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QUARTERLY UPDATE

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BOND INVESTORS

Gold has captured everyone's imagination as it climbs to record highs. One could argue that gold has become the latest bond substitute – the safe haven and ultimate hedge against the disappearing dollar. But, never mind that gold pays no interest – the paltry rates from bonds are not sufficiently appealing to attract gold bug money. There are, of course fundamental reasons for soaring gold prices, the primary one being deliberate central bank monetary depreciation, happening globally, not just in the U.S. If the current stock of gold held worldwide were exchanged for all the outstanding paper money, it is estimated that it would sell for close to \$4,000 per ounce. No wonder investors are clamoring to buy gold.

But, don't hold your breath on gold becoming a medium of exchange (other than as a bartering asset in private transactions). Individuals haven't been able to exchange dollars for gold since 1933 (foreign governments since 1971). The main reason for this sanction is that a gold standard precludes fiat money (the creation of dollars out of thin air). Government wants fiat money which has no precious metal or other intrinsic asset collateral backing because a lot more money can be borrowed, created and spent on pet projects. Government debt is then paid back in depreciated dollars. This inflation of the money supply always hurts savers while benefiting debtors, and government is the biggest debtor. A gold standard imposes fiscal discipline on government by removing the ability to pay back debt in cheaper, inflated 'fiat' dollars. The unprecedented gush of stimulus and bailout activity is a shocking reminder of unbridled government profligacy – the inflation process incarnate – hence the mad scramble to own gold and other real (store of value) assets.

Gold's rise is similar to oil last year when it spiked to \$147 per barrel, now \$72 per barrel, a 49% decline. Given irresponsible money creation, higher gold prices are warranted, however, investor psychology has pushed the price beyond fundamentals. The gold frenzy is further fueled by headlines proclaiming that the global gold supply is dwindling (the same argument heard about oil). Currently, over 97% of futures traders are bullish on gold – the highest reading since 1987. Even though gold is ahead of itself (pushed too high by investor psychology), we have, over the past year steadily increased real asset allocations (primarily in dividend paying commodities). Gold could also be added to portfolios following at least a modest correction in price.

It's a total mystery how the price of gold can continue climbing without negatively impacting bonds (normally bond prices fall when gold rises). The only logical reason must be that the Federal Reserve's massive \$2 trillion bond buying

program is propping up bond demand, which of course keeps prices high and yields low. Watch for bond prices to begin coming down (yields rising) as this bond buying operation winds down in 2010. As we have been saying for quite some time – avoid long maturities and take advantage of the still wide yield spread offered by corporate and prime mortgage notes – deflation will continue to play out for awhile until the global economy gets traction. When that happens, interest rates will have to go higher – hence the reason to maintain shorter maturities.

STOCK INVESTORS

It has been a strange year for the stock market – financial news regardless of content is viewed in the most positive light. Selling at 23 times earnings, the market P/E (price to earnings) ratio is historically on the high side. The market seems to be pricing next year's GDP growth at over 5% - very unlikely given the continuing deflationary trends still in place. We are emphasizing (and exercising) caution, making sure portfolios have a more conservative asset allocation and absolute return style hedge (where possible) to protect against the downside.

The forces driving stocks higher this year are: 1) better earnings from extreme cost cutting (one of the reasons unemployment is so high), 2) accommodative interest rates (a Federal Reserve Fund rate near zero), 3) excess liquidity – a literal mountain of cash on the sidelines and 4) investor fear of being 'left at the station' as the perceived bull market train pulls out. Investors are clearly tired of getting zero interest on money market accounts and are seeking other alternatives. Certainly, stocks yielding relatively juicy 2% to 5% dividends are an appealing choice. There is also a desire for stability after experiencing the harsh downdraft of 2008, and blue chip, dividend paying stocks, in particular are perceived as offering that stability.

The S&P 500 Index has soared some 61% off its low of March 9, 2009. Today's market has priced in vigorous growth going forward. Valuations reflect robust earnings from top line revenue growth, not just cost cutting (which is about over). Given the unrelenting poor economic fundamentals, this bounce is looking more like a bear market rally rather than a new, longer lasting bull market. Never before has a true bull market been sustained with high and rising unemployment, an almost complete lack of credit to the private sector and deflating wages, real estate values and rents. True, third quarter GDP grew almost 3%, an impressive improvement from the previous quarterly negatives (the prior 4 quarters averaged -2.9%) but look 'under the blanket'. There were significant inventory liquidations in the third quarter, adding almost a third of the

3% growth; cash for clunkers added another 45% with the remaining 20% or so delivered by the first-time home buyer credit.

