



# Globalist

Quarterly

January | 2010

## Too Early for Grave Dancing?

*These thoughts were originally shared with our private clients in early January 2010. They are now being shared, unedited, to stimulate discussion of these issues. These thoughts are considered general in nature and not specific investment advice. Please feel free to contact us and share your comments with us. –Barry Strudwick*

After the wild rollercoaster ride of the past 18 months, we are happy (and relieved) to bid a breathless adieu to 2009. While we performed very well, exhilarating is not the word we would choose for the most volatile year in the markets since the 1930's. We've also just closed out the first full decade of a new century where our "globalist" strategies substantially outperformed the S&P. Despite Wall Street's hypnotic mantra of "stocks for the long run," the S&P 500 actually lost 23% over the full decade.

Strategically, 2009 was a year of big changes for us as we transitioned from our "global go-go" strategy of the prior 10 years to a more "go slow" approach post apocalypse. The results were impressive as our new "bond-centric" portfolio hit the performance bull's eye. Please see the attached reports for your specific performance.

As the dust settles, we're starting to see an unsettling alliance of Big Government and Big Business emerging. This might well develop into a dominant investment theme going forward, reversing the freewheeling entrepreneurial spirit of the last decade. Philosophically and politically we might not like Washington taking a direct role in the private sector, but as investors this

is potentially an emerging reality. Our role is to proactively position for profit, just as we did with the falling dollar and emerging markets last decade. After all, isn't this what Goldman Sachs does, but on a grander scale?

For the next six to twelve months, the primary play will continue to be in corporate bonds as liquidity continues to return to the credit markets. It's late in this game, making it time to start shifting to new opportunities. However, the U.S. stock market remains fraught with uncertainty as both the U.S. and global



*An Elegant Investment in Paradise*

economies remain anemic and vulnerable. Main-lining stimulus steroids into the economy simply stemmed the loss of jobs as opposed to creating new ones. Once the quick jolt of "shovel ready" projects wears off, Washington will awaken to realize a trillion dol-

lars spent didn't add an ounce of new economic muscle mass. Does it take a cabinet full of Goldman Sachs alumni to figure out creating "national wealth" means we need to sell more to the other guys than they sell to us? Does building bridges accomplish this goal? Nope. Healthcare reform? Nope. First time homeowner tax credits? Nope. Cash for Clunkers? Aren't these all just circular flows within the economy? *"A new car in every*

## A Bull's Eye with Bonds

While we were defensive with stocks in 2009, we hit the bull's eye with our 50% allocation to riskier corporate bonds. Intermediate quality bonds returned about 20% and our more aggressive junk bonds averaged over 75%, exceeding even our optimistic expectations for last year. It's now the 8<sup>th</sup> inning of the bond bonanza and we're starting to stroll to the parking lot ahead of a late arriving crowd.

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*Heading towards the blue skies of the Market future?*

*garage*” might win votes, but it does not improve our global competitive advantage. More troubling is that the entire trillion dollar remedy failed to address the core underlying issue which still exists. In a globalized economy you need a globalized monetary and banking system. (Our prior discussions on this are available at [www.noload.com](http://www.noload.com)).

Our financial world is calmer, but not necessarily safer. Washington's massive bailout focused an 800 billion kilo-buck klieg light on America's self inflicted currency crisis. Congresses appalling public display of pork grubbing has hastened the demise of the monetary goose who laid the golden eggs we call U.S. T-Bills. China and OPECs appetite is already shifting. They are now gobbling up strategic natural resource supplies around the world as well as UN votes. So why should we worry? Absent their demand, for T-bills, interest rates could spike up sending second shock wave through global markets. Frankly, absent some serious monetary monkey business currently going on behind the scenes, our opinion is rates should be higher now. If the true rate of inflation is more than 3.5%, why are T-Bills lower than the rate of inflation? Doesn't this imply the Chinese and the Arabs are actually losing money on every dollar they have invested with Washington? Should we expect this to continue indefinitely thus implying they are just plain stupid? Let's face reality, the current period of low rates is an aberration allowed by the low “velocity of money” and high unemployment... This set of conditions will not last. Taking advantage of today's relative calm to position proactively for rising rates seems prudent. Let's recap where

we've been so we can better project where we're going.

