



Putting a Handle on the Truth... Is Globalization Endangered?

By **Barry Strudwick**

This newsletter was originally shared with our clients in October 2006, before the November elections. It is now being shared, unedited, 60 days later to stimulate thought on these issues. The comments and observations should be considered general.

We're happy to say that, even after the sudden 25% drop in energy prices, our globally diversified strategies continue to hold up nicely with gains for the first 9 months of the year. While several hedge funds imploded in the wake of two-buck petrol, we suspect this sudden flood of cheap gas has much more to do with election-year maneuverings than any sustainable shift in either supply or demand. Post-November, we look for oil prices (and our strategies) to move upwards again.

While gyrating energy prices and pandering politicians are grabbing the headlines, the *real story* we all

should be watching is the *growing backlash against globalization*.

Over the past six years, the secret to our success has been keeping in front of the gale-force winds of Globalization. If these should shift, we will need to re-assess our strategies. The first warnings came last year when we cautioned Hurricane Katrina might signal a sea change in the American psyche *and* a shift in the balance of power in Washington. Over the past 12 months the rhetoric from The Left to put the Genie of Globalism back into the bottle has increased. While these efforts will inevitably prove futile, in the short term they could fuel some disturbing political maneuverings which could negatively impact your net worth. Of immediate concern is a groundswell sentiment to "*redistribute the wealth*" as "*workers have been penalized by globalization.*"

This is simply *The New York Times* and others floating trial balloons and code-speak for tax increases. Soon 78 million Baby Boomers will be retiring, most of whom haven't saved enough for retirement. Will the Nanny-State be called to the rescue? If we ever saw a sure-fire prescription for higher taxes, it would be a Democratic controlled Washington playing to a bunch of *Broke Boomers*. Unlike most pundits' dire predictions, this one has a

measurable fuse. It is within 4 years. Two years to the next election and then two years to push through the legislation. In 2010, the first Boomers will be age 64 and the sunset provision of the estate tax repeal will have expired. This is not idle ranting and rambling. *Now is the time* to start positioning to mitigate any impacts here, not after Hillary's coronation.



A Democratic-controlled Washington's efforts to reverse Globalization will ultimately fail. However, Globalization *can* come to a screeching halt *if* the West loses cheap energy. Think hard right now about this for just 5 minutes. The incredible global logistics machine that brings you oranges from Argentina and tea from China was conceived when oil was in the \$20 to \$30 –a-barrel range. How does an era of oil in the \$60 to \$100 range impact the logic of global logistics? Virtually all our food and manufacturing has been “outsourced” around the world and is absolutely dependent upon cost- efficient distribution. Even the salad bar at the local grocery has perishable ingredients brought in daily from 3,000 miles

away. Will this continue to make sense? If not, from where will you get your lettuce? The local farm is now a suburban subdivision.

While on this topic of unpleasant possibilities and realities, has anyone else noticed the big hairy elephant sitting over in the corner called Militant Islam? In case we've forgotten, these guys control our oil supply. And lest we forget, their stated mission is to destroy our satanic.....err..... economic way of life. Bob Woodward's “*State of Denial*” is eerily ironic, because it conveniently ignores our even greater “*Nation in Denial.*” Does anyone want to admit Western Civilization is in a life or death struggle over the control of the world's energy supplies? Without cheap energy, our massively “just in time” global logistics system comes crashing down. While we fiddle with politically correct terms such as “The War on Terror”, “WMDs” and acceptable interrogation procedures, the reality is that without cheap energy, the suburban American Dream collapses within a year. Debating whether Bush knows we're stuck in a quagmire in Iraq is disingenuous. Isn't Congress's failure to acknowledge the severity of the crisis we're facing the real American tragedy?

America's very awkward situation can be summarized very simply: The world's actual supply of oil is rapidly depleting while at the same time demand is increasing. With our newly globalized economy and supply chains reaching around this world, any disruption in the supply of oil can cripple us almost overnight. Long-term price increases ultimately do the same thing, but simply bleed away our strength over time as the trade deficit siphons off our accumulated wealth a bit every day. This is the *clear and present danger* to the entire American Dream. A couple of camels with a few pounds of semtex could crash the entire system.....tomorrow. Oil at \$70 a barrel and over will do the same thing over the next decade as our national infrastructure based on highways and suburbs becomes increasingly cost prohibitive.

Luckily, my job, as an investment advisor, is purely a dispassionate analysis because there is quite an *ethical dilemma* here. Will the champion of Democracy, Religious Freedom and Capitalism ultimately have to jettison Jeffersonian ideals and conquer radical Islam to secure the energy it needs to survive? How long will it be before we get gored on the horns of this dilemma?

