



Views From the Edge of the Abyss

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Editor

These thoughts were originally shared with our private clients in early April 2008. They are now being shared, unedited, 60 days later to stimulate discussion of 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

While the storm winds certainly have kicked up since the end of the year, our Globalist Strategies continue to hold up far better than the markets. While nicked a touch, gold, oil and commodities buffered our positions considerably leaving us down only less than 5% versus about the 10% losses for the broader markets.

Going forward, while we'd like to blow some sunshine your way, our short-term forecast is for darkening clouds and increasing turbulence over the next several months. Longer term, the

forecast is even more uncertain as the fundamentals underpinning our Globalist Strategies may be shifting.

While our broad diversification has performed admirably, what we're witnessing are not just a couple of market inefficiencies to be smoothed over. Rather than a cyclical tempest, we're experiencing the *structural repercussions* from globalizing the world's economy some 10 years ago. The most serious of these appear to be more "*systemic*" and not "*economic*" in nature. Global banking and monetary systems problems can't be left to Adam Smith's "invisible hand" to correct via market forces. Rather, "systemic" problems inevitably involve the "human" intervention of politicians, regulators and the central bankers to engineer a solution. Of course, "global" problems also require divergent interests to agree on not only the malady and the cure but also who has to swallow the medicine. Right now 90% of Wall Street and 99% of Washington are in denial we even have a problem. The ir solution? "*Take two aspirin and buy on the dips.*" OPEC and China have a very different opinion which is closer to the reality. Hence our apprehensions.

To recognize the reality of the situation, it's imperative to ignore the group-think, spin, and wishful thinking of Wall Street. The sign posts are in the financial newspapers daily if you take the time to read them. When you see the amount of leverage the banks and brokerages added in the past 10 years to multiply profits, it's not hard to figure out what happens when the liquidity gets squeezed back out of the system. The amount of additional capital potentially required is 10 times the amount CitiGroup raised last year from China and Dubai. Connect the dots. Will

they pony up for more equity again after getting burned with a 33% stock loss since december? This isn't "research," its common sense.

A distressing scenario has emerged where the credit virus that initially infected the U.S. real estate market has contaminated the entire bond market. The massive resultant write offs in turn have seriously weakened the capital base of the entire global banking system. Now the eroded financial position of several major players is contributing to a **crisis of confidence** throughout the entire global system. The Bear Stearns situation was not about mortgage or bond defaults; it was about keeping the global banking system stable. Unfortunately the Fed's quick cure of pumping massive amounts of money into the system is now placing considerable strain on an already vulnerable U.S. Dollar. The warning lights of a **global currency crisis** are flashing "**Code Red.**"



Is the sky falling? Not if you own International Real Estate!

So what's going on? First off, let's look around and get a realistic reading of the magnitude of the current situation. Blow past the media spin that this is a "cyclical" mortgage or real estate down turn which can be corrected by another quick fix of cheap credit. If that were

only so! The problems created by a decade of cheap credit will not be fixed by 6 months of "*the hair of the dog that bit you.*" Second, forget the propaganda saying that we've "touched bottom." Not even close yet. Thirty days of contrition and three Hail Marys ain't gonna solve the problems caused by a seven-year credit binge. The \$64 trillion question now is: "What happens when you squeeze nearly a decade of liquidity back out of the system?" To get a better handle on the ramifications here, let's take a quick look thru the macroeconomics of globalization.

It's hard to believe it's been ten years since we first noticed prices in all the malls across America were falling at the exact time Wall Street was clanging the warning bell to beware of the boogeyman of inflation. With GDP a strong 4.5%, falling prices could only happen if worldwide *supply was greater than demand.* This was an important observation because for the previous 75 years, the opposite of that had been true, conditioning investors to anticipate inherent inflation and annually increasing prices. A world with *excess supply* is a different animal. It translates into price wars and cost cutting which we came to know as "outsourcing" as suppliers fought for market share. For investors, increased competition means lower profit margins and a long term bear market for stocks. It also meant as inflationary expectations fell, the resulting drop in interest rates would lead to rallies in both real estate and bonds. These and other observations formed the foundation of our "Globalist Strategies." The results? As predicted, since 2000, the S&P 500 is essentially flat. On the positive side of the equation, our "supply dominant" Globalist Strategies allowed us to anticipate the rallies in the commodity market, the oil

and energy markets, international real estate and also the emerging stock markets. Can we add we also called the falling dollar and the current financial sector crisis? Not a bad record for simply noticing “sale” signs in the malls.