- In 1998, well before the tech bubble burst, we predicted a dreadful decade for stocks due to what we called “deflationary” pressures. We recommended an alternative “globalist” approach which posted super gains. Our prediction was accurate and the S&P 500 closed the 10 year span with a loss of 23%.
- For the first nine years, we surfed the cresting “globalist” wave, investing ahead of the worldwide expansion of trade.
- At the same time we profited by simultaneously hedging against a falling US dollar starting in 2001.
- An early and proactive commitment to emerging market stocks, commodities, international real estate and energy were all key ingredients here.
- Fearing a bubble, we exited the US real estate early, leaving at the end of 2005.
- Our positions were not token “me too” allocations as “alternative” investments reached as much as 70% of our holdings before we called an early warning to the global banking crisis in mid 2007.
- We exited the financial sector in mid 2007, emerging markets in late 2007 and commodities in early 2008.
- In March of 2008, we called the end of our 10 year run Globalist Era and “Code Red” for a global banking crisis 6 months before the storm.
- In 2009, in the aftermath of the worldwide financial crisis, we dramatically shifted our strategies away from the global growth model to focus on bonds, elite cash-

will talk your ear off about why \$2,500 is just around the corner, what if central bankers spike gold prices simply to prove they can pop a bubble? After all, aren't surging gold prices a proxy vote against all paper money? And isn't the #1 job of a central banker to protect the plausibility of fiat currencies? Gold looks a touch too popular right now for our taste. For example, the ratio of gold to silver is currently a super high 60 to 1 versus a more typical 16 to 1. After our profit taking, Gold remains about 5% of most accounts. We won't be afraid to take more profits and reinvest in other ways to hedge against a falling dollar.

### **The Hooking Up with the 'Cuda's of Wall Street**

Bottom fishing for bank stocks? Not us. But there is a smarter way to play the battered financial sector. Financial pundit Jason Zweig once told me "Never invest in mutual funds; instead invest in the stocks of their management companies." Now is the time to apply this same logic to the ravaged financial sector by investing in publically traded private equity firms like Apollo, Blackstone, Fortress and KKR whose shares have been absolutely hammered since we exited in June of 2007. From today's prices, it would take a 200% gain to get back to where they were at the peak. However, these guys will be the ultimate survivors and beneficiaries of the meltdown. The "going private" part of the recent LBO cycle is now unwinding and there is a bursting pipeline of IPOs that the PE firms will be dumping on the public. This means huge profits and fresh capital to reinvest. Blackstone alone says it has eight companies it plans to foist on the public in 2010 (they also already have \$25 billion in cash). Also, with some fresh capital, look for the PE baracudas to rip a few pounds of flesh out of the TARP carcass and related stimulus programs. If anyone can figure out how to make a buck off the bailout, these guys will. Again going back to our political theme, since the PE firms didn't partake of the bailout booty, they remain largely outside of Washington's oppressive thumb. This distinction alone makes the group a more attractive investment than traditional banks and brokerages that now need a hall pass from Washington to wash their hands.

### **The World is Tilted**

In the early years of the past decade, we were early proponents of "the world is flat" and invested globally ahead of the pack. Now in 2009, we're witnessing the next phase where the "world is tilted" in favor of the emerging markets. The global corporate power structure has already been reshaped. 75 of the Fortune 500 companies are now from "emerging markets," up from just 19 of them in 2002. And the winner of the 2009 East/West Stock Bowl? Check these matchups and tell me who fared better last year: GM or Hyundai? AIG or China Life? HSBC or Citigroup? However, as investors the sector appears over priced right now. Heavily reliant on exports and natural resources, the global economic slowdown and credit contraction should be hitting the emerging markets more than the developed Western economies. A 75% rally last year doesn't add up. We like the sector long term, but not at these prices. Is this another asset bubble?

