Commentary
by Steve Henningsen

July 2009

Danger on the Horizon?

The free market punishes irresponsibility. Government rewards it.
–Harry Browne

We have to come to the realization that there is a sea change in what's happening. This is an end of an era and that we can't re-inflate the bubble, just as we devised a new system of Bretton Woods in '44 which was doomed to fail. It failed in '71 and then we came up with the dollar reserve standard which was a paper standard; it was doomed to fail and we have to recognize that it has failed. And if we think we can re-inflate the bubble by artificially creating credit out of thin air and calling it capital; believe me, we don't have a prayer of solving these problems. We have a total misunderstanding of what credit is vs. capital. Capital can't come from the thin air creation by the Federal Reserve System; capital has to come from savings. We have to work hard, produce, live within our means and what is left over is called capital. This whole idea that we can re-capitalize markets by merely turning on the printing presses and increasing credit is a total fallacy; so the sooner we wake up to realize that a new system has to be devised, the better.

Right now I think the Central Bankers of the world realize exactly what I'm talking about and they're planning, but they're planning another system that goes one step further to internationalize regulations, internationalize the printing press. Give up on the dollar standard, but we have to be very much aware that that system will be no more viable. We have to have a system which encourages people to work and to save. What do we do now? We're telling consumers to spend and continue the old process; it won't work.
–Congressman Ron Paul

Congressman Paul sure makes it sound easy, so why isn't anyone listening to him? I realize that after the stock market's big bounce this past quarter, the last thing anyone wishes to discuss is the 800 pound "Green Giant" of debt looming on the horizon and ready to stomp on all the little "Green Sprouts" running around the financial farm. However, I wouldn't be the skeptic you have come to know all these years unless I brought it up. I realize it is difficult for most investors to focus on the debt field through the green shoots these days, but I equate the government's stimulus program with artificial turf – it may look similar, but it certainly doesn't hold up the same over time, as one eventually wears thin while one naturally regenerates. As Mr. Paul points out, a <u>sustainable</u> economy is one built on capital, not credit. Over the past year, our government spent trillions of dollars to hold up failed, incompetent businesses while assisting them in the process of either hiding their toxic – I mean legacy – debts or simply transferring them from private hands to the public books (Freddie/Fannie, AIG, Bank of America, Citigroup, General Motors, etc.) to be paid back through future taxes. When will we stop throwing money at past mistakes and begin investing in this country's future growth via funding infrastructure programs, alternative energy, etc? To date, the majority of stimulus funds have been used for short-term fixes. Continuing with the farm metaphor, we have depleted the nutrients in our economy's soil over the past 20 years and instead of taking the long-term approach of spreading manure (not to be confused with the B.S. coming from Washington), we are spending tax dollars on short-term Miracle-Gro solutions.

"… small distributional coalitions tend to form over time in developed nations and influence policies in their favor through intensive, well funded lobbying. The policies result in benefits for the coalitions and its members but large costs borne by the rest of population. Over time, the incentive structure means that more distributional coalitions accumulate burdening and ultimately paralyzing the economic system causing inevitable and irretrievable economic decline."
–Mancur Olson, the American economist

Regarding the stimulus plan, I couldn't help but include this item from *The Kansas City Star* (hat-tip to Tedbits Newsletter): *more than $100 million in federal stimulus money will be spent on Kansas City's Richard Bolling Federal Building to modernize its energy system, U.S. Rep. Emanuel Cleaver announced Tuesday. Construction should begin in about 120 days and will continue through 2014. The federal government expects to save about $45,000 a month with the new energy system. It would take more than 180 years of those savings to pay the cost of the upgrades, but a spokesman for (Rep.) Cleaver said people shouldn't expect a dollar-for-dollar return on energy conservation investments.*

180 years– How's that for return on investment! I'm not against spending money. I just believe we should do it wisely and only fund long-term, sustainable projects.

On a side note concerning alternative energy, President Carter created The Department of Energy in 1977 for the purpose of advancing the energy security of the United States. It now employs 109,000 people and spends $24 billion annually of our taxpayer dollars. If anyone is aware of any benefits derived from this investment, please let me know, as I am currently unaware of any.

Extend and Pretend

I have read countless articles and newsletters recently, and the following quote best sums up what has taken place over the past year. ("Extend" refers to businesses with maturing loans, which can't be paid back and therefore they would default on their debt; however, creditors are "extending" the loans in the *hope* that the businesses turn profitable. "Keys" refers to when the company finally gives up on paying the loan and hands over the business to its creditors.)

