BLUE WATER'S Market Perspective

May/June – 2011

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We welcome back all of our long-term readers, and in addition we extend a warm welcome to those who are new readers. We will present our usual review of the economy (authored by Wilson), market trends (authored by Wilson this time, since Sivalingam is on vacation), and a segment on financial planning (authored by Pfahl), followed once again by a brief discussion of a special topic (authored by Wilson). **This time the special topic for discussion will be "The Retirement Income Dilemma and How To Fix It."** We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions. For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bi-monthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions.

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Economic Summary:
Deficits, Deflation, Defaults and Denial

Overview: Deficits to Continue; Debt-Deflation Cycle Alive and Well; Inflation Scare Overdone

By Kevin M. Wilson

As the Federal Reserve winds down its quantitative easing (QE2) program, a national debate on raising the debt ceiling has taken center stage. I don't think the debt ceiling itself is very important, since it has been raised 70 times in the last 50 years, although any technical default would roil the markets for a bit. However, the underlying issues being debated are very important indeed. At stake is the future solvency of the United States – and nothing less. The budget deficit this year is again an almost insupportable 10%, one of the worst budget problems in the world. This year's fiscal deficit has been funded in part ($600 billion) by monetization of the debt under the Fed's QE2 monetary easing program, but the remainder, and all deficits going forward (about $1 trillion per year) will probably rely on the global markets to continue to buy U.S. Treasuries in huge quantities. Unfortunately, foreign purchases of U.S. Treasuries have recently plummeted, covering only 16% of the debt issuance in the 1st Quarter.[1] This may throw almost the entire responsibility for funding the federal debt onto the private sector, at a cost of about $370 billion each quarter. Nevertheless, bond investors are holding firm so far, suggesting that private sector demand will be substantial, although it is unknown whether it will be enough.[2]

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Deficits, Deflation, Defaults and Denial (Continued)

The unfunded obligations of the U.S. government, including such popular programs as Medicare and Social Security, now total an overwhelming $75 trillion, or about $260,000 per person.[3] The future funding of this level of debt is clearly impossible, and to quote a famous person, "What can't happen, won't." Taxes may have to go up, but spending, including on benefits programs, will absolutely have to come down, and permanently. The dithering of Congress and the Administration over such an important issue, and the nonsense put out by both parties are a little disheartening to the credit markets. Indeed, rates on credit default swaps (CDS) on U.S. debt, a form of insurance against sovereign defaults, have recently tripled. U.S. Representative Paul Ryan's balanced budget proposal has been roundly criticized and viciously attacked by various demagogues, so it probably can't be passed. However, alternatives are not apparent at present, and it seems likely that any meaningful budget reform will be recklessly delayed until the 2012 elections. Even if both houses of Congress and the presidency end up aligned on the Republican side, no reform will be likely to actually work unless the Federal Reserve itself is reformed.[4] Unless reformed, the Fed, under pressure from some future president, could simply (with its central bank partners) monetize future deficit spending and circumvent any reform-based restrictions on Congressional spending. I'm not sure what the specific solution for this is, but it is another factor in any solution to the problem.

The U.S. consumer and small businesses have continued to reduce debt by various means, and that has kept the recovery on a weak footing.[5] There are many signs of an economic slowdown over the last few months, and the outlook for the recovery has weakened.[6] GDP growth (annualized) in the 1st Quarter was only 1.8%, and various economists have recently downgraded 2nd Quarter GDP growth estimates to the 2.0% range.[7] About two-thirds of the 1st Quarter GDP growth went into business inventory buildup, which is not a good sign at this stage of the recovery. Real final sales (i.e., GDP minus inventories) grew at just a 0.6% annualized rate, which is a very anemic result.[8] Economist Gary Shilling has pointed out that, based on empirical data, GDP growth needs to come in at 3.3% or more in order for unemployment rates to be reduced.[9] This implies that unemployment rates, which have already risen for two months in a row, will continue to do so, perhaps reaching as high as 10% by early next year. The job market has improved over the last two years, not because there are more jobs for the nearly 14 million unemployed, but because employers have decreased the number of layoffs.[10] Even so, there are now 7 applicants for every job in America. Several commentators have suggested that a double-dip recession is possible in the U.S., based on slowing activity and slumping markets.[11] Others are more sanguine, citing reasons to believe we are simply experiencing a mid-cycle slowdown.[12]

