. Then, there is a commercial real estate fiasco that is just getting started. Unemployment is rising; consumers, unable to consume, are hoarding their savings. The rising sea of debt in Japan has fostered deflation and talk of an eventual sovereign debt crisis. While our government debt-to-GDP ratio is approaching 100%, Japan’s is close to 200% of its GDP.

All of the above is forcing investors to allocate assets and construct portfolios around future risk with much less reliance on past experience. This is because there are now so many more potentially severe events. In the past, these were referred to statistically as “fat tails”, or outlier events, which created severe volatility and big economic swings. The increasing frequency of these events now has radically changed outlooks and expectations. This has been the theme of our monthly asset-allocation analysis research, which is available via e-mail and on our website. We have

endeavored to seek permission for a gold allocation in all of our portfolios over the past two years. We continue to be most positive on the important role of gold in portfolio protection.

Our equity market outlook remains very cautious, and we have continued to reduce positions other than in gold miners. The outlook for the economy in the ensuing three quarters is for a reduction in growth from the 3.5% 3Q09 real GDP growth as the federal stimulus programs are removed. Our interest-rate outlook continues to be for further downward pressure on long rates as high “real” rates will restrain growth, wages, and jobs. High quality income streams continue to be the offense for both taxable and tax-free investors. The Treasury sector should continue to be most important as will vital service municipal revenue issues. In all strategies, maturity will continue to be the best risk to assume as opposed to credit risk, particularly now with the return to more normal yield spread relationships everywhere.

## MARKET HIGHLIGHTS\*

Foreign Money & Bond Markets	9/30/09	10/31/09	US \$ Tot. Ret. (%)
3-mo. LIBOR BP Fixing	0.54188	0.59125	N/A
ML UK Gilt 10+ Index	3.98	4.04	2.48
3-mo. LIBOR Yen Fixing	0.352125	0.32563	N/A
ML Japanese 10+ Index	1.89	1.97	-1.91
Currencies	% Change		
British Pound (US \$ per pound)	1.5982	1.6453	2.95
Japanese Yen (yen per US \$)	89.70499	90.09	0.43
Euro (US \$ per euro)	1.464044	1.4719	0.54
Commodities			
Gold Comex Spot (\$ per oz.)	1,007.70	1,045.40	3.74
CRB Future Com Pr. Index	259.39	270.38	4.24
W. Tex. Int. Crude (\$ per bbl)	70.61	77.00	9.05
Equities	US \$ Tot. Ret. (%)		
S&P 500	1,057.08	1,036.19	-1.86
DJIA w/ Income	9,712.00	9,713.00	0.14
NASDAQ	2,122.42	2,045.11	-3.61
NIKKEI (TOKYO)	10,133.23	10,034.74	-1.32

\*Source: Bloomberg

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