

May 2011: Markets' Risk Reappraisal

By John Goltermann, CFA CPA

Several recent events and news releases have caused a risk reappraisal in the markets, portfolio rebalancings and a sell-off in the commodity complex. First we got the news about Osama bin Laden, and then healthy payroll numbers were reported across the U.S. and Canada. Both of these items halted the most recent decline in the dollar. These past weeks also saw a 38% hike in the initial margin requirements for silver futures contracts (in three increases over the course of a week) followed-on by margin hikes in various energy products, which caused liquidation across the commodity sphere because speculators and funds suddenly had to pledge more collateral. Given the continued strong crosscurrents within economies and financial markets, these downward movements are expected and normal.

This pickup in market volatility has occurred amidst a period of seasonal weakness, a resurfacing of the European debt crisis and a return to risk aversion as commodity inflation heats up. However, we expect continued government interference in financial markets in the form of the Federal Reserve's low interest rate policy, rule changes from Congress and regulators and perhaps QE3, depending on housing and stock prices in the next few months.

The opposing interests of public and private sector constituents and the effect of a highly charged political environment makes it very difficult to project near-term economic and financial market outcomes. The private sector wants lower taxes and less regulation, and the public sector wants larger benefits and more controls on excesses. Neither desire is wrong, but we can't have it all. From an investment strategy standpoint, it is difficult to allocate capital in an environment where fiscal restraint is needed, but where government spending makes up 25% of U.S. GDP, where 33% of income is from government payouts of various forms and where 42 million people are on food stamps.

The Fed is doing its best to weaken the dollar so that debtors can pay back their debts more easily, but this debasement has thus far not improved home prices. Instead, it is showing up in higher food and fuel prices, which causes pain among lower and middle income earners.

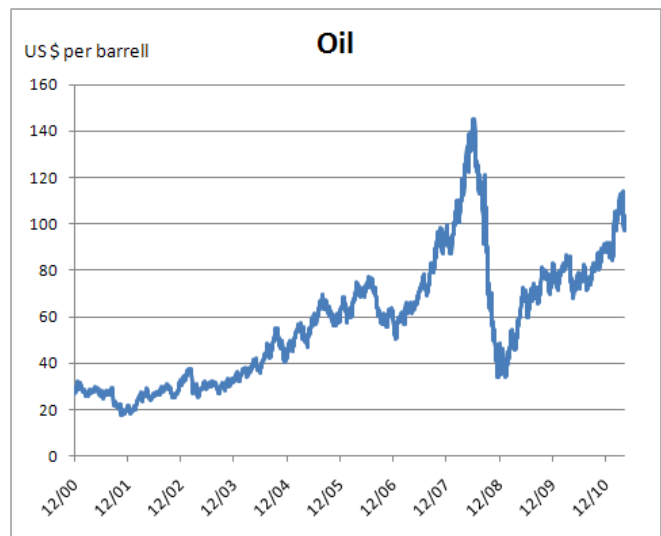
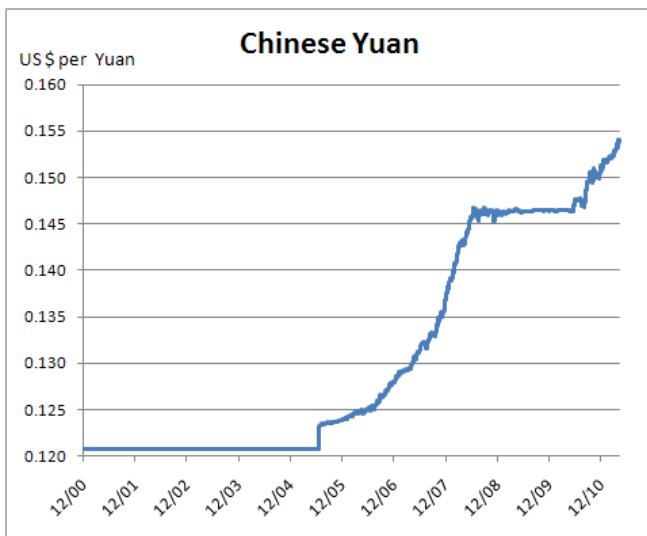
The latest upset in commodity markets that shook out some leveraged players brought the requisite ululations from television pundits that "the commodity bubble is over." Many of these pundits, however, fail to make the link between monetary and fiscal policy and commodity price

action and merely see dramatic price increases in *anything* as another bubble. We see it differently.

