The Wealth Conservancy, Inc.

Commentary
by Steve Henningsen

October 2009

Biding Time

So I'm just gonna sit on the dock of the bay
Watching the tide roll away
Ooo, I'm sittin' on the dock of the bay
Wastin' time…

Look like nothing's gonna change
Everything still remains the same
I can't do what ten people tell me to do
So I guess I'll remain the same…
–Otis Redding, *Sitting on the Dock of the Bay*

There's been no real economic improvement apart from that resulting from government handouts and stimulus; nothing real has been built, such as major infrastructure; manufacturing capacity is stagnant following years of contraction due to cheap labor sources offshore; and there's been little job creation (except in the ever-expanding public sector). I don't consider a person working four hours a week to be employed. Banking and finance-sector balance sheets have been prettied up, but I'm skeptical at best about this sector looking forward. Applying lipstick to a pig changes nothing; it's still a pig.
–Laurie Mcguirk, investment manager

You aren't the only skeptic, Laurie, but it sure hasn't paid to sit on the sidelines, as the markets have been on a tear lately. I have déjà vu – it seems like 2006 all over again, when we were also sitting back watching the markets go up while the music played, until it stopped and the mad scramble for seats began. That's not to say that this will occur again – I'm just uncomfortable with how quickly the markets have rebounded.

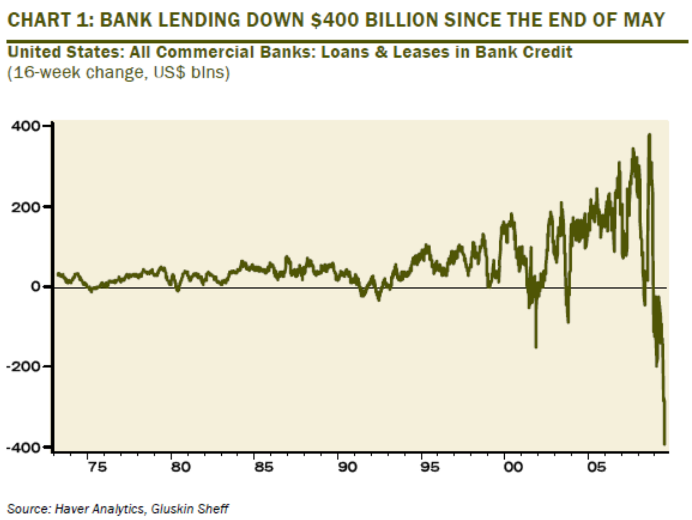
As I sat pondering this commentary, I realized that nothing has changed in three months. I have been inundating clients with emails so, mercifully, this commentary will be short. However, I do recommend that you go back and read my 2nd quarter commentary again.

If you aren't confused, you don't understand what's going on.
–Quote from unknown investment manager

I found this investment manager's comment honest and refreshing, as the crosscurrents of deflation and inflation, mixed in with various government support programs, are testing everyone's abilities these days. Well, I guess it isn't fair to say everyone, because it seems many believe that the problems of last year are ancient history and better times lie ahead. As you know, I am still having trouble with this view. I have long stated that I need to see meaningful evidence of self-sustaining private sector demand, which is usually needed for a sustainable economic recovery. What I have seen is asset price gains derived from the world's largest financial experiment ever – $14 trillion expansion in the Fed's balance sheet, the $1-plus trillion in various stimulus programs, and monetary printing to the tune of $1 trillion. I cannot find any historical precedents for good economic cycles emanating from the destruction of government and central bank balance sheets and my gut tells me that this experiment won't end well.

It isn't just Laurie and I who are concerned, as the respected investment managers at Hoisington wrote the following in their 3rd quarter review entitled *The Impossible Promise:*

> *The federal government's promise to extricate the U.S. economy from this recession involves more spending (increasing public debt) and more subsidies for consumers, such as car rebates and home buying incentives (more private debt). In other words, more debt is supposed to solve the problem of over-indebtedness. The truth is that this policy merely indentures its citizens further without providing any income for repayment of debt.*



So while Joe consumer wisely continues to pay down debt and increase savings, Uncle Sam continues its drunken spending/printing spree. While this government intervention will make the economy appear brighter in the short-term, it simply masks the weakness of the patient, and once the morphine wears off, the cancer (debt) will still be with us. With unemployment and foreclosures continuing to rise, income growth non-existent, consumer credit contracting (see graph), state and federal tax receipts falling, and large banks still undercapitalized (insolvent if not for accounting shenanigans) it is hard to see how this won't end badly.

Speaking of banks, I just read this quote from investment manager Barry Ritholtz regarding J.P. Morgan's great earnings release:

> *Taxpayers took all the risk and received none of the upside when lending money to banks such as JPM. Rather than our public servants negotiating on our behalf to get a genuine capitalist deal like Warren Buffett did with Goldman Sachs (GS) and General Electric (GE), we now get to watch JPM et al swim in their profits while our broken system could have benefited from a savvy deal.*

Yes, it's great to be a taxpaying American these days!

