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## SPECIAL MARKET UPDATE

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**FROM:** BARRY STRUDWICK  
**SUBJECT:** ECONOMIC CRISIS UPDATE #1  
**DATE:** SEPTEMBER 30, 2008

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Quite a number of folks have called to get our opinion about what is happening in the stock, bond, cash and real estate markets right now. In particular, people want to know our thoughts with respect to the Government intervention in the financial system. When I started writing this update the market was down 200 points and when I finished, it was down 777 points. Obviously it's very emotional out there.

***Please consider this report a very short run prognosis subject to rapid change.*** I will write a more complete update once the dust settles a touch here. Rest assured we are monitoring the situation closely, and trying to look for sign posts in these uncharted waters.

To summarize my personal thoughts on this whole mess:

- 1) It's necessary to separate the world into two piles of problems. The Bond/Credit market and the Stock market. Right now, the Bond/Credit market presents the bigger and more immediate problem. While the Stock market may seem more visible, it is not really in as bad a predicament. Yes, it is ugly. Yes, it will likely go down even more. Yes, we are in a recession. Etc. etc. etc. But the problem we all need to focus on is the freeze up of the Bond/Credit market and the global banking system.
- 2) The greatest problem right now is not the true underlying credit quality of the Bond markets (this has already been more than fully discounted in the bond market prices), but the fact that the buyers for bonds have been scared to the sidelines. A subset of this "debt" market is that Bankers won't lend to each other. Debt is the grease that lubricates the entire global economy. This lack of faith has created a "liquidity crisis."
- 3) Government intervention is imperative at this point to bring "liquidity" back to the market. Even if, in the short run, the Government is the only Buyer (or the Market), and then resells the bonds once stability is re-established.
- 4) ***Political debate aside, there is no choice but to accomplish this intervention at this point. In a market economy, you need a Market, which requires both sellers and buyers.***
- 5) The political squabbling as we see it is whether ***the Left*** can leverage the

crisis into an opportunity for a mandate for social change (New Deal- Part II) under the guise of financial system reform. **The Right** is fighting what they perceive as the "Road to Socialism." Both sides realize at this point that any solution will mean higher taxes. The partisan bickering and back stabbing is inexcusable ... from both sides.

6) These political differences will get resolved. We might not like the long term impact of the remedy, but they will get resolved in the very short term.

7) We recently wrote a special report entitled "*Why the Election Spells a Bull market for Costa Rican Real Estate.*" This makes the case of "why" owning real estate outside the United States is a good idea to consider. After yesterday, the argument is even stronger. Please email us or call to let us know if you would like a copy.

8) The steep declines in the stock market this week are based more on fear than economics and will likely reverse quickly once a resolution is reached. For the small comfort it might provide, you may have noticed that we reduced stock modestly exposure last week. We are also holding large cash reserves in a combination of money market accounts and FDIC insured bank CD's.

9) We will hold tight and look for buying opportunities in selected stock sectors. Nuclear, Electricity, Alternative Energy look attractive. We already believe these to be "over sold." The only question now is whether we can get them even cheaper. We were close to pulling the trigger last week and are now glad we deferred.

10) Bonds are likely to be even more undervalued than stocks. It makes sense to start buying high quality bonds accepting the reality that we won't pick the exact bottom. We might be 1, 3 or 6 months early, but this is better than missing the opportunity entirely. Bonds at these prices can produce long term "equity type" returns. We will likely have to weather some short term losses here, but longer term bonds could provide double digit returns.

11) The Dollar will rally short run, but the longer term trends are down. We exited from our "down dollar" positions in April and we continue to stay out of commodities until we can separate the global monetary crisis from the basic supply/demand factors. Since we exited commodities, oil is down 35%.

12) The full wallop of this down term has not been felt in the Emerging Markets yet. Even though these are down 45% to 65% since we exited late last year, it's still too early to re-enter. This sector could get very ugly. The Emerging Markets will be long term buys and the prices are tempting, but a drop for \$50 to \$40 is still a 25% loss and will also take a 33% to return to a break even.

13) One opportunity right now is that the interest rate on long term debt is very attractive. For aggressive investors with stable income streams, you might want to consider taking advantage of relative low cost long term fixed rate loans to leverage into other investments. Recall the Carter Years ... the winner were the borrowers not the savers!

This is not intended to be comprehensive report, but a very short-term opinion due to the dramatic shifts in the markets. We are monitoring this very carefully knowing

that people are concerned. Please feel free to give me a call if you have any questions. My personal email is [barry@noload.com](mailto:barry@noload.com).

*Barry Strudwick*  
Strudwick Wealth Strategies  
September 30, 2008

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## SPECIAL MARKET UPDATE

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**FROM:** BARRY STRUDWICK  
**SUBJECT:** ECONOMIC CRISIS UPDATE #2  
**DATE:** OCTOBER 16, 2008

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What an incredible time in the markets over the past several weeks and especially the last three days. While we are relieved on the massive turnaround in the stock market on Friday and Monday, we are still very concerned about the stability of the banking system. Again, rather than writing a longer analysis of the markets, I will instead substitute another shorter and more immediate analysis.

Once we get some level of stability, we can reassess the net impact of all these changes in the playing fields. Under separate cover, you will be receiving the hard copy of our account performance as of the end of the calendar quarter (September 30, 2008.) This is all obviously ancient history after the most volatile 2 weeks in the market's history.

Please feel free to call me if you would like to discuss this directly with me.

Here are our most immediate thoughts. In the interest of getting these out to you immediately, I've spent less time on editing and polishing, but I hope you get the main points:

You might recall in July we said "the Hedge Funds will be the next shoe to drop." Last week that happened in spades; on Thursday and Friday a number of the Hedge Funds got washed out of the markets due to margin calls. This greatly added to the both the volume and volatility of the markets, but doesn't have too much real impact. While we can't predict whether this was the climax of the selling frenzy, certainly the rebound in the markets on Monday has given some breathing room here.

We will monitor this closely and make a determination of whether to reallocate once some of the spring back has played here.

