



Awash in Liquidity

By Barry Strudwick

This newsletter was originally shared with our clients in January 2007. It is now being shared, unedited, 60 days later to stimulate thought on these issues. The comments and observatory should be considered general.

Once past the bally-hoo of last fall's elections, our globalist strategies rallied to finish the year with most accounts up. As a quick recap, last year started like a rocket on the strength of energy and the emerging markets, but we gave back part of the profits in the 2nd and 3rd quarters. We then **recouped** down the homestretch after the election for another excellent year. As long as nothing fundamental occurs to shift the prevailing currents of globalization, diversifying away from a weakening U.S. dollar and seeking opportunities outside the U.S. is the way to go.

However, there are several squalls on the horizon. The first and foremost is the growth of anti-globalist sentiment over the past year in the U.S. (just as we predicted in our Fall 2005 newsletter "Hillary Ascendant or Katrina the Catalyst".) How the newly empowered Dems either embrace or retreat from the new economic world order will be critical over the next 24 months. Be on the lookout for seemingly "patriotic" policy

shifts, which could impact your wealth. Here is why:

There's now no question there is an increasingly vocal and restless "anti-globalism" crowd gathering at the foot of Capitol Hill. For a barometer, look for articles describing "The Two America's" and the "inequitable" distribution of wealth caused by globalization. It's a new spin on the old story of Fat Cat Capitalists profiting at the expense of the Proletariat. A Democratic Congress and a fragmented Republican leadership open the door for this equalitarian anti-globalist to influence both tax and trade policy. While the tides of globalism can't be reversed, this doesn't mean the newly ascendant "special interests" won't try to "work the system". Taxes, tariffs, trade wars and general isolationism are all negative for the United States longer term, but shorter-term, there is a reason this is a valid threat.

While we normally wouldn't fret about the "Two Americas" contingent, another political time bomb is ticking away with an actuarial precision to make a Swiss watchmaker proud. Seventy-six million Baby Boomers are growing grayer every day and are no better prepared for retirement than they were last year. Evidence? The national saving rate was a **negative 1%** last year! Now consider 7,000 Boomers turn 65 every day and the average retiree has a total net worth of less than \$100,000. Let's see, at a 5% after tax rate of return that's only \$5,000 a year. At \$50 a fill up, half their annual income is gone, leaving less than \$7 a day to sip Mocha Javas at Starbucks. Eating? Healthcare? Retirement? Details! John Smith's pilgrim ethic of "**No work, No Eat**" is long forgotten. Any guesses where the moolah is going to come from when the Nanny State is called to the rescue? These

Graying Boomers might be the catalyst to cause adverse legislation. Why?

Not that we've ever been accused of being "deep thinkers" but, have you ever wondered what happens in a democracy when the people who need money outnumber the people who have it? What happens if the margin is 20 to 1? And they vote?!!! It won't take long before the lobbyists figure this one out. Can you hear it now... "These hardworking people have been exploited and have the **right to retire?**" Justification? No higher moral authority than the *New York Times* has already proclaimed the America's wealth distribution was "inequitable." When millions of Boomers realize how pathetically un-prepared they are for retirement, we must anticipate retirement **and tax policies** to shift. Leaving wealthier Americans to shoulder the burden. Where else can it come from? This isn't academic anymore; it's starting now with the new Congress.

Congress doesn't even need to act effectively to put a tax on your savings. How about the "silent tax"? The incredible shrinking greenback has lost 17% of its value since its peak in 2002. Why? In large part, our spending spree of the last 5 years. With \$3 trillion of foreign debt and our lenders tired of the falling dollar, we are on the brink of a global currency crisis. How did we get here? When the global economic boom caused the worldwide supply of "stuff" to start outstripping demand, the U.S. initiated a shortsighted strategy to bring the two forces back into balance. Our brilliant solution? Let's balance the global equation by encouraging Americans to spend our way back into equilibrium. Seriously, "shop until you drop" has been our national response to the economic disruption of Globalization. The wild spending orgy of the past 5 years

has simultaneously hollowed out our home equity nest egg and ballooned our international debt. And guess what? The underlying fundamental problem of a global supply glut is still with us. We hate to say we told you so, but we did. Now, the next act of this international monetary play is starting to act out. Our foreign creditors are getting tired of the sucker's play of getting paid in a falling currency. We are like the mooching deadbeat brother-in-law and they are saying, "**Enough is enough!**"



Our own "Patta" at the Del Pacifico Rodeo

Are the **dominoes starting to tumble right now?** Even our staunch allies the United Arab Emirates have reduced the amount of dollars they are willing to hold by 8%. This is likely just the first in a long line of reductions. With Bush a veritable punching bag for the next two years and the blood sport of a presidential election in the air, do you see anyone in the Congress or the Senate leading the charge for national austerity? The tragic thing is for most Americans 90% of their total wealth is tied to the dollar and they don't even know this the wealth erosion is happening. While Washington fiddles around, the probability of a **major international currency crisis in 2007** has increased significantly. We will be increasing our hedges here by holding **more**

precious metals. As it is more important than ever to diversify away from the U.S. dollar.

