
February 2011: Seismic Shifts
By John Goltermann, CFA, CPA

In the first month of 2011, markets experienced improving sentiment, reacted to a few new headlines and saw divergence in the price action of certain asset classes: U.S. equities are up, gold and bonds have slumped, emerging market concerns have increased and the inflation/deflation debate is front page again. If the financial press is any indicator, many people overly focus on these short-term gyrations and give them excessive importance as they relate to future possibilities. In *our* view, not much has changed except for the headlines, which *always* change. We remain focused on excessive debt, super easy monetary policy and global economic power shifts, which are factors that have *not* gone away. Maintaining focus on these bigger-picture elements will be critical to earning returns and avoiding big risks.

Inflation complicates the investment outlook

Inflationary pressures are building in key commodities – an inevitability for which our clients are already positioned. As economic activity picks up around the world, supplies of cotton, feed grains and energy have tightened and prices have risen. Our government, through statistical manipulation, maintains that there is no inflation *as an excuse to keep short-term rates punitive* – a dynamic we expect to continue.

The magnitude of the recent price increases in commodities has the potential of perturbing capital markets and causing consternation among business executives, central bankers, consumers and investors. Any government policy response could have a similar effect, although we believe strongly that *even if the Federal Reserve raises short term rates*, the Fed funds rate will remain far below the actual rate of inflation for an extremely long period of time.

Certain companies are already reacting to commodity inflation. John Anton, Anton Sport's founder, saw the price of cotton shooting up and decided to act. Last month, when his T-shirt suppliers warned about the fourth price rise in six months, he borrowed \$300,000 through his home-equity line of credit and bought more than a year's supply. Mr. Anton typically has about 30 boxes of shirts on hand at one time, but now has more than 2,500. "It just kind of clicked that

I can borrow at 2.45%, and if cotton is going to go up between 10% and 12%, why wouldn't I do this?" Mr. Anton said. Cotton prices rose 92% last year and are up 22% this year.¹

This attitude is increasingly common. Hoarding is a phenomenon that we haven't seen for over 30 years; it contributes to rising prices and *feeds on itself* as businesspeople and speculators adapt to inflationary monetary policies and try to protect their businesses and wealth from higher future prices. Rising prices are symptomatic of inflation, which is defined as an increase in the quantity of cash and credit. There is no indication hoarding will let up.

Inflation, which has been building in the emerging markets for a while, can *and will* make its way back into the western world in the form of price increases of finished goods. Markets could be volatile as investors and businesspeople adjust to this reality because *memory conditions expectations* and many remain in denial that inflation can happen again. The last period of high inflation, rising costs of capital and declining incomes – the 1970s – is a very distant memory. One has to be a student of history to adopt an effective *investment* strategy for such an environment; for our clients, long duration reserves of base metals and crude oil, as well as agricultural production will serve to protect portfolios in an inflationary environment.

Liquidity continues to influence investor sentiment

Despite obvious inflation, the Fed funds rate and the policy of quantitative easing remain unchanged. The Fed is trying to force money out of bonds (by engineering interest rates to be set at levels ridiculously below the annual increase in the cost of living) and into riskier assets. This strategy has worked. Mutual fund flows have reversed and are now starting to flow back into equities. Investor confidence has returned in the U.S.

As confidence has returned, liquidity in markets has improved. It's hard to project, however, where this liquidity will end up and which assets will see future price increases. Often, because of performance chasing and competition among money managers, liquidity first goes to bidding up assets that are on the front page and/or to businesses that appear strong *at the moment*. Examples include Amazon, Netflix, Apple, Google, Chipotle and F5 Networks. We choose to let others chase those returns (if any) and to continue with our current strategy.

