



Greenspan's Grand Illusion

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Editor

These thoughts were originally shared with our private clients in early October 2007. They are now being shared, unedited, 60 days later to stimulate thoughts on these issues. These thoughts are considered general in nature and not specific investment advice. Please feel free to share your comments with us at www.theglobalistmonthly.com

In our highly regulated world, we shouldn't really talk to specifically about investment performance, but suffice it to say our strategies have weathered the recent market turbulence quite well. Certainly our holdings in oil, gold and avoidance of financial stocks were all contributors to this.

The origins of our gains are quite different than the typical "balanced account," which is about 60% U.S. stocks, 30% bonds and 10% international. Our current strategy is only about 25% exposed to the gravitational pull of the U.S. stock market and very heavily weighted in favor of energy, natural resources

and commodities. In fact, our largest gains are from sector plays which don't even appear on most advisors' radar screens. For example, our ***Latin American*** positions are up over 60% in the past nine months; while our ***Alternative Energy*** positions are up over 30% and our ***Water*** play is up 19% over the same period. While we gained great returns here, these holdings have superior defensive qualities in the event of a global slowdown or a falling dollar.

Despite the recent rally in the markets following the turmoil in August, we do not share the recent stock market enthusiasm. Quite candidly, we see the potential for both a U.S. slowdown and a major monetary crisis in the immediate future. The current rally is for all the wrong reasons and ignores warning bells ringing all around. Our gut tells us that in 6 months when the academics pull out their "all knowing" rear view mirror analysis, they will tell us how Bernake's interest rate was the catalyst for an international assault on the Dollar. Few realize the recent nominal stock market gains have largely been offset by the plunge in the Greenback. Our wager is that the ***Dollar will continue to fall*** faster than the stock market will gain.

Are we caught in a video loop like Bill Murray in *Groundhog Day*? In

June, the Dow finally broke thru 14,000 for the first time since 2002 and the market wags were celebrating the return of the stampeding Bull. Then suddenly over the next 90 days, the credit environment changed, triggering what many have called “the worst crisis in 25 years” as banks in Germany and Great Britain collapsed and more importantly, the short term commercial credit market dried up over-night. Under this weight, the stock market plunged from its highs in July. In September, with the specter of the entire banking system freezing up, Uncle Ben gave the stock market a quick dose of his Magic Monetary Elixir. Almost immediately, Wall Street rose off its death bed and the Dow has busted thru 14,000 again. Happy days are here again? The Bernake interest rate cuts weren’t intended to pull some hedge fund’s chestnuts out of the fire, but rather to avert an international crisis when the entire banking system was threatening to crash. Bernake did this knowing the immediate consequence would be the dollar getting hammered; this has cost soon to be retiring American boomers billions in purchasing power.

Given the already eroding global opinion of the Greenback, this is grounds for grave consternation not celebration. There is no quicker way for Boomers’ retirement nest eggs to

get pilfered than to have the Dollar lose value. And for what net benefit? It doesn’t take a rocket scientist to figure out if “too much money” was the source of the recent mortgage and credit market problems, goosing up the money supply yet again will not be the long term cure. Every college freshman knows “the hair of the dog” might let you limp thru the morning after, but ultimately it compounds the hang-over. And after a 5 year spending binge, America is already working on a whopper. To make matters worse, Wall Street is already clamoring for more cuts like later this fall.



A Bird's Eye View of Del Pacifico

Over the past 5 years I’ve talked a number of times about a pending international monetary crisis. We might finally be there. Before your eyes glaze over, allow me to cut to the bottom line and say what I really think is going on and why it’s very important to not only grasp the concepts, but also to take a proactive position right now.

*The current **pickle** we're in is much larger than "just" a typical 10 or 20 year real estate bubble bursting. There are actually 3 or 4 simultaneous crises playing out at the same time. There's the real estate problem, the housing market crisis, the CDO /CMO securitization crisis, the commercial paper crisis, a plunging U.S. dollar and just the garden variety toppling of banks and funds around the world. Don't make the mistake of believing this is being easily "contained" simply because the evening news says so. "Contained" is PR spin-speak that usually means "things are pretty ugly and we need some time to figure out what to do."*



Browsing La Prada

Bernake's squirting a little monetary lubricant into the gears of the global banking machine will not fix what ails the system. This was not done to "bail out" investors; it was done to avert the entire global banking system from freezing up. The real estate crisis is simply the catalyst that has potentially triggered a chain

reaction revealing significant cracks in the international financial system. In the last 60 days a number of mid-sized banks and investment firms around the world have lost billions. Merrill Lynch, Citi Corp and Morgan Stanley have each already taken multi-billion dollar "write offs." If history is any indication, this is likely just the first round and more will follow. Given the highly leveraged balance sheets and the questionable market value of hundred of billions of "securitized" investments, there are whispers about the potential for a major brokerage firm failing. Bailing out the banks will damage the buck.