- 1) The blow off of the Hedge funds has little or no real economic meaning, it was simply letting air out of the over inflated balloon faster than we anticipated. This wasn't all taken care of in one day. There are more firms that will get washed out over the next several months. We had been waiting for this to happen and net -net, it's favorable.
  
- 2) Our prediction last week that 2/3's of all Hedge Funds that were in business at the start of the year will be shuttered by December 31 is likely too conservative. If you're looking for the silver

lining here ... there will be a bull market for garage sales in Greenwich, Connecticut, the nesting ground for these self anointed Masters of the Universe. I say this only half in jest. Baubles, trinkets and toys of the fast track crowd will be dumped as these firms crash and burn. Check out Craig's list and E-Bay for deals on anything from boats to real Rolexes.

- 3) While we are breathing somewhat easier, it is important to keep in mind that this crisis is first and foremost a credit market crisis which remains very serious. I doubt anybody can accurately access the long term implications of these massive changes. Short term we need to see two things happen to signal an easing of this crisis. First, we need to see the "overnight" interest rates in the credit markets drop which will signal an easing in the "loss of confidence" factor. Second, we need to see the aggregate trading volumes in the stock market decline, which will signal that the sell off and the "deleveraging" is abating.
- 4) The extreme volatility of the stock market is largely just a spill over effect based on fear (psychology) and a contraction of credit lines for Hedge Funds. In other words, don't put much credence right now on "economic analysis" of the impact of the credit crisis for a slower economy and its ultimate impact on stock prices. There is no way in God's green earth that anyone can make an intelligent assessment of the impact of the last several weeks on the world economy or commodity and stock prices. Anybody who claims to be doing so is simply spouting off at the mouth for "air time." Recall our warning in April when we signaled a "Code Red" for the global banking system and that Academics would be trotted out to try out pet theories in the real world. This is exactly where we are right now. There are too many wild cards being played behind the scenes here.
- 5) We agree that global unified action is exactly what is required to help out here on the short run. It's just that we can't predict what the longer term impacts are going to be. We'll try to decipher this weekend's actions over the next several days.
- 6) Here is the BIG PICTURE ISSUE that ultimately has to be resolved. In the 90's we globalized the world economies, but we didn't create a global currency. The true root of this problem is that there is no mechanism to control the global currency supplies. The Dollar became the ex officio global currency. The Fed is supposed to only work in the US and simply doesn't have the tools to control a "global currency." As a result, a "shadow banking" system entered into the vacuum. This was an unholy alliance of the major international commercial banks, the major investment banking firms, the private equity funds and the hedge funds stepped in to exploit the inefficiencies created by the official vacuum. What we have been watching for the past 12

months is the unraveling of the Shadow Banking System. I will explain this scenario later, but the important point to keep in mind today is that even if we resolve the current global banking crisis and even if the stock market calms down, somebody, somewhere will still have to resolve the root underlying problem of the need for a global currency or standard of payments.

- 7) For American politicians this is the political "third rail." Another way of saying this is that the U.S. Dollar cannot remain the global reserve currency until a mechanism is placed to preserve its value. Now, who is going to announce to the nation we are going to move from the sacred Greenback to a global currency?
  
- 8) This also means the Congressional practice of debasing the dollar to fund the government ATM must end. This is no longer an academic debate. The markets have spoken. Do you think China and OPEC will continue to buy T-Bills yielding 4% when the currency is depreciating by 5%? In the real world, this can only happen by 1) increasing taxes 2) decreasing spending and 3) decreasing our foreign trade deficit (including energy). While it's easy to see Obama increasing taxes, do you see him cutting spending? What are the implications of his increasingly isolationist and Union oriented positions? On the flip side, McCain wants to cut taxes, when economic growth hasn't been the problem. We cut taxes 6 years ago but it hasn't fixed the foreign trade deficit. Why should it work this time? Is it realistic to see him able to cut spending with a Democratic controlled House and Senate?
  
- 9) This is a very complex (and very boring) topic, but unfortunately, it is the core problem that somehow must be addressed. If this doesn't get on the radar screen very quickly, we will have unpleasant consequences. Just at first blush this will be either a shift away from a global economic system or another financial crisis. Short run the psychology will be very volatile, especially in an election year. It really does make a difference this time who gets selected; we just don't know whether either candidate really grasps the situation and the very tough choices that must be made.
  
- 10) Very short run, we see opportunities to dollar cost average in our alternative energy and nuclear positions, but it's still too crazy out there. No matter who gets elected, these sectors should do well.

- 11) Continue to stay clear of the emerging markets. While tempting at close to 65% off their highs. The ripple effects will hit these harder than elsewhere. The markets were over leveraged with margin loans and a slower worldwide economy will hurt earnings more than elsewhere
  
- 12) Watch out for the continued barrage of half baked advice on the air waves. Today in the barber shop, the barber in the next chair was telling his patron that he exited the market on last Wednesday and bought back at noon on Friday ...sure he did. Is this a great country or what? We psychic barbers who remain humble enough to still cut hair even after making a fortune in the stock market. My advice is to stay calm and let's make some rational decisions once the dust clears a bit.

I'll send another update in a few days after we get some visibility here, but for now let's hope this rally continues.

Barry Strudwick

October 16, 2008

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## SPECIAL MARKET UPDATE

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**FROM:** BARRY STRUDWICK  
**SUBJECT:** ECONOMIC CRISIS UPDATE #3  
**DATE:** OCTOBER 22, 2008

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Normally, right after the close of a calendar quarter, I try to synthesize global economic and political trends into a coherent common sense strategy. For this, I collect notes from the prior 3 months to draw inferences. With the rapid fire developments of the last 2 weeks, my longer term observations are now yesterday's news before the end of the day. As we predicted in April, we are in the midst of a dramatic sea of change and it's impossible to make intelligent longer term forecasts.

Until the situation calms down, I will produce a series of shorter pieces on our opinion of the scenario that is unfolding. It doesn't take a brain surgeon to recognize this isn't a garden variety, "take two aspirin and buy on the dips" market. The entire global financial system is in severe flux. There has been no real safe harbor as bank and brokerage firm failures have made all asset classes risky: stock, bonds, real estate, even money market accounts have been at risk.

