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Wealth Management for Changing Markets

17 Village Road, New Vernon, NJ 07976-0271

973-267-8120

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Searching for Quality Income – October 2011

By Scott P. Noyes, CFA[®] CFP[®]

Panic and indiscriminate selling have hit the markets. Should we run and hide or are there strategic opportunities to make money? The epicenter of the market's current decline is the fear of a collapse in the Euro caused by excess debt buildup in the PIGS (Portugal, Italy, Greece & Spain). The concern is that debt defaults could destroy major European banks and force a bailout by the stronger Euro countries. This European problem has led to reduced expectations for worldwide growth and contributed to a broader malaise in the United States.

Fear of European Default Could Lead To Recession

While Greece is central to the market's current focus, uncertainty about other European countries falling into the same default trap is beginning to impact the outlook for European economic growth. In all likelihood an intelligent resolution for Greece is going to occur, but not in sufficient time to keep the investor herd from panicking. With Greece and Portugal incapable of paying for their debt, banks will be forced to take limited write-downs in the value of Greek and Portuguese bonds and European taxpayers will fund the balance. In anticipation of these write-downs, several European banks are actively reducing the leverage on their balance sheets by selling off loans and investments around the world. This de-leveraging could be the primary driver of the current market correction, particularly in Asia. This is deflationary.

Further deflation may result as many European countries aggressively reduce their spending and future borrowing needs. Austerity movements in Ireland, France, Britain and Spain are focused on forcing countries to live within their means. In Spain, a country with 20% unemployment and a massive collapse in real estate, the impulse to slash spending is now so strong they agreed to cut their deficit to 3% of GDP by 2013 and passed a constitutional amendment to limit deficit spending over the business cycle. In another recent example of this frugal mindset in Spain, thousands of protesters turned out to complain about the \$50 million expense of a visit by the Pope. This new "public sector frugality" is likely to provide the precondition of deflation and recession in the intermediate term but save them from future fiscal crises in the long run.

The Current Malaise in America

On August 5th, after weeks of watching political wrangling over the debt ceiling negotiations, Standard & Poor's downgraded the credit rating for the United States from AAA to AA+. To many Americans, the specter of government deadlock causing a humiliating default suddenly made the U.S. resemble a European country that was teetering on the brink of insolvency. Europe's story became America's story.

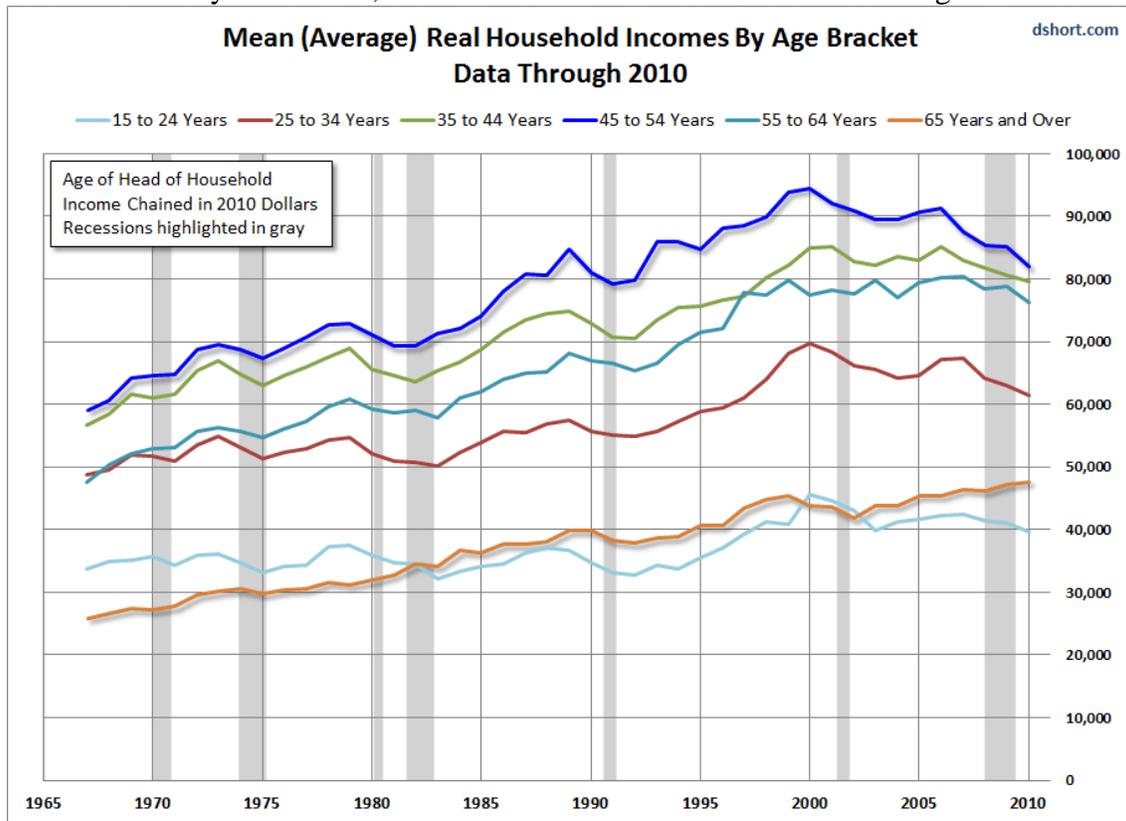
Changes in public confidence are driven by such narratives, because the human mind is very receptive to them, particularly human-interest stories. The story of a possible U.S. default is

resonant in precisely this way, implicating America's sense of pride, fragile world dominance, and political upheavals. Even though financial conditions in the U.S. and Europe are quite different, the debt downgrade unified several long-developing concerns in investor psychology.