While we’d like to stay in this sweet spot forever, we sense a change may be at hand. The early signs are appearing that the cumulative impact of misguided U.S. monetary policy might disrupt this long term global dis-inflationary trend. Ever since the stock market started to falter in 2001, Washington’s response was to encourage Americans to fulfill their “patriotic duty” by going on a national shopping spree to rebalance the global supply demand equation. While we love tax cuts and cheap credit, we warned at the time a “shop-until-you-drop” solution would prove to be a tragically flawed strategy. Why? Because increased U.S. spending will simply encourage *more* foreign production. We have now just witnessed five years of empty caloric consumption fueled by the crack cocaine of cheap credit and tax cuts. The result? China and India’s economic output is growing at four times the rate of the western world and we have hollowed out our nation’s net worth via home equity loans and shipped it back to China in empty super freighters.

The combined weight of all the public and private debt is threatening to topple the world’s financial dominoes. Here’s the short version of the chain reaction: What started off as a relatively small U.S. mortgage problem has turned into a massive worldwide bond market meltdown. The IMF predicts nearly \$1 trillion dollars in bond and loan losses, which will severely erode the capital base of the entire worldwide financial

system. The global payments system relies on the trust between banks that the “counterparty” bank will honor its debts. This good faith is based on the quality of the balance sheet and the banks liquidity. The recent dramatic erosion of the capital base has led to a “crisis of confidence” which now threatens to freeze up the entire global system. Alarmists? The IMF says the current situation is “the worst since the Great Depression.”

Why Hedge Funds Might be the Next Shoe to Drop

In 2007, Peloton was among the world’s highest flying hedge funds with an 87% return. Just 3 months later in March 2008 it has imploded, losing \$17 billion. The reason: “De-leveraging”. Peloton’s Banks called there lines of credit. Poof! It’s all gone.

So what’s an investor to do? Last year, we reduced our U.S. stock market exposure and in particular exposure to the financial sector. Sensing a recession, we have also already exited from the volatile “emerging markets” due to their sensitivity to both the U.S economy and any reduction in global liquidity. As we suggested last fall, the “next dot” is likely a “currency crisis” as foreign governments are tired of getting paid in depreciating dollars. Recent events triggered by Bear Stearns have accelerated this risk and recently no less an authority than former Fed Chairman Paul Volker said:

“You don’t have to predict a Dollar Crisis, we’re already in it”

Straight talk from the guy that bailed us out of the Jimmy Carter monetary debacle 25 years ago. This wasn’t at a rubber

chicken lunch in Albuquerque, but rather the editorial page of the *Wall Street Journal*.

And if you're "already in" a currency crisis? The first thing to do is accept that ***the risk is real*** and not an academic theoretical exercise. Less than 5% of all investors will clear this hurdle. The second step is to anticipate the most likely response by both Washington and then by the markets. One of the oldest adages on Wall Street is "don't fight the Fed" meaning when money supply is expanding, go with the flow. ***And vice versa***. When Paul Volker says we're in the midst of a crisis, this implies "***intervention***" is ***imminent*** and actions to prop up the dollar in the very near future are likely.



Another Fish Story

Practically speaking, from our perspective it's time to ***trim our "falling dollar" hedges*** like gold, commodities and oil. These hedge strategies work best when there is an orderly slide in the buck. "***Crisis***" implies the significant risk of a ***disruptive decline*** requiring intervention from the world's Central Banks. If this happens, the price of gold and oil might actually fall, not rise. This might seem counter intuitive, but these hard assets already have large speculative premiums which might be as much as 30% of the current market price

which could be wiped out overnight by a coordinated move to support the Dollar. So on a risk/return basis: Do we risk a 30% sell off to capture another 3% or maybe even 5% short term upside? With gains of over 100% in the past three years, the math says, ***it's time to trim our positions***.

A looming Dollar crisis aside, let's not forget the entire financial morass that is already upon us and is far larger and more serious than most people have yet to grasp. Just this week, the IMF has revised its estimates that the total losses to the banks, brokerage houses and hedge funds will top \$1,000,000,000! How big is a trillion? In the old math, it's 1,000 billions. And how big is a billion? Last year the value of all the fresh-baked bread in the U.S. was only \$6 billion. So a trillion is a lotta dough! The speed and size of the crisis has stunned many, but most finance professionals are still in denial of the full magnitude. Why? Because they don't grasp the amount of leverage that the Banks and Wall Street have packed onto their balance sheets in recent years. There is a very simple reason that profits from financial stocks have grown to 40% of the S&P profits form just 6% in ten years. It's what Wall Street calls "leverage" or what us common folk call "debt." Because these Masters of the Universe are smarter than the rest of us, they permitted themselves to break the Rule #1 of lending. They "borrowed short" and "lent long." Ooops! Their "models" assumed they could always borrow at very low rates because they were "AAA" credits. Ooops, again!! Ratings are cut! Capital call!!