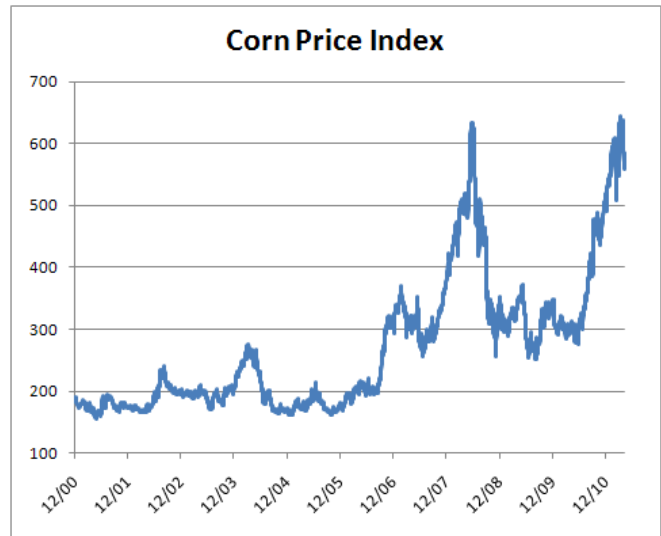
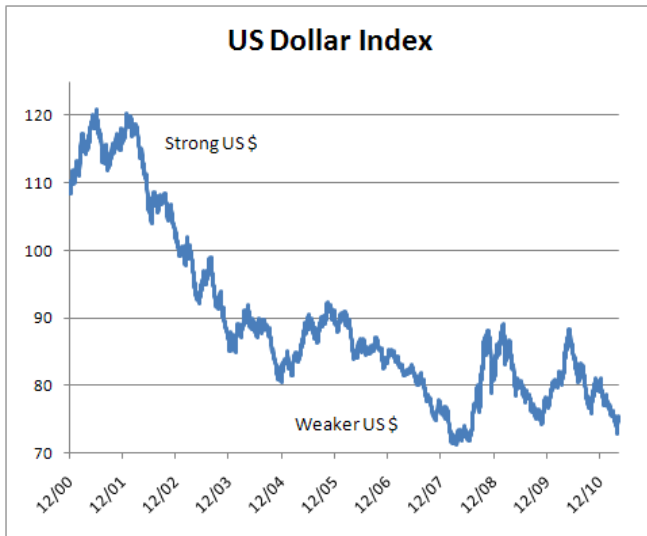
Bubbles, by their very nature, are unsustainable. They are fueled by a mania, driven by dubious assumptions and wildly one-sided views. We don't see this kind of froth in the resource industry. Instead, we see scarcities and strong global demand across various commodities, a government keeping the cost of credit artificially low to stimulate demand (and debase the currency in which commodities are purchased) and a high level of skepticism in the investment community toward owning any resource producers – *and even skepticism among certain producers themselves*.

However, because leveraged participants dominate commodity trading, prices are volatile and susceptible to dramatic swings. Risk aversion and deflationary impulses are likely to occur periodically as we move into an environment of stagflation (high unemployment, slow growth and rising prices). When we speak with clients, business associates and other investment managers, we continue to hear that prices of many finished goods (such as apparel) will increase due to higher input costs – and that these price hikes are expected to be in the 10% range over the coming year. Even if the Federal Reserve raises the Fed Funds rate, it is woefully behind in tightening the cost of credit to anything approaching the annual increase in the cost of living.

The charts below show the effects of a highly accommodative Fed policy: significant appreciation in oil prices, food prices, etc., and decline in the dollar vs. myriad currencies (many of which are also kept suppressed by their issuing central bank) as dollar liquidity has to go somewhere.¹



¹ Source: Bloomberg



The Fed’s zero-rate policy is a manifestation of its attempt to rescue banks (both traditional and “shadow”) from their past excesses. If these banks can effectively borrow from the Fed for free and re-lend or reinvest the proceeds to earn a “spread,” they eventually will be re-capitalized and their bad loans can be written down.

But in our view, current interest rate policy is simply another form of bailout of Wall Street that transferred the burden of bad debts from financial institutions’ shareholders and bondholders to future taxpayers and all citizens in the form of higher prices. When house prices began to decline from unsustainable levels (making lending institutions insolvent in the process), Treasury Secretary Henry Paulson, a former Goldman Sachs CEO, lobbied Congress for this bad debt transfer and it was granted. Surprisingly, no one so far has been held accountable.

Some argue that allowing the insolvencies of Wall Street institutions to run their course would have brought a much more painful economic environment. While this may be true, we’re not sure this would have been a bad tradeoff for the possibility of preserving the integrity of the financial system, disallowing taxpayer subsidization of bad behavior, rewarding smaller institutions that played straight, paving the way for much needed financial sector reforms and, finally, having a stronger base upon which to grow going forward.

