



Globalist

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A Long Road to Recovery

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These thoughts were originally shared with our clients in June 2009. 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.

What an incredible rollercoaster ride over the first 6 months of 2009. We've already experienced both the worst and best months in stock market history and it's only the beginning of July! Fortunately, by positioning to profit from improved liquidity in the bond and credit markets and hedging against long term deterioration in the U.S. dollar, we have performed well. With over 65% of our allocation oriented to corporate bonds and hard assets, most accounts are up over 10% for the year versus a break even stock market. Going forward, we see these basic trends continuing over the next several months and will hold steady on our strategy. However, this is hardly a "buy and hold" market.

Last quarter we used the analogy of a patient recovering from a near fatal coronary in the ICU to describe our frail economy. Ninety days later, the world's economic giant continues to recover, but the recovery will be much slower than most people anticipate. The massive

amounts of government stimulus has only slowed the deterioration in the economy, not reversed it. Severe and permanent damage has been done to our economic muscle mass and it will take years not months to recover. You don't replace AIG, Merrill Lynch, GM and Chrysler and dozens of others overnight. Keep in mind the entire financial services and housing industry provided most of the U.S. growth over the past 10 years.



Casa or Castle At Del Pacifico?

Both industries have been decimated. In the housing industry, even the strong survivors such as Toll Brothers and Lennar, have seen sales drop 50%. The auto industry is down 35% across the board.

Who or what is going to replace this growth? Expectations that the sprinkling of a little Presidential pixie dust would result in a return to business as usual are sadly misplaced.

Back to the patient analogy: Before our \$14 trillion economic giant can be released from the ICU, much less get back to the job of being the world's economic engine,

the pa-tempera- must return near fatal level. After to the lent of 105 last fall, our 102-degree



Surf 'N Turf Del Pacifico Style

is encouraging. Liquidity is starting to return to the banking, credit and bond markets, and the commercial paper markets are functioning again. Despite this improvement, there are still legitimate concerns. The banking system has raised about \$100 billion in new capital in the last 3 months. But worldwide, bankers are reluctant to put money to work and many sectors are still bone dry. Without normal trade credit, the only logical conclusion is global commerce will continue to contract. The only good news is that the rate of contraction will slow. In turn, a smaller global economy means an increase in the excess manufacturing overhang which needs to be mothballed. In the short term this means more unemployment and operating losses. While the U.S. might experience less disruption than some other countries, our overall situation is tenuous. Aren't the "shovel ready" stimulus jobs just a social safety net to ease the contraction? Without question, our patient remains very weak and needs to be watched carefully. How much of this will actually create new international trade?

Economic Activity Crawling Along at Dial-Up Speed

Already the credit drought has been fatal to several icons of American capitalism, and hundreds of other less visible companies have suffered irreparable damage. Dramatic cutbacks simply to survive are now the norm. While banks apparently have plenty of capacity to lend, the overall **velocity** of the economy is very low. Both companies and consumers are hoarding cash and not spending. If everyone stays on the sidelines waiting for bigger and better distress deals to emerge, this can turn into a very ugly self- fulfilling spiral. This is more than simply deciding you can run the old clunker for another year or order the value meal at McDonald's. Companies are deferring major upgrades on software and equip-

ment's ture from its fever spiking equiva-degrees current reading

ment. Vacations and corporate travel are being cut back. As our economy is gutted and revamped, where will the new profits and success stories going to come from? Does anyone think the massive Obama stimulus package will actually result in new long term productive capacity to replace the fallen giants? Or are we simply mainlining empty economic calories which will burn off as quickly as Bush's rebate checks? Absent this, is it even rational to hope the stock market might rebound to 14,000 in the near term? Without signs of a sustainable economic expansion, profits are impossible to predict. Instead, we believe it is more prudent to focus our strategies short term on the return of capital to the credit markets and longer term on the almost inevitable deterioration of the U.S. dollar. With proper positioning, it will be possible to profit from both of these trends.

Another Body Blow to the Dollar –Brace for Higher Interest Rates

As the global financial system apparently stabilizes, we're starting to witness a new phenomenon, which could prove to be very significant. This is a reversal of last fall's "flight to safety" into U.S. Treasury Bills. Just several months ago, worldwide fear of a global financial system meltdown was so great, investors were willing to accept a virtually 0% return on US Treasuries for short term liquidity. The longer term 10- year Treasury was also "bid down" to a meager 2.5% yield, well below the longer term inflation trend of 4.5%. Investors were so scared they actually paid the U.S. government to borrow money from them! As money starts to flow back out of these low yielding safe haven investments, there could be serious negative ripple effects. Not the least of these could be higher interest rates which could choke off revival of the real estate markets, which Washington says is essential for a U.S. recovery.