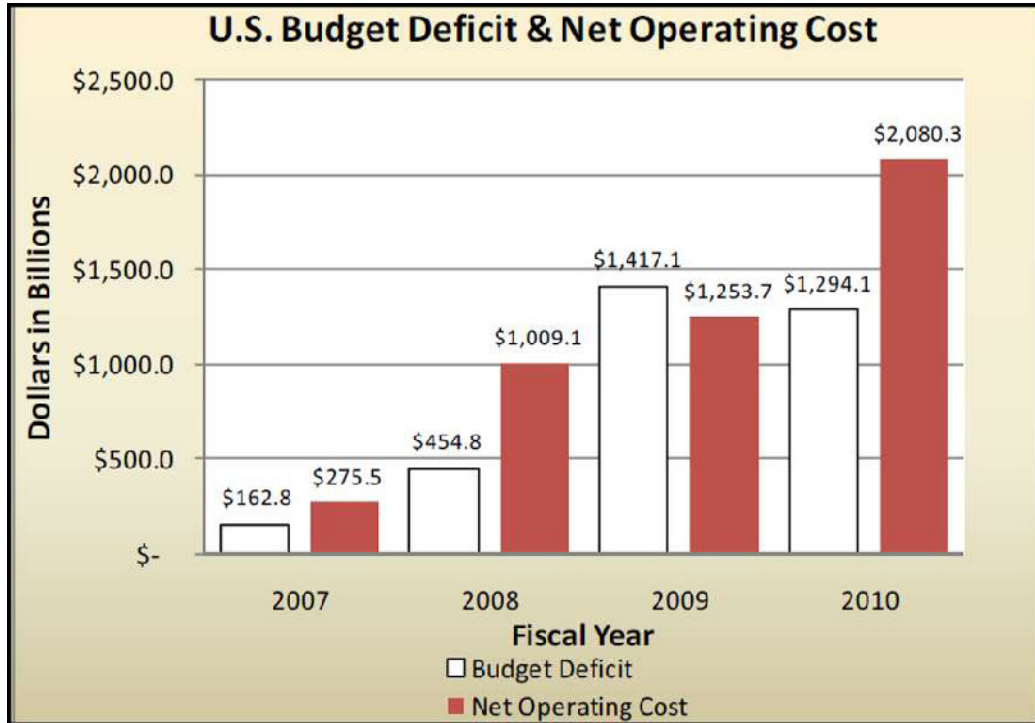
Economic recoveries built on liquidity and consumption (such as we see in the U.S.) – as opposed to education, savings and investment – can be fleeting. Businesses that rely on a strong U.S. consumer may not be sustainable. We opt instead to hold claims on businesses that, in our view, remain underappreciated and are highly valuable in a long-term global context.

¹ Source: Wall Street Journal, 2/3/2011

Leverage remains a huge problem

Although the domestic economy has recovered, it has been engineered by monetary and fiscal hyper-stimulus, which punishes savings and incentivizes borrowing (and debt levels remain at record highs), meaning that today's economic recovery is borrowed from the future.

Furthermore, high unemployment and a lack of real solutions to structural deficits are two issues that remain unresolved.



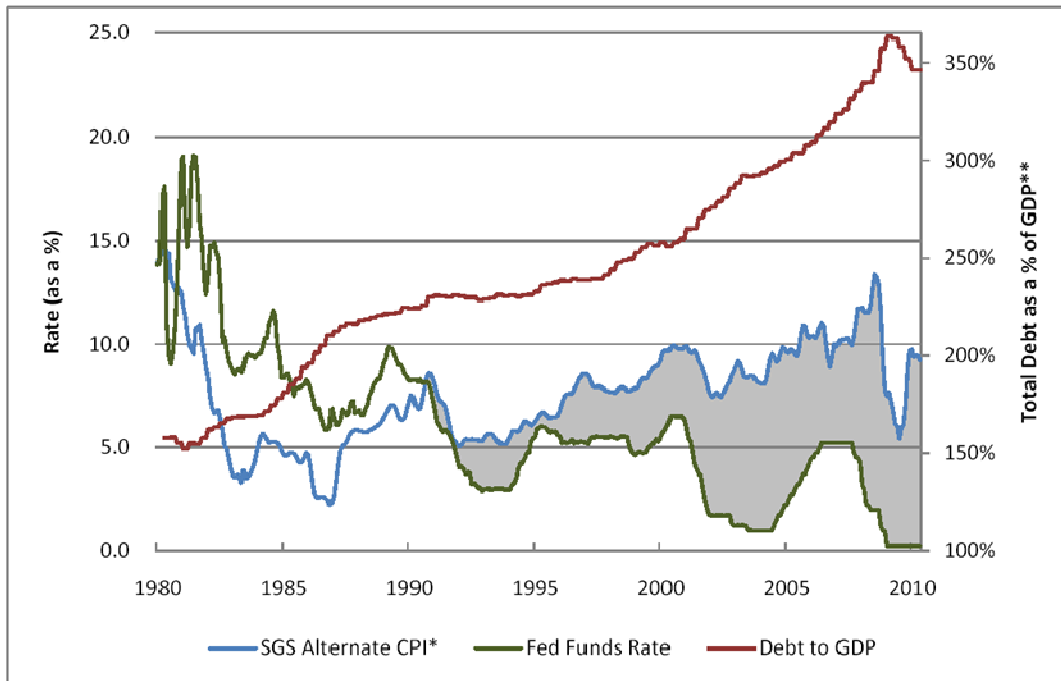
Source: Department of the Treasury

What we fear is this: in a heavily indebted economy and in order to continue funding an *obviously unsustainable \$1.5 trillion annual budget deficit*, new buyers of Treasury bonds will require much higher interest rates for loans to the U.S. government. When this happens, interest payments on government debt will spike, crowding out almost all other government expenditures. This change in mindset could happen in an extremely short period of time, such as a week, and likely will not be a process that is gradual.

