

# *The Q.T Report*

*These thoughts were originally shared with our private clients in January 2011 before the eruption in the Middle East and also Wisconsin. They are now being shared, unedited, to stimulate discussion of these issues. These thoughts are considered general in nature and not specific investment advice. Contact us with your comments—Barry Strudwick*

## ***“The Year of the Pushback”***

Even after the made for TV midyear drama of the Gulf Oil Spill and the largely ignored but more important Euro-zone Crisis, 2010 turned out to be a pretty good year as liquidity started to return to the worldwide system. Overall, we played the markets defensively by raising cash earlier in the year in the wake of the Euro-zone turmoil and adding to stocks after the Elections. We also significantly reduced our bond holdings. After all, when there are enough suckers, err... investors, in



As 2011 starts, what do we see? **“Time”**, not more Federal spending, is the missing ingredient necessary to cure what ails the US economy. For over 10 years misguided, (if even well intended), government policy over-allocated both capital and people to the real estate sector. It will take time for our self correcting markets to adjust. Only power mad politicians actually believe Washington can simply wave a magic wand over the rubble of 2008 and produce an immediate recovery.



The “Creative Destruction” of Capitalism is the true force at work right now. Over the next several years, entrepreneurs will recognize new niches, will innovate solutions and then capital will chase the potential of profits. Sooner rather than later, the cover of *People* will be toasting the world’s next *Facebook* billionaire. So, as we wait for Adam Smith’s Invisible Hand to push the pieces around the globe, the real story to watch in 2011 will be the potentially disruptive domestic and international political currents already swirling about.

Last year ended with an incredibly strong push back from the Middle Class on Washington’s spending. This could upset the status quo of both politics and finances at the state level. How this conflict plays out could have significant long term impacts on the value of the dollar, inflation and interest rates and thereby the markets. A quick review of last year can help put the prospects of 2011 into better focus.

We witnessed three very distinct phases or mood swings which could be defining a new important economic crossroads. Just as Globalism defined the prior decade, the path taken in 2011 could define the best investment strategies for the next 10 years. The right path will be bullish for America and the wrong path could doom the dollar.

By late April, the one–two punch of the BP Gulf Oil Spill and the Euro-Zone crisis buckled national confidence and the stock market plunged 13% in a matter of days. For the next three months the constant underwater video showing oil spewing from the BP well mesmerized America. Both anxiety and pessimism were rampant during the summer months as talk of a “double dip” recession was the coffee klatch conversation. By late July, the S&P 500 was down 7% from the start of the year. Middle America’s anxiety was evident when the populist gadfly Glenn Beck attracted an astounding 400,000 people to the Mall in DC.

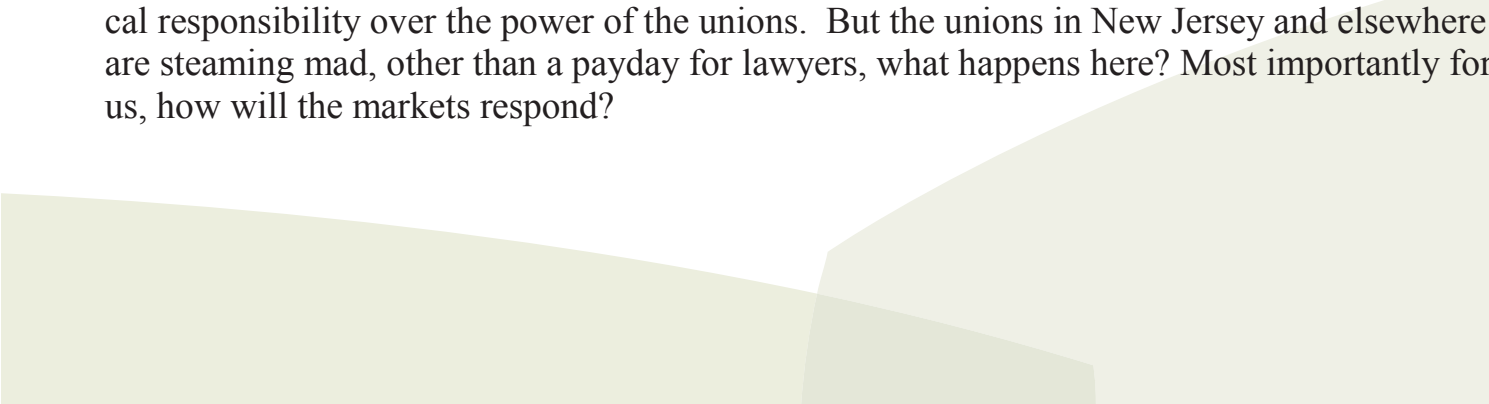
The Beck phenomena proved to be a precursor of a massive “Anti-Big Government” backlash that would topple hundreds of incumbents of both parties across the country in November. What Obama called “a shellacking” for the Democrats was also a warning to Republicans that Middle America believed spending endorsed by both parties was out of control. On the strength of a shift in the political balance of power, the national mood seemed to improve and the S&P 500 surged strongly ending up 13% for the year.