Big picture, we're relieved that the markets are stabilizing, but there are still some major worries. Consumers aren't spending, corporations aren't making capital expenditures and unemployment is rising. If this weren't enough, 1 in every 398 mortgages is in default and refi's aren't happening anywhere near what was projected. The recent spike in mortgage rates back to last year's level won't help this. Without question the amount of money that has been pumped into the banking system will absolutely gut the purchasing power of the US dollar over the next 5 to 10 years. I call this phenomenon "Barry's Rule of 8." As I emerged from high school onto college and had my first jobs, a bottle of Coca Cola was 25 cents, a pound of hamburger was \$0.69 and on, and on. If I take the current purchase price of something and divide it by 7 or 8, I get pretty close to the "old price". The \$1.65 soft drink at the 7-11 divided by 7 comes back close to the 25 cents. Today's \$20,000 auto is deflated back to about \$2,500, or what a Ford Mustang sold for. The \$750,000 suburban house was about \$100,000. A \$200 hotel room becomes \$30.

Put another way, in my adult lifetime the dollar has lost about 85% of its purchasing power! And this was largely in good times!!! What is going to happen in bad times? ***Fears of hyper inflation in the near future are entirely justified right now.***

The reason is that in the past several months there has been an absolutely massive increase in our money supply and also the banking system reserves. Evidence? The 12-month growth rate of M1 is up by 15%, the biggest increase in 50 years. At the same time, bank reserves have spiked up 10 times, also the biggest increase in 50 years. This means banks have a huge capacity to lend money. When they actually get around to this, it will increase the money supply by \$4 or so for every \$1 in bank reserves. This means a whole lot of money will be pumped into the system which should be very inflationary.

Right now we are not seeing an immediate uptick in reported inflation because the ***velocity of money*** is

extremely low. If you talk to anyone in the business world right now, there are virtually no deals being done or big investments. So, massive bank reserves and very low velocity can equate to low inflation in the very short term. But once deals start being done again, inflation could roar back. And this could start at any time. In order for this not to be inflationary, the Fed will need to squeeze money back out of the system as the recovery accelerates. Exactly who in Washington wants to the known as the guy who squashed the recovery by pulling money out of the economy too soon? Our bet is on inflation. This makes it important to invest ahead of the inflation curve, not behind it.

How We Are Investing Ahead of Inflation

We shifted our investment strategy earlier this year from one based on global economic expansion to our current strategy of positioning for a recovery of the credit and bond markets which we see as a prerequisite for any expansion. Our current allocation is 25% to alternative/market neutral investments, 50% to corporate bonds, and 25% to U.S. stocks.

We view this as a lower risk strategy than playing and praying for a strong stock market rally to recoup the devastation of last year.

Over the past six months it has been quite an adventure, but we think we have a good idea of the general direction right now.

Below are some of our current thoughts on how to position going forward. The most investment specific ideas are placed earlier.

For the first half of the year and especially over the past 90 days, our alternative investments have been exceptional. These are holdings which tend to move independently to the broader US economy and stock market. Currently our primary positions are in gold, oil, commodities, alternative energy, nuclear energy and water.

The real strength of our alternative investment sector has been in alternative energy (up 30% YTD) and nuclear (up 20% YTD) versus the US stock market which



is approximately at a breakeven point YTD. These should be independent of our larger economic mess because they are direct plays on the geo-political reality that the U.S. must cut its reliance on foreign oil. This strong rebound makes up for the failure of these defensive holdings to buffer the shock of last year. Better late than never! Last quarter, we had been concerned about the impact of little credit or capital on this sector, but the stocks have spiked up as the price of oil has risen making them more competitive this year. Outperforming the market by 20% to 30% is likely too far, too fast. We'll keep an eye on these going forward.

The second theme in our other alternative section is proactive positioning for a long term decline in the value of the U.S. Dollar. As money shifts away from Treasuries, the increased demand for investments to hedge against currency decline is driving commodity prices up ahead of consumption. Certainly gold, oil, natural gas and commodities will protect (hedge) purchasing power.

However, with oil doubling from \$40 to nearly \$ 80 and a weak global economy, prices for the sticky stuff could be ahead of itself with fleets of super tankers holding large floating inventories. As an alternative, natural gas now appears to be a more attractive hedge than oil. The price of Natural Gas relative to Oil is at its lowest ratio since 1991. We will be adding this to accounts.

