

## October 2009: The Elephant in the Room

September has often proven to be a difficult month. Not this year.

With the U.S. stock market up by more than 50% since March, many investors seem to be saying that the recession is yesterday's story and the next bull market has begun. While this view has been confirmed by major indicators such as ISM, Leading Economic Indicators, etc., it is not just stocks that are rising: so are foreclosures, unemployment, bankruptcies, bank failures, and government deficits at all levels.

This month we update some of the cautionary themes we have discussed in earlier newsletters and conference calls – against a backdrop of euphoric stock markets, an increasingly bullish economic consensus, and a dramatic shift in voters' views on the financial and economic implications of our government's policies.

Every week, we read analyses from strategists and economists comparing this recession to its predecessors all the way back to the Great Depression that use the implicit assumption that the world will largely look and behave the same way as it has for the last 75 years. Yes, each downturn is unique in some way, but the unstated rule is that the current state of the U.S. and OECD economies can be best understood by evaluating how they behaved at past turning points.

In our view, this recession is unlike any other since the onset of the industrial revolution in two important ways:

1. It is the first to hit North America and Europe where an aging demographic is a key feature – and none of the policymakers or the elite economic forecasters even mention this.
2. It is the first in which the continued strength of the economies of China, India and East Asia is widely recognized as the condition precedent to a global recovery.

These unprecedented factors make forecasting the strength and shape of the U.S. and European recoveries unusually difficult. Policymakers within the OECD nations are resorting to remedies based on Keynesian economics and Friedmanesque monetarism that *should* have been used to prevent or end the Great Depression, and *have* been used in subsequent recessions with successful results.

But with a major shift in the global balance of power away from the U.S. and Europe to emerging economies – combined with demographic decay and rising concern about Congress' ambitious programs – we worry that *if* the recovery falters, it will be difficult for the administration to rally public support for new stimulus or bailout legislation. There is heightened risk that global investors' appraisals of the relative attractiveness of U.S. assets could deteriorate

given our huge government borrowing needs and President Obama's and Congress' declining approval ratings. This could challenge America's ability to finance its coming decade of deficits.

A huge factor in last year's financial debacle is a multi-decade collapse in birth rates in the industrialized world. In the OECD, fertility rates have declined dramatically from 2.7 to 1.6 children per woman since 1970. By 2004, the fertility rate was below its replacement level of 2.1 in all OECD countries except Mexico and Turkey. In the U.S., the fertility rate is right at its replacement level of 2.1.<sup>1</sup>

The bad news is that the ratio of new twenty-somethings to new seventy-somethings will continue its long decline – a decided drag on the future. This not only affects the homebuilding industry, but will also be a fundamental reason why U.S. GDP growth in each new cycle will probably be constrained by the cost of government benefits for the elderly, declining consumerism, and increasing shortages of experienced skilled labor.

This trend, combined with the prospects of increased taxation and a higher cost of doing business in the United States from potential new regulation (e.g., cap and trade, health care reform, new financial regulations), could cause capital to flow to other areas of the world that potentially offer higher returns with less risk.

Investors' preoccupation with the outlook for the U.S. economy could mean missing the reality of where the world's economic power is heading. Yes, the U.S. remains the biggest economy in the world, but it is also the only huge economy in which consumer activity is 70% of GDP—at a time when consumer debt is roughly twice the level of consumer income. The evident reduction in consumers' willingness to take on more debt means that thrift threatens the prospect of a powerful domestic recovery.

The night-and-day contrast between the performance of the U.S. and Chinese economies is starting to attract the attention it deserves. As the August 24<sup>th</sup> *New York Times* quoted Neal Soss, chief economist for Credit Suisse, “The economic center of gravity has been shifting for some time, but this recession marks a turning point. It's Asia that's lifting the world, rather than the U.S., and that's never happened before.”