Now since it takes \$10 of loans to make up for \$1 of lost capital, trillions of dollars of loans have to be unwound at a loss.

Ooops!!! Now with credit lines reduced, hedge funds and private equity funds have been forced to dump their most liquid investments to meet margin calls. But where are the buyers? If you can't sell, then the collateral is forfeited to the bank. This is what happened at Carlyle Capital. Ooops!!!! Now the bank needs to liquidate the collateral, but there are still no buyers and they liquidate at a loss..... Ouch!!!! Now the banks need even more capital. ***It's a very dangerous and vicious cycle.***

When Banks need capital there are just two choices. Either raise \$1 of new capital for every dollar of losses written off. Or, alternatively, reduce your loan portfolio by \$10. Last December Citi, Merrill Lynch, UBS, and a few others went hat in hand to China, Dubai, Singapore and Hong Kong and raised about \$100 billion by selling stock. Since then their stocks have plunged by over 33%, meaning their new foreign partners have lost \$33 billion in less than 6 months. This makes it doubtful they can go back to this well again. The sheer magnitude of the problems also appears to be larger than initially fessed up to. How much bigger? Mucho- Mega - Gargantuan!!! About 20 times larger. It's estimated if 50% of the losses are to banks, it will take a \$3 trillion contraction in outstanding loans!!! Now, how do you contract your credit base by \$3 trillion and not slam the brakes on the economy? Can you spell "recession"?

Have we hit bottom? Doubtful. We see a couple more major hedge funds imploding and maybe also a major bank. Top on our list? How about the one that is "too big to fail?" Citigroup. We see too much off-balance sheet financing

here to handle in a market where the buyers have vanished. The real problem is the timing and compliance with accounting rules. But even if Citi and the others are able to finagle a solution to getting this off their balance sheets, the loss of "leverage" will stunt the profit growth in the entire financial services sector for up to a decade.



*Lifting the weight of the world?
Or Happy to be Above Water!*

Given this ominous backdrop, below are our most recent thoughts on the current market conditions and their impacts on our investment strategies.

- 1) While the broader stock markets are down about 7%, most of our accounts have fared much better and are only down in the neighborhood of 1% to 3% for the calendar quarter. We attribute this largely to our positions in gold, oil and other commodities which have buffered the turmoil in the stock market as well as taking a more defensive approach in the second half of last year as it appeared the financial crisis was worsening, not abating as Wall Street was claiming.

- 2) We are currently holding larger cash reserves than we have in the past 15 years. We hope this is a short-term scenario as we get better visibility on the extent of the banking and currency crises and also how they are responded to.
- 3) In September we took proactive moves to reduce our exposure to the U.S. stock market and to the financial sector in particular. Our domestic equity allocation remains under 25%. Since then the bank and brokerage stocks have plunged 33% or more and are still getting pummeled. Do not be tempted by “high yielding” dividends from financial sector stocks. These dividends might be vulnerable to cuts if it’s necessary to raise more capital. Witness Wachovia.



Swing with a View

- 4) Recall last September when Wall Street declared “the coast was clear” after the August credit market scare? We warned of the potential collapse of a major brokerage firm. In January we even

singled Bear Stearns out by name. Why? There was no special research or intelligence here, simply what anyone could read in the *Wall Street Journal* or *Financial Times*. **All the brokerage** firms have added a huge amount of leverage to their balance sheets in the past five years, and there are no buyers to roll these loans over to.

- 5) Clearly it is still too early to re-enter the financial services sector as there remains a high risk of another major collapse. Citi and Merrill both look precarious to us. If the entire financial industry added gobs of leverage in the past 10 years, why should Bear Stearns be the only one buckling under the pressure? This is an incestuous industry and there is no reason to believe that when the music stops playing only one player will not have a seat.
- 6) Additionally, the dynamics of leverage which propelled the financial sectors over the past decade will not be present to cause a trampoline effect in any recovery. The huge amounts of “off-balance sheet” financing which allowed banks and brokerage to multiply their profit relative to their capital, will not be available going forward. In other words, don’t go bottom-fishing for Citigroup because of the rebound story in the 90s.
- 7) In December, we also pocketed the profits from our “emerging markets” which had long term gains of over 100%. This is the

first time in ten years that we haven't had exposure to this sector. The BRIC index (Brazil, Russia, India and China) has lost 22% since the beginning of the year and we suspect the real carnage here is just set to start. With a U.S. recession and a global credit squeeze, it's not too dramatic to envision a 50% to 75% drop from their recent highs. China is now down 45% from its recent highs and India down over 25%. We think it is still too early to consider re-entry.