### **Buying Votes at the UN**

As we warned several years ago, don't look for the Sovereign Wealth Funds to continue to play the patsy for the US any more. The days of foreign government bureaucrats passively buying 1% T-bills and relying on Wall Street for stock tips on "blue chip" western companies are over. So where are our trade deficit dollars being re-invested? The answer is the SWF's now have their own team of Harvard, Wharton and Stanford MBAs making direct strategic investments in the emerging market infrastructure and natural resources in the Latin, Asian and African markets. Almost everywhere, Chinese investment delegations are touting cheap loans for massive infrastructure projects which these countries could never finance themselves. China is building Costa Rica a new soccer stadium with the laborers brought over from the mainland. Natural resources are also a focus as China also just bought 1/6 of Nigeria's existing oil production. So if the Chinese are on large scale buying binges around the world, exactly who is going to finance our still mushrooming deficit? And how can this not result in sharply rising U.S. interest rates? Now, does anyone think UN votes might be for sale here? This is a very volatile

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2009, EAD bounded up 98%, PHK was even better at 158%, and DVF scored 92%. Similar, though different than our junk bonds was UTF which holds bonds and stocks of utilities and was up an impressive 66%. Individual accounts varied based on actual purchase timing.

To balance out the junk bond holdings we allocated another 25% of our total strategy to intermediate quality corporate bonds which had similar mispricing due to a lack of liquidity. Credit risk superstar Dan Fuss posted a super 38% return and this year he is seeing more opportunity in international bonds. Our interest rate guru Bill Gross matching the DJIA with an equity-like 18% with his portion.

The “easy money” from junk bonds has now largely been captured and in October and December, we reduced our exposure to junk bonds by roughly 1/3 in most accounts. Look for us to trim these holding further this year. Where to next? As we trim junk bond exposure, look to see us increase holdings of hard assets and energy.

### **Energy: Expect the Nuclear Sector to Glow like Homer Simpson**

While the bond bonanza might be largely over, the buy sign for the nuclear sector is still flashing with stocks still down 50% from their 2007 highs. Nuclear remains our only scalable solution to our continued reliance on Arab Oil since wind, solar and geothermal (while intriguing) are still just niche plays.

Our nuclear play isn't just through electric utilities but also includes uranium mining and nuclear plant construction companies which should capture some of the infrastructure spending booty. Now is a good time to accumulate because cheap natural gas prices and decreased energy consumption have hurt earnings. This as a 3 year not a 3 month play.

Speaking of cheap natural gas, after prices plunged 45% last year, we started building gas positions as compliment to both our oil and gold hard asset positions. We might be early but the ratio of oil to gas prices is the most favorable in 15 years. Natural Gas is about 2.5% of most accounts. Look for

additions to these positions over the next year.

We called the top in oil and exited in April 2008 at \$125. Post crash we started re-entry last year at \$40. Currently at the high end of our \$60 to \$80 a barrel trading range, oil prices seem oddly high given stories of fleets of full supertankers parked offshore and a slow economy. One way to reconcile the relatively high prices with weak demand is the “asset bubble” hypothesis. Could a by-product of all the money printed last year be a bubble in hard assets like oil and gold? If so, might the central bankers move to pop this bubble? Pretty deep stuff, but let's just say oil (and gold) prices seem a little out of whack right now. Still, most of the 2008 spike factors (except super stoked growth) are still with us. Certainly, proven reserves are depleting, the geo-political picture isn't any prettier and the global supply chain remains vulnerable. Once actual economic growth returns, oil prices should rise again .Oil is currently about 5% of most accounts but we aren't adding right now.



*Making the best of the rough financial waters*

As an alternative to adding to our oil trove, we're investing in oil and gas exploration stocks which appear to offer better relative long term value. With the current oil glut, the number of oil rigs at work is down 35% and the daily rate for offshore rigs has plunged from \$225,000 a day to \$165,000. But at the same time with the major fields depleting, it's necessary to find another Saudi Arabia of production every two years just to maintain the status quo. This looks like a good time to be adding stocks in a depressed sector as an alternative to the actual commodity.

### **Gold Bubble?**

Gold is another potential hard asset bubble caused by too much money being pumped into the global banking system. While we loved gold late last year at \$400 an ounce, we recently took profits and reduced our holdings by 1/3 after the glittery stuff busted through the \$1,100 mark. While any self respecting gold bug

rich companies with gold-plated balance sheets, and international real estate.

- Starting a new decade in 2010, we see a frail global economy with contracting credit, increased concerns about fiat currencies and emerging powers expecting and pushing for higher standards of living. Our conclusion: accumulated wealth and power will flow from the West to the East & South.



