NOESIS CAPITAL MANAGEMENT

A REGISTERED INVESTMENT ADVISOR

October 15, 2010

Dear Client:

The U.S. House of Representatives recently passed a bill imposing punitive tariffs on a variety of Chinese imports to penalize China's foreign exchange practices. Proponents of the bill view China as an unfair competitor and blame it for contributing to the high unemployment rate in the U.S. As Brazil's finance minister, Guido Mantega, commented on September 27th, "We are in the midst of an international currency war, a general weakening of currency." As a global portfolio manager and a firm with many overseas clients, we pay attention to foreign exchange and think it is timely to convey our thoughts.

Before we address the issue of foreign exchange, let's examine a fundamental question: why does a country want to devalue its currency and in what situation(s) does a country prefer a strong currency? As a general rule of thumb, when a country is experiencing a period of low unemployment and a high level of economic growth, the economy tends to move towards inflation because the aggregate level of demand for goods/services increases and thus the purchasing power of money decreases. To prevent inflation, a strong currency is needed as it provides consumers more purchasing power and incentive to consume. On the other hand, when a country is suffering high unemployment and low growth, the economy tends to move towards deflation and therefore a weak currency is desirable. A weak currency helps raise the cost of imports and reduces the price of exports. As a result, it motivates domestic manufacturing and, in turn, the hiring of more workers, while discouraging the purchase of foreign products/services.

Now, let's take a brief look at history. Before 1930, most countries used the gold standard and there was little incentive for devaluation. However, during the 1930s Great Depression, many countries abandoned the gold standard in order to survive. Unfortunately, devaluation of one county's currency encouraged a corresponding devaluation in another country, which caused a wide fluctuation in exchange rates. As a result, global trade volumes declined sharply and many global economies struggled for an extended period of time. The lesson learned is to avoid a global currency war by all means as there are no winners in the long run.

At the end of World War II, the signing countries of the Bretton Woods Accord agreed to adopt fixed exchange rates using the U.S. dollar as a reserve currency, which at the time was a gold standard currency. Global economic growth was quite healthy in the following couple of decades until the U.S. unilaterally gave up the gold standard in 1971, as the Vietnam War accelerated inflation and the U.S. began to run a trade deficit. The world eventually went back to a floating currency system.

1801 Clint Moore Rd., Suite 100, Boca Raton, Florida 33487
561-999-9888 • Fax 561-994-2893 • E-Mail: info@noesis-capital.com
www.noesis-capital.com

In 1985, France, Germany, Japan, the U.S., and the U.K. signed the Plaza Accord to depreciate the U.S. dollar in relation to the Japanese yen and Germany's Deutsche Mark. The purpose of the Accord was to reduce the U.S. trade deficit and help lead it out of the recession. It eventually worked for the U.S. Japan, on the other hand, acted too late in letting its Yen appreciate which lead to an asset bubble and the resulting decade long recession.

The 1997 Asian Financial Crisis started in Thailand, when the Thai government decided to float the Thai baht, cutting its peg to the U.S. dollar. As "hot money" flooded into Thailand, it quickly created a bubble for this small highly indebted economy which eventually burst. This situation spread quickly into other highly leveraged economies worldwide. Both Japan's lost decade and the Asian Financial Crisis are the hard lessons many export-oriented small economies learned. Stabilizing the exchange rates has become their major focus.

Following the recent "Great Recession", overall global trade declined by 12% in 2009 and recovery around the globe so far is very imbalanced. Most developed economies remain weak and have continued to struggle in a deflationary environment, while many emerging economies have recovered quickly and are facing inflationary pressure. The U.S. economy, for example, remains weak and the unemployment rate high. A weak U.S. dollar could help stimulate U.S. exports, reduce debt levels and prevent deflation. Therefore, right now a weak dollar is welcome in the U.S.

On the other hand, as China manipulates the renminbi, its devaluation likely will not help the country as much. China defends its intervention with the argument that a strong renminbi may cause the country to lose its export competitiveness, weaken its economic growth momentum and result in high unemployment and social unrest. However, as its economy is expected to grow more than 8% and its unemployment rate remains at around 4% for the foreseeable future, China should have an incentive to maintain a strong currency in order to abate the risk of rising inflation while benefiting from a rising purchasing power. Keeping the renminbi artificially low also requires the help from an artificially low level of interest rates. Low interest rates may cause inflation and an asset bubble, as the longer the renminbi is kept low, the more speculative "hot money" will flow into renminbi-based assets. Besides, aggressive devaluation may eventually push trade partners towards a corresponding devaluation. As history has shown, no one wins in a currency war.

