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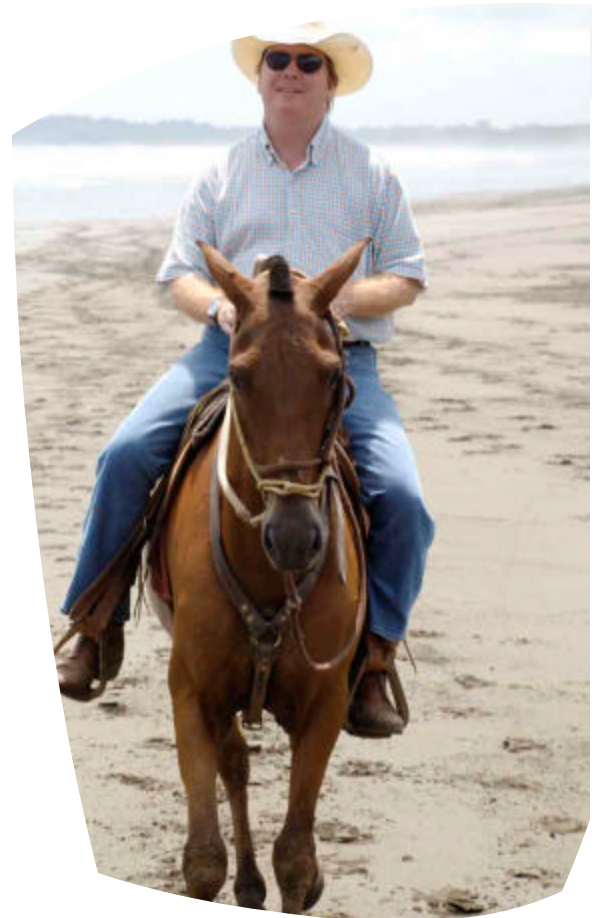
These thoughts were originally shared with our private clients as of June 30, 2010. They are now being shared, unedited, to stimulate discussion of these issues. Since then, the stock market has had a strong rally. These thoughts are considered general in nature and not specific investment advice. Please feel free to contact us and share your comments with us. – Barry Strudwick

Dawn of the Dead Blue Chips

We are now two years past the near apocalyptic global financial meltdown. Given our 24-hour attention span, this now seems like a fading nightmare. In its place is a worldwide deleveraging dubbed **"The Great Recession"** (*The GR*) which historians say is the longest and most severe downturn since the 1930's. In a world with suddenly less credit, the GR is proving to be painful especially for several generations for whom recessions were usually pronounced over before most realized they had started. But this is a real re-adjustment. Unemployment is at 10%. And, when you have to pad the numbers with Census workers, the real numbers are actually much worse. Few real new jobs are appearing and those which have emerged have little to do with the \$1 trillion spent. So where did it go? Too much went to keep state and local government workers on the payroll, which adds zilch to national productivity. Some of the gnawing anxiety is simply unrealistic expectations of our instant gratification society; but part is

also a growing apprehension that the downturn signals a permanent decline in the American Dream. Fairly or unfairly, much of this anxiety is being directed at the Obama social agenda where **Middle America** is becoming increasingly vocal about the financial impact of entitlements on their **standard of living**. The national mood has grown suddenly darker since our last communiqué. This can have important implications on investing especially if it tips us into deflation. Recent CPI increases are actually a touch too low, these needs to be watched carefully.

As we discussed before, the Lehman Brothers collapse in September 2008, caused America's economy to suffer the economic equivalent of a massive coronary. Fear was everywhere. Remember, only 18 months





ago there were whispers of our food distribution system breaking down. Rumors were rife of martial law being imposed, and FEMA getting ready to take control of cities. While this hysteria was overwrought, a look back at the shattered skyline of corporate America is a sobering reminder of the near fatal shock our system received. Take AIG, Bear Sterns, Chrysler, Citigroup, Countrywide, GM, Lehman Brothers, Merrill Lynch, and Wachovia, just to name a few. Like a bad George Romero movie, ***Dawn of the Dead Blue Chips***, these former icons are now corporate zombies wandering the streets of a deleveraged America seeking to suck the credit out of any living creature.