Instead, Congress authorized the bailout and TARP, the Federal Reserve dropped rates to zero and banks began operating in an environment of make-believe (with the Financial Accounting Standards Board changing U.S. Generally Accepted Accounting Principles at the behest of Congress). Essentially, a conscious decision was made at the highest levels of Washington to impose the cost of the excess on every citizen (the innocent along with the culpable) instead of on just those who funded the ridiculous risks that financial institutions had taken on.

Because of past excesses, pain will likely continue to be dispensed into the economy – it’s just a question of in what form and how long it will take to run its course. Deflationists such as Robert

Prechter and Gary Shilling believe the pain will come in the form of much lower asset prices (i.e., stock and real estate prices). While this is certainly possible, our view is that pain will more likely come in the form of declining *real* income and wealth because cost of living increases can't be recouped in the bond or money markets due to monetary policy. Either way, *in real terms* the outcome will be similar for those not positioned properly: a loss of living standards.

Those who try to protect themselves by holding too many dollar deposits and Treasuries may not fully appreciate the risk of doing so because the dollar is something that many people take for granted. If one believes the Consumer Price Index's calculation is approximately correct, then the value of a dollar has been relatively stable over the last decade. However, because the dollar has no monetary anchor such as gold and/or silver to keep its proliferation in check, when we compare the *relative* prices of things the dollar's value begins to appear less stable.

For example, let's take house prices and contrast them with the cost of gasoline. In February of 2011, the median U.S. home price was \$207,700, which was approximately the same price as it was in November 2003 (\$207,100). During that period, our government pulled out all the stops to facilitate credit expansion and incentivize home purchases. Moreover, it looked the other way at regulating Wall Street's securitizations, its sales practices of dubious loan packages and the unchecked balance sheet expansion of our leading financial institutions.

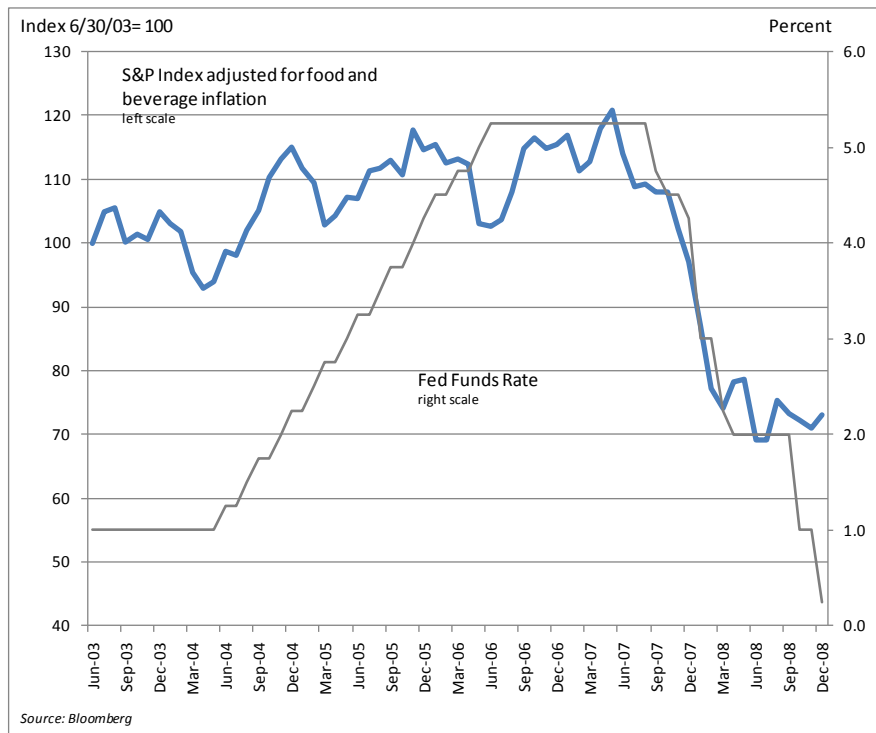
During this same period, gasoline prices moved from \$1.49 (November 2003) to \$3.59 (February 2011).² This means the median home was worth 139,000 gallons of gas in 2003, but only 57,850 gallons of gas in 2011. Some (including Obermeyer Asset Management) see that as a loss of real wealth. Why? Because homes, a major component of people's wealth, lost value in gasoline terms, and gasoline is a continuous input to most people's standard of living.

