

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



***The Flash of the Phoenix***

**By Barry Strudwick**

That good ole elixir of low interest rates has once again put some kick back into the stock market. Needless to say investing public has become intoxicated from just sniffing the fumes from the rocket fuel Washington has been injecting into the economy. Some are already so addled they believe they're witnessing their stocks and funds reemerging in Phoenix-like splendor from the ashes of the market wreckage. Recent polls show 70% of investors are now officially "bullish". Who'da thunk it? Was it only a scant 3 months ago the Dow brushed 7,500 and the bears roamed freely?

We'll let you bask in the warmth of the best calendar quarter for stocks in five years, but just for a moment or two. After 3 years, we all deserve a break, but brace yourself for the cold water, which could douse the flaming phoenix and leave a puddle of ashes! Ask yourself this simple question: Has anything fundamentally changed in the economy in the past 90 days? Nothing that we can discern. While the pre-Iraq gloom was likely too thick, soaring at the current altitude, the air of enthusiasm in this market is likely too thin. While we fully anticipated (and have played)

the post war rally, with out question the clouds of deflation have darkened steadily over the past 90 days.

Now don't get us wrong. We enjoy a party as much as anyone especially when the Fed is picking up the tab. In fact, we had a great quarter with most accounts now up for the first half of the year. But don't count us as Bull market believers.

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

*From the Mutual Perspectives Broadcast  
May 11, 2003 on WYPR 88.1*

Instead, we'll gracious use this rally as a tailor-made opportunity to gradually reduce our stock holdings once again.

It appears even Greenspan has come to the same conclusion, saying deflation is a "more serious threat" than when he spoke to Congress just several weeks previously and is now a greater risk than the old bogeyman, Inflation. This is an ominous development especially when just 3 months ago

Thought #67 Hark ! Hark ! Build an Ark! While we watch a game of global Duck, Duck Goose, maybe Chicken Little was right after all.

*From the Mutual Perspectives Broadcast  
April 5, 2003 on WYPR 88.1*

Washington was in full-fledged denial. Last quarter we said *the time has come to stop simply predicting rain and to start building the Ark.* We're following our own advice.

While we're glad to see that AI is now officially on the case, we tend to differ with the Money Maestro's definitions of "what is is". What we've been calling "deflation" is an environment where excess supplies of goods and services force sellers to *lower prices* over time. This causes profit *margins to erode*, so even if you're selling more, you're making less. This differs from Greenspan's definition which "*corrosive*" *deflation*, which is really a more advanced form of deflation. Here prices spiral down dramatically, causing severe recession and high unemployment. Consumers stop spending, lenders stop lending and the economy freezes up, causing a real mess. Not to get Clintonesque and quibble about terms, but isn't this what most of us call a "*Depression*"?

While we agree with Greenspan that "corrosive" deflation is unlikely, it's also clear that general price deflation is already with us. Our concern is whether our leaders and policy makers can stop the slide down the slippery slope. Greenspan has already publicly acknowledged the Fed has little or no experience in how to reverse this trend and might have to resort to "*unorthodox strategies*". Part of the strategy is to keep the public's attention diverted elsewhere because the media's focus on the issue could accelerate the spiral. While we understand this tactic, at the same time we shouldn't play ostrich and ignore the obvious. We suspect the Fed might not have the monetary tools or political consensus to unilaterally correct what is at its root a global not a domestic problem. *This is why we prefer to take some preemptive actions here to preserve capital.*

In the short run, expect to see gobs of liquidity being pumped into the system as the Fed encourages us to consume our way out of the global production glut. Certain sectors of the economy such as consumer non-durable goods will benefit from this. But this is not sustainable. Regardless, still look for Wall

Street to spin this consumption orgy as the reincarnation of the Bull and deny deflation until the bitter end. You know the mantra, "Buy stocks for the long run, diversify, blah, blah, blah .....". Realistically, what else can they say? They are in the business of selling stocks. However, understand *with an economic environment of deflation you can have the unusual situation of the economy growing, but profits shrinking!* Rather than accept spin, think for yourself and simply connect the dots, which continue to point to increasing deflationary pressures.