It's not denial. I'm just selective about the reality I accept.
–Bill Watterson, author

That's not to say that the current stock market can't continue to rally for several more months or even longer. In my commentary from the 2nd quarter of 2006, I quoted from Marc Faber as follows:

> *If the central bank decides to support asset prices such as stocks and homes with easy money and by cutting interest rates aggressively, it is the currency that will tumble. If, on the other hand, a central bank decides to support its currency by implementing tight monetary policies and by increasing interest rates, stocks and home prices will tumble. So, whereas the Fed indeed has two options - print money and support asset prices at the cost of a weak dollar, or keep the dollar strong at the cost of weak asset markets - US assets will continue to decline in value relative to those abroad…this adjustment process*

will occur either through the value of the dollar or through the pricing of asset markets. <u>Now, it should be clear that in any society, but especially in democracies, the necessary adjustments are less obvious and initially less painful to the people who vote when they occur through a weakening currency.</u> This is particularly so in a country where most people have little interaction with foreign countries and where asset prices are, if not grossly inflated, then at least - by historical standards - elevated and highly leveraged."

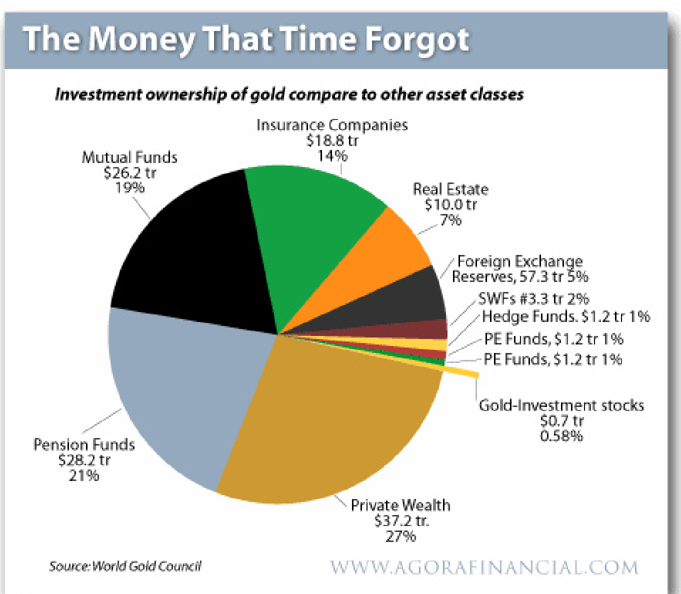
The underlined part (my emphasis) is important to understand and is what I have been watching for over the years. Which way will the government go in trying to save the economy? I think we can now safely surmise that they have chosen as Mr. Faber suggested – *inflate through currency depreciation*. While this may seem like a good thing, it isn't. Government officials may come out and state that they want a strong dollar, but they don't. By depreciating the dollar they can pay back our debts with cheaper dollars – good for the U.S., bad for our foreign debt masters. This may also double the stock market in price, but what does it matter if your purchasing power decreases? TWC focuses on purchasing power because this leads to true wealth preservation and growth over time. There is no better friend of wealth preservation than gold, and since TWC has 20% of our clients' portfolios currently invested in gold (and silver) bullion and the shiny one has been getting some press lately, let me comment on it first, before discussing other aspects of our portfolio.

Oh Precious One!

"Never believe anything in politics until it has been officially denied three times."
–German Chancellor Otto von Bismark

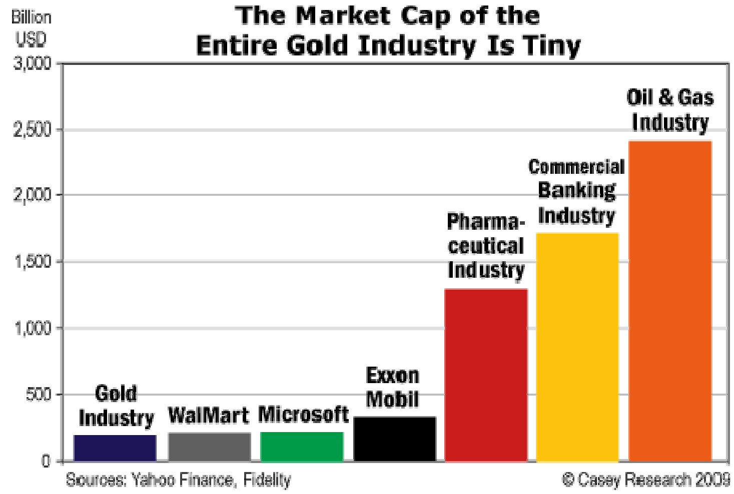
The gold market (and silver) got all excited recently when Robert Fisk wrote an article for *The Independent* called "The Demise of the Dollar," in which he stated:

In the most profound financial change in recent Middle East history, Gulf Arabs are planning – along with China, Russia, Japan and France – to end dollar dealings for oil, moving instead to a basket of currencies including the Japanese yen and Chinese yuan, the euro, gold and a new, unified currency planned for nations in the Gulf Co-operation Council, including Saudi Arabia, Abu Dhabi, Kuwait and Qatar.



