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## First Quarter Commentary

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The first quarter ended on a strong note for equity investors while bondholders worried that the bull market in fixed income has finally ended after almost three decades. Although bonds are widely viewed as safe and conservative investments, a new generation of investors may be about to discover how U.S. Treasuries earned their nickname “Certificates of Confiscation” in the 1970’s.

Index Performance 12/31/09 through 3/31/10	
S&P 500 w/divs.	5.40%
DJIA w/divs.	4.82
Nasdaq Comp w/divs.	5.68

Last year, amid great turmoil and uncertainty, I suggested that economic headlines and unemployment would get worse as the year unfolded but that our portfolios would perform strongly for reasons including: (1) surprising overall strength in stocks; (2) good relative performance of our favored industry groups during the last part of the downturn; (3) the critical decision by the Fed as well as other central banks to ignore currency debasement and avoid a deflationary spiral *at any cost*; (4) a prediction that oil would confound conventional economic cycle theory and *increase* in price despite a continuing recession; and (5) the tendency of oil service stocks to move up sharply ahead of actual earnings improvement.

Sentiment has greatly changed in the past year, and as we start the second year of the market recovery, many, if not most, investors and commentators agree with the official White House assessment that “a second depression is no longer a possibility” and “the worst of the storm has passed”. Indeed, some recent economic readings suggest a nascent recovery in consumer activity. However these “green shoots” are offset by real weakness in employment and incomes, rapid contraction in private sector borrowing, low consumer confidence, falling state and local tax revenues, and rising oil prices.

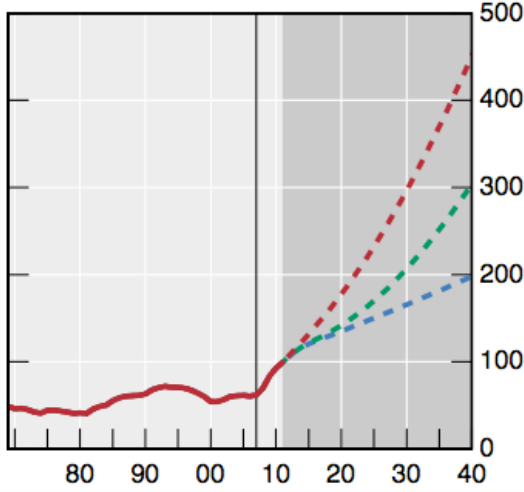
This last factor, the price of oil, has been consistently underestimated as the critical “last straw” that led to the economic



collapse of 2008. The most important thing that the mainstream misses about Peak Oil by focusing on the false question of whether we *will* run out of oil is that we have already run out of *cheap* oil. The International Energy Agency (IEA) warned in its most recent monthly report that rising oil prices had the potential to stall our economic recovery.

I have great admiration for President Obama, but the notion that we have somehow dodged a Great Depression is just wishful thinking until we find a way to reconcile the reality of our economic trajectory with the fantastical nature of our obligations.

### United States



**Government Debt as a Percentage of GDP**  
Bank for International Settlements

The chart (left), by the Bank for International Settlements, shows their thirty-year projection for U.S. government debt as a percentage of GDP. The upper dotted line represents business as usual. The other two lines include measures of fiscal discipline that have yet to be adopted. Notably none of these projections factor in the materially lower GDP rates that we can reasonably expect based on higher oil prices. Higher interest rates than the average between 1998 and 2007 (the tail end of the bull market in government bonds) would also negatively affect the projections. History suggests that past a certain tipping point this type of economic model will fail completely and the pretty chart will be meaningless. Anyone who is buying 30-year Treasuries or even 10-year Treasuries today should realize that they are voluntarily submitting their money for confiscation. Although no one suggests that the U.S. government will fail to pay the principal and interest on its bonds, a bondholder may find this guarantee worthless in terms of purchasing power.

The loss of purchasing power for the U.S. dollar is not something new. As the table below (from Shadowstats.com) shows, the dollar has lost between 82 percent and 94 percent of its real value in forty years depending on whether or not you trust the official government calculation of the CPI. The bottom row is Shadowstats' alternate CPI calculation that represents the methodology used by the government before changes introduced during successive administrations starting with the first President Bush.

