MORE OF THE SAME

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I thought this would be a good time for me to convey my views on the economy, financial landscape, current Federal Reserve policy as well as thoughts and reactions to the President's speech Thursday night. In it he laid out a new plan on how to attack the unemployment crisis and economic stagnation. This is my first written commentary since I took my sabbatical in 2010. I've wanted to take some time this year to review and reassess many of the risks and economic forecasts that I laid out in my May 2009 Morningstar speech, "Reflections and Outrage."

During the financial crisis of 2007-2009 and subsequent periods, many short-term monetary and fiscal policy actions have been implemented with the goal of bolstering and then shifting the economy to a sustainable growth rate. Generally, I viewed them critically and was of the opinion they would have little, if any, sustainable impact. Most economic growth forecasts since then, particularly those of the Fed, have been overly optimistic compared to my subdued expectations. I even referred to the emerging economic recovery as the "caterpillar" economy—rising with economic stimulus and then slowing when it was withdrawn while it moves ahead slowly. The President's speech was, unfortunately, but yet another example of MORE OF THE SAME. His plan is all about quick fiscal inputs that will help the economy grow in 2012. What about post 2012? It addresses none of the structural issues facing our nation as a result of the tectonic economic shifts taking place both here as well as overseas. Several economic forecasts are estimating incremental growth of 1% to 2% in 2012, if his plan is implemented to its fullest extent. Again, what follows in 2013? Will this be THE correct fiscal policy plan that jumpstarts the economy to sustainable 3+% real economic growth? I think not. There were many who had great expectations for improved sustainable economic growth after the nearly $800 billion 2009 stimulus plan. I was not one of them.

In my Morningstar speech, I railed against the short-term focus of both fiscal and monetary policies being implemented. Because they addressed the symptoms and not the disease, I viewed them as having only ephemeral benefits. The President's speech focused upon reductions in payroll taxes for the employee and the employer as well as new infrastructure projects. The payroll tax reductions are a direct hit to the Social Security Trust Fund. Social Security cash flows turned negative by $47 billion in 2010, the first time since the 1983 reform, and are again expected to be negative in 2011 by approximately $58 billion. These payroll tax reductions add to the program's negative cash flow trends and thus, its funding status is worsened. Furthermore, since these cuts are viewed as onetime events, both the employee and employer are unlikely to change their personal and business plans. President Bush and President Obama were victims of policy prescription recommendations that focused on stimulating short-term demand with temporary tax benefit programs. Temporary consumer tax cuts were used by their recipients to mostly pay down debt rather than increase consumption. I believe history has shown that my 2009 assessments of the "Cash for Clunkers" and $8,000 home purchase credit programs were correct in that they would "succeed" in stealing demand from a future period and thus, provide little sustainable support for the economy. "Shovel ready" infrastructure programs were also of questionable success. I believe that many were not well thought out. To rush another round into 2012 would be a mistake. It is all about a quick stimulus fix. This sounds more like we are talking about prescription medicine rather than economics.

Rather than short-term "solutions," I argued that we needed to redirect and reform our economy since a fundamental structural shift had just taken place. In my view, it would be at least ten-years before the U.S. consumer's net worth would return to its 2007-2008 pre-crisis level. Unemployment would be structural rather than cyclical. Unless we took a multi-year restructuring approach, the economy would not achieve escape velocity from its morass. As I wrote, "We have entered a new world economic order" and "If the American public is willing to accept a prolonged period of expanded government spending as a percentage of GDP, possibly in the range of a mid- to high- twenty percentage proportion versus a typical 19% to 21%, the U.S. economy will face an even more protracted period of substandard economic growth than it otherwise would." Unfortunately, no real structural employment policy changes have taken place while extraordinary increases in ad hoc governmental spending have attempted to fill the economic void caused by contracting consumer demand. There has been no attempt to aid in helping build a new economic foundation. Changes in tax policy and a fundamental revision of the tax code would and could have been very helpful in this area.

Additionally, we have witnessed a misdirected monetary policy. Since the inception of the financial crisis, I've held the view that Chairman Bernanke and the Fed placed too much faith in the beneficial effects of a low to zero interest rate policy. Their view was predicated on the belief the economy faced a liquidity crisis rather than one of capital and balance sheet impairments. At FPA, we were of the opposite view. Zero interest rates and the Fed's massive intrusion into the capital markets, with purchases of various types of bonds, have achieved little sustainable benefits. Stabilization of unemployment and real estate home prices were among their primary goals but I believe one would have to conclude they have had limited, if any, success. The fallout from this policy has been a pernicious attack on responsible financial behavior and savers. Ask any retiree about their interest earning income. Because the economy experienced negative structural changes, for example, the credit supply curve of the U.S. shifted to the left (at all levels of interest rates, the supply of credit provided is less) when the structured finance industry collapsed and several economic sectors, such as, housing, autos and finance, were likely to remain moribund for many years to come, I concluded the economy faced a higher level of sustained long-term unemployment, unless we improved our export capability.

