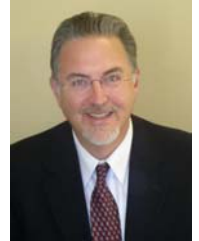


# MATRIX

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## WEALTH MANAGEMENT

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### **The Economy**

Two and a half years after the financial crash of October 2008 and two years after the official end of the U.S. recession, it is clear that none of the underlying problems that plunged the world economy are faltering. Growth rates are slowing in most of the world, and the European financial system is once again teetering on the edge of the abyss. Super-low interest rates haven't done what they usually do after a recession; they haven't ignited economic growth or revived the home market or persuaded consumers to spend freely again.

Job creation is weaker than at any time at this point in a recovery, even weaker than after the Great Depression. Instead, ultra-low rates are hurting retirees and other savers. Savings accounts, on average, are yielding 0.15%, 1-year CD's 1.15% and even 5-year Treasury notes yield only 1%.

The world economic crisis was precipitated by an orgy of speculation, in which the boundary between financial wheeling and dealing and outright criminality was largely effaced. Yet the unswerving focus of the corrupt politicians in Europe and the U.S. from the outset has been to protect the wealth of the financial aristocracy. To this end, state treasuries were plundered to cover the gambling debts of the bankers. The multi-trillion dollar bank bailouts inaugurated the greatest transfer of wealth in human history from the bottom to the top.

After enduring 11-1/2 years of a secular bear market, most retail investors seem to be abandoning Wall Street and buying bonds or Gold and Silver. Nowadays, 60-70% of the trading volume on the NYSE and NASDAQ is handled by high-frequency trading (HFT) computer cowboys. The lightning fast activities of HFT operators has led to wild and erratic swings in the marketplace, and has turned-off the general public from investing, seeing Wall Street as nothing more than a high stakes gambling casino.

The extraordinarily insightful and brilliant John Hussman recently wrote a similar theme (he is a 'must read' for me). Hussman said:

“The global economy is at a crossroad that demands a decision – who will our leaders defend? One choice is to defend bondholders – existing owners of mismanaged banks, unserviceable peripheral European debt, and lenders who misallocated capital by reaching for yield and fees by making mortgage loans to anyone with a pulse. Defending bondholders will require forced austerity in government spending of already depressed economies, continued monetary distortions, and the use of public funds to recapitalize poor stewards of capital. It will do nothing for job creation, foreclosure reduction, or economic recovery.”

The alternative is to defend the public by focusing on the reduction of unserviceable debt burdens. This requires restructuring mortgages and peripheral sovereign debt, recognizing that most financial institutions have more than enough shareholder capital and debt to *their own* bondholders to absorb losses without hurting customers or counterparties, but also recognizing that properly restructuring debt will wipe out many existing holders of mismanaged financials and will require a transfer of ownership and recapitalization by better stewards. That alternative also requires fiscal policy that couples the willingness to accept larger deficits in the near term with significant changes in the trajectory of long-term spending.

In game theory, there is a concept known as 'Nash equilibrium' (following the work of John Nash). The key feature is that the strategy of each player is optimal, given the strategy chosen by the other players. For example, 'I drive on the right / you drive on the right' is a Nash equilibrium, and so is 'I drive on the left / you drive on the left.' Other choices are fatal.

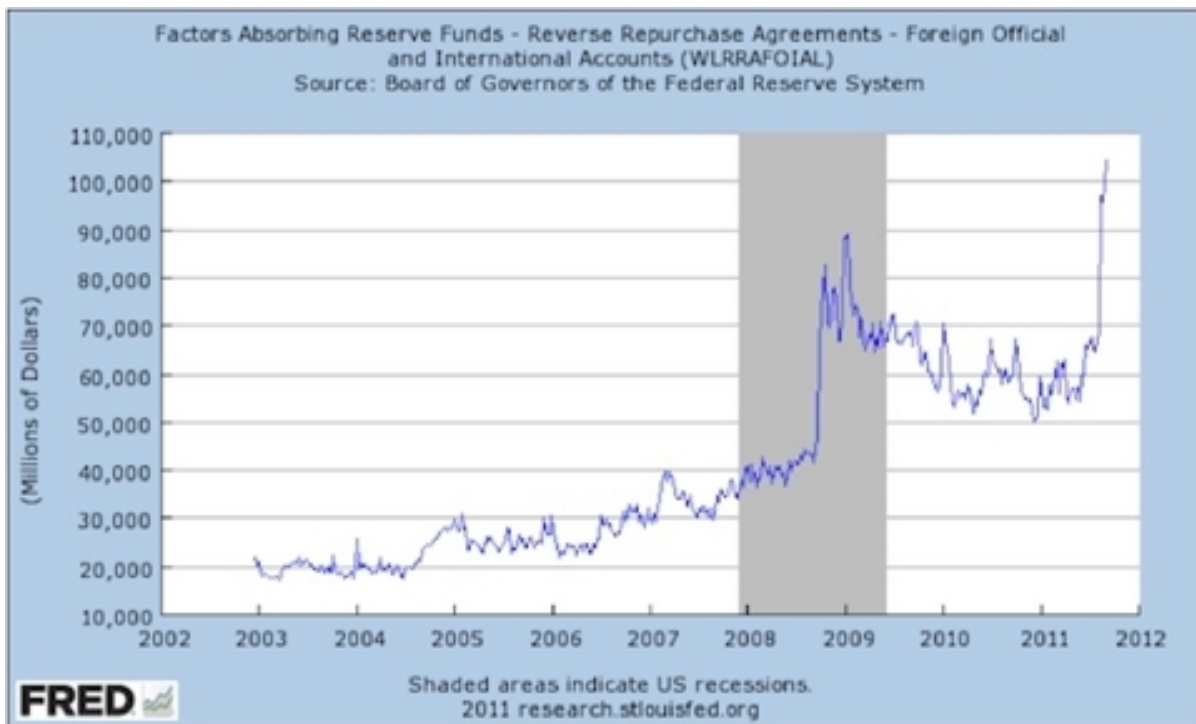
Presently, the global economy is in a low level Nash equilibrium where consumers are reluctant to spend because corporations are reluctant to hire, while corporations are reluctant to hire because consumers are reluctant to spend. Unfortunately, simply offering consumers some tax relief or trying to create hiring incentives in a vacuum will not change this equilibrium because it does not address the underlying problem. Consumers are reluctant to spend because they continue to be overburdened by debt. A significant proportion of mortgages are underwater, fiscal policy leans toward austerity, and monetary policy distorts financial markets in a way that encourages further misallocation of capital while at the same time starving savers of any interest earnings at all.