Without question, this past week which started with the Houses rejection of the Bail Out package and ended with its ultimate approval was the most stressful in my career of over 20 years. Even the 817 point drop in the Dow masks the true volatility.

***Let me emphasize, last week's dramatic actions were simply a firebreak and not a solution. The turbulence will continue and the risk level is still very high.***

Here are some very short term comments as the market conditions do not permit for longer term observations.

- 1) The passing of the "Bailout Bill" on Friday was a necessary firebreak not a solution to the larger systemic global banking crisis. This was a drastic measure for a dangerous time. There is no way to know at this time whether it will be effective in stopping the spread of the global economic meltdown. Nor is it possible to predict the long term social and geo-political ramifications of last week's actions. Overnight, since I wrote this on Sunday afternoon, the banking crisis has now hit the European markets hard.

- 2) On paper, last week's emergency actions should be adequate to stem the damage to the banking system from the collapse of the domestic mortgage market. But, it is imperative to recognize that there are several other wild cards in play. The biggest one right now is fear and anger on Main Street and its impact on the upcoming election. We are at a precarious point where the damage to the markets could be made worse if the herd is spooked into a stampede at any time. We need to hope the emotions clam down.
- 3) While last week's actions might stop the tumbling of the dominoes in our financial system, it does not address the second half of the problem, which is a financial system with a severely depleted capital base. The daisy chain of hastily arranged shot guns weddings between banks and brokerage firms is not a cure for the malady. Massive amounts of capital need to be raised both in America and Europe to shore up the financial system. The question is from where? China? Dubai? Last week a Japanese bank purchased 20% of Morgan Stanley and hardly anyone noticed.
- 4) The financial system cannot stabilize until housing values underlying the massive portfolios of mortgages firm up. Until and unless this happens, the tide of foreclosures and losses cannot be calculated. Until losses can be projected, banks will not have confidence in each other. There is no firm evidence of a bottom yet and an economic downturn could increase the foreclosures. Without this bottom being touched, banks will question the solvency of other banks. Relaxation of the "mark to market" rules is already helping here somewhat. But right now, the credit markets are so bone dry that even AT&T and GE are having difficulty borrowing for more than 1 day at a time.
- 5) The ripple effect of the crisis of confidence is now spiraling outward in a half dozen different directions. It should go without saying at this point that the tightening of credit will slam the breaks on the consumer driven U.S. economy. With this accounting for 70% of our economy, this will hurt. The collapse of real estate will cause severe problems in municipal finance as tax collections will drop. This will be compounded by the shrinking of the Muni Bond market due to the loss of "insured" AAA ratings. This in turn will force mutual funds to sell some of their holdings into a market without buyers. Please stay clear of muni bonds at this time!
- 6) A slowing global economy will also mean the commodities markets are very vulnerable which in turn hammer the emerging stock and bond markets. While these markets are down up to 50% so far, we could see another 50% decline from here. It is too early to be looking for values here. The carnage is just starting.
- 7) The liquidity crisis in the insurance industry has set off its own chain reaction in the business world. Look for the Fed to take massive actions to restore liquidity immediately.

- 8) Based on the action last week, we are hopeful the corporate bond market in particular and sectors of the stock market are oversold. However, we need to see confirming signs of stability before even considering increasing holdings. In the very short run, we anticipate the market to ease back and erase some of last week's losses. As this occurs we will make the decision to either use the opportunity to further reduce overall exposure or to selectively add to certain sectors.
- 9) We believe a significant contributing factor to the market's plunge last week was the implosion of a number of highly leveraged hedge funds. There are two factors working here simultaneously. Hedge funds are highly leveraged and rely on the "Prime Brokerage" divisions of Wall Street Firms for their credit. These firms also hold their securities as collateral. The collapse/consolidation of the large brokerage firms has caused Hedge Funds to both move their accounts and also a severe contraction in the available credit. The second factor is that many Hedge Funds are facing massive redemptions as investors flee to the exits. They are recognizing that the fee deals on hedge funds have encouraged a "damn the torpedoes" style of management and not a "hedging of risk". The net combination is that last week we started to see a massive forced unwinding of positions. While we exited our hedge fund positions in April, we believe this may have led to sudden market losses in several of our holdings such as nuclear energy and alternative energy which have been favorites of the hedge fund sector. If we are correct here, we anticipate these holdings to rebound in short order as the impact of the forced selling dissipates.
- 10) We suspect that last week marked the death knell for hundreds of hedge funds as credit constriction forced selling into a falling market. Our prediction is that over 65% of the hedge funds that were in business at the beginning of the year will have shut down by 12/31. This is really not a bold prediction because the failure of the brokerage firms means the closing of their "prime brokerage" units which provided the leverage to hedge funds are gone. Who is left to lend to them? Poof! And they are gone. We do not view the demise of the hedge funds as having a real economic effect, its simply letting air out of the balloon faster than expected.
- 11) We also had a tough week with our U.S. corporate bonds which comprise about 15% to 20% of most accounts. These holdings are split between the two top bond mangers who take different approaches. Bill Gross is the genius on predicting moves on interest rates and Dan Fuss is considered as perhaps the smartest eye for credit quality. In recent months we added slightly to our positions with Dan Fuss' fund in hopes that he could shift through the rubble and find intrinsic values. Fuss has moved from a 17% cash position in the beginning of the year to a fully invested position. After this week, it appears Fuss might have moved too soon with his fund dropping 5% this past week. We are hopeful that some or all of these paper losses will disappear once more liquidity returns to the market.