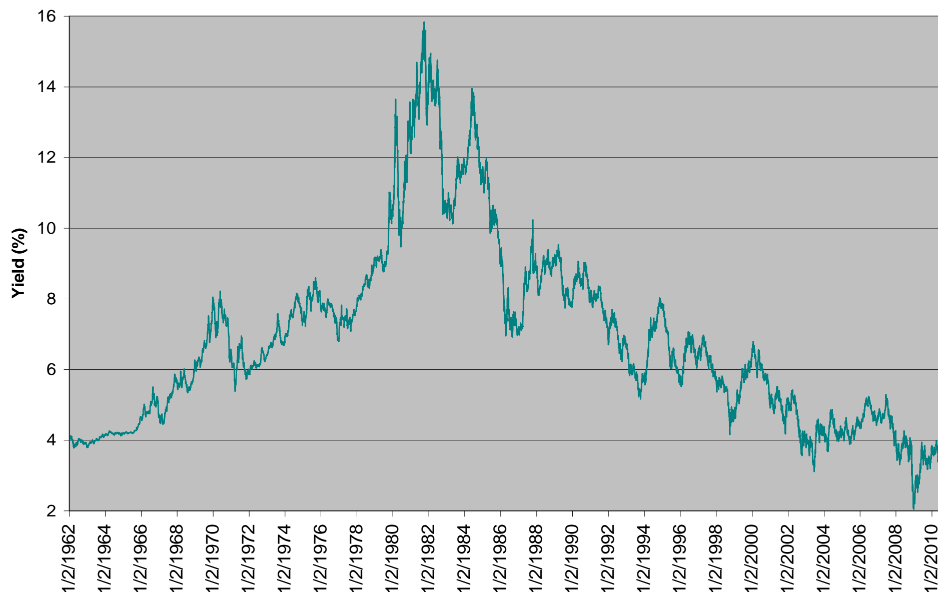
From an investor's viewpoint, the foreign exchange market is very volatile and difficult to predict as it is continuously manipulated by both governments and speculators worldwide. It is not fundamentally analyzable. As such, we prefer not to speculate on exchange rates. As a global portfolio manager, in order to manage the exchange risk, we focus on long-term perspectives instead of speculating on short-term exchange rate directions. We prefer investing in local-currency-denominated foreign securities whenever they are available and favor investing in global companies rather than in local companies.

As long as investors are concerned about a currency war, gold prices may look attractive. However, the rising gold price in recent years is less based on fundamentals and more on speculation and, accordingly, we are not interested in building any position at this point.

The bond market continued its trend of declining yields, with the 10-year US treasury nearing a record low of around 2.30% (see the chart below). Investors are starting to raise the reasonable question of a bubble in the bond market.

In its recent statement, the Fed expects inflation to remain subdued and indicated its willingness for additional monetary accommodation, so called "quantitative easing 2", which describes the policy of injecting money into the banking system while purchasing government debt. Evidently, the Fed's past efforts starting in 2009, did not sufficiently stimulate the economy and reflect the difficulty to return to a more stable level of inflation and employment. We expect yields to remain at these low levels longer, while acknowledging the possibility and risk of a sudden reversal in the downward trend. Consequently, we favor intermediate maturities and caution not to overweight short-term duration. Furthermore, we continue to prefer debt of high-quality companies over investments in highly leveraged firms.

Chart: 10-Year U.S. Treasury Yield



Source: Bloomberg Indices

RECENT PURCHASES

Energy Select Sector SPDR Fund (XLE)

XLE holds 40 energy-related companies of the S&P 500 Index. Its top 5 holdings are: Exxon Mobile (19%), Chevron (13.5%), Schlumberger (6.7%), Occidental Petroleum (5.3%) and ConocoPhillips (5.2%). Since oil is just an interchangeable commodity, prices globally tend to be highly correlated and, historically, so do energy stocks worldwide. We chose this low-cost, highly-liquid passive vehicle to participate in both the oil commodity and energy sector.

SPDR S&P International Small Cap ETF (GWX)

GWX provides exposure to smaller-capitalized companies (under $2 billion) in the developed economies excluding the U.S. The funds top 5 countries are: Japan (30.0%), U.K. (12.2%), Canada (11.2%), Australia (7.3%) and Korea (7.2%), while its top 5 sectors are: Industrials (22.7%), Consumer Discretionary (18.7%), Financials (17.2%), Materials (12.3%) and Info Tech (9.6%). The current dividend yield is 1.66%. We chose this passive vehicle to diversify some risks away from our normally large-cap-focused portfolio.

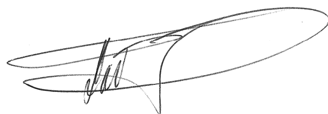
Fluor Corporation (FLR)

Fluor is one of the world's largest engineering, procurement, construction, maintenance and project management companies. Its business is organized into five segments: oil & gas (53.8% of 2009 revenue), industrial & infrastructure (21.9%), power (9.0%), government (8.1%) and global services (7.2%). More than half of Fluor's business is from international markets.

Walt Disney Company (DIS)

Disney is a diversified and world-famous family entertainment company. It operates with five business segments: Media Networks (45% of 2009 revenue) which includes ABC, ESPN, A&E/Lifetime and Disney Channel networks; Parks and Resorts (30%) which includes several theme parks and resorts in LA, Orlando, Paris, Tokyo and Hong Kong and two Disney cruise lines; Studio Entertainment (17%) which includes Walt Disney Pictures, Pixar, Touchstone and Marvel Entertainment; Consumer Products (7%), and Interactive Media (2%).

Sincerely,



Joseph Lai, CFA
Chief Investment Officer

Our most recent Form ADV, Part II is available upon request