"One of my partners said yesterday that we are going to call this phase the "extend and pretend" phase in our economy. Which is you extend someone's maturity – because they are going to default – and you pretend that business will come back or that leverage factor is going to come back. Then we'll enter phase two, which he said is the request to extend or "amend." Then "send." In other words, send the keys.

Those are the phases we are in right now. Everyone is trying to buy time, as opposed to dealing with the leverage, they are trying to buy time. Whether you are a banker or a company, they are all trying to buy time. I don't see the leverage coming back, and I don't see the consumption of goods and services coming back."
–Bryan Marsal, CEO of Lehman Brothers Holdings

Mr. Marsal, who was put in charge of liquidating Lehman after it went into bankruptcy, is spot on in my opinion. The government has done nothing to solve the debt crisis, only postpone it. At some point in the future – and I don't believe we will have to wait long – banks will have to eventually face the losses from their holdings of commercial real estate loans and consumer debt.

"Unless we are prepared to clean house – to purge ourselves of the majority of politicians now in power and to substantively overhaul the boards of directors of most public companies into meaningful, hands-on overseers, then we're just deluding ourselves...This isn't merely a battle to re-start American capitalism; it is a battle for the heart and soul of our way of life. While it would be popular to suggest that we still have a fighting chance, I think we also need to wonder whether we have the political will to implement the wholesale changes that are necessary."
–Bill Singer, veteran regulatory attorney

Switching back now to our standard "boat' metaphor: While many Wall Street analysts point to their various risk-measurement devices (contracting credit spreads, decreasing Libor rates, increasing consumer sentiment, etc.) and state that all's clear ahead, I, as your captain, look down at my own instrument panel and am declaring a "full stop" for now. By this I mean that I have further reduced our equity exposure in the past few weeks and reinstituted some of our equity hedges (short positions). We have never been this light on equities, nor this heavily weighted in cash since I have been at the TWC helm. I will discuss our current portfolio position later, at the end of my commentary, but would like to first explain what concerns me.

Before I proceed, let me state that we continue to receive positive feedback regarding my periodic email updates sent to clients and friends of TWC, as they tend to be more timely and interactive via web links and videos. (They have the added benefit that if someone doesn't wish to read it they can delete it and we haven't wasted any paper! ☺) Therefore we will continue sending them with the hope of making my quarterly commentary shorter, as it will become more focused on investment management. Anyone not receiving these email updates and interested in receiving them can let us know and will be added to our email distribution list.

What Lies Over the Horizon?

"Last year the world economy tipped over into a slump. The policy response has been massive. But those sure we are at the beginning of a robust private sector-led recovery are almost certainly deluded. The race to full recovery is likely to be long, hard and uncertain."
–Martin Wolf, *The Financial Times*

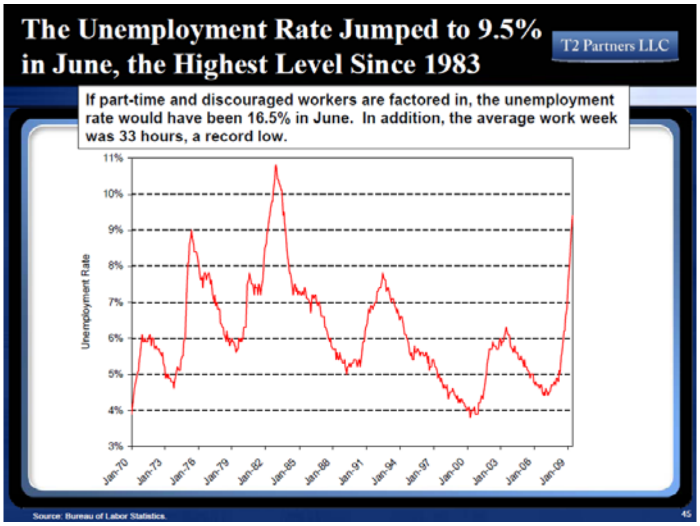
By flooding the financial system with trillions of dollars and propping up various financial institutions, the government has caused gross distortions to our navigational system. In my opinion, this money injection has been the cause of the reduced credit spreads, labor rate, etc., and not from the market naturally repairing itself via deleveraging. Therefore, I believe these risk-measurement devices are giving false readings to those watching them – similar to placing a magnet next to your compass.