- 12) The Emerging Markets will get hit even harder than here. While these are already down 50% from their highs, they could easily drop another 50% from here. The combination of forced hedge fund selling and rapidly cooling global commodities markets will hammer these shares and test the metal of their banking systems even more than ours. For several years we have been hearing reports of how the new entrepreneurs were highly leveraged into the stock markets in Russia and China. These markets could be in an extended freefall. We exited these markets last December.
- 13) The silver lining in this entire debacle is that a number of sectors might be attractive for investment once the dust settles. But it is too early right now. For example, just 18 months ago, junk bonds yielded just 1.5% over treasuries. This week the spread reached 11.5%. This isn't to say we're ready to plunge into junk bonds, but simply there have been shifts which will soon mean opportunities.
- 14) There are 30 days to the election which might shape the direction of the country for the next 25 years. While increased regulation of the financial system is a given, the bigger issues will be more social, trade and tax oriented. Obama appears susceptible to "protectionist" pressures and higher taxes. McCain will favor policy that free trade will increase the total collection of taxes. Neither is convincing about actually cutting spending. Yet, somehow this whole train wreck needs to get paid for. The question is whether this will be by either free trade or higher taxes.
- 15) Be wary of the extremist talking heads on TV. Please don't accept these rants as facts. Let's face it, many of these shouting voices pander to the editors to get air time or ratings. Where were they and what were they saying last month? This week I caught a couple incredibly inane and dangerous populist rants from both the Left and the Right with both Bill O'Reilly and Keith Olbermann; more inflammatory than informative or substantive. This is the electronic equivalent of shouting "Fire!" in a crowded theatre and is irresponsible. The current crisis is much more complex than the salaries and personal greed of the execs of Fannie, Freddie and Wall Street. Nor is it about the Bush Administration. As you know, I've never been bashful about bashing the excesses of Wall Street, but fanning the flames of fear through partisan finger pointing is very dangerous right now. All of us have a responsibility to pause, reflect and think before we spout the latest gossip.

Please feel free to call me directly if you want to talk thru any thoughts or issues.

*Barry Strudwick*  
Strudwick Wealth Strategies  
10/22/2008

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## SPECIAL MARKET UPDATE

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**FROM:** BARRY STRUDWICK  
**SUBJECT:** ECONOMIC CRISIS UPDATE #4  
**DATE:** OCTOBER 27, 2008

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Just two weeks ago the entire global financial system was just 1 minute away from cardiac arrest. Now, after the equivalent of financial defibrillators (in the form of massive Central Bank and Government interventions) the system of Global Capitalism has been revived but is very weak and in intensive care.

Right now, we are optimistic/hopeful that the worst part of the credit and bond market crisis is now past, but the after shocks of this near fatal event will be working the way through for several weeks or months ahead. There will be good days and horrible days and the market might drift down. But just as likely, the market could suddenly surge forward. No one knows with any certainty, but we suspect a short term snap back could happen at any time. We're hoping such a sudden partial recovery could provide a better opportunity to readjust total risk for the changed environment.

We have all watched too many Bruce Willis and Matt Damon adventure epics, so please resist the temptation to envision our patient (global capitalism) will leap from the virtual deathbed and resume immediately fighting the Über Evil villains that nearly brought Western Civilization to its knees just days ago. Full recovery is likely several years out.

- 1) Let's address the primary question on everyone's mind right now: "Should we bail out of the stock market right now?" The answer to this is an emphatic "NO" unless you absolutely have to. Right now it's not about "comfort". It's about waiting a bit longer to find a better exit point. Now is the worst time imaginable to sell because two selling forces are at play forcing the market price of stock below the actual economic value. Hedge funds are facing margin calls and small investors are stampeding to dump their mutual funds. Once these forces are exhausted, we would expect stock prices to rebound at least partially to a new economic equilibrium.
- 2) However, we can't predict how long this selling spree might last. A day? , A week? Or longer? While it's impossible to predict exactly how long this will last, it's becoming increasingly evident stock prices have already overshot to the downside.
- 3) Before we discuss more about these unusual selling pressures in the market, let's first touch on some good news from last week. Recall that first and foremost this crisis is about the credit and bond markets and not the stock market. The wild gyrations in stocks are a secondary impact from this. Once the credit markets start to stabilize, so should the stock market. Over the past several weeks, we've said the most important indication that the crisis is passing is a drop in the

short term borrowing rates. Last week these rates dropped a strong  $\frac{3}{4}$  of 1% indicating that the freeze up in the global credit markets was starting to thaw. This is very positive and the critical first step we need to see. Without this thawing, we would likely join those panicking. The next factor to be looking at is how the longer 3 and 6 months rates also start dropping, allowing global commerce to start flowing again. The Federal Reserve's program to sell commercial paper directly to private companies starts this week further reducing the pressure, perhaps allowing

- 4) With the stock market already down 50% from its highs last October, we suspect a huge hunk of any global slowdown is already factored into prices. Right now the S&P 500 is trading at about 12X its trailing 12 months earnings. A "normal" ratio is 18X, indicating, that if profits dropped a huge 25% year over year, we'd be back to an 18X PE. I recognize this is very simplistic, but the point is a lower PE should provide cushion on the downside of any economic slowdown.
- 5) Now, if the credit markets are thawing, why is the stock market still falling? The simplest reason is because right now there simply very few "Buyers" waiting to step in, there are only Vultures waiting to prey on distress sellers. This makes it the absolute worst time to sell because there are two simultaneous selling vortices.
- 6) The first is the forced stock sales by the Hedge Funds which we warned of way back in April and July. A good deal of the selling last week was not because the owners wanted to sell, but rather because of margin calls which forced brokerage firms to sell the Hedge Funds' most liquid assets. With no buyers waiting to step in, the stocks aren't trading on the basis of real underlying values, but rather a sudden surge of supply with no offsetting demand. Since it's impossible to gauge the selling out wave, it's best to wait it out. Our suspicions are this will be fairly concentrated as the combination of investors requesting redemption at the end of the 30 September calendar quarter and brokerage firms margin calls coincide to force sales.
- 7) The second selling vortex is the retail investors panicking and selling their mutual funds en masse. Thank you Jim Kramer, whose hysterical style overrides the substance of what he might actually be saying. This is the "Joe the Plumber" factor. History always shows during a panic, the Little Guys always sell at the exact wrong time.
- 8) So the next question is "Why has this Hedge Funds thing cropped up?" And, "Aren't you worried about it?" The short version of this story is that over the last 5 years, The Big Banks and Brokerage firms whored themselves to woe the business of Big Deal Guys with cheap credit. Many are leveraged up to 30 to 1. This means a 4% move in the value of your collateral wipes out your equity. Do you think many of these guys have had more than a 4%, 5%, 15%, 25% drop in the value of their holdings? What is happening now is that many of these guys are getting flushed out of the system via margin calls and are being forced to sell by their banks or

brokerage firms. At the end of the day, I'm not sure what economic impact these guys have in the bigger scheme of things.