So, to recap the year, 2010 started with a short, cautious breath of relief; we then fell into a dark hole of national despair for the next 6 months until the Elections; and then with a break in the Democrats control of both Houses, the stock market rebounded on a perceived change in political direction. Meanwhile unemployment remained stuck at 9.5% and foreclosures continued to grow. So where does this leave us for 2011?

Our take away is that despite few signs of a robust recovery, America is now another year along in the healing process. However, the year end stock market rally was based largely on excess liquidity, emotions and hopes for change; not tangible evidence. Going into 2011, the ugly elephant in the room is the state and local government budget crises. This might be the year of reckoning and how this is handled (if at all) will have major impact on investment strategies.

Unlike Washington, which can literally print money, States borrow money by issuing bonds which require voter approval. The November election put the spot light on the massive unfunded state retirement liabilities all across the country. After two years of recession and lower tax collections, these numbers are mushrooming. If the voters won't allow the states to push the massive amount of new debt required onto future generations via new bond issues, how will the budgets be balanced? The only options are either raise taxes or cut benefits. And herein lies the simmering conflict.

Will a graying Middle America tolerate tax increases to pay for government retirement benefits which are significantly richer than their own? Or, will they demand that state workers share the pain of the last several years and cut their benefits? Any increase in taxes equates to a reduction or deferral of their own retirement. The retiring Baby Boomers are on a collision course with the politically powerful government unions. What will happen? Last summer European Governments were forced to make dramatic budget cuts which resulted in street riots of students and workers. We suspect similar tensions are already seething in America as local governments faced with intransigent unions are being forced to fire teachers, firefighters and policemen. These are just the early skirmishes and the bigger battles lie ahead. If state governments fail to make the necessary spending cuts or float new bonds, the result could be bankruptcy. New Jersey provides a hopeful sign as the people apparently are supporting fiscal responsibility over the power of the unions. But the unions in New Jersey and elsewhere are steaming mad, other than a payday for lawyers, what happens here? Most importantly for us, how will the markets respond?



The big battlegrounds will likely be New York and California, already a dichotomy is emerging. Andrew Cuomo is positioning New York towards spending cuts. On the other hand, California is a much tougher call. Contrary to the national trend, last year every single statewide incumbent in California was re-elected. Recently Jerry Brown announced a plan which is essentially 50% spending cuts and 50% tax increases, but is this a non-starter because of an entrenched legislature? Certainly Arnold, the Governor, had little luck during his two terms. If the legislature doesn't approve Brown's compromise plan, then his only option is to slash the budget. Could California's unions go on strike?

Will the American tax payers absorb/tolerate a Federal bailout of the Golden State? Would this open the flood gates for another 10 states that are teetering?

While in prior years we would have bet on the states pushing off the inevitable indefinitely, the retiring Baby Boomers are a new wild card in the deck. Their visions of cruising the highways and by-ways in a Winnebago are being replaced by the nightmare of part-time work as a "Welcomer" at Wal-Mart. The blogosphere is also stirring the pot with stories that Washington has secret plans to "confiscate" retirement assets under the guise of averting a national emergency. Recent actions in Hungary and Poland to nationalize private retirement assets are also contributing to this angst.