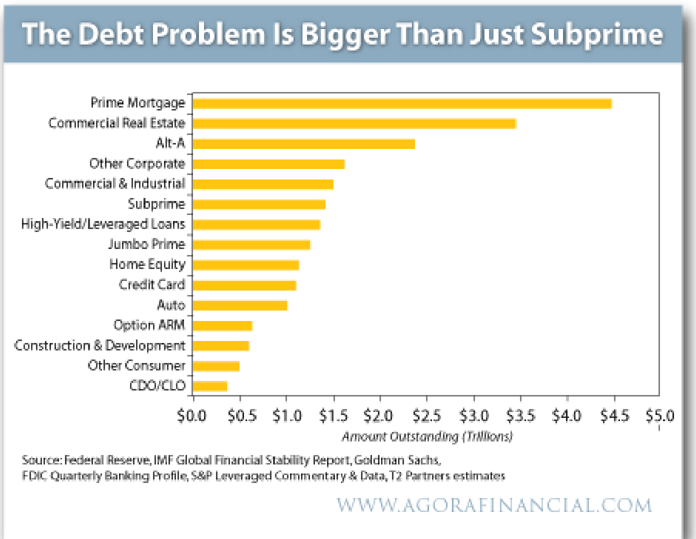
"Doubt is not a pleasant condition, but certainty is absurd."
–Voltaire

In addition, the passage for our journey ahead is lined with many dangerous cliffs that could collapse at any moment. Here are some of them:

Unemployment!

Everyone was jumping for joy at the release of May's unemployment report, as claims came in less than expected. However, as investor/blogger Barry Ritholtz pointed out, *"The 'exhaustion rate' for jobless benefits reveals that people are not leaving the pool of continuing unemployment claims because they are getting new jobs; Rather[sic], they are leaving because they have exhausted their benefits. They are now unemployed AND broke."*

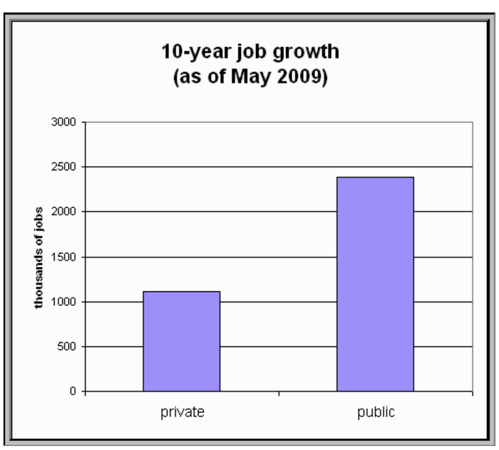




The unemployment rate will soon be over 10% (in reality, it's already over 16%, as shown in this graph from T2 Partners LLC), and I feel it will go much higher for several reasons. First, states are only just beginning to cut back on their workers. California is not alone in its budget problems and we will be reading a lot more about other states having to reduce services and increase taxes on their residents. Secondly, many corporations have either reduced worker hours or furloughed them in hopes that the economy will rebound. If it doesn't, then layoffs will result, which won't help the residential real estate market, as it becomes difficult to pay one's mortgage without any income. Thirdly, as if homeowners don't have enough to worry about, the second wave of residential defaults will be hitting in the next 12 months, as Alt-A loans begin having their interest rates adjust. (See accompanying chart.) Lastly, although the commercial real estate industry has forestalled its inevitable deleveraging, I believe it will finally succumb within the next 12 months.

In addition, many who are currently receiving unemployment insurance will have benefits run out in the next few months, although I expect we will be reading about Congress extending this coverage very shortly.

