EXCELSIA®
Investment Advisors

Excelsia.com
t: 912-598-4032 f: 912-598-4142
15 Lake St. Suite 100, Savannah, GA 31411

First Quarter 2011

Bubble-Liscious

Bazooka, Double Bubble, Bubble Yum, Topps with baseball cards; all great choices, but as a kid the one I loved the most was Super Bubble, sold for $.02 cents per piece at Stones Drive-In, which was the local sandwich shop where I grew up. I never liked Bazooka or Double Bubble because they never produced the bubbles that Super Bubble could bring forth. After all, the purpose of the gum was to blow huge bubbles; either that or stick it in my sister's hair.

And so, as we enter 2011, it seems the entire investment community is chewing the Fed's Super Bubble and blowing bigger and bigger bubbles in every asset class other than cash and bonds. The Bernanke magic pixie dust that was sprinkled on the financial markets at the beginning of the fourth quarter resulted in several interesting facts for 2010 stock performance:

1. Index Performance:

    a. Until the end of August, 2010:
        i. S&P 500 was down 4.62%.
        ii. Dow Jones Industrials down 2.12%
        iii. Russell 2000 Small Cap down 2.96%

    b. Since September 1, 2010:
        i. S&P 500 up 20.66%
        ii. Dow Jones Industrials up 16.45%
        iii. Russell 2000 Small Cap up 31.75%.

2. Stocks across the board had their best September since 1939.

3. In the month of December only four of 22 trade days produced a negative result, and these were very low-volume, marginal declines. Thanks, Santa.

4. During the last 30 days, stocks have not broken their 10-day moving average, a feat NEVER accomplished in the past 82 years. Happy New Year!

In our fourth-quarter letter, “Risk On, Risk Off,” I pointed out that the immediate shifts in market sentiment were the results of global macro monetary policies being imposed by Bernanke and other central banks, rather than any backdrop of economic results or corporate earnings/valuations. I opined in our Q4 letter that expanding the Federal Reserve’s balance sheet under QEII would result in “risk on” by the investment community, since the Fed was purposefully encouraging mindless speculation in financial assets.

The speculation during Q4 was most prominent in smaller-cap stocks, as evidenced by the double-digit difference in returns for the quarter versus their large-cap brethren. The fourth quarter of 2010 had stellar performance with zero to little volatility, all the while ignoring euro credit issues, emerging market inflation, potential policy gridlock between Congress and the President, a real potential for a housing double dip, and the start of what I believe is protectionism disguised as currency war. These risk factors are being overlooked by investors because of the conviction and consensus of opinion that Federal Reserve policy will continue to maintain a very accommodative position (i.e., No Tightening) plus, the consumer (as a result of the Congress extending Bush tax policies) will return and GDP should grow at 3% or better during 2011, which should equate to stocks having another good year in 2011. But, to invest on the promises of economic forecasts has proven over the last two years to be an exercise in mental folly, due to the actions of central bankers on a global scale. Today, I think the old saying “Whenever everybody is thinking the same then no one is thinking” applies. The question that keeps nagging me: what’s wrong with the consensus opinion?

What Now?

“There are many methods for predicting the future. For example, you can read horoscopes, tarot cards, or crystal balls. Collectively these methods are known as ‘nutty methods.’ Or you can put well-researched facts into sophisticated computer models, more commonly referred to as ‘a complete waste of time’ ”.

