

HOLLENCREST CAPITAL MANAGEMENT

August 10, 2011

Dear Hollencrest Client,

The Federal Open Market Committee (FOMC) pledged yesterday to keep the fed funds rate near zero through mid-2013 – a small but meaningful change in terminology. By promising to hold short-term rates low for the next two years, the Fed showed its hand at the poker table in the hopes of convincing investors that it will continue to support the economy and financial markets. This possibility was outlined by Chairman Bernanke in a speech last month along with several other tools the FOMC could use to further ease monetary policy, including:

- Provide more explicit guidance about how long the balance sheet would remain at current levels
- Increase the average maturity of Fed security holdings
- Reduce the rate of interest paid on bank reserves
- Initiate a new round of securities purchases

In short, the Committee decided that only the most junior of measures was required, despite the recent large selloff in financial securities. Meanwhile, concerns of economic recession continue to percolate through the markets. Sluggish growth – if it persists – may eventually demand more aggressive action on the part of the Fed, but it will be difficult to convince a majority of Fed members to be proactive without a further decline in security prices or even more troubling unemployment numbers.

There is a fear that an economy already weakened by Japan's tsunami and the crude oil spike has been dealt a fatal blow by the Treasury debt ceiling/downgrade saga and Europe's ongoing sovereign crisis. The global meltdown in equities has been steep and swift, reinforcing the negative feedback loop between recent financial market action and economic activity. Unfortunately, political gridlock and fiscal limitations are preventing elected officials from enacting policy responses in both Europe and the US. The European Central Bank (ECB), which has the ability to take unilateral actions, is seen as dragging its feet and people wonder if the Fed is burned out even though it claims to have more and stronger medicine in its cabinet.

Following months of political wrangling regarding the US budget and debt ceiling crisis that ended with a lackluster fix, S&P downgraded the US sovereign credit rating from AAA to AA+, and assigned a negative outlook to the rating. Although the downgrade sparked immense TV coverage, non-stop debate, and much self-reflection, it was not done without warning. The Hollencrest partners met a few weeks ago to discuss the possible flight to quality that would come from such an action. Markets would be volatile and, at times, illiquid, which could provide exceptional opportunities for acquiring new assets. Nonetheless, at the end of the day, the larger concerns would continue to be the European debt crisis which is massively deflationary, Chinese growth which is slipping, and global economic deterioration. In addition, with the U.S. downgrade, there is skepticism whether France, UK, and Belgium can maintain a AAA rating.

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If there is one issue hurting risk assets it is the escalating Eurozone sovereign crisis and the inadequate response from policymakers there. Investors continue to view Europe as being slow to respond to its growing crisis. On the monetary front, the ECB continues to suffer from communications issues, doubt that bond purchases will be large enough, and questions regarding whether Germany will truly back the necessary initiatives. Meanwhile, the fiscal response continues to suffer from strained balance sheets and political disputes. The ECB will likely eventually have to be a significant long-term holder of a considerable portion of Europe's troubled debt over the next few years if we are to avoid the unthinkable in Europe. We are still in the early stages of the Sovereign crisis.

Similar to the introduction of QE2, Chairman Ben Bernanke will probably hold off on stiffer medicine until his address at the annual Jackson Hole Summit, which takes place on August 26. Stay tuned.

Sincerely yours,

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