

# HAYES ASSET MANAGEMENT LLC



## Index Returns as of 10/31/09

DOW JONES INDUSTRIALS	↑ 10.62%
NASDAQ	↑ 29.68%
STANDARD & POOR 500	↑ 14.72%
DJ TOTAL STOCK MARKET INDEX	↑ 16.86%
BARCLAYS CAPITAL AGGR. BOND	↑ 6.24%

## Treasury Yields for 10/31/09

6 Month T-Bill	.16%
2 Year Note	.84%
10 Year Bond	3.39%
30 Year Bond	4.23%

## Commodities for 10/31/09

Oil	↑ 72.65%
Natural Gas	↓ 26.16%
Corn	↓ 9.25%
Wheat	↓ 35.79%
Gold	↑ 19.58%

**If I owe you a pound, I have a problem, but if I owe you a million, the problem is yours.” John Maynard Keynes**

The last week of October saw the U.S. treasury set a record \$123 billion for its weekly debt auction. Total U.S. public debt now stands at \$11.92 trillion and growing. The public debt ceiling is \$12.1 trillion although Congress can, and likely will, raise the ceiling. There is nothing like a bunch of politicians with an open-ended line of credit. Our children, grand-children, and great-grand-children will be on the hook to pay this off.

As long as the dollar remains strong and continues to be the world's reserve currency, our government can continue to fund our deficits with foreign currency. However, we have to be wary of China, particularly if it begins to express concern about our government's mounting debt and questions whether the dollar should remain the global reserve currency. For example, if China and other countries decide to invest their reserves in another currency, like the euro, the Federal Reserve would have to raise interest rates in order to fund this deficit. This is not necessarily a bad thing. In fact, at some point the Federal Reserve is going to have to shift course and begin to raise interest rates. Right now, rates are low to help weather the current financial crisis, but if they are kept artificially low, that will only encourage greater speculative activity in the financial markets. And if these rates were meant to create stimulus money to put into the economy as loans to businesses and individuals, that is not what is happening. Instead, the banks are using the stimulus money to buy

treasuries which does not help the situation at all. Raising interest rates prudently will satisfy our creditors and discourage speculative activity in both the stock and bond markets. This would particularly help the investors who saved, lived prudently, and put away a nest egg planning to live on the income when they retired. The best example of this would be the risk-averse investor who worked his or her entire life and saved \$2,000,000 and invested it in Treasuries and CDs. In 2006 and 2007 one could get 5% on a one year Treasury which would have generated \$100,000 income from the \$2,000,000. Today, a one year Treasury yields 0.34% which would provide an income of \$6,800 per year. (Talk about a pay cut!!!)

We are concerned that bond funds are the next area in which investors could suffer heavy losses. The Investment Company Institute released figures for the week ended October 21, 2009 that showed inflows to mutual funds totaling \$13.84 billion. The breakdown of those inflows was: stock funds, \$1.68 billion, bond funds, \$11.18 billion, and hybrid funds, \$979 million. For every dollar put into a stock fund, \$6.65 went into a bond fund. These bond fund investors are going to be very disappointed. What worked last year when interest rates were declining will not work in a rising interest rate environment. Bond investing 101: Interest rates and bond rates move inversely, as yields rise, prices fall.

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In a recent CFA "Private Wealth Management" issue, Roger Ibbotson and Pang Chen of Ibbotson & Associates discuss the relative performance of stocks versus bonds. Over the past year and decade, bonds have outperformed stocks. Over the past 40 years, the bulk of bond returns have come from yields, the income return portion. Yields today are much lower. For bonds to outperform stocks, bonds would need to continue to generate the same amount of capital gains they have enjoyed for the past 40 years. If that were to happen, bond yields would be negative. That outcome seems very unlikely, if not impossible, because that would mean that investors would be willing to lend money to borrowers and pay them an interest rate. Everything in the stock and bond markets moves in cycles. It seems to us that the cycle of low interest rates is about to come to an end. The tide may be shifting from bonds outperforming stocks to stocks outperforming bonds. In Berkshire Hathaway's 2009 annual report, Warren Buffet wrote: "When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s. But the U.S. Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary."

Interest rates are starting to rise around the world. Australia has raised rates twice over the last two months and Norway raised rates as well. Governments raise rates when their economies are becoming stronger. The common thread between Australia and Norway is that both are commodity driven economies; Norway driven by oil and Australia by mining. This could be the first sign of a global recovery.

Taking advantage of the stock market rally, we sold our AVX and Electronics for Imaging holdings over the past month. We exited breaking even. Though both are well capitalized technology com-

panies, we felt they were under-performing and that we could do better taking positions in other companies that were poised for growth.

Intel, another well capitalized tech company that we own, just increased its dividend by 12.5%. Intel also settled a long running dispute with rival Advanced Micro Devices. Under terms of the agreement, both parties will end all outstanding legal disputes, including antitrust litigation and patent cross license disputes.

Another positive factor affecting the stock market has been the recent pick-up in activity in mergers and acquisitions. Two of our pharmaceutical holdings just completed acquisitions. Merck purchased Schering Plough and Pfizer bought Wyeth. Berkshire Hathaway is purchasing the remaining shares of Burlington Northern Railroad. Black and Decker has agreed to be purchased by Stanley Works and Kraft Foods has just initiated a hostile bid for Cadbury. Even the IPO market is heating up and our old friend Dole Foods has once again become a public company. This tells us that the public equity markets still offer some bargains even after the huge run we have seen since mid-March of this year. The \$64,000 question is: Will the consumer show up again to power companies' earnings after managements have cut costs to a bare minimum? Typically, when the consumer focuses on debt reduction and savings, consumption wanes. We do not think we will see another consumption cycle fueled by debt again any time soon. People are going to have to feel confident in their jobs again before they are inclined to spurge on the goods and services that propel our economy.

***Thank you again for the business. If you have any questions or thoughts on anything, please give us a call, toll-free at 1-866-423-5332.***

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