Quarterly Point of View
Skinny Dipping at Low Tide

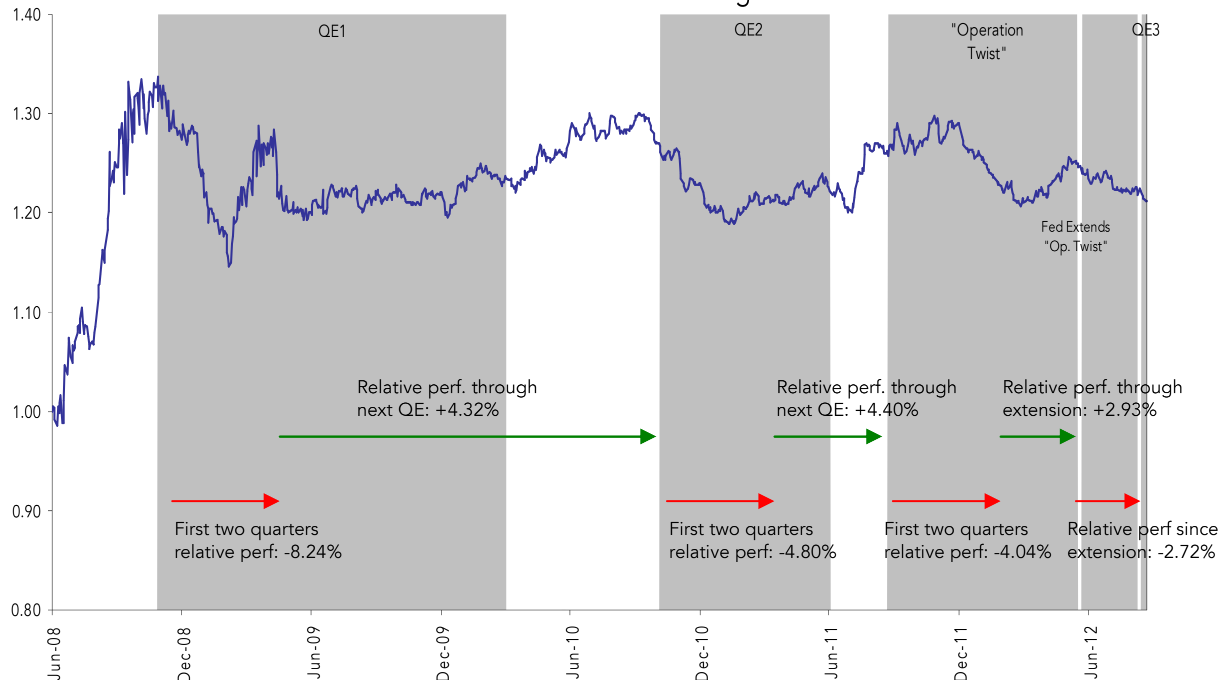
October 17, 2012

Ben Bernanke and the Federal Reserve are in an admittedly tough spot. Since taking the helm in 2006, the Federal Reserve Chairman has spent the vast majority of his central bank leadership dealing with the crisis that emerged from the deflating credit bubble. Many however, argue that he was an enabler of that bubble, as an ardent supporter of the concept that central banks should not 'lean against asset bubbles'; this view he most clearly outlined in public remarks to the National Association for Business Economics in October of 2002, as a member of the Fed's Board of Governors. Still, an argument can be made that his deep knowledge of the economic and political causes of the Great Depression -- a topic on which he has written extensively -- combined with his pragmatic approach to monetary policy, made him the right person for the job at this particular time.

In any case, the Fed currently finds itself in unchartered waters, and measures being taken are experimental and unproven. On September 13th, the Federal Open Market Committee launched its fourth round of 'Quantitative Easing' since 2008. This effort, dubbed 'QE3', follows 'QE1', 'QE2' and 'Operation Twist'. The committee stated that it agreed to increase monetary policy accommodation by purchasing additional agency mortgage backed securities at a pace of $40 billion per month, and that if the outlook for the labor market does not improve substantially, they will continue until improvement is achieved. In other words, this is an open ended commitment from the Fed. At its root, quantitative easing is a gentle term for injecting newly created money/credit into the economy directly through the purchase of financial assets. When securities are purchased this way, it can be likened to the government simply creating money to pay its debts. Many would argue that this form of easing is just like turning on the printing presses, and that may indeed be the appropriate description. Its goal is to keep interest rates low, in an attempt to spur economic growth while enhancing the wealth effect. What it may end up causing is asset price distortion -- an artificial boost that earnings can't support -- which raises the risk level for the average stock in the market that's elevated due to the Fed's pump priming.

Below is a chart displaying relative performance of the S&P 500 compared to the S&P Dividend Aristocrats index; it starts just before both the crisis began, and Quantitative Easing was implemented. Dividend paying companies tend to be more mature, with better-than-average balance sheets and relatively stable operations – a good proxy for lower volatility, less aggressive investments. When you look at the difference between the two indices, it is interesting to note that dividend stocks lag the market substantially (red arrows) during the first two quarters following a Fed announcement of stimulus. After a couple of quarters pass, and the 'Fed Fix' as we might call it, wears off, the less aggressive and normally more fundamentally sound dividend stocks start to outperform the averages (green arrows). This is important to keep in mind as these measures can't last forever… yet the longer they do last, the more dangerous the side effects may become.

2911 Tennyson Avenue, The Inkwell Building, Second Floor ▲ Eugene, OR 97408
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com



Relative performance of the S&P Dividend Aristocrats to the S&P 500 6/2008 – 9/2012. QE1 11/2008 – 3/2010. QE2 11/2010 – 5/2011. The Fed began Operation Twist in September of 2011 and extended the program June 20, 2012. The Fed announced QE3 on September 12, 2012. Sources: Thomson One, the Federal Reserve and Martin Capital Partners, LLC.

Given the quite obvious and consistent difference in performance between the subsets around the time of the Fed's decisions for action, it appears that the market is following the old adage, "don't fight the fed" – by being fully, possibly even aggressively, invested while monetary policy is loose and accommodating. One should acknowledge that this does not come without risk. Attempting to enhance the wealth effect and keep some assets at levels that may be harder to achieve without artificial force, the danger comes when that force is no longer present. Fundamentals from a dividends and earnings perspective will then have to prevail, and it is wise to be positioned beforehand. With the drumbeat of Fed 'stimulus' continuing in 2012, dividend stocks have started to drop a bit in the market's daily popularity contest. The anticipation and recognition of yet another round of monetary stimulus has fed the appetite for stocks whose fates depend more heavily on an improving economic environment (whether or not the stimulus actually helps the economy remains to be seen). The important thing about a dividend focused strategy is that it's not about the markets, economy or short term performance – it's about each investor and the ability to meet future financial needs and goals in a prudent and relatively consistent manner. Short term popularity will ebb and flow, but the tangible nature of dividends, and the long term force of growing cash payments are undeniable.

A final thought – if the Fed is having to continually take these measures and is on its fourth and arguably most aggressive round of quantitative easing, what does that say about their feelings for the global economic backdrop? It likely reflects some deep concerns. One can definitely make the case to be invested in high quality securities with acceptable valuations that offer good upside potential with reasonable downside risk… but now is not the time to ratchet up the risk profile. In other words, to relinquish some current upside may be wise if the portfolio is positioned to retain

more value when the Fed steps away. As Warren Buffett once said "*It's only when the tide goes out that you learn who's been swimming naked.*" We'll try and make sure we have our suits on.

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Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

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