

## Commentary

by Steve Henningsen

October 2007

### A Summer's Tale



Over the past couple of years various individuals have been comparing the American economy to Goldilocks: *not too hot, not too cold*. Here's my own spin:

With apologies to Amy Winehouse:

*They tried to make Goldi go to rehab but she said 'no, no, no'  
Yes she's been bad but when she comes back you'll know know know  
She ain't got the time and if Ben thinks she's fine  
The bears tried to make her go to rehab but she won't go go go*

**The Woodland Gazette** sadly documented the whole ordeal. Goldilocks' neighbors had been talking behind her back for years regarding her extravagant spending and how she always seemed a little *too* happy meandering through the money-tree forest late at night. Goldi, as her friends called her, denied having any problems, but others knew differently.

The first sign of trouble began with the bears, or The Stearns family, as they're known, when they claimed that someone had broken into their house and not only eaten their porridge, but had stolen all the funds in two of the Stearns' family cookie jars. The local sheriff, Mr. Fox Paulson, along with other government foxes, were quick to tell everyone not to panic, as the problem was isolated to their neck of the woods. (They would later clarify their statement by saying they meant isolated to planet Earth.) The word *isolated* still hung in the air as news was received that *someone* had been passing off worthless CDO bonds to their furry, foreign friends across the pond. Paws were beginning to be pointed at Goldi, as she and her spending posse, had just completed a European vacation, but all Goldi could do was complain about how little her "bread" could be exchanged for while shopping there. She then added that her foreign friends should stop complaining because they have benefited over the decades from her buying their goodies.

Her foreign friends were beginning to have their doubts about Goldi, though, as they too had noticed that the quality of her bread had been in decline over the past several years—even though she claimed to have a "high-quality bread policy." They knew that *their* bread would buy more tourist treats when they visited her, but also knew that the value of all the IOUs that Goldi had piled up at their doorsteps over the years were being devalued. Yes, Goldi had been

good to them over the years, but she was beginning to look a little fatigued, as her debts continued to mount. Some even whispered amongst themselves that maybe her best years were behind her. Rumors began to flow about a younger Asian girl that had been seen skipping through the woods. Goldi had seen her as well, but was quick to state that the younger girl could make all the goodies she wanted, but it was Goldi's *thinking* that made her treats extra special.

Deep down inside, though, Goldi knew she wasn't the young, spry teenager she once was, but like an aging Hollywood starlet, a little extra makeup helped hide her blemishes while more supportive dresses helped hold up her falling "infrastructure." Even her doctors privately begged her to slow down, but that was something she just couldn't accept. So a few years ago, she secretly began popping pills (*rate cuts*, as they were known on the street), and she knew just where to get them. There was a wizard deep in the woods that went by the name of Greenspan, who was known to provide stimulants when needed, and although she knew the long-term effects would not be good for her, she just had to remain the envy of the world. And by Goldi remaining strong, the animals of the woods would benefit as well. Sure the animals were concerned about Goldi, but she had been the belle of the ball for decades, so why count her out? Besides, they were having too much fun, as the government foxes had made it easier for them to borrow against their nests and burrows over the years, and it seemed like the tooth fairy came nightly to deliver new credit card applications to their mailboxes. Mr. Squirrel couldn't remember the last time he had gathered a nut, and Mrs. Bluebird was happy as a lark about the new three-level nest she had traded up for, even though the three-week adjustable-rate loan she had to get ruffled her feathers a bit. Oh well, she thought, like the nice, nest agent told her, nest prices never go down. Besides, she had been flying by her neighbors' nests for years with envy and now she had her very own McNest.