You don't know my kind in your world
Fairly soon the time will tell
You, telling me the things you're gonna do for me
I ain't blind and I don't like what I think I see
Takin' it to the streets
–Doobie Brothers, *Taking It to the Streets*



Source: Michael Mandel, Business Week

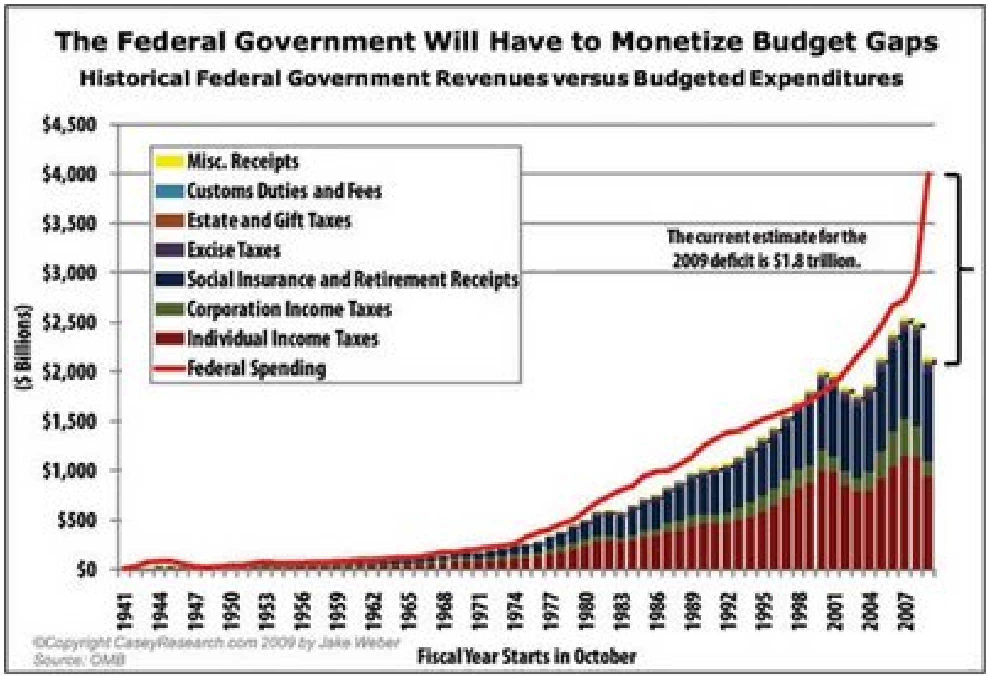
With unemployment rising, we shouldn't be surprised by a rise in crime and social unrest. It is already occurring in Europe and China and those who think it couldn't happen in the U.S. will be sadly mistaken.

One last thing regarding employment: the only one who seems to be hiring lately is the government (see chart). This coupled with the fact that the government accounts for an increasingly larger percentage of our nation's GDP doesn't bode well for faster growth, in my opinion. (I realize that there may be some that disagree with that statement, but I don't believe the government can do things more efficiently than the private market – can you say Amtrak?)

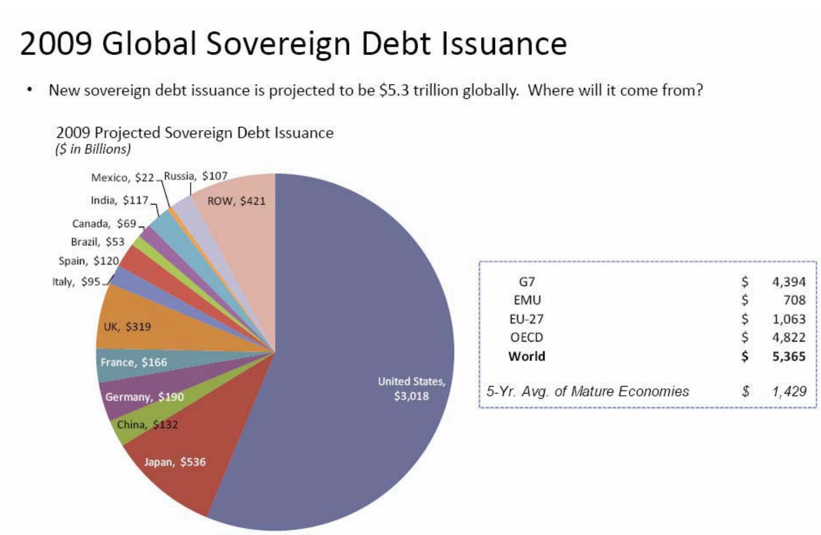
The Increasing Potential for a Debt-and-Balance-of-Payments Crisis!

