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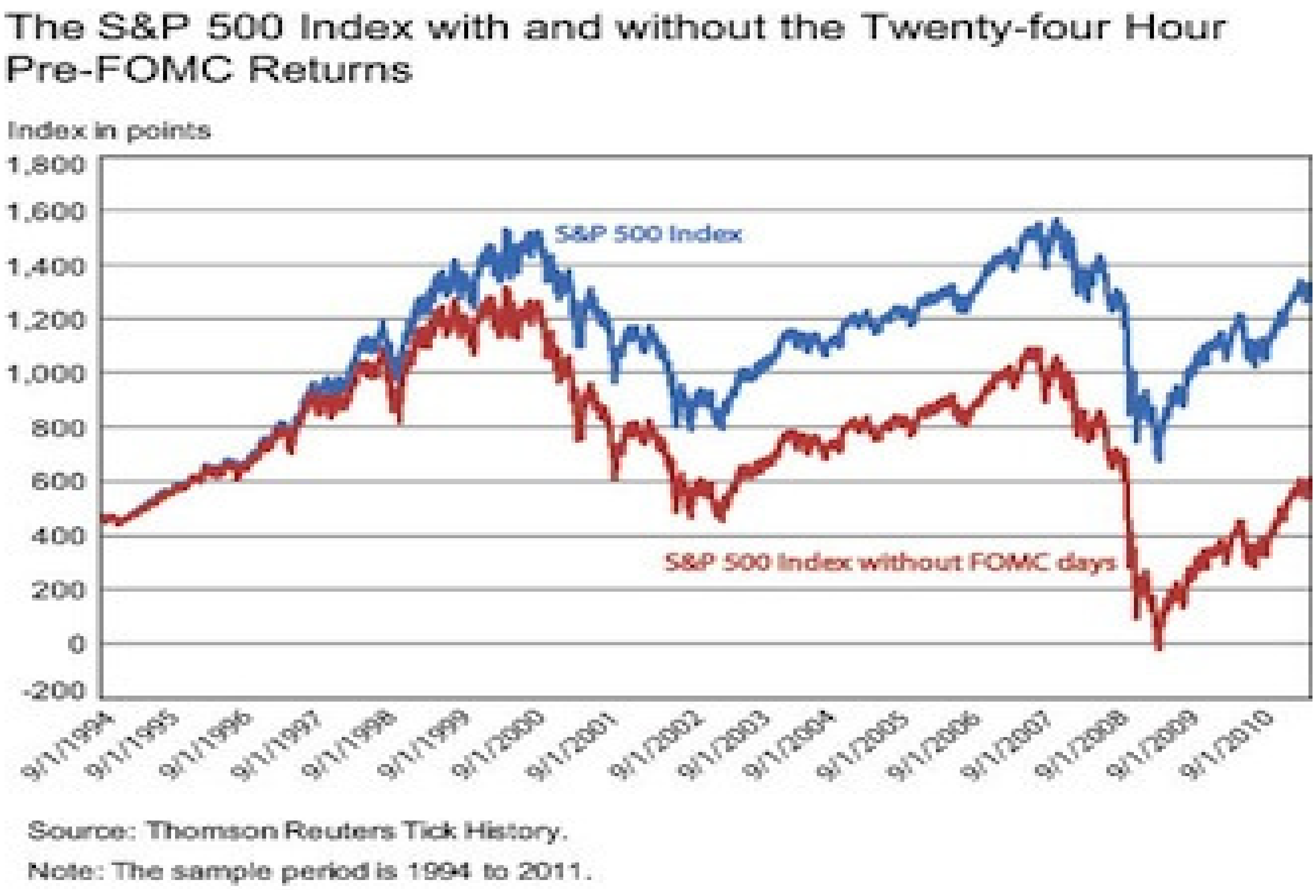
Excerpts from Quarterly Report written by Investment Partners Asset Management – Q2 2012

"…What is *normal*? Is it the *new normal*, the *old normal*, the *present normal*, what? The *old normal* was a constant degradation of the present buying power of a dollar or other denomination of fiat currency. To own an asset was to protect oneself from the near-certainty of inflation. The investor class received dividends, interest, and capital gains; while the poorer classes were protected by welfare and subsidization keeping pace with the rising level of living costs. This was a workable social contract because there was something for everyone, and if it required deficits and future promises to fund it, so be it. Nowadays this contract is under extreme stress. Perpetuating entitlements is becoming un-financable, and back-stopping the investor class is becoming politically unpopular. Domestically voters seemingly despise both factions. What is going to give?

