

**STRUDWICK**  
**Wealth Strategies**  
*“Innovation Equals Opportunity”*



**BEWARE THE COIN  
FLIPPER’S LOGIC**

By Barry Strudwick

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If radio listener phone calls are a barometer of the investor angst, pop the top on the Paxil and pass it around! Last week we reached the same depths as last fall. Last time we had a bout of national depression, we advised people to hold on and look for the Election Rally and then lighten up on stock exposure. Right now, we have an almost identical setup of events. This time, we believe people should use a War Rally as an opportunity to decrease stock exposure.

Our logic is outlined below in a letter we sent to our clients in early February. It’s unedited, but I think it encapsulates our overall thinking at this point and is right on point. I will take the time to snap my suspenders and point out the Oppenheimer Real Asset Fund is up 27% for the first 2 months of this year.

We’re working hard on some new “alternative asset” investments for our existing clients, which are focused on real estate in Costa Rica and other Central America countries. If you’d like to find out more. Drop us an email. As far as how to invest in these deflationary times, we’ve also included some new additions to our “Thought of the New Age” series.

*Thought # 4...Regardless of Inflation of deflation ...stock prices are ultimately about the value of underlying profits relative to risk free alternatives.*

*Our forecast is for lower profits, even with a growing economy. This calls for lower stock holdings.*

By now, we all know how tough last year was in the market. The Dow off 22.5% and the NASDAQ off 39.3 %, who would have thunk it? Certainly not the big name “Wall Street Wizards”. This time last year 25 of the 25 pundits polled by Rukeyser predicted a 2002 year end Dow over 10,000. That’s a 100% strikeout rate. We were very much alone with our (then contrary) opinion that 2002 was going to a tougher year than 2001 and we decreased stock holdings in January. Our biggest regret was that we didn’t cut back further.

Our predictions for 2003? Barron's this week pointed out the average market pundit is calling for a 20% increase this year. We just don't see it. The Bottom Line? We think it's going to be an "OK" year for the economy but another tough year for Wall Street. There are several reasons for this, but most importantly, the grip of global deflation appears to be tightening not abating. Short run, deflation will put the squeeze on profits even while the economy "grows". Long Term? If deflation is not treated aggressively now, the longer-term consequences are very ugly, resulting in severe recession. With Washington and the Press still in "deflation denial", what concerns us the most is the lack of easy solutions once they finally recognize the true issue.

***Thought #57...Hold on Momma!  
We're slipping out of the Sweet  
Spot of deflation and we're now  
teetering on the brink of a  
deflationary abyss...***

***We wrote this last December. AND  
ITS STILL TRUE TODAY. Deflation  
creates an ugly scenario for stock  
investors because even an expanding  
economy doesn't always mean profits.  
Use the current rally to cut your stock  
market holdings to where you wish  
you had cut them to a year ago...***

As we did last quarter, rather than build the case first and then get to our conclusions, I've arranged these thoughts somewhat in order of interest so as to get to the "bottom line" ideas first.

Here are our thoughts about last year and what's in store for 2003.

- 1) Bonds will outperform stocks yet another year. Hard assets and commodities will likely do even better. We will increase our holding of bonds and hard assets and decrease stocks. More on this below.
- 2) At this time we will move to reduce stock holdings by 5% to 10%. We've likely gotten the bump to be had from the Election rally. As we said last quarter "This is a short term rally with no substantive economic rationale". We suspect the Executive Branch and not the Fed engineered this rally. The markets have now had time to access the implications of the Republican sweep and the bold Bush tax plan. Our opinion is that neither of these events will fundamentally impact the core underlying problem of excess global manufacturing capacity.

- 3) When looked at in conjunction with our previous reductions last January and March would be a 15% to 25% reduction from 2001 levels. Further, there is nothing magic about reaching the prior year psychic high water mark of a 10,000 Dow or 9,000 for that matter. With the Dow trading at 39 times earnings, we see too much optimism already priced into the market.
- 4) We might cut even further over the next several months should the deflation clouds darken. But, there are several wild cards in the deck which could spike the stock market short term. The most immediate is the “Showdown with Saddam”. We suspect that the negative emotional aspects of the war are already priced into the market. It’s the anxiety of thinking about war that has the worst impact on the markets. The market could rebound after the war actually starts. Emotional aspects aside, from an economic perspective, a war could also immediately alleviate some deflationary pressure by soaking up a portion of the excess manufacturing demand. Second, the war premium in oil prices will likely fall quickly after the war. However, clearly none of these factors is a longer term solution for the worldwide supply/

demand imbalance. The root problem persists, but ironically a war could give us a better exit point for further reductions in the stock market.

