



# Globalist

Quarterly

April

2010

## How to Profit from “Obamism”

*These thoughts were originally shared with our private clients in early April 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*

Our “bond-centric” strategy which we started implementing in early 2009 has continued to do well over the first 3 months of 2010. Corporate and high yield bonds continued to outperform and our core equity holdings of super cash rich companies like Berkshire, Cisco and GE surpassed the S&P 500 by a wide margin. In the last two weeks our overall performance was trimmed a touch by a sudden 25% drop in Natural Gas. This is likely just a very short term issue which will self-correct with any uptick in the economy. While we’d like to sit back and rest on our laurels for a month or two, the sudden shift in the political climate has caused our internal alarm system to start twitching. We now see pressure building for higher interest rates which means its likely time to start shifting out of bonds.

The **good news** is both the banking system and the overall economy have stabilized and we see a gradual return to growth. The **less good news** is that the credit markets are still very tight and the lack of credit is slowing down any recovery. At the same time, the slow growth is holding down inflation. An uptick in growth will also mean an uptick in inflation. This scenario is exactly what we forecasted last quarter. The **disconcerting news** has to do with the nasty political

tempest that is brewing with the Tea Party. This current runs deeper than many in Washington and Wall Street seem willing to acknowledge publically. Going forward this will likely be a factor influencing our investment strategies.

For the past year we have positioned our investments for a weak economic recovery and **exceptionally tight credit** markets. In this environment we’ve profited from our aggressive bond holdings and companies with super strong balance sheets. We’ve also taken advantage of the weak economy to



*Glimpsing into the Investment Future*

start rebuilding commodity positions with an eye towards higher market prices in another year or two. Normally we’d be content to let this strategy run for a while longer. However, the surprise passage of Healthcare Reform two weeks ago has sparked a massive pushback from Middle America which appears alarmed over the direction of Obama’s social and political

agenda. It would be a mistake to classify this as just a typical political squall. This is a tropical storm with the potential to grow to a Category Five hurricane. Just like we watched the network news plot the course of Katrina straight for New Orleans; this storm is headed straight for Washington with an ETA of November.

## “The Dollar is Falling!”

Now if you're a “the dollar is falling; the dollar is falling” town crier, don't think we've deserted you. It's all a matter of timing. Recall we entered in '04 at under \$400 and then exited in early '08 at over \$1,000. More recently we re-entered post crash in 2009 at \$400 and then reduced holdings by 1/3 last October at about \$1,000 which means we still have chips on the table (about 5% for most accounts) but we're playing with the House's money right now.

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*With skill, you can ride the turmoil.*

Political punditry aside, the Healthcare Reform Act is already having dramatic impacts both on Main Street and Wall Street. Even its most ardent supporters are saying the OCB cost estimates are extremely low and that no one actually knows what the true cost might be. The global bond markets are already pricing the impact via higher interest rates. In just two weeks, the cost of a home mortgage has jumped by .25 of 1%. Every uptick in rates not only adds to the mushrooming federal deficit but also slows down any potential growth in the economy as housing becomes more expensive. In response to this upward pressure in interest rates, we made some changes in the accounts immediately after the Healthcare Bill was passed. Is a national VAT tax going to be sprung on us to pay the huge cost?

The rising hue of political discord is the loudest shrill heard from the Heartland in over 40 years. The political backlash coming from Middle America is not about healthcare per se; but about the script for The American Dream being rewritten with the scene where everyone retires happily to live on Golden Pond cut out. In its place a more Orwellian vision of Big Brother style Big Government is rapidly emerging. Because the growing dissent potentially can negatively impact the markets, this trend should not be ignored simply for the sake of politeness or because of political correctness.

### ***Cross Currents Cross Country***

Despite efforts to label the Tea Party movement with the double R-words (Republican and Religious), this actually appears to be a non partisan secular spear-headed by women. The binding tie here is “fiscal” not “social” conservatism which has been galvanized by opposition to the new \$1 trillion plus unfunded “right” to healthcare. As one observer noted, the Wall Street bailout was a payout to those above the Tea Partiers on the economic ladder. At the same time, the Healthcare Reform Act is perceived as a giveaway to the unemployed and immigrants below them. The middle class feels squeezed out with their children left to foot the massive bill for generations to come. This is a movement from the “Hearth Land” and is dominated by women who typically oversee the household finances. In what future historians might define as Obama's classic Marie Antoinette “then let them eat cake” moment, Washington committed to a \$1 trillion expenditure while national unemployment was over 10%. Middle America views this as elitist arrogance especially since the surprise Scott Brown election victory in Massachusetts made it clear jobs and household finances were Middle America's #1 priority. Cynics are saying he just bought a 32 million person voting bloc with the debt of future generations.