For the average person, the biggest risk is whether other Governments still want to accept the Dollar as the primary international store of value. This has huge implications for both Washington's ability to finance our deficit and also the stored wealth of all Americans. The turmoil we're seeing might be the early stages of a massive international monetary realignment in which the supremacy of the U.S. dollar is being challenged.

At this time, there is a real risk this could spiral into a full-fledged global banking and monetary crisis beyond the Fed's ability to correct unilaterally. Our message is don't try to predict the bottom of the stock market here but rather to hedge

against a falling dollar. For the individual investors the strength or weakness of the dollar will be the single most important factor to impact your personal wealth over the next 18 months.

Why? Because virtually each and every American's net worth is denominated in U.S. Dollars. In a global economy, if the Dollar drops in value, retiring Boomers will be able to purchase less with their life savings. We aren't talking nickels and dimes here. The Dollar is currently at a 25 year low against virtually every major currency. And falling!

Middle America remains eerily ignorant of the dollar's plight, because a by-product of Washington's flood of money is the market "price" of houses and stock market indexes have "increased" giving the appearance of an increase in "value." In reality, the sticks and bricks are still worth about the same, it's just the "price" has ballooned, because our currency has been debased.

Over the past several years this loss of wealth isn't just marginal, it's massive! Need evidence? What's more American than a glass of milk? A gallon of moo cost \$2.00 in 2002 and now will set you back \$4.00. In case you're asked to appear on "*Are you Smarter Than a 5TH Grader*"

that's a 50% loss in purchasing power in 5 years. Now, let's look at gold. Just 5 years ago an ounce of glitter cost \$300. Today it's \$750, which is a 150 % "price" increase or a 60% loss of purchasing power. Is it just coincidental that houses costing \$300,000 five years ago, are now selling in the neighborhood of \$600,000 to \$750,000? If you "deflate" the current market price by the change in the price of gold or a glass of milk, the grim reality of the *Greenspan's Grand Illusion* will settle in. There are dozens of other examples, but you get our point: Over the last 5 years while America has been spun a tale of incredible wealth increase from the real estate boom, in reality their piggy bank has been robbed as the Dollar has been pushed off a cliff.

The "stealth effect" of a debasing dollar is also devastating on "paper assets." For bond owners, a falling currency is like a silent (and non-legislated) tax, which confiscates accumulated wealth. What about Government selling "risk free" bonds to retirees when it's simultaneously debasing the currency? Where's Elliot Spitzer when you need him?! This is more unconscionable than the plaid clad insurance salesman fast talking seniors into buying annuities.

Working from this overall assessment, below are our most

current observations and recommendations:

- 1) To protect against a falling dollar and profit from an expanding global economy our **current asset allocation** is about 50% “market neutral,” 20% domestic equity, 15% domestic bonds, 10% international bonds and 5% emerging market equity. We will maintain this overall allocation, but will further shift our domestic equity positions to reduce exposure to the financial services sector.
- 2) Our **market neutral** has performed very well with overall returns of about 15%. These positions include Alternative Energy, Commodities, Water, Gold and International Real Estate.



Unique Architecture, exquisite Design

- 3) We aren't prone to try and “play” the credit market crisis, however a falling dollar should be immediately reflected in **oil and**

natural resource prices. Since Uncle Ben gave the financial system a squirt of adrenalin, oil shot up to \$85 a barrel. Our positions in commodities (up 12% YTD) and energy (up 27% YTD) reflect gains from both the growing global economy and the falling dollar.

- 4) **How high is too high with oil?**
At \$85, if the dollar were stable, we might be near a peak, but with the dollar falling, who knows? Global supply is declining while demand is steadily increasing. Either the world finds more oil or the price will continue to increase. Being “the glass is half empty” kind of guys, we aren't willing to bet on the miracle **Alternative Energy** discovery happening in the next 12 months. Goldman Sach's analysts are now predicting \$95 oil within 18 months. Add to this the risk of a terrorist attack or weather disrupting supply and we'll hold our positions. Our energy and oil positions are up over 25% so far this year.
- 5) The hard part of investing is not the logic of a position, but actually making the decision of when to buy and when to sell. Recall just 12 months ago the NYT and WSJ were full of articles on why oil had peaked and the experts saying it was time

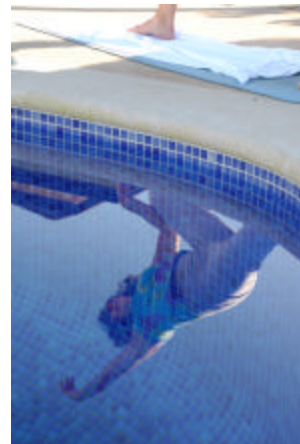
to get outat \$50 a barrel. At current prices, oil has had a 70% run-up in 12 months.