A Declining Standard of Living Contributes to the Malaise...

The standard of living for many Americans has been declining for over a decade. For most Americans, income levels peaked in 2000 according to the most recent data from the U.S. Census Bureau (Exhibit 1). The hardest hit have been those aged 45 to 54 where real income has fallen 13.3% in the past decade. Younger Americans between 15 and 24 have witnessed a drop of over 13.0% in real income. The only group that has not suffered an income decline are those over age 65. The lack of sustained growth in household income is a contributor to the decline in consumer confidence.

Exhibit 1. For Many Americans, the Past Decade Has Been One of Declining Real Income



Source: U.S Census Bureau; Doug Short

A Lack of Inflation Contributes to the Malaise....

Americans do not feel better off in non-inflationary times such as these. Low inflation has contributed to declining real estate prices and has put a lid on expectations for future price increases. As a result, many Americans are trapped in homes they can no longer afford. Approximately 22% of homeowners are unable to refinance because they lack the equity or

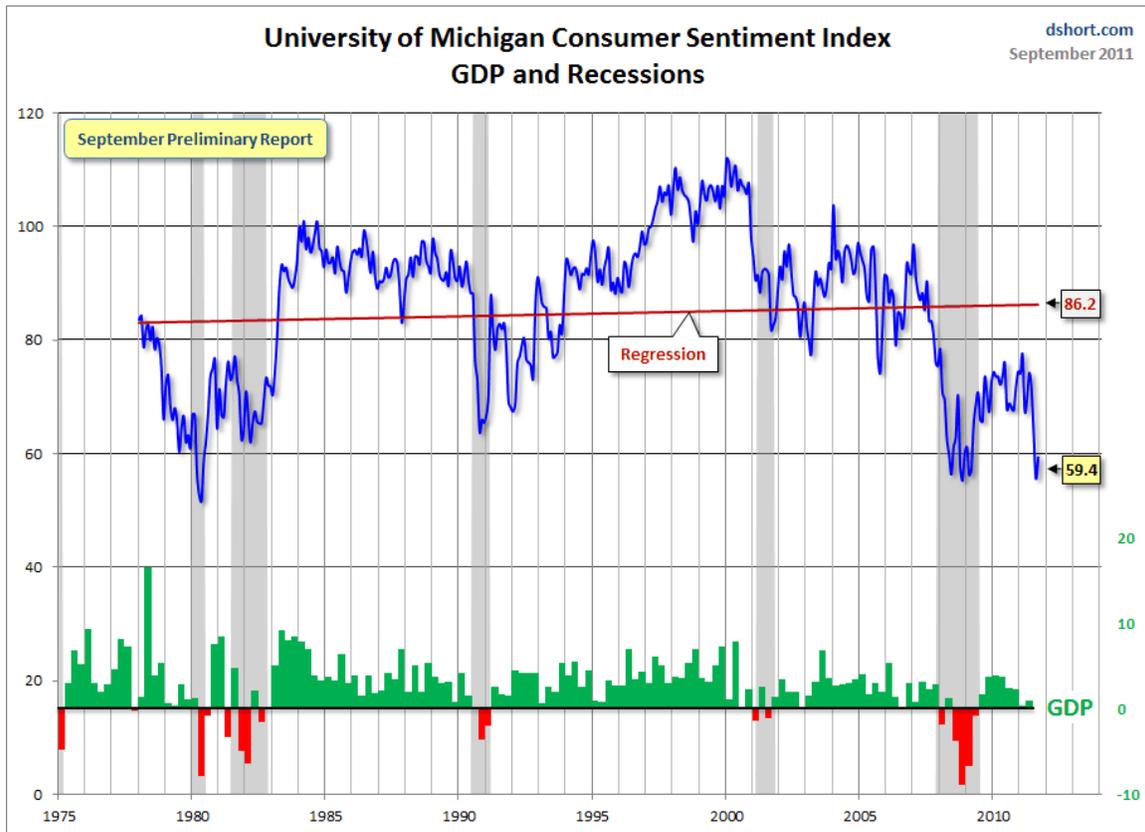
credit scores required by lenders. Gone for now are the days of increasing wealth via real estate ownership. In addition, labor costs are declining in many areas and commodity prices, set globally, swing wildly based on speculative demand. Without inflation, cost cutting is the path to success and people only get ahead by saving more and spending less; a “Catch 22” in these challenging times.