However, the reason it [the government's financial injection into the banking system] *hasn't actually produced increased credit activity is because the debtors are still too indebted and not able to properly service the debt. Only when those debts are actually written down will we get to the point where we will have credit growth. There is a mortgage debt piece that will need to be restructured. There is a giant financial-sector piece — banks and investment banks and whatever is left of the financial sector — that will need to be restructured. There is a corporate piece that will need to be restructured, and then there is a commercial-real-estate piece that will need to be restructured.*

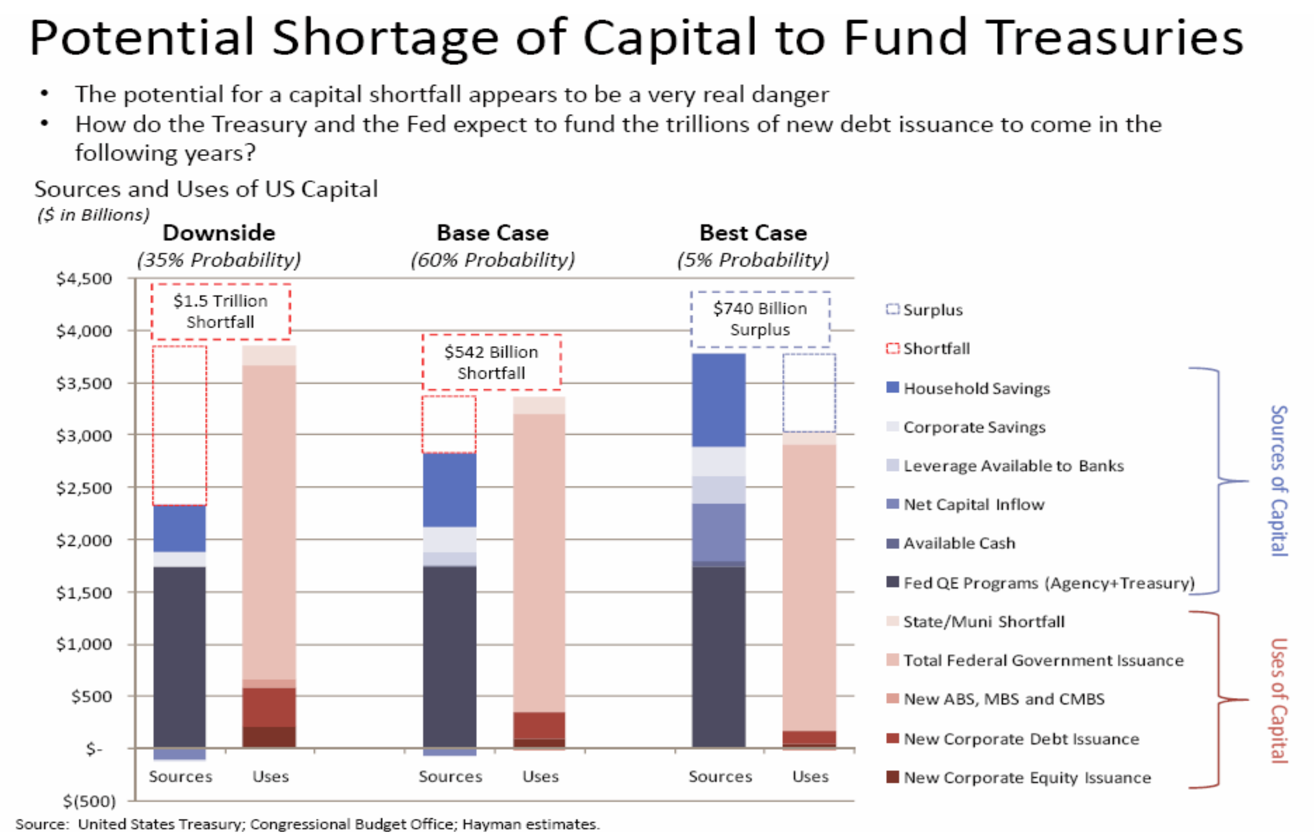
Ray Dalio, Chief Investment Officer, Bridgewater Associates from *Barron's* interview



As Mr. Dalio states above, much of our nation's debt has yet to be "restructured," but this will be worked out over the next several years. The debt that concerns me is our government's debt. The U.S. does not possess a money tree, and all the money that has been thrown at the financial system over the past year has to come from somewhere. Normally, it would simply be paid from the country's surplus; however, unlike China, we don't have any extra funds lying around. As one can see by this nifty chart from the folks at Casey Research, our nation is running a budget deficit of approximately $2 trillion dollars. This means we have to borrow the funds to cover the difference by selling U.S. Treasury Bonds. Countries defaulting on their debts is nothing new, as countless examples litter the history books; the last large one being Argentina. Typically, when a country's fiscal deficit gets in a range of between 4% and 5% of their GDP, investors get nervous and flee, as they did with Argentina. The Congressional Budget Office projects the U.S. fiscal deficit for 2009 at 12.3% of GDP. There are those that say that this shouldn't be a concern, as the U.S. has the advantage that we have the world's reserve currency and the reputation (and military) to back it up. However, it is usually an unexpected, outside event (collapse of European bank, failed U.S. debt auction, etc.) that occurs that sets the process of default in motion.