Sure Washington has opened the spigots up all the way, but don't confuse an "expansion" with a "recovery". For a recovery, we need "profits" not just "sales". From our perch, the best we see right now is a consumer led economic expansion with weak potential for recovery in profits. This could spark a *short run* stock market rally. At worst, after bingeing on the economic equivalent of empty calories, consumer spending could fail to ignite the economy and the huge increase in money supply could push up interest rates. This would of course result in a very nasty economic slow down, a battered real estate market and least we forget.... a brutal environment for both stocks and bonds..... *The Phoenix and Ashes scenario...* Overly pessimistic? We don't think so. Over the past 4 years we have steadily pointed out the increasing signs of deflation. Is it rational to expect this trend to miraculously reverse itself

**Thought # 77 Where have all the profits gone? The answer, my friend, may be blowing in the wind .....as in the hot air generated by Wall Street media hypsters. Ultimately stock prices are about profits ...not interest rates .....Beware of any rally that is not supported by visible profits!**

*From the Mutual Perspectives Broadcast  
July 1, 2003 on WYPR 88.1*

in the next 90 days?

Right now, what we fear most is an economic expansion that creates neither jobs nor profits but sets the stage for rising interest rates down the road. This could whipsaw the average consumer. Here's why: Intoxicated by low interest rates, the average person who refinances has added over \$30,000 of debt. What happens if rates rise causing real estate values to fall?

There is a lot to digest here. Over the past several quarters, we've listed the most important action specific ideas, which have the most direct impact on your investments first. We'll then follow with the more in depth observations, which we don't believe you'll find elsewhere. So you can read until either your eyes glaze over or you scream "enough already"!

- 1) We are moving to a progressively **more defensive** position using the strong stock market rally to **reduce equity** exposure by yet another **5%**. This will bring the total exposure to stocks for most accounts to under 40%. This is a very low equity allocation by historic measures. Our rationale? We simply do not see hard evidence of improving earnings. As we have said many times in the past, stock prices are not about "new paradigms" or patriotism but **profits!**
- 2) With the monies from the reduction of stock positions, we will **add to** both our "**market neutral**" sectors as well as our "**fixed income**" positions. Most accounts will be 40% to 60% fixed income and 10% to 25% in our market neutral strategies. We have made shifts within both the fixed income and market neutral portions of our strategies based on our perception of

deepening deflation. These changes are discussed below.

- 3) Where will we make our cuts on equities? Our positions in the **NASDAQ Biotech Index (IBB)** are **up 45%** on a year to date basis so we'll bank some gains here. In addition we'll selectively prune back other equity positions on a client-by-client basis.
- 4) Remember earlier this year when in January everyone else was saying rates couldn't go any lower? So much for the consensus! Our bond positions have done exceptionally well this year with our positions in **Loomis Sayles Bond** up 15% for the first six months and our **Strong Government Securities** are up about 3%. We will continue the shift we started last quarter to a **heavier weighting in corporate bonds and away from government bonds**.
- 5) We are **reducing** our holding of **U.S. government securities** by 1/3 and replacing these with **international government bonds**. The rationale here is simple: interest rates are higher now outside the United States and economic conditions slower. By driving down the value of the dollar, the U.S. is in the position to export some of our deflation to Europe. It follows that these rates have more room to drop. Our initial choice here will be **Julius Baer Global Income Fund** from the Swiss private bank.
- 6) As far as other deflation strategies, we like the logic of buying hard assets such as **real estate outside the United States**. We've included a recent piece we wrote for **SmartCEO** magazine called '**The Double D Strategy**' which

argues for holding foreign real estate that lies in the path of the aging Baby Boom. To convert theory into practice, we recently completed our first real estate investment partnership with the acquisition of a 350-acre ranch on the Central Pacific coast of Costa Rica. This partnership and all future deals will be “all equity” land banking acquisitions where we hold the land for future resale to builders and developers. Several more similar transactions are planned for this year. ***Please contact me directly if you would like to know more about our activities here.***

#76 Ashes to Ashes and Dust to Dust .....Our crystal ball sees the growing risk of stock market flame out and a real estate bust. Don't get duped by the real estate boom and borrow out your equity. Instead, take advantage of the low rates and use the deflation savvy strategy to pay down your mortgage faster!

*From the Mutual Perspectives Broadcast  
June 15, 2003 on WYPR 88.1*

7) We're also making some shifts in our “market neutral” sector with a reduction in our real estate holdings selling the ***Cohen & Steers Realty Majors Index*** (ICF- up 14% YTD). We're likely pre-mature here, but real estate and REITs sure look like one monster bubble getting ready to blow up. Want evidence of an over heated market sector? According to ***Investors Business Daily*** (June 26, 2003), so far this year the amount of capital raised in just two new REIT stock offerings has been greater than the total amount raised in all other IPOs combined!