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Nobel Laureate Robert Mundell has suggested that deflation should be the main concern now, not inflation, which is a position that has long been supported by economists Gary Shilling and David Rosenberg.[13] Mundell proposes that the U.S. fix the exchange rate between the dollar and the euro to avoid falling into a double-dip recession. This makes sense because exchange rates tend to act as transmission mechanisms for inflation and deflation by causing the prices of imports and commodities to rise and fall (i.e., higher dollar = deflation). In fact, Mundell believes that the crisis of 2008 was in part caused by the Fed allowing the dollar to soar against the euro when it paused in its easing program that summer. He doesn't think a postulated QE3 monetary easing would be useful now – instead he favors the U.S. Treasury coordinating the stabilization of dollar/euro exchange rates. Globally, deflation pressures are rising in the developed world as Japan, Ireland, Greece, Portugal, and Spain have seen their recoveries weaken dramatically or flip over into outright recessions. In the emerging world, inflation has been the problem, and efforts to fight it risk a hard landing (i.e., recession). The yield curves in India and Brazil have recently flattened or inverted, suggesting that recessions are possible next year in these two major developing economies.[14] China is also slowing down dramatically as it too fights the inflationary pressures caused by monetary easing during the financial crisis; some however still hold out hope that the Chinese will manage a soft landing. The question is what impact the Chinese slowdown will have on global demand for commodities, since the Chinese are the dominant marginal demand player in many raw materials.

European Financial Crisis Looms; Greek Bailouts A Ponzi Scheme?

Mario Blejer, a former Argentine central banker and researcher at the Bank of England recently published a provocative piece in the *Financial Times* that caught my eye.[15] He made the case that various European efforts to save Greece and its fellow "PIGS" constitute a Ponzi scheme. By this he means that the original bond holders of Greek debt are being paid with the same loans that also finance the Greek deficit. When the Greeks fail to meet agreed upon austerity goals, which they are in the process of doing, they will not be able to return to the markets. This was always a fantasy anyway, but now the reality of it is hitting home. The loans therefore will be rolled over, even enhanced by other Eurozone members, the ECB, the World Bank, and the IMF. Thus will private bond holders (mainly banks) transfer their losses to various governments and international organizations supported by foreign (non-Greek, including U.S.) taxpayers. This approach is not new; in fact it is well along by now throughout Europe, as about 130 billion Euros ($183 billion U.S.) in debt from Ireland, Portugal and Greece have already been bought (i.e., monetized) by the ECB[16] in its efforts to fix a solvency crisis by promoting the issuance of more debt. Paper losses on all

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Deficits, Deflation, Defaults and Denial (Continued)

outstanding Greek debt already exceed E150 billion, and probably another E150 billion has been lost on Irish and Portuguese debt. If Greece defaults by the way, the ECB will be in even more trouble than Lehman's once was, as their paid in capital is only E10 billion. Of course they could just print the money, but that would be a pretty damaging scenario. This explains why the ECB is so adamant that there will be no default.

Bond holders who were originally willing to take higher risks to get higher rewards are being released from that risk, but get to keep the rewards, so they are quite pleased of course. Taxpayers, if they had any sense, would be demonstrating like the Greeks. The good news is that some public demonstrations have already occurred in Germany, so maybe the taxpayers are waking up. Michael Hudson of Bard College has suggested[17] that the proposed new loan package for Greece, estimated at E86 billion, but perhaps as high as E120 billion, while being presented as a rescue plan, is actually a bailout for German, French and other banks who are the main bond holders of all that Greek debt.

