



# HAWK | Talon

## HAWK 100

Monthly News from Hawk100

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### Stocks wilt in August heat.

Despite forecasts for the summer of recovery, recent reports show the economy flagging. Joblessness remains rampant with unemployment at 9.5% and payrolls shedding 131,000 jobs. The index of leading economic indicators was revised for June to negative 0.3% while July was barely positive 0.1%.

With failed expectations, stocks dropped again during August, giving back much of the July advance. Small US stocks led the decline by losing 7.5% according to the S&P SmallCap 600 Index, with value stocks fractionally underperforming growth. The large US stock S&P 500 lost 4.5% during August. As in earlier months of the summer, financial stocks dropped more than any other sector, losing 7.9%.

Foreign stocks performed better declining only 3.1% in US dollar terms. Measured in local currency, those stocks declined only 2.6%. A falling dollar prolongs pain for investors who hold capital overseas.

The flight from stocks landed on government securities. Treasuries rose 2.9% and municipal bonds climbed 2.5%. The 10-year bond yield settled at 2.48%, and the yield curve term structure flattened.

Commodities lost 2.4% mostly due to correcting agricultural prices. Yet rising 8.6%, the Philly Gold/Silver index shined.

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### Banking on Income Irregularities.

August 10, the Federal Reserve Board announced efforts to reinstate quantitative easing (QE) whereby it will buy treasury securities to maintain its enormous \$2.3 trillion asset position. Holding "exceptionally low levels of the federal funds rate for an extended period" causes income irregularities that constrain capital flow and formation.

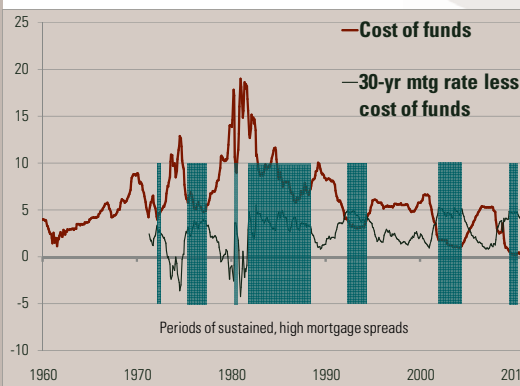
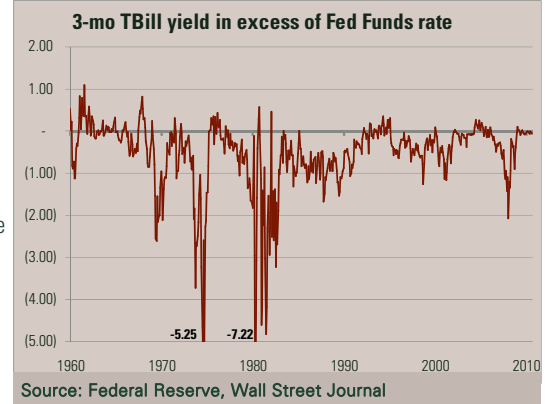
**No easy options.** To implement QE, the Fed buys treasuries, pumping money into the economy in measured amounts, which offsets real economic recession. Otherwise, we may suffer deflation—general price declines—among government's greatest fears while borrowing \$1 trillion annually and carrying \$13 trillion in public debt.

Hawk100 has doubted the Fed's discretionary and political power to reign in monetary supply. We believe QE is most likely to render the Fed unable to manage its balance sheet, will prove ineffectual at promoting wealth, and will lead to eventually high inflation. Excessive inflation would devastate savings and investment and constrict capital.

"The Fed is Running Low on Ammo" in the August 26 The Wall Street Journal by Alan Blinder, a professor of economics and public affairs at Princeton University and former vice chairman of the Federal Reserve Board, elucidates the weakness of options available to the Fed. Having maintained its federal funds target rate near zero since December 2008, the cost of funds among banks is nominal. Any remaining Fed ammo is as impotent as a child's cap gun.

**Arbitrage principle.** Arbitrage, the financial anomaly of a riskless profit, redirects capital. Arbitrageurs forego risky investment opportunities and consolidate assets to maximize arbitrage gains with zero risk. While fed funds remain near zero and T-Bills yield even as little as 13 basis points, banks can borrow at zero cost and buy "risk free" T-Bills to capture a riskless arbitrage profit. The above chart depicts that normally 3-month T-Bills yield less than fed funds cost, thereby encouraging lending and capital formation. Lately, riskless profit encourages banks to idly buy T-Bills. \$956 billion free reserves idling on bank balance sheets provides ample evidence of banks pursuing this arbitrage.

**Glass half full.** Observe the chart of banks' cost of funds—a Hawk100 index combining costs for fed funds, customer deposits (CDs) and interbank borrowing (LIBOR)—compared with mortgage spreads, the average 30-year mortgage rate less bank cost of funds. Mortgage spreads tend to peak when cost of funds are relatively low. With recent cost of funds at the lowest level recorded, mortgage spreads are near the all-time high of 5.5%. While banks enjoy low borrowing costs, consumers are stuck with elevated mortgage rates. An eventual rise in the fed funds target will likely correspond with increased lending and lower mortgage spreads. That would reign in bank profits and compress financial stocks. Ironically, it may also remove income irregularities that have crowded funds from private enterprise thus nudging banks into resumed lending. An economy longing for capital flow and formation would again rise above half full.



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