

November 2009: Page 16 Stories

(Updated 11/10/09)

We have always strongly recommended to clients that they never invest on the basis of a headline or a Page 1 story. Instead, we point them towards Page 16 stories that are *on their way to becoming Page 1 stories*.

Unfortunately, many Page 16 stories these days are unpleasant and have negative implications for domestic investments. The U.S. economy faces significant challenges, making investors wary of purchasing equities and other riskier assets; however, cash, Treasuries, and dollar deposits could be the most vulnerable in real terms to a weakened U.S. currency. Congress, the Treasury and the Federal Reserve are doing their level best to devalue the purchasing power of dollars to support our debts. While the devaluation will not happen overnight, the end result will likely be a rising cost of living for Americans and our standards of living, on average, will decline. Further, price increases will show up first in things we *need* like food, energy and health care, as opposed to things we simply *want* like flat panel TVs, luxury automobiles, and designer handbags.

As we mentioned on our recent conference call, the U.S. is at an inflection point in terms of its position relative to the rest of the world. Global power continues to shift toward the nearly 3 billion people in China, India, and Brazil – people who are not over-leveraged, are not challenged by demographic decline, and who are experiencing huge improvements in productivity, infrastructure, education, and healthcare. These populations also have large pools of labor and tradable commodities for the rest of the world. Further, their governments do not fund Cash-for-Clunkers programs (which edmunds.com estimated cost taxpayers \$24,000 per vehicle sold) with future tax revenues in a desperate attempt to keep labor unions busy.

It is a problem that the United States government now has the largest debt-to-GDP ratio since World War II (a time when debt was actually needed to overthrow an ambitious, cancerous regime bent on taking over the world). Today's debt has been taken on to replace the debt that *used* to be carried by financial institutions that no longer have lending capacity. That our currency has held up so well in the face of this, given the weakened state of our economy and the potential implications of government policy, is fairly miraculous – but likely not sustainable. The recent price action in gold makes it look like gold is increasing in value, *but it is not gold that is increasing in value, it is confidence in the dollar (and other assorted monetary and financial assets) as a store of value that is waning*. Investment positions that help offset this effect have become necessary.

Over-indebted nations usually do not have a strong currency for long. As we learned from Nassim Taleb, the past does not hold predictive value, so just because our currency has been strong, does not mean it will *continue* to be strong. This may be the beginning of the end of Americans living the Life of Riley, but most people don't know it yet.

One recent page 16 story (appearing in the Wall Street Journal) reports that suicide figures in the U.S. military are increasing, suggesting that our troops are fatigued and that the military is stretched thin. Seven years of continuous warfare and an upcoming surge in Afghanistan makes it unlikely that the U.S. could take on another major campaign if needed. Historically, our military superiority helped support the dollar as the world's reserve currency. But that superiority may be on the wane.

Worryingly, political, military, and economic power shifts tend to occur in tandem. As Niall Ferguson observes, China is building up and upgrading its navy, which will eventually challenge U.S. hegemony in the Pacific. In a recent presentation, Niall also projected that China will be a net seller of Treasuries by the middle of next year because they are pouring so much money into commodities and resource development. This is yet another headwind to the dollar as the world's reserve currency and investors need to be well-positioned for the fallout, when it comes.

Another challenge to the U.S. military's hegemony is its dependence on energy to operate; the U.S. imports two-thirds of its crude oil needs, making the economy vulnerable to supply shocks. We have repeatedly brought up the crude oil supply situation because its importance cannot be understated. It is *critical* to our economy functioning properly as 97% of the transportation sector runs off of petroleum products. Further, the decline of almost every major oil-producing field around the world means there could easily be another shock coming if global economic activity continues to pick up (and it doesn't have to pick up in the U.S. to cause another price shock).

Illustrative of the problem, Exxon claims a 15.3 year reserve life (oil and gas reserves divided by the production rate). If you take out the reserves in Russia and Venezuela, countries that are not afraid to expropriate assets, you get down to about 12 years. If you take out the effect of partnership sharing arrangements that grant increasing royalties to host countries based on increasing oil prices (agreements made before 2003 when oil was under \$30 a barrel and Exxon's CEO said that it would never go above \$35 on a sustained basis), then the reserve life goes to about 11 years. One must then adjust for the financial alchemy that allows for the accounting conversion of natural gas to BOE (barrels of oil equivalent) which uses BTUs instead of dollars. Per this scientific conversion, one barrel of oil equals 6 mcf of natural gas, but in dollar terms one barrel of oil is the current equivalent of 16 mcf of natural gas (and gas has different applications than oil).

Exxon has about half its energy reserves in natural gas. The gas reserves are really only about 2.1 years ($6/16 \times 5.5$ years). This means that the useful life of Exxon's reserves are 7.6 years ($5.5 + 2.1$ years) at current production rates. With oil production becoming more and more

expensive to replace, *this is a problem* for Exxon, our largest domestic supplier. And from a macro perspective, this is a major problem! However, when taking a global perspective, this presents compelling opportunities; for example, it's a tailwind for oil sand assets in the Western Canada Sedimentary Basin.

Investors generally hear very little about these types of page 16 stories in the financial press. Instead, commentators and interviewers on CNBC fixate on the U.S. employment situation report, Intel's earnings announcements, and the stock market internals. We relay this information not to ruin your day, but instead to highlight the Page 16 stories that we feel may have a significant impact on investment outcomes. Understanding these global trends before they make it to Page 1 is critical to one's financial well-being. Because the future is so uncertain, we have to be cognizant of *where* future problems are likely to show up. Without doing so would be like trying to drive down the interstate with a blindfold on.

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