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Just such a bailout transaction is also the explanation for the so-called privatization plan. Under this plan the Greek government is to sell about E60 billion in public assets to raise capital that would provide political support for the E86 billion in new loans from foreigners. However, almost exactly the same amount has been withdrawn from Greek banks! Meanwhile a national referendum is planned, but 85% of Greeks now oppose the austerity plan and bank bailouts. Greeks have caught on to what's really being negotiated, and although their collective views on spending and benefits seem totally unrealistic, they at least know that this is a bank bailout.

Greek voters now seem to favor default, and since paying off their debts (now estimated at 159% of GDP by year-end) is a mathematical impossibility,[18] they have a point. Any attempt at rolling over Greek debts, as mentioned above, is doomed because 10-year bonds are selling now at yields of 17.7%, and 2-year bonds at yields of 30%, leaving really no way for the Greeks to return to the markets, or to service the debts if they did.[19] Effectively, default is mostly priced into bonds already (but not stocks), in spite of widespread denial throughout Europe. If the bailout plans of the ECB, EU and IMF take place, default will be postponed for a year or two possibly, but it will still occur. If the Greek government falls, as is increasingly likely over the long term, an unstructured, sudden default is probable and a catastrophic collapse of the European banking system is possible. This is because European banks not only hold lots of bad debt; they are levered 40:1 or 50:1 as well.

One potential sleeper is the Italian sovereign debt situation, which is far worse than markets are currently discounting.[20] Italian debt service payments as a proportion of GDP are second only to those of Greece, and the Italians owe about $2 trillion. It would be far better to plan a "Greek" default or restructuring now, in order to retain some element of control over events. Other crisis avoidance solutions could then occur, such as cleaning up the European banking system in advance of the planned restructuring. While this would be expensive and politically unpalatable, is certainly no worse than the alternative. But as these things generally go, based on human nature and 800 years of financial history,[21] this is the least likely scenario. Investors would be wise to factor in a Greek default of some type in the next two years or less, and a potential European banking crisis as part of their asset allocation decisions.

Market Summary:

The End of the Bear Market Rally: Next Stop QE3?

By Kevin M. Wilson

The recent economic slowdown has thrown a little fear into a hitherto heedless market, causing some to question whether the two-year old bear market rally is finally over.[22] The markets, as represented by the S&P 500 Index, have already fallen about 7% through mid-June, from their peak at 1,371 in early May. However the financial sector, often considered a leading indicator of stock market direction, has fallen over 16% since February, and the NASDAQ Composite Index crossed its 200-day Moving Average and has lost almost 10% on an intra-day basis, which is close to what would be officially termed a correction. Several factors have contributed to this so-far modest downturn, including high relative valuations, reduced positive earnings surprises, high rates of negative economic surprises on recent data, and obviously slowing global industrial production and trade activity. Some believe that this is merely a mid-cycle slowdown, which is a fairly common occurrence.[23] Markets are nervous though, as evidenced by light trading volumes, the rising put/call ratio for equities, sector rotations towards defensive stocks, and a strong bond rally over a period of three months.

Markets have fallen enough that about 317 out of 500 stocks in the S&P 500 Index have become oversold, with only 10 overbought.[24] Certain contrarian indicators, such as the American Association of Individual Investors (AAII) Bullish Sentiment Index, have recently fallen low enough to suggest that a counter-trend rally may occur, but we are still skeptical that a bottom has been reached. For one thing, only 19% of the market is still above its 50-day Moving Average, and a breach of the S&P 500's 200-day Moving Average (MA) is still possible. The market came within 5 points of a breach on June 16th and again on June 23rd. If a breach occurred, it would probably have a profoundly negative impact since this indicator of market trends is very closely followed. The last time the S&P 500 fell below the 200-day MA while in a downward trend was on May 20, 2010. The market then fell another 10% to the market low for last year on July 1, 2010. Current support for the markets lies at 1251 for the S&P 500, which is coincidentally at the same level as the YTD low set back in mid-March, and would represent a drop of 10% from the high. Even stronger support is found at 1229, if the markets keep falling; this level marks the previous high in November of 2010, and also marks a Fibonacci Retracement of 62% from the cycle low at 667 set in March, 2009. Fibonacci Retracements are favored trend stopping points for technical analysts, and markets are frequently observed to pause at Fibonacci markers. Another potential marker for the bottom of this correction may be found at 1,044, which is where the market bottomed in late August of last year, right before Fed Chairman Bernanke announced the QE2 monetary easing program. Let us hope we won't need this very low support level, since it represents a potential drop of about 20% from the high.