Think about that one for a while and it's plain scary! How's this from the June 9, 2003, ***Barron's*** weekly roundup of the real estate sector: “*Vacancies are still significant in all property types and cash flows are declining*”. Could yield starved investors be looking right past the underlying business that produces the fat dividends? We've spoken to several commercial real estate brokers and they all tell us the same story: very few businesses are actually expanding and requiring new space. We purchased REITs when they were unpopular. ***Now its time to move on*** and wait for a more favorable time to rent the shares again.

- 8) Not to be a spoilsport, but if businesses are ***not adding more space***, can they be creating new jobs? And if they aren't adding jobs now in June, what's the likelihood of an economic expansion in the “second half” of the year? And without an expansion, where are the profits going to come from that Wall Street is already pricing into stocks?
- 9) Today I did a very unscientific survey over breakfast at the Café Hon in beautiful downtown Hampden. Using my deca-digit bio-calculator, I simply tabulated *The Wall Street Journal's* digest of corporate earnings reports from the prior day. Only 5 of the 26 companies in this day's tally had both growth in revenues and a growth in profits, which was greater than the sales growth rate. In other words, 3 out of 4 companies either had a slow down in sales or if their sales had increased, there was evidence of deflationary pressure on product prices as profit growth hadn't kept pace with expanded sales.

*This is exactly what you would expect to see in a deflationary economic environment.*

Thought # 78 Denial is more than a river in Egypt ..... it's the party line of Wall Street when it comes to acknowledging Deflation. Why? Because you can't pitch stocks in a prolonged period of falling profits.

*From the Mutual Perspectives Broadcast  
July 6, 2003 on WYPR 88.1*

- 10) As we've said several times in the past, in *deflation you can have an economic expansion that not only does not create new jobs but also fails to create profits for companies.* Government policy to stimulate demand will grow the top line, but price wars from excess capacity can eat away the profit margins. As a result of the price wars, companies redouble efforts to cut costs and lay off workers. In the press these layoffs are tabulated as "productivity gains".
- 11) A *jobless recovery* is indistinguishable from a *recession* to a working family.
- 12) A *profitless expansion* is indistinguishable from a *recession* to an investor. Unless of course he's been told by his broker profits will arrive in the "second half."
- 13) Once again, here is a topic I have brought up several times before. Hopefully, it is beginning to sink in, why the current rally is "wishful thinking". Stimulating *domestic demand* will not resolve what is at its root a *global manufacturing and monetary supply problem*. Believing that the U.S. can spend its way out of a global supply problem is wishful thinking. Will encouraging U.S. consumers to buy more "stuff" now discourage China, Russia, Korea, India, Mexico, Brazil, and Malaysia from making more "stuff" next year? It's really that simple. So to life a phrase from the past, it's not "demand" it's "supply", stupid!
- 14) In fairness, *Greenspan* and the Whitehouse understand this but they *lack the tools* and political environment to do much of anything else other than stoke up demand, hold their breath and hope for the best.
- 15) This does not mean you should hold your breath along with them! *Proactively* take prudent rational steps that anticipate a growing awareness of global deflation and its implications. Act before the crowd, not after!
- 16) I'm not sure where this fits, but it irks me to no end when I hear pundits glibly say not to worry about the real estate spending spree because "*Greenspan won't let interest rates rise*". I'd venture to wager these were the same tongue wagers and gadflies who proclaimed the never ending IT revolution in 1998, yet failed to see the train careen off of the cliff in '99. With all due respect to Dr. Al, he can't control this. He only controls short-term interest rates and the U.S. supply of money. Real estate is more impacted by long-term interest rates where the bond markets perceptions of credit risk and inflation are the driving forces. An increase in the *perceived* rate of inflation or in credit risk, and the bond market will demand to be rewarded with higher rates..... and Poof! There goes the real estate

market and the billions of dollars of paper net worth people have in their homes.

17) We will once again repeat our advice that one of the *very best investment strategies right now* (in a period of deflation) is to *refinance your mortgage* and to accelerate your repayments. **DO NOT** increase the amount of your debt if at all possible. Don't procrastinate here!!!! 47% of all mortgages have not been refinanced in the past 3 years during this incredible drop in rates. Less than 10% of homeowners have refinanced two or more times. Take advantage of this now. If the real estate bubble bursts and rates rise, you'll still have your home and a nice low rate locked in.

Thought # 79 Don't get cut by the "Old Saw" that "Diversification" will cure your investing woes. Deflation has redefined relationships between stocks, bonds, real estate and cash. The combination of investments will work best in deflationary times has shifted.

