

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



***Hark! Hark!***  
***Build That Ark!***

**By Barry Strudwick**

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The Oracle of AI (as in Greenspan) uttered a cryptic musing last week and it sent a chill down the backbone of Wall Street and the mainstream media. All of a sudden the airwaves are over – run with experts on Deflation. Gentleman that he is, AI actually avoided saying the D-word” in polite company. Instead in classic Delphic tradition, AI did some verbal contortions and sputtered the risk of “*a sudden unwanted decline in the rate of inflation*” is now a greater threat than inflation. News? Not to us. But even the boneheads in the broadcast booth got the idea and are starting to flog the story we’ve been sharing with you for the past 4 years. You see, Deflation is not simply a potential threat... It is our current economic reality. We continue to be amused by the lazy analysis we’ve seen in the past week. For example, the Wall Street

Journal had a headline that read, “*Who’s Afraid of Big Bad Deflation...near zero inflation is good for stocks*”. Journalism? Or advertiser friendly puff piece? After all what did we learn from Woodward and Bernstein? “Follow the money!” We suspect many more similar pieces are sure to follow are just a game of “spin the tale on the donkey” (as in the “dumb ass” retail investor) to condition public thinking on deflation and appease Wall Street.

***Thought # 73 ...“I’ll Huff and I’ll puff and I’ll you’re your house down!” The Wolf of Deflation is now rattling the shutters, but Wall Street is encouraging us to play outside.***

**Don’t be a little piggy and try to squeeze too much out of the Iraq War rally. Beware “Idiot Spin” of the Wall Street Friendly media! Get defensive NOW!**

From the Mutual Perspectives Broadcast May 18, 2003 on WYPR 88.1

For example, we were befuddled by the recent proclamations of the “Return of the Bull! ” (Cover of Barron’s and others). The story line was that “strong” first quarter earnings marked a new dawn. But it didn’t take Sherlock Holmes to see what few “gains” there were came mainly from “cost cutting” not improvements in demand and pricing. Color me a curmudgeon, but

I'd much rather see profits grow from "pricing power" than "cost cutting". Why? Because, increases in prices are recurring, while cost cuts tend to be "one time" improvements. More importantly, when you cut costs, you lay off workers who are ultimately the consumers of your products! In this rainy spring, the words of another whinny crank come to mind "*You don't need to be a weatherman to know which way the wind blows*".

***Thought #72 ... Momma Come here quick...and bring me that licking stick! The Boogey Man of Deflation is under the bed after all! Uncle Al told me so last week.***

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Take the uttering of the Oracle of Al, the long term impacts of cost cutting, the looming pension scandal, SARS and half a dozen global hotspots and we wonder whether if we're not feeling the first drops of a coming storm. Since we're in a quoting mood, let's draw from the words of the wisest of all pundits and seers, Anonymous, who once told us "*You don't score points predicting the weather, but you win the game by building the Ark!*"

We think it's now time to start thinking in these terms. After predicting the darkening clouds of "deflation" for several years now, we're concerned the

storm will not blow over. Prudence, not wishful thinking is the right course of action here. We might be a step or two ahead of the crowd here, but often connecting the dots now for nearly 5 years, we don't like where they are pointing. The bottom line is that war or no war, intense global competition is forcing companies to slash prices (and profit margins) faster than they can cut costs. ***This is a toxic environment for stock prices.***

Over the past several years we've commented numerous times on this brewing deflationary environment, but in the past 12 months it has grown increasingly apparent we've moved from the "sweet spot" of deflation to the edges of a very dangerous abyss. Rather than chant the media led mantra of "It can't happen here (because the Fed won't let it)", the prudent course at this time is to continue moving to a progressively more defensive position.

How can we invest in a period of deflation? We need to anticipate an environment of falling interest rates, lower corporate profits and actions by the Fed to battle an overly strong dollar. Logic says we should reduce exposure to the stock market, increase bonds and add to assets that profit from a falling dollar such as non-U.S. holdings and hard assets (commodities, real estate).