Our view here is that 2011 and 2012 will be landmark years for redefining America's will to either maintain its financial stability and economic leadership or bust the buck. Failure to act now will accelerate the decline of the dollar and be brutal on all financial markets and especially bonds. We are more hopeful than many that the entrenched interests will be pushed back this could be bullish for the US interests. However, this will be a very tough fight. As investors, determining the shifts in power here will be more important than the short term economic gyrations in a sluggish economy. "Business as usual" will have very negative long term effects. A strong "push back" on spending and a commitment to fiscal responsibility could have a surprisingly strong positive effect.

***Investment picks for 2011:*** The environment for bonds will continue to deteriorate. Stocks now offer the better opportunity even though actual signs of growth remain elusive. Also anticipate an uptick in inflation as the recovery gradually strengthens. This argues for increasing holdings of "hard assets" such as commodities and some sectors of real estate ahead of any actual economic upturn. We're neutral on the dollar overall as it could actually strengthen during the year due to actions in Europe and China. With this in mind, below is a summary of what transpired last year and our insights for what this means for our strategy in 2011:

- 1.) Throughout 2010, we decreased bond holdings by about 50% while increasing holdings of stocks and also hard assets such as commodities. Stocks are now about 60% of accounts, with another 30% allocated to commodities and other alternative holdings.
- 2.) Last year we completed our staged exit in junk bonds after a very profitable 2 year play. Some our holdings were up over 125% during this period. The mushrooming crowd of yield seekers pushed the risk premiums down too low relative to other options.
- 3.) Our more traditional bonds also did very well. Dan Fuss' fund was up 11.5% for the year and the Bill Gross' managed fund was up 8.5%. Going forward, as the bounce back from the credit crisis has been recouped; we see these types of returns as more typical. Last year, we cut these positions by 50%, but will maintain a core holding.
- 4.) This past fall, stocks were so out of favor relative to bonds that Johnson & Johnson issued new bonds at 2.7%, while its stock was yielding 3.5%. Seeing this type of imbalance we started increasing our holdings of domestic stocks to about 50% of accounts. In December, money starting to flow back into stocks which will help prices.
- 5.) Before the elections, we predicted that a power split of the House and Senate would be good for stocks and could result in a 30% rise. Since the elections, stocks have popped about 15%. We think there is more to come if the national psyche doesn't shift due to disappointment about the ability of newly elected legislators to actually get spending under control. This is a "Big If".
- 6.) It was only 3 months ago that the fear of a "double dip" recession was on all lips across America. Profits look great, but we really need to start seeing more top line revenue growth. Until then, we'll continue to favor defensive stocks with large cash hordes (Berkshire, J&J, and Cisco). Yes, in a downturn they could get hit, but they will survive no matter what and they are also positioned to play the white knight for cash strapped companies. Recall Berkshire bailed out both Goldman Sachs and GE in 2008.



- 7.) While the broadcast news sock puppets are trained to talk about housing statistics, this isn't where the profits are likely to be. Instead we'll focus on the sectors which actually are already posting great profits and accumulating cash. Cisco and Microsoft continue to accumulate cash and acquire companies. Microsoft is generating cash flow equal to 14% of its share price.
- 8.) Wall Street had another record year and some financial companies are starting to do well. Cash rich Berkshire Hathaway is the largest holder of Wells Fargo which was up 43% in the last quarter, pushing the book value of the entire portfolio up by 6%. There are rumors of Berkshire starting to pay a dividend as large acquisitions are more difficult to find.
- 9.) Our somewhat cynical strategy of investing in companies that will profit from large government spending programs also still seems solid. GE, which is very politically connected worldwide, was up 24% last year. Another holding, Cohen & Steers Global Infrastructure, had an exceptionally strong second half of last year and surged by 35 % in the last six months and ended up 11% for the year.
- 10.) We also see Merger and Acquisition activity heating up with private equity firms poised to profit. Our position here (PSP -up 19 %) with core holdings here like KKR and Blackrock should be well positioned especially if the IPO window re- opens. For example, Blackrock owns Hilton Hotels which might go public this year.
- 11.) We have very limited exposure to the US residential real estate market which we're playing through high end home builder Toll Brothers. With a cash war chest of \$1.25 billion this should allow them to purchase land today at distressed prices. Cheap land today means higher future profit margins. In the 4<sup>th</sup> quarter TOL actually posted profits of \$39 million versus prior year losses of \$133 million.
- 12.) About 10% of our accounts are in "hard assets" like industrial commodities, oil, natural gas and gold as a hedge against a falling dollar.