From the Mutual Perspectives Broadcast July 14, 2003 on WYPR 88.1

18) If things are so gloomy, why not run to the sidelines now? Because the Fed is throwing a lot of gasoline onto the fire trying to jump-start the economy with low interest rates. Since the majority viewpoint remains to be that deflation is "impossible", these stimulative efforts could very well drive the *stock market up*. ...*short term*..... as people are spun the hopes of future profits. Right now the

consensus on Wall Street is for the S&P 500 profits to increase by 24% in the 4<sup>th</sup> quarter. Now if you've forgotten, the "second half" has already started and the "fourth quarter" ends in just 180 days.

*Does this sound optimistic to you?*

To bore you with the facts, on the weekday that the fed Cut interest rates to the lowest levels in 45 years, demand for manufactured good slipped for the second straight month. Here are a couple of more "details" that might have escaped the media's attention:

What's Down... Versus This Time Last Year	
Source Baron's Market Laboratory, June 23, 2003	
<i>Industrial Output:</i>	<i>Lumber Production:</i>
<b>Down</b>	<b>Down</b>
<i>Durable Manufacturing:</i>	<i>Lumber Shipments:</i>
<b>Down</b>	<b>Down</b>
<i>Plant Capacity Utilization:</i>	<i>Factory Shipments:</i>
<b>Down</b>	<b>Down</b>
<i>Non-Durable Manufacturing:</i>	<i>Factory Backlog:</i>
<b>Down</b>	<b>Down</b>
<i>Non-Residential Investment:</i>	<i>Auto Sales:</i>
<b>Down</b>	<b>Down</b>
<i>Electric Production:</i>	<i>Durable Goods Orders:</i>
<b>Down</b>	<b>Down</b>
<i>Non Residential Construction Spending:</i>	
<b>Down</b>	

So where are the *profits* going to come from against this backdrop?

19) The only sector of the economy that is *booming* is the housing market, which is fueling consumer non-durable goods consumption. Neither is an engine to lead extended economic growth like semiconductors, the PC or other previous engines.

What's Up... Versus This Time Last Year	
Source Baron's Market Laboratory, June 23, 2003	
Residential Investment: <b>Up</b>	Consumer Spending: <b>Up</b>
New Housing Permits: <b>Up</b>	Consumer Debt: <b>Up</b>
Residential Construction Spending: <b>Up</b>	Non-durable Good Orders: <b>Up</b>

20) Let's take a look at the **residential real estate spiral**: Lower interest rates inflate the value of residential real estate because a lower interest rate means a fixed monthly payment will support a larger principal amount. This in turn creates an **illusion of wealth** as a house that had a market value of \$250,000 several years ago is now valued at \$500,000 or some other fanciful number. The "wealth effect" here encourages people to pull a part of this windfall out thru refinancing. They then perform their **patriotic duty** and consume more goods (note the increase in non durable good spending). Whether these are consumed or squandered depends on your perspective, but regardless, non-durable goods do not add to the long-term productive capacity of the economy or the wealth of the country. The total amount of consumer debt goes up with nothing to show for it except expanded waistlines and a straw hat from an island vacation.

21) This is all fine .... **if and only if** ..... two things happen. First, people keep their **jobs** so they can repay the debt. Second, **interest rates** don't rise, preserving the inflated equity of the real estate and keeping the amount of the monthly debt service manageable. Both of these underlying assumptions are tenuous at best and blissfully

ignorant and sloppy thinking at worst. Let's approach these separately.

22) The lesser of these two problems is the **employment issue** (at least right now!). However, we would be remiss in not pointing out that unemployment has been rising not falling. Not to bore you with facts, but "initial jobless claims" are up significantly since last year and the average duration of unemployment is 20% longer than it was this time last year. The Wall Street Journal summarizes the current state of affairs nicely "**In short, the United States is experiencing the most protracted job market down turn since the Great Depression**" (WSJ May 29,2003 P.1). Nothing critical here, but facts are facts.

23) The more important issue is the **stability of interest rates** and its impact on household debt service. Last year 46% of people who refi-ed their homes pulled money out of the piggy bank to an average tune of \$30,000. How much of that is fixed at a low rate and how much will float upward with rising rates? With a \$30,000 home equity loan, at 4%, a consumer has \$1,200 a year in interest expense, at 6% it's \$1,800 and at 8% it's \$2,400. See where we're going? Can they afford to repay it if rates rise?