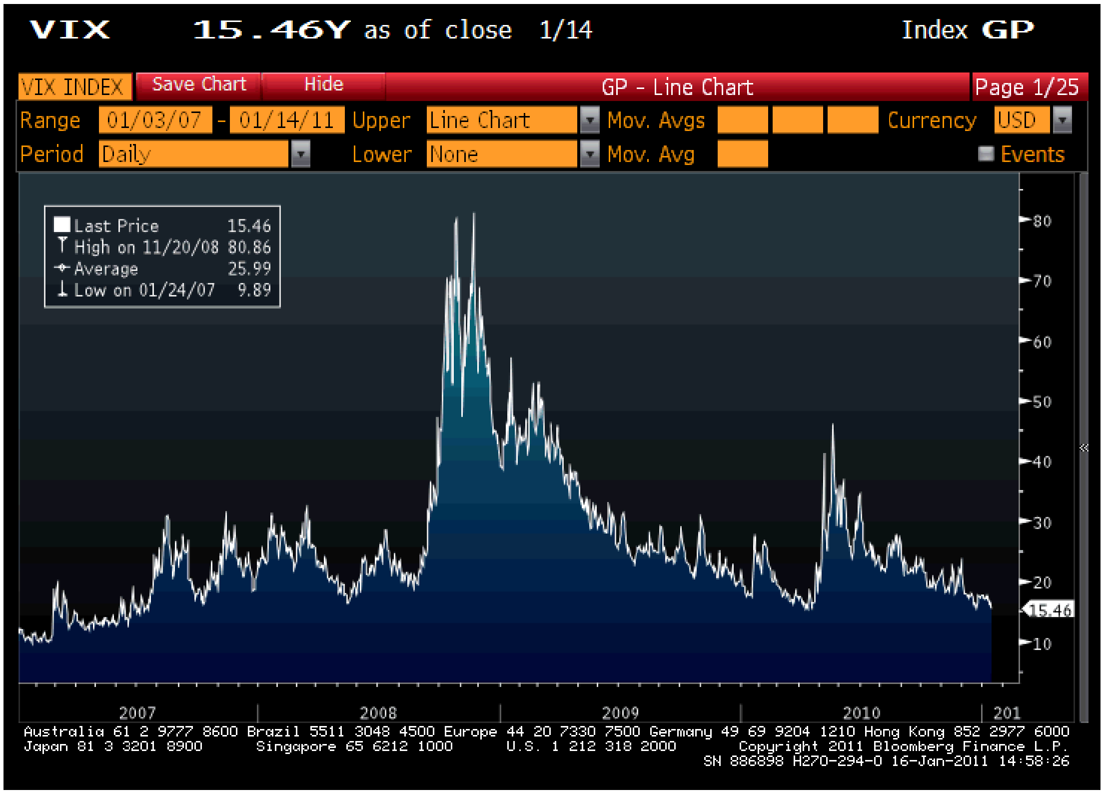
Scott Adams, creator of *Dilbert*

2011 is now before us, and the turn of the calendar brings about reflection on the past and predictions of the future. I have spent countless hours during the holidays and the first days of 2011 reading independent research, magazines, newspapers, and book excerpts from the purveyors of knowledge in the investment community. With a couple of rare exceptions, all are drinking the same Bernanke Kool-Aid. The denizens of Wall Street have arrived at a consensus of view for 3% US GDP growth, increasing profits from corporations, and a "choppy" (read: we don't know) stock market that will finish 2011 with 6-10% gains. I borrow the following from my January 2007 newsletter:

"However, as I sit today and look into the crystal ball, what I can tell you about the beginning of 2007 is that according to Investors Intelligence we are at an all-time peak for bullishness from the investment advisor survey. I can also tell you that "insider selling" reached a new all-time high in November, despite the fact that if corporate officers and directors had waited until January they could have delayed the payment of potential taxes until April of 2008. What was the hurry? All this bullishness, the lack of volatility, and above-average insider selling has me eerily remembering the beginning of 2000, when all was well and the catch phrases of "New Paradigm" and "Cash is Trash" had integrated into everyone's vocabulary. I am not saying that a repeat of 2000 is in the offing. But the level of bullishness, the broad consensus of earnings projections, belief of a Bernanke put, and the stark narrowing of credit spreads seem strangely familiar."

History never repeats itself, but it often rhymes.