- 8) Several factors propelled the emerging markets upward, any or all of which could be reversing. Hedge funds have used cheap credit to speculate in these thinly traded markets which at their peak were trading at P/E's of over 60. Some of this speculative froth will get squeezed out if credit tightens in the U.S. and Japan. The growing risk of a worldwide recession will also have a negative impact on these shares. As these are also "dollar hedge" plays, any intervention to prop up the dollar might be negative for the market price of these stocks. Finally, the emerging markets are very sensitive to commodity prices. Either a slowing global economy or a stronger dollar will have a negative impact on commodity prices, which will in turn have a magnified impact on the emerging market economies.

Right now we just don't like these odds.

- 9) Unlike the financial sector, the emerging markets will also have greater potential for a near term recovery, but the downside can also be very severe and swift. Over the next several months we'll keep an eye open towards re-establishing our emerging market positions. While we still believe in the long term global growth story of the emerging markets, at the present time it is more important to protect capital then to stretch for growth.

The Great De-Leveraging

Right now we are witnessing the Great De-leveraging of the global financial system. This is a sudden "change in the rules" all investors have played under for the past 10 years. Yet 95% of all investors are oblivious to the potential risks and consequences. Now is a time to be pro-active in your response.

Please contact us if you would like to discuss your investment options.

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As a further defensive precaution from tightening liquidity, we sold our positions in **Alpha Hedged Strategies**. While we didn't see any manager-specific risk here, we also didn't want to get caught up in any backwash in the entire hedge fund sector if banks tighten their credit requirement causing hedge funds to contract their investment portfolios.

11) Ever the contrarians, in March we actually started trimming our positions in gold and other hard assets just when many are starting to flock to them. Why? In order to be effective, intervention must come as a surprise so no one will have a chance to respond. With gold at now \$1,000 an ounce, our uneducated guess is about \$300 reflects a speculative premium about the deteriorating global system. If a currency intervention is imminent, a coordinated effort to support the dollar could wipe out this \$300 premium overnight. We don't want to risk this large a loss for another 3% or 5% of short-term upside. Since we started getting in a under \$400 an ounce to hedge against a currency crisis, the math says its time to take some profits now. We'll be monitoring this as conditions change.

12) Our logic for investing in commodities, energy, and precious metals over the past five years has been two fold. First, as both the developed and emerging economies expanded there would be a basic supply chain squeeze on basic commodities which would likely take five to ten years to work out. Second, commodities, energy, and other hard assets provide a simple and cost effective hedge against the loss of purchasing power of the U.S. Dollar. Over the past five years or so, this

strategy has worked very well with gains of over 100%. We have in fact stayed the course here for several years longer than most pundits predicted, especially those who opined the peak in oil would be \$65 a barrel and gold would peak at \$750.



The New Design Center at Del Pacifico

13) While the underlying logic of investing in commodities remains in place, in the immediate short term we see the potential for a global liquidity squeeze to force speculators to dump commodity contracts to meet bank margin calls. While these positions have been profitable YTD with gains of 11% (gold) and 12% (oil) respectively, the current high values we see more downside risk from the potential de-leveraging of financial speculators than we see on the upside.

14) Our position in agricultural commodities also did exceptionally well closing out the calendar quarter with gains

of 10%. Without question, global per capital caloric consumption will continue to climb which is bullish for agricultural and commodities. Grains are as much as 60% of the diet in the emerging markets and it takes ten pounds of grain to produce one pound of meat. As standards of living increase, so will the demand of both grains and meat. But, right now there are also signs of yet another speculative bubble in the agricultural commodities sector could plummet quickly. Although we had just established our positions in January, we took our profits here in March. Longer term we like investing in food, however in the immediate present we need to look to protect capital.

You're invited to our upcoming Gatherings in Costa Rica!

June 19-23, 2008
August 14-18, 2008
November 13-17, 2008

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15) This sudden spike in agricultural commodities is creating a major geopolitical storm as the poor people around the world can't afford to eat. Part of the price rise is the falling dollar; another portion is abnormal levels of speculation in the commodity

markets, fueled by excess liquidity. And a third factor is the alternative energy/ethanol demand squeeze. The price of rice has risen by 150% in the past two years. Corn is up about the same. The political risk of skyrocketing agricultural prices is a factor to keep an eye on.