Upon my return from sabbatical, I conveyed to my associates the view that I was extremely concerned the Fed would continue its zero rate policy for possibly another two years. Furthermore, it might implement more unusual policies. As an example, I circulated the Richmond Fed's study of the Treasury/Fed accord of 1951. The new name for this type of policy action is "Operation Twist," whereby the Fed potentially shifts its ownership of short-term Treasury securities into mid- to long-term securities, with the goal of holding down longer term interest rates. Unfortunately, these types of actions can and do result in the "law of unintended consequences" - effects that are unanticipated or unintended. With zero rates and a much flatter yield curve, various types of financial service firms and products will be negatively affected. The bottom line is that I expect these financial institutions to implement higher level risk strategies, in an attempt to offset the negative profitability effects from a low and flatter yield curve. In light of this, I believe the Bernanke Fed is traveling down a dangerous road with its policy prescriptions.

Why do I believe the Fed and the President are misdirected in their policies? They have underestimated the magnitude of the fundamental core issue facing the economy. It became top heavy as a result of consumption rising to a record level of GDP that was a function of excessive borrowing. Not only did this drive GDP to a level that was unsustainable, it also skewed employment demand. An imbalance between employment skills and currently available job openings is the direct outcome from this consumption bubble. This is particularly true among those who have a lower level of education. I have witnessed this outcome personally because of

where I live, South Lake Tahoe, Nevada. The unemployment rate here is 17%, more likely higher, if you count those who are working part-time and who would prefer to work full time. We've had an implosion in the real estate and construction sectors that are not likely to improve for many years to come. Those who worked in these fields are ill equipped to transfer their current skill sets to another economic sector and be paid equally as well. They have to be retrained and re-skilled so as to have the opportunity of returning to their previous income level. This outcome creates a period of transition risk. Monetary policy is ill equipped to attack these types of issues. How does the Fed Chairman view the issue of unemployment? I've had two confirmations of the following question that was posed to the Chairman by two people I know: "Do you view the unemployment situation as being a function of cyclical rather than structural forces?" Both times his answer was "cyclical." In my opinion, if he answered structural, the Fed's power to affect outcomes would be viewed by many as being diminished and thus, it would likely have less influence over future policy development discussions. The President's employment policies have focused on positive short-term effects and have ignored the structural nature of unemployment. I believe my viewpoint is being validated since the August employment report of the percentage of long-term unemployed to total unemployed is a record 42.9%.

I returned this year with a decidedly negative economic outlook. The weak first half 2011 GDP reports pretty much confirmed my expectation. I felt that structural issues, economic and regulatory, would prevent a return to historical economic growth levels. The economic landscape was unstable and this was before the recent debt limit budget debate circus. After evaluating each budgetary reform proposal, I was struck with the obvious realization that the hard choices were always being deferred because, allegedly, one of the goals was not to harm the fragile economic recovery. Chairman Bernanke weighed in on this side of the argument several times. Trust in his judgment has to be questioned since he has misdiagnosed several of the major economic issues of the past decade. I reviewed some of them in my 2009 Morningstar speech. Whether it was the President's 2010 fiscal reform commission report, the first or second debt limit agreement, expenditure cuts have always been deferred to "way out there" and I believe it was this aspect of the second debt limit agreement that helped cause the recent stock market instability rather than the U.S. credit downgrade. Investors are looking to see whether this nation has the strength of fiscal character to address its financial problems in the near term rather than in the distant future.

I do not believe MORE OF THE SAME type policies will have any material long-term beneficial economic impact and thus, the financial markets will view the President's proposed program cautiously. There are other issues that may also upset the economic apple cart. A near term one is whether the new "super committee" can achieve $1.5 trillion in debt reduction over the next ten years? The debate will be over how and when. Their report, including a deficit reduction plan with legislative language, must be voted on by November 23. If a majority vote is not attained, programmed spending cuts in the defense and non-defense categories, the nuclear option, must take place beginning January 2, 2013. It seems like a tall mountain to climb for this new committee to reach the necessary fiscal reforms, within 75 days, whereas the President's National Commission on Fiscal Responsibility and Reform and the Senate "Gang of Six", with substantially more time available, failed to gain majority agreements. If this committee rises to the low levels of previous fiscal committees, we are all in trouble. The critical questions for me are when will the required cuts take place and what are the enforcement mechanisms? The next challenge involves the Supreme Court. Will it hear the constitutional challenge to the new healthcare law, the required purchase of health insurance, and what will its decision be? We will not know whether it will review this challenge until probably next June. My guess is that they will defer a decision to hear and rule until after the 2012 election and thus, this uncertainty will only add to the other undetermined aspects of the new healthcare law. I have no idea what