- 5) Beware the “Coin Flippers Logic” on the stock market. The logic goes like this: After 3 straight down years, the market has to go up this year. After all, the odds of flipping tails 4 times in a row are about 256 to 1. Unfortunately, the rules of probability do not apply because Wall Street and economics are not “fair games” subject to the rules of probability. Stock prices are about profits (not probability) and the outlook for profits don’t look good at this point.

***Thought #59... Washington has received the “wake up call” on Deflation...***

***But the traditional stimulus tools of tax cuts and domestic spending programs are very blunt instruments when dealing with a global monetary problem***

- 6) Last year our positions in U.S. Treasury bonds had nice returns with the Strong Government Securities fund up 10.5%.

Interest rates should continue to fall, causing U.S Government bond prices to rise. Yes, even with interest rates now at 4.0% versus 5.7% last year there is still room to fall further.

Working from a lower base, a change of just 1/2 of one percent would cause a significant capital gain.

- 7) The case for investing in corporate bonds is less clear. Last year our position in the Loomis Sayles Bond Fund were up 13.3% with 8.3% coming in the last 90 days. While the business press touts the “end of a recession”, the story being forecast by bond markets continues to be one a financial stress. In fact, while interest rates on government bonds have fallen over the past year (creating gains), intermediate quality corporate bond prices haven’t profited from this as their yields have actually risen (creating losses). The chart below shows the interest rates on both high quality and medium quality corporate bonds expressed as a “spread” over the rate of the risk free 10 year treasury note. An increase in “spreads” shows the bond markets increased concern over companies ability to meet their obligations. This chart shows the cost of “credit risk” has actually

risen dramatically over the last year.

Spread of Corporate Bonds over 10 Year Treasuries

The Increasing Cost of Credit Risk

	1/2002	1/2003	Changes
<b>10 Highest Grade Corporate Bonds</b>	+1.3 %	+2.2%	+0.9%
<b>Medium Grade</b>	+2.4%	+4.2%	+1.8%

In the year “Post 9-11”, the “risk premium” demanded by the bond markets has risen not fallen. A 75% increase relative to this time last year! In English, this means, the “default risk ” or the risk of corporate bankruptcies by America’s largest corporations is very high and bond investors demand higher returns for this risk. Evidence? 88% of S&P’s recent bond rating changes have been downgrades. Junk bonds defaults have reached 16% of the amount outstanding.

- 8) Are the high spreads of corporate bonds an opportunity or harbinger of more hard times to come? Great question! Should

this spread narrow, corporate bonds will have large capital gains. Over the past 60 days we've seen some easing here and corporate bonds have responded with a 10% gain. But, we suspect this improvement has more to do with aggressive government efforts to combat deflation intervention than actual strengthening of the economy. In an environment like this, we'll err on the side of being safe rather than sorry and favor U.S government securities over corporate debt. In most accounts we'll favor treasuries by a 2:1 ratio.

- 9) Our "Market Neutral" strategies did well last year with the Oppenheimer Real Asset fund returning 27.5% and Cohen & Steers realty major ETF up about 1%. At this point we will be reducing holdings in our real estate funds as we think the domestic real estate market is overheated. While deflation would argue for falling commodity prices, Fed efforts to drive down the value of the dollar and global economic expansion argue for commodity prices to rise. A couple other of our hedged positions had more mixed results. They both outperformed the S&P 500 by 17%, but each had its first down year in over 10 years. The

Merger Fund experienced its first ever down year (off 5.7%) and rallied to gain 4% in the final quarter. Similarly, the Gateway Fund also had its first down year in 10 years, and was down about 4.7%. We have talked with both managers and are comfortable with these holdings.

- 10) The Bush Tax Bill will not likely be a magic elixir. Bush is confronted with trying to resolve what is at its source a global economic problem without international coordination. To compound matters, the only tools at his disposal are domestic in nature. Stimulating consumer demand and eliminating the dreaded double tax on dividends will not alter or correct the real problems we're facing which has to do with the "supply" side of the equation not the "demand" side.

***Thought #63...How long can they go? To find out connect the dots!***

***Despite Fed intervention, continued deflation will cause Interest rates to continue to fall from here... making Bonds a good place to be.***

11) One way of describing deflation is that the Dollar has appreciated in purchasing power. This comes from two major sources: excess manufacturing supply and a shortage of dollars. Short run, this experience is pleasant as products are cheaper and your dollars buy more. Longer term it is very painful, as debt has to be repaid with more expensive dollars and consumers hold off on buying to await lower prices. We haven't started to experience the longer term effects, but the credit bubble causes concern.