Are Big Government, Big Biz and Wall Street all in bed together? In the past 18 months with the auto, banking and health-care industries now under the direct con-

trol of Washington. That's nearly 50% of our "free market capitalist" system. And who are the watch dogs? It's pretty clear that a *Goldman Sachs*' pedigree is a prerequisite. Highly emotive terms like "Socialism" or "Fascism" are being bandied about, but we prefer "Obamism." This is direct government influence into the private sector with Wall Street serving as a shadow cabinet. This way the investment



*How beautiful are your investments?*

bankers can reap huge fees without having "conflicts of interest." The Progressive Left sees this as Washington looking out for the under classes. The Tea Party sees this as an unholy union and they are the ones getting screwed. Middle America is fearful the whole political system has been "hijacked" by a coalition of the intellectuals on the Left and the under classes. If you add to the 20% hard core "progressive left" block an additional 40% of households which some observers claim don't pay any income taxes, the fear is you create a

built in permanent majority voting bloc. This leaves the remaining 40% of people on the Right and the Middle to permanently foot the tax bill for an ever expanding array of social programs. After all, won't the newly "entitled" bloc always vote for another government benefit program if it won't cost them anything personally?

The key point is that the US economic system as we've known it for the past 50 years is going through a sudden *disruptive change*, not a gradual evolution. The Graying Baby Boomers now see their lifestyle and pending retirement threatened. They are upset and very concerned. With a rough split of 20% hard core ideologues on both the Left and Right, the remaining 60% of America is caught in between. High anxiety over jobs and retirement is making for a volatile and combustible combination which is not likely to subside on its own. Fears of an Obama led "*cram down*" on other social issues such as immigration reform or other highly partisan legislative initiatives has heightened anxiety.

As *Peggy Noonan* has so aptly said "it is a mistake not to see something new, something raw and bitter and dangerous in the particular moment we're in" (WSJ March 27-28, 2010). Noonan goes on to urge everyone to act to lower the temperature, including the Obama administration in which the most recent actions she likens to poking a stick in a hive of already angry bees.

We might not like the current trends but our job is to figure out an investment strategy regardless of the environment we're faced with. For the past 10 years we invested in front of "globalism." Going forward, we see a new strategy of in-

vesting ahead of "*Obamism*" or an environment of Big Government and Wall Street calling the shots. Washington's objective is to increase social entitlements. Wall Street goal is to be positioned ahead of nay sweeping regulation to collect the gatekeeper's fees. This is hardly the freewheeling global capitalism of the past 10 years. So how do we do this? Our initial observations are already forming.

First, we'll favor *uber-large companies* with clout with Washington. Our holdings of *Berkshire, Cisco, GE and Microsoft* all meet these criteria. They all profit from large scale infrastructure and/or technology projects. To play the Wall Street angle to our advantage, we're investing in the *publicly traded Private Equity firms*. These are the sharpest players and are outside of Washington's direct control. We have no question they will maneuver to profit from the boondoggle bucks floating around. A third area is to start rebuilding a longer term "*hard asset*" position to protect against the prospect of a falling US dollar. This will have precious metals, industrial commodities, energy and real estate. To protect against rising interest rates, we will also need to restructure our fixed income strategies. In just the first week post Obama-care it's already apparent the global bond markets are demanding higher interest rates to finance the annual cost of healthcare for 32 million new people. Since bond prices fall when interest rates rise, now is the time to

## 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."**

reduce exposure here.

### ***The Flows Tell a Story***

The chart below shows a very interesting picture of where money had been as the financial system recovered from the 2008/2009 financial crisis. There are several interesting observations. First, even during the much ballyhooed “50% Bull Rally” investors have actually **removed** a net \$26.5 billion from U.S. stocks in 2009 and into 2010. Also note the 2009 decrease in U.S. stocks was matched almost dollar for dollar by an increase in international investing. This surge of new money can help explain why international stocks soared last year despite no real economic growth. In less than 24 months the pendulum has swung from “irrational exuberance” to “super-pessimism” with investors shunning U.S. stocks and favoring international equities. Is there any reason to expect the International stocks to fare better? We see this as a good sign to start to re-enter US equities.