The markets (S&P 500) are still negatively correlated with the US dollar (r-squared = -0.46), but this negative correlation was much stronger in mid-May. Interestingly, the correlation of the U.S. markets with gold has fallen substantially since December, and is now fairly weak (r-squared = 0.30). The markets are also negatively correlated (r-squared = -0.25) with the price of the generic 10-year U.S. Treasury, and this inverse correlation has been increasing over the last few weeks, indicating that Treasuries are serving as defensive allocations in portfolios as the markets sell off. The normally high correlation between the Healthcare sector and the markets as a whole has been falling (r-squared now = 0.46), indicating that this sector has been serving as a defensive component in portfolios. The same is true for the Consumer Staples (r-squared = 0.47) and the Utilities sectors (r-squared = 0.42). In contrast, the Materials sector has a high correlation (r-squared = 0.80) and has suffered accordingly.

There is reason to believe that the current correction may have a little downward momentum even though it has only slowly declined so far. For example, insider selling spiked right before the correction got going, indicating that the officers of companies were taking major positions off the table. Market expectations for profit margins and earnings growth are very high, suggesting that a poor earnings season or outlook in July will negatively surprise markets.[25] Also, some pretty big investors have called the top, or end of the two year rally; this list includes Jeremy Grantham of GMO and Donald Coxe of Coxe Advisors.[26] Grantham points out that one typically observes a switch to defensive blue-chips at the end of a bull rally, and that is what we have seen recently. The average cyclical bull rally within a secular bear market mega-trend lasts about 26 months, which is exactly where we are in the present rally.[27]

The list of worries the markets face is also longer than usual. Some truly dire consequences could follow if the Greeks or the Irish default and Eurozone banks melt down, or the yields of U.S. Treasuries continue to fall and the U.S. dollar to rise. The alternative scenario, mentioned above, is that this is a mid-cycle slowdown and all will soon be well again. This is the consensus viewpoint of the big Wall Street firms, but some of them are displaying a level of caution not observed in the last year. We are also cautious and willing to wait for confirmation of any trend, up or down. Our portfolios are generally well-positioned for a correction, but we would have to re-allocate a bit if markets return to normal, or if the Fed intervenes with a QE3 monetary easing at some point. This scenario could happen by late fall if economic data continue to degrade; however, so far the Fed doesn't (officially) see this as anything but a mid-cycle slowdown. We will of course keep a close eye on events. ■

Wealth Management Planning Note:

Managing Retirement Income and Distribution - Not for Sissies

By Patrick J. Pfahl and Kevin M. Wilson

The first wave of Baby Boomers will reach age 65 this year. Over the next 13 years, 78 million of them will reach that age. It is expected that 10,000 boomers per day will be retiring for the next few years. In addition, there are about 30 million retirees already attempting to produce some kind of income stream out of their savings, to supplement their retirement income from Social Security and pensions. There is one simple fact that I can share with you about producing income from your retirement savings – you will need to be a lot more sophisticated about it than the previous generation.

A person cannot just park a major portion of their funds in a money market or interest bearing account and expect to make it on cash flow. Such accounts are now yielding near zero interest because of the monetary easing stance of the Federal Reserve. The thought that "it is what it is" or "at least I can sleep at night" is understandable, but not rational – what one is left with is a return that is negative in relation to inflation. The fact is that we will shortly be entering a prolonged period where it appears likely that interest rates will continue to rise for years to come. This makes the use of long-term government bonds in a buy-and-hold strategy, long a traditional safe harbor for retirement investments, a potentially pretty scary approach. Also, bond rates at near all-time lows, so there is considerable inflation risk over the long haul, assuming the current deflationary trend ends at some point. Recall that bond prices move inversely to interest rates. Thus, when interest rates go up, bond prices go down and when interest rates go down, bond prices go up. Note that these price shifts occur only if we're talking about previously issued bonds trading on the open market.

