



POTOMAC
STRATEGIC INVESTMENT SYSTEM

CAPITOL MARKET REVIEW

In This Issue: US Stocks Continue Slow Rally...US Bonds Still Flashing Recessionary Yields...Markets Re-Pricing Global Growth...Return of Some Capital Not Return On Capital

At the Close: SPX 1314 US10Y 1.97% Gold \$1657 Oil \$100 Jan 19, 2012

US stocks had another good day. So what. Who made money in stocks last year? Very few funds and investors. 2011 was notable for some of the most legendary investors either closing down their funds, or drastically under-performing their benchmark.

US Treasury securities are at historic lows. So what. Do these yields allow entrepreneurs to access capital? Are mortgages available? Are banks lending? No.

Today, BAC announced better than expected numbers, but Goldman Sachs reported a disappointing quarter. The banking industry, whether its Wall Street banks, the nations leading deposit banks or regional banks, are still struggling to generate returns on capital.

Gold remains high. In spite of near recessionary levels of economic activity, gasoline at the pump is averaging \$3.30. Food prices are down from lofty (inflated,) levels, but many American food budgets are stretched.

For the past six months, investment professionals and economists, (one should never confuse the two,) have been engaged in a re-definition of global risk/reward for currencies, bonds, stocks and derivatives. And this has impacted the real economy as well as financial markets.

This process has either been conducted in a slow, deliberative manner, or in sheer panic. At this point in the process, all the metaphors regarding the US being a safe haven...the best of the worst...have been advanced and discounted.

The movement of assets has been constrained (artificially,) by central banks and sovereigns who fear that de-leveraging in conjunction with unrestricted capital flight, (creating a negative feedback loop,) is far more dangerous to the health of markets, currencies, economies than dramatic moves on any given trading day, or trading week.

As has been noted in previous Capitol Market Report's, fatigue has set-in and the speed with which assets are moving through the global markets has subsided. What we're left with is the following. Ongoing algo and high frequency trades that generate fractional returns, pump liquidity into markets, but make for almost non-existent investment trends.

Here's what markets are saying. Assets come into US markets in the morning as Asia traders end their day and European traders are in the midst of theirs. Then just before lunch when Asia and Europe go offline, volume drops and volatility drops, as just US traders are left to move markets. Even absorbing a higher percentage of global trading/investing assets, (and revenues,) US markets still post anemic volume in anything but the safest trades. With Asia and Europe out of the equation, US stocks ease higher on historically low volume. Retail investors are absent.

In order to understand why this is occurring, politicians must understand the global markets in some macro depth. At any moment in time investment decisions, (and asset valuations,) are based on a *forward looking* discount model. It has long been said that the investment markets reflect, (with decent historical accuracy,) valuations looking six months into the future. In this regard, central bank, (monetary,) and political, (fiscal/tax) policy does have an impact on investor behavior and economic activity; also thought to be about six months in lag time.

However, these are not normal times. Increasingly global investors have concluded that the world's leading central banks have ostensibly swelled their balance sheets and created a series of monetary policies so constrictive that the forward looking discount model of investment markets no longer exists. Put simply, investors don't trust what asset prices are telling them. However, ANY bold action to move markets, to question the control of central banks, (and the leading OECD governments,) is a recipe for investment bankruptcy. So investors are either in cash, or riding a few obvious trends that are well known.

Ultimately, fiscal policy will change. Europe cannot sustain the current impasse. Same with America. Same with Japan. Emerging economies, said to be the engines of growth for global GDP can grow only so much by generating infrastructure within their borders. China, Brazil, India and other emerging economies rely heavily on the US and Eurozone for their growth. If the US is subpar and Europe is in recession, emerging economies must exercise caution expanding their economic base...it's the prudent thing to do.

What most Washingtonians do not understand is that the established European banks, *banks now said to be more insolvent than US banks in the aftermath of the credit crisis here in 2008*, are responsible for 80% of emerging markets finance. In spite of what many in DC might think, the US is *not* the leading lender for most emerging economies. These Eurozone (thinly capitalized) behemoths are facing a crisis. It is having a chilling impact on global GDP.

The World Bank has just released its semi-annual report wherein it reduced global GDP in 2012 to 2.5%. Furthermore, the World Bank also issued a warning as to the overall health of the global financial system. The World Bank finances emerging economies. The IMF finances established economies. Both of these post-war entities are stretched to their limits grappling with the complexities of global economics. Many economists and strategists agree with the view that both the World Bank and IMF lack the requisite capital to stimulate their constituencies.

There are certainly pockets of strength throughout the world. Macro themes regarding infrastructure builds, technology enhancements...the creation of new social orders are evolving. These are strong positives. However, just as the pace and volume of exchanges is lackluster, the momentum in social change is also slowing.

The reality is the valuation models and funding sources for the world's needs are experiencing a crisis in liquidity, solvency, and just as importantly in social will. Increasingly, the world which has expanded so dramatically in the past decade, is now contracting; a function of a reduction in capital and confidence. Global entities, be they monetary or fiscal, are straining to redefine equity investments, debt covenants and social contracts.

Investors have paused awaiting the results of what was originally said to be a cyclical event(s.) What is becoming increasingly clear is that the global change sweeping through the world is secular. Investors traditionally deploy capital based on risk/reward and complex valuation models. However, if investors cannot trust the visibility of markets...the forward looking nature of markets...then they must seek markets that offer the most predictable returns; which is why assets continue to stream into the US.

In a seminal research report issued in the heady days of emerging market expansion, Brown Brothers, Harriman claimed that all major capital inflows are inefficient. In essence, the theory was that all economies reach a point where they can no longer properly allocate capital. (It also said that smaller/developing economies lack the financial infrastructure to efficiently deploy capital and that established economies are better at this.) But the point was when global capital crowds into, markets, dislocations occur which make investment returns difficult to predict. Brown Brothers intimated that risk increased even as traditional measures of risk/reward said otherwise.