We cannot simply shift to a high-level equilibrium (consumers spend because employers hire, employers hire because consumers spend) until the balance sheet problem is addressed. This requires debt restructuring and mortgage restructuring. While there are certainly strategies, such as property appreciation rights, that can coordinate restructuring without public subsidies, large scale restructuring will not be painless, and may result in market turbulence and self-serving cries from the financial sector about 'global financial meltdown'. But keep in mind that the global equity markets can lose \$4-8 *trillion* of market value during a normal bear market. To believe that bondholders simply

cannot be allowed to sustain losses is an absurdity. Debt restructuring is the best remaining option to treat a spreading cancer. Other choices are fatal.

You think the world's central banks and main institutions are not worried? They are pulling back from bank debt in Europe, as are U.S. money-market funds. (Note: I would check and see what your money-market funds are holding – how much European bank debt and to whom? While they are reportedly reducing their exposure, there is some \$1.2 trillion still in euro-area institutions that have PIIGS exposure.)

Look at the following graph from the St. Louis Fed. It is the amount of deposits at the U.S. Fed from foreign official and international accounts, at rates that are next to nothing. It is higher now than in 2008. What do they know that you don't?



John Hussman, in the same report, offers the chart below, which is a variant on themes I have highlighted in past issues, but with his own personal twist. It is a combination of four Fed indices and four ISM reports. And it has been reliable as a predictor of recessions – one of which it strongly suggests we are either in or heading into.



The recent revisions to economic data suggest that companies are going to have even more trouble making those powerhouse earnings that are being estimated. As Albert Edwards of Societe Generale reported this week:

“at the start of 2011, productivity trends took a remarkable turn for the worse – especially compared to what was initially reported. An initial estimate that Q1 productivity grew by 1.8% was transformed to show a decline of 0.6%. A slight 0.7% rise in Q1 ULC (unit labor costs) was transformed to show a staggering surge of 4.8%! In addition to that 4.8% rise, ULC rose a further 2.2% in Q2. But the news gets even worse. Last week the BLS revised the ULC rise in

Q2 up from 2.2% to 3.3% QoQ. U.S. non-farm business unit labor costs are now rising by 2% year-over-year.”

That is very bad news for profits. It's bad news for equities. And because the pace of ULC is a key driver of inflation (upwards in this instance), it is bad news for an increasingly criticized and divided Fed.

In addition, there is so much that could push us into another 2008 Lehman-type credit crisis. It is not a given, but the possibility should be on your radar screen. Lehman may have been the straw that broke the camel's back, but there were a lot of other problems. Prior to 2008, we had seen several large companies in the financial world simply disappear. REFCO comes to mind. Not a whimper in the markets. Remember, Lehman was one of a dozen problems all over the world resulting from the larger subprime crisis. Howard Marks of Oaktree writes about simultaneous problems in the markets and what happens:

“Markets usually do a pretty good job of coping with problems one at a time. When one arises, analysts analyze and investors reach conclusions and calmly adjust their portfolios. But when there's a confluence of negative events, the markets can become overwhelmed and lose their cool. **Things that might be tolerable individually combine into an unfathomable mess whose extent and ramifications seem beyond analysis. Market crises are chaotic, not orderly, and the multiplicity and simultaneity of contributing causes play a big part in making them so.**”

But whether you want to make it 50-50 or 70-30 (or pick a number), there is a reasonable prospect of another credit crisis.

## **The Market**

Our outlook for the S&P 500 is bearish.