*Avoid the Monkey-See,  
Monkey-Do of Wall Street*

### A Quick Recap Of 2009

Key to our current strategies is recognizing that the root of the 2008 meltdown was the credit markets and not the stock market. The resulting crisis in confidence created a once-in-a life time bond buying opportunity. We shifted a whopping 50% into intermediate quality and high yield (junk) corporate bonds and preferred stocks. Our logic was as the initial panic subsided, the returning tide of liquidity would result in double digit capital gains for those invested ahead of the flow. Another 25% was placed as a hedge against a falling US dollar via commodities, gold, natural resources and energy. The Fed printing a trillion dollars assures long term success here. Our final 25% was placed into a select group of US stocks with super strong balance sheets which could survive and even prosper with double dip recession. This

group performed adequately, but we suspect the true value here is down the road.

Our bottom line? Last year, our strategy produced excellent results with considerably lower risk than wagering on a reflex rally in the post crash stock market.

### Recent Stock Market Rally: Regression to the Mean or Sucker Play?

We remain very skeptical about the sustainability of last year's rallies in either US or emerging stocks. Despite the DJIA rebounding 18% last year, there is very little evidence of "sustainable" growth once the massive stimulus effect wears off. No growth, no rising profits, no bull market. It's a pretty simple equation. Since stock values are focused on the prospects for "growth," what's a fair price for stocks? Anybody's guess.

Ditto the emerging markets. We exited in late 2007 and stayed on the sidelines missing the 75% rally last year. But they are still 50% below our exit point in 2007, so we are still ahead of the game. We'll remain spectators until someone explains how these markets can skyrocket without global trade expanding. Tighter credit in the West means reduced consumer demand which translates to falling exports from the emerging markets. For example, the Baltic Dry Sea Index which measures that

## Barry's Crystal Ball

**“Starting a new decade in 2010, we see a frail global economy with contracting credit, increased concerns about fiat currencies and emerging powers expecting and pushing for higher standards of living. Our conclusion: accumulated wealth and power will flow from the West to the East & South.”**

cost of shipping freight is still down 75%. So, if it ain't shipping, how can it be selling? If it ain't selling, where are the profits for stocks? So, what justifies a 75% rally? Could the emerging market's pop last year simply be an asset bubble from money seeking a haven outside the dollar?

### Credit Squeeze Still Chokes Global Recovery

Before we discuss our bond performance, here's the very important back story: Small Business, which accounts for 40% of the U.S. economy, is dying due to a lack of credit. In 2010 this will get worse, not better. Trillions of cheap credit vaporized last year and the drought will continue as banks rebuild their capital bases. This is a mega-problem, especially for small and mid-size companies who can't access the bond markets. This isn't a normal cyclical liquidity squeeze; it's an ultra-arid Sahara-like drought which is killing viable companies. The evidence? Despite massive government infusions, bank loans actually contracted this fall by 3%. This was the first quarterly decline since they started keeping records in 1980. The squeeze is getting tighter, especially for small business which do not have access to the corporate bond markets. Do-gooders in Washington have made the problem worse with credit card reform. The Big Banks have already cancelled 10% of all the credit cards outstanding which are a major source of funds for small business. Experts say an additional \$1 trillion of available credit card capacity contraction will occur in 2010.

Unless and until banks get back into the business of lending the odds are stacked against any real recovery and the actual survival of many well run companies. Let's all give a special "shout out" to Washington for protecting America's small business from themselves by increasing regulation on the "predatory" credit card industry. Right now, 60% of small business owners question whether they will survive the next two years. Our U.S. stock strategy is set to profit from this credit crunch.

### **Bureaucrats Bump Buccaneers: Government Seizes Helm**

But there is more to the back story. To avert a potential financial apocalypse which would have made cave dwelling in Afghanistan an attractive alternative, Congress and the Fed struck a deal with the Devil and we're just now figuring out how onerous the true price will be. The laissez faire magic of free markets has been replaced by a new era of direct government intervention into the private sector. Pandora's Box has been opened and this is very bad for free enterprise. Politicians and bureaucrats are now calling the shots in our auto, banking, brokerage and insurance industries. "We The People" now own 60% of GM and over 20% of Citigroup. The healthcare sector might be next.

