



Commentary
by Steve Henningsen

Where does the *can* go next?

“Travel is fatal to prejudice, bigotry, and narrow-mindedness, and many of our people need it sorely on these accounts. Broad, wholesome, charitable views of men and things cannot be acquired by vegetating in one little corner of the earth all one’s lifetime.”

–Mark Twain

“We do not receive wisdom; we have to discover it for ourselves by a voyage that no one can take for us, a voyage that no one can spare us.”

–Marcel Proust

My honeymoon to Greece was where I first got bit by the wanderlust bug. My wife would claim she was born infected. For us, there is no bigger joy than travel, because it is through our journeys that we find ourselves and new friends. We feel fortunate that we have been able to pass along this desire to our two children, both of whom covet their passports over all else. (Yes, even the Wii.) For the Henningsen clan, experiences trump “things,” and we tend to prioritize around travel. (Although I’m afraid my wife has finally grown tired of our 11-year-old Volvo.)



We have managed to pack a whole year’s worth of vacations into the previous two months, with a two-week visit to Argentina and a one-week stay in Mexico. The trip to Argentina (our first) was the chance of a lifetime, as we were invited to join two other families who were familiar with the country. Although we did not know most of the family members initially, we quickly got to know them through participation in a long-lost ritual here in the United States – the experience of eating. Those who travel outside the U.S. know what I’m talking about, for somewhere along the line, Americans

recategorized eating from an experience to a task – something to be sped through as quickly as possible. I’m not sure how this developed – maybe it came about as part of our television culture or our move towards “short-termism.” We even created a whole new food industry based upon quick preparation and use of the microwave oven.

I realized this around day two in Argentina, as I sat and observed the discussions circulating around the table (and not just among the six adults, but the six children, as well.) For you see, in many foreign countries, eating is still an *experience*, something not to be rushed, as meals can easily last two hours or more. It is about people, interaction, laughter and stories. Something deep inside us that goes back thousands of years to when our ancestors sat around a fire eating and telling tales. These gatherings, and not just dinner, consumed hours in our day, but we always looked forward



to them. What would have tormented me years ago, I have come to enjoy, as I realized that these place settings were merely the canvas for the art of conversation. By the end of our 12 days together, our three families knew each other better than most families know their neighbors they have lived next to for 10 years.



Another thing that strikes me when I travel outside the U.S. is how good the food tastes. I believe it is because the food is usually grown locally, as most foreign countries don't have the broad food network we have in the U.S. (I realize that there are ways to buy locally produced food in the U.S., but it isn't as easy to find in most areas.) In Argentina, we ate fresh cheese daily (made at the ranch we stayed at) and enjoyed fruits and vegetables grown nearby. Even the beef tasted better, as the cows are grass fed with no hormones. In Mexico, we visited the farmer's market, where we interacted with the local people while shopping for fresh fruits and vegetables. Another thing one notices is that the majority of foods are prepared without using preservatives or synthetics. This is much different from the U.S., where you have to go out of your way to find any sort of food that has not been processed and made with preservatives. You simply feel better after eating pure, unprocessed food.

These encounters lead me to the thought that these things together, task-oriented eating and poor food quality, are contributing to the obesity and diabetes problems in the United States. I, for one, have noticed that when I sit down for a long meal, I tend to eat at a measured pace and eat less vs. the days of wolfing down a meal in order to get on to the next thing. (You don't see many overweight Europeans.) I have been slowly trying to change my eating habits and mindset around meals, and I feel very good about it.

By now you are probably asking yourself what this has to do with investing. Well, I see the same parallels in the financial world. Business deals were once built upon relationships and simple financial products. Over the past 30 years companies have become more short-sighted in their business deals or simply shifted towards a more transaction-based model. They began using complex financial products, such as derivatives and other synthetic investment vehicles. This made their balance sheets less transparent to their shareholders and deceived their executives into believing they had control over the "risks" embedded within their companies.

Alongside the changes in the business world was the morphing psychology of investors and consumers. Beginning in the 80s, consumers no longer had to patiently sit through a long period of "saving" to get what they wanted. The developing credit markets would allow them to forgo the *experience* of placing a down payment for something. The age of consumerism was born. This led to a false economic boom built upon credit, which elevated the financial markets and shifted investor expectations in the equity markets. Whenever this false prosperity began to waiver, the government was there to prop it back up with low interest rates or financial incentives. Americans kept on consuming, hardly noticing their expanding waistline of debt.

"Credit expansion is the governments' foremost tool in their struggle against the market economy. In their hands it is the magic wand designed to conjure away the scarcity of capital goods, to lower the rate of interest or to abolish it altogether, to finance lavish government spending, to expropriate the capitalists, to contrive everlasting booms, and to make everybody prosperous. The final outcome of the credit expansion is general impoverishment."