Today, our economic patient has been released from the ICU yet remains frail and has suffered a permanent loss of economic muscle mass. Look at the long term devastation done to the auto, banking, securities and housing industries. All were major drivers of both jobs and profits over the past decade. With

millions unemployed and 1/3 of all homeowners "under water," housing and autos cannot "lead a recovery." In their place, America needs new **sustainable** industries to emerge. This will take time. Until a trend emerges, the best and safest strategy is to focus on ideas that can still profit with the existing reality of a tight credit market. When credit conditions eventually ease, corporate bonds should get a bump. Money is still flowing out of stocks, even though profits are good. Stocks are starting to look pretty attractive. We still like cash rich companies with an appetite for acquisition. Also Energy and Tech both look attractive in the long term. If the truth be told, we're actually more optimistic than most about the potential of stocks and could increase our allocation soon. But, this would be very selective as we don't see the type of tide that can raise all boats. A number of Blue Chips are selling at P/E's of less than 10X. This is a "1/3 off sale." Rarely do prices get better but it's still a touch early to increase holdings here. Finally, when economic activity increases, **commodities** should also start to pick up and the Dollar will weaken due to inflation fears.

Going forward, life will be different as everyone adapts to a new sustainable growth rate. Off the cuff and very unscientifically, if cheap credit over-stoked GDP growth by about 1.5% annually for about 10 years, then we can guesstimate the steroids helped the US economy bulk up by an extra 15%. Now having sworn off the juice, the US economy should revert to the old long term trend line. In housing this has already largely occurred. On the business side of things, this could take several years to adjust to the lower GDP.

America's Permanent Hangover and Sour Stomach

While we are optimistic about the direction of corporate earnings, the decidedly darker mood on Main Street has the potential to dampen investment returns. Middle America appears frightened that their nest eggs are vulnerable to higher taxes. The aging Baby Boomers, within a couple of years of retirement, see Washington trying to "confiscate" their IRA accounts. Just listen and you'll hear the tapped-out retiree chorus wailing the "*The End of America As We Knew It Blues*." For the younger set, Sarah Palin has also just released "*Grizzly Mama*," a foot-stompin' (but off-key) rocker telling women to protect their family finances like a mother bear protecting her cubs. Talk show pundits warn us that we're headed the way of Japan, whose economy has been battling deflation for 20 years and whose stock market remains 75% below its 1989 peak.

Obama's Dilemma

Let's be fair, whether or not you approved of the specific steps taken in the Obama Bailout, we have escaped a trip to the Stone Age. Obama's "stimulus" spending had two purposes. **First** was to soften the crash and prevent a total collapse. Mission accomplished. **Second**, the idea was to invest in projects that would help build a long term competitive advantage for the United States. Big, Big question mark. Where did it go? With no apparent benefit from the Federal stimulus, the growth of corporate earnings will be much slower and there will be no slingshot recovery.

To this underlying fear, we can add half a dozen other Bogey-men including the latest in reality programming: the BP underwater disaster-cam showing the oil spewing on every newscast. The past 75 days has also brought us the Greece/Euro zone crisis; a mysterious “flash crash” in the stock market which lost 10% of its value in 8 minutes; and the brewing battle between Arizona and Washington over border protection.

With America teetering on the cusp of a deeper and darker stage of the deflation cycle, Obama must try to shatter this increasingly negative mood. But right now he has few options. The classic Keynesian cure of Big Government “fiscal stimulus” has already been tried. With interest rates at all time lows, the monetarist option of interest rate cuts is DOA. The third unspoken weapon in the anti-deflation arsenal is military action (think FDR and WWII.) However, this is also currently not an option with both Afghanistan and Iraq lingering on and becoming increasingly unpopular. We would hate to think of war as an economic alternative, but many feel WWII is what brought an end to the Great Depression.

If conditions deteriorate significantly, Obama will need to create optimism via a national vision that unites America in a bold and grand common quest. One option might be a national alternative energy program. This could appeal to the fiscal conservatives enough to justify additional deficit spending by reducing Arab oil imports while also creating high paying engineering and manufacturing jobs. This is a better option than starting a war south of the border.

Deflation DNA

Whose fault is deflation anyway? Political rhetoric aside, our current pickle was not manufactured over the “last eight years.” The true roots go back over 20 years to the fall of Communism and the free trade policies set up under Clinton (with strong republican support). In 2001, Bush’s post 9-11 responses to a suddenly wide open world economy, simply delayed the inevitable day of reckoning. The fact still remains that the world is making more stuff than it needs in a capitalist system; this is very bad news for the stock market. But in a world where emerging countries subsidize production, it is even worse. To understand this better, here’s a quick recap of the past 20 years and why we are where we are right now.