The current crop of boomers is probably the last large group of retirees where a significant portion will have the luxury of a defined benefit ("DB") pension plan (as opposed to a 401k or IRA-based plan). Twenty-five years ago 63% of employees retired with DB pension plans. The fact is, unless you are a government or union employee retiring today, the overall likelihood that you have a pension to supplement your income is about 17% and falling. An interesting fact that is raising ire across the country (and here in Duluth with our HUGE $208 million city employee unfunded pension and healthcare liability) is that while private DB pension plans must comply with federal standards for fund reserves to meet future liabilities, government plans are not required to – and most cannot and do not – choosing instead to "kick" the proverbial "can" down the road. The virtual evaporation of defined-benefit pension programs has forced the population in general to take on the responsibility to save and invest for itself and actively participate in their own retirement planning. The replacement for the traditional DB pension plan, involving transition to a 401k (or its equivalent 403b, etc.) has been swift in relative terms, with the vast majority of employees now having the responsibility of saving and managing their own pool of retirement assets.

As many 401k participants have found out, the "help line" personnel and the "human resources" employees who help with the plans are limited to ONLY discussing the plan investment choices and are explicitly prohibited from giving investment advice – again leaving the vast population to by-and-large fend for themselves. The good news here is that as registered investment advisors and fiduciaries we have been able to help people with this issue. The job of converting a nest egg into a lifetime income stream, and perhaps a legacy for their children or the community is probably the greatest concern for our clients. The portfolio that helped you reach retirement may not be the one you need to sustain your retirement, and determining the exact proportion of stocks and bonds that is appropriate for your retirement portfolio can be a challenging task.

To create cash flow from investments during retirement, most investors rely on payments produced by dividends, interest, annuity distributions, IRA distributions, systematic withdrawals from an equity portfolio, or a combination of these options. The selection of specific income-producing investments begins with a review of your tax situation, as taxes play a role in determining when and how much income should be taken in the form of distributions from 401k plans and other tax-deferred investments. If we anticipate a lower tax rate in the future (probably unrealistic today, but you never know), we may suggest a delay in using your tax-deferred investments until a more favorable tax rate will apply.

As a routine part of planning we calculate distribution rates from our clients' portfolios and suggest a number that is realistic and

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Managing Retirement Income and Distribution (Continued)

sustainable. The old planning standard is 4% as a rule of thumb, based on mathematical calculations and historical data. For example: with a nest egg containing a mix of 60% stocks and 40% bonds, using the 4% distribution rule would have a 90% chance of success, or only a 10% chance of exhausting the retiree's nest egg by age 97, assuming past market history for performance going forward. If the retiree stepped up the withdrawals to 6 percent per year, he/she would probably face a 10% chance of running out of money at age 82, under the same assumptions. But if the markets didn't perform in the same sequence as before, i.e. with an 18-year bull market at the beginning, the results would be considerably worse. This potential outcome needs to be included in planning assumptions, and many people we talk to are not doing so because of the psychological phenomenon called "anchoring," in which we all tend to project recent trends forward even though we know that "past performance is not indicative of future returns."

There are numerous variations on this theme, but none comes with a guarantee of purchasing power or adequate cash flows for retirement. We encounter many instances where we have to discuss the sustainability of income distributions from accounts – another situation where an unemotional observer/advisor can be a valuable addition to your planning. ■

Special Topic:

