

NOVEMBER 9, 2011

*If it's Wednesday, it must be Rome.*

It seems like hardly a day seems to go by without some European head of state stepping down. Yesterday, Greece. Today Italy. Tomorrow...France?

*An update for clients and friends.*

It's been another crazy few weeks in the global economy and financial markets and we thought it would be helpful to provide you with an update of our current thinking and how your portfolios are positioned.

Although macro-level issues, and especially the ongoing European debt saga have dominated the headlines, economic news at home has been more encouraging.

Against this backdrop, global stock markets have shrugged off sovereign debt concerns, at least through yesterday, and staged a sharp snap-back rally since early October. Meanwhile global bond markets continue to warn of rising systemic risk in Europe.

On the positive front, economic data in the U.S. has shown signs of improvement. Gross Domestic Product for the third quarter was revised higher to 2.5%, consumer and business spending and industrial production have all reversed course and are trending slightly higher. Corporate earnings were also generally



strong, although future guidance remains guarded. Companies are in good shape and for the time being, things have stopped getting worse on this side of the Atlantic.

Economic growth is still below where it needs to be to foster meaningful job growth and to support our mounting debt load, but the prevailing trends are in the right direction. And the U.S. has the added current benefit of *not* being Europe.

Meanwhile, Europe continues to dominate the headlines as well as the hearts and minds of investors. Although there appears to be greater awareness of the problems and required solutions, there is still more talk than action.

Talk of “Grand Bargains” and statements of solidarity, resolve and good intentions, and even resignations of political leaders may assuage

markets for a period, but they do little to solve the actual problems. The people may leave but the debt remains. Without bold action, the problems continue to escalate. The hard work lies ahead, time is running short and the risks are growing larger by the day.

In our view, the stock market has become increasingly complacent about to the European situation, giving the politicians the benefit of the doubt and focusing more on corporate earnings and signs of recovery at home.

As we have seen in the past, this can change quickly, especially as debt problems move from theoretical to real, usually in the form of a swift and crippling rise in sovereign borrowing rates. We saw this with Greece. We see this happening with Italy now. In the past 10 days, Italian 10 year borrowing rates have risen by over 1.5%.

Italy will be the next and pivotal battleground in the European debt crisis. Unlike Greece, which had an estimated 200 billion Euros in outstanding debt, Italy has almost 2 trillion Euros in outstanding debt and needs to refinance 300 billion of that in the next 12 months. Italy is both too big to fail and too big to save without a much grander bargain.

This will likely involve the European Central Bank (ECB) promising to supply an unlimited supply of funding – by printing Euros – to buy Spanish and Italian debt and stabilize European bond markets, lower borrowing costs, capitalize banks, and allow indebted countries the necessary breathing room to restore fiscal balance. It will also likely involve full fiscal integration of Euro member countries, including borrowing, and the issuance of Eurozone bonds by the ECB. Finally, it will involve Germany and healthier countries going “all-in” and using their economies as collateral for Eurozone borrowing.

Had they done this several months ago, Europe

would not be in the same pickle it finds itself today. This final step however has been strongly resisted by the ECB and Germany, both of which have been more geared to fighting the ghosts of inflation rather than preventing deflation. Germany and France have also been looking for solutions that primarily use and risk “other people’s money” rather than their own.

The good news is that the Eurozone does have the power to solve it’s own problems, but this is only possible by fully committing to fiscal integration, and subordinating national interests for the good of the entire Eurozone. This is where theory and politics collide and why, we suspect, things may need to get worse, thereby forcing the hand of the ECB along with Germany and France to take this final step.

Finally, at some point soon, media cameras are going to move from the Eurozone back to Washington and the debt commission. Expectations are low but we will likely be reminded how little progress we are making in putting our own fiscal house in order.

### ***Portfolio Strategy:***

We have been maintaining a positioning in client portfolios that is generally cautious but selectively opportunistic. Despite the signs of improvement in the U.S. economy and stock markets, the outsized risks that the Eurozone debt conundrum poses to the global financial markets keep us on a more defensive footing.

In our view, the potential for capital loss, if Europe stumbles, while less probable, is significantly greater than the potential for near-term gain if they muddle through. We also believe that the credit markets tend to be a more rational indicator of risk than the equity markets, which swing wildly from hope to fear on each new headline or rumor. Finally, we have maintained all along that Italy



matters a whole lot more than does Greece, and so we have been closely monitoring Italian bond yields over recent weeks as they have risen. They have been telling us to stay cautious.

One thing that we have done in most client portfolios – depending on objectives and other constraints - is to make an investment in a specialized “Structured Volatility Note” offered by J.P. Morgan. We expect market volatility levels to remain elevated and the Note is designed to benefit from significant movements in the level of volatility in the stock market - whether rising or falling - and provide some measure of hedge or insurance for the entire portfolio.

The Note has also provided us with a little more cover and confidence to add to a few existing positions as well as several individual stocks such as Cisco Systems that we think are downright cheap and offer an attractive potential return relative to risk.

But for the most part, we think the prudent course is to maintain our current positioning and to watch

how some of these big imponderable problems unfold in Europe, in the U.S. and elsewhere in the world. It does seem like we are reaching the end of the road, quickly. Much more will be known in a relatively short period of time.

If we feel that significant progress is being made in Europe, and we see that progress reflected in the bond markets believing it, rather than stock markets hoping it, then we will feel more comfortable increasing our risk-oriented exposure.

Please feel free to call us if you have any questions about this and/or if you would like to discuss our strategy and your portfolio. We are here to help.

As always, on behalf of our whole team here, thanks for your ongoing trust.

Best,

Karl O. Mills, CFA  
*President*

Jurika, Mills & Keifer is a private advisory firm, providing investment management and counseling services to a select group of individuals and families.

Our firm is built on a core set of values and investment principles that have been central to our identity and success for more than a quarter century.

Our objective is to preserve and build the purchasing power of our clients' capital over time through effective planning and investment management.

We think for ourselves and are often willing to challenge conventional wisdom. In our experience, unconventional wisdom often leads to uncommon opportunity.

Our offices are in San Francisco, California, and we are registered with the SEC.

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