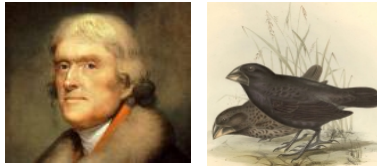




Commentary
by Steve Henningsen

January 2009

2008 - Jefferson and Darwin
Roll Over in Their Graves



*Even if your hands are shaking
And your faith is broken
Even as the eyes are closing
Do it with a heart wide open
Say what you need to say
—John Mayer, Say*

*“Education is a progressive discovery of our own ignorance.”
—Will Durant, Historian*

Happy New Year to everyone, and good riddance to 2008. Nope, won't be many tears shed for that year, although it was an historic year in many ways, and investors got to witness the financial landscape change forever almost overnight. I'd like to believe that with a turn of the calendar good things would begin emanating from the economy, but I know better. However (surprise, surprise), others from Wall Street see it differently, as one financial seer trips over another to proclaim the financial storm over (thanks mostly to Big Government) and that 2009 will be the beginning of a new bull market! (Barron's annual survey highlighted a bunch of Wall Street investment strategists all predicting higher returns in 2009.) Everyone seems to be spouting the same reasons for their optimism: lots of cash on the sidelines just itching to get back in the game, lower oil prices, humongous government stimuli, low valuations—and I even heard one guy say that after such a rough year we are *entitled* to an up year. I would advise a little caution, as these were, by and large, the same individuals who thought 2008 was going to be stellar—*caveat emptor* as usual!

My transgenerational stock market outlook is this: stocks are cheap when valued within the context of a financed-based economy once dominated by leverage, cheap financing, and even lower corporate tax rates. That world, however, is in our past not our future. More regulation, lower leverage, higher taxes, and a lack of entrepreneurial testosterone are what we must get used to – that and a government checkbook that allows for healing, but crowds the private sector into an awkward and less productive corner.

—Bill Gross, December *Investment Outlook*

I have no idea what the new year shall bring, but I will say that I'm not as dire about the stock market, which is different from the economy, as I was at the beginning of 2008. This doesn't mean we are reallocating back to our target stock percentages yet; we are not. Investor Marc Faber spent four pages in his recent newsletter showing how one person could make the case that stock prices are “cheap” on an historical basis, while another could claim them to still be over-valued. I don't give much credence to the “cheap” crowd since I believe, along with Pimco's Bill Gross, that yesterday's measuring stick can't be used for tomorrow's “un-leveraged” earnings. I also believe that companies' earnings will be

much worse than analysts predict and that this probably isn't factored into the markets' current pricing, but time will tell. Right or wrong, I still feel the potential risks outweigh the rewards at the moment, but remain ready to change my position. Keep in mind that the upward movement of stock markets doesn't necessarily signal a more stable financial foundation. (A good example of this is given by Mr. Practical later in my commentary.)

All attempts to emerge from the crisis by new interventionist measures are completely misguided. There is only one way out of the crisis: Forgo every attempt to prevent the impact of market prices on production.

- Ludwig von Mises, *The Causes of the Economic Crisis*

Furthermore, many Wall Street technicians point out positives such as reduced credit spreads and increased liquidity, but I question whether these things can really be positive if they were caused by government intervention. Are they simply false signals? Consumers are cutting back on their discretionary spending in order to pay off debt and save—just what they should be doing, may I add. However, as our economy is based upon consumerism, Uncle Sam doesn't like this and is in the process of trying to stimulate “fake” demand by pouring billions (trillions?) of our tax dollars into the financial system. My question is what happens when this stimulus package ends? Does anyone know what the real level of consumer demand is? I have a feeling it is pretty low and will stay that way for many years, which means that if the government is successful in tricking companies into production based upon “fake” demand, upon withdrawal, supply will swamp demand and we will be right back where we started. The bottom line is that companies and consumers need to deleverage and we can either do it relatively quickly, albeit painfully, or drag it out into the next decade, thanks to government interference.

“This recession is by no means mechanical. People have lost a sense of confidence, a sense of trust in institutions and in each other. It is very hard for a central bank to address that by just cutting interest rates.”

—Professor Robert Shiller, Economist (one of the few good ones)

The markets have me more conflicted than usual because we still have to get through these psychological changes that Professor Shiller refers to as investors become disillusioned and lose faith in the financial system. I've touched on these things enough in the past, so let's continue with our government and some of the other issues on the table.