The Retirement Income Dilemma and How To Fix It

By Kevin M. Wilson

One of the side effects of the massive federal interventions of the last three years has been the harsh treatment of savers and income-oriented investors under the low interest rate regime put in place to "save" the financial system. At the same time, weakness in the U.S. financial system and deficit spending have caused the dollar's value to decline, imposing a form of inflation risk on retirees that made the impact of falling rates even worse. Real (inflation-adjusted) bond yields for 10-year U.S. Treasuries have been negative for months at a time in three separate episodes since 2006, including presently. Current short-term real rates are strongly negative as well. Federal Reserve policies have thus had an especially unfortunate impact, forcing savers to take near-zero rates on money market funds and various types of bank deposits for years now, with no prospect of an end to low rates until perhaps 2013.[28] But this is really just an overprint on a long secular trend towards lower fixed income rates that has been impacting retirees for many years. In effect then, income investors have experienced a quadruple whammy in the markets. Not only did the dollar, interest rates, and bond yields fall, but simultaneously these same investors, if they were diversified into balanced portfolios, got pounded by the stock markets. They were hit by two separate stock collapses in a decade, one that dropped a cumulative 49% by October of 2002, and another that dropped a cumulative 58% by March of 2009. Finally, income investors experienced a halving of stock dividend yields over the last 20 years as Wall Street changed its theory on dividend payouts.

The lower rates, falling stock prices, and lower yields have forced many retired investors to cut back on the distributions they've taken each year, or to cut into principal in order to maintain their standard of living. Although the investment picture right now does seem somewhat bleak for income-oriented investors, there are things one can do to boost income. Unfortunately, there is no way to do that without taking more risk. One method that has worked for some investors is to buy preferred stock, royalty trusts, and/or Master Limited Partnership (MLP) shares. Typical preferred stocks include the guaranteed dividend-paying securities of banks, REITs and utilities. Typical royalty trusts pay distributions of income derived from oil and gas production in large, established fields. Typical MLP shares include the securities of oil or natural gas pipeline companies, energy storage companies, or energy transportation firms. The problem with all of these is that they are subject to considerable market risks, and share price fluctuations have been very large in recent years. Still, for those who can stand these price fluctuations, yields are relatively high (4%-9%) compared to almost all other types of income investments.

If these investments seem a bit risky, there are still some alternatives that could work. One very promising option is to invest in foreign developed market and emerging market bonds. This is often a complex type of investment due to currency exchange risk and political risks, so it usually makes sense to buy these bonds within a managed fund or an ETF, rather than attempt to buy such bonds individ-

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The Retirement Income Dilemma (Continued)

ually. The main advantage of foreign bonds is that yields are often much higher than in the U.S., especially for sovereign debt issues, even though actual risk is sometimes relatively low. Markets still treat some of these bonds as very risky, so they remain volatile, but their credit ratings are high and default rates are very low. If one is concerned about currency exchange risk, it is relatively easy to offset that risk by seeking out currency-hedged bond funds run by large investment companies. While we are thinking about foreign assets, it also makes sense to consider foreign stocks that pay high dividends, especially stocks in relatively safer sectors such as telecoms, utilities and banks. Dividend yields as high as 7%-9% are not unusual, although stock volatility can also be high. Income can also be derived from a blue chip stock portfolio by selling call options on the stocks. This gives others the right (but not the obligation) to buy stocks that you already hold, and the other party pays you a premium for this right.

Another form of bond that has become more popular lately is known as a floating rate bond. It consists of securitized bank loans with variable interest rates. These have the advantage of adjusting their yields upward over time when inflation rises or rates climb, offsetting much of the sting that comes with inflationary rate environments. Floating rate bonds can be quite volatile, but some bond funds use coupon formulas to impose caps and floors on yields, which limits losses (and gains) to some degree. High yield corporate or municipal bonds can also be helpful in some situations, although the risk has to be carefully evaluated for each individual bond. Again, complexity suggests that these bonds are best purchased in a managed fund. Specialized currency trading mutual funds and ETFs can also add income to a portfolio in the form of gains from simple currency trades and more complex currency derivatives hedging strategies.

Although the investment picture right now does seem somewhat bleak for income-oriented investors, there are things one can do to boost income. Unfortunately, there is no way to do that without taking more risk.