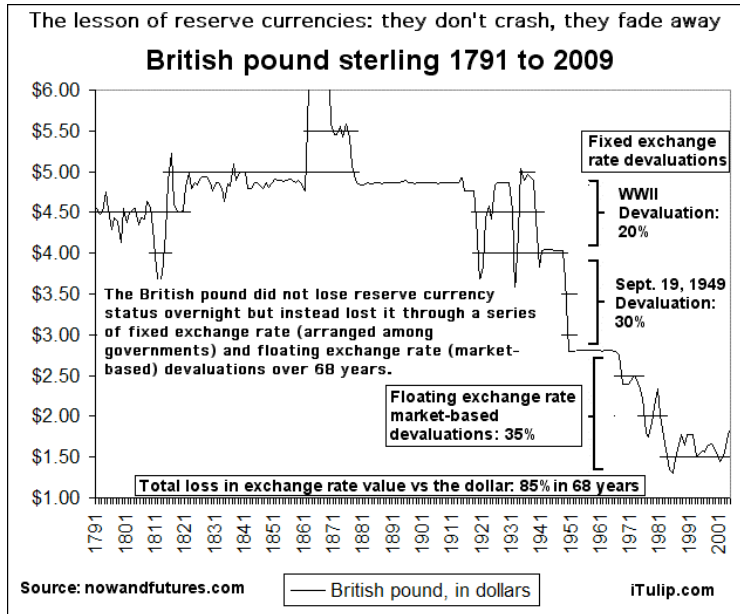
The Swiss have clearly worked to maintain the relative integrity of their currency and it is also clear that gold has maintained its purchasing power over these various timeframes, suggesting that those who would call the yellow metal speculative, should look first at the money in their pockets.

Loss of U.S. Dollar Purchasing Power Through October 2009			
	Since January of		
Versus	1914	1933	1970
Swiss Franc	-80.0%	-80.0%	-75.6%
CPI-U	-95.4%	-94.1%	-82.6%
Gold	-98.1%	-98.1%	-94.1%
SGS-Alternate CPI	-98.5%	-98.1%	-94.3%

Shadowstats.com

Anyone thinking that the U.S. dollar's status as the dominant global reserve currency is somehow the assurance of anything needs to consider that the British pound sterling was also once a dominant reserve currency. The chart on the next page documents the miserable performance of Sterling as measured against the quicksand of the dollar. In 68 years the pound lost 85 percent of its

value against the dollar that in turn lost roughly 95 percent of its purchasing power. In other words this former glorious reserve currency lost roughly 99% of its value well within a human lifetime.



Every few weeks I have a conversation with someone who thinks that they have “missed the boat” on gold and questions how much higher it can go. My last chart is for them. It shows the price of gold in pounds sterling from February 1st, 1970 through April 20<sup>th</sup> 2010. (For reference, gold was priced at £4.10 in 1930 so it had more than tripled in the prior 40 years.) At the start of February 1970 it was trading at £14.49 per ounce. Gold now trades over £740 per ounce having appreciated more than fifty fold versus the British paper currency. When we wonder how much higher gold may go over

the next ten or twenty years, we might instead wonder how much value the dollar will lose, and keep in mind the British lesson.

The past several months have been dominated by the passage of healthcare reform and the Greek solvency crisis. If you followed any of the coverage of the sometimes violent protests in Greece as their government grappled with the need for fiscal retrenchment, and then saw the anger and calls for violence in the US over healthcare reform, you can easily foresee that the worst of the storm is ahead of us. Many people may support the idea of fiscal discipline, but far fewer will willingly accept that their taxes will be higher and their government services and benefits will be smaller. At the same time, Peak Oil will be enforcing its own energy discipline on a country and an economy that is structurally ill prepared. It is my goal to ensure than my clients and friends are positioned as well as they can possibly be to deal with our future as it unfolds.

M.S.