U.S. Government Busy Trying to Shore up an Economy Built Upon a Rotten Foundation?



*Once upon a time you dressed so fine
You threw the bums a dime in your prime, didn't you?
People'd call, say, "Beware doll, you're bound to fall"
You thought they were all kiddin' you
You used to laugh about
Everybody that was hangin' out
Now you don't talk so loud
Now you don't seem so proud
About having to be scrounging for your next meal.*

—Bob Dylan, *Like a Rolling Stone*

"Illusions commend themselves to us because they save us pain and allow us to enjoy pleasure instead. We must therefore accept it without complaint when they sometimes collide with a bit of reality against which they are dashed to pieces."

—Sigmund Freud

I have mentioned several times that I fear America's best years may be behind her, as living beyond her means has finally caught up to her. As Freud would surmise, reality has arrived and she doesn't look so good. However, Uncle Sam is doing his best to give her a new look and disprove the simple reasoning that the same medicine that got us in this mess (cheap credit and excessive spending) will

not cure us. Poor Obama has been left an economy in disrepair. Throwing a trillion dollars of borrowed money at it won't fix it, although it may seem so in the short-term. Again, debt got us into this problem and more debt won't get us out. I realize America has never been good with preventative maintenance, as we prefer to wait until it breaks before fixing it—similar to our approach to medicine and car repair. We have been living off our past and have not just eaten our way through our seed-corn, but the bottom of the box as well. As recently stated by former Assistant Secretary of the Treasury and former associate editor of *The Wall Street Journal*, Paul Craig Roberts, "*The United States is walking on quicksand. It is dependent on foreigners for the funding to conduct the day-to-day operations of its government. Its economy is a hollow shell reduced to dependence on a financial sector that is discredited worldwide. America's government believes that its foreign wars of aggression are more important than any domestic needs, including the health care of its population.*"

She isn't terminal yet folks, but if the right steps aren't taken soon there will be no turning back. (I would recommend Paul Kennedy's book, *The Rise and Fall of the Great Powers*, for anyone in doubt.) I have spent the past six years pointing out some of the problems that ail the US, and a week ago sent an article recently written by James Quinn, "Unintended Consequences 20th Century & Beyond," that I felt summed it all up nicely, including his thoughts on what needs to be done:

- Consumers need to cut back dramatically on consuming. Spending as a percentage of GDP needs to decline to 65%, or by \$1 trillion. This would be approximately \$3,000 less spending per household per year.
- Twenty years of consumer debt accumulation must be unwound. This required deleveraging needs to eliminate \$2 trillion of household debt. The result will be thousands of retail store closings, mall closings, restaurant closings, and auto dealership closings. The distinction between needs and wants will reveal itself like a sledgehammer.
- The consumer needs to increase their savings rate from 2% to 10%. This would provide more capital for investment.
- People who cannot afford the mortgage on their home need to sell or enter foreclosure. When home prices fall far enough, the market will clear the inventory. Lower prices are the only way to eliminate excess supply.
- Companies that have failed to prepare for this downturn by taking on excessive debt, allowing expenses to soar, and having no clear strategic plan should go bankrupt. Unemployment will reach 9%. New businesses will be created and Americans will be hired.
- The Government should make sure that no one starves to death or has to sleep on the streets. The safety net of food stamps and unemployment insurance should be strengthened.
- The Government's purpose is to protect its citizens, enforce the laws and maintain the public infrastructure. Our roads are crumbling, we have 156,000 structurally deficient bridges, millions of miles of pipes under our streets are rusting away, and our power grid is antiquated. The job of Government was to maintain these things. They have failed miserably. Why does anyone think a new government infrastructure plan will work? Bridges to nowhere will be everywhere.
- Reducing spending dramatically on our military empire would provide funds to support the social safety net that is required during a depression. Congressmen in the pocket of the Defense industry will never allow it to happen.