So, the U.S. has $2 trillion dollars of bonds to sell this year in order to pay its bills. Unfortunately, many other debtor nations are in the same position, leading to an over-supply of bonds vs. demand (savings) in the world, as this chart from John Mauldin's recent newsletter vividly shows. Great Britain was the first country to experience a failed bond auction earlier this year (no one wanted to buy their bonds at their offered price), and I think that it's only a matter of time before the U.S. experiences a "failed auction" of its debt. The Fed's already seen the handwriting on the wall and has begun its "quantative easing" program – printing money to buy its own debt – earlier this year. This "printing" hasn't had any consequences in the markets yet, as it isn't just the U.S. but many nations that have begun their own quantative easing programs. The problem is that this only represents the United States government debt, and if the other debt needs of our country (corporate and municipal) are factored in, then we need to come up with a lot more funds to keep the nation's financial system going. Again, another great chart on the next page from John Mauldin:



"We have tried spending money. We are spending more than we have ever spent before and it does not work. And I have just one interest, and now if I am wrong somebody else can have my job. I want to see this country prosper. I want to see people get a job. I want to see people get enough to eat. We have never made good on our promises. I say after eight years of this administration, we have just as much unemployment as when we started. And enormous debt to boot."
–Treasury Secretary, Henry Morgenthau, angry at the Keynesian spenders, confided to his diary May 1939

I realize it may seem far-fetched to believe that there might be a currency crisis concerning the U.S., but if you went back to 2006 and told people that within 24 months AIG, Lehman Brothers, Merrill Lynch, Bear Sterns, Chrysler and General Motors would be gone or taken over by the government, they would look at you like you were crazy.

In addition, China, Russia, India and Brazil have been increasingly complaining about the dollar and suggesting that a new global reserve currency replace the U.S. dollar. In the last four months alone, China has signed currency swap agreements worth more than $95 billion (650 yuan) with an array of nations, including: Argentina, Brazil, South Korea, Indonesia, Malaysia, Belarus and Hong Kong.

"Your highness, when I said that you are like a stream of bat's piss,
I only mean that you shine out like a shaft of gold when all around it is dark."
–Monty Python

Several times over the past year, China has sent conflicting signals in the press criticizing the U.S. government's handling of our currency, in addition to pressing other countries to move to a "new" reserve currency, but then coming out the next morning with another press release stating that they still supported the dollar and believed it would remain the reserve currency for many years to come. One gets the sense that the winds of change are blowing. The only question is the timing.

*"**There is a slow-burning fuse underneath the dollar**,"*
–Gerard Lyons, chief economist at Standard Chartered Bank

There is still time to prevent a currency crisis, but it requires the government to cut back on its spending drastically, and we all know what the odds are of that occurring– not to mention how much worse off we will be if the government's new healthcare plan gets passed. (I'm not against the idea per se; I just believe one should have the ability to pay for it first.)

Can You See The Trend?

If I was rich girl (na, na...)
See, I'd have all the money in the world, if I was a wealthy girl
No man could test me, impress me, my cash flow would never ever end
Cause I'd have all the money in the world, if I was a wealthy girl
–Gwen Stefani, *Rich Girl*