Well, after a few years, with her debts building and the stimulants' effects beginning to wane, that fateful August day came when Goldi was found lying in the middle of the path, with hardly a pulse. The woodland creatures that had come to depend upon her more than ever surrounded her as the panic began to build. Mr. Squirrel suddenly thought to himself that maybe it would be a good idea to start saving some nuts, while Mrs. Bluebird began asking herself if she really needed this big a nest. The wizard was no longer around, having conveniently left the woods to travel the world, while writing his soon-to-be-published book, *The Age of Unaccountability—It Wasn't My Fault!* Just as all hope was lost, with the scissors within a whisker of cutting the animals' credit cards in half, a white knight, Sir Ben (Bernanke), jumped from the bushes and with a syringe full of *rate cuts* held high (in a scene right out of *Pulp Fiction*), drove it into Goldi's heart. Goldi sprang to her feet while the woodland creatures danced with joy. Yes, Goldi was back, and all of the animals' thoughts of prudence went *poof!*

Sir Ben stood there with a forced look of confidence on his face, watching as the animals carried Goldi off to celebrate. They didn't seem to notice the bead of sweat hanging from his brow; he knew that the drug he had delivered was not a cure for what ailed Goldi, but it would buy him time for now . . .

## NOT THE END

*(Disclaimer—The author is by no means implying he has the medical knowledge to ascertain the actual health and outlook for Goldilocks; nor is he stating that it is beyond the magical powers of government pixie dust to keep her levitated indefinitely. In addition, it is not known at this time whether or not the woodland creatures live happily ever after or whether the author is just a gloomy-pants and should throw down his skeptic shield and believe in the magic of the times.)*

And now back to the real world. (No, not the television show *Real World* but the *real*, real world!) As a warning, I got rather "quotey" this quarter because there have been many people with things to say lately.

## Can I get an Amen!

*"The global credit bubble is bursting. This bubble is primarily leverage financing for owning risky assets. The people who were responsible for what happened played with other people's money, marketed arcane financial products with false promises of fat profits, but stuffed their own pockets with big bonuses. Neither these masters of the universe nor their greedy but naive investors deserve to be bailed out. They deserve what is coming to them.*

*"The central banks should focus on price stability, not financial market stability, and should provide liquidity only to contain the multiplier effect of the bubble bursting on the economy. Nor should central banks stimulate to avoid recession at any cost. Business cycles are not bad. Excesses must be followed with cleansing. . . .*

*"Markets have been taking more risk than they should because they believe that central banks will come to their aid during times of crisis, like now. The penchant of Alan Greenspan, former U.S. Federal Reserve chairman, to flood the market with liquidity during financial instability is the genesis of this 'central bank put.' As long as this expectation remains, financial bubbles will occur again and again. Now is the time to act. Let the crooks go bankrupt. Central banks should bury the Greenspan 'put' for good."*

Andy Xie in a recent *Financial Times* article

As well as:

*"The current crisis is the result of the normal ebb and flows of credit cycles, and the free market will amply handle the correction that is already happening. Calls for Federal Reserve intervention or for other governmental involvement -- including an increase of the Fannie Mae/Freddie Mac lending limits -- must be rejected.*

*"In the free market, those that made bad credit decisions must be allowed to pay the price, and only by paying dearly can lessons truly be learned. Borrowers who were unwitting and took on too much debt must learn that there are consequences for their actions. Homebuilders that built too many homes or overpaid for land need to face the consequences. Wall Street firms that provided credit to all of these activities with too much laxity must also pay a price. This is all part of a healthy correction. All of these players reaped benefits during the housing boom that preceded the current crisis. Certain homeowners were able to temporarily live above their means. Homebuilder and bank profits have been exorbitant, and shareholders and executives of these companies have profited mightily in the boom. To not permit losses now would be a direct violation of the free-market ideals at the foundation of our economy."*

Ethan Penner, Principal at Lubert-Adler in *Wall Street Journal* Opinion section

Followed by:

*...credit boom and bust cycles "have occurred in every institutional, monetary and regulatory setting," and (correctly IMO) places the blame on the "human race, first and foremost. Well-intended public policy, second. And Wall Street, third — if only for taking what generations of policy makers have so unwisely handed it."... "Now comes the bill for that binge and, with it, cries for even greater federal oversight and protection. Ben S. Bernanke, Mr. Greenspan's successor at the Fed (and his loyal supporter during the antideflation hysteria), is said to be resisting the demand for broadly lower interest rates. Maybe he is seeing the light that capitalism without financial failure is not capitalism at all, but a kind of socialism for the rich."*