All of this may seem pretty complex to the traditional income investor, and the above-mentioned asset types and income sources are not for everyone. But if investors are still seeking a better cash flow stream from their portfolios of stocks or fixed income securities, there are alternative opportunities available; however, risk must be taken if one wants to beat the current low rates. One alternative hat fits the current situation rather well is to buy bonds, bond funds, or ETFs for the purpose of making capital gains rather than for yields alone. For example, if you expect the either the equity market sell-off or deflation trends to continue for awhile, investing in U.S. Treasuries could make sense. People tend to forget that Treasuries don't just help offset risk when equities correct – they actually make gains. The generic 20-year Treasury made almost a 34% gain, and the generic 10-year Treasury made 18% when the equity markets tanked by 37% in 2008.[29] In comparison, MLPs and preferred stocks dropped by 37% and 26%, respectively. This is not to suggest that such gains can be had again; rather, that significant gains may be obtained under certain conditions that cause investors to seek the safety of Treasuries. Of course, now that U.S. Treasuries are at risk of a ratings downgrade, the situation is more complex than it was in 2008. Caution is thus required in seeking capital gains from Treasuries at present.

Other opportunities for capital gains on bonds have also arisen from time to time, and may do so again. One good example is the recent sell-off in municipal bonds caused by dire prognostications by market researchers on the potential for municipal defaults. The defaults have not materialized yet, but the sell-off reached the level of 20% or more for many muni bond funds and ETFs recently. Some investors bought in after the initial sell-off to get any gains that might be obtained as the funds recovered, which they have indeed partially achieved. Still other, more risk-tolerant investors have bought high yield corporate bonds whenever their spreads (i.e., yield differentials) against Treasuries have been very high (i.e., prices have been low). Then when those spreads come back down, as they did after the worst of the financial crisis was over, substantial gains can be made. All in all, this seeking of capital gains rather than just yields from bonds and bond funds is not necessarily for amateurs, since it can be a fairly risky undertaking, but it is one way investors can add to cash flows in a very tough investing environment. ■

Please Share Our Newsletter or Refer Others to Blue Water to Help Them Preserve and Grow Their Wealth

We encourage you to share our newsletter with business associates, friends and family. Let them know what we have done for you to preserve and grow your wealth. We would be glad to help your contacts benefit as well. We are not a "stay the course" or a "do nothing" type of firm. We are actively researching, analyzing, and managing risk every day. We do not take our fiduciary responsibilities lightly. We work hard on your behalf to anticipate economic trends and take action accordingly based on our assessment of risk and potential returns. We have made significant investments in our business to make sure we have the best information and people that are capable and intellectually equipped to make important and timely decisions managing your wealth. **Also, please visit our website at www.bluewatercapitaladvisors.com, and our weekly blog at http://bluewatercapital.wordpress.com.**

Please attend our next "Monthly Market Forum" if you can; we'd love to see you, your relatives, and your friends there. Scheduled meetings will be held at 5:00 pm - 6:30 pm on September 15 , 2011 at The Kitchi Gammi Club, Duluth; and October 20, 2011 at a Location TBD. The meetings are suspended for July and August to accommodate summer vacations. If you can attend in September or October, please RSVP to Blue Water. Business casual attire suggested.

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3 Bill Gross, Investment Outlook, PIMCO, http://investments.pimco.com, 3/31/11
4 Lewis Lehrman, Op-Ed column, *The Wall Street Journal,* 4/26/11
5 Francesco Garzarelli, Global Markets Daily, Goldman Sachs Research, https://360gs.com, 6/15/11
6 Paul Kasriel & Asha Bangalore, US Economic Outlook, www.northerntrust.com, 6/9/11
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10 Edward Lazear, *The Wall Street Journal,* 5/16/11
11 John Hussman, Weekly Market Comment, www.hussmanfunds.com, 6/13/11; Prieur du Plessis, Commentary, www.investmentpostcards.com, 5/13/11
12 James Mackintosh, *Financial Times,* 6/14/11
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14 Richard Bernstein, *Financial Times,* 4/27/11; The Lex Column, *Financial Times,* 6/02/11
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