



Market Commentary

A Cautious Look at the Dollar

In recent days, we have received many inquiries regarding the “weak dollar.” The topic has become one of the most prolific stories in the business media. In fact, since this year’s high in March, the dollar has declined 15%. However, we believe there is more to the story than what is portrayed in the news. In light of this, we want to provide our friends and clients with a brief overview of the current environment and express some of our thoughts on the matter.

“Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed.”
– Benjamin Graham

What are They Talking About?

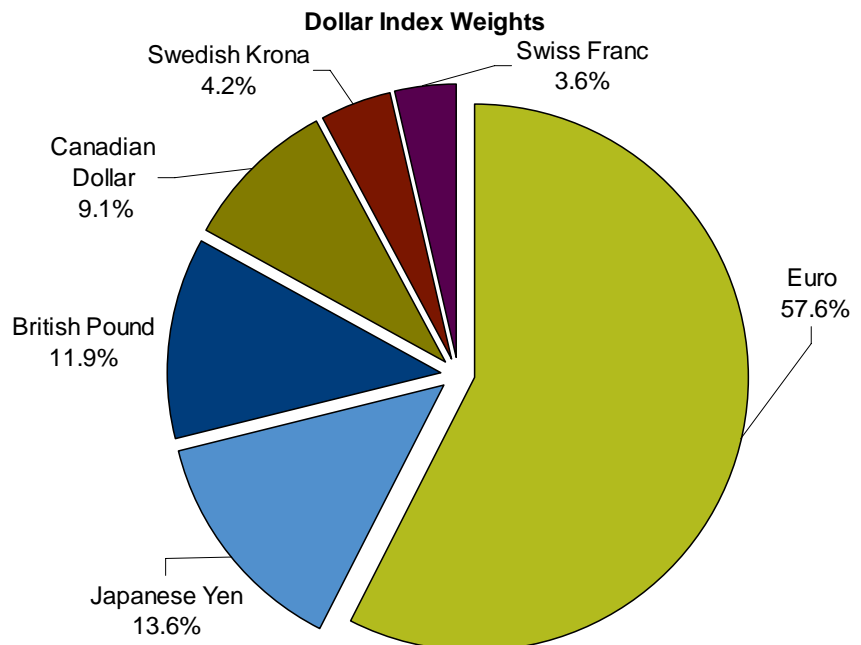
When pundits, politicians and other persons in the media speak of a “weak dollar,” they are specifically talking about the decline in value of the dollar versus a basket of currencies. This basket represents some of the most significant U.S. trading partners. Specifically, the Euro, Japanese Yen, Canadian Dollar, British Pound, Swedish Krona and Swiss Franc are found in this basket, and each is given a specific trade weighting. Trade weighting is important because certain currencies hold a much larger weighting in the index.

At its most basic level, currency is a store of wealth and is priced relative to other currencies or assets. A declining dollar means deterioration of purchasing power relative to these other currencies or assets. Without a doubt, the dollar has seen a sharp decline during the second half of the year. We take issue, however, with the almost incessant banter asserting impending doom.

Perspective

It is easy to get caught up in the provocative nature of discussions surrounding this topic. Therefore, we urge prudence when considering how this situation impacts investing decisions. Pundits can selectively use information to seemingly support almost any conclusion. To put things in perspective, the dollar is higher today than it was during the first half of 2008, and although the media focuses on the short-term, this is not a new phenomenon. In actuality, the dollar has steadily declined since its all time high prior to 9/11.