When and if this happens, the government could default on domestic liabilities or renegotiate them – not by choice, but because of discipline imposed by capital markets. Therefore, Social Security, Medicare and prescription drug benefit payments are all at risk to be cut significantly.

The days of debt-fueled consumption within the U.S are probably over because we have reached debt limits at the household and government levels. As we have repeatedly written, debt grew to

excessive levels because the Fed underpriced credit to banks and other financial intermediaries for 20 years (the shaded area in the chart below represents the period when the Fed funds rate was below the actual cost of living, as measured by Shadow Government Statistics) and they merely responded to this incentive. Now that debt has reached an unsustainable level and 75 million baby boomers will retire in the next 15 years, a huge rebalancing of the global economy is about to take place. Americans will become thrifter by necessity and Asians will consume more *by ability*. This path will likely be fraught with much confusion, denial and angst, and the future relative growth rates of each economic bloc will probably differ greatly.



* Source: Shadow Government Statistics

**Source: FreeLunch.com

Continued growth and opportunities in emerging markets

Many Asian and certain Latin American economies are growing strongly but in a much more sustainable way. China, India and Brazil have notably made huge investments in research, education, equipment, infrastructure and healthcare. As we highlighted above, economic growth built on investment – as opposed to consumption and debt – stands on much stronger legs. In the shorter term, some of these countries could experience growing pains and perhaps some sort of slowing due to the dramatic impact of inflation and the fact that higher percentages of their incomes go to basic necessities. But we expect their governments to make necessary adjustments to their currencies to offset this effect.

In a recent interview in Davos, George Soros commented that inflation is beginning to be exported by China back to the U.S. in finished goods. This is a direct result of Fed policy; it took a two year lag to occur, but it can be expected to continue. China has allowed the yuan to appreciate vs. the dollar over the last 6 months (see chart below) and will likely continue to do so. This means that finished goods imported from China will cost more in dollar terms, but also that commodity prices could continue to rise – a situation for which most American consumers are ill-prepared.



Source: Bloomberg

Moreover, when commodities are delivered, they are invoiced and settled in dollars. A stronger yuan will allow Chinese citizens to purchase more resources with their earnings as their currency strengthens, meaning more dramatic scarcities across the commodities complex as we compete with 1.3 billion people *who have a stronger currency* to purchase the same amount of resources.

We are aware of the Sino-skeptics and their arguments. One thing that they forget (or neglect in their arguments), however, is that the U.S. is becoming a smaller trading partner and Asia, Europe and Latin America are becoming much larger. As such, the cottage industry of China bashing now has to find new recruits as the credibility of its existing members continues to plummet in the face of 10 years of calling it wrong.

In the early years of China's boom, "experts" predicted that the Chinese banks would implode. Instead, those banks became world leaders, displacing such supposedly reliable banks as Citigroup. Industrial & Commercial Bank of China is the biggest bank in the world and the 6th largest corporation in the *Financial Times* Global 500; Citigroup is 32nd. Many Chinese banks' balance sheets look formidable compared to those of some of the very American banks that published warnings about the coming decline of China – and they don't hold hundreds of billions of dollars in U.S. mortgage-based products.

The response of the U.S. government to China's rise (which is the rise of a *bona fide* superpower, not a petro-economy like cold war Russia) so far has been to admonish it about its currency peg and to increase promises and programs to U.S. citizens in an attempt to ameliorate the effects of declining real incomes and a loss of living standard. We believe strongly that we live on the cusp of the reversal of 500 years of wealth and capital moving from Asia to the U.S. and Europe, which brings far-reaching and multi-generational investment implications.

Policy responses

To keep asset prices up and the wealth effect in play, the Fed can continue to be counted on to pursue quantitative easing, either stealth or overt, where the Federal Reserve buys Treasuries issued by the government (or buys other assets) because foreign and domestic demand is insufficient to take up the size of the issuance without an increase in rates. The U.S. government is essentially being bailed out by the central bank because Congress lacks the political will to make hard decisions. The problem is that the further this goes, the more it is like swimming upstream against an increasingly strong current. Today's Treasury purchases necessitate even *greater* future purchases to engineer the same interest rate outcome.