Today there are a number of similarities to the beginning of 2007, including hot money flowing to risk assets as a result of ultra-low savings rates, food and gasoline prices rising, income inequality that could lead to a year of tensions not only at home but abroad, and increasing apathy to risk by investors, as evidenced by the VIX:



As investors regard the markets with apathy, the central themes for 2011 are:

- Europe: A Bay of PIGG's
- Commodities
- Investor Sentiment

Europe

Is the euro in danger? In a word, yes. Can it affect other global markets? In a word, yes.

Until recently most of us in the financial community thought a breakup of the eurozone or the withdrawal of support by Germany or France of its weak half-sisters was impossible. However, if I am German Finance Minister Wolfgang Schaeuble, then the question I am asking is, Is it better to try and cure our PIGGS' financial gangrene infection, or would we be better off simply amputating the limb? Three years ago neither Spain, Greece, Ireland, or Portugal exuded a hint of trouble, because they were attracting capital by selling bonds in a market that believed the PIGGS were safe due to their inclusion in the eurozone. But along came the 2008 crisis and the river of credit dried up and what had been easy money, increasing wages, and increasing prices for these countries were now being seized upon by deflation and credit contraction. In the old days the PIGGS could have adjusted for deflation and costs by manipulating their currencies in the open market. However, that is no longer an option, as they share a currency with Germany and France. And since the Germans are determined there will be no inflation, then the rest of the countries must endure deflation, high unemployment, and government spending cuts. European finance chiefs are working today on another debt-crisis-fighting strategy, with Germany easing and seeking some form of "Euro Rescue Fund." Eventually, I foresee a series of bank runs in the problem countries that will crack open the door to a euro exit. Probably first out will be Sarkozy and France. Reminds me of the old joke, "How many Frenchmen does it take to protect France? No one knows because it's never been done before." Unless the euro gains outside assistance from China or other trade partners, the Bay of PIGGS could prove more volatile to the global markets than the 1961 version. The consensus of opinion does not include euro woes.

Commodities

If you were a cheerleader for Team Commodity then your chant these days would be "My team is red hot, your team ain't doodily squat … ba bomp bomp". Energy (excepting natural gas), Metals, and Agriculture all recorded exceptional price appreciation in 2010. Overall, world commodity prices rose 25% over the past six months, oil is at $90 a barrel, gold is at $1,361, and Dr. Copper is $441, up from $291 six months ago. Why? In a word: Bernanke.

The Federal Reserve's ongoing push to debase the dollar and destroy its purchasing power by continued monetization practices such as QE II seems never-ending. As I have noted in the past, the Keynesian Cowboys are all-in at the game of monetary hold 'em. From last week's WSJ:

"Prices are rising despite over-supply and a lackluster recovery in industrial demand. Many analysts expected those factors would keep a lid on prices in 2010. What they didn't expect was an overwhelming flow of money into the market from investors eager to ride a commodity rally."

And where did this overwhelming flow of money come from? In a word: Bernanke.

A brief comment on gold and its recent decline from a high of $1,421 an ounce on November 9, 2010 to $1,361 today. If you do not own gold, then take advantage of this correction to add or create a position in the metal. Why? The high for gold during its last bull market run was $850; and based on December 2010 CPI-adjusted dollars from 1980, gold would now be $2,395. If you were to use the pre-Clinton methodology for CPI calculation, then gold would now be $7,943 an ounce. Gold seems to perform whether we have inflation or deflation. If inflation runs too hot, or deflation runs too cold, the metal appreciates. The other outcome, of a “just right Goldilocks” economy, could be gold’s downside risk.