If this weren't enough to get your attention, let's ponder the **true significance** of our humbling experience in **Iraq**. To cut to the chase, Western Society is utterly dependent on an uninterrupted supply of oil to maintain our "just in time" inventory systems we've got 5,000 mile long supply chains???? Ninety-eight % of all our cars, trucks, trains, boats, and planes still require fossil fuels. Let's face it, a major disruption in our supply of oil the entire complex global logistics machine crashes. Could this lead to a **Second Dark Age**? War, Disease, famine, the whole "shebang". Think about it... it is scary! Iraq has shown that the world's sole remaining superpower is very impotent (to protect these vital military assets. While 3,000 troops have died, the lifestyles of 300,000,000 Americans and another 460,000,000 Europeans are in a **very precarious position** right now. This threat alone argues for higher oil prices.

Our conclusion? We see the continued slide of the dollar and a significantly greater probability of higher energy prices. Lower cost oil is an aberration and simply is not sustainable. This combination argues for a long term **siphoning of wealth** away from the United States and into the economies of the emerging markets. As added factor, there is the short to intermediate term risk of an international currency crisis or a political event impacting our oil supply while at an **"orange" warning** level and close to flashing red. Our investment conclusion is to continue to overweight (?) hard assets such as commodities, precious metals, oil and international real estate, despite short run volatility.

As an update on our crew here on Eager Street, there are some new faces. Stacey Murray is heading up our client relations, so if you have a question please give her a call. Candice Martin has joined us and accepted the challenge of keeping me organized and on schedule. Melissa Long is doing a great job on our account administration. Another new name might be Mike Torino who is helping to oversee our overall operation and growth. Dan, Harry, Tim, and Stephanie are full time with our Costa Rican activities which are going great. If you'd like to visit us in Costa Rica anytime, please give us a call. The first four episodes of "Costa Chica" starring Rowdy Roddey Piper have finished filming. Give me a call if you'd like to learn more.

Once again, our most recent observations on the world of high finance and how we're responding, please feel free to call me to discuss your thoughts.

- 1) Our **globalist investment strategies** finished strong with most clients ending up between 14% and 16% for the year. New accounts that opened during the year had lower returns because the 1st quarter was very strong last year and we harvested profits from the emerging markets. Please check the attached reports for your actual performance.
- 2) Going forward into 2007, we anticipate another year where the basic premises of globalism with continue to profit. However, we also anticipate **higher volatility** particularly in the areas of **energy and currency**. However, our sense is that this volatility is more political than economic in nature.

Ultimately markets will return to their economic equilibrium. In English this means, we see settling in with oil north of \$60 a barrel for the long run. Thirty days of warm weather doesn't warrant a \$10 a barrel drop in oil prices. This is just a small blip in the long term demand curve. Much more important is the stability of the supply side of the equation. The potential fragmentation of Iraq, terrorists, and the stability of Saudi Arabia are all much more important long term.

- 3) The core of our investment strategy is based on what we believe to be **two primary currents** to stay positioned in front of: The **first** is a long term trend for the dollar to lose global purchasing power.



When you owe \$ 3 trillion to other countries, it will always be easier for a politician or legislator to “stay the course” and leave it for the next administration to clean up the mess. We don't see this trend reversing until Washington gets

serious about it, which will require an **international currency crisis**.

- 4) The **second major trend** is the long-term flow of wealth out of the United States and into the economies of the faster growing emerging markets will continue and actually accelerate. Last year the U.S. economy grew by about 2.5% while China & India grew by 10.5% or 4 times as much! Perhaps this is also why their stock markets also outperformed the U.S. markets by 400% as well.
- 5) **Don't confuse patriotism with profits** when it comes to your personal investing. The combination of “**hard asset**” investments, **emerging market** and other international investments total about 65% of most of our globalist strategies. This is a proactive position, which is quite different from Wall Street's typical Ameri-centric strategy. Again, there is nothing wrong with making rational investment decisions based on irrational national policy.
- 6) The typical Wall Street stockbroker might have 10% allocated to these types of investments. However, if you believe that the dollar is in a long-term decline and that the U.S. economy will only grow at ½ the rate of the emerging markets, a 10% position is simply a **philosophical proxy** leaving you 90% exposed to these wealth-corroding forces.