—Ludwig von Mises

These underlying risks, like diabetes, eventually came home to roost in the financial crisis that began in 2007. The question is whether or not we will learn from it and shift our consumer habits going forward. The government does not have the political appetite to allow the economy to shrink to its real level, as this would involve a long economic contraction. Therefore, they want us to continue our old habit of eating greasy, fast food (buying what we cannot afford via credit), so much so that they are wasting billions of taxpayer dollars to incent us to buy autos and mortgages. Their nightmare is for Americans to return to the frugal, slender days of spending below their incomes and demanding simpler financial products to assist them, instead of enslave them.

Squirrel!

"What a good country or a good squirrel should be doing is stashing away nuts for the winter. The United States is not only not saving nuts, it's eating the ones left over from the last winter."
 –Bill Gross, managing director at Pimco

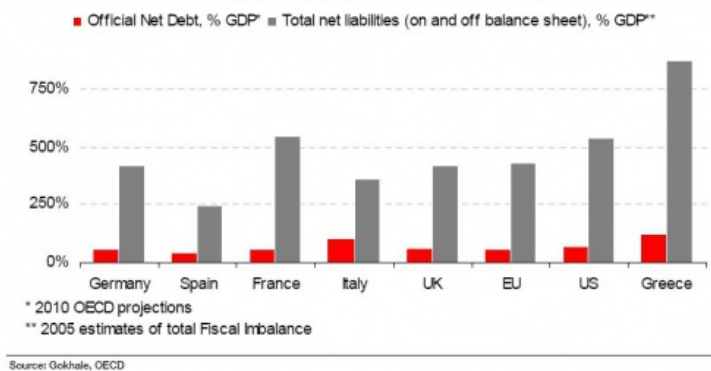
Speaking of squirrels, in the Disney movie “Up,” there are some funny scenes where dogs get distracted whenever someone yells “squirrel.” This is what I currently see the government attempting as they try to distract us from what we all know deep down inside: the economy is not getting better.

"From government reports to corporate earnings to private measures of the economy to media reporting, we simply are being fed lies and deceit."
 –Grant Noble, investor

As more and more information comes out about how we have been deceived (the latest was the Lehman report) my question is: When did it become okay to distort the truth – whether it’s the banks playing accounting games, The Federal Reserve transferring bad assets from the private sector to the public, or the world pretending that Greece is still solvent (or Spain, Portugal, Italy, or the U.K. for that matter.)?

"Panics do not destroy capital – they merely reveal the extent to which it has previously been destroyed by its betrayal in hopelessly unproductive works"
 - John Mills, “Credit Cycles and the Origins of Commercial Panics,” 1867

Greece isn't that different 1: its *real* fiscal problems are in its off-balance sheet unfunded pension and health obligations, like everyone else's



As one can plainly see by this chart, much of the developed world is beyond hope, when their promises (off-balance sheet liabilities) are taken into account. In simple terms, many countries, including the United States, have outstripped their capacity to service their debts.

And this is while global interest rates are at historic lows. What happens if rates should begin to rise over the next few years?

"The question is when markets will start putting pressure on governments, not if. When will investors start demanding a much higher compensation for holding increasingly large amounts of public debt? In some countries, unstable debt dynamics -- in which higher debt levels lead to higher interest rates, which then lead to even higher debt levels -- are already clearly on the horizon."

"Official debt figures in the West are 'very misleading' since they fail to take in account the contingent liabilities and pension debts that have mushroomed over recent years. 'Rapidly ageing populations present a number of countries with the prospect of enormous future costs that are not wholly recognized in current budget projections.'"

–Recent report from the Bank of International Settlements

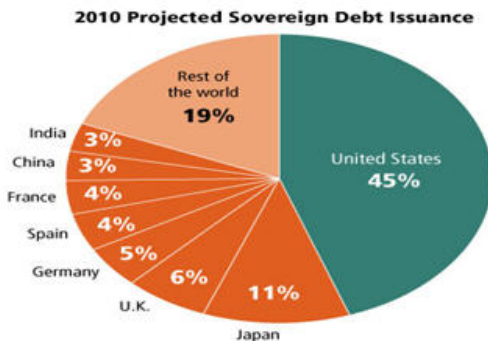
This leads me to the quote below where I got the title for my commentary: *Where does the can go next?* It may be referred to as a “parcel” in England, but here we say “kick the can down the road” and like Mr. Bowers, I don’t see us being able to kick the can much further.

“It’s the last game of pass the parcel. When the tech bubble burst, balance sheet problems were passed to the household sector [through mortgages]. This time they are being passed to the public sector [through governments’ assumption of banks’ debts]. There’s nobody left to pass it to in the future.”