James Grant, Newsletter writer and all-around Federal Reserve Critic

Well, I'm glad a few in the financial world had the chutzpah to come out and tell it like it is. Who else was speaking his mind this past spring? . . . Oh yeah, Federal Reserve Chairmen Ben Bernanke stated that, *"Given the fundamental factors in place that should support the demand for housing, we believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited."* Yes, limited to about 2 million U.S. homeowners and all the schmucks (mostly foreign investors) that were greedy enough to buy all the securitized debt! He then noted that, *"Importantly, we see no serious broader spillover to banks or thrift institutions from the problems in the subprime market; troubled lenders, for the most part, have not been institutions with federally insured deposits."* Well maybe bank blowups throughout Europe and Australia aren't quite broad enough for the Fed. Now if they spread to the moon, now *that* would be broad.



No, the lines in this picture from London aren't because the iPhone went on sale, but a good, old fashioned bank run at Northern Rock. Americans haven't seen one of those since the Great Depression...aah to reminisce. Couldn't happen here though...right! Anyway, I'm glad it won't affect any of the financial institutions here in the good old USA. Hmm, what's this coming over the newswire from Citigroup's CEO Chuck Prince—they have tallied a \$6 billion loss so far? (Remember his snazzy quote from last quarter, "...but as long as the music is playing, you've got to get up and dance."). And they aren't the only ones to pull up lame on the dance floor—Merrill Lynch writes off \$5 billion, UBS \$3.7 billion, and Deutsche Bank estimates \$3.1 billion. Fred Astaire they're definitely not!

*You can hide `neath your covers and study your pain  
 Make crosses from your lovers throw roses in the rain  
 Waste your summer praying in vain  
 For a savior to rise from these streets*  
 "Thunder Road" by Bruce Springsteen

And rise he did. It was Ben to the rescue with 50 basis points, and the market took off like a scalded cat. Wow! Can lowering short-term interest rates really rescue all those people hitched to their depreciating houses, as well as those "quants" on Wall Street that were apparently all using the same computer geek to program their trading "strategies?" Well, I had my doubts until this *strategist* made me feel better:

*"The market believes that the crisis is over... Whatever problems emerged last quarter are last quarter's problems. They're over; that's it; they're done. So let's move onto the next thing."*  
 William Rhodes, Chief Investment Strategist of Rhodes Analytics

But then an eerie feeling crept over me as I thought to myself, "Where have I heard this before...?"

*"I'm pleased and happy to repeat the news that we have, in fact, caught and killed a large predator that supposedly injured some bathers. But, as you see, it's a beautiful day, the beaches are open and people are having a wonderful time."*

Mayor Vaughn, The movie *Jaws*

### **Gone, but not Forgotten!**

*"All this emphasis on statistics and calculations..., without a proper theory, it is all nonsense. And your economists seem to have no theory at all...they just think they can manipulate the system in order to get whatever outcome they want. They think economic growth comes from consumer spending and that they can control consumer spending by adjusting lending rates. It is unbelievable that anyone takes this seriously. It is capital formation that really matters. A rich society is one with a great stock of capital...one that builds capital and puts it to work to create more capital. A rich society is not one where people consume. Just the opposite. It is not what is consumed that creates wealth; it is what is NOT consumed. Yet, all the Anglo-Saxons focus on motivating consumers to consume. And now they are consuming more than they make. I tell you, in 70 years of studying economics, I have never seen such nonsense..."*

*I have always thought it was the duty of each generation to leave the next one a little better off. That means, each generation has to consume less than it produces. It has to leave a little something extra. The problem, you see, is not an economic one...what we are doing to our children with this use of credit and debt is deeply immoral. It is wrong to burden the future with our mistakes, our conceits, our ambitions. This is what we are doing, and it is shameful."*

Dr. Kurt Richebächer, International banker and economist

Dr. Richebächer passed away this August; I write about him here because of the respect I have for him as an economist (a rarity) and because I have quoted him so many times over the past several years, as I was a subscriber to his newsletter, *The Richebächer Letter*. He was unusual in that he railed against the majority of today's economists and warned us all of the negative consequences of "credit-managed" economies. In September of 2001, he warned us again, "*The new housing boom is another rapidly inflating asset bubble financed by the same loose money practices that fueled the stock market bubble.*" The investment world lost one of the few who are unafraid of pointing a finger at those who work the machinery behind the green curtain.