- 7) Likewise, if you believe the dollar is a long-term decline, why would you want to hold U.S. treasuries or bonds? That's why we have allocated just 15% here. This being said, we were pleasantly surprised when our *domestic bond* sector actually did well last year with a return of over 10%.
- 8) Our allocation to *U.S. stocks will remain about 25%* with an emphasis on *small & mid caps* sectors, which has been our preference for the last 7 years. Last year this was the right call again as the S&P small cap value index has posted an average return of 17.5% last year versus 14.1% for the large caps. Over the past 5 years, the small cap "value" shares have averaged 14.6% versus just 6% for the S&P's "blue chips". Using the "old math"... 5 years times an 8.6% annual differential adds up to 43% for the past 5 years.
- 9) But is the leadership torch about to get passed? We suspect that the point is getting close, but not quite yet. The PE ratio of the *large caps stocks* is finally out of the mid 20's nose bleed territory and is now back in the teens. It is actually a touch below the P/E of the small caps. More signs of a slow down might alter our thinking to shift to a larger cap growth orientation.
- 10) However, one of the prime movers of stock market prices right now isn't so much the actual profitability of companies, *but the massive amount of liquidity* sloshing around. Last year the U.S. economy grew by only 2.5% but our money supply grew by 9%. This is the result of both Government policy and the explosive growth of the "derivatives" market, which now provides 75% of the world's liquidity versus just 11% from the mood (?) Government money supplies. With this much money available, this means that there is fierce competition for investment opportunities globally. Government policy cannot control this source of liquidity
- 11) Additionally, post Enron we also have a regulatory environment gone nut-zo, which is scaring capital away from the public markets. Who in their right mind would want to be an executive of a public regulated company these days?
- 12) The combination of cheap credit and over zealous regulators leads to a curious market phenomena we're in the midst of right now of *more companies "going private" than "going public!"* Last year \$97 billion of public companies "de-listed" by going private and only \$43 billion of stock was issued by companies doing IPOs. We can play this phenomenon by investing in publicly traded companies that do private equity investing such as *American Capital Strategies and Alliance Capital*. Aside from avoiding the high commissions on private equity partnerships, the public company approach also avoids the 5-year "lock up period" many private funds require. If the liquidity spigot shuts off later this

year, we'll want to head to the exits. We'll likely be building a new position here of up to 2.5% of our allocation.

- 13) Here is another variation on the same theme. Last year, S&P 500 companies spent more of their profits on "**stock buybacks**" then they were willing to reinvest in new plants and equipment! What is this telling us? Could it be the guys in the executive suite see so much **excess global capacity and competition**, retiring stock is a better bet than growing their own business? Only a cynic would ponder the short-term impact this might have on vested stock options.



- 14) And speaking of liquidity. What about the new "**Blue Gold?**" Or investing in companies focused on the **potable water industry?** Like oil, water is another commodity where demand is growing quickly while supplies are diminishing. Every emerging market desperately needs a safe supply of clean water. Currently, water related positions

are about 2.5% of most accounts for the year of 2006, our basket of water related stocks was up about 20%, but we built our position up over time. While we don't see dynamic growth here, this should be a recession resistant industry as supplies all over the world are strained. India and Latin America have huge supply problems and uncontrolled suburban /exurban growth is finally catching up in the U.S. as well. Atlanta is tapped out and Las Vegas and Denver are even worse off.

- 15) Someone asked us recently, "**Why commodities and not currencies if you think the dollar is going to fall?**" Our rationale is pretty simple; we're investors and not speculators. Also, to make money in currencies requires both leverage and a quick trigger finger. Commodities on the other hand also have an economic growth play in addition to the currency play. We're more comfortable wagering oil or water consumption will increase over the next 10 years than the daily inter-play between the dollar, yen and euro.

- 16) The biggest question we need to be asking ourselves right now is "**Which way will commodity prices go?**" Last year was tough with the indexes down about 11%, which perhaps reflects too much speculation in 2005. Is this a new trend? Doubtful, as investors we're supposed to have long-term horizons. So tell me which factor you think will be more important over the next 5 years on oil prices; A) Two months of a warm winter

or B) China's economy growing by 10% a year? When put this way, seeing a 5% or 10% fluctuation in the price of oil based on a couple of warm weeks is either ludicrous or an entry point.