Let's take another example: after the dot-com implosion in early 2000, the Federal Reserve adopted ultra-expansionary monetary policy (by dropping the Fed funds rate to 1%) to prop up asset prices and encourage credit creation by Wall Street. As a result, the stock market traded up significantly between mid-2003 and mid-2008 (in dollar terms). However, in terms of food prices, the S&P traded down during this same period (see chart on the next page). The net effect of central bank intervention is often to distort rather than to improve. Some people benefit and some people lose. We would argue that when speculators benefit at the expense of the risk-averse, the Federal Reserve's policies should be reconsidered.

² Source: EIA, U.S. Unleaded All Formulations Retail Gasoline

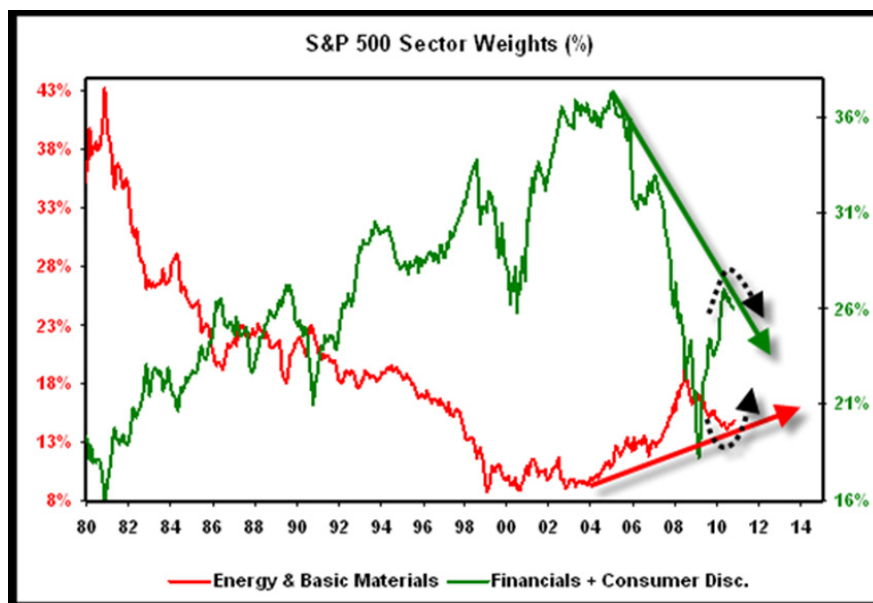
S&P 500 Index Adjusted for Food and Beverage Inflation

June 2003 through December 2008



The complicating factor from an investment strategy standpoint is that it is difficult to project what central bankers will think and say. No longer can we judge investments purely on their merits. Instead, we must now also judge how they will hold up in real terms under consistently inflationary monetary policy. Inflation is not conducive to an environment of expanding P/E ratios. To the contrary, it forces P/E ratios to contract because rapidly rising replacement costs of fixed assets and inventory mean that depreciation and costs of goods sold (especially under FIFO) are understated on the income statement. The market adjustment can be for stock prices to stay even or decline, or increase at a slower rate than the increase in booked profit. It's a subtlety, but an important one.

We expect the relative weights of the financial sector and the energy sector within the S&P to continue to move toward their historical mean (i.e., the former smaller and latter larger – see chart on the next page). However, because of debt deflation and government attempts to offset its painful effects through monetization, we expect higher levels of market volatility in the future – a paradigm to which those who wish to protect themselves from a long-term dollar decline will have to get accustomed.



Source: Chris Puplava, www.financialsense.com

When policymakers try to manipulate asset markets, currencies and debts through policy, they still won't be able to stop investors' natural inclination to protect themselves by owning things they will need in the future (e.g., commodities) and hedge themselves from the effect of dollar debasement. In our view, expansionary monetary and fiscal policies will continue because they are the most politically expedient.

But one unfortunate result of debt monetization (quantitative easing) is that as long as the Federal Reserve continues to buy Treasuries it totally eliminates the need for any fiscal discipline whatsoever. We don't know how that situation will end, therefore we have a duty to hold positions in precious metals despite their price volatility.

At the moment, our foreign trading partners' central banks are tightening credit to slow their economies, which has caused some underperformance of foreign stocks as well as commodity stocks year-to-date. Indeed, whenever we see big news items and substantial price action (such as those outlined in the beginning of this piece), we review our positioning and consider whether our strategy remains on course. But given political interests, continued government intervention in the financial markets and mounting inflation risks, we remain comfortable that our current strategy is sound. While some investments will not work out as anticipated, we feel confident that our clients' standard of living will be protected over the long run.

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels. Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.