16) Commodities guru Jimmy Rogers says "*The dollar is a terribly flawed currency and its days are numbered.*" We tend to agree as politicians have abused the currency to avoid facing the tough decisions of raising taxes. The question is now whether the dollar will become "worth less" or "worthless." We're already seeing international trade starting to shift over to the Euro-based pricing. To add insult to injury, several months ago, Taj Mahal in India stopped accepting U.S. currency to pay the admission fee ... a whopping 25 cents! It's signs like these that point to currency intervention.

17) The concept of a currency crisis is a "big thought" and warrants reflection. Over the next several years it will make a big difference who is pulling the levers and throwing the switch. Political agendas will be very important here as it will impact both tax and monetary policy. At the macro level, the political dynamics of isolationism versus globalism will come to the forefront. At the micro level, expect to see this reflected as labor versus free trade.

18) Certainly the potential exists for the expansionary phase of globalism to come to a grinding halt. How Washington, London, Tokyo, Beijing, and OPEC collectively and individually respond to the current situation will impact how we invest over the next five to ten years. Going forward, we cannot simply “connect the dots” and invest in front of a falling dollar, increased energy consumption and global growth. Careful attention needs to be paid to how Washington responded who is doing the responding.

19) Why? Behind the scenes some very powerful medications are being pumped into the global financial system attempting to restore both liquidity and confidence. Since these are uncharted waters, some of those treatments are experimental and untested. Simultaneously, we’re in an election year with the electorate calling for change. You want to know what’s really scary? Now is the time academics could be trotted out to apply their pet theories in the real world while politicians will declare a mandate for change. The New Deal Part II is a distinct possibility at this point. A decided shift towards social welfare and higher taxes is a high probability scenario.

20) This scenario will be compounded by the political

reality that Baby Boomers are now retiring and their 401(k) accounts have been ravaged by the silent tax of a falling dollar for the past seven years. The dollar has lost over 25% of its purchasing power since 2002. So what do you think a 65-year-old Boomer retiring with less than \$100,000 in total assets will be voting for over the next four years? Austerity or entitlements? *Another Boomer retires every nine seconds...and they vote ...kinda scary isn't it?*

Here’s the Big Question to Ask Yourself:

In the face of the worst Bond Market and Banking crisis in 75 years, why hasn’t the contagion spread to the stock market... yet?

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21) And what about Fed bailouts for mortgages and real estate? Will the government intervene to prop up the values of an over-heated real estate market? Who knows when you get a lot of populists “listening to the will of the people”? The important thing will be to monitor the political barometer of which way the power base is tilting. These Populist mortgage bailout programs will further undermine the stability of the Dollar.

22) On real estate in general, we haven’t touched bottom here and our guess is we’re still 12 months out from having a clear

read. A domestic recession will prolong this. Again, we hate to always saying “we told you so,” but we raised the issue of a nation faced with negative equity in their houses back when the world thought trees grew to the sky and housing prices only went up. The ripple effect of negative equity and a recession could ratchet up the banking crisis sever levels. This is the potential Horror Story of a classic “deflammatory spiral.”



What? Me worry? We're in Costa Rica!

- 23) A stable dollar is a prerequisite for the Fed to coax lower long term mortgage rates which will serve to support stabilizing real estate values. Without this, the markets will require higher interest rates to offset the likelihood of a depreciating currency.
- 24) We are much more favorable to international real estate, especially resort properties in the path of retiring Boomers which is a trend that will not be reversed. This trend will accelerate among resort properties with a Democratic

Washington. Come visit us in Costa Rica this year!

- 25) A sliver of silver in this mess? Despite near panic over the prospects for energy prices, **alternative energy stocks** have been hit much harder than other stocks (down about 30% YTD). We are looking toward modestly increasing our holdings. Whichever party wins the November election, Washington will throw money at the energy dependence problem and all alternative energy will rise in this tide.

- 26) Something we wish we had said: *“Ethanol is not a silver bullet for energy... it’s a hand grenade in the food chain.”* After the current liquidity situation is resolved we will look to re-establish our agricultural commodity positions to complement our alternative energy positions. Even in a recession people will still need to eat and the net impact of global economic growth will be to improve the dietary standards of people around the world.

Now is a time for caution and patience, not investment heroics. As a very wise man once said, *“any fool can buy stocks, the hard part is selling.”* We add to this that it’s not only *knowing when* to sell, but also being able to break away from the crowd and **actually do it**.

We’ll be keeping a careful eye on things over the next several months.

Barry Strudwick
April 15, 2008