12) The world has a glut of manufacturing capacity as a result of NAFTA, GATT, the fall of the Soviet Union and the opening of China. Our government lacks the tools to unilaterally correct this imbalance. Will encouraging U.S. consumers to run up credit card balances (consume more) encourage or discourage China from pumping out more low cost toys and textiles? Korea with its cars, or India with its software and engineering? Stimulating domestic demand will not remedy what is at its root a global supply problem. It will only prolong and potentially deepen the problem.

13) Government policies encouraging consumers to acquire more debt in order to stimulate demand are dangerous as they create a bigger problem down the road. Action Idea! **You should use the current low interest rate environment to refinance your mortgage and use the savings to accelerate your principal repayments.**

*Thought #64...Don't play Ostrich! If you're stuck with your head in the sand, a wave of global deflation could drown your investments.*

*If you need help, please feel free to call us at 410-727-6444 or email us at [invest@noload.com](mailto:invest@noload.com)*

14) The second source of deflation is an imbalance in the supply and demand for dollars as a currency. While we have globalized world economies, there is no global currency. The greenback has been pressed into service to fill this void creating an imbalance in supply and demand for dollars. Excess demand of dollars drives up the value of the buck and by definition creates deflation. In

theory you can remedy this by prioritizing more dollars, but the success of this strategy is far from a forgone conclusion. The tools the Fed has to work with are domestic, and once again we're dealing with a global problem. When dollars are outside the U.S. banking system there is no multiplier effect.

- 15) This leads to a pretty "dry" observation, which I'd like you to think about for a moment. I believe this will become a major issue over the next several years. Now that we have globalized economies, please name the global monetary authority? Think about it for a minute... there isn't one. The significance is that if the Fed cuts interest rates in the U.S. to drive down the value of the dollar, and if these rate cuts are matched by Germany and others, the rate cuts cancel out each other in effectiveness. This has been the pattern of activity over the past several years. As rates spiral down we lose the precious ammunition of interest rate cuts as a tool. At 1.75%, we don't have a lot of bullets left. As importantly, we don't see a consensus merging for coordinated global action. Do you see your Congressman leading the charge for a global currency? Do you see France

and Germany supporting a U.S. led global currency? This is not just an academic argument, but also a real looming crisis, which will not have easy solutions.

Conclusion:

Our biggest regret last year is that we didn't decrease our stock exposure by more when we suspected we were drifting out of the "sweet spot of deflation". We don't want to repeat that mistake twice. While anxiety over the war has driven the market down a touch, we still don't like the longer term trends.

Easy credit and boosterism have simply pushed off the day of reckoning by "buying forward" consumer demand. Zero percent financing will not encourage Korea and Japan to make fewer automobiles. Now is a good time to lower risk in portfolios and grow even more conservative. Remember, with deflation it is possible to have a growing economy, but also for lower profits as price competition cuts margins. This could also hurt corporate bonds even in an environment of falling interest rates.

Our forecast of "deflation" remains right on target. This time last year the official rate of inflation was 1.7%. This past month it was 0.1%. Connect the dots. With this trend line we'll soon "officially" plunge into "negative

inflation”. You don’t want to wait for the Press to start whipping up a frenzy when that happens.

This is not a 3 or 6-month phenomena, but a longer-term problem. Zero percent financing, no money down, etc. are not formulas for profits; they are recipes for stock market disaster. “Selling forward” future economic demand ultimately reduces future profits. These expansive economic policies will continue because there are no other clear alternatives. BUT, regardless of the short run stimulus being used, the bottom line is that stock prices are about buying future streams of profits. Lower profits, mean lower stock prices.

Another factor here is that the public mood has changed radically in the last 12 months. We sensed the shift in the public mood last year when we talked about the “Cock Roach Effect” and how this could cause stock market values to spiral downward. Despite the settlement of the Wall Street scandals, the average investor feels spurned and cheated. As long as this mood prevails, investors will be willing to pay less for every dollar of projected profits exerting pressure on the market. Demand for owning stocks is eroding as more people are shifting a portion of their savings into investments where they have more “control”.

Understanding these issues is important. Recognizing we’re dealing with a worldwide economic problem

means that “we” (The U.S.) are NOT passing thru a “mild recession” and everything will be back to normal in 6 or 12 months. The prevailing media spin that after 3 down years, things have to be better is lazy logic.

Remember, we are not flipping coins. This is a time to be conservative until we get some visibility that the global supply glut is manageable.

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### ***ABOUT BARRY STRUDWICK...***

*Barry Strudwick serves an international client base of wealthy individuals developing enhancement and protection strategies. With over 20 years experience, Barry is a frequent contributor to The Nikkei Times, CNBC, and S&P MarketScope. He is a graduate of The Wharton School of Finance.*

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