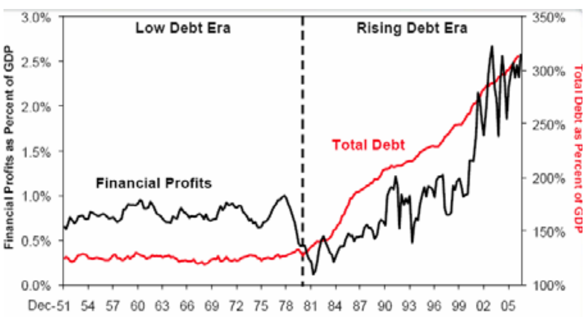
One major reason why people own gold is that gold can't go broke. Gold can't go broke because it has no counter-parties or liabilities against it. Gold can't go broke because gold is pure wealth. Sure gold can go down in price in terms of a currency, but gold CAN NOT GO BROKE…This is the crucial fact that the "dollar-bugs" fail to comprehend. This is the reason why sophisticated wealthy people own large quantities of gold. Gold represents eternal unquestioned wealth…Wealthy people do NOT hold gold for appreciation. They don't care about the price of gold today or tomorrow. That is not why they hold gold.
–Richard Russell, *Dow Theory Letters*

I cannot leave a discussion on a potential currency crisis without mentioning gold; especially as it has been receiving more press lately and some even think it is a bubble, because some famous hedge fund managers have been buying it. (Given that none of my friends own gold, I highly doubt it is a bubble.) My belief and a large part of the reason we hold a lot of it, is that should a currency crisis occur, gold would be the beneficiary for the reasons Mr. Russell explains above. However, Gwen – along with most people – has fallen into the trap of equating money with wealth – the two are different beasts. Wealth is tangible, while money in its fiat form is depreciable. A fact not lost on our government.

Slow Growth Ahead?

Hey, don't you know it's a waste of your day
Caught up in endless solutions
That have no meaning, just another hunch
Based upon jumping conclusions
Caught up in endless solutions
Backed up against a wall of confusion
Living a life of illusion
–Joe Walsh, *A Life of Illusion*

As it happened, rather than following policies that would have allowed for a sustainable recovery, our policy makers opted for a stunningly unethical strategy of making bank bondholders whole with well over a trillion dollars in public funds, watering down accounting rules to allow banks to go quietly insolvent while reporting encouraging "operating profits," looking beyond the continued shortfall of loan loss reserves in relation to loan defaults, and doing nothing meaningful with regard to foreclosures, whose rates continue to soar and which face a fresh wave later this year and well into 2010 and 2011. These policy responses have more than doubled the U.S. monetary base within a period of months, added a trillion more in outstanding Treasury debt, and virtually assure that the value of those government liabilities will be repriced in relation to goods and services over the coming decade. A range of different methodologies suggest a doubling in U.S. consumer prices over the coming decade, though with the majority of this pressure occurring 3-4 years out and beyond…Moreover, there is a far weaker prospect for a return to 2007-like profit margins than investors seem to recognize. Economic expansions are paced not by major growth in consumption (which tends to be fairly smooth even during economic downturns), but instead by gross investment in capital goods, technology and housing, as well as debt-financed durables such as autos. Yet our policy makers have aggressively crowded out private investment through this bailout policy, which allocates good capital to the worst stewards, and they have done virtually nothing to abate the housing downturn. Add deleveraging pressure to that mix, and an absence of opportunity for mortgage equity withdrawals (which fed GDP growth during the last expansion), and we have an economy that is likely to produce a very stagnant recovery even if one has begun – of which I am also skeptical.
–John P. Hussman, investment manager



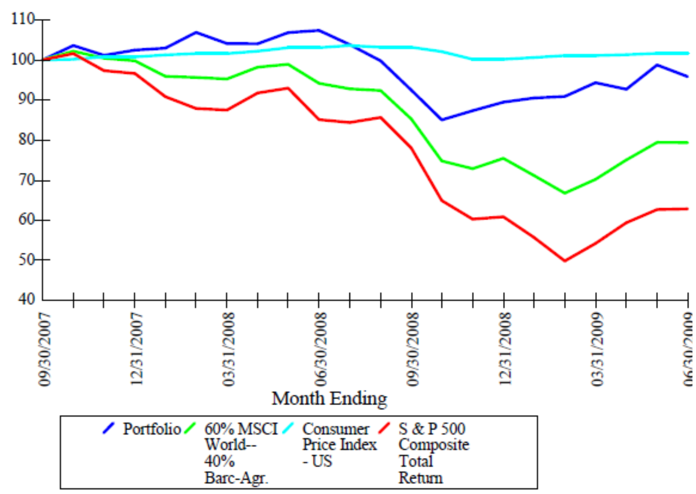
As Mr. Hussman explains, even if my concerns fall to the wayside, our economy will not be growing as it did over the past 20 years. I also believe that much of the "profits" reported in the past quarter were due to *cost-cutting*, as opposed to real growth. The next few quarters should determine where the truth lies. I accept that GDP will probably turn positive before year-end, which will be highly hailed as a return to "good-times," but don't be fooled. Much of it will simply be from the impact of increased production, as companies restock their inventories. However, once this is complete, GDP will slow to a positive rate, but at a lower rate than we have become accustomed to over the past 20 years. As this chart from T2 Advisors shows, the past 20 years of prosperity were built upon debt, and deleveraging from this era in a return to more prudent times will take many years.

