



10300 SW Greenburg Road
Suite 115
Portland, OR 97223

ALL EYES ON THE FED

ALL EYES ON CONGRESS AND THE PRESIDENT

Client Newsletter
Quarter Ending June 30, 2011

Investors have seen their eyes cross, as congress dithers over an increase in the debt ceiling. Both sides dig in and positions harden. The Tea party is particularly intransigent, and Republicans are having a hard time delivering a untied position let alone votes. Liberal Democrats are unhappy with President Obama as he tries to adopt a centrist position in anticipation of the upcoming Presidential elections. Sclerosis of the political process makes a deal more and more in doubt.

One Republican leader Sen. Mitch McConnell (R-KY) floats the idea of a plan which would allow the president to raise the debt ceiling himself while at the same time allowing Republicans to ability to vote against a debt ceiling increase. Many Republicans criticize the plan. Sen. Harry Reid, the Democratic leader in the Senate supports the McConnell plan. Other plans emerge.

With the August 2 deadline approaching the negotiations enter into their most intense phase. Pres. Obama plays political hardball by warning that Social security, soldiers, and Medical bills will not be paid, inflaming Republicans. He threatens to take his case to the people, but other than threats, it is not at all clear what his case is since he has not proposed the cuts to the budget necessary to get a deal.

In the meantime the clock ticks and in the absence of a deal, Timothy Geithner, the Secretary of the Treasury, warns against a default in stark terms. Rating agencies warn of downgrades of U.S. debt.. A default is unthinkable. But the Tea party insists that if it takes a default to win their position, so be it.

The Federal Reserve chairman Bernanke says that the Fed does not have the resources to backstop a default. Negotiators seem boxed in and clueless at the same time. There is no telling what the fall out will be from the political gamesmanship, but the fall out from a default is clear. While the negotiators point fingers, it is clear that downgrades of U.S. debt resulting from a default will cost more in additional interest costs that can be saved by cuts. One would think that reasonable and rational people, interested in the future of the country could come to terms in such circumstances, but it is not at all clear, that reason will prevail.

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The investment outlook is totally opaque. There is no clear path. If an agreement is reached, the markets will rally, perhaps sharply, in relief. If no agreement is reached, stocks may well sell off. If there is some sort of middling muddy middle ground, the markets will probably continue on the current course. Until the outlines of the deal, if there is one, are clear, there is no one right answer. At the moment, the economy is still in a slow recovery mode. Retail sales have enjoyed good numbers. The Fed has adopted a watchful stance, ready to jump in if the economy weakens, and is more fearful of deflation than inflation; so expect continued low interest rates, for the "foreseeable future". As the Fed examines its limited arsenal of tools left, Chairman Bernanke first seems to suggest another round of quantitative easing.

We have adopted a stay the course stance. If you have questions or disagree, give us a call.

Best personal regards,

William D. Rutherford, President
Rutherford Investment Management LLC.

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