Truth, Justice and the American Way! If only Superman could fly to the rescue! Sadly, our Uncle Sam has become addicted to foreign oil and is wasting away. Remember Jack Nicholson's classic line about whether the PC American public could accept the behind-the-scenes battles necessary to preserve the American Dream? "***The Truth, you can't handle The Truth!***"

The irony that Uncle Jack rant was about Guantanamo shouldn't be lost on us today either. Still think our military occupations of Iraq and Afghanistan are about "spreading democracy" to the Middle East? Or is it about preserving both your and my very comfortable "American Way of Life" which is dependent on cheap supplies of fossil fuels? Stated more selfishly, it's also about preserving your wealth, which could get sucked down the drain in about 30 seconds in an all-out war. Well, the time is much closer now when all Americans will have ***to handle The Truth and reconcile ideology with reality.***

It is really that simple. It is also almost inevitable. Once we understand this, the likely course of events over the next several years becomes fairly predictable. This, in turn, will assist in positioning our investments.

The options to break out of this trap in order to preserve our lifestyle are very limited. We can hold onto the hope/hype that the Holy Grail of Hydrogen Energy miraculously appears, but believing in this seamless segue from fossil fuels is akin to hoping the Easter Bunny will morph into the Energizer Bunny. The odds of perfect timing are remote and an economy based on just-in-time inventory needs perfect timing.

This leads us to the very ***uncomfortable conclusion*** that the American economy and our own personal lifestyles are in a very precarious position.

Somebody recently called me an “***optimistic pessimist***” meaning I am concerned about the long-term trends facing our economy, but also find investment opportunity in their very predictability. I don’t disagree. While we can’t control the course Washington takes, we can still make logical investment positions based on illogical national policy.

Currently, our strategy can be distilled down to two very basic observations: ***First***, the global demand for energy will continue to increase and the supply will decrease. This means energy prices will continue to climb. ***Second***, as Washington fiddles around and avoids the real problem, the

competitive position of the United States will decline and the U.S. dollar will fall in value. This means hedging against a falling dollar and investing more outside the United States.



Is Globalization Endangered?

Even the icon of heartland investors, ***Warren Buffett is*** hedged against the possibility of a sharply-falling dollar. In our estimation, this free fall is already underway. It’s just that Washington and the media aren’t bothering to tell us. It amounts to a ***silent tax increase*** that doesn’t require a vote of Congress. Code words signaling a decline in the Dollar as an accepted policy are coming out of Washington ever more frequently. One Fed Governor said last month “an orderly” decline in the dollar was an “acceptable means of bringing our budget deficit under control.” If China and others pick up this perception, an ***international currency crisis*** could occur at any time.

Over the past several weeks, the price of oil slid over 25%. Now does anyone else find the timing of this before the mid-term elections perhaps just a shade more than coincidental? Could **Karl Rove** be trying to buy back the conservative core voters with a quick binge on cheap dinosaur wine? Does anyone with an IQ above 65 actually believe that demand for gas, cars and food from India, China and Brazil will ever “decline” again? On the other side of the equation, has anything happened to improve the long term supply? Don’t be fooled, the long term trend is up !

Still, it seems our globalization philosophy is spreading. In the last several months we’ve contributed to articles in *Investment Advisor*, *Financial Planning* and *Boomer Market Advisor*. Additionally, the professional investment research website *www..Research.com* has posted our last newsletter. Please let us know if you would like copies of any of these. To help with our growth, we also added two new members to our team. Stacey Murray is now taking on client relations and Candice Martin is now helping to keep my life and workflow in order. They are both doing a great job and Smiling Dan is now full time on our Costa Rican activities. Please give Stacey a call if you have a referral for us!

As we wait for the election season to come to a close, it’s time once again to layout our current investment strategy and how we are positioned. As usual, we’ve tried to list the more important issues near the top of the list and some of the concepts we see emerging further down. Read on until your eyes glaze over!

- 1) Our investment strategy rests on **two basic concepts**. The first is a long-term trend for a **falling dollar**. The failure of Washington to face up to the trade deficit makes this almost inevitable. This argues for a significant allocation into investments which are insulated from the dollar. Our second pillar of the net impact of globalization is that the **emerging markets** will continue to grow faster than the Western economies. The BRIC economies are still growing at 200% to 400% the pace of the U.S. economy. So what if China’s GDP growth slows from 10.5% to 10%?

Common sense says we want to put our money in front of both these tides. Upwards of **60% of our total strategies** are tied to them.