### **Dropping the F-Bomb on Obama**

While the media populists rant about "socialism" could everyone actually be looking the wrong direction and missing the real threat? The text book definition of "fascism" is government control of the private sector due to a fear of unfettered capitalism or "*a political ideology which seeks to combine radical and authoritarian nationalism with a corporatist economic system.*" There is no question the Barack Administration has more control on private business than we would have ever imagined just 18 months ago. Check it out in Wikipedia and draw your own conclusion on where Obama's first 12 months fall in the political spectrum. This is an important trend to observe and understand over the next 24 months. The direction here will drive the nature of investment opportunities.

Rather than despair, here's how to have some fun with your new found tid bit of political science. There are few better sports today than dropping the F-bomb into a roomful of starry eyed economic reformers and watching them scramble. Two weeks ago Puck posed the following question to Robert Reich during a Q&A session. "*From your perspective as an*

*academic, is the Obama Administration's direct involvement into the private sector a form of Fascism?"*

You should have heard the yelps! Keeping in mind that Maryland is the second most liberal state, only trailing the Peoples Republic of Massachusetts, the gasps were audible and the howls of protest and heckles from the shocked audience were worth the price of admission. Even better, our uber-politically correct NPR moderator actually requested with incredulity, "*Will the person who submitted this question please stand and identify yourself,*" and added, "*Mr. Reich might come looking for you later tonight.*" After taking a quick stock of the number of beards and Birkenstocks surrounding me, discretion was clearly the better part of valor. As the Littlest Professor fielded the anonymous query, my adolescent side secretly envisioned the next day's *New York Post* headline blasting out "*Reich Declares Obama Fascist.*" But my day dream was dashed as the 1/3 Reich deftly evaded the trap and ducked the question saying he was more concerned about the intrusion of Big Business into government, than vice versa. However, it was clear the query touched a nerve on both sides.

Could Obama's first 12 months in office be seen as Big Government launching a political and economic blitzkrieg on the "allies" of Big Business and Wall Street? Have the allies' largest citadels (AIG, Citigroup and GM) already been stormed and captured? While Middle America's attention was diverted by watching the troop build up over the pending battle over healthcare, has the real battle already started? This is an important and alarming development which very few in the media have addressed, but we suspect the grass roots Tea Party movement is in part an instinctive response here.

Whether the correct label here is "socialist" or "fascist," we'll let the academics decide. But as investors, it is imperative to anticipate the implications of the policies being proposed (and implemented.) There are fundamental structural changes afoot which require more than a passive acknowledgement that "my taxes will be higher." This all being said, the question we need to be asking is how can we invest ahead of this?

## Diamonds in the Bargain Basement (The Irresistible Lure of Sparkling Balance Sheets)

Let's start with stocks. The combination of the credit crunch, slower global trade and Big Government will be negative for most, but not necessarily all of corporate America. In fact, we see a cluster of diamonds sparkling in the bargain basement that should retain value or even profit during this period of economic and political flux. Right now the prudent play is to focus on mega-cap US stocks with the absolute strongest balance sheets and huge hordes of cash. The logic is very simple: tight credit is strangling both good and bad both companies. Cash means the ability to acquire weakened companies. Bigger is also better for access to Big Government and bailout contracts... It's the old "Golden Rule": "He who has the gold makes the rules."

Here's how the golden rule worked last year: Last year, Berkshire Hathaway made \$20 billion in "distress" investments in cash-strapped companies such as Constellation Energy, Goldman Sachs, Harley Davidson and GE. Buffet's price for liquidity was steep requiring not only stock at fire sale prices but also debt yielding 10% -15%. Now the crisis is past, Berkshire got a hefty slice of equity cheap and last year's deals alone should throw off \$2 billion in recurring annual income. More recently, Berkshire did another mega deal when it snatched up Burlington Northern railway for \$25 billion. Why a railroad? Oil ain't getting any cheaper which makes air and trucks less competitive. Rails also have a "wide moat" vis a vis competition. 60% of our freight travels over the rails, the industry has been consolidating for 100 years and they certainly aren't building any more of them. Finally, a cynic might add, the Rails are already government regulated so better the devil you already know! This ties loosely back to our earlier political comments.

Now, with all this cash and great acquisitions, how did Berkshire fare last year? Up a paltry 3%. Go figure! Berkshire's stock would have to rise another 50% to regain the 2007 high water mark, so we're buying.