As we've done for the past several letters, here are our most current

thoughts listed in the order of direct interest to you. Our more specific action oriented ideas come first, and the underpinning logic and analysis follows. We recognize some of this gets somewhat theoretical and academic, but we think it's important to outline the logic of deflation because you're not getting it from the mainstream media and Wall Street.

***The following comments were written for the benefit of our clients in late March 2003 and where appropriate have been updated. If you would like information on how to become a client, please call us at (410) 727-6444. Accounts start at \$100,000***

- 1) As we predicted last quarter, in the week immediately following the start of the war, a strong (1,000 point) rally followed. But we suspect ***more upside*** is in store once Baghdad falls, the supply of oil is secure and the threat of chemical warfare diminishes. We wouldn't be surprised to see another 1,000 points from here which would put us in the ***9,000 to 9,500 range on the Dow.***

***Update: Since this was written in late March, we have seen a 1,500-point rise in the Dow. We suspect we are now closer to the end of this rally than the beginning.***

- 2) We will use the rally as an opportunity to further ***decrease exposure*** to the stock market by an additional ***5% to 10%***. Once completed these reductions (combined with the cuts last year and earlier this year) will put most accounts at less than 40% exposure to gravitational pull of the S&P 500. To put this into perspective, this is our lowest equity allocation since we started over 15 years ago.

***Thought #70 ...As if on cue, the Iraqi war rally has arrived...but this has not altered the fundamental economic dynamics that plague the world... excess manufacturing capacity! The picture for profits remains UGLY and at the end of the day the stock market is about profits not patriotism. Use this rally as an opportunity to decrease your stock holdings.***

From the Mutual Perspectives Broadcast April 20, 2003 on WYPR 88.1

- 3) With the money we shift from the stocks, we will ***add to both our bond and our "market neutral holdings"***. Together these will now comprise 60% of strategies versus 30% in 1999. Bonds should benefit from falling interest rates and our market neutral strategies from a falling dollar and increased merger activity as businesses consolidate. ***The Oppenheimer***

**Real Asset** (QRAAX) fund gained 4% for the 3 months but was up as much as 27% during the quarter. Our two hedge fund positions, **Merger** and Gateway **held** their own and were up about 1%. We continue to have concern about the potential of a real estate bubble in the United States and will reduce holdings in this sector.

- 4) With respect to **interest rates**, our **long term** forecast is for rates to **continue to fall** as a by-product of Deflation. This should **favor bonds over stocks**. But we anticipate some **short run volatility** on rates with several spikes upward. To adjust for this we will also reduce the ratio of government to corporate and bring them closer to equal weighting. We think the credit risk spreads (which are the highest in history) on corporate bonds might buffer a short term rises in interest rates. If these extraordinarily high spread narrows to more normal levels, we'd have the potential to see significant capital gains in the corporate bonds.
- 5) **Don't get greedy** with the stock market rally and allow yourself to get sucked into the "*I'll make it all back*" temptation, which is sure to follow a rally. An 11,000 Dow is not a realistic economic expectation. Solely the easing of emotional stress fuels this rally. It has little or nothing to do with economic fundamentals. A 10,000 Dow is a 33% gain from the lows of the last several weeks. If you were uncomfortable with the stock market with the Dow at 7,500, you should be just as uncomfortable with the Dow at 8,500 or 9,500. Why? Because nothing has changed in the economy. Remember what we said last quarter: the stock market is about **profits and not probabilities!** Right now the picture is for **profits to worsen**. Now is an opportunity to **reduce exposure**, not let your chips ride on the roulette table. If you want to discuss this, please give me a call and we can discuss at length.
- 6) What's our rationale? Simply, all is not well with the world and its economies in particular. We're experiencing a **hangover from the globalization** of world economies brought on by NAFTA, GATT and the opening of China / fall of the USSR. Even without recession, the dominant trend is for "revenues"

**Update: Corporate Bond positions are up 15% year to date thru May. So much for the conventional logic prevalent at the beginning of the year that "interest rates can't fall any further".**

to grow but the all-important “profits” to fall over the next several years. This will be brutal on stock prices. The Iraqi War has created a diversion, which Wall Street is using to rationalize weak profits as a short-term issue. Don’t buy this story!