Thought for the New Age #113

As the battle for control of the world's natural resources shapes up, the influence of short term factors such as weather will have less of an impact on commodity and energy prices. Look for a steady rise in prices and lower volatility

This is at significant variance with a “typical” investment advisor who might venture to hold a 5% position in gold and perhaps another 5% in emerging market stocks. A 10% position is simply a ***philosophical proxy, not a bulwark*** against the tides we are facing.

- 2) Rather than try and bet on the currency markets as our hedge against a falling dollar, we've opted to build a diversified strategy through international real estate, precious metals, commodities and also energy. In addition to these ***“hard asset”*** positions, we have also used the ***“paper assets”*** of the emerging equity markets. However, we see the emerging stock markets as subject to ***faddism*** on both the upside

and the downside. Earlier in the year, we reduced our positions here when it looked like Wall Street had bid the prices of these stocks to high.

- 3) While oil is down 25% from the August highs, we strongly suspect election-year political maneuvering is the source of ***the sudden drop in energy prices***. This has put a ding in our returns in the last 30 days, but until evidence of a fundamental shift in either the supply/demand equation for commodities and energy emerges, we'll hold tight in our positions. For new accounts, the recent correction presents ***an attractive entry point***.

- 4) And what about the ***U.S. stock market?*** We simply do not buy the media hoopla. If this is a Bull Market, then “where's the beef?” It has taken six long years for the Dow to simply make it back to where it was when we started this decade in January of 2000. And that's in “today's dollars” which masks a 15% decline in global purchasing power, worth over 1,500 points on the Dow. With a declining housing market likely to

- cool the economy, we see very little to get excited in the U.S. stock market. Our positions here are *under 25% of total assets*.
- 5) If **GM** is about the top performing stock in the Dow, we all have reason to be concerned. After all, GM slashed its dividend by 50% earlier in the year and its domestic market share continues to plunge. When Hyundai tops the quality ranking and even Renault snubs you for a date, where's the good news?
 - 6) Longer term we're much more intrigued with the *emerging market stocks*. However, because these markets are so small relative to the world capital markets, we felt prices had gotten ahead of results causing us to reduce positions earlier in the year. From a high of about 20% this time last year, we are now under 10% in most accounts. We should note that this is still a higher level of exposure than all but the most aggressive "traditional" advisors. We'll hold steady here for now and look for a re-entry point in the event of some market turbulence.
 - 7) Our exposure to the more *developed international markets* is minimal, because these markets now move largely in tandem with the S&P 500. We see little actual diversification effect here in either reducing market risk or from a falling dollar.
 - 8) And what about the "safe haven" of *Bonds*? If you think the dollar is going to fall and interest rates might rise, U.S. bonds are about the worst place imaginable to invest. Currently, we are about 15% in U.S. bonds. However, somewhat surprisingly, we've had some nice returns here as long-term rates have actually dropped over the past several months.
 - 9) With so much volatility, where else can we invest? Earlier in the year, we started building positions in two new sectors, which we hope will add stability to our longer term returns. These are *Water Resources* and *Alternative Energy*, which now account for about 10% of most accounts.
 - 10) *Water* is the essence of life yet virtually every country and community around the

world has some level of a *water crisis*. We can also make an argument for a recession-proof industry with a very predictable long-term growth curve. Did you know the U.S. consumes 60 times the world's average of water per day? This adds up to about 1,300 gallons of water per day, per citizen. We view this as a long-term defensive position and not a rocket ship. Patience should pay off here.

SORRY – The JANUARY GATHERING to Del Pacifico in Costa Rica IS FILLED TO CAPACITY!

Make your reservations now for future GATHERINGS: March 22-26; April 26-30, or June 21- 25. (Hint: The April Gathering will feature the Costa Rican National Bull Riding Championships!)

- 11) Our other new position, *Alternative Energy* is likely to be much more volatile. While we could put on our Birkenstocks and give you the “feel good” spin on alternative energy, the real reason we’re aggressively adding to these positions is purely cynical. In fact, we doubt “Alt Energy” stocks will collectively earn a nickel of real profits over the next decade. So why are we investing in them?

Because, it is almost inevitable Washington will hit the panic button and start throwing bushels of money at that a looming energy crisis. Can you imagine the boondoggle that will be launched as soon as the ink dries on the legislation for the “*Energy Manhattan Project?*” We’re just staking our claim before the pork rush. Our energy addiction makes a massive Alt Energy push almost inevitable. The recent rise in the election prospects for the Democrats moves this ever closer to no-brainer territory.

