



## Mid-Quarter Newsletter

November 15, 2010

### From My Corner

Jeff Mengis – President

The recent decision by the Federal Reserve to initiate a second round of Quantitative Easing (dubbed “QE2”) has dominated headlines. Below, we address a few questions from clients with regard to QE2.

#### What is quantitative easing and what are the effects?

Without delving into the mechanics of quantitative easing, the Fed is performing the electronic equivalent of printing money. The Fed has announced plans to buy as much as \$600 billion in bonds from banks, increasing their capital reserves. In theory, this should have the effect of devaluing the dollar relative to other currencies and increasing inflation.

#### Why is the Fed taking this action and what are the risks?

Following the first round of quantitative easing, which ended in March 2010, economic growth was not as robust as hoped. The Fed’s recent action is driven by fears of deflation, which can lead to a downward price spiral. The stated goal of QE2 is to lift the level of core inflation closer to the Fed’s target of 2% and generate better employment growth. One of the greatest risks of QE2 is that inflation occurs and slow growth persists, resulting in stagflation.

#### How does it impact my investments?

If the Fed’s actions lead to inflation, investors holding cash will lose value in real terms and yields on fixed income investments will likely go higher, sending bond prices lower. In addition, as a result of a weaker dollar, the price of commodities should move higher and American exports would become more attractive. We maintain that a diversified portfolio is a prudent way to spread risk exposure across asset classes. Our fixed income allocations are generally positioned with a lower duration to protect against inflation risk. With regard to equities, our bias is toward positions in large-cap, dividend paying companies with strong international sales.

### Investment Focus:



**Medtronic**

With sales to over 120 countries, **Medtronic (MDT)** is a leading manufacturer of implantable medical devices. The company sells a wide variety of medical products

within the following divisions; diabetes, neurological/spinal and cardiac rhythm management. Medtronic experienced success in bringing new products to the market through acquisitions and the development of its product pipeline. The company is currently in the final stages of approval for a specialized orthopedic electric drill and a pacemaker that is compatible with MRI. If approved, those products would create further differentiation from the competition and allow for a potential revenue increase.

Over the past decade, Medtronic has grown sales and profits by an average of 23% annually. Despite that growth, the stock has steadily declined over the past ten years (see 10 year chart below). Lack of investor interest has potentially created an opportunity for patient shareholders. Medtronic’s stock currently trades at about 10.5X 2011 consensus earnings estimates and offers a 2.5% dividend yield. There’s risk that the company may be vulnerable to reduced market share and increased pricing pressure due to competition. However, given Medtronic’s valuation, those risks appear to be priced into the stock. As the company’s new product pipeline comes to market, it should enhance Medtronic’s ability to increase sales and margins.