For the 75 years prior to the fall of the Soviet Block, our economic boycott of communism politically limited the worldwide supply of manufactured goods and natural resources. This was great for manufacturers because it meant demand for US and Western goods was always greater than supply. Healthy profit margins were also great for the stock market. This dynamic started to shift during the Clinton Administration with the passage of NAFTA and GATT. Suddenly capital was free to flow to Eastern Europe and tap into the huge supply of both low cost labor and previously constrained natural resources. Thousands of new plants were built. A few years later, the granting of WTO preferred status to China opened the flood gates of production in Asia. Western politicians assumed they were the puppeteers and would control the currents they had unleashed. Tragically, our elected politicians, who negotiated the trade treaties, thought in terms of 4 year election cycles. The Chinese negotiators thought in terms of decades or centuries. This “political attention deficit disorder” (P-ADD) caused us to get snookered big time.

For investors, NAFTA and GATT led to a wave of media spun optimism in the late 90’s. Anticipating a new Global Golden Age, Wall Street forecasted massive profits resulting in a Bull market as stocks were bid up. By 2000, the S&P 500 traded at a very hefty P/E ratio of 30X profits, nearly twice its normal valuation. But as the reality set in that global supply outstripped demand, profit projections were reduced and the market lost 45% by 2003. More importantly, this devastating loss of paper wealth had absolutely no impact on the underlying core problem. The growing flood of new merchandise from around the world continued unabated. Additionally, the internet allowed high paying engineering and tech jobs to move to lower cost countries, further diminishing US demand. Just as Ross Perot had predicted in his 1993 televised debate with Al Gore, the all important reciprocal demand for Western goods from Mexico and China failed to materialize. The result, as Perot had predicted, was “the great big sucking sound” of jobs and capital getting siphoned out of the United States. Clinton and Gore, out of office by 2000, failed to renegotiate the treaties as they had promised. They were now someone else’s problem.

The September 11, 2001 catastrophe actually provided Bush convenient camouflage for the nasty convergence of global macro-economic forces. Waving the flag, Bush’s response was to cut interest rates and stoke up U.S. consumers

to “save U.S. industry.” Few really stopped to question why 9/11 alone could have such an impact on the entire U.S. industrial complex. At the time, SWS went on the record to say the Bush Policy was a “tragically flawed strategy” and cautioned it “is not your patriotic duty” to shop the country back to salvation.

Somehow, those brainiac Washington Wonks failed to see how touching off a U.S. consumption orgy would only encourage even more manufacturing capacity. After a seven year spending spree, the wheels fell off the cart in 2008 with the global banking crisis. Now, America has paid a terrible price as decades of national savings were frittered away at Wal-Mart. Today the all important global supply/demand equation remains seriously out of whack and we’re out of cash.

When viewed this way, Obama did in fact inherit a gigantic mess from Bush’s tragically misguided efforts to avert our first bout with deflation. But in fairness, Bush inherited this from Clinton’s poorly negotiated trade policies. The bottom line here is that there is plenty of bi-partisan blame to share here from 20 years of bad decisions and a failure to our politicians to make hard decisions. More importantly, the core problem of a global supply glut remains. This is now Obama’s to fix.

Investors: Keep Playing Defense

Our current **asset allocation remains defensive**. The portfolios have approximately 45% corporate bonds, 30% US stocks, 20% commodities, precious metal and energy related shares and international stocks are less than 5% of our total. Given the uncertain period of transition, we’ll hold steady for now.

Over the past 3 months, our **bonds** performed well as the “flight to safety” from the Euro crisis has led to lower US interest rates. We reduced junk bond holdings last quarter and remain comfortable with this decision. As discussed last quarter, more money continues to flow into bonds than stocks by a large margin. About ½ our bonds or 20% of accounts are in short term bonds as a defensive position.

However, offsetting our bond gains has been **the surprising strength of the Dollar** which has nicked our “falling dollar” hedges. Currency hedges like oil, commodities and natural gas have been negatively impacted by the suddenly stronger dollar. This will reverse. Longer term trend, the depreciation of the dollar is a safe bet due to the bail out and Washington’s institutionalized excesses. Normally **deflation favors bonds** over stocks because interest rates tend to fall (good for bonds) and profit margins erode (bad for stocks.) However, most of this effect has already occurred over the last 10 years. The S&P 500 is down over 20% for the past decade. We made our big play (and profits) in bonds last year by increasing junk bond holdings which we have been decreasing this year. It’s too late in this cycle to load up on bonds if you are not there already.

The world’s largest bond manager, Bill Gross of PIMCO has coined a new expression, **“the new normal”** which translates to sustainable growth at about half the rate that we’ve seen for the past 20 years. We agree. With 10% unemployment and 1 in 3 homeowners “under water,” looking for a “consumer based economy” to be the primary engine of economic growth again is wishful thinking.