–David Bowers of Absolute Strategy Research

Uncharted Waters

Governments around the world will issue an estimated \$4.5 trillion in debt this year, triple the five-year average for industrial countries.



Sources: IMF World Economic Outlook and other various public sources, including news media and respective government data; Hayman Advisors estimates.

With trillions of various governments’ debt rolling over in the next 24 months, will there be enough buyers, and at what interest rate? Can these governments keep passing the bill down the generational line or will the pyramid of debt finally collapse upon itself through debt defaults? When will politicians finally get the courage to tell us the truth – that the cupboard is empty?

“I am a firm believer in the people. If given the truth, they can be depended upon to meet any national crisis. The great point is to bring them the real facts.”

– Abraham Lincoln

Governor Chris Christie, my new hero!

One hopeful sign that I received recently through blogger Mike Shedlock, was a speech by New Jersey Governor, Chris Christie, as he candidly explained the problem to 200 mayors at the New Jersey League of Municipalities. Here is part of that speech that was on his blog site:

We need to understand we are all in this together. And you know, all of you know in your heart, what I am saying is true. You all know that these raises that are being given to public employees of all stripes, we cannot afford. You all know the state cannot continue to spend money it does not have. And you all know that the appetite for tax increases among our constituents has come to an end.

And so the path to reform and success is clear. We know what it is. We just have to have the courage to go there. What we are doing is showing people that government can work again for them, not for us. Government has worked for the political class for much too long.

There's no time left. We have no room left to borrow. We have no room left to tax. So we merely have room left now, to do this. We are all reaching the edge of a cliff. And it reminds me a bit of that part of Butch Cassidy and the Sundance Kid where the [sic] had a seminal decision to make. So what did they do? They held hands and they jumped off the cliff.

We have to hold hands at every level of government, state county, municipal, school board. We have to hold hands and jump off the cliff.

I firmly believe we will land and we will be fine. It does not mean it will not be a scary ride on the way down. And it does not mean there won't be moments of fear and moments of apprehension.

But for certain, the troops of the decades of overspending and overborrowing and overtaxing have gained on us. So the ruination of New Jersey's economy, and of the quality of life we want all our citizens to have, is certain if we do not take this course.

It's time for us to hold hands and jump off the cliff. It's time for us to do the difficult things that need to be done and to stop playing the petty politics of yesterday, of lying to the people telling them they do not have to pay for it because someone else will.

We are going to make the leap because that's what people elected me to do. We are going to make the leap because it is the responsible thing to do. We are going to make the leap and we are going to do it together because that is what leadership demands for us. That is what the responsibility of the offices we hold requires of us.

It's a rare politician that can tell a crowd what they don't want to hear, and let's hope that he isn't the last.

Portfolio Happenings!

"Consideration of risk must never take a backseat to return."

–Seth Klarman, investor

"I fully expect to be here in five or six years telling you to buy US stocks at 6 times earnings - at a time when the geopolitical decline of America is on the front page of every newspaper; at a time when you have capital controls; at a time when the government is manipulating the debt market."

"The last time that [America] had no government debt, you had a Scottish president. His name was Andrew Jackson. Not only did he pay off the national debt, he also abolished the central bank and tried to close down all the commercial banks."

- CLSA Strategist (and Scotsman) Russell Napier, March 24 CFA Society speech

"This search for returns has already started a new asset-price boom - an echo bubble – in stock and commodities markets, setting the stage for the next bust when the relevant financial data disappoints. The Fed's current stimulus program is helping to push securities higher, but is not producing much benefit for the economy."

-James Melcher, President & Founder, Balestra Capital

As much as I agree with these gentlemen's views, I must say it isn't easy sitting back and watching this melt up in stocks. Especially, with one investment advisor after another telling you how foolish you are for not sitting down to enjoy the free liquidity lap dance being offered by your government. Not only did we not keep up with the markets this past quarter (we tend to underperform during bull markets if you hadn't noticed), but we managed to lose money, as not much went our way.



Specifically, our positions in gold/silver, agricultural commodities and equity shorts hurt us the most. Although this bounce in the markets has been admittedly breathtaking to watch and the temptation to join the party can be overwhelming at times, nothing has changed to make me want to abandon our prudent stance. I still maintain that this is simply a large cyclical rally in an incomplete secular bear market. Why do I maintain that it is still a bear market? It's simple; one cannot rebuild a sustainable economy on a rotten foundation. Until the bad debt is purged from the system and a solid foundation put in place, risk of collapse still remains. It's not a question of if, but when, to me. Should markets continue their upward advance, I will have exposed you to loss of opportunity, but not loss of capital.

PS. As this picture of my son shows, even after traveling thousands of miles to the Southern Hemisphere, one can find similarities in other cultures.