By the way, the CPI has been reported on a monthly basis since 1919. The index has been revised several times through the years, in 1940, 1953, 1964, 1978, and last in 1995 at the encouragement of then-Secretary of the Treasury Robert Rubin (yes, the same Rubin who gave the repeal of Glass Steagall to his pals at Citigroup). The changes approved by Congress in 1995 eliminated food and energy from the “core inflation” calculation. As my friends have heard me remark, “There is no inflation as long as you don’t have to eat or drive.” In my opinion, the meaning of CPI has been changed from one that reflected what it took to maintain one’s standard of living to something else, called controlling budgets via suppressed CPI. Under the pre-Clinton method, CPI inflation would today be running at about 7.1%. As John Williams of Shadow Stats comments:

Cost of living was being replaced by the cost of survival. The old system told you how much you had to increase your income in order to keep buying steak. The new system promised you hamburger, and then dog food, perhaps, after that.

Today, most investors believe the numskulls of the financial media who kowtow to the Federal Reserve and its supposed ability to control inflation. Specifically, they believe two big lies from Bernanke’s December 5th appearance on *60 Minutes:*

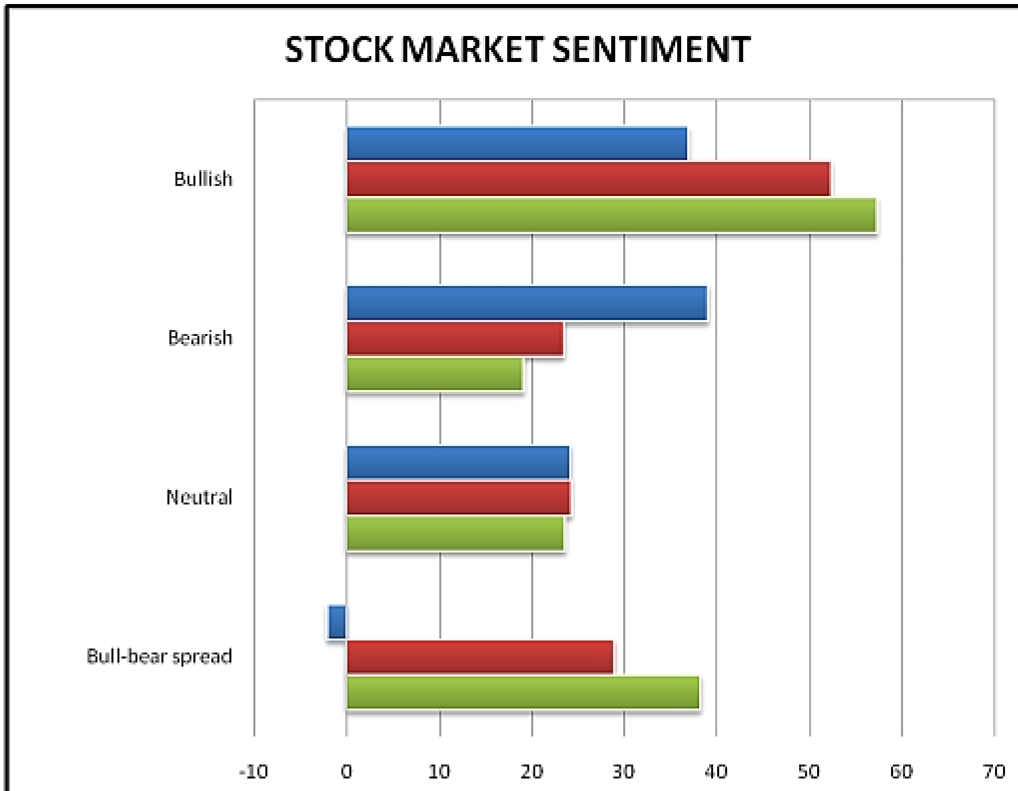
1. The Fed is not printing money. "*The amount of currency in circulation is not changing ... the money supply is not changing in any significant way. What we're doing is lowering interest rates by buying Treasury securities.*"

2. The Fed can control Inflation. *"We've been very, very clear that we will not allow inflation to rise above 2 percent. We could raise interest rates in 15 minutes if we have to. So, there really is no problem with raising rates, tightening monetary policy, slowing the economy, reducing inflation, at the appropriate time."*

The consensus believes in the Bernanke put and an accommodative Federal Reserve. Call me a cynic here, but I will not fight the Fed as it relates to market sentiment. However, caution seems to be warranted.

