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The Economy

In Mary Shelly's Frankenstein, the monster that was created by Victor Frankenstein to save mankind realizes how he came to be and seeks revenge on his creator. The question that comes to mind is have we created our own "monster" that will have its revenge on us too?

I think it's pretty clear that the current unrest in the Middle East was sparked at least in part by higher food cost caused by the current monetary policies of the FED (the central bank of the United States) and other central banks around the world. It's one thing for a developed country like the United States to absorb increases in food and energy, but in Third World regions like North Africa and the Middle East, where some people make two dollars a day, these increases can make the difference in whether you can feed your children or not.

While these central banks can print money at will they cannot control where that money goes. Judging from the almost parabolic price increases in commodities, oil, and stocks, we conclude that a lot of that newly printed money is going into these asset classes as speculation.

Think of it this way: If you were a money center banker or CEO of a major Wall Street firm why would you "loan" money to someone to buy a house, start a business, or expand at a low interest rate when you could "borrow" money from the American taxpayer at no cost, speculate with it, and be indemnified against any risk because you were too big to fail?

The rapid build-up of the MZM money supply, and zero percent interest rates for the Wall Street Oligarchs, are vital cogs in the Fed's clandestine efforts to jig-up the stock market, and thereby increase the "paper" wealth of US-investors. However, two years after launching QE, Murphy's Law, "Anything that can go wrong, will go wrong," is starting to kick in. North Sea Brent Crude priced in London has hit a recent high of 115.14 per barrel (2/3 of the world's oil in priced in Brent Crude). This has left the world with very little room for error should problems in the Middle East lead to further oil shocks.

Brent Crude is also very closely linked to the direction of the big-3 Trans-Atlantic stock markets, and thus, any further attempt by the G-7 central banks to expand liquidity further, could also lift Brent Crude to $125-200 per barrel. This will lead to gas at the pump at 4 bucks or better. Heating oil and all other products made with oil will, of course, see further price increases as well.

Of the 20 million barrels it consumes daily, the U.S. imports about 12-million barrels. Oil at $120 per barrel for any length of time would transmit unmanageable inflation to the Third World causing further unrest and "Stagflation" here in the U.S. and other developed countries. Stagflation is the worst of all economic environments. Stagflation is slow economic growth and high prices. Think Jimmy Carter and the 70's.

Still, Fed officials refuse to acknowledge the widespread damage that is transmitted to the World's economy, by their radical QE-2 money printing. On February 23rd, Philadelphia Fed chief Charles Plosser declared that, "It would take a significant and sustained rise in oil prices to seriously hurt U.S. economic growth. Commodity price increases do bear watching. I don't think these things cause inflation, but they may be symptomatic of incipient inflation; that's harder to tell."

I think this guy needs to take a ride down to the grocery store in his limo and go shopping with his driver and then stop on the way home to fill'er up. To exclude food and energy from the inflation calculation for the purposes of setting fiscal and monetary policy could be a big mistake for our economy.

China the other day reported its first trade deficit. As my readers know, we have been concerned with economic growth slowing in China now for some time. This is a lagging indicator, so the numbers do not reflect any global slowdown as a result of higher oil prices, but clearly suggest that unless things change, even China like the rest of the world will suffer. I believe they know this, and that is why the Chinese government has done the unthinkable and publically criticized United States monetary policies!

Meanwhile, on February 25th President Obama said that "The world can weather a spike in oil prices." His Treasury Secretary Tim Geithner said the world had plenty of oil reserves. This hints that at least publically the administration believes that this is simply a supply problem that can be solved. In our opinion, this could turn into a supply problem should dissent in the Middle East grow, but for now it's primarily speculation by investors and profit gouging by the oil companies. What did Rahm Emanuel say…"never waste a good crisis".

Of course it would be hard for the administration to admit this because the very dollars that are driving the speculative practices are coming from the American taxpayer in the form of an ever and ever lower standard of living.

Bill Gross announced on March 10th that his PIMCO bond fund (the world's largest) does not own any U.S. Treasuries! The reason….interest rates are so low that investors have no reason to buy the bonds. People, governments, and institutions that buy Treasuries do so because they do not want credit risk. [U.S. Treasuries are backed by the full faith and credit of the U.S. Government].

As I pointed this out in our Q1 newsletter, both Standard and Poor's as well as Moody's have both warned that the U.S. may lose its AAA rating. That's called credit risk. So treasury investors are now faced with almost the perfect storm. A possible credit downgrade, low interest rates, and the possibility of higher interest rates in the future, which will lower the face value of the bonds. No wonder Bill doesn't want any!

As we and Bill Gross have pointed out many times, about 80% of U.S. Treasuries are being purchased by the Fed. The remaining 20% are purchased by foreign governments like China. However, there is some early evidence to support the conclusion that China has now become a net seller.

Also, remember that most of the bonds issued as a result of QE1 and QE2 were very short maturities. So now we must face the fact that these bonds are coming due soon and there might be fewer buyers. Where do you think Bernanke will have to go to get the money to redeem all of these Treasuries? That's right, the printing presses.

If we don't stop this soon, the American tax payer and future generations of Americans will be left with a second rate economy and a debt so great that there will be no hope of ever paying it off. This will mean a lower standard of living for future generations for the first time in this country's history. I despise Bernie Madoff as much as any other legitimate financial professional that cares about their profession, but he was right when he said recently, in a jailhouse interview, that the Government is running a Ponzi scheme that dwarfed his own. I think we could all agree that Bernie Madoff knows a Ponzi scheme when he sees one.

I'm starting to hear the monster coming to life.

Our Portfolios

"Never waste a good crisis"

We believe that we have positioned our client's portfolios to profit from positive cash flow in large cap dividend paying U.S. stocks, further inflation, further devaluation of the dollar, and global political uncertainty.

We are also buyers of apartments, big box retailers, and managed timber (offered through non-publicly traded REIT's). Many of the assets currently held in these portfolios were purchased as other investors needed to sell in order to raise cash to stay in business. As a result, we feel that there is good value currently in these asset classes.

We have sold 100% of our exposure to the emerging markets. We feel that these economies are particularly vulnerable to further increases in food and energy cost, as well as political uncertainty and civil unrest.

Special Note

The past few weeks have been rife with horrifying headlines. The limelight has shifted from Egypt to Libya, and now of course to Japan. The geopolitical risk spectrum is huge, and investors are running scared as a result.

In times of fear, speculation and panic reign supreme, but with them come enormous opportunity for the calm, long –term minded investor.

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

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