

Greetings Clients & Friends,

In my commentary from the beginning of September I suggested that the stage was being set for a significant move higher in global stocks over the next six months. This prediction ended up being quite timely and fortuitous, as global stocks have rallied strongly over the last month, which resulted in the strongest gains for the month of September in over 70 years for the U.S. markets. Admittedly, I wasn't expecting that strong of a move in this short of a time period, but we will take it nonetheless!

Smith Capital client accounts also performed well during the month of September and for the third quarter. Year-to-date through September 30th, the total returns for all of our model portfolios are positive, and each model portfolio is outperforming its respective market benchmark. Furthermore, we have generated good returns across the board for our clients even with a relatively high level of cash reserves for much of the year. As you may recall from my commentaries this year, we have been tactically navigating these highly emotional and uncertain global financial markets, seeking to take advantage of shorter-term peaks and valleys in various asset classes. This of course is within the context of a basically flat overall equity market since the beginning of 2010.

As the calendar rolled over to the month of October, I made some portfolio management maneuvers toward a slightly more defensive posture in most of the Smith Capital models. These actions were driven by the fact that global stock and commodity markets have very quickly priced in much the positive catalysts I thought could push the market higher through year-end. While I still believe stocks will move higher over the next several months, and I continue to view stocks as much more attractive than government or even corporate bonds, I do believe we have moved too far too fast once again.

In the SmithCap Income & Moderate Growth and SmithCap Capital Growth model portfolios I have sold a little bit of our large-cap growth exposure, and added between 4% - 7% exposure to S&P 500 inverse and market volatility ETFs. These positions act as a hedge for the equity exposure within each of our clients' accounts, which I believe is warranted and prudent in the short-term.

Within the Smith Capital Tactical ETF portfolio I have also reduced the large-cap growth exposure, added to the S&P 500 inverse ETF, added in the long volatility ETF position, sold out of our highly profitable silver ETF position, and took some recent short-term profits on a long crude oil position. This model portfolio strategy also currently has a fairly high cash reserve position, currently around 30-40% depending on each client account circumstance.

Finally, in our Smith Capital Opportunistic Equity portfolio I have been selling a few of our individual stock positions and raising overall cash reserve levels. A couple of the stocks we sold hit our short-term price targets so we wanted to lock-in some nice profits, while a couple were sold with slight losses because they were disappointing in their price action. We have added a slight hedge ETF position within these portfolios as well.

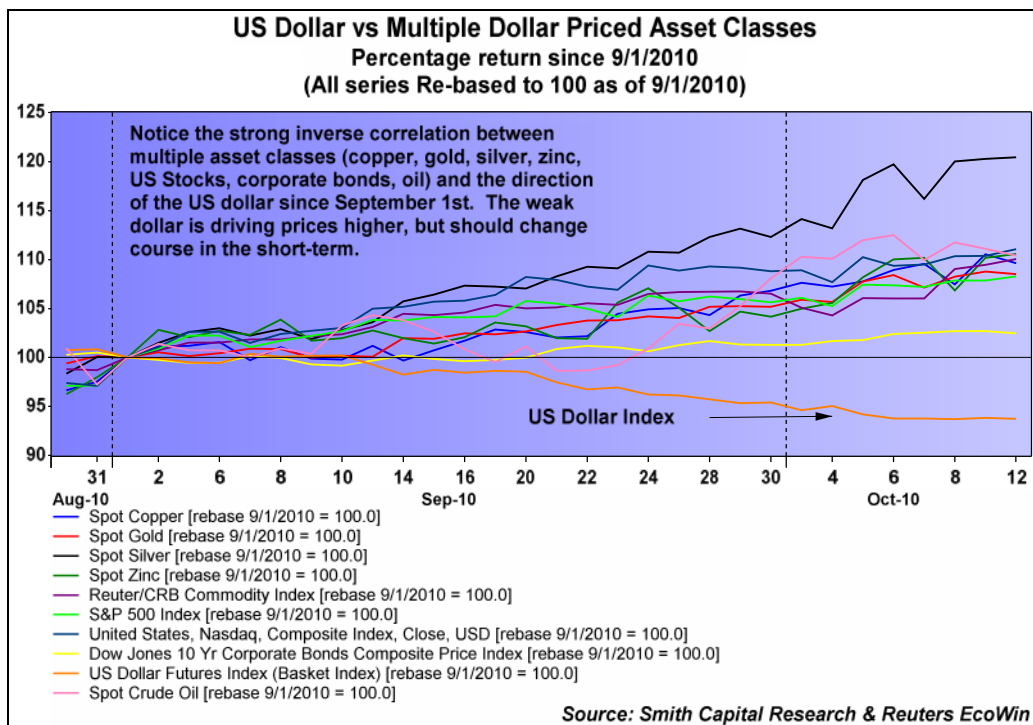
So, let me address why even though I remain positive on the intermediate-term outlook for U.S. and foreign stocks, in the short-term I am concerned and have positioned our client accounts more defensively.