However, as he correctly points out, no politician will endure the economic pain involved with this type of sacrifice (which is why there is a massive stimulus plan), nor, may I add, will the public endure long-term solutions after being conditioned by easy money and credit for 25 years. Many others have been writing and blogging about actions and their "consequences" over the past year, and here are some other things to add to Mr. Quinn's consequence list:

U.S. Government's attempt at stopping "Natural Selection"

It may well be asked whether the damage inflicted by misguiding entrepreneurial activity [condo flipping, false consumer demand, investment leverage, etc.] by artificially lowering the loan [interest] rate would be greater if the crisis were permitted to run its course. Certainly many saved by the intervention would be sacrificed in the panic, but if such enterprises were permitted to fail, others would prosper. Still the total loss brought about by the boom (which the crisis did not produce, but only made evident) is largely due to the fact that factors of production were expended for fixed investments [houses] which, in the light of economic conditions, were not the most urgent. As a result, these factors of production are now lacking for more urgent uses. If intervention prevents the transfer of goods from the hands of imprudent entrepreneurs to those who would now take over because they have evidenced better foresight, this imbalance becomes neither less significant nor less perceptible.

-Ludwig von Mises, *Monetary Stabilization & Cyclical Policy*, 1928

When will government learn what most good investment managers already know— that sometimes it is best to just sit on one's hands and do nothing! But the cameras are always clicking and our congressmen need to look like people of action. As you can see, Mr. Mises and other Austrian economists knew even back then that sometimes inaction was the right prescription.

"Failure is the opportunity to begin again more intelligently."

– Henry Ford

Not in the 21st century, Henry, as Uncle Sam is here to prop up one failed business after another.

However, there is a glimmer of hope as I have been reading an increasing number of articles *against* the reverse-Darwinism going on in the business world. Natural selection works in the biological world and should be maintained in the financial world, by letting good, prudent managers take over failed businesses. Instead we have companies either applying to become banks (Goldman Sachs) or *pretending* to be a financial institution (CIT, CVS, American Express, auto companies, etc.) so they can huddle under government protection and suck from the teat of TARP. Now everyone wants in the game including the porn industry, as well as various state governors who have petitioned for a trillion-dollar bailout. If the government really wants to go against the natural order, then it should allow the prudent, well-managed smaller banks to gobble up the ill-managed, greedy bigger banks!



The *consequence* of giving this amoral debt to our children is that it will further weaken our dollar and move the U.S. closer to bankruptcy. "Mr. Practical," an investor who occasionally writes for Minyanville, recently explained it this way:

"When a government that can create its own money becomes insolvent, it is manifest in a much lower currency. Ironically it is manifest in a higher currency in the first stages as debt is destroyed. But as government takes on more and more assets financed by printed dollars it becomes weaker. We are seeing that struggle play out each day. When the dollar goes up due to deflationary pressures, stocks go down. When the government replaces debt with its own by printing currency and takes the risk as it did with the Citigroup bailout (a huge amount for one company), the amount of dollars printed to finance the bailout causes the dollar to drop and stocks to go up.

"Why do stocks go up when the dollar goes down? Imagine one person owning all the shares of a company who is willing to sell the stock for \$50 a share. If the dollar drops 50% over-night and you go to that person to give them \$50 for a share of stock they will say 'no, no, today I need twice as many dollars for a share of stock because the dollar is worth half as much...' so the stock price rises to \$100.

“So you say let's just devalue the dollar fully and watch stocks go soaring. Well be careful what you wish for as I have explained the consequences of that: total debasement of a currency will lead ultimately to a deflationary collapse. Study your history. A total debasement of currency creates no wealth and the stockholder is no better off, it just looks that way for awhile. But if all confidence is lost, the fiat currency system fails altogether.”

He also pointed out an article from professor Walter Williams of George Mason University stating that:

“Knowing the dangers posed by central banks, we might ask whether our country needs the Federal Reserve Bank. Whenever I'm told that we need this or that government program, I always ask what we did before. It turns out that we did without a central bank from 1836, when President Andrew Jackson closed the Second Bank of the United States, to 1913 when Federal Reserve Act was written. During that interval, we prospered and became one of the world's major economic powers.

“The justifications for Federal Reserve Act of 1913 was to prevent bank failure and maintain price stability. Simple before and after analysis demonstrates that the Federal Reserve Bank has been a failure. In the century before the Federal Reserve Act, wholesale prices fell by 6 percent; in the century after they rose by 1,300 percent. Maximum bank failures in one year before 1913 were 496 and afterward, 4,400. During the 1930s, inept money supply management by the Federal Reserve Bank was partially responsible for both the depth and duration of the Great Depression.