If history is a guide, the S&P 500 stock index might fall an additional 8-20% lower from the current level in the event of a recession, according to an equity research report issued August 22, by Standard and Poor's. S&P's advice is “be proactive and expect the worst”.

So what should you do?

As Benjamin Graham, the dean of Security Analysis would say, “you shouldn't let Mr. Market's views dictate your own emotions or worse, lead you in your investment decisions.” Decide if you are an investor or a speculator. For a speculator, value is only determined by what someone will pay for an asset. Don't make the mistake of deluding yourself into believing you are investing, when in fact, you may be really speculating.

Now, think back to 2008. Were you liquid enough? Did you have enough cash? If not, then think about raising that cash now. When the crisis hits, if you need to sell you must sell for what you can get, not what you want. In the next crisis, opportunities to buy assets on the cheap will grow, so having some cash will make it easier to buy things you want to own for the next 10-20 years.

In our opinion, you should not own index funds or long-only mutual funds or anything that is not at least partially hedged. We make very specific choices when it comes to long-only investments that we want to hold over and beyond a ten-year horizon.

**If you plan correctly, the next crisis will be an opportunity for you and not a personal crisis.**

I know I sound rather glum at times, but I really don't want you to dig a hole, get in and cover yourself up. While we are more cautious, we are also looking for opportunities.

### **The Portfolio**

Currently we have about 35-40% in cash.

We are long very high quality stocks that pay good dividends and have a history of increasing those dividends over time. Unlike many money managers who focus on dividends exclusively, we also want a good growth story to go along with those dividends.

We also continue to be long gold and are expecting the price to reach \$2,000 per ounce. Governments can print money but they can't print gold. Our investors own a divided interest in actual gold bullion held in a bank vault in London. This gold meets the highest quality standards and is inspected and audited on a regular basis. It will be very important to watch the political process very carefully heading into the Presidential election cycle. While it's too early to make predictions about the race if President Obama loses the election to a Republican, the tenure of Mr. Bernanke would be terminated in January 2013. This would give the new Fed chief the green light to begin unwinding QE-2. In our opinion, a real commitment to a stronger U.S. dollar will cause a sharp selloff in gold.

We are accumulating commercial real estate in the apartment/condo markets, big box retailers, national chain grocery stores and managed forest. These types of alternative asset classes have had a history of having a very low correlation to the more traditional asset classes, like stocks and bonds, and have done well in periods of inflation. We also feel that much of commercial real estate have cap rates that have already factored in a very bad market, making these investments available at attractive prices for long term investors. Many of these types of investments also pay attractive dividends. [Note: Real Estate investments and managed timber are offered through public non-traded Real Estate Investments Trust.]

While we have reduced our short position in U.S. 20-year Treasury bonds, we are still believers that as soon as the printing presses stop, U.S. bonds will reverse course and start to go back up in yield and down in price. In our opinion, the U.S. treasury market is the mother of all bubbles.

In non ERISA accounts, we are accumulating positions in foreign currency. While the dollar is currently showing strength relative to other currencies, we feel that this situation will reverse itself as more investors come to grips with the fact that the economic situation here in the U.S. is not much better than it is in Europe. We also see potential upside opportunities in foreign currency that is currently pegged to the greenback; these policies have the effect of importing unwanted inflation as the U.S. floods the world in fiat currency.

We continue to look for opportunities in mergers, acquisitions, and event arbitrage. As the economic crisis deepens and capital becomes more difficult to obtain, many companies will find it impossible to remain in business and will seek the financial stability of their larger and better financed competitors. In many cases, these acquisitions will be made at fire sale prices, as the alternative is to simply close up shop.

Our strategy here is to go long the potential takeover targets and short the companies that are in acquisition mode. History has shown us that companies often overpay for acquisitions. This track record has resulted in the companies that are being acquired going up in value while the companies doing the acquisition usually go down in value.

We have turned bearish on many commodities near term as the likelihood of a global recession increases and demand decreases. We remain bullish on precious metals for monetary reasons and copper for supply and demand reasons. BHP Billiton forecasts a 10% decline in production at the world's largest copper mine in Escondido, Chile this year due to lower grades. India's investment in new infrastructure means its annual copper demand is expected to more than double to nearly 1.5 million tons a year. "India's urbanization will be on a scale, that outside of China, is unprecedented", according to the McKinsey Global Institute's report titled, "India's Urban Awakening". By 2025, China's urban population is expected to increase 50% to 926-million. Over the next two decades, China will build 20-50 thousand new skyscrapers, and by 2025 40 billion square meters of floor space.

It is clear to us that our country has many opportunities to usher in a new era of prosperity as we are presented with the opportunity to help meet the growing demands of a world that is growing in size and prosperity. Our intellectual capital, technology, and financial capabilities can compete with anyone in the world.

Our biggest problem now is political. Our leaders need to step up and remove the uncertainty that swirls around the financial markets. We are not optimistic that this will happen anytime soon but it is that very uncertainty that creates the opportunities to buy value for those investors who know who they are and what they want.

As always, we would like to thank our clients for all of their confidence and trust.

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