- 9) We are beginning to sift through the rumble and see some interesting plays emerging. Sectors of the bond market are looking interesting, but it is still too early. Junk bonds are yielding close to 20%. Some convertible bonds are yielding in double digits. Some blue chips are yielding 8%. But it is still too early until the redemption flood stems.
- 10) As we predicted, commodity prices are plunging and the emerging markets are really getting hammered. The contagion has spread into Eastern Europe and Asia is really devastating. Russia is absolutely getting crushed. Japan has hit 26 year lows and is down 80% from its highs 20 years ago!

I could go on, but the important point is that the credit markets are thawing and this is independent from the gyrations of the stock market. Let the selling frenzy blow itself out. This should result in at least a modest rally. This will hopefully create a better opportunity to adjust strategies.

Please feel free to call me to discuss your personal concerns or situation.

Barry Strudwick

October 27, 2008

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## SPECIAL MARKET UPDATE

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**FROM:** BARRY STRUDWICK  
**SUBJECT:** ECONOMIC CRISIS UPDATE #5  
**DATE:** NOVEMBER 10, 2008

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The past two weeks have shown some more encouraging signs in the easing of the credit and stock market crisis. As we have discussed previously, this remains first and foremost a credit market crisis with the stock market a secondary effect. Our focus needs to remain on watching the credit markets to see if liquidity starts to return which is crucial to freeing up world wide commerce. With short term rates dropping, money is starting to flow again through the banking system. The Fed has also started issuing commercial paper to private companies helping the flow of credit. If you think about it, in the past 15 years or so, a very large and complex worldwide "just in time distribution" has evolved. This system is tuned for perfection and we keep our inventories and supplies very lean. Without the lubricant of short term credit, the entire global distribution machine can grind to a screeching halt. Earlier this month this is exactly what we came very close to. This isn't just our supply of oil and electronics, but much of our food supply as well. We get our iceberg lettuce from California, pineapples from Costa Rica and lamb from New Zealand. Global commerce is totally dependent on the uninterrupted flow of money which requires trust between banks. Short term rates are a barometer of this trust. While few investors look at this on a daily basis, it is currently more important than obsessing on the daily or even weekly gyrations of the stock market. While the focus on the stock market is understandable, without global liquidity returning, there won't be an economy or a society to be worried about... At least at this point, it appears that the global banking system is on the mend, but it is fragile at this point.

As the credit markets ease, we'd expect the stock market to rise back up to the 10,000 to 12,000 range, but this might take a while as a great deal of excess speculative liquidity is squeezed out of the entire global economy. Right now we suspect we are witnessing extreme volatility as a very unusual "storm within the storm" works its way through the system. This is the bursting of the hedge fund bubble combined with the final stages of the retail investor capitulation. Mixed in with this is also some level of a post election "Obama Effect" as some stock owners are dumping stocks due to the fear of higher capital gains tax rates in the future.

The hedge fund deleveraging has become an incredible phenomenon to observe and much more powerful than we had imagined, who knows how much leverage has been pumped into this unregulated corner of the global financial system? The carnage is incredible! Last week, no lesser an authority than George Soros has dittoed our prediction that 65% of all Hedge funds will be wiped out. On Friday, the front page of the Wall Street Journal had an extensive article on this as well. The important "take-away" here is that on top of the huge margin calls, Hedge funds are also being forced to sell even more of their

stocks as they are facing on average 35% redemptions from their clients! This means raising even more cash and also freezes them from stepping into the market to buy right now. This period of high volatility could last through the end of the year.

The short term results have been huge swings in the markets. For example, last Wednesday, I sat transfixed watching the TV Ticker as the DOW ratcheted up a 250 point gain in just 20 minutes... Was I witnessing the breaking of the fever? No such luck, the fickle market suddenly turned direction only to plunge 400 points in the following 15 minutes! But hopes spring eternal and the following day, the Dow surged 900 points! Not yet.

My current thoughts remain to hold steady until the "storm within the storm" blows off. When more purchasing power returns from the sidelines the stock market should move up somewhat. This will create a window of opportunity to reduce over all exposure to the stock market or to access other opportunities.

Right now is the wrong time to sell stocks to reduce risk because non economic factors have driven stock values below likely fair value. I would like to see the market return to between 10,000 and 12,000 as a sign of some stability. We reached 9,600 last week and then flipped post election. With the markets swings 500 and 1,000 points in a day, this is the worst time to sell unless you have a very short term need. Even if you are a longer term pessimist, let this play out further and wait to sell once buyers return to the markets.

- 1) The Hedge Fund blow out is very much a major factor in the market volatility right now. I liken it to the noise and volatility when air is let out of a balloon in a room. However, once the air is all let out and the balloon is spent, there is still the same amount of air in the room. We just don't know how big this balloon is. Once we're past this crisis, I'll try to explain my thoughts on what is coming to be known as "the shadow banking system." This all ties back to our discussions of "deflation" over the past 5 or 10 years.
- 2) How much air is still in the balloon? Did you hear what happened to VW stock last week when Hedge funds got caught in a short squeeze? The common stock spiked 145% in three days as Hedge funds scrambled to cover their short positions. Porsche announced it had already acquired 75% of the company leaving only about 5% of shares available as float. Hedge funds are estimated as high as \$20 billion of losses in one stock in one week! Keep in mind, CitiGroup's entire market value **before the financial crisis** was \$35 billion while there is little economic significance here, it shows the wild gyrations going on around the world.
- 3) A good deal of the most recent selling spiral has been sparked in Japan as the strength in the Yen has forced hedge funds to unwind massive yen based loans which are referred to as "the carry trade." The short version of the story here is Hedge funds would borrow at less than 1% in Japan and then invest around the world in higher yielding investments. This could be Australian bonds yielding 7% or leveraged oil and commodity contracts. They also bought huge amounts of stocks and bonds in the US. When the Yen rises, the cost of repaying the loans increases dramatically causing the Hedge funds to unwind their strategies.