With a 50% allocation (up from 25% in recent years), corporate bonds are now the largest part of our strategy. Half of this is invested in intermediate maturity corporate bonds and the other half in short to intermediate maturity high yield or junk bonds. Both portions have performed nicely with the corporate bonds returning about 9% over the past 90 days and the high yield bonds have jumped about 35% over the same time frame. Both sectors have move room to move.

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Over the past 18 months, high yield bonds have moved wildly from being extremely over-priced to being extremely good values. In 2007 and early 2008, investors weren't being compensated for the risk assumed. After the bond and credit markets crashed last year, bonds became undervalued. Currently junk bonds have perhaps the greatest value potential we are likely to see in our life times. We entered this market in February and it has moved quickly, but we are likely only in the 4th inning of this rally.

If you couldn't guess from our rant above, we continue to be very negative on U.S Treasuries. Normally, T-Bills return about 2.5 % over the prevailing rate of inflation which most people peg at about 4.5%. This would imply an equilibrium yield for Treasuries of about 6.0%. We would not be surprised to see 7.5% in the next 24 months. Until very recently people were actually willing to take a negative return (after adjusting for inflation) for the safety of owning U.S. dollars. As fears of a global meltdown recede, fewer countries (and people) will be willing to pay a premium to own U.S. dollars. This is likely why we saw the recent spike up in the yields new investors required to hold Treasury bills. In the last month or so, the yield on Treasuries spiked from 2.5 % to 3.75%. Look for the yield on Treasuries to continue to rise, and owners of Treasuries will continue to lose money. I'll say it again: Treasuries are not a low risk strategy.

Now let's look at the positive side of things. Junk or high-yielding corporate bonds historically return about 5% over Treasury bills. So if we expect a fair yield for Treasuries should be about 6%, we'd anticipate that Junk Bonds should be priced to yield about 11%. However, in February high yield bonds were actually priced to yield over 20%!

So were T-Bills yielding too little or Junk too cheap? A little of both. Treasuries yielding 2.5% were a trap for the unsuspecting. However, high yield bonds yielding over 20% were

The first law of financial physics states money always flows to the highest risk adjusted rate of return. As the panic recedes, money is seeking higher returns. However, the first flows are apparently not going into the stock market. For every \$1 going into stocks, \$2 goes to bonds. And more money is also moving into hard assets and commodities like oil and gold.

Could the recent surge in the oil prices be a flight from the U.S. Dollar rather than a rebounding global economy? The World Bank is predicting the emerging market growth will be just 1.2% this year, down from 8.1% in 2007 and

6.0% in 2008, and the developed countries will be lower than this. So if surging consumption demand isn't driving up oil prices, then what is? Recent polls indicate a growing realization that the Obama Bailout will cause severe damage to the long term value of the U.S. Dollar. So, if you're China and no longer afraid of a global meltdown, could oil offer a better store of value than T-Bills? We see this as a major factor because our creditors are seeking alternatives for their liquid reserves rather than subsidizing the U.S. deficit. If the demand for Treasuries declines, interest rates will rise. This means a near term flight from the dollar could choke off an already fragile recovery. In the last month or so, Treasury investors have required a 50% increase in yield from 2.5% to 3.75%. Over time this higher benchmark will filter through the US markets. Already mortgage rates have returned to where they were a year ago. This means fewer re-financings and ultimately less spending.

But the longer term implications on the dollar are perhaps even more important. While Washington did what it felt necessary at the time, now the rest of the world might be saying printing \$3 trillion of new "stimulus" money must, by definition, debase the value of the dollars already in circulation. The only way this could not happen is if the velocity of money remains at its current very low levels or if the Fed takes money out of the system as expansion increases. This is very difficult under the best of circumstances, but nearly impossible given the incredible Obama spending plans. So who do you put your money on: Obama extracting extra money out of the system and risking being blamed for starting another recession/depression; or most of the money staying on the table and a bunch of forecasts that we'll grow into the increased money supply?

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The impact on the world's willingness to continue financing our massive deficits could be dramatic.

The reversal of the flight to safety combined with massive deficit spending in the United States could shape the investing landscape for the next 5 to 10 years. If this plays out, this is a very cold, hard reality check that there is no free lunch. Treasuries will lose money both from a currency debasement perspective as well as from higher interest rates. What does this mean for the average person? For the average American with no savings, it doesn't mean too much other than everything will be more expensive over time. But for people who have already accumulated wealth, the implications are more insidious. Holding your accumulated wealth in US dollars could be a tacit acceptance of a silent and confiscatory tax on your accumulated net worth. There could also be explicit tax increases as well.