6) Speaking of *oil and natural resources*, keep an eye on China aggressively hoarding global resources. The battle over the world's natural resources is starting to heat up. Last month it was a multi-billion deal with Somalia, but this trend has been going on largely unnoticed for several years. As China increases its daily consumption of almost everything, over the next 10 years this should lead to major supply chain squeezes. As investors, this argues to increase our natural resource holdings over the next several years. We'll be also looking at increasing agricultural commodities as a shift in dietary standards will increase prices.

7) At the same time China is banking natural resources, the Multinationals are pulling back from political hotspots like Nicaragua and Venezuela. Long term, this will further decrease *Free World Supplies* which will translate to higher prices. While you've heard about Chavez's antics, what about Nicaragua? While Danny Ortega and the Sandinistas remain the darlings of the NYT's, but did you hear Nicaragua just seized a storage facility from Exxon Mobil and

has also revoked 4 deep-sea oil exploration concessions?

8) We have long been advocates of investing in Central American real estate, especially resort locations which will benefit from the retiring Baby Boomers. We still believe a Hillary election will create a bull market for International resort real estate. Real Estate investments in Nicaragua are high risk as the political stability has deteriorated significantly. Do we need to mention that Iran opened an embassy there in August? The Overseas Private Investment Corporation has also recently "suspended support" for any new investments in Nicaragua. Ortega is not a capitalist and *Nicaragua is not "the next Costa Rica."*



Rise and Shine! Poolside Yoga

9) You cannot change a leopard's spots. Putin is an ex - KGB authoritarian and Russia is not

“Pro-Democracy.” China is still a communist country which is quietly increasing its global economic and military presence. ***These people are not looking for “democracy” or to be our friends.***

10) Whether its China, Russia or OPEC, every dollar invested in ***Sovereign equity or Natural resources*** works to raise interest rates in the U.S. in order to attract the foreign capital necessary to finance our budget deficit. This trend will continue to accelerate over the next few years. Without cheap foreign financing, our deficit becomes a very real rather than academic problem.

11) The immediate crisis is the Dollar. The recent Fed interest rate cuts will accelerate this already negative trend. Any further rate cuts will make this worse. In addition, to indirect ***“currency hedge”*** plays in commodities, energy and international real estate, we have also established 5% Gold positions in most accounts to specifically hedge against a global monetary crisis. Our Gold positions are up 15% YTD.

12) The actions of the last 120 days portend that the Monetary Day of Reckoning might be much closer at hand. China and OPEC will no

longer passively invest blindly into U.S. Treasury Bills which are steadily dropping in value. The old ***“sucker play”*** of buying T-Bills yielding 3.5% and then watching them depreciate by 3% to 5% a year is over. Higher interest rates will be required to attract foreign investors. How much more? Perhaps as much as 2% higher over the next 2 years.

13) Since bond prices move in the opposite direction of interest rates, a 2% rise in rates could mean a 15% loss for 10-year U.S. treasury bonds. In other words, despite the recent “flight to safety,” ***U.S. Treasury Bonds are not a safe haven now.*** Longer term rates will rise and any short term gains will be more than offset by a decline in the purchasing power of the Greenback.

The Globalist Straw Poll

Send us an email and tell us who you see winning the election and also who you'd like to see win.

14) Over the past several years we warned repeatedly that Washington could not correct a ***global supply/demand problem*** by hyper stimulating domestic demand. We now have to face the consequences of this

tragically flawed political decision. The global excess supply is still with us and the U.S. consumers are tapped out.

- 15) Higher T-Bill rates will also mean higher *residential mortgages* over the next several years. Right now 15 & 30 year mortgages rates are as favorable as we're likely to see for the next 5 years. This means if you haven't already, now is a good time to lock in these long term rates.



Saturday Night Fever at the Poolside BBQ

- 16) I know you still are trying to forget, but try to remember the Carter years when we had “double digit” inflation. Why? Because if this situation spirals, a depreciating currency is functionally the same thing as spiraling price inflation. ***During extended periods of inflation, Borrowers prosper over Savers.*** While this is contrary to our core conservatism, this argues that you should leverage your hard assets

and invest in additional hard assets. The alternative is to have your wealth silently stripped away. Please feel free to call me to discuss this directly.