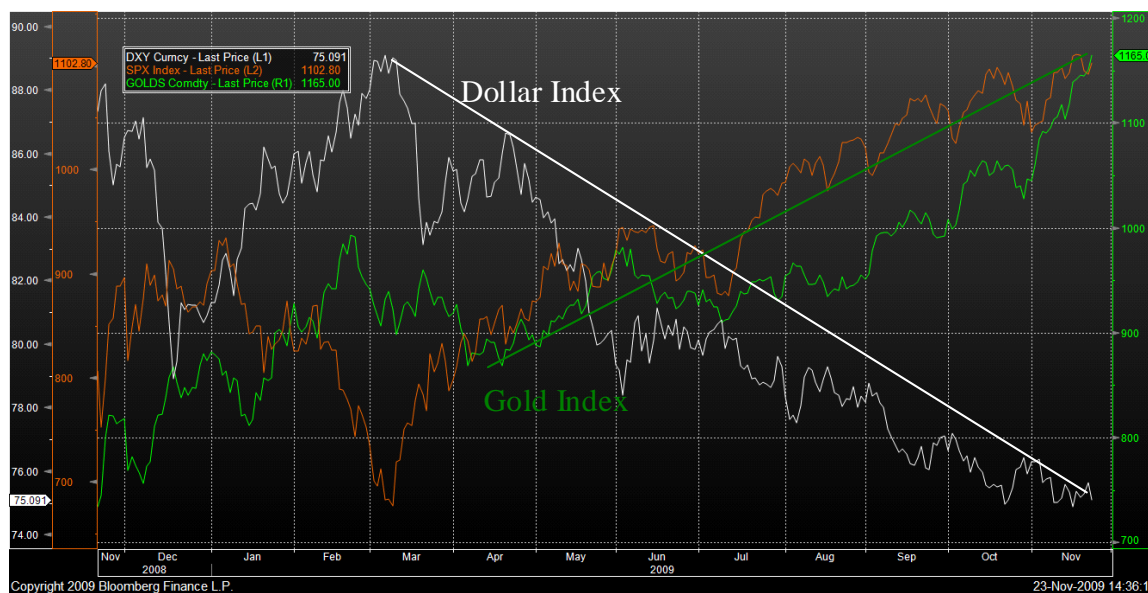
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US Dollar Index 11/24/00 to 11/23/09

While the relative decline in value of our currency can have far-reaching implications, investors should not panic. A thoughtful investor uses this information as a clue to build a complete picture of the investing environment. Decline in one asset class may mean opportunity in another. For instance, global commodities such as gold and oil are priced in dollars, and therefore they will tend to rise in value as the dollar declines. The recent rally in gold prices is a clear demonstration of this effect.



Why is the Dollar in Decline?

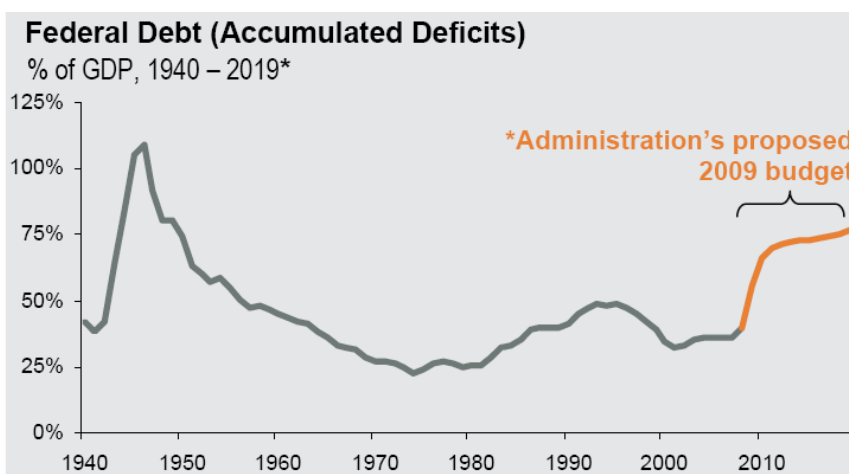
Price fluctuations in currencies are driven by many complex factors. On the surface it is a simple supply and demand problem, but the devil is in the details. The dynamics which drive supply and demand are multifaceted. Factors such as fiscal and monetary policy, economic and geopolitical risks and the balance of trade are the primary drivers of relative currency movements. These factors are not only considered in respect to one country but are analyzed relative to other currencies or assets. Investors, traders and governments compare their different options and search for the most beneficial store of wealth.

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Impact of Fiscal and Monetary Policy

Fiscal policy relates to tax policy and federal debt levels. Increases in federal debt can have wide ranging implications. By borrowing to fund projects, the government hopes to increase economic output during a depressed business cycle. By adding dollars to the economy, the policymakers hope to increase jobs and production. Indirectly, this exposes the economy to inflation. As there is an unnatural increase in projects, more money is forced into circulation. This increase in money supply leads to increased demand for goods or services. To date, the deflationary pressures continue to counteract this policy, but should economic activity increase and liquidity get pushed down to the consumer, inflation will develop.

