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Halloween Came Early

*Round about the cauldron go;
In the poison'd entrails throw...
For a charm of powerful trouble,
Like a hell-broth boil and bubble.*

Witches, *MacBeth*: Act 4, Scene 1

All Hallows' Eve is a few weeks away, but 2011's Third Quarter already delivered more than enough thrills and chills:

- A debt ceiling debate in the U.S. that solved nothing and served only to undermine confidence in political leadership on either side of the aisle;
- A U.S. credit rating downgrade which, though much lamented, really just acknowledged out loud what had already been tacitly accepted, and thus was not a cascading event for the bond market;
- Unremitting befuddlement among Europe's leaders about 1) how to keep a set of half-broke nations yoked to a set of totally broke nations, 2) how to backstop the gargantuan banks which repeatedly lent to said ne'er-do-wells, 3) how to avoid being remembered for presiding over the demise of the most ambitious currency experiment in history, and 4) how to escape their own citizenries' coming after them with pitchforks and torches for bucking along the butcher's bill for aforementioned efforts 1, 2 and 3;
- Last year's market darlings got trashed (from July-September: US small cap stocks -22%, US mid caps -20%,

foreign emerging markets -23%, high yield bonds -6%).

In short, plenty of tricks. How about the treats?

The pullback was fiercer in some of its details than the major indices painted in broad strokes. This gave us opportunity to build positions in foreign bonds and hard-hit tech, energy, and precious metals stocks at prices we'd been holding out for. Moreover, we were able to exit our Treasury positions when their prices rose to levels that looked likely to deliver negative real yields going forward.

Portfolio improvement is, for us, an incremental and ongoing process, and altogether the Third Quarter helped us accelerate rebalancing and deploy cash we'd been keeping in harbor for just such an environment. Meanwhile, our largest holding, a long-short fund we accumulated throughout the QE2 rally (that bizarre fever dream of unfounded enthusiasm – but sometimes hope springs ephemeral), proved a whopping good offset to the bumps and bruises we took elsewhere in our strategic, long-only core.

On the whole, we feel we've emerged with dinged-up but better portfolios for the long haul. But the Witches are still stirring at their cauldron. What hell-broth's now on the boil?

Europe, to be sure, notwithstanding their fitful stabs at yet another temporary fix; my May 2010 letter (click here: [Europe and the Fattest Tail](#)) still captures our essential outlook there. The U.S. keeps wrestling with legacy issues of the financial crisis, and faces diminishing returns from Federal Reserve gimmickry aimed at dulling the pain. These are familiar and ongoing challenges...

Perhaps less familiar is what this means for China. Faced with stagnation in its two largest export markets, Europe and USA, can it smoothly wind down its own spectacular double bubble in credit and real estate? Can the most ambitious command-and-control mercantilist experiment in history bend without breaking? Stay tuned!