- 12) While The Street is abuzz about *ethanol* as our savior, did you know that if every single ear of corn grown in America was used for ethanol...with out a single kernel going to feed livestock or popcornonly 12% of our gasoline needs would be met? Still, do you want to bet the Ag-lobby in Washington will throw billions this direction anyway?
- 13) So what about the *real estate* bubble? The word is 2007 will be the first year since the *Great Depression* housing values will fall for

an entire calendar year. How much? Some say 10%. We aren't personally concerned, because we exited REITS about 3 years ago, but it will be a while before the next buying opportunity appears.



- 14) Some fodder for *Doom's Day Speculators*: Here's the ugly spiral's next ring *If* housing values plunge and *if* mortgage balances become greater than the market value, does Middle America keep paying the mortgage or simply turn over the keys? A 10% drop in market values puts many houses under water.
- 15) The next logical question is: *If* this were to happen, would it lead to *a banking crisis*? Somewhat surprisingly, the answer here is "not likely," because most mortgages have now been "securitized." However, this would likely add to our

retirement crisis. First, the *homeowner's equity* component of most retiree's balance sheet will be wiped out. Second, the brunt of any defaults would be borne by the *bond markets* which in turn are now owned by mutual funds and retirement plans. In this sad scenario, look for the losses to ultimately be paid by the 401(k) investors who thought they were playing it safe with bond funds.

- 16) So what about those good ole "almost" government guarantees of *Fannie Mae and Freddie Mac*? If the housing markets deteriorate, the big money investors will require a higher-risk premium as the "quasi-risk free" status evaporates. This will translate to higher interest rates and falling bond market prices.
- 17) As a slower real estate market causes the overall U.S. economy to cool, can *China and India* pick up the consumer spending slack? More wishful thinking. This is the economic equivalent of a "Hail Mary" pass in football. Sure, it could happen, but you might as well buy a lottery ticket. The prudent course of action is

to position for the pass to be either deflected or intercepted. Going back to our Global Deflation 101 scenario: if global supply of “stuff” is greater than global demand, prices will fall and profit margins will get squeezed. This can’t be good for the stock market.

- 18) Let’s face reality: *the global economic boom* of the past 4 years was *never sustainable*. It was created out of the liquidity boom resulting from attempts to fight a nasty bout of *global deflation* which started to take hold in 2002. You can revisit all our old newsletters about this. Lowering interest rates bought the U.S. some time to stabilize after shaking off the impact of the Tech Bubble, and the Islamic Jihad’s Pearl Harbor on September 11.



Smilin’ Dan at his new office in Costa Rica.

Now the Fed is trying to squeeze out some of the surplus cash. This will require letting some air out of the “asset inflation bubble” which leads to the housing issues above. Given this scenario, future growth has to come the old-fashioned way where modest increases in demand will come from gradually-increasing income around the world. The artificial crystal meth stimulant created by the housing bubble’s pseudo wealth effect over the last 5 years is now played out. The withdrawal could be painful.

- 19) With most of our attentions focused on the rising global tensions, we hate to be the bearer of bad tidings, but the *Baby Boom is very close to retirement*. In fact, 90,000 Boomers are turning age *60 everyday*. Clearly the Social Security system is in bad shape and can’t even get onto the front page. Nevertheless, beware the rising political rhetoric about the wide *divergence between the rich and the poor* over the past 5 years. This is media code-speak to start setting the stage to “re-distribute wealth” from us

that “has got” to our less thrifty fellow citizens. This is no longer a theoretical debate. There is a finite horizon on the Baby Boomers reaching retirement age. Start giving very serious consideration as to how you will protect your accumulated wealth going forward.

21) Intralytix the private biotech company we mentioned last quarter has recently been profiled by both CNN and CBS, because they are right in the forefront of the E. Coli battle. Go to the web and Google them. If you’d like an update, please give me a call directly, it’s really quite exciting.

22) Movie Madness? The filming of *Costa Chica*, our detective action film is just about finished. The professional wrestler, Rowdy Roddy Piper, is the bad guy and, David Heavener tells me, he’s added an “*X Files*” element. David will release the film at the *American Film Market* in Santa Monica in November.

Strudwick Wealth Strategies specializes in investment management. The information provided has informational purposes and is not a solicitation of securities.

strong to reverse, we see short-term political opposition rising. This might require some re-thinking of our long-term strategies over the next year or two, and perhaps it creates some tactical opportunities. Going forward, we continue to see hard assets being the foundation of our strategies, but this might shift over time.

Barry Strudwick
September 30, 2006

P.S. Please feel free to call any time, Also, we really appreciate the referrals!