Another cash cow in an acquisition pasture is Cisco. Despite a

100% increase in revenues in the past 10 years, the stock is actually 50% cheaper than at the tech bubble peak in 2000. Not bad for a company with a 70% market share in corporate data networking. CSCO is also the primary arms merchant for the coming era of cloud computing which will boom even in a sluggish economy. Did we mention it has \$45 billion in cash on its balance sheet? With a pristine balance sheet and a dominant competitive position, we like both the defensive qualities and the acquisition potentials here.

Ditto GE. Jeffrey Immelt is the Rodney Dangerfield of Big Biz, he gets no respect and the shares of GE today are cheaper than 15 years ago! But GE has been restructuring for the new government dominated era and has the heft to command a spot in almost any large infrastructure or energy project. GE is a major player globally in nuclear, solar and wind energy. And how did Wall Street reward GE last year? The stock was actually lost 3% last year. Again we view this as an excellent time to accumulate.

Do you see a pattern here? Huge stashes of cash, super franchises and stock prices below where they were a decade ago.



*Flying high above the rest!*

This triple combo provides both long term growth potential as well as a great defensive position if the market hits a weak spell this year. Look for us to increase these holdings as we take our profits from other sectors such as junk bonds.

### The Great Bond Bounceroo of '09

While our cash rich stocks lagged last year, we got a bigger boost from bonds where "risk premiums" were even higher than in the

Great Depression. We allocated about 50% of our accounts into fixed income which was split between good quality intermediate term corporate bonds and junk bonds with short maturities and super high yields. Yields north of 30% were effectively saying that 1/3 of all companies were going to fail. Not that the Chicken Littles of the world didn't have some foundation for their fears with AIG, Citigroup, GM and Merrill Lynch all teetering on the brink. However, our assessment was that either emotion had gotten out of hand or it was time to stake out a cave in Wyoming. For now, modern urban dwelling has gotten a reprieve as our junk bond skyrocketed. For the full year of

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## About Barry Strudwick

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situation and not an academic curiosity.

### U.S. Real Estate: Too Early for Grave Dancing

What about real estate? Recall we got a touch of vertigo in 2005 and exited US real estate early. Today the U.S. commercial real estate market remains the big question mark as over \$1 trillion of securitized mortgages which are coming due over the next 3 years. As these loans mature, who is going to re-fi them? Add to this that 20% of America's mall space is vacant and 25% of all residential mortgages are "under-water." Sam Zell, who made his reputation as "the Grave Dancer" by buying into distressed real estate after the S&L crisis, says it's still too early. We agree. While there will be big winners here, we need to survey the landscape a bit longer. The smart play might be to invest in some new equity funds currently being raised.

We're more favorable towards international real estate and have started adding some small positions, especially in the emerging markets. Our old friend Sam Leiber started a new emerging market real estate fund this year and posted returns of over 100%. Condos and lots in internationally branded and operated luxury resorts is also an idea people should consider if you're concerned about a falling U.S. dollar and/or an increasingly intrusive federal government. If you have concerns about a plunging US dollar, now might be a good time to purchase real estate outside the U.S. Look for luxury resort properties in warm weather countries with a modern infrastructure and easy air connections to North America and Europe.

### A Final Thought: Don't Confuse Profits & Patriotism

Over the last 10 years, our often unconventional insights have been "spot on" allowing us to capture profits by recognizing

trends ahead of the pack. Going forward, we'll continue to connect the dots as we see them and invest accordingly. Don't confuse profiting from the apparent geo-political trends and your personal patriotism. We might not like the apparent trends, but that didn't stop us from investing ahead of a falling dollar for the past 10 years. This is a transitional period and perhaps some of the more disturbing trends will shift before they become entrenched. Longer term we suspect U.S. interest rates will rise, the dollar will fall and the stock market will stall. However, it's too early to bet "all in" on any of these. Right now there are too many monetary wild cards in the game causing what we see as "irrational" aberrations. As the noted economist John Kenneth Galbraith famously wrote after his own personal bankruptcy, "*Markets can remain irrational longer than investors can remain solvent.*" For now, let's watch how the massive changes play out with an open and objective mind. We're prudently defensive and gradually building positions in a range of new opportunities.

Barry Strudwick  
January 15, 2010

PS. We really appreciate the referrals and if you have friends who you think might like to discuss investing with us, please let me know.

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