<b>Estimated Net Flows \$Mil</b>	<b>Feb. 2010</b>
U.S. Stock	(3,692)
International Stock	4,634
Balanced	1,235
Taxable Bond	19,797
Municipal Bond	4,989
Alternative	2,189
Commodities	1,117
<b>Total</b>	<b>30,268</b>

But ***the real story*** is in the bond numbers. Look at the incredible flow of money into the corporate and municipal bond markets. About 85% of all the money returning from the sidelines has gone into bonds (over \$350 million of the \$377 billion). This is exactly what we predicted in 2009 and why we loaded up on bonds last year. In simple English, this flood of demand has been chasing the super high yields of last year. As “spreads narrowed” we captured huge capital gains. The incredible bond bargains we dis-

cussed last year are now fairly priced. As the flood of new money continues, there is now a red hot bond new issue market with March 2010 was the biggest month for junk bond new issues in history. Excessive rallies always end with a bust so beware of brokers bearing new bonds!

Now here are the questions we need to be asking: First, in light of the current political environment, are bonds now to risky? Even before the passage of the Obama-care bill, S&P warned the US government is at risk of losing its AAA rating. Adding another trillion or two of unfunded debt won’t help here. As the true cost of Obama-care unfolds, look for it to get priced into each monthly Treasury auction via higher interest rates. This has already started with a ¼ of 1% increase in rates in the first week after passage. Do you believe the Chinese, Japanese and OPEC fund managers actually believe the OCB budget forecasts? Our take away from all of this? The combination of falling corporate bond yields and rising Treasury rates leads to the inescapable conclusion that “***spreads are narrowing.***” This is just a fancy way of saying the risk for owning bonds is increasing and playing this game too long is just asking for disappointment.

Here are our changes and observations for the past quarter and also some of the developing trends and issues we see out there:

The market’s first objective assessments of the actual cost of adding 32 million people to the healthcare system were already reflected via the recent Treasury bond auction where rates spiked up by ¼ of 1%. This might sound small but it caused the typical 10 year bond to lose about 2% in value. It also caused home mortgages rates to rise to their highest level in 18 months. As more pencils are sharpened, the true cost of Obama care will force interest rates even higher. Hardly good news for an already fragile housing market.

Our immediate response is to reduce exposure to the risk of rising interest rates by ***decreasing the average maturity*** of our bond holdings. At the same time, we’ll

also climb higher up the credit quality ladder by reducing our junk bond holdings.

Our **Junk bond** positions did well in 1q10 with DVF up 12.9% and EAD up 4.5% for the 90 days. These both might have more room to run but when everyone else is in love with junk, we know it's time to reduce both of these positions by 50%. Let's not get greedy! Recall we also exited from PHK last fall with a very nice return.

The second leg of our bond strategy was to place another 25% into **intermediate quality corporate bonds** which had maturities of 5 to 8 years. We split this between two managers with different approaches. Both did well with credit expert Dan Fuss up 50% since last January (including 5% for the past 90 days.) However, going forward, extracting excess returns from improving credit spreads will be more difficult. Great job Dan! We still love ya, but it's time to reduce our exposure here by half.

Our other bond manager, Bill Gross focuses more on interest rate movements rather than credit spreads and has been up 18% since last January. Gross is now forecasting an extended period of slow growth and has been talking about a "**new normal**." This is a nice way of saying we will have slower long term growth now that the steroids of cheap credit have been removed from the system. Gross cites 3 factors: 1) deleveraging 2) re-regulation of the financial sector 3) de-globalization. These are all factors we've previously identified as keys to investing going forward.

"Deleveraging" means there will be less credit in the overall system which means slower overall growth. Without the grease of cheap credit to keep the gears of global commerce moving, there will be an overall contraction worldwide. This can also lead to trade wars which are starting to flare up. Finally, increased regulation of the financial services industry will also mean less credit especially for small businesses (witness the recent contraction in credit card lines) and also

the entire securitization market will be very slow to recover since the loop hole of off balance sheet debt financing is now closed. This accounted for 70% of the mortgage volume. These three factors mean "normal" growth must be slower going forward. This can help keep rates lower, but not if the base rate of U.S. Treasuries is rising.

Given our concerns over T-bill rates, one alternative is to reinvest into **shorter maturity** bonds with higher credit quality. As this strategy will never capture outsized returns, hopefully this is a shorter term holding as we evaluate the relative merits of potentially increasing positions in stocks, commodities or even returning to longer maturity bonds.

Speaking of stocks.....over the past quarter we've allocated 25% to companies with **pristine balance sheets** and exceptionally large hordes of cash. In other words, we are not buying into a typical "growth" story which focuses in on improving sales. Instead we're looking at super staying power and also dominant positions in their industries. A slow economy combined with the credit crunch could make for an exceptional period for M&A action. We envision cash strapped companies seeking stronger partners who have deep pocket. All of our cash cows have already been active in the acquisition markets and are in effect buying future earnings at a discount.