This is the backdrop for the *present normal* – a way station to some *new normal* in which policy leaders can neither cater to both classes nor hold both classes hostage. For nations whose welfare states are terminal, austerity favors no one, while stimulus only provides a fleeting fix until a next one is needed. The reason why leaders have yet to satisfy both urges is that saving and spending are diametrically opposed human impulses. This is why, at least for the past two years, the market has called the bluff of the economic planners several times. However, hope being what it is, so far buying the dips (particularly in large cap indices, based on anticipation of some investor-friendly future action) is a strategy that has worked. However; without concrete, decisive, and coordinated action from all corners of the globe, soon a rapidly deteriorating fiscal picture in all the major economies (including China) may propel markets to reverse course.

This is the main reason for our reticence in either going *all in* - or *all out*. For in the present normal, holders of securities and assets are no longer really investors, but have been reduced to tactical traders. Precise timing in trading is the order of the day. Most amazingly – the best trades have been made after the worst news; a major bank on the brink, a country cut off from the capital markets, or a tech bellwether missing its earnings guidance by a wide margin. The markets think that we are not out of rumor rallies yet, and that escalating negative news is a great reason to buy into the expectation of the next enormous monetary stimulus.

But don't just take our word for it – observe this graph:



Words speak louder than actions

This graph depicts the levels of the S&P500 with *and without* the returns which resulted from ***comments*** made by the Federal Reserve in conjunction with its actions. We call the dichotomy of the top and bottom lines the graph above the **confidence premium**. It is also affectionately known in industry parlance as the Bernanke Put. Anyone can see that this gap is yawning, and getting wider. Our interpretation of this graph seems to suggest that without the threat, promise, possibility, expectation, etc. of Fed intervention (read: money printing) the equity markets would probably be markedly lower than they are now. In other words, according to this chart, jawboning has been a significant market catalyst over the last 14 years. While we admit that a certain degree of confidence can, and should, be interjected to serve the common good, ironically the above seems to illustrate that politically spinning the Fed's monetary policy has had more impact on market dynamics than it has had on creating actual economic growth and stability.

… In a day-to-day environment whose future and direction are opaque, uncertainty abounds within the political, economic, and social climates of essentially every country in the world. Coupled with an enormous leadership vacuum, very few people are doing much of anything. The reason for this catatonic state is that there are seemingly only two outcomes for managers or managements – win small or lose big. As a result, and not surprisingly, business activity, whether it be mergers and acquisitions, joint ventures, spin offs, or other corporate actions has slowed to a trickle.

Waiting for Godot

Our frustration and angst is coupled by the very real possibility that a semblance of the *old normal* may not return anytime soon. After all, we could be in a transition period that will usher in a new order, or perhaps more appropriately a new *dis*order - where markets misprice assets… for extended periods of time. Do we really have to remind you as to how this may manifest? No. But we will anyway, if only to illustrate how our collective expectations may have to adjust, adapt, and improvise to a world in no way amenable to its former investment fabric.

The Lord of the Flies

In William Golding's book <u>The Lord of the Flies,</u> a group of boys is deserted on an island. Some interesting social dynamics evolve. One subgroup wishes to adhere to the former lawfulness order and structure of the mainland while another faction descends into tyranny. The story is apropos to today's markets since not a day or week goes by whereby a new scandal or trading glitch is not exposed.

Formerly these folks would have been nameless and faceless, but now the cases have an identifiable persona, and they are none too pleased about it. All the sins of the past are becoming *personal.* This signifies that the markets as we know them are in survival mode and devolving from the order associated with the *old normal*, into one which is more chaotic. Do we get rescued from the proverbial island and revert to civility, or are we resigned to a similar fate as were the boys in <u>Lord of the Flies?</u>

We believe that the current odd levels of commodity prices, interest rates, and exchange rates, seem to be creating a disconnect between what our perceived *real* price of something would be in a normal market versus what they are now in an un-normal market."

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