- 13.) An additional 10% of accounts are in energy related plays such as nuclear and exploration. Together these provide not only a currency hedge but a political buffer if things heat up in the Middle East as well.
- 14.) Gold surged 27% in 2010 as fears of a collapse of the Dollar grew and people voted with their wallets as Washington failed to rein in spending. The price of gold appears to be creating a distorted political barometer as it appears to be higher than other commodities.
- 15.) While gold was up 27% in 2010, two other Dollar denominated commodities told a different story. Oil was only up 1.5% for the year while natural gas plunged 45%. Our opinion is that Gold is overvalued and could be prone to a significant correction. On the other hand, both oil and gas should rise as the global economy gradually gains traction.
- 16.) Other Industrial and Agricultural commodities were up about 12% last year. These positions which are about 5% of most accounts should do well over time with an expanding global economy and also as a hedge against a falling Dollar.
- 17.) Improvements in both revenues and profits will start to appear later this year and we've already increased our allocation to the stock markets in anticipation. However, we'll need to sort through the differences between political and economic currents for the next several months. Real push for change will be very bullish. Staying stuck with the status quo will be very negative.
- 18.) While it's easy to predict a falling Dollar from an armchair, these are not normal times. The global financial system is fragile, especially in Europe. The crisis is still not resolved and the EU is in uncharted waters. EU bailouts could push the Dollar up in 2011 through a combination of "flight to safety" and "competitive devaluations" to boost their exports.
- 19.) Another wild card is whether China raises interest rates to slow growth which would raise the price of imports. Is this good or bad for the Dollar? Again, this is almost impossible to predict, but will have a major impact on both the Dollar and our economy.

- 20.) We still like the nuclear energy sector as an alternative investment sector. Our position NLR lagged the markets but was still up 8.25% last year. This includes uranium mining as well as nuclear oriented utilities. NLR should do better when oil prices rise either due to economic growth or political unrest. Over the longer term, we just don't see any other scalable alternative solution to our energy dependence and we don't see our relationship with the Middle East getting any better. Of the 40 nuclear plants under construction around the world, only 2 are in the United States. If Washington wants to spend money for stimulus, this would be a great place to start.
- 21.) Last year we started investing in the Oil and Gas Exploration sector, which should do well over the next several years as the global economy strengthens. Exploration stocks provide a leveraged play on the underlying commodity prices meaning they should go up more than either oil or gas. Our holdings here were up 20% last year, with most of this in the last quarter.
- 22.) Another hard asset play is through global commercial real estate which rose about 12% last year. Either a global economic recovery or a longer term falling Dollar are the factors that will boost these holdings. This is about 5% of most accounts.
- 23.) While not part of our SWS investment strategies, direct ownership of international resort real estate (condos and lots) is an alternative investment strategy for individuals to consider. This provides a direct play on the depressed real estate markets and a dollar hedge at a personal level. A popular strategy is to use pre-tax retirement dollars to purchase a resort condo inside an IRA account. This means the rental income is "tax free". Make sure that the condo is in a "branded" resort (Marriott, Hyatt, Four Seasons, etc.) which means they handle the all important rentals and also the property management. Major resort flag branding also boosts the resale price by providing a broader market, and a "good housekeeping seal of approval".

Barry Strudwick  
January 15, 2011

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.