- 4) The unraveling of the "Carry Trade" will have large short term impacts on all the emerging markets as a healthy portion of these borrowed monies were invested in the stocks, high flying Chinese, India and Asian stocks. Recall that we exited these positions almost a year ago, last December. We'd like to buy again, but certainly not until the storm has past.
- 5) We are likely in stage 2 of a 4 stage cycle. The first was the real estate and mortgage blow out which is still underway. The second was the global financial and banking crisis which is also still unwinding. The next phase will be a global recession which will be ugly, but worse in Europe and the emerging markets than here. While Wall Street is now mumbling about a recession, it should be clear to almost anyone with a brain, that we are in store for a severe slowdown as the psychology of the public is changing and with the home equity ATM shut off, retail sales will slow. While this is hardly good news for our "consumer based" economy, it is a necessary purging step and the only question is whether stock prices at these low levels have already factored this in.
- 6) Surprised by the collapse in oil prices? Over the past 50 years, there has been a connection between the price of gold and oil. Basically, an ounce of gold has usually been worth 12 barrels of oil. That relationship is still holding up now. What we're saying is that despite the plunge in oil prices, there has been a corresponding fall in gold. This indicates to me the changes are more currency related than demand related. This is a classic "deflationary" as the dollar is purchasing more. The Fed will fight this effect longer term. We'll discuss this more later on, but right now, it's something to be keeping a watch on. Ponder this one, if the market price of everything, houses, stocks, oil, gold drops by 35% what is going on?
- 7) When will the buyers return? We're not sure, but we are starting to see some compelling values. Junk Bonds are yielding 12% over treasuries (versus 2% just 12 months ago.) Energy Master Limited Partnerships are yielding 11% and on and on.

We are keeping an eye on the Hedge fund blowout and we are hopeful that to get a market bounce once the "storm within the storm" abates. Please feel free to give me a call if you want would like to discuss your personal accounts.

Barry Strudwick

November 10, 2008

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## SPECIAL MARKET UPDATE

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**FROM:** BARRY STRUDWICK  
**SUBJECT:** ECONOMIC CRISIS UPDATE #6  
**DATE:** DECEMBER 2, 2008

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Has the last big shoe finally dropped? The 12% rally last week after Citigroup announced it was the latest victim of the storm is certainly a very good sign. We had been waiting for the implosion of Citigroup for a long time (since they were perhaps the biggest culprit in the global finance fiasco) and the strong rally last week certainly removed some of the sting of the last 60 days.

There are a couple of reasons last week might have marked either a floor or at least the peak of the selling frenzy that has overwhelmed the markets for the past 60 days. As one person said, "it has never felt so good to get out of November with 'just' a 5% loss in the stock market."

We have said that we would be looking for two factors to signal an easing of the crisis. First, we needed to see short term interest rates drop which would indicate that liquidity was returning to the system. These rates have now dropped from over 5% at the crisis peak to under 2%. The second factor was to see the blow out of the hedge fund industry ease, as this was creating abnormal selling pressures. We suspect last week may have marked this transition.

Over the past 90 days we have said that stock prices were getting unnaturally hammered by a huge selling wave as the Hedge Fund industry was being hit simultaneously by two factors which have little to do with the real economic value of stocks. The first is that legions of clients are exiting Hedge Funds which are forcing them to raise cash to meet the redemptions. We suspect that this wave is now subsiding because most hedge funds require at least 45 days before an exit window. This means that November 16<sup>th</sup> marked the date clients wanting to leave on December 31<sup>st</sup> would have to have a letter submitted. With that said, last week was the first week Hedge funds had visibility on the amount of cash they would have to have at year end. It also means they also know how much liquidity they will have to be able to buy into this undervalued market. The second factor has been that the "prime brokerage" units which service the Hedge Fund industry with everything from loans to office space, has been forcing a sector wide reduction in the amount of "margin" edge funds are using. Some estimates are that the amount of margin loans has decreased by as much as 50% in the last 8 weeks. This contraction has also forced more selling.

Normally the Hedge Funds are like vultures waiting to pounce and purchase stocks when the small guys panic, but this time they haven't been able to perform this function in the market ecosystem. They need to sell, not buy, in order to meet and redemption requirements. It's estimated that hedge funds

had \$125 billion in market losses and another \$60 billion was redeemed in October. Even Ross Perot's family hedge fund is reported to have dumped stocks and bonds two weeks ago as it faced margin calls. Reports are that the Swiss banks are squeezing their private clients who borrowed money to invest in hedge funds. Insult to injury? Citi liquidated a hedge fund that had a 55% loss in just the last month. Everyone knows the December redemptions will be far larger. But we suspect the peak of the abnormal selling pressure has been at least defined.

There has also been a calming effect as Obama has taken a centrist approach. As Tom Friedman recently said, "We need a catalyst of confidence and capital to turn this thing around." Perhaps the abating of the hedge fund meltdown combined with the solid political and economic team can give us some breathing room.

It might be almost time to venture out of the hurricane shelter.

- 1) For more conservatively oriented clients, we will want to try and ride the recent momentum for the very short run. If the market runs to the 10,000 to 12,000 range, I'd like to look to move to reduce overall risk. We have been advising to hold tight until the worst of the global storm has passed. Our rationale has been the stock market is likely now below its true economic value and it would be a mistake to exit too early. But it will also be a mistake not to take advantage of an exit opportunity to reduce overall exposure to the stock market if it appears in the near future.
  
- 2) For more aggressive investors, the bond markets look like they are showing unusual values. Shifting of assets from stocks to bonds might serve the dual objective of reducing risk in the event of a global recession and also potentially recouping some stock market losses as bonds return to more rational pricing. The yields on corporate bonds are at all time highs. High Yield bonds are returning over 20%, but of course these are the highest risk bonds. As yields return to more historic levels, each 1% decline in yield might reflect a 7 -10% capital appreciation in the price of the underlying bonds. So, a 5% drop in yield might equate to a 35% plus capital appreciation.
  
- 3) Even though Jimmy Rogers is now re-entering the commodities markets, it's still too early for us to make a re-entry. Rogers also continues to avoid the emerging markets and we agree. The fall out from this meltdown will rock the emerging markets even harder because of the amount of leverage involved and also the exposure to commodities. While its ancient history now, after the recent terrorist siege in India, I'm very glad we exited from India and China nearly a year ago.