***Thought # 68 ...Forget SARS as a threat to your Health ... the more immediate peril you face is called DIYD.... for “Do It Your-selfer Denial”!***

Before the War Rally ends snap out of suspended animation and take the first step to financial recovery. The first step? Reach out to an advisor you can trust to help you sort out both where you are and where you need to get to. If we’re your choice, feel free to contact us by phone or email. After all, we’re not telepathic!

7) The early signs of a **global imbalance of supply and demand** (Deflation is caused by excess supply) started to appear before the Iraqi war, before the Afghani War, before the Wall Street research scandal was unmasked, before the 9-11 attack, and also before the Enron, Tyco, WorldComm scandals. None of these shocks to our stock market has anything to do with the basic imbalance of supply and demand. As Adam Smith’s invisible hand moves to

reduce excess global manufacturing supply, the inevitable result will be **price wars, write offs and low profits**. Think about it, does a war with Iraq have any significant impact on how much China manufactures and exports to the world? Detroit is still making more cars than we need and prices are falling across the board.

8) Falling **prices** are great for consumers, but falling **profits** are hell for investors! Cars are cheaper than they were last year, but Ford loses \$1,300 on every one sold! And its stock is down 90% since 1999 and the “B word” of bankruptcy is being whispered in ever growing circles.

9) We’ll also **increase** our holdings of **hard assets** and reduce our reliance on the financial markets. Look for Washington to combat Deflation by driving down the value of the dollar relative to other currencies. We can see this right now with a Fed funds rate is already lower than the official rate of inflation (1.25% vs. 1.75%). This can be interpreted to mean the Fed is paying member banks to borrow from it and expand the money supply! A falling dollar means hard assets will appreciate as

will assets valued in other currencies such as the Euro.

10) We are also developing some new investment options based on hard assets outside the United States. These include several different *real estate* based projects located *outside the United States*. These strategies are non traditional in nature and not appropriate for all clients, they range from 12% mortgage notes secured by prime real estate in *Costa Rica* to private equity investments in a large *Marriott* anchored hotel and golf resort in Nicaragua. While not for widows and orphans, these types of investments stand to capitalize on both deflation and the looming retirement of the Baby Boom.

***Update: Please feel free to call to me directly if you would like to learn more. These opportunities are appropriate for accredited investors only.***

11) Deflation *breaks the linkage* between a growing economy and a “good” stock market. Think of it this way: when you hear news reports about “The Economy” growing, this is about “top line” growth in total sales (GDP). However, stock market valuations are

based on the “bottom line” of profits. In a period of deflation you can have the unusual combination of “top line growth” while simultaneously having your “bottom line” of profits fall! Why? Because with deflation you have excessive manufacturing capacity (by definition). This results in price wars to grab market share from competitors, which spirals downward to a point where you ultimately result in lower profits. Look at the price wars right now in computers and even hamburgers!

12) The *economy slowed* dramatically in January and February. TV and Wall Street have rationalized this as the effects of a harsh winter and “concern over the war” slowing consumer spending. The implication being a quick war and the sunshine of spring will bring back the good ole days. I’ll accept that weather can impact the sale of donuts, but not on technology or automobiles. We read this situation quite differently. The world remains awash with excess manufacturing capacity and removing Saddam and the return of spring won’t change this.

13) Our increasingly grave concern is it’s now time for the

manufacturing sector to “*pay the piper*” for using easy credit in the Post 9-11 period which simply “*sold forward*” future demand over the past 18 months. Unless global capacity was dramatically cut during this same time period, once the tonic of easy credit wears off, we still have to deal with the problem, but now it’s compounded. How many new cars and big screen TVs do you need anyway? This credit binge simply delayed and likely worsened the hangover effect the entire economy will experience. The *day of reckoning* to shut down excess manufacturing capacity has drawn nearer. Want hard evidence? Last year Standard & Poors downgraded the bonds of 42 major companies valued at \$122 billion from ‘investment grade’ to “junk bond” status!