- 17) If we're dealing with a ***Global Monetary Crisis***, it is logical that there will be a magnified impact on banking and brokerage firm stocks. The potential for a daisy chain of losses exists. Certainly recent bank failures in Germany, England, Australia and even Iceland don't give us comfort. How solid is the capital base of the brokerage industry? Over the past 5 years the lending obligations of the Big 5 brokerage firms has grown from \$20 billion in 2002 to \$150 billion today. A significant portion of these loans are now under pressure with market price reductions of as much as 60%. While financial stocks have rallied in the past several weeks, we will be using this as an opportunity to reduce stock exposure to financial stocks. There is the distinct possibility of a failure of a major top tier firm.
- 18) ***Strategy Shift!?*** After flirting with this move for the past 9 months, we are shifting our small and mid-cap “value” orientation over to a combination of mid and large cap “growth” stocks. For us, this is a ***major shift*** after

about 10 years of being in the small/mid cap “value” camp. Our primary rationale here is to reduce our exposure to financial stocks from about 30% to about 10% of our domestic equity holdings.

19) *Tempted by the Yield of Another?* Now is not the time for amateurs to be sifting the debris of the bond markets looking for higher yields. A Triple Whammy is about to hit the junk bond market. Since this is pegged off the U.S. treasury rates, an increase here will cause these bond prices to fall. But, more importantly, for the past two years the “risk premium” or the “spread” over the U.S. treasury bill rate was way too low. In the last 90 days or so, the “spread” here has nearly tripled from 1.5% to 4.5%. This is a huge increase which has caused some bond prices to drop by up to 30%. The third whip of the Whammy is that the credit rating agencies are now warning about a “full blown debt crisis like 2001-2002” with 75 companies at high risk of default over the next 15 months!

20) Last year someone asked us, “*Why commodities and not currencies if you think the dollar are going to fall?*” Our rationale is pretty simple, we’re investors

and not speculators. Making 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 consumption will increase over the next 10 years than the daily inter-play between the dollar, yen, euro and yuan. Once again, we’ll leave the art of grenade juggling to those glamorous Young Turks who know more than the rest of us.



Dinner for four at the Condos at La Prada.

21) We’ve got healthy holdings of oil and commodities, but we also believe there are investment gains in *Alternative Energy*, but more for political reasons than classic economics. Over the next several years, the fundamental supply/demand squeeze on oil and the instability in the Middle East will cause Washington to throw money at Alt Energy. We want to own these stocks before the feeding frenzy at the pork

barrel begins. With gains of over 30% YTD, the results so far are super and we think the best is yet to come.

22) We are also investing in **Water** oriented stocks. The logic is simple: global expansion increases the standards of living world wide which will increase the demand for potable water. Demand for clean water should continue to increase even if the global economy goes into the tank. We have been investing in a basket of water stocks, which is up about 20% YTD.

23) Another alternative asset we've held for a long time is **International Real Estate** which is up 14 % YTD after being up as much as 20% earlier in the year. While we've already trimmed positions somewhat earlier this year, we're still heavily weighted here. We're inclined to let this run until we see signs of a global slowdown. Look for us to harvest more profits here later in the year.

24) It should come as no surprise that we are still very negative on the **U.S. Real Estate** market. Regardless of how tempting the wreckage might be, **stay on the sidelines at this time**. The U.S. real estate correction is far from being over. A 15% price drop in

residential prices over the next 12 months is within reason. Some well regarded experts see some coastal areas having 50% price declines over the next 2 years. Our advice? Bottom fishers can still get hammered even buying stocks that have even lost as much as 50% to 75%. We've been out of this sector for 2 years and are content to wait awhile longer.

25) **Need a warning sign it ain't over?** Recently a number of national home builders like Hovnanian, Ryland, KB and Lennar have issued pink slips to 33% to 50% of their workforce! St. Joe, the largest land owner in Florida laid off 75% of its employees. This will take years to rebound from.

*** If you want to make sure you keep receiving our newsletters, please send us an email. ***

*** Also, if you agree with our message and want to share the wealth, please feel free to send this on to a friend. ***

26) One of the surprises in August was that U.S. interest rates actually dropped causing a rally in **U.S. bonds**. This was due to a "flight to quality" which temporarily increased demand for bonds driving interest rates.

Once investors determine alternative safe havens, this money will move to other homes. We are about 15% in U.S. bonds which is about as low as we're apt to go. However, our holdings have performed surprisingly well with returns of 6% YTD.