the outcome will be other than it is likely to be a close call decision, possibly 5 to 4. Finally, I have had substantial concerns regarding the stability of the euro. Greece should never have been allowed to become a member. Milton Friedman was highly critical of the euro's structure from its inception. I do not see a return to euro stability unless member realignment occurs along with fiscal integration—a very hard set of requirements. European governments and the European Central Bank have tried to kick this can down the road for nearly two years with successive bailout maneuvers. Until these issues are decided, European economic uncertainty will continue and thus, a recession is highly probable, if not nearly certain. In the case of the U.S., I said on CNBC, just a few weeks ago, that I believed the odds of recession were more than 50% and rising. Recent consumer sentiment, employment and business activity data have been worsening. The possibility of a new set of fiscal and monetary policy initiatives, again short-sighted, only shifts the timing of this potential outcome by a small amount.

What would it take for me to shift to a more optimistic longer term outlook? The following are examples and by no means all inclusive.

First, there should be a discussion and then implementation of real and substantive congressional budgetary reforms that have a standing in law. Without this change, a future congress can overturn any of the expenditure cuts that are voted on today but are not implemented until much later. With a congressional approval rating of 13%, according to the August Gallup poll, the American public should demand nothing less because the Congress cannot be trusted to fulfill its future fiscal promises. Both parties are equally responsible for the fiscal mess the nation faces. David M. Walker, former Comptroller General of the U.S., founder and CEO of Comeback America Initiative, www.tcaii.org, has proposed various budgetary improvements. I believe he knows far more about this area than I do. Please visit his website.

Second, federal expenditure and entitlement reform must involve meaningful cuts that take place in the near future and not until after the end of the next presidential term. Congress has to prove that it has the strength of will and the conviction to make some very hard choices. Unless these fiscal issues are attacked now, when there is still time, a much crueler adjustment may be forced upon us by the financial markets. Expenditure cuts must precede revenue enhancements, especially if there is no congressional budgetary reform.

Third, our tax system is in desperate need of reform. With so many entrenched special interests, this will be extremely difficult to accomplish. Sacred cows will have to be gored.

Finally, unless the Fed, Congress and the President recognize that the nation faces structural issues rather than cyclical ones; monetary and fiscal policies are likely to be incorrect, ill timed and ineffective. MORE OF THE SAME and kicking the fiscal can down the road are no longer acceptable, given the difficult tasks that lay ahead.

Despite my negativism, I do see reasons to be hopeful. Several state governors have successfully fought entrenched interests to begin their state's fiscal reform process. There have been ugly and public fights. Recall elections have taken place but mostly unsuccessfully. This is encouraging since it implies the citizenry is finally awakening to their state's worsening financial situation. These governors had the courage to begin this fight since they recognized that a continuation of the status quo was fiscally unsustainable. This realization must also take place at the federal level. I believe the American public is finally awakening to the grim fiscal reality that a painful restructuring process must begin now. It can be accomplished. We've had the courage to face other daunting challenges before, such as, WW2 and the former Soviet Union threat, which required a long term focus. We must rise above the typical political posturing that pits one age group against another

and poor against rich. What is in the best interests of future generations? What type of country will we leave to our children and their children? Any politician that says our entitlement programs are financially sound and not in need of significant restructuring is either delusional or is intentionally trying to mislead. MORE OF THE SAME is unacceptable.

When I left to take my sabbatical, I referred to my year off as the "interlude year" -- the one between two crisis periods. Unless there was a radical and significant shift toward fiscal prudence, another crisis of equal or greater magnitude than the 2007/09 one was likely to take place within 3 to 7 years and that it would emanate from the federal level. With the passage of the new healthcare law, I moved this time frame to within 2 to 5 years. The display of incompetence by the congress in the recent debt limit negotiations is not encouraging. However, the huge negative response it caused in both the financial markets and the electorate may finally force our representatives to face fiscal reality. In many cases, a rebirth begins when the alternative is totally unacceptable.

Upon my return, I was pleased to see that FPA's portfolio managers had been initiating precautionary portfolio measures, in light of the political and economic uncertainties. Within the equity portfolios, the quality of a company has been a paramount feature. Average market capitalization and exposure to the international sector have increased. Liquidity levels have risen. Within fixed income, quality and limiting portfolio volatility have been the primary goals, despite the Fed's attempt to encourage risk taking by its monetary policy. Capital preservation remains paramount. I could not agree more with these actions.

The purpose of this letter is not to depress but to provide an unvarnished and clear view of the risks I perceive. By being honest and straightforward, you can rest assured that we take our fiduciary responsibility seriously.

Respectfully,

Robert L. Rodriguez