Moreover, quantitative easing may not help the real economy at all. In our view, it incentivizes speculative behavior, at least in the short run. All by itself, the policy of quantitative easing makes stocks more attractive and bonds less attractive, which is the whole goal...to transfer wealth from creditors to debtors. The unfortunate consequence is that for risk-averse people who prefer savings accounts and/or dollar denominated bonds, there will be a loss of real wealth because the total return on bonds has a strong likelihood of being dwarfed by a future increase in the cost of living.

The gold market

After 10 consecutive years of outperforming stocks, gold was due for some sort of reappraisal by investors – as we witnessed in January. The chart below shows gold's price performance relative to large U.S. stocks.



Source: Marc Faber Limited, 2/1/2011

1980 to 2001 was about the worst period in history for gold, but it recovered some ground during 2001–2010. Clearly, there is a long way to go to return to the level seen in 1980.

For gold investors, it is important to be aware that many gold market participants are heavily levered, hot-money players, and as such, price moves tend to be large and fast. A recent *Financial Times* article listed the swings in speculators’ net long positions in contracts and options on gold, which were as high as 220,000 ounces last summer but had fallen to 160,000 ounces by January 11th – down 18.5% over a year earlier. That contrasted with a 19.7% gain in oil exposure, a 63.1% increase in corn and a 74.6% increase in soybeans over the same period.² In other words, commodity speculators change bets frequently and at any given time the purely speculative aspect of commodity pricing can be large or small. But over a longer term, these trading maneuvers cancel each other out and pricing is dictated by the supply and demand balance.

January’s renewal of general investor confidence and a less acrimonious political environment brought selling in gold. The agreement to extend the Bush tax cuts for another two years also removed an element of *perceived* uncertainty among investors.

² Source: Bank of Montreal

So what is the case for gold between now and the next financial crisis or the onset of worrisome *official* inflation in the OECD? For one, \$1,300 bullion didn't seem to spook jewelry buyers last year: according to the World Gold Council, they bought 1,468 tonnes in the first nine months of 2010 – up 18% over 2009. Central banks were, on balance, net *buyers* of gold last year for the first time in two decades. The IMF, which needed to sell some of its gold to help bail out the eurozone, sold 403.3 tonnes, which did not disrupt the gold market in the slightest.

But more and more gold is also coming from the cash-strapped sector of the middle class as television hucksters and coin and jewelry stores ramp up their marketing to participate in the business of buying and selling physical gold. This trend naturally evokes sneers from elites who hold it up as evidence of the sketchiness of gold as an investment. But what they always neglect to mention is that gold is doing what it has always done – serving as a readily acceptable savings vehicle that can be used at any time to buy goods and services or discharge debts.

The reason to remain invested in gold even when its price is slumping is that bad things can happen easily. This is particularly true when the Fed risks its credibility to bail out Congress and the Treasury department, as demography across most of the OECD goes from bad to worse, as debt-to-GDP ratios go from bad to worse and as the list of nuclear weapon-owning states goes from long to longer. Gold provides an effective hedge to the risks derived by these factors.

Interestingly, gold remains an unpopular asset among investors since it is “non-productive.” It's hard for us, however, to buy into the “non-productive” argument when the dollar is merely a piece of paper with green ink on it that can be produced in unlimited supply and cannot be saved or stored with any interest compensation. Gold has scarcity value and, like dollars, it is fungible.

We do not believe gold is remotely close to being in a bubble. Never have we seen a bubble in an investment, asset or sector that has such broad-based skepticism and scorn among “serious” investors. Some of these same investors were heavily involved in tech stocks during the late 90s and residential real estate during 2000 to 2007. We don't see them in the gold market today. While gold may underperform for a while, there is nothing to suggest that the recent price action represents a permanent reversal. When gold sees the same level of panic buying by institutional investors that tech stocks experienced in the late 90s because investment firms were failing outright for *not* loading up on tech stocks, *then* we will be in bubble. We're not there yet.

Final thoughts

Sentiment shifts and large swings in asset prices create opportunities for investors with a long-term focus. The high level of myopic decision-making among professional investors from performance competition and a pervasive under-appreciation for the change in global power also creates opportunities. We are concerned that the recent improvement in confidence is being

driven by liquidity borrowed from the future, which may not last. We want to own high-quality assets that benefit from improved living standards in developing countries and to avoid too much exposure to investments tied to robust consumption in the U.S. We also wish to protect our clients as private sector deleveraging continues, but include a reasonable allocation to assets that benefit from an environment of increasing food and fuel inflation.

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