Low inflation has also contributed to record low interest rates. Last week the yield on 10-year U.S. Treasury notes hit a low of 1.70% and 5-year yields dropped to 0.71%. Part of this decline can be attributed to the spike in demand as capital from Europe seeks a safe haven. The bond market is suggesting that the demand for capital is negligible and inflation prospects are limited....for now.

The Measure of the Malaise

Several measures of consumer sentiment document the current state of the malaise. Although the University of Michigan’s Consumer Sentiment Index rebounded to 59.4 in September from 55.7, these levels are commonly associated with recession (Exhibit 2). In fact, the last occurrences of Consumer Sentiment falling to these points were in 1974-75, 1980 and 2008-2009; all periods of recession.

Exhibit 2. Consumer Sentiment Is At Recession Levels



Source: University of Michigan; Doug Short

Fiscal and Monetary Response Reach Their Limits

The financial markets are starting to feel unloved. The Federal Reserve is running out of traditional monetary bullets to revive the economy and policy responses from Washington are mired in gridlock. It appears that the economy and the markets must succeed or fail on their own.

The Federal Reserve's mechanism for expansion is to either deposit reserves into banks' accounts at the Fed or to purchase securities in the open market. The purpose is to lower interest rates and stimulate the economy. However, the banks are not lending these excess funds out at the same rate as in the past and the Fed's expansionary plans have been ineffective. One has to wonder if the Federal Reserve has the political support to keep up its pace of printing money and building up reserves.

There appears to be little hope for new fiscal stimulus originating from Washington. Over the last fifty years, the U.S. economy has run on a Keynesian model of counter-cyclical government spending. When the economy falters, new policies are created to re-energize the economy. During the current cycle, which is based more on a credit meltdown than a typical inventory cycle, traditional stimulus measures have not created the desired result.

Similar to Europe, the U.S. is in the midst of substantial cost containment efforts at the federal, state and local levels. The monthly employment data shows that the U.S government has been laying off workers for the past two years. This trend is likely to continue for the foreseeable future adding to unemployment and reducing economic growth. With limited prospects for successful monetary and fiscal stimulus plans, the U.S economy must grow on its own accord. Banks may even have to pay for their own bad investments and bad loans!

Our Economy Could Soon Slip Into a Recession

Current economic indicators point to a modest recession in the U.S., not an economic collapse. While many businesses have stopped hiring, they have not built-up an excess supply of workers during the recent economic expansion. They do not have a surplus of workers to fire. Secondly, many businesses have been reluctant to spend capital on labor saving technology as can be seen by the cash buildup on their balance sheets. The conditions that created the last decline do not exist currently. Without a buildup of excess labor and excess capital spending a deep recession is unlikely.

Our Investment Strategy – Income, Income, Income!

As we move from the “Run for the Hills!” stage in the market decline to “Where are the Opportunities?” we are finding excellent opportunities to direct our client portfolios toward income-focused investments. We believe this strategy will help stabilize our portfolios during choppy stock and bond markets. Additionally, if the global economy slips into a recession, investors must balance their needs for safety, income and portfolio growth.

Here are some of the investment areas we are reviewing:

High-dividend individual stocks – High-yield stocks such as Verizon, Vodafone, Merck, Exxon, Total S.A. and others appear attractive at this time. We tend to avoid stocks of financial institutions.

Quality Corporate Bonds – Portfolios of high-quality, non-financial bonds should succeed in generating positive returns. In our opinion, the current liquidity squeeze is creating a once-a-decade opportunity to buy good bonds at cheap prices.

Municipal Bonds – Taxes are likely to go higher and good quality municipal bonds may perform well. They have been hit hard in the recent credit market consolidation but are likely to provide long-term value.

Preferred Stock – Preferred stocks can add tax-favored income to a portfolio.

Income Trusts – Income trusts are created to finance stable projects such as pipeline transmission, energy reserves and other special purpose vehicles. While Income Trust stock prices are volatile, their income flow can be significant.

Income REITs – Real estate can provide a consistent flow of strong dividends, even in a recession. The key is to purchase the REIT's at the right price. When the credit markets improve, REITs should offer a strong upside performance.

Foreign Fixed Income – Over time, the price of a trillion dollar budget deficit is likely to be a weaker dollar. Foreign fixed income investments, particularly sovereigns, are likely to perform well over time.

Conclusion

If the global economy slips into a recession, investors must balance their needs for safety, income and portfolio growth. We have generally moved from an income and growth strategy to a strategy seeking safety and income. In most of our portfolios, we have substantially reduced our equity exposure and hold that liquidity in safe investments. In a no-inflation world, sources of quality income are to be treasured. However, a strategy of all safety currently results in no income. We are left making prudent risk decisions with the goal of creating sustainable income.

At some point there will be a major buying opportunity in the market. We intend to participate. While we are still waiting for a deeper discount, good bargains do not last forever.

Please call me if you have any questions at 973-267-8120.

Scott P. Noyes, CFA[®], CFP[®] is the President of Noyes Capital Management[®], LLC, an independent fee-only wealth management firm based in New Vernon, New Jersey.
www.noyescapital.com

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