Of course the story was quickly denied by all parties – except the Chinese. Anyway, this shouldn't have been a surprise for TWC clients, as we have been discussing the U.S. losing its reserve currency status for years now. Now that gold has surpassed the $1,000 level, many are beginning to say that gold is a bubble or that it is overvalued. As you can see from this chart, the amount of money invested in gold is tiny compared to other investments and gold equities are also tiny in size when compared to other sectors. When investors truly move into the gold market you will recognize it because it will take relatively little to drive up the price of either the bullion or the stocks.

I believe investors are slowly moving to gold because they are losing faith in their governments and their currencies. But don't take my word on it. Let's see what one of the brightest investment managers, John Paulsen, had to say about gold after investing a large portion of his fund in gold bullion and gold stocks a few months ago:

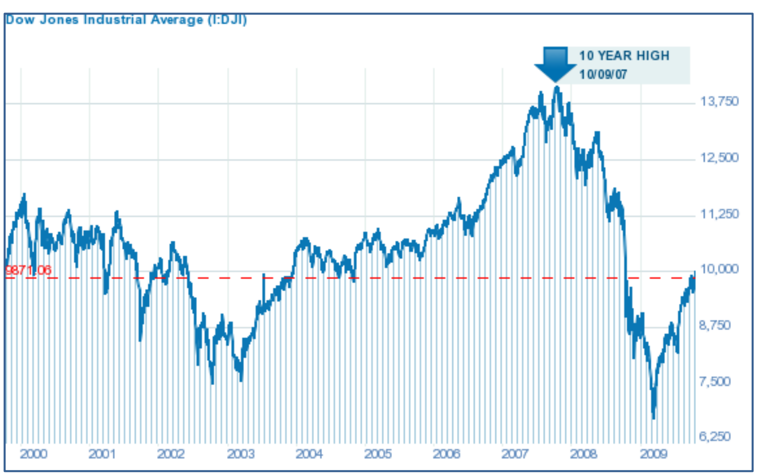


> *Once the Fed began directly buying Treasuries and mortgages, I lost faith in the dollar as a reserve currency for my assets... What I'm looking at is not where gold is going to be tomorrow, one week from now, one month from now, three months from now. What I'm looking at is where is gold going to be vis-a-vis the dollar one year from now, three years from now, five years from now…And I think with a high probability at each of those points, gold will be higher than it is relative to the dollar today. That probability increases the further out you go, and the magnitude of that difference also increases the further out you go. So when I look at what the risk is, the risk to me is far more staying in dollars than it is in gold at this point.*

As I have stated several times since we began buying gold, it is a volatile investment and we could easily see it dip down $150, but I agree with John in that it will be higher further down the road – higher than most imagine.

Portfolio

Let the good times roll
Let them knock you around
Let the good times roll
Let them make you a clown
—The Cars, *Good Times Roll*



Our defensive stance has served us well over the past two years, but has held us back so far this year, as our equity hedges (reverse ETFs) have neutralized most gains since the first quarter. It also didn't help that I decided to sell some of our equity ETFs in the spring, fearing a summer downturn. Mea culpa – sometimes you're the redeemer and sometimes the clown! Wall Street is celebrating (again) that the DOW is back to where it was a decade ago (technically, it is at 7,537 if one were to factor in that the dollar has lost 25% of its value since 1999) and I can feel the pressure as the siren call of an upward moving market draws investors in. However, as John Maynard Keynes stated years ago, "The market can stay irrational longer than you can stay solvent," and if the government is determined to reinflate the markets, I don't wish to stand in the way and will need to reevaluate our equity hedges over the weeks to come. ("Live to fight another day," as they say.) This doesn't mean that we will be increasing our weightings to equities, although I may begin getting back into some of our commodity stocks that we sold out of earlier in the year, as a depreciating dollar increases the price of commodities. Cash is king for now, but I will be reallocating some of it to foreign currencies to offset the depreciation of the U.S. dollar.

Let me be clear that I would *like* to get back into some of the stock markets and sectors that I find have great future potential; energy, Brazil and emerging markets in general. However, the picture remains murky to me, as the government programs have muddied the water. So we will remain mostly on the sidelines until I have a clearer understanding of the outcomes *and* any unintended consequences. I believe we will find out how sustainable this rally is within the next six months, when the government stimulus will be over and we will see whether the economy can stand on its own.

> *All is not hopeless. Markets are turbulent, deceptive, prone to bubbles, infested with false trends. It may well be that you cannot forecast prices. But evaluating risk is another matter entirely.*
>
> –Benoit Mandelbrot

The picture I began my commentary with symbolizes the banks and commercial real estate companies. They have substantial real estate losses on their balance sheets and are holding their breath, hoping that the government can push back the tide of bad debts via reinflating asset values. For now, patience is needed, as we sit on the dock of the bay, singing a little Otis, while the banks hum a different tune, "*the tide is high but I'm holding on*…"