“It is not wise for us to permit a few people on the Federal Reserve Board to have life and death power over our economy. My recommendation for reducing some of that power is to repeal legal tender laws and eliminate all taxes on gold, silver and platinum transactions. That way there would be money substitutes and the government money monopoly would be reduced and hence the ability to tax — some people would say steal from — us through inflation.”

San Francisco Federal Reserve President Janet Yellen, speaking at the annual American Economic Association meeting, stated that: *“The new enthusiasm for fiscal stimulus, and particularly government spending, represents a huge evolution in mainstream thinking.”* Evolution...? Some look at it as a step back when government is the solution.

Bureaucracy to the Rescue?

“Yes, we did produce a near-perfect republic. But will they keep it? Or will they, in the enjoyment of plenty, lose the memory of freedom? Material abundance without character is the path of destruction.”

—Thomas Jefferson

“Americans have always been able to handle austerity and even adversity.

Prosperity is what is doing us in.”

—James Reston, New York Times journalist, 1939-1989

Warren Buffet was quoted as stating, *“It's only when the tide goes out that you learn who's been swimming naked.”* This wouldn't be such a big deal if it were just a few investment managers who got caught without any swim trunks. Unfortunately, but not unusually, greed breeds many slimy mollusks in the tide-pool. So far Mr. Madoff is the biggest, but he won't be the last, and it isn't confined to only the United States. A case in point: One of India's largest companies, Satyam, revealed that its founder and chairman, Ramalinga Raju, had been massively inflating profits for years. Of course none of this helps with the rebuilding of investor faith in the capital system.

Some are using this as another excuse to increase government oversight claiming free markets don't work. Firstly, there is no such thing as free markets, nor has there been for centuries. Secondly, government intervention is the cause of many of the current problems, such as the housing bubble. Besides which, there were already regulations and laws on the books to stop crimes like Madoff and

Enron from happening, but it seems the regulators dropped the ball. Again Marc Faber elaborated on these points in his recent newsletter:

“The cause of the current economic slump isn’t the financial crisis and free markets that failed, but ill-conceived government policies, which handed out privileges to special interest groups such as Fannie Mae, Freddie Mac and the financial establishment— in particular, Wall Street. The economic slump was also caused by the Fed’s intervention in the market for interest rate pricing— especially after 2001 when the Fed fund rate was cut from 6 ½% to 1%.

“Another cause of the slump was the bailout of LTCM, which encouraged financial institutions to increase their leverage. In a free market, LTCM would have failed and the surviving market participants would have been much more prudent in taking large debts on their balance sheets. Therefore, it isn’t free markets and the capitalist system that have failed; rather, governments and government agencies that have intervened in the free markets should bear the responsibility for the current economic contraction of which the financial crisis is just a symptom...It is utter nonsense to believe that governments know how to run an economy better than free markets, and that interventions can solve problems. Interventions may solve some problems temporarily, but they create far greater problems down the road.”

Again, no amount of bureaucracy or laws will prevent a corrupt person from doing unscrupulous things, which brings me to another bugaboo related to Madoff:

*“The trouble about man is twofold.
He cannot learn truths which are too complicated;
he forgets truths which are too simple.”*
—Rebecca West

Most times when people come into our office to kick our tires the questions are mostly directed at what our investment returns are; not our investment philosophy. Nor do they ask what underlies our returns. (What is the process that allowed us to achieve them?) That is the mistake that investors continually make, as they search for the investment world’s magician without questioning the magic.

Truthiness

“A government big enough to give you everything you want is strong enough to take everything you have.”
—Thomas Jefferson

I feel Stephen Colbert’s word “truthiness” fits nicely here because we all want to believe that all the money spent on Homeland Security since 9-11 has been put to good use, although there isn’t any proof. Some would consider it proof enough that there haven’t been more attacks—others would argue that the loss of our liberties and increased power of government wasn’t worth it. I thought one of the analysts at *The Casey Research Group* (I find their opinions far from the mainstream and therefore invaluable) did a good job recently of summing it up, and it circles back to my point about stopping bad people from doing bad things: *“The truth is that bad people do bad things. There is no way to make the U.S. completely secure. It is not only possible but even probable that there will be a weapon of mass destruction detonated in the U.S., and not even a police state can change that. All the checkpoints at airports, land borders, and shipping points do is make the honest people wear slip-on shoes and pack differently. The only way to reduce the threat is to make fewer enemies – and the way to do that is to stop sticking our collective noses under other people’s tents. The best foreign policy and national defense has always been based on increasing trade and international codependency. But nobody who has made a career studying ‘threats’ will find this acceptable.”* (Before you go pooh-poohing the man who said that, realize that he is ex-CIA and a West Point Grad.)