The **S&P 500** had a very rough quarter down nearly 13%. Stocks right now are very cheap. About half the Dow 30 are selling for a P/E ratio of less than 10X. The downturn this past quarter was widespread and our “cash rich” holdings gave up the gains of the first quarter. However, this appears to be more emotional than economic. We are actually warming up to U.S. stocks as corporate earnings are improving. However, we will need to see the psyche improve before increasing our exposure significantly. With respect to U.S. stocks, we will continue to focus on a few well-managed companies with strong **balance sheets** and hordes of cash. Why? If there is a “double dip,” cash rich companies can acquire good companies which are now too tired to keep swimming against the prevailing tide. There are only a handful of companies like this: **Berkshire Hathaway, Cisco Systems, GE and Johnson & Johnson.**

Brighter Days for Tech and Energy

Ten years ago in a newsletter called **“Escape From the Copper Cage”** we modestly declared the advent of what we

then called the Evernet Age. This has emerged now into what is called **cloud computing**. Going forward, cloud computing will change the way we live and work as much as air conditioning did in the 50's. Witness the future today with smart phone "apps" to watch TV or movies on your phone. **Cisco** will be one of the prime beneficiaries with the technology, the scale and the cash to dominate cloud computing for the next decade. Since the end of 2008, CSCO's cash hoard has increased by 1/3 o \$39 billion. This is the type of balance sheet we like to see.

In the past 3 months our holdings in **Natural Gas** have defied gravity and are up about 15%. This retraced about half of their paper loss year to date. This uptick in Gas is an especially pleasant surprise when compared to a loss of 13.5% for oil. Could this be the start of a long term movement of Natural Gas which remains at historic low prices relative to the price of oil? We'd like to think so.

At these prices, fueling cars and trucks with natural gas is equivalent to paying 50 cents per gallon of gasoline. With every 18 wheeler on the highway guzzling about 20,000 gallons of petrol, this represents a potential savings of \$40,000 in annual operating costs per truck. With 10 million trucks on the road, this would mean a theoretical decrease of 5 billion barrels of oil a year. Now with oil at \$70 a barrel, that would be about \$350 billion in oil savings each and every year. The cost to convert every truck in America to natural gas? About \$8 billion. That could cover the cost of the Wall Street Bail and TARP in 3 years. How's that for a cost/benefit analysis? This would be the type of Federal "stimulus" payment we could support.



Natural Gas is also a hedge against a **falling dollar**. This looks more attractive to us than the sky high precious metals. Natural Gas has dropped by 80% over the last 5 years and any increase in demand or a fall in the Dollar will benefit the price.

It was just 24 months ago that **Oil** spiked to over \$150 a barrel. But with tepid international economic growth, the slick stuff has been stuck in the \$60 to \$80 trading range. Despite a deteriorating global political scenario, Oil has actually dropped about 10% recently due to the strong dollar. The chart shows the movement of Oil (gold line) versus Natural Gas (blue line) over the past 3 months. Note Oil's fall since the Euro crisis emerged in early May. At the same time, Natural Gas over came the gravitational pull of a rising dollar and has had a strong rally.

Earlier this year we took our medicine and exited from **Alternative Energy**, only to have a bona fide energy disaster appear 45 days later! Surprisingly, the sector has failed to rally on the Gulf oil spill disaster and actually lost 15% in the quarter. We still see an opportunity here, but it's a question of Washington giving the sector a push. Will Obama seize his FDR moment and push money in this direction? We'll keep an eye on this for a time to re-enter which could be near.

We still see **Nuclear** as an important part of any long term energy solution. Right now it's cheap with the nuclear energy index still down 45% from 5 years ago. In the old math, this means these shares could gain 65% by simply getting to where they were in 2005. We like the odds of this a lot better than betting on the Dow to go from 10,000 to

15,000. Our investment in this sector includes plant construction, uranium mining as well as nuclear utilities.

Is it finally time to jump back into **Real Estate**? The housing and residential real estate related sectors will not be the engine of domestic growth for at least 2 more years. Our play here has been **Toll Brothers** (NYSE –TOL) which has a highly liquid balance sheet and should emerge from this downturn in an even better competitive position.

On the **commercial real estate** side of the equation, huge amounts of cash have been waiting on the sidelines hoping to swoop in for vulture purchases. However, these have been fewer than initially anticipated and several “opportunity” funds have actually returned investor’s money. Given the potential impact of a wave of “securitized” mortgages set to mature in 2011 and the black hole where the collateralized mortgage market used to be, who can predict what will happen here? We’ll wait for better visibility, but it does appear that the big institutional money is beginning to move again and the über-distress sales are passing.