The article continued:

The United States is also being shoved aside as the make-or-break customer for export-driven nations like Germany and Japan. China overtook the United States as Japan's leading trading partner in the first half of 2009, while in Europe manufacturers are looking east instead of west...Deutsche Bank released a report titled 'Eurozone Q2 GDP: Made in China?' French exports to China and other East Asian economies rose 18.7% in the second quarter...a sharp turnaround from the 16.2% drop in the previous quarter.

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<sup>1</sup> Source: OECD.

It concludes with a quote from Simon Johnson, formerly of the IMF: “It reflects how the world is changing, and economic power does translate, of course, into political power.”

What all this means is that because the U.S. government is desperate to boost asset markets and economic activity, it will continue to provide sustained doses of liquidity to financial markets in the form of fiscal deficits and zero percent interest rates. All this liquidity will ultimately end up where investors perceive the highest returns.

We believe this capital will migrate to capacity-constrained industries such as resource producers as investors seek protection from inflation. And, given the global shift in economic power, we believe capital will flow to companies that participate in economic improvements in Asia.

There of course are arguments against our perspective:

- Theory says that with all the monetary creation, bonds markets should collapse and interest rates should soar. Since rates remain low, monetary creation is not a problem;
- Real estate, since you can't make any more land, is a better inflation hedge than commodities;
- Rates on inflation index bonds have gone nowhere, signaling there is no inflation in sight;
- Commodity consumption is falling everywhere except Asia where their economies are all dependent on exports to the U.S. and Europe, so without a recovery in the OECD, raw material prices will fall to new lows and their economies will collapse; and
- There is no other currency to take the dollar's place. It will always be the world's reserve currency and the ultimate store of value.

Our responses are:

- The current flood of liquidity from central banks makes the excess monetary creation in the 1970s look absolutely miserly. Despite the assurances of Ben Bernanke, investors who look at a \$9 trillion U.S. deficit projection (which, by the way, assumes an optimistic 3% GDP growth and only a 1% increase in interest rates over that period) would be wise to hedge themselves against inflation with resource investments.
- Real estate filled the inflation hedge function in earlier cycles, but that was before people could get 100% financing, artificially boosting real estate values into the stratosphere and before the demographic trend conspired to keep a lid on demand. Moreover, Dennis Gartman cited research reporting that says “15.2 million of American mortgages or just over 32% of all mortgaged properties were upside down as of June 30<sup>th</sup>.”<sup>2</sup> The pricking of the real estate bubble has likely discredited residential real estate as an inflation hedge for years to come.
- Long-term Treasury yields are super-low because of the Fed's purchases and the continued willingness of Asian economies to maintain currency relationships with the dollar. Also, given concerns of ballooning U.S. deficits, global investors may decide a

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<sup>2</sup> Source: *The Gartman Letter*, August 24, 2009.

different long-term position makes sense. As for TIPS, they are dollar-denominated, so not much meaning can be extrapolated by their recent price action. Moreover, like the fox guarding the henhouse, the index rate they adjust from is calculated by the government itself.

- While commodity prices are indeed a function of supply and demand, every major oil producing field around the world is in decline at a time when oil consumption per capita in the world's developing (and strongest) economies remains a fraction of what consumption is in the OECD. And increased crude oil consumption demand correlates strongly with rising living standards.
- In addition, China has serious drought problems and is buying U.S. soybeans like they're going out of style. This, along with other evidence of strain on global grain supplies, causes us to be concerned about a potential global food crisis.

A logical question, having been chastened by the collapse in stocks and commodity markets last year, is shouldn't investors avoid positioning for global growth in the future since this strategy did not work in 2008? The answer is 'no'; it is important to recognize that last year's commodity collapse was not caused by problems with the issuing companies of commodity stocks or excessive speculation by investors. Commodity prices sank because of massive withdrawal of liquidity due to the global credit crisis.

Prior to the collapse, there were real shortages in real commodities; and since many capital investments in these sectors have been scuttled, we could see real scarcities again soon. This, along with continuing headwinds to the U.S. economy, increased fiscal and monetary stimulus and a shift in the balance of global economic power, means caution combined with responsible opportunism is the best course for the foreseeable future.

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.