The New "Fairness": If You've Got it, Obama Wants It

Now is not the time to debate "taxation without representation," but rather to proactively protect your accumulated wealth from a transfer to those whom Washington deems more worthy, whether this is via the military, social security or health care. We are about to witness first hand the answer to a question we have raised many times in the past: "What happens in a Democracy when the people who don't have money outnumber the people who have saved?" Obama's plan to re-engineer capitalism will certainly transfer wealth into different pockets. Witness how the UAW benefited at the expense of the bond owners (by some estimates the UAW benefited at a ratio of 5 to 1 relative to the "senior secured" lenders). Any guesses on who will pay the tab for universal healthcare if we can't get OPEC or the Chinese to buy our debt? And just how

do you produce cost savings when you add 50 million new users to the system? A large number of moderates and independent voters are beginning to question the wisdom of their “feel good” votes for Obama last November. Poll numbers with Independents are already falling fast. Will the push back from Middle America alter the implementation of Obama’s “mandate” for social change? Obama is trying to steam roller through his changes while the opposition is in disarray and without apparent leadership. This has major long term implications for anyone with accumulated assets.



Monkey Time!

Where is the Love? World’s Fast-Growing Economies May Divorce the Dollar

Not only are we in the midst of a domestic wealth transfer, but a new international maelstrom is brewing as well. America’s international creditors are up in arms about U.S. monetary policy which is seen as debasing the greenback at their expense. While a longer term issue, this is actually moving faster than we would have anticipated just months ago. In mid-June, the BRIC countries (Brazil, Russia, India and China) held a private summit in Moscow to discuss how to replace the U.S. dollar as the global reserve currency. Why? Because they see the current global monetary system forcing them to “lend” money to the U.S. at very low rates by using their trade surpluses with the US to buy trillions of dollars of U.S. government debt. Try to envision the world order from their perspective. China, Brazil, India and Russia all have massive poverty at home, yet they are pressured into making low cost loans to support U.S. “imperialist forces” around the globe. By trading directly with each other in their own currencies (and not using dollars), they could start to break away from this U.S. Dollar controlled system. So why should they continue to subsidize a global monetary system that isn’t always seen as being in their interest?

What happens if the Dollar is challenged as the global reserve currency? First and foremost, Washington would lose its ability to inflate its way out of our massive federal deficit. This is no longer an academic debate; we could already be seeing real shifts in global investments patterns. Certainly, the rise of Sovereign Wealth Funds has been a start. In February during the Davos summit, China took out a full page ad in the financial press calling for a new global reserve currency.

There are two immediate implications all investors should heed: First, China and others are tired of subsidizing America’s deficit spending. Going forward, investments in intermediate and long U.S. Treasuries should be considered at higher risk as higher rates will mean capital losses. China and OPEC are signaling a shift in what they will purchase. In the past 30 days, the rate on Treasuries has risen by 1% meaning Treasuries are now 7% underwater for the year.

This could get uglier. Logically, T-Bills ought to return about 1.5% over the rate of inflation. While the Press might be spinning that CPI is actually dropping, a trip to the grocery store should tell you these government statistics are misleading at best. The 50% drop in oil and commodity prices since last spring is skewing the published numbers. After Washington prints \$3 trillion, should inflation be any lower than 4.5%? If this is a reasonable guess, then 6% would be a reasonable long term treasury return. If interest rates simply go to this level, we’re talking about owners of “risk free” T-Bills taking a “25% plus” market loss from when yields were at 2.5%. For the record, I think T-Bill rates could get much higher than this (and losses for T-Bill owners much higher) over the next 3 years. This, of course, means even larger losses.

potentially a windfall for those willing to take the calculated risk that liquidity will return to the debt and bond markets over time. As more capital returns to the credit markets, the increased demand for higher yield will drive up the price of mispriced bonds, creating the potential for capital gains.

If this doesn't happen, it means our banking system is frozen again and we have far bigger problems. This is when you want to be stocked with canned beans and shotgun shells. The good news is that the stocks of Smith & Wesson and Ruger have been falling back from their recent highs. Our high yield strategy was to create a maturity ladder of bonds starting at about 6 months and moving out to about 5 years using closed end bond funds which trade on stock exchanges. Over the next several years we see Treasury rates moving to the 7% level (from about 3.5% today) and Junk bonds appreciating as yields continuing their decline from the current yields about 16% down to a more normal 12%. This could mean handsome profits in the bond junk bin as each 1% decline in Junk yields can translate to 5% to 10% in capital gains.