Portfolio Happenings!

You can't always get what you want,
But if you try sometimes,
Well you just might find you get what you need!
–The Rolling Stones, *You Can't Always Get What You Want*

Regarding our 2nd quarter's investment performance, I predicted in my 1st quarter's commentary that I would probably look as foolish this quarter as I looked great last, and I didn't disappoint. Our conservative position gained us only 2% vs. 13% for the blended benchmark, thus giving up the majority of our 1st quarter's performance advantage.

"A jump in financial speculation is NOT an economic recovery. If the S&P 500 goes to 20,000, but we are drinking $1,500 beer and wiping ourselves with $100 bills, we have not gotten richer. Never mind the fact that an S&P 500 of 20,000 DOES NOT create jobs."
–Graham Summers, investor



While long-time clients know that I don't pay much attention to short-term results and don't discuss performance much (call me superstitious), the past 21 months presents a great opportunity to review something we at TWC harp on continuously: negative compounding. As we state over and over (ad nauseam), our investment philosophy is about wealth preservation and focused on risk, as opposed to return. So if some are disappointed to only return 2% this quarter, while the S&P 500 Index returned almost 16%, keep in mind that even after this quarter's big bounce, the S&P 500 Index is still down approximately 37% from its high in September of 2007. Again, when you lose 50% on an investment, you need to obtain a return of 100% just to get back to the starting point. As we were fortunate to minimize our losses in 2008, we don't *need* to take on excess risk to win back losses. The graph visually demonstrates this as the average – net of fees – equal weighted cumulative return for our clients was -5.25%, while our blended benchmark returned -20.56 and the much talked about S&P 500 Index -37.17%. I am not presenting this to boast, as maybe the markets will recoup all their loses over the next 21 months, while we remain flat, but simply to show how difficult it is to make up for lost capital.

In the middle of June, I increased our already heavy cash position by liquidating ETF positions in gold stocks, oil companies and agriculture companies after their big, three-month run-up. I look to re-enter these positions in the months ahead at hopefully lower prices. I also re-entered some of our inverse market ETFs to hedge against a potential stock market pullback. Given our current large cash position and neutral equity exposure, we will not gain from any further upside from stocks. I don't expect that we will increase our stock exposure much until I feel we are past the various headwinds I see coming up: commercial real estate, a 2nd wave of residential real estate foreclosures, increasing unemployment, and state and federal deficit funding concerns. In addition, our 20% position in gold and silver bullion will obviously skew our returns going forward. There are many investments I am excited about buying, just not yet.

"Life is a school of probability."
–Walter Bagehot

I realize that some investment managers respond that their clients "aren't paying us to manage cash." I don't agree. It is my fiduciary duty to maximize *risk-adjusted* returns and protect principal from losses, not to blindly invest in a buy-and-hope strategy based upon what worked in the past. Neither is it my duty to outperform some arbitrary benchmark (although don't tell that to my ego); especially when the "consequences" of being wrong these days could have serious, long lasting repercussions upon clients' financial wellbeing; especially when we are in an investment environment never experienced before. Our investment philosophy has served our clients well over the years. Whether this was derived from luck or our consistency in focusing on "risk-adjusted" returns – along with a healthy dose of skepticism – only time will tell. However, my belief (and I may be wrong about this) is that if nine years from now our fortune is reversed and TWC clients haven't kept up with the benchmark world, they will still feel satisfied, knowing that we acted in their best interest. They might not get what they want, but hopefully they get what they need!

"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on."
–Amos Tversky

To summarize, until I feel more confident in our navigational system and the fog of uncertainty begins to lift, we shall remain at "full-stop." I do not pretend to be clairvoyant, but believe we face many more challenges in the next two years, some of them with potentially devastating financial consequences. Although the possibility of some of these problems manifesting into a crisis has been with us for decades, my feeling is that the probabilities of them occurring have never been higher than now.