- 17) However, we might be shifting a portion of our commodities position over to *precious metals*. The rationale here is that gold will likely do better as a hedge in a *currency crisis* than broader based holdings of oil and industrial commodities. Did we mention Harvard's international monetary expert feels there is a "significant risk" of a "big (monetary) tsunami" because of the U.S. current account deficit? This will not be a major shift, but a tilting of perhaps 2.5%



- 18) We're especially bullish on *Alt – Energy* with the Dems taking full control of Congress. It doesn't take a psychic to see the pork-meisters lining up to throw money at "clean energy." While we hate to be so flippant as to say we don't see a nickel of actual real profits coming from the aggregate of all the solar, hydro, hydrogen, ethanol, bio-diesel, and geo-thermal and wind companies over the next decade, we're pretty confident the share

prices of clean energy stocks will profit handsomely from the global geo-political tensions. These positions are currently about 5% of most accounts

- 19) Surprisingly, over the last 9 months of last year, the Alt Energy sector was down about 15%. With Iraq highlighting our inability to protect our fossil fuel supplies, we view this as an *accumulation opportunity*. As sure as night follows day, "*green & clean*" will become a mantra in Washington and on Wall Street. Patience will be rewarded as we await the inevitable over-reaction. *Fad-ism is your friend if you're in front of the craze.*

- 20) Speaking of which, you'll recall we *took profits in our emerging markets* last year when Wall Street pushed the prices too high. Over the year we reduced our exposure by about 50% from our high water marks. Our big performers last year were *Brazil, India and Latin America*. Right now, India looks very pricey, but we'll hold our chips for the time being. Please look at your individual reports for your actual performance.

- 21) We have a new saying around here. "*Half a BRIC is better than one*" meaning we're fans of *Brazil & India*, but are *avoiding China and Russia*. Maybe we watched too many James Bond movies, but being children of the Cold War,

we're very leery of Mr. Putin's power plays.



Did you see the bear hug he applied to Belarus? Putin threatened to cut off the gas supplies in the dead of winter unless they gave up ownership of half their pipeline and also swallowed a 100% price increase. This has also impacted the supplies of gas in Europe. The political risks here outweigh the prospects of an already overvalued stock market. We'll stay clear.

- 22) Another important part of our global strategy is investing in the **global real estate** via publicly traded securities. Our core holdings here returned 36% last year. The logic here is very simple, as economies boom outside the United States, the real estate markets tend to move ahead of the local stock markets. This is for several reasons. First, in the early years of a market's development there simply aren't many good quality stocks to purchase. Second, as wages improve, people want to upgrade their housing, driving up real estate values. Ex-Pat quality housing in Bangalore is now priced higher than London and Tokyo! Can you believe a 3- bedroom

condo is priced at over \$1.5 million? As discretionary income increases; malls also start to sprout up. Last year wages for professionals in India shot up 20%. Shopping centers are this year's hot investment sector. Real estate is also a "hard asset" and holding dirt outside the United States is a solid hedge against a falling dollar.

23) While every cabbie these days is also an expert on real estate, here are some stats from the WSJ. Over the past 10 years the U.S. real estate market was up 100%, but the real money was made outside the US... **South Africa** is up 327%; **Ireland** was up 252%; **Britain** up 192%, **Spain** was up 173% and even **France** was up 123%...

- 24) Last quarter we discussed extensively the **looming battle over control of the world's natural resources**, as a major new current of Globalism. We haven't changed our opinion here. China is now the world's second largest oil importer (and Russia is the second largest exporter). Did you see China invested \$4 billion in Nigeria for oil field infrastructure? This follows other natural resource deals they struck with Chad and Gabon earlier. Putin's bullying Belaruss is just another example of this. This is why we need to be over weight here for the long haul.

- 25) **Loss of Saudi Oil is our worst nightmare.** With our experience in Iraq, do we have the Military capability to protect this vital interest if need be? Did you know that both the King and the Crown

Prince of Saudi Arabia are both in their 80's and the two family factions are wrangling for control? The Sunni Saudi's sees Iraq as a victory for their long time enemy the Shiite Iran. Our "failure" here might lead to a shift in allies. Now consider this, what would happen if China became the "protector" of Saudi Arabia from Iran? How might we respond? Is this far fetched? Go back and watch the George Clooney movie *Syriana*.



Barry Strudwick
December 31, 2006

- 26) To keep good relations with our friends over at the SEC, we bring you this annual reminder that our managed investment accounts are limited to marketable securities. Any direct investments in private equity real estate partnerships, which you may have invested in, are outside of this relationship. This exclusion includes any private equity in which any principals related to Strudwick Wealth Strategies might be the general partner or have a personal economic stake. Investments in these private companies are not charged fees as the decision to invest was made by the individual investor and not by Strudwick Wealth Strategies.

- 27) This is also a reminder that a copy of our most recent ADV form filed with the SEC is available upon request. Just give our office a call.

We're optimistic going into 2007, but it's clear that there are crosscurrents to the prevailing stream of Globalism. We'll be seeking ways to buffer ourselves from any turbulence.

P.S. We appreciate the referrals! Please feel free to call us if you think you have someone that "thinks like us!"