Happy Trails!

27) While it is off the radar screen of most Americans, ***Japan remains a key indicator*** of the global liquidity and ultimately our own financial stability. Recall our discussions previously about “***The Carry Trade***” where ultra low interest rates in Japan have enabled investors like hedge funds to borrow low in Japan and then invest at higher rates in other markets around the world. Higher rates in Japan will slam this door shut, forcing hedge funds to unwind leveraged positions. While Japan had indicated previously that they would like to increase their interest rates in August, the recent Fed cut forces Japan to put this on hold because it would cause the dollar to plunge even further. But ultimately, this is beyond the control of the Fed.

28) How bad can a Real Estate bubble mess get? Japan's real estate bubble burst and their stock market ***is still down 65%*** from its highs ...***in 1987***.

29) Japan's battle with deflation can be a very scary mirror for the US to reflect on. Consider the number of ***Boomers now reaching retirement age***. What would happen if every Boomer's 401(k) account were slashed by 65% over the next two years and didn't rebound for another 10 years? After having to tread water for the past 5 years, can Middle America ride out a 5 or 10 year correction? The retirement of the Boomers is a time bomb ticking away with actuarial precision. This is about to become a major political issue.

30) Don't expect the Fed to talk about “deflation” publicly, but the classic solution is to print gobs and gobs of moneywhich certainly appears to be exactly what we've been doing for the past 5 years. We've written extensively about the “***supply/demand***” imbalance caused by globalization. If you are interested, review our prior

newsletter on the website
(www.noload.com)

31) In July, the U.S. National Petroleum Counsel issued a warning calling for the U.S. to implement “*radical measures*” to increase fuel economy as quickly as possible. *The Financial Times* called the statement “*a defining moment in the history of the global energy industry.*” This is a very strong statement from the staid FT, but evidentially not a message anyone in suburbia seemed to care about with Britney and Lindsey competing for the headlines.

32) ***Poof! And it was over.*** After an incredible \$2.7 trillion in deals in the first half of 2007, the party in ***Private Equity*** shut down in July. Without question the repercussions will be felt for months as the feuding between the Private Equity firms and the banks that promised to fund their deals gets worked out in back rooms and court rooms. Over the past 6 months we built a small position using a fund which has exposure to 30 Publicly traded private equity firms which collectively have investments in over 1,000 companies. While the buying binge might be over, there is still the latent value of the existing portfolios, which ultimately will be sold to the

public again. Our position is at breakeven now.

33) While we can't invest in them, “***Sovereign Wealth funds***” have really started grabbing headlines since we first mentioned them last year. Dollar rich countries no longer invest in depreciating U.S. T- bills. The OPEC countries have about \$1 trillion to invest, China another \$200 billion. As their comfort level and experience with direct equity investing grows, this trend will expand and will have an immediate impact on U.S. interest rates, which will have to rise in order to attract alternative replacement capital. This is a negative.

34) In the last 24 months our ***Emerging Markets*** holdings have been as high as 20%. More recently, we significantly reduced our holdings to under 5%. We still have excellent returns here but we're concerned about “faddism” as these markets are priced extremely high based on fundamentals. Our guess is that we're about due for a 35% to 50% correction which would mark a nice re-entry point. In particular we are avoiding positions in China, Russia and India while maintaining Latin American exposure. We've been

well rewarded here with returns of 60% YTD.

35) Talking about bubbles, did you know ***China's market cap is now larger than Japan's!*** Also almost without question there is some funny money accounting going on with the published earnings reports. Some estimates are that as much as 50% of all profits being reported are actually unrealized stock market gains from cross equity holding between companies. When the market is up 80% so far this year, you can have a real distortion. If we were smart enough (and young enough) to be hedge fund managers, we'd be shorting China.

36) Stuck for a Christmas present for a college or high school student? Remember our zombie movie from a couple of years ago? Well, ***"Dawn of the Living Dead"*** is now on sale in every Wal-Mart in America! It's even made their "top 10" several weeks. Allergic to the Blue Light Special? You can also order copies off of Amazon. We'll admit, it's no work of art and has no redeeming social value, but apparently the younger set finds it amusing. Ain't America great, or what?!

37) Finally, we still think Hillary's election will create a bull market in International Real Estate. Give me a call to discuss this further.

While predicting the timing of an international monetary crisis is virtually impossible, the Dollar is under pressure. This is a more rational investment strategy than trying to play an imploding real estate market.

P.S. Again, thanks for the referrals! Please keep us in mind if you have a friend that could use our services. We have been ahead of the curve for several years, click here to read for yourself!

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