- 4) Make no mistake we remain in a very high risk and uncertain environment. This is not a 90 day crisis with a return to "business as usual." The global banking system remains in critical and unstable condition.
  
- 5) While the market appears to have backed off from its "panic" stage, the next logical stage will be for the average American consumer to awaken to the new reality of a very severe global recession. This means attention will shift to the quality of earnings for stocks and the default risk for bonds. No question, profits will drop, the question is whether this is clearly reflected in this market.
  
- 6) Soon consumer fear will sink in and "cheap is the new chic" will take hold. This might lead to what John Maynard Keynes called the "The Paradox of Thrift" when consumers and companies start actually saving rather than spending individually, their aggregate actions lead to a decrease in demand, making it harder for the government to use either monetary or fiscal policy to stimulate the economy. In other words, don't look for Washington to wave a magic money wand and the good ole days to return.
  
- 7) The collapse of oil and commodity prices means consumer inflation will not be a threat in the short run, but a general debasing of the currency will cause a major loss of purchasing power over the next several years. Don't get fooled that cheap gas (the opium to the masses) means everything is alright.
  
- 8) We're pleased to see Paul Volker is on the Obama Team and he clearly understands that this whole mess is first and foremost a global monetary issue. Bailouts and stimulus packages will not fix the underlying problem which is the collapse of the "the Shadow Banking System" which emerged to fill the void of having globalized the world economies without creating a global currency or monetary authority. In the near future, I'll discuss this at greater length, but right now the focus is on reading the vital signs of a critically ill patient.

This remains a very dangerous market, but we do see some signs we might have touched bottom.

Barry Strudwick

December 2, 2008

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## SPECIAL MARKET UPDATE

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**FROM:** BARRY STRUDWICK  
**SUBJECT:** ECONOMIC CRISIS UPDATE #7  
**DATE:** DECEMBER 16, 2008

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The last two weeks have seen the stock market rally 1,000 points for a gain of 17% off the recent lows. But just when the sun might be peeking through, we get slammed with two scandals and a failed bailout. Last week's Obama Senate seat scandal and Bernie Madoff's \$50 billion investment fund implosion combined with the failed bailout of Detroit was a triple bucket of cold water in the face. The good news is that the market seemed to shake it off and ended the week on an up note, perhaps this is encouraging even after the grim predictions about Detroit and the unveiling of the biggest financial scam in history.

Ironically, I'm getting calls from both people wondering if it's time to take advantage of the market carnage and others wanting to know whether it's time to bail out. My personal opinion is that it's not time for either. It's a touch too early to put more money to work and it's too early to exit the market because of the potential for a short term rally giving a better exit point.

The reason for this conundrum is because the better intermediate term opportunities will likely be in bonds but the better short term opportunities might be in the stock market. However, the stock market opportunity might be very short while the bond market opportunity is emerging. The bond market rally will be helped by the resolution of the credit/banking sector crisis. The stock market will be tied more to the global macroeconomic cycle which could be deteriorating.

My personal guess-ti-mate is that we are now about 75% through the banking/financial system crisis but only about 25% into the "recession /depression" which is about to slam all of the world's economies. The vital signs in the credit markets are slowly improving, while the signs in the global economy are eroding. However, these might already be factored into both the bond and stock prices. Certainly with the junk bond market yielding over 20%, a wave of bankruptcies is apparently already priced into the markets. It is just way too early to guess whether they are right or wrong.

In the short term we will be taking some tax trades to capture losses to offset some dividend gains, but the objective will be to maintain the current levels of equity exposure, while looking for an opportunity to decrease total exposure in the near future.

Why are we waiting to decrease our equity exposure when we see a deteriorating economic environment? The reason is that we strongly suspect that the extraordinary selling pressure caused by Hedge Funds needing to meet the combination of both 1) margin calls and the 2) redemption requests from clients has forced stock prices perhaps 20% lower than where we might expect them to be right now.

For the past 3 months we've made the argument that this huge waterfall of selling pressure has been holding stocks and bonds below the fair market value of the actual investment assets which are extraordinarily cheap by normal valuation methods.

While a tired cliché, we liken the avalanche of bad news to a waterfall holding a beach ball under water. The question has been "how long can you hold a beach ball under water?" Eventually the beach ball will pop out and find its own equilibrium for fair pricing.

Last week, I was about to say we'd run out of size 15 shoes to drop on our heads... then we start last week with the Obama Senate seat scandal, followed by the \$15 billion Auto Industry bailout bombing in the Senate. If that wasn't enough, Friday's shocker of the \$50 billion implosion of the Bernard Madoff Ponzi scheme is by a factor of 10X the greatest scam of all time. The number is just staggering. To put it into perspective, it's about 3X the amount of the entire GM and Chrysler bailout and larger than the entire capital base of Citicorp a year before the train wreck.

It's hard to assess the exact impact here, but it's likely not to have a serious long term impact. Normally, something like this would shake the faith in the system, but that's already been done. Now, it's just \$50 billion of hot air and just an acceleration of the implosion of the Hedge Fund industry. We're suspecting that if this was a Ponzi scheme to begin with, the stocks and bonds weren't there to begin with, so it's likely more of an accounting issue than a stock market issue. There will be more hedge funds selling in the very short term as recognition of the loss of collateral which will increase margin calls. The second impact will be on the wealthy individual investors in South Florida and Long Island. This will have a ripple effect in real estate and with local charities. But in a broader context, this will not have a major impact. The Madoff Affair is largely a result of the collapse of the Hedge Fund industry which has no impact on our holdings as we exited out of those positions last April.

The second big event last week was the Detroit bailout. While most people are looking at this as being part of the inefficient legacy of Detroit, the issue here is really about the de-leveraging of the entire system, not the design of U.S. cars. The lack of consumer credit and "the negative wealth effect" from falling home values is keeping consumers out of the showrooms. Plunging sales have started dominos toppling throughout the economy. American consumers did not decide to stop buying Detroit's products in the last 60 days; they have stopped purchasing all big ticket items which require credit. The favorable news is that it looks like the housing market might be thawing a touch, but this is still too sketchy to see a clear pattern.