Investor Sentiment

From the Prieur de Plessis letter *Investment Postcards from Cape Town*:



	Bull-bear spread	Neutral	Bearish	Bullish
Plexus	-2.1	24.1	39.0	36.9
AAII	28.9	24.3	23.4	52.3
Investors Intelligence	38.2	23.6	19.1	57.3

One item Prieur's data does not include is the long-term averages of the bullish, neutral, and bearish stances:

- Bullish 39%
- Bearish 30%
- Neutral 31%

As you can see from the AAII and Investors Intelligence sentiment, we are currently back to levels last seen at the market peak in 2007. I believe the markets are caught in a trading range in what I deem to be a long-term secular bear market that began in 2000. Today's bullishness is based upon a firm belief in the Fed Reserve to make the right decisions, and in a new Congress that will stem the tide of anti-business legislation and somehow, some way get our government's budgets under control. That's a lot to ask of our elected officials, whose principal concern is getting re-elected. Therefore, where will the trade range fall?

The graph above depicts the S&P 500 from the start of 2000 until last week. The red line drawn is the rolling average of the S&P; the blue lines depict trade range of one standard deviation from the average, and the green lines depict two standard deviations from the average price. Although simplistic, if we look at a one standard deviation of price variability, then it is reasonable to opine that the market is stuck somewhere between a low of 965 and a high of 1347. The two-standard-deviation move has only occurred on the upside, at the peak of the dot-com bubble in stocks and the peak of the real estate bubble. The downside max has only been met in the recession of 2002-03 and the credit crisis of 2008. Who knows where the current bubble in commodities will lead stocks, as the Fed creates another bubble? Do we pierce through to a two-standard-deviation move to the upside? Jeremy Grantham recently commented:

"*The Fed can drive a market higher yet eventually, of its sheer overpricing, it will eventually pop. Be aware the ice is thin. It's a dangerous game. Don't believe that it's somehow justified. It is not justified by anything except the crazy behavior of the Fed. The problem is in the not too distant future, stocks will be too expensive and they'll crack again*."

For now, it is still "risk on" for the investment community. Let us hope the consensus does not end up with bubble gum in their hair after the sugar high is gone and the gum is flat.

Closing Comments

Freud once said, "Thinking is rehearsing." What he meant was, after you accumulate the data and analyze the opportunities, then you have to take action. In the world of investing there is no substitute for taking action. Therefore, as your advisor, I seek to understand our bias and attempt to make rational and prudent decisions. Savvy investors understand the risks inherent in their assumptions and adopt a more businesslike approach to investing by reducing and hedging risk. Investors are typically surprised when facing a loss, and the psychological power of losses far outweighs the power of gains. Therefore remember the critical rule of compounding: *Don't lose money.*

Excelsia Investment Cornerstones:

- Mean Reversion
- Markets are Affected by Human Behavior
- Critical to Success/Failure: How Do You Handle the Crisis?
- Look for the Slow Pitch Down the Middle
- Being Different Requires Non-Traditional Asset Management

We know that our investment process of active asset allocation has produced consistent returns over time. We know that, from a psychological standpoint, during down markets you want your returns to be absolute and during up markets you want your returns to be relative. As an investor, there are two steps you can take to improve your ability to handle the coming year:

- Actively Manage the Asset Mix – Look to be contrarian (<u>this is our primary job</u>).
- Develop Reasonable Expectations – <u>Wishful thinking is not a strategy.</u>

I, for one, am glad 2010 is in the rear-view mirror. Here's to a more prosperous 2011.

CLIFF W. DRAUGHN

PRESIDENT AND CHIEF INVESTMENT OFFICER

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