The basic concern I have now relates to the recent excitement by short-term traders over the prospect for significant quantitative easing by the US Federal Reserve. While other central banks like the European Central Bank and the Bank of Japan have also recently signaled their intentions to pursue further monetary easing measures such as bond and other credit asset purchases, it is the message from Ben Bernanke and the Fed that is really driving equity and commodity markets higher.

Basically, due to signs of further economic sluggishness down the road, combined with a stubbornly weak housing market and a very sticky unemployment picture, the Fed is concerned economic growth will slow again. Hence, they have announced their willingness and intention to pursue what has been dubbed QE2 (Quantitative Easing round 2), which amounts to the Fed purchasing a host of government and agency related bonds in an effort to keep the financial system flush with liquidity and to keep interest rates low for an extended period.

QE2 is deemed necessary mainly because the Fed is out of bullets, so to speak, with the Fed funds target rate effectively at 0%. This recent communique by the Fed of their intentions has caused a massive round of selling pressure in the US dollar. Here is where my concern lies. Remember that the US dollar is still the world's reserve currency, so as the dollar falls in value, not only do other currencies rise in value versus the dollar, but other "dollar-priced" assets like U.S. stocks, crude oil, base metals (copper and zinc), precious metals (gold, silver and palladium), etc. are rising in value commensurately.

The following chart depicts the recent strong moves in various asset classes, and their associated inverse correlation to the direction of the US dollar.



So, while I was looking for the market to advance higher at the beginning of September, a potent combination of factors drove the markets significantly higher in a condensed time period. These factors included the following:

- The massive decline in the dollar
- Record low interest rates
- Institutional investors (& hedge funds) who are under-invested in equities, coming around to the theory that bonds are expensive and stocks are cheap, and thus re-allocating into equities before year-end
- Indications that the November elections outcome will be more tax / investor / corporate friendly
- Increased merger & acquisition activity announcements
- Stock buybacks and dividend increase announcements
- Relative valuation of equities rhetoric spreading

At this point, much of the hoped for catalysts for the stock market from the aforementioned factors have been baked into stock prices in the near-term in my opinion. This is the reason for moving to a more defensive stance. However, if the current Q3 earnings announcement season comes in strong, and if more of the fear-oriented capital that still sits in perceived safety positions (i.e. cash, money market, CDs, government bonds, and corporate bonds), keeps flowing back into equities, then we could easily see a "melt-up" scenario. This means a quick, strong advance in global stocks being driven by the anticipation of global economies improving and being pushed by capital re-allocation flows.

I do believe such a bullish scenario could unfold, but I am concerned about its prospects in the short-term. Hence, I believe the most prudent, risk-control oriented decision at the moment is to be modestly hedged with some dry powder for further stock purchases at slightly cheaper levels.

Within the SmithCap Income portfolios we have kept our relatively high bond exposure at about the same level, but in the third quarter we added a small bond hedge position. As I have communicated recently, I am concerned about over-valuation within bonds, and I foresee a day of reckoning in the government bond market that will push prices lower and yields higher. We have begun hedging this potential risk, but will look to further reduce bond holdings as the turning point appears imminent. For now I have been giving our bond exposure a longer leash so as to ride this momentum wave a little further. But, vigilance in this exposure is key.

I will be publishing another commentary with a report on the composite returns for each of the Smith Capital model portfolios for the third quarter and 2010 year-to-date very shortly.

Thanks for the privilege of serving you and your families.

Sincerely,

Chad R. Smith, Managing Director

[chad@smithcapital.org](mailto:chad@smithcapital.org)  
[www.SmithCapital.org](http://www.SmithCapital.org)