KCM'S KOMMENTS—CURRENT NEWSLETTER

KELLY CAPITAL MANAGEMENT, LLC

VOLUME 7 ISSUE 7

SPECIAL EDITION SEPT 2012

1204 Baltimore Pike, Suite 305
Chadds Ford, PA 19317-7374
610 558 1159
jkelly@kcm-invest.com
www.kcm-invest.com

SPECIAL EDITION—PART ONE

We question the long term logic of what our Federal Reserve ("Fed") and the government are doing. It seems way too political. From a basic economics standpoint, buying mortgage backed securities ("MBS") from Fannie and Freddie does not produce jobs. It props up two weak lenders that could be replaced by local banks. Many pundits have wondered if the time has come for government to get out of the real estate business. We see no way that giving Fannie and Freddie money in exchange for their MBS inventory will produce any increase in mortgage lending, construction of new homes, or the jobs that would result from such activity. Maybe mortgage rates go down more from here because there will be more cash to lend? However people are now expected to be able to actually repay their mortgage loans as opposed to before 2009 when *anyone* could get a loan, e.g. "No Doc" loans. Without jobs, how can they do that?

Another point is that the MBS buybacks, coupled with Operation Twist (Fed buying long term, higher coupon government debt and replacing it with lower coupon shorter term debt) will continue. We have seen numbers that reach almost $90 billion a month when both programs are combined. Where does the money come from to buy all this stuff? Washington may want high income earners to pay more taxes and the Fed is bumping up the money supply ("M1" and "M2"). Unfortunately, consumers are not spending much they are "de-levering" by paying down credit card and auto loan debts. Companies are holding on to their cash. Millions of people are out of work but still looking. Many have given up looking for a job. The result is that the velocity of money has fallen to the lowest level since December 31, 1964!

It looks like the USA has joined Europe in some fantasy world that says we can print all the currency we need, growth will come from flooding the lenders with cash, and we can have higher taxes to help pay for what growth-based tax revenues don't. The problem is, inflation will rise dramatically at some point: a la 1970's. That will require higher interest rates, stifle economic recovery, and kill jobs. Since our firm is not the government, we can't fix things. *So what do we do as investors*?

We shall be opportunistic, holding what is "in favor" from both investment/economic analysis and trading standpoints. Right now, the US stock market looks good, followed by institutional real estate, commodities, and lastly, emerging markets. We *are holding* some *gold* in our commodity strategy and just *sold platinum at a profit*. We are not running for cash. As to bonds we favor shorter term debt (except in our "yield strategy") and use funds (closed-end and ETF). We are awaiting the eventual rise in interest rates before we go back into individual bonds (2-12 year maturities) that have realistic coupons, are call protected, and are new issues at par or at a discount. We won't pay over 101 for secondary bond market purchases. *More on the Fed in part two next week!*