- 14) Why isn’t the media talking about this? Because bringing *supply and demand* back into balance means two things neither Washington nor Wall Street want to acknowledge. *First*, industrial capacity must be reduced either in the U.S. or elsewhere. This means publicly traded companies will take large “write-offs” and report lower profits. In a rational world, this means lower stock prices. *Second*, when plants are

shut down, workers are laid off and stop being consumers meaning “demand” will flag even further, leading to yet lower profits and stock prices. This is not likely a 6 or even 12-month phenomena. A recession during a deflationary environment is *the Fed’s worst nightmare* because monetary policy is powerless. Witness Japan over the past 10 plus years.

***Update: Greenspan’s recent reassuring comments not withstanding, with 2/3’s of the World’s dollars held in banks outside the U.S. The Federal Reserve System doesn’t have control. Cutting interest rates and tax cuts to stimulate domestic U.S. demand will not resolve a global supply problem.***

- 15) A secondary emerging trend is that “*savings*” *rates are up* and credit card balances are down. Again we do not see this as being a short-term “war and weather” impact but a longer-term shift in consumer psychology that might be good for the consumer but *bad for Wall Street*. This is the exactly the behavior we’d expect to see emerge as consumers adjust their behavior to the continual falling prices that accompany deflation. Why shop until you drop if prices are going to be lower next month? While this is the correct

thing for consumers to do, it hurts the Wall Street spin for a stock market recovery in a consumer led economy.

16) A few more words on corporate bonds and more specifically the damage done by “selling forward” demand. Look at Ford. Post 9-11 we’ve had 18 months of 0% financing and selling every car at a loss. Every driveway in suburbia has a new truck or car and the fundamentals remain the same. Worldwide there is as much as 30% excess capacity in the Auto industry. The company is on the verge of bankruptcy. Its bonds are trading at junk bond rates. This one is close to being on respirators. Scan the WSJ any day and you’ll find a few more.

17) If all the above isn’t bad enough, the low interest rate environment caused by deflation is wrecking havoc on the ***pension plan games*** many large companies had played during the bull market. This scandal could be bigger than Enron and WorldCom. A number of large companies now have unfounded pension liabilities larger than the market capitalization of the company! A prolonged period of low interest rates and a stock market slump will make this crisis progressively harder to

sweep under the rug! While this will mainly impact larger companies with large unions, the psychological impact will be a body blow to the entire stock market.

18) Here’s a question for you, if a company’s unfounded pension liability is larger than the market value of the stock, who actually “owns” the company, the stockholders or the retirees? After all the value of the stock is just a claim on future earnings and these might already be claimed!

19) Washington is in a box here. Higher interest rates could bail out the pension plan crisis, but they would pop the real estate bubble! More on this story as it emerges.

***Update: A bubble is building in domestic real estate. Avoid the lure of high yields in REITs.***

20) The picture that is emerging is pretty UGLY; so let’s get defensive.

### ***Conclusion:***

The ***economic*** issues aside, what ***really*** scares us is there doesn’t appear to be a ***political willingness*** to address the problem. The elected officials in Washington are in denial because it’s a

thorny *global* economic and political issue we're dealing with. If things keep going the direction they are headed, this will require global cooperation and intervention to correct this. Which partisan Hack do you see volunteering to be the point man to head off a global monetary crisis? After Iraq, how much cooperation do you think we'll be getting from the French, Germans and Russians? Can we do another unilateral intervention? The Fed doesn't have the tools to control global monetary supply.

We can still hope the storm will blow over, but we'd prefer to watch from under cover and not out on the fairway. I think if we focus on preserving capital we'll weather the storm.

***"The Double D Strategy"*** ... How to invest taking advantage of deflation and demographics...*Send us an email for a copy of this Article recently published for SmartCEO magazine.*



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***For more information, please call 410-727-6444 or email us:***

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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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