Where are we right now? In September the entire global banking system suffered a near fatal cardiac arrest. The bail outs were the defibrillators that bought the entire global capitalist system back to life. While the patient has been stabilized, it will need time to recover. We're seeing small signs in the credit markets, but it is very fragile and frail. Now it's time to make an assessment of how much permanent damage has been done to the world's economic system. There has been permanent significant damage to global trade and it will take years to recover. The question is "how much?"

#### Summary:

- 1) The abnormal selling pressure of the hedge funds will continue as the system unwinds. This will take several more months as a number of large hedge funds have suspended redemptions. This is actually good because spreading out redemptions is giving price support to stocks and bonds. Prior to this recent suspension, they are currently being forced to sell their most liquid stocks and bonds to raise cash to meet redemptions from clients and retain their most illiquid holdings. While this might sound "academic," it is a very real and significant factor which is distorting the market prices of good quality stocks and bonds right now. Once this abnormal selling pressure abates, the beach ball of fair value should pop back up.
- 2) How big is this implosion of Hedge Funds? It's estimated there have been over \$350 billion in redemptions since June this year and there are likely another \$450 billion in redemption requests pending. To put this into perspective, when I entered the investment business, the entire mutual fund industry was only about \$40 billion or less than the Madoff implosion by itself.
- 3) The normal role of opportunistic investors like Hedge Funds is to be bottom feeding scavengers and buy when everyone else is selling. Right now, they are being forced to sell when they would normally be buying. Once they can start buying again means the selling pressures have slacked off.
- 4) We anticipate a "bear market rally" once this selling pressure drops and our beach ball pops up. How much? Perhaps this could be a 20% to 30% increase from the current levels which could soothe some of the sting from this fall. This could easily happen very quickly, in a matter of days. We can't predict when this will happen, so we will hold tight on our stock holdings for the short run. How much longer? This could be days, weeks or perhaps a couple of months.
- 5) In the short run, we will do some juggling and swapping of positions for tax trading purposes. However, overall we will maintain the same total exposure.

- 6) However, for the intermediate and longer term we see the overall economic environment darkening, meaning we will very likely decrease our exposure to stocks and increase our positions in bonds.
- 7) Overall, Bonds appear to have more short to intermediate term opportunity. At the same time, U.S. treasuries are yielding 0%. The tougher question is “how is the best way to play this market?” Our inclination is to seek options with a shorter maturity as without question these high yields are not risk free and reflect the markets perception that we will be facing a wave of bankruptcies. After the current flight to safety subsides, we see interest rates increasing as the inflationary aspects of the trillion dollar bailout cause the dollar to fall in value. Short maturity corporate bonds with high yields appear to be the way to play this.
- 8) What about Oil? We exited commodities in April when Oil was in the \$135 range. Now it has plunged down to the \$40's range. Goldman Sachs is now predicting \$30 oil. If we see this level of prices, we will likely reenter in the near future.
- 9) As bleak as the U.S. looks, the emerging markets will be hit even harder. These are leveraged plays on the global supply chain.
- 10) We're not brave enough to play with financial stock sector. However, REITs will start becoming attractive again in the near future.
- 11) Our positions in both Alternative Energy and Nuclear energy positions have rebounded about 20% from their lows. We still suspect these have been hurt by the hedge fund selling more than most sectors. If dependence on foreign fossil fuels is a major source of our underlying problems, it only makes sense that alternative energy and nuclear will be part of the solution.

Please call me if you have any questions.

Barry Strudwick  
December 16, 2008

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**SPECIAL MARKET UPDATE**

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**FROM:** BARRY STRUDWICK  
**SUBJECT:** ECONOMIC CRISIS UPDATE #8  
**DATE:** JANUARY 9, 2009

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Dear SWS client,

I wanted to touch base regarding the investment strategy I plan to implement in the 1<sup>st</sup> quarter of 2009. This is a shift from my prior approach over the past 10 years which could be summarized as investing ahead of the Global Expansion of Capitalism. This long term trend has been abruptly halted by the global banking crisis and the resultant massive direct government intervention in the markets. Going forward, Government participation in the markets changes where the opportunities will be. As one person said, Governments are no longer just the referees, but they are now both players and referees. Common sense from the playground tells us that this will influence who the winners will be over the next several years. So with Adam Smith's "invisible hand" shackled for the near term, we now want to reposition to profit from a game where the government will be an active player and not just a referee. There are some logical ways to do this.

The global financial crisis has radically twisted the signposts towards globalism, but has also created perhaps great opportunities due to the pessimism and mis-pricing of sectors of securities. Now is the time to get a bit more specific and aggressive with plays.

Overall we will be reducing risk by increasing our bond holdings and decreasing our stock positions. With the stocks we hold, we'll prefer those with large cash holdings.

The high bond holding (50%) will likely decrease over the next 6 to 12 months as the yields drops (and we capture capital appreciation.) This is a short turn opportunity. The closed end funds are at huge discounts and very high yields. They have risk because of leverage, but I've kept the maturities shorter and limited the junk bond exposure to 2.5%.

**New Allocation:**

**Overall this amounts to a 25% reduction in our exposure to the stock markets by increasing our holdings in bonds. We are also seeking to invest in areas where the interest or dividend returns are significantly higher than the current CD returns. For example, Berkshire Hathaway currently has a dividend yield of 8% versus a CD at 1.5%. Here is how we plan to rebalance:**

- **Cash & CDs - 5%**
- **Market Neutral - 25 % - lower correlation to overall U.S. economy, heavy on oil, gold and energy.**
- **Bonds - 50% - Focus on corporate bonds which are yielding over 10% above T-Bill returns.**
- **Domestic Equities - 17.5 % - Focus on specific companies with large cash holdings for possible acquisitions in their sectors.**
- **International Equities -2.5% - Look for higher yields. Avoid high risk emerging markets**

A more detailed explanation of this strategy will be explained in the Client Letter with your year end statements and tax information. You will receive this information within the next two weeks; in the meantime do not hesitate to give me a call with any questions.

Barry