

# SCHARF INVESTMENTS LLC

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## The Picture of Dorian Gray

In Oscar Wilde's famous novel, Dorian Gray remained ever youthful with his dreadful deeds leaving no mark on his countenance. Instead, the darkness of his soul was reflected in a portrait hidden from public view.

Today's stock market reflects a similar tale. The economic news gets worse and worse as the market looks better and better. The latest manifestation was a rally to new yearly highs after the October 8 release of the latest dreadful employment report.

The unemployment rate remains stuck at 9.6% and the underemployment rate at 17%. The housing market remains a morass with government supports and a gridlocked foreclosure process keeping prices above market-clearing levels. The federal government is out of stimulus bullets with deficits at unprecedented levels. The Federal Reserve has cut interest rates to 0% leaving a second round of quantitative easing known as QE2 as its only option. Given the lack of success of QE1 – the massive purchase of mortgages and other securities – one wonders why stock investors would grow giddy over the prospect of a second helping.

While a rising market tide lifted all boats in the third quarter, we believe investors continue to overestimate the strength of the economy and the prospective earnings of economically-sensitive stocks. These cyclical stocks continue to sell at what we believe are unwarranted premiums to both the market averages and the seemingly undervalued stable-growth stocks that make up the bulk of our portfolios.

While stock investors expect a robust recovery, bond investors foresee economic stagnation with interest rates on 10-year and 30-year Treasury bonds ending the quarter at 2.5% and 3.7%, respectively. Given the Fed's focus on re-inflating the economy, we believe these bonds have too much risk relative to their reward as do most corporate issues. We continue to emphasize inflation-adjusted Treasuries and State of California general obligation bonds in the fixed income portion of balanced accounts.

Jeffrey R. Scharf  
Chairman  
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