Bottom line, solid, long term fundamentals such as low consumer debt, rising wages, low unemployment and ample credit for business expansion needed to fuel a new bull market are simply not present - yet. The other huge drag on future economic growth as we have mentioned many times is the U.S. debt bomb, counting all government liabilities, almost four times annual GDP! This massive debt bomb is crowding out private sector borrowing and recovery (the real engine of employment and prosperity). It also promises higher interest rates in the not too distant future – not positive for stocks and bonds.

NEW WORLD

Despite the endless remonstrations from many financial 'talking heads', this economy is not back to 'normal' nor has the recession ended. The post credit crisis economy and investment market only vaguely resemble what we have known in the past. The big change is the enormous debt burden created in an effort to save the banks, brokers, insurance companies and selected other 'too big to fail' entities such as GM, Fannie Mae and Freddie Mac. In the last year, federal debt has grown \$4 trillion to about \$7.5 trillion. This does not include FHA / Freddie / Fannie liabilities for insured mortgages (about \$11 trillion). And, don't forget the venerable FDIC that insures some \$6.2 trillion in deposits with only about \$10 billion in assets. If universal healthcare passes, quickly add at least \$1 trillion. Entitlements – Social Security, Medicare and Medicaid already take almost all federal tax revenue, requiring yet more borrowing for defense and the payment of interest on the burgeoning debt. It is no wonder that the Federal Reserve is keeping interest rates at near zero – a literal confiscation from savers to debtors.

In such a highly leveraged economy, the private sector gets squeezed with a rising tax burden and higher interest payments. Then, it gets crowded out of the credit market by government's endless borrowing appetite. This makes economic growth and expansion very difficult. However,

policy makers don't want to 'kill the golden goose' (taxpaying businesses), so they must try to maintain enough credit to assure a certain level of production while making an effort to keep a lid on inflation (meaning that there is a limit as to how much fiat money can be created).

Although the consumer is over leveraged, the good news is that they are working hard to 'tighten their belts' by increasing savings and paying down debt. Energy costs (a big part of everyone's budget) have also come down. For example, significant, new natural gas sources have been discovered, eventually adding to consumer savings and investment. Government must also begin to cut back. Even though the probabilities for government budget cuts are low (given the big spending proclivities of the current leadership in Washington), the massive grass roots voter mindset is demanding a more conservative track. It may take an election or two, but a more limited, responsible government will eventually take shape (and it could last a long time, especially if the boomer echo is on board). Ultimately, it is unlikely that Americans will tolerate a European / Japanese style socialism which has always been rejected in the past. But, it will take time to roll back the big government policies and programs that have been compounding for many years.

In the meantime, we expect a choppy investment environment. Thus, investors should focus on high quality fixed income and equities, real assets (such as commodities and precious metals) and hedging techniques to thrive in a slower growth economy, muted profits and dollar devaluation. And, as suggested before, another 'silver lining' in an otherwise bleak economic environment is the emerging economies, now 30% of global GDP (vs. 24% and 27% for the U.S. and Euro zone). This is a full 10% increase in the emerging market share since 2000. In addition to the American consumer rebound described above, emerging country demand for global goods and services is a huge global growth engine leading the world out of recession. High debt 'developed' countries such as the U.S., Japan and Europe will benefit by instituting more fiscal responsibility.

By: ECA Investment Group, Inc.

FEATURED INVESTMENT MANAGER AND MARKET INDICIES:

	1 Year Ending <u>9/30/09</u>	3 Years Ending <u>9/30/09</u>	5 Years Ending <u>9/30/09</u>	10Years Ending <u>9/30/09</u>
<i>This quarter's featured Investment Manager is :</i> Symons Capital Management (One of ECA's All Cap Value Managers)	-0.9%	2.3%	7.2%	9.5%

STOCK AND BOND MARKET INDICES:

S & P 500 Stock Index	-6.9	-5.4	1.0	-0.2
MSCI EAFE International Index	3.8	-3.1	6.6	2.9
91 Day U.S. T-Bills	0.2	2.3	2.8	2.8
Consumer Price Index	-1.4	2.1	2.6	2.5

OUR SERVICES TO YOU

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