### Debt Ceiling!

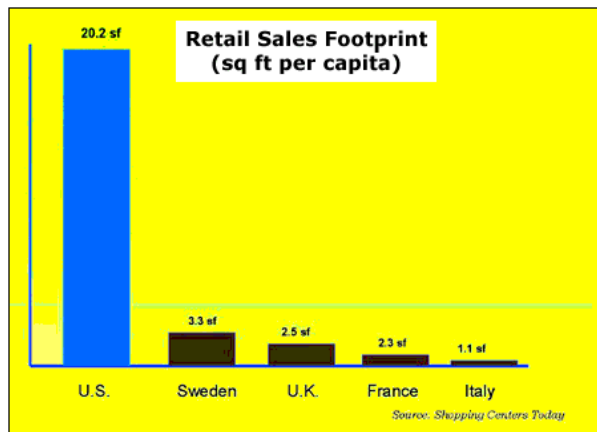
*The Senate gave final congressional approval to an \$850 billion increase in the public debt, the fifth such adjustment under President Bush and one reflecting the rising costs of the war in Iraq. Adopted 53-42, the revised \$9.815 trillion ceiling is intended to give the Treasury enough borrowing authority to manage through the end of Mr. Bush's presidency and into 2009... When Mr. Bush took office in 2001, the debt limit stood at \$5.95 trillion, a statutory ceiling that had remained since August 1997. By June 2002, a \$450 billion increase was needed, and in 2003, 2004 and 2006, three increases added an average of about \$855 billion each to finance government costs and wars overseas.*

Why, *why* is this called a debt ceiling!! Aren't ceilings supposed to be immobile objects? How many people have ceilings that can be adjusted upwards? Wasn't the whole reason for a debt ceiling to stop reckless politicians from spending the country into the poor house?

*"The budget should be balanced; the treasury should be refilled; public debt should be reduced; and the arrogance of public officials should be controlled."*

Cicero. 106-43 B.C.

### Nobody Shops Like Us—Nobody!



After seeing this chart, my prediction is that the next area to "contract" will be the commercial real estate market. Within a five-mile radius of my house we have 4 huge malls, 3 Targets, 3 Wal-Marts (with one more under construction in my town), 2 Lowes, 3 Home Depots and I can't even begin to count all the Walgreens stores, but I'm pretty sure if I hit a golf ball from my backyard in any direction, it would ricochet off one of their stores. I can't imagine how they are all going to prosper as the age of consumerism begins to moderate.

### Filed Under *They Just Don't Get it!*

*Paper is paper  
Gold is gold  
Once they were joined  
Or so I've been told*

Our old friend Gold (not to be confused with Goldi) has been getting some favorable press recently. This is a good thing, as up until the past few years, he'd been in a funk for a very long time and needed a lift. Just when he was beginning to crack a smile, some of my fellow financial advisors took the opportunity to try to dampen his spirit as follows (with, of course, my own snide comments): "*It's esoteric,*" said Richard Bregman, Chief Executive of New York-based financial advisory firm MJB Asset Management. (Steve pulls out his handy dictionary and sees

that esoteric means *restricted to initiates; intended for or understood by only an initiated few; abstruse; difficult to understand.*) Wow, I thought, sitting up straight, am I part of an initiated few? And here I thought my fraternity hazing was the only initiation I've ever had. As for difficult to understand, might I suggest the following formula: gold = *real* money.

*"I don't think we are seeing or hearing from our clients that they have a desire to increase their allocation, even after (the rate) move,"* said David Jeter, Senior Vice President of Allegheny Financial Group, which manages \$2.9 billion of client investments. Silly me—I thought it was the role of the advisor to *advise* their clients what to invest in and not to sit back and wait for the clients to make suggestions to them. No wonder I don't manage billions.