In addition, increased debt levels imply increased future federal revenue requirements. The required debt servicing means every person owes a share of the debt. Unfortunately, the only way for the government to get you to pay your share of the debt is through taxes. Theoretically, governments wouldn't increase taxes until the economy rebounded. Taxes reduce the flow of capital in economies and create drag. The government will pay the bill, and the only way to accomplish this is more taxes. The critical question is, "When will this happen, and how much is it going to cost?"



Source: St. Louis Fed, Bureau of Economic Analysis, Office of Management and Budget, J.P. Morgan Asset Management. Data reflects most recently available as of 9/30/09.

Since March, monetary policy has led concerns regarding the dollar. Monetary policy has a more direct and quicker effect on the value of a currency. Monetary policy manipulates the supply side of the equation. Recently, the dollar has seen a significant decline due to quantitative easing (QE). QE describes an extreme form of monetary policy used by governments to stimulate their economies. Essentially, the central bank buys government debt off the books and thereby increases the liquidity of lending institutions. The central bank basically creates money *ex nihilo* (out of nothing) and thereby increases the money supply in the economy. This is what people mean when they say the Fed is "printing money."

This increase in liquidity should have a long-term inflationary effect on the economy. As stated before, we believe deflationary pressures from the overall economic decline have kept inflation in check, and this injection of liquidity has simply filled voids. However, going forward this increased liquidity should begin to increase inflationary risk as the economy recovers. Furthermore, since currency relationships drive price, when QE occurs across many countries, the effects may cancel out. Nevertheless, this effect is driven purely on the magnitude of QE and the economic growth of the country.

What do I do with this Information?

With the fear surrounding the future of the dollar, we believe it is important to step back and analyze the situation objectively. A weaker dollar may impact many facets of investing, but it does not necessarily indicate economic disaster. A weak dollar makes domestic goods cheaper to foreign buyers, which boosts our exports. Of course imports, particularly petroleum and other commodities, are more expensive. As an investor, we must consider these factors,

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Tuesday, January 19, 2010 at 2:00pm Central/3:00pm Eastern

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among others, when planning a course of action.

We believe our domestic equity managers are well-positioned for continued dollar weakness. We focus on building well-diversified portfolios that hold core equity positions in high-quality multinational firms. Thus, our clients gain exposure to talented management teams with strong financial resources, which enables them to not only survive these conditions but take advantage of them.

Additionally, we continue to recommend a position in foreign-developed and emerging market equities. We believe investments in these asset classes not only provide an opportunity for strong organic growth but also act as a natural hedge against a declining dollar. Currency translation during these periods provides investors with added benefit. For investors concerned about the state of the dollar going forward, we feel it is the smartest move to protect against continued weakness.

Investing in real assets and commodities also provides protection against continued weakness. A small allocation to these types of assets in a portfolio serves as a proactive measure against a potentially inflationary environment in the future. However, as inflation remains a future concern, a measured approach to this asset class is warranted. Commercial real estate, historically the primary real asset in investor portfolios, faces a potentially perilous environment ahead. The combination of declining lease rates and rising debt costs warrants extreme caution when considering this asset class. While selective opportunities exist, investments in this area have a risk and return profile similar to other distressed types of investing. Master Limited Partnerships (MLPs), which own and operate the U.S. energy infrastructure, provide the best option for a core position in real assets. Timber remains another attractive, but less liquid, option.

We consider carefully how to best position client assets in light of economic and market conditions. As always, the world is an uncertain place, and the best way to position a portfolio is through a thoughtfully diversified asset allocation. Through careful allocation, portfolios may not only weather the storm but may indeed benefit from a weak dollar. It is easy to get drawn into much of the hyperbole on either side of current discussions. We urge a cautious approach. Investments motivated by headlines in the financial press rarely generate profitable returns. We remind you that we are available to discuss this issue individually and work with you to ensure that you are prepared for the future.

"What I've tried to teach is no big secret: Buy good stocks. And don't get spooked every time the market panics. It sounds dull, but it's worked." - Louis Rukeyser

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