With the S&P 500 up 6%, our domestic equity strategy has worked exceptionally well. **Berkshire Hathaway** spiked from \$65 to \$82 in the quarter (up 24%); **GE** was up 22%, **Toll Brothers** was up 14% and **CSCO** up 8%. **Microsoft** was our sole loser and was down 4%.

**Berkshire's 24% gain** over the past 3 months can be partially attributed to its recent inclusion into the S&P 500 which has increased the demand for the shares as index funds and many mutual funds added the shares to their holdings. We also like Buffet's use of the last 12 months to snap up more assets especially in monopoly like businesses. In



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economy shading towards government influence / control, Buffet becoming a media cheerleader for the administration is a rational business move.

**Cisco** (up 9% for 1q10) which dominates the corporate networking and data transfer industries continues to make money almost as fast as Washington can print it. With \$40 billion of cash on hand, Cisco has also made 3 major acquisitions in the last 12 months. Additionally Cisco has increased the number of internally funded startups from 20 to 30. It believes each of these has the potential for \$1 bn of revs. We also look for CSCO to be a dominate player in the entire cloud computing revolution.

Another company well positioned to snuggle up to Big Government and also with tons of cash is **GE** (up 22% YTD). GE has been aggressive in repositioning the behemoth to important areas such as alternative energy, nuclear power and water where government influence counts. Even better, while we wait, it's paying a dividend equivalent to a 4% yield.

Over the past 10 years, the **Private Equity** firms used the era of ultra- cheap credit to acquire over thousands of companies. The real game here is to exit by foisting them onto the public via IPOs. Any strength in the stock market and an increase in the net flow of funds and the IPOs will start flying out the door. There has already been a pickup in Private Equity led IPO activity. These barracuda's are also figuring out how to grab some of the free money coming out of Washington. PSP was up 11% for the quarter and we suspect the best is yet to come. We will be adding to this position.

The company everyone loves to hate, **Microsoft** (down 4%) was the sole laggard in our domestic equity holdings. On the positive side, it's a mammoth cash cow, generating \$18 billion of free cash flow in just the last 12 months. Did we mention MSFT had a 44% return on equity and a 22% return on assets last year? It's also paying a dividend

equivalent to 1.7% which beats all the money market funds. While analysts are worried that "cloud computing" will hurt sales as application software moves from the desktop to the web, we suspect MSFT has a strategy and the resources to be player here.

When money starts to flow back into the US stocks from the sidelines, US equities could be spring loaded for gains after 2 years of cost cutting. Over the past 3 months, 65% of the S&P 500 companies exceeded earnings. While it might be early for US stocks, experience tells us that the **excess enthusiasm in the bond** markets could be a tell tale sign that now is the time to start shifting emphasis over to stocks. We'll be shifting more money to our domestic equities and raising this allocation to about 35%.

*Domestic versus International stocks?* We remain reticent to re-enter the international markets primarily because of high valuations, sluggish global growth and a global lack of credit. Our guess is that last year's rally in international stocks had more to do with global stimulus than any fundamental growth story. Let's face it, with the US consumption

engine stalled and no worldwide credit, where could the growth be coming from? We're tempted by Latin America, but we'll have to wait right now.

Will "Obamism" be good for **gold**? While all our glitter bug friends see an express train to \$2,000, we're less bullish on the short term prospects, as we see subdued inflation until the "velocity of money" increases with a hotter economy. However we agree the 2009 stimulus spending will debase the dollar long term if Washington doesn't squeeze the stimulus money out of the system before it GDP stokes up. For the short run, this seems to be the correct call as over the past 3 months gold has only gained 1.5% versus 4.5% for the S&P 500.



*Are you enjoying the ride or swimming in dangerous waters?*

With gold at \$1,100 there are *other hedges* which may offer better relative value. For example, Natural Gas is still down over 80% from the early 2008 highs. The market price is being impacted by a slow overall economy. An upturn would help here. Longer term, cheap and plentiful natural gas is a logical way to stop shipping petro-dollars to OPEC. What if Obama mandated a conversion of our commercial trucking fleet to natural gas? It might take another 2 years for Natural Gas is rally, but we like the odds of a double or triple from the current low prices more than the odds of a double for gold from here. We're taking advantage of the recent 25% price drop to increase our positions.

*Dirt* is the ultimate hard asset and investing in International real estate is another way to hedge against a falling dollar and also participate in economic growth outside the US. Witness the real estate booms in Ireland in the 90's and India more recently. When emerging countries experience real economic growth; workers' wages expand which goes to improved housing and shopping. The number of shopping malls built in India over the past 5 years is staggering. Too bad we can't ship malls from Detroit to New Delhi. Last quarter we started re-establishing a small position in international real estate with an emphasis on Latin America and Asia. The sector is still down 40% over the past 2 years and we will continue to gradually build these positions to about 2 1/2% of most accounts. While volatile, the gains here can be dramatic.