William Rutherford, President of Rutherford Investment Management, said gold and gold funds are *"a very specific kind of investment for specific people."* But not for his clients. *"It hasn't become mainstream yet,"* said Oregon-based Rutherford, who manages \$25 million for some pension funds, individuals and foundations. Again I seem to be missing the boat on something here. Let's see, I should be waiting until an investment becomes *mainstream* before buying for clients? In other words, don't buy while it's cheap and no one is paying attention; wait until people begin talking about it (preferably on CNBC) and bid the price up to a 20-year high and *then* buy it for them—genius!

And what does John Hathaway, manager of Tocqueville Gold Fund and L.P., have to say about gold these days? *"There is no politically viable way to counter the threat of general insolvency, other than to devalue debt burdens through inflation. As this dilemma becomes increasingly apparent, I expect that money will flow into the gold sector at an unprecedented clip. The Fed will have to cut interest rates, expand its balance sheet and start to print money. So will other governments, at first reluctantly, and then they all will try to outdo each other. It will come as no surprise when politicians also get into the act with deficit spending measures and debt relief proposals. The page has turned for gold. In the previous chapter, the metal was just another hard asset and a laggard at that. It was outperformed by base metals, energy and all manner of tangible assets. It was also ran and an afterthought in the commodities derby driven by the expectation of unstoppable growth in the emerging sectors of the global economy. In the current chapter, I expect gold to outdistance its tangible brethren as its unique monetary traits become more widely understood. Unlike dollars, euros or yen, it cannot be printed. In comparison to these suspect contenders for safety seeking capital, it is scarce and difficult to produce."*

Of course, I agree with John, which is why we have a good chunk of clients' funds invested with him. With the recent interest-rate cut, the Fed has made it clear that it is willing to destroy the value of our currency in order to give a fleeting boost to the economy. As John points out, the U.S. is not the only government, either; I believe governments around the world face the same situation—suffer severe economic contraction due to their debt obligations or devalue their currencies. Politicians in need of votes have a tendency to go with the latter, because it functions as the equivalent of a stealth tax hike. (A weaker currency makes import prices higher for consumers.) And yes, I still believe that this will make for an inflationary environment going forward, although not in all asset classes. As Mac Overton was quoted in Marc Faber's newsletter, *The Gloom, Boom & Doom Report* recently, *"We're going to see inflation in things people buy and deflation in things people own (homes, cars, boats, etc.)."*

## History's lessons!

*I hope our wisdom will grow with our power and teach us that the less we use our power, the greater it will be.*

- Thomas Jefferson

Over the past few weeks, I've been watching Ken Burns' documentary on World War II in complete awe at the sacrifices made by both our soldiers *and* citizens. I was struck by the differences of the war then vs. our war today in Iraq. Most striking, how most of us (myself included) just go about our daily lives today without much thought for what's going on over in Iraq. No need for rubber drives or war bonds, especially when our international friends are paying for the war through their 3-billion-dollar *per day* support. Back then, government officials were urging citizens to conserve, while after 9-11 New York Federal Reserve President, William McDonough, gave the following advice to Americans: *What we dearly want is for Americans to spend like Americans—to do the patriotic thing and go out and spend.* This was followed by President Bush telling Americans to “*go shopping.*” Is this what our country has come down to? When the going gets tough, we go shopping?

A book review of *American Theocracy: The Peril and Politics of Radical Religion, Oil, and Borrowed Money in the 21<sup>st</sup> Century* by Kevin Phillips recently caught my attention. Chris Mayer reviews how empires transition from a place of power based on industrialization to one based upon finance. As many of you know, this type of history fascinates me, and I discussed this point a few years ago in my Commentary. I believe it is an important point, as most countries, upon reaching their economic zenith, have allowed their manufacturing capabilities to become hollowed out. This, as Mr. Mayer points out, is followed by “the business of financing things, of pushing paper, of printing money.” His review continues, “Spanish observers in the 17<sup>th</sup> century wrote smugly about how London made fine fabrics, Holland chambrays, Florence cloth, and India linens. But it was Spain that enjoyed these things, because Spain had money. The Dutch and British held a similar conceit.” Mayer goes on, “The British economist William Stanley Jevons wrote with assurance: ‘The plains of North America and Russia are our cornfields, Chicago and Odessa are our granaries, Canada and the Baltic our timber forests, Australia our sheep farms . . .’ The whole world worked for Britain, which paid in sterling.” Does this sound eerily familiar to current American thought?