James Dale Davidson, author and venture capitalist, also pointed out recently that, *“The Homeland Security will spend \$50 billion in 2009, more than the combined military budgets of every country in South America and sub-Saharan Africa and so far have screened three billion travelers in U.S. airports. The number of terrorists detected: zero.”*

I think the key takeaway—which my children probably figured out by 1st grade—is to stop doing things that cause others to dislike us. And while we are on the subject of the loss of liberties, here is a thought from one of the better economists, Merrill Lynch’s David Rosenberg, *“What does concern us is the risk to civil liberties when bankruptcy judges can alter contracts, the government can force banks to accept public capital injections, the government by fiat can bring mortgage rates down as opposed to market forces and the government tells lenders how to price their credit card business.”*

Moving away from Uncle Sam...

China—Be Nice to your Debt Masters!

America has spent many years telling the rest of the world how to play its game, and some countries are running out of patience. James Fallows of *The Atlantic* magazine recently interviewed Gao Xiqing, China’s largest sovereign wealth fund manager, and I thought a few of the passages would be of interest, since Mr. Xiqing is one of China’s most influential people:

“People, especially Americans, started believing that they can live on other people’s money—and more and more so. First other people’s money in your own country and then the savings rate comes down, and you start living on other people’s money from outside. At first it was the Japanese. Now the Chinese and the Middle Easterners. We—the Chinese, the Middle Easterners, the Japanese—we can see this too. Okay, we’d love to support you guys—if it’s sustainable. But if it’s not, why should we be doing this? After we are gone, you cannot just go to the moon to get more money. So, forget it. Let’s change the way of living. [By which he meant: less debt, lower rewards for financial wizardry, more attention to the “real economy,” etc.]

“...If you look at every one of these [derivative] products, they make sense. But in aggregate, they are bullshit. They are crap. They serve to cheat people... The current conditions can’t go on. It is time for the new government, under Obama or even McCain, to really tell people: “Look, this is wartime, this is about the survival of our nation. It’s not about our supremacy in the world. Let’s not even talk about that any more. Let’s get down to the very basics of our livelihood.

“...I have great admiration of American people— Creative, hard-working, trusting, and freedom-loving. But you have to have someone to tell you the truth. And then, start realizing it. And if you do it, just like what you did in the Second World War, then you’ll be great again! If that happens, then of course—American power would still be there for at least as long as I am living. But many people are betting on the other side.”

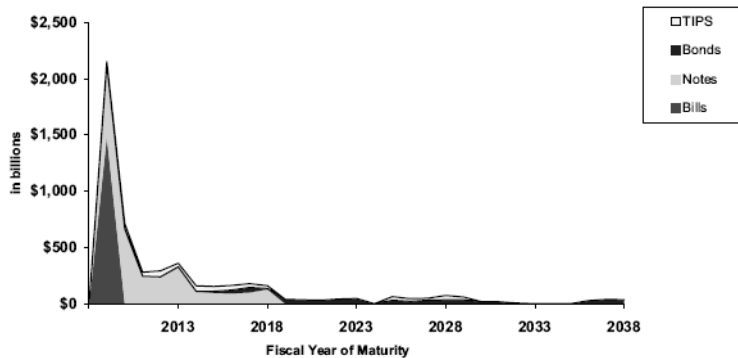
Speaking of Debt!

“Money will be attracted to the liquidity and transparency of the U.S. long Treasury market. I think this will be the final bubble of my generation. Crowding into a 20-year bond in a depreciating currency when inflation sets in, and long rates inevitably rise, will be a religious experience for the victims, in my opinion.”

—Rick Rule, Investor

What’s the problem with low interest rates you ask? Nothing at the moment, but as shown by the chart below from the United States Government Accountability Office, the majority of America’s \$5.2 trillion in marketable debt held by the public matures within the next four years. (This doesn’t include all the new debt issuance that will be needed over the next few years for all the “bailouts.”) At maturity, the U.S. Government will try to “roll them over,” preferably at the same low interest rate. Will the U.S. find buyers at these historic low rates? Many have been stating that treasury bonds at 2% can’t last, and they won’t. It’s just a question of who begins to doubt the paying ability of the U.S. Government first, and then as Mr. Rule states above, all hell will break loose.