*Industrial and Agricultural commodities* are another way to hedge against a falling dollar. However, these prices have not rebounded like gold and would have to double from current levels to reach the "normal" pre bust prices. With a weak global economy and a stronger dollar, commodity prices are down slightly and a somewhat stronger dollar. Longer term, both of these conditions are likely to reverse and commodity prices should rise. We have started rebuilding our commodity positions last quarter and see this as a 3 year hold.

While beyond the scope of our managed investment accounts, we're seeing a sudden increase in people wanting to have *direct ownership in international real* estate to protect against a falling dollar and deteriorating political scenario. There can be a number of benefits to direct ownership, including the actual benefits of using a condo or house and having some assets actually outside of the United States.

Where? Most of the interest is in *Costa Rica, Panama and Argentina*. Each has its advantages, but Costa Rica is the star. Costa Rica is much closer (only 2 hours from Miami and 5 hours from New York) and has superior infrastructure including an internationally lauded healthcare system at 25% of the U.S. costs. Panama offers attractive values but appears more oriented for those looking to live in an urban high rise condo. The climate in Panama is also hotter and more humid than Costa Rica. Argentina is beautiful and cheap but the 12 hour flight from the U.S. makes it impractical for aging Boomers with grand children and /or health care concerns.

Unless your Walter Mitty is Indiana Jones, *rule out Belize, Ecuador, Guatemala, Mexico and Nicaragua* which all lack the safety and political stability most sensible retiring Boomers will require. The dirt might be "cheap" but the Rule of Law and North American level amenities are not usually included in the price. Don't drink the Kool-aid, unless you're 25 and single you can wait a decade for infrastructure.

What about *domestic real estate*? Last update we said it was still "too early for grave dancing", but a twitch in our toes says the time is approaching. However, don't anticipate buying for a dime on the

dollar. The deals just haven't been there. Last year, REITs raised \$24 billion of fresh cash last year in hopes of finding super distress values. However, with only \$5 billion actually invested. The number of properties being sold at distress prices will be much lower than originally forecast.

### Del Pacifico Gatherings

Do you know someone who wants to explore International real estate investments? Here are the upcoming "Gathering" dates at Del Pacifico in Costa Rica:

June 17-21, 2010  
August 5-8, 2010  
November 11-15, 2010

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Right now there are more vultures than cheap lunches.

**Toll Brothers** (Up 13% YTD) has been our real estate play thru residential building. Inventory levels of the 12 biggest builders has dropped from 8 years of supply to just 5 years which is triggering a race to snap up an inventory of building lots around the country. Toll should continue to profit from this trend.

Switching over to hydro, we recently exited our position in **Water** (up 5.6% YTD) related stocks primarily because the sector did not provide the defensive qualities anticipated in 2008 and doesn't have the qualities we'd expect to profit from Obamism. Additionally, the recently modified charter of the of our holding in the C&S Utility fund to now cover global infrastructure and our existing holdings in GE both provide exposure here.

Our patience has run out of steam on **Alternative Energy** (down 8.4%). Before the Obama election Alt Energy appeared to be in a great position to capture some high voltage DC currency. While even a luddite recognizes the long term need to get weaned off of OPEC oil; the combination of low natural gas prices, expanded offshore drilling and tight bank credit has added up to weak stock prices in the sector and continued negative prospects for the short term. Color us gone.

We still like the concept of Alternative Energy but just not as an investment right now. Here's a cool idea that happening already : **Bloom Energy** has come out with a commercial hydrogen fuel cell that is the size of a parking space and uses natural gas as a source fuel. 8 of these boxes are enough to

power 2,000 employees. These have a 3 year payout based on energy savings. A consumer version will be available in 10 years at a cost of \$3,000. In the long run this is bullish for gas.

Speaking of alternative energy, did you know that **wind turbines** already provide 6% of the electricity in Texas? This is said to have had a measureable effect on the price of Natural Gas in the Lone Star state. By the way, GE is now a major player here and is building a plant in South Carolina to export these to Europe.

Our shift this quarter has been to reduce the risk in our bond holdings and increase our holdings of the large cash holding companies. We see the economy gradually healing on its own, but in the environment of Obamism, the playing field is tilted in favor of very large companies. Right now it's time to stay conservatively invested but positioned in front of these trends.

Barry Strudwick  
April 1, 2010



*If the Market goes lower, we'll still be having fun!*