The book also points out how these waning empires end up relying on “debt and easy credit” and eventually become bankrupt because of their “spendthrift ways and financial ineptitude.” I know, I know, this can't happen in America (people say), but history isn't on our side. I point this out again not to depress people, but rather to make them aware. There is always opportunity in the investment world and as Mayer points out in his article, knowing what to own is more important than ever. And on this I firmly agree with him (the underline is my own): “Own things and sell paper. Oil, natural gas, water rights, land, timber — the tangible assets, and all the supporting cast, that built the fortunes of old, will also build the fortunes of the future.” Sound familiar to our investment theme?

## Portfolio Happenings.

*Leaves are falling all around, It's time I was on my way.*

*Thanks to you, I'm much obliged for such a pleasant stay.*

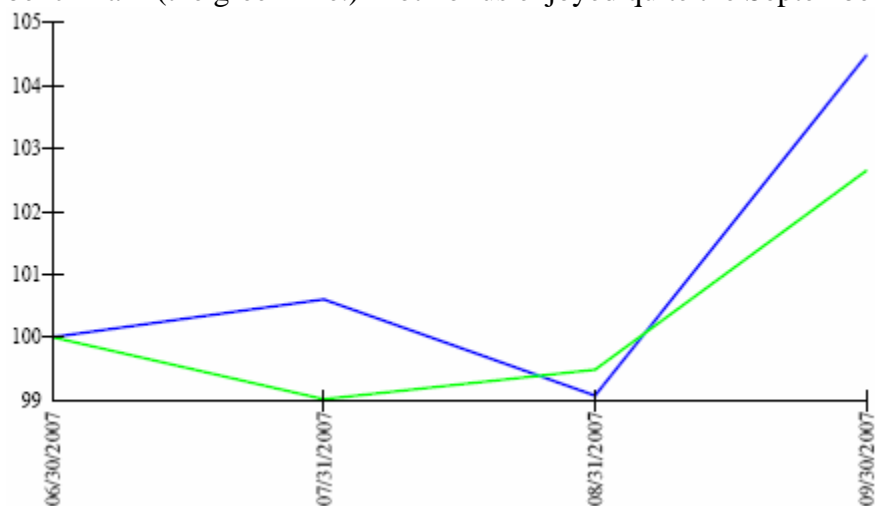
*But now it's time for me to go. The autumn moon lights my way.*