We have started to rebuild our positions in **global commercial real estate** with an emphasis on Latin America and East Asia. Look for a rollercoaster ride here, but prices are still down about 40% from the highs two years ago. This has more upside than the US commercial sector and is also a hedge against a falling dollar. Currently, this is about 2.5% of most accounts.

Investors seeking a personal hedge against a falling dollar should consider luxury branded **resort real estate** in the Caribbean and Central America. Owning in an internationally “branded” resort provides liquidity and a good barometer of values. The “brand” can also help with generating better rental streams than buying “outside the gates.” Current prices are low and the market is just starting to heat up again. Look for good price increases down the road as future construction will be constrained by the credit crisis. This means demand is rising and supply will remain tight over the next few years.

What about **Commodities**? “The stuff that stuff is made out of” is a good barometer of both worldwide economic growth and also the U.S. monetary policy. In the last 90 days, commodities dropped about 6% reflecting the Euro fright flight which boosted the Greenback. Slower global growth also calls for weaker demand for commodities over the near term. Given both short term reasons for holding commodities are negative, we’ll take our time rebuilding these positions. These are currently less than 5% in most accounts but had reached 20% of accounts in 2007.

From the longer term **monetary angle**, *The Economist Commodities Index* was 100 in 2000 and is now 202. This means that the US dollar has effectively lost 50% of its purchasing power over the last 10 years. No wonder everyone feels poorer. This has been a 50% silent tax imposed by Congress without a vote.

Is the Bogey-man still lurking in the shadows? Mortgage rates are currently at historic lows of under 5%. If mortgage interest rates were to rise sometime in the near future, an argument can be made for a second sell off in residential housing beyond the 30% plunge already realized. How much could market values tumble? Since home mortgages are like 30 year bonds, a rough estimate is a 1% increase in mortgage rates could result in a 10% decline in the market value of the average house. Ouch! Now the truly dark side: If the average American home is 50% leveraged (and the bulk of the Average Joe’s net worth) a 1% bump in mortgage rates could result in 20% or greater reduction in the average homeowner’s net worth! Imagine how this “negative wealth effect” could impact consumer spending and hopes for any recovery.

Our short term conclusion: Politically, Washington cannot afford to allow the market mortgage rates to rise. However, longer term they cannot hold the beach ball under water forever and rates will rise to reflect the longer term depreciation of the currency. **Investment opportunity:** refinance and lock in on these hyper low rates.

Entitlement Reform at Last?

After 20 years of threats, the massive **State and Local pension crisis** is finally upon us with a vengeance. This has been amplified by a stock market that is down 20% over the past decade. Add to these two years of fierce reces-

sion and falling tax revenues. Moody's estimates the unfunded state pension liability at \$150 billion. At least 10 states (including New York, New Jersey, Connecticut, Illinois and Indiana) could be in default within 5 years. Last year Illinois borrowed \$ 3.5 billion just to cover its unfunded pension liabilities and will need to borrow another \$4 billion this year. Such funding gaps are no longer sustainable.

So **increase taxes or cut public sector benefits**? With the wage/ benefit package for public workers already 50% higher than comparable private sector workers, do you see Middle America agreeing to higher taxes for yet another bailout? The financial crisis in Greece brought this issue home to America. California alone has 15,000 retirees collecting over \$150,000 a year each. **Budget Stretcher?** If wages and benefits of public sector workers were slashed to the same level as their private sector counterparts, it would save \$330 billion a year! This pays back the TARP in 3 years!

On the national level, **Social Security**, which was once the political third rail, is now seen as the low hanging fruit of reform. Increased retirement ages and means testing are almost a given.

The Retirement Crisis Hydra has a third head: the huge **"multi-employer" or union pension** plans are also critically underfunded. There is certainly less will to put these private sector workers on the dole via bail-outs, but unions have the ear of the White House. Again, this could get ugly, but where will the money come from?

When it comes to money, **Middle America is matriarchal** and the household finances are watched over by the women who are afraid their savings and retirement plans are about to get taxed away to pay for federal entitlement programs. When viewed this way, the Tea Party phenomenon is a movement of frightened women concerned about protecting the family nest egg, not angry old men. Sarah Palin calls them the "Momma Grizzlies" who will fight to prevent higher taxes from whittling away more of their golden years dreams. This is a movement with both teeth and claws.

A shift in balance of power due to the midterm elections could spark a positive mood change. These elections are just 90 days away, but we expect any stock market move will happen before this. We will keep an eye on this.

We know these are confusing and emotionally challenging times. Please feel free to give me a call to share your insights and views.

Barry Strudwick

P.S. We also thank you for the referrals! A few more are always welcome. Let us know if any friends or colleagues might want to talk.

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