Figure 3 Maturity Dates² of Marketable Debt Held by the Public as of September 30, 2008



Cheap Oil

"There is no such thing as luck. There is only adequate or inadequate preparation to cope with a statistical universe."
 –Robert Heinlein, Science-fiction author

While motorists may feel “lucky” to once again be filling up their SUVs with \$1.50 gasoline, few are contemplating the possible ramifications from oil crashing back to \$30 barrel. However, at this price many uneconomic oil and gas wells are being shut down and capital for future exploration is drying up. (Not to mention at these prices alternative energy programs are being terminated.) This will simply create a bottleneck further out and delay our inevitable energy crisis. Investors are fixated on the demand side right now, but it is the supply side that they should be watching, as the majority of mature oil fields globally are in decline. (Another point Casey Research has been discussing for some time now.) Lastly, many nations such as Mexico and Russia depend heavily on oil for their economies to run well and are currently at risk of collapse if prices remain this low. While many may not care if these countries’ economies crumble, I would surmise that an unstable country that shares our border or one that’s a nuclear power isn’t a good thing.

Portfolio Happenings!

*"The Pessimist complains about the wind,
 the Optimist hopes it will change,
 the Realist adjusts the sails."*
 –William Arthur Ward

I have to thank one of our clients for sending me this quote, both for the compliment, as well as the great quote. For newer clients, it was in my 2003 commentary that I used a Boston Whaler to describe our investment portfolio (as my wife points out, no one can beat a metaphor to death better than I) as compared to that of a cigarette speed-boat—the more traditional investment portfolio. My purpose was to explain why I felt our portfolio would survive the coming rough seas better than most. At that time I didn’t know when the storm would hit, but I’d say given the collapse of many of Wall Street’s titans this past year and that 2008 delivered some of the worst financial market returns in history, it has arrived.

I read an article the other day by *Bloomberg’s* Christopher Condon in which he cited the following:

- Thirty-six percent of respondents said their [investment] advisers performed well last year, according to a November poll of 750 U.S. households with more than \$1 million in net assets by the Chicago-based consulting firm Spectrem Group.

- Nearly two-thirds of U.S. millionaires say their investment advisers have failed them during the global recession. “*While they blame the government and Wall Street directly for the situation, many millionaires are not happy with their advisers’ performance,*” Catherine McBreen, a managing director for Spectrem, said in the statement.
- U.S. millionaires lost an average 30 percent of their assets last year, with 17 percent of respondents saying their assets declined by 40 percent or more, Spectrem said. The Standard & Poor’s 500 Index dropped 38 percent last year, its worst since 1937, and global stock markets surrendered \$28.7 trillion of their value, or 47 percent.

One might think that given this view of the destruction left from the storm I would be satisfied with our performance—we ended the year down approximately 13%. While our boat wasn’t swamped like many others during the year, I am disappointed that I didn’t do a better job at preserving your wealth. I realize that we may look good in a “relative” world, but I have made the point over the years that we measure ourselves in “absolute” terms—positive or negative—and while comparing our returns to that of various indexes may make me feel better, it doesn’t hide the fact that we lost money. Looking back at 2008 I have no excuses; a few regrets—one being that I should have reduced our commodity exposure sooner. But in the end I can state that I gave it my best and promise to maintain the same level of diligence and prudence as we continue our journey into uncharted waters.

I would also like to take a moment to thank my wife, Lana, along with my associates at TWC for putting up with me this past year. This was a truly challenging, frustrating, humbling, yet mentally stimulating year in which I spent countless hours reading, thinking and mumbling to myself in hopes of keeping us on course. I realize that this made me not the easiest person to be around at times, and I apologize for occasionally letting it get the best of me. I am actually getting used to the craziness (it’s called acceptance, Steve) and promise everyone to be more tolerable in 2009. ☺

I will discuss how our portfolios are invested in my next commentary. Suffice it to say for now, as I stated at the beginning, I don’t know what awaits us in 2009, but I don’t believe the storm is over and I remain cautious. For those that think they know...

*So you think you can tell a bear market from a bull,
a stock bottom from a bounce,
Can you tell a deflationary trap from the Paradox of Thrift?
Productive investment from wasteful Keynesian spending?
Do you think you can tell?
—With deep apologies to Pink Floyd, Wish You Were Here*