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24) Will they ever “get their money back” from the remodeled kitchen if higher rates cause a nationwide housing prices slump? As surely as night follows day, *if interest rates rise, the market value of residential real estate will fall just as quickly as they rose.*

25) Now for the \$100 billion question: “ Is it logical to expect interest rates to remain at their lowest levels in 45 years?” The answer is “*yes, it’s possible but it isn’t logical*”. We suspect this would require a set of economic conditions you wouldn’t want to see. For the short course, *witness Japan* for the past 12 years.

26) Still, many people are taking the recent Fed statements as an “*assurance*” that interest rates will remain low for an extended period. This is dangerous blathering and wishful thinking not founded on any real logic. Why? Because first, *the Fed doesn’t control “long term” interest rates* like mortgages. The Fed, only influences short term interest rates. Bond and Mortgage rates are long-term rates, which are set by the global markets consensus opinion of the yield required for the use of money and the credit risk. A change in these perceptions and rates will go up regardless of what the Fed wishes.

27) The strongest tool the Fed has to fight deflation is simply to inflate our way out of it. In every day English, this is called cranking up the printing presses and printing up a serious quantity of money. In fact, several Fed Governors have already said that this is the course they would take to fight to “*reflate*” the economy. Now from your personal experience in the late 1970’s, do you recall what happens to

interest rates when Washington cranks up the printing presses? Won’t lenders demand *higher interest rates* if they are going to be repaid in a depreciating currency?

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28) *If interest rates go up, the residential real estate bubble bursts as the paper equity in the houses vanishes.* Additionally we’d have a significant portion of our refi happy consumers who did not lock in the lower rates for a 15 year or 30 year fixed mortgage who will now be squeezed on monthly payments when that 3.25 rate creeps back to 6.5%, essentially doubling their monthly payments. Ooouch! So, unable to make the payment .....as non-recourse lenders ..... they will simply turn the keys over to the bank and walk across the street to rent from another bank’s swelling foreclosure portfolio. So, it’s easy to say the Fed can simply “reflate” but if the Fed overshoots we will have a very nasty mess on our hands. Without any experience, how will they know the right amount?

29) Risk free or fraught with Risk? Now a few words about government agency bonds like *Freddie Mac and Fannie Mae*. We see higher risk here and recommend *avoiding these issues*. Recall our discussion last year of the “Cockroach Effect”. It’s amazing how when you see one Wall Street

cockroach emerge with bad news about a company, you can bet there are a hundred more that haven't come out of the woodwork yet. When they do scurry out, they create a selling panic, which can hammer prices as large institutions sell into a vacuum. A little voice says we should go home when we see heavy use of derivatives combined with an environment of volatile interest rates. Now, add to this a consumer perception of a "government guarantee" which really isn't, an over heated housing market. Perhaps, and we don't like the risk/reward trade off you get in exchange for a 4% yield on a government agency bond. Whether there is a real scandal or problem isn't the issue, we want to avoid the neighborhood in case any one else starts selling.

Start planning your fall "get away" NOW! Call us about upcoming seminars in Costa Rica (July and October) and Belize (October)!! Topics will include real estate, asset protection and tax saving ideas.

30) The thought of *shorting the U.S. government bonds* has entered our minds, but this is something to start looking into down the road when we start seeing signs of interest rates rising. We received notice recently that the Luethold Core equity fund has already taken this aggressive move. Clearly we are not at this point, but we mention this simply to remind you that it's possible to profit during a period of rising interest rates.

31) I've rambled on too long here, but keep an eye on the *corporate pension crisis*, which is lurking in the

background. This could hit the stock market up side the head like a 2 X 4. A prolonged period of low interest rates and low profits will aggravate this problem. With investor confidence in Wall Street shaky at best, another crisis would be tough on the valuation of all stocks, not just those with pension problems.

Let's bank our gains from the recent rally and continue to keep a careful eye on the deflation scenario as it emerges. To put this all into perspective remember this chestnut:

"The Rich accumulate *assets* that put cash in their pockets. The Middle Class accumulate *liabilities* that they think are assets."

Clearly the risk of deflation is growing and its time to get more defensive. A change in the consensus perception here will rock the markets. We want to be moving in this direction before the media starts whipping the public into a frenzy. Let's get to the high ground before the herd starts to stampede.

Barry Strudwick  
July 9, 2003

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

Barry Strudwick serves an international client base of individuals, investors and entrepreneurs designing and implementing wealth enhancement and protection strategies for over 25 years. *For private consultations Barry Strudwick & Dan Somerville are available to meet with you. Please contact them to arrange a meeting. We can be reached by calling*

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