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THE BIG PICTURE

Our big picture view seeks to understand what is affecting asset prices now, so we can position portfolios for both upside return and downside risk management. Over the last several quarters, we have consistently focused on the interplay between inflationary and deflationary forces as a key big picture theme that will effect portfolio positioning and returns in the months and years to come. The concern over a deflationary outcome for the U.S. economy is a relatively new one for anyone born after the great depression. The post World War II experience of the U.S. economy has generally been marked by inflation and, at times, hyper-inflation as we experienced in the 1970s. Chart A tracks the Consumer Price Index (a broad measure of price inflation) from the hyper-inflation of the 1970s, through the great moderation of the 80s and 90s, and finally to the dip into deflation that occurred in late 2008 and early 2009.

Chart A



After the 1970s, a major focus of the Federal Reserve's monetary policy has been to maintain a low stable level of inflation. We believe that the bursting of the real estate and credit bubbles of 2008 and the recession that followed has caused the Fed to shift its primary concern away from maintaining low inflation to battling outright deflation. Here, it is important to note that the Fed's intent is not to generate consumer inflation (increasing cost of goods and services) but asset price inflation (increasing prices of stocks, real estate, etc). Increasing prices of assets has the effect of increasing household wealth, thereby making consumers "feel wealthier" and more willing to spend. In an economy where consumption represents 70% of Gross Domestic Product, it is important to get the consumer spending again.

It is too early to tell whether the Fed can successfully "reflate" household asset prices. It appears that given the choice between above average inflation or deflation, the Fed views inflation as the lesser of two evils. Ultimately, this shift should have a major effect on inflation expectations and asset prices that are tied to inflation. Over the short-term, we think this will be a positive for assets like stocks, commodities and real-estate.

REASONS FOR SHORT-TERM STRENGTH

Quantitative Easing (QE) Part 2

Quantitative easing (QE) is a technical term to describe the process of “printing money” and then purchasing securities to increase the money supply. Under QE, the Fed trades money for assets which simultaneously increases the size of the Fed balance sheet and injects money into the economy. In the spring of 2009, the Federal Reserve embarked on a large scale asset purchase program for the first time since the great depression by announcing a 1 trillion dollar stimulus package. Initially, asset prices and the economy responded strongly to the injection of this “stimulus” with both stocks and GDP rising quickly. However, signs that the economic recovery was beginning to sag this summer intensified concerns that the economy may face a double dip recession. It appears increasingly likely that a new round (QE 2) of stimulus will be announced following the November elections. Like QE 1 this should be a positive for economic growth and asset prices in the short-run.

Prevailing Pessimism

As the effects of the economic recession have become pronounced (high unemployment, weak consumer confidence), we have noticed a prevailing pessimism among individuals, the media and financial professionals. This is natural given the depth and magnitude of the recession and subsequently “weak” economic recovery. Nevertheless, excessive pessimism about the future is typically not a characteristic of market tops. This “behavioral” element is what makes economic decision making so tricky. In the sterile environment of the economic text book, market participants are all rational, profit seeking individuals with perfect access to information. In reality, market participants often behave irrationally with imperfect or even bad information (i.e. dramatically overpaying for real estate near the market peak because ‘real estate always goes up’). Unlike natural sciences, like physics, which are governed by immutable scientific laws, economics is a social science. The ever changing mood and behavior of market participants has a direct effect on asset prices, driving them to excessive valuations during periods of extreme optimism or, alternatively, to discounts during periods of extreme pessimism.

Washington Gridlock

The Republican party is now expected to win a majority in the House of Representatives, and there is an increasing chance that they will gain senate seats. While the economy and asset markets tend to be politically agnostic (Democrats and Republicans have both presided over their fair share of economic booms and busts), gridlock reduces the likelihood of any one-sided and potentially disruptive legislation being passed.

LONG-TERM: CAUTION WARRANTED

Asset reflation may be successful in creating a “wealth effect” and boosting consumer confidence over the short-run; however, our longer term view remains cautious. Ongoing “structural” headwinds such as consumer de-leveraging, high levels of unemployment, weak wage and income growth, tight credit availability to households and small businesses, weak housing markets, higher taxes and cuts in local, state and federal government spending are real challenges to economic growth that are not going to be miraculously cured overnight. Our best case “goldilocks” scenario would be that the economy follows the trajectory of a “normal cyclical recovery” leading to sustained multi-year economic growth similar to what we experienced after the 1990-1991 recession. Our most likely scenario is that while we avoid a double dip recession, the above challenges lead to a sub-par level of economic growth in the coming years.

WHERE WE ARE INVESTING CAPITAL NOW

As we have written before, just because there are serious macro risks does not necessarily mean it is a bad environment for identifying attractive long-term investment opportunities. Below we provide a brief synopsis of where we see opportunity in the current environment and where we are reducing or liquidating positions.

Alternative Assets: We continue to focus our alternative asset exposure in inflation-oriented assets like commodities and income-yielding real estate. Additionally, where appropriate, we continue to include exposure to merger arbitrage strategies with low correlations to the stock market.

Bonds: Over the last ten years, long-term treasury bonds have outperformed the S&P 500 (a broad basket of US stocks) by 140 basis points, the best 10-year outperformance since the 1930s. Money continues to flow out of US equity mutual funds and flood into bond funds. While some (maybe much) of this activity is due to a rational reassessment by investors of their risk tolerance as a result of their experience during the 2008-2009 market crash, we cannot help but believe that some portion reflects investor habit of investing through the rearview mirror rather than based on a disciplined forward looking assessment.

From a strategy perspective, we have begun to reduce our bond weighting in client portfolios by selling intermediate-term corporate bond exposure. In some cases, we are also reducing, but not eliminating, exposure to emerging market bonds which have had very strong performance year to date. While we believe long-term bonds are near excessive valuations, we plan on maintaining and even adding to treasury inflation protected bond (TIP) exposure over time.

Stocks: We view the massive underperformance of stocks relative to bonds over the last ten years opportunistically. Specifically, we are adding to larger, dividend paying stock investments, which provide investors both income and growth potential. Further out on the risk scale, we continue to add exposure to stocks in the emerging markets (China, Brazil, India, etc...) and Frontier Markets. With relatively strong balance sheets and demographic tailwinds, these economies will likely exhibit stronger growth than developed economies in the coming years.

THIRD QUARTER 2010 IN REVIEW

After a difficult second quarter for global markets, asset prices rebounded strongly in the third quarter. Year-to-date through September 30th, the S&P 500 gained 3.89%, International stocks (EAFE) gained 1.07% and Bonds (BarCap US Aggregate Index) gained 7.94%. The below table provides some perspective on the longer-term returns of the three major benchmarks. While equity oriented markets (S&P and EAFE) have recovered from their bear market lows, longer-term returns are still at depressed levels. This should provide equity-oriented investors solid upside as equity markets continue to recover in the years ahead.

	3 Year Annualized	5 Year Annualized	10 Year Annualized
S&P 500	-7.16%	0.64%	-0.48%
EAFE	-9.51%	1.97%	2.56%
BarCap US AGG	7.42%	6.20%	6.41%

Please contact us if you would like to review your individual portfolio performance or if your investment objectives and/or risk tolerance have changed since we last spoke.

As always, we thank you for entrusting AMM to help you achieve your investment and retirement objectives. If you have any questions, concerns, or comments, please do not hesitate to contact us.

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