*For now I smell the rain, and with it pain, and it's headed my way.*

*Sometimes I grow so tired, but I know I've got one thing I got to do...*

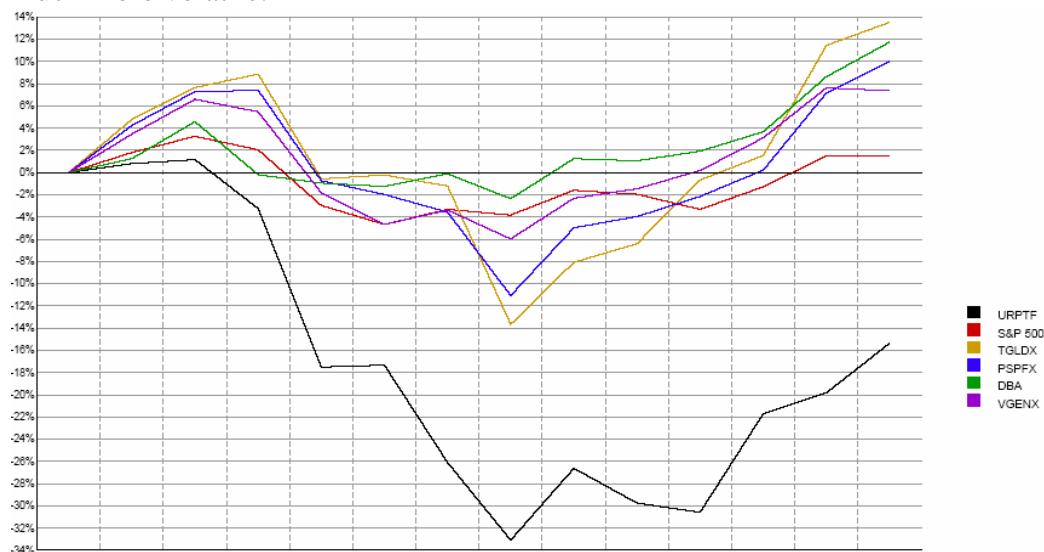
*Ramble On by Led Zeppelin*

In a nutshell, we had a pretty good quarter, with most clients gaining over 4% and putting us at double-digit returns for the year. I don't expect this to continue and remind clients that it is only by the luck of the calendar that we look so good. As you can see by the chart below, had the quarter ended in August, we (the blue line) would have been negative even more so than our benchmark (the green line.) Both of us enjoyed quite the September bounce.



Anyway, it is not the performance numbers themselves that I wish to focus on, as we will have both good and bad quarters, but more importantly how we derived them. The more interesting thing about the chart above is how our portfolios correlate (or don't, I should say) to our benchmark. This is representative of the overall stock and bond markets. As you can see, the global stock markets sold off in July, while we actually went up. Vice versa, the global markets rebounded in August, while we lost money. *Why, Steve?* should be your question.

As I have discussed, ad nauseam, in the past, our portfolios are heavily weighted towards alternative assets, mostly tangible assets represented by commodities (gold, energy, copper, wheat, etc.). During July, this helped stabilize the portfolios, but during August it detracted, especially as commodities got whacked. Commodities came roaring back in September, from which we greatly benefited. The chart below plots the performance of some of our natural-resource investments, and you can see, as compared to the S&P 500 Index (red line) they are much more volatile.



This does not diminish my enthusiasm for these investments; I just want to remind clients to keep their seatbelts firmly fastened at all times during the ride.

Our best performer for the quarter was Caldwell & Orkin Opportunities Fund, which gained nearly 16% and soundly demonstrated, this year, why having a manager with the flexibility to both “short” stocks as well as go “long” (buy) stocks can be a great way to make money *and* reduce risk. Our uranium investment, Uranium Participation Corp., was our worst performer, losing 15% after being up over 55% for the year. However, it was a great opportunity to get some of our newer clients invested in this stock. We also benefited from the fortitude, sprinkled with luck, I showed in June by increasing clients’ gold- and silver-bullion exposure after gold traded down to \$649 an ounce. ☺ *Yeah, Steve, while you’re patting yourself on the back, don’t forget to tell them that you also sold half the Powershare Wilderhill Clean Energy Fund in June, right before it shot up 15% for the quarter.* Uh, yeah, there was that too. ☺

I will end with a quote from Alan Greenspan, who’s been rather chirpy lately on his book tour: *“In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. If there were, the government would have to make its holding illegal, as was done in the case of gold. If everyone decided, for example, to convert all his bank deposits to silver or copper or any other good, and thereafter declined to accept checks as payment for goods, bank deposits would lose their purchasing power and government-created bank credit would be worthless as a claim on goods. The financial policy of the welfare state requires that there be no way for the owners of wealth to protect themselves...This is the shabby secret of the welfare statist’s tirades against gold. Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statist’s antagonism toward the gold standard.”*

What’s that—you couldn’t find the quote in his new book? That’s because it’s not from his new book, it’s from his newsletter *The Objectivist* written back in 1966, in an article entitled Gold and Economic Freedom. Seems like someone lost his way while traveling down the path of life through a place called Washington D.C. It just goes to show you that if you take any intelligent, ethical, law-abiding citizen and place him in an environment surrounded by politicians and lobbyists, he doesn’t stand a chance against having his moral compass ripped from his pocket and being drawn to the flame of avarice by special-interest dollars. Well, almost everyone—

*The moral and constitutional obligations of our representatives in Washington are to protect our liberty; not coddle the world, precipitating no-win wars, while bringing bankruptcy and economic turmoil to our people.*

Congressman and Presidential candidate Ron Paul

My time to ramble on is over.