To close off the topic of bonds, we also remain negative on Muni bonds. How can you get excited as 30 states are running deficits and several are on the verge of insolvency? What really scares us is that Barney Frank is starting to push a government bailout for muni bonds.

The Case for Underweighting Stocks

1) What about the stock market? At 25%, our low allocation to the US stock market says we are not believers the Bull is back. Overall we remain negative and very selective. This is not a time for index

funds and ETFs. There will not be a tide to lift all ships. If 65% of our economy is consumer based, high unemployment and tight credit makes it unlikely that the consumer will lead a return to the 2007 levels anytime soon. How can this be positive for the stock market?

2) Cheap is the new chic and our national savings rate has gone positive for the first time in ages. While most people would view this as a positive sign, in the short run increased savings will hurt the reported economic growth numbers.

3) Despite a strong rally from the darkest days of March when the Dow hit 6,500, today at a little under 9,000, the market is just back to where it started the year. To return to a pre-Lehman value of 14,000 with take another a 50% return. Is this realistic? Doubtful. Keep in mind that stock prices are really a wager on the stream of future profits for a company. In 2007, the world was giddy with the prospects for global expansion and the overall profit picture was much rosier. Since then we have had major carnage

in the banking and industrial sectors, rising unemployment, and a massive pull back in consumer spending. Is it even rational to expect profits projections to get even close to last year's boom time forecasts in the near future?

4) There will be a few winners in this overall mess. In the past, most stock jockeys focused on companies that "grew revenues." Today, the focus needs to be on the balance sheet not the income statement. The key

will be companies with cash and the ability to acquire the assets of weakened competitors at a fraction of replacement costs. We continue to like the logic of large companies with huge cash reserves such as GE, Berkshire Hathaway and Microsoft. In the real estate sector, we have added Toll Brothers who has over \$400 million and is acquiring land at distress prices.



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5) We don't have the courage yet to return to the REIT markets. There is a huge amount of debt coming due in 2011 to 2015 (over \$1 trillion) and no place to roll it over. About \$400 billion of this is "securitized mortgages" and the securitization industry is dead. Banks don't have the capacity or the appetite for this type of lending any more. Large institutional investors are praying for a solution to emerge. This is another big mess waiting to emerge.

6) It has been nearly 10 years since we said that the net impact of a sudden increase in global supply would be a long term negative for stocks. At the time everyone thought we were crazy. In 2000, the value of all the U.S. stocks was \$15 trillion. Today the value is just \$10 trillion. So during the last 10 years of strong economic expansion, the value of all the stocks actually declined by 33%! While a very contrary opinion at the time, it's now official we were right with the rolling 10 year averages for the U.S. stock market now negative.

7) We have been surprised by the strong rallies in the emerging stock markets (which are now up 30% YTD) and haven't understood the pundits logic here. Given the heavy reliance on exports and natural resources, where is the optimism? The World Bank predicts emerging markets' GDP to be only 1.2% from last year's 6.8%. How can this be good news for these stocks? If you think the credit crunch is bad here, imagine what it's like in Eastern Europe and Asia. Private investment capital in these economies has dropped by more than 50%. Most of these economies relied heavily on exporting to the U.S. which is not a growth strategy right now. We've always been fans of the emerging markets but we're fine sitting out this party out.

Exploding the "Diversification Myth"

Why didn't "diversification across different asset classes" work last year? The reason is that the old inter-relationships between different assets broke down. These MPT (modern portfolio theory) models calculate the mix of stocks, bonds, commodities and other assets based on their historical inter-relationship, sometimes using data going back to 1929. But most of this data occurred in a world when there was always inflation; demand was greater than supply. In the last 5 or so years, rapid globalization resulted in global excess supply of virtually everything or a "deflationary" environment. This fundamental shift in the underlying dynamics has twisted all the established inter-relationships. In other words, the old historic data no longer has "predictive ability".

More importantly, why do we believe it's dangerous to put blind faith in a pie chart spit out from a computer? While an incredibly complex (and dry) topic, the rationale is very simple: "Garbage in-garbage out" (GIGO). The microcomputer revolution put incredible computing power into the hands of financial planner and stock brokers who didn't understand the underlying mathematics or logic. Press a button and presto, out pops a pretty pie chart that tells you how to invest and purports to control risk.

Not until the new inter-relationships based on a global economy stabilize and enough data is collected will it be prudent to rely on most computer models. This is an important concept to understand, because it means it is not prudent to assume you can "dial down" the risk in a portfolio simply by increasing bonds and decreasing stocks. Please give me a call if you would like to discuss this further.