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REMEMBERING THE FUTURE
Vol. 1, Issue 10, April 2010

A Eulogy of Bifurcation: Income and Growth Opportunities in an Era of Currency Debasement, Unfunded Liabilities, and Hard Asset Revaluations

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Introduction

The markets have been going sideways for the last three months. They lack direction, inspiration, and perspicacity. This observation seems to apply to most asset classes. In developed economies like ours, when something like this takes place a bifurcation emerges. Markets under those circumstances tend to segment and a fragmentation takes place. The uncertainty of the banking/financial crisis has been succeeded by an uncertainty about the viability of public finances (hence the Euro fiscal uncertainties). As I explained in last month's issue, tightening of the belt encompasses the danger of a double dip recession, since the private and public sectors go through a deleveraging cycle.

We believe that this bifurcation will have two faces. The first one is already under way in the form of divergence/decoupling between the growth prospects in the developed and developing/emerging markets. The second one would involve a bifurcation between paper and hard assets, with the latter emerging not just as a clear winner, but also as a hegemon of all asset classes. With that in mind let's examine the issues that are at hand and see whether that scenario is plausible.

Bifurcation Phase I: Decoupling and Continent Segmentation

The U.S., and partially the E.U., used to play the role of the consumer of last resort. Thus, when the Asian crisis broke out (1997-98) and was transmitted also to other parts of the globe (Russia, South America) the US through its leverage machine bailed out those economies that had structural imbalances. The latter were reflected in their current accounts due to lack of reserves and also due to huge trade deficits. Of course, such a scheme had been successfully tried before during the Mexican crisis of 1995. The late 1990s crisis encompassed several countries but also the counter-parties of the infamous LTCM (Long Term Capital Management). The running up of the leverage press inflated the undergoing bubbles (chief among them the internet stocks), while bailing out the parties that held the liabilities of those who used paper assets and derivatives to extract leverage and perpetuate an irrational party.

The prosperity bought on credit had either to be paid back or to be passed on to another bubble. Rolling over debts by manufacturing bubbles (another bifurcation explained later is real production vs. paper asset production) and creative accounting schemes make up the theater of the absurd. We need to learn how to connect the dots. What followed the burst of the tech and internet bubble (stimulated also by low interest rates) was the burst of accounting scandals at Enron, MCI, and other major corporations that had been rolling over their debts using accounting tricks. It seemed that the people soon forgot about them since they had opportunities to participate - isn't the democratization of finance a marvelous thing? - in other bubbles being manufactured in housing, derivative, and synthetic products that involve both the private and public sectors. These are the paper assets whose real value few - if any – understood and which derived their market prices by formulas rather than by fundamental historical values of production, sales, profits and cost assessments.

The theater of the absurd continued for a few years, perpetuated by easy credit, low interest rates, misguided ratings and overseas adventures, corrupt practices and policies, where even federal, state, and city governments started hiding their real debts (the cases of Greece, Alabama, and Milan where with the help of major investment banks the books were cooked, are only the tip

of the iceberg). When the time came for an audit e.g. at Lehman Brothers, they used Swaps (recorded as sales) to cover their nakedness. It was a house of cards destined for destruction. The issue at heart was not whether it would be destroyed, but rather when.

"Crises come in twins," I wrote last September. The second phase is underway. Deleveraging and a credit crunch pushed governments to take the role of consumer of last resort, rushing to inflate their budgets and deficits. While they are doing so with the assistance of central banks that resort to quantitative easing (a.k.a. exploding their balance sheets by the acquisition of questionable/toxic paper in exchange for fiat money), the result is some losses pass from the private to the public sphere. The latter is known as the tragedy of the commons, a.k.a. the socialization of costs while profits are privatized. At the same time, the perpetrators and originators of toxic assets enjoy the benefits of a carry trade where they borrow at zero percent from the central bank, and lend that money back to the government for a return of at least 350 percent more than their costs! In that perspective and in the life of collateralizing and securitizing again paper assets, major players can make huge profits and cover up some of their counter-party risks.

Bifurcation Phase II: Unfunded Liabilities and Currencies' Trajectories

However, the postman always rings twice. The governments' spending will push to the limit their ability to roll over their debts especially if they have given up their monetary sovereignty, as is the case with the Eurozone group. Such inability will create fiscal crises, political and social turmoil, and belt tightening. In some cases, it will even push for default that will take place in some form or another (e.g. when the IMF is involved we may sugarcoat it as structural assistance; however it simply implies inability to meet financial obligations).

All these possible outcomes shake the faith of fiat currency, and this is what is taking place in the EU and the Euro these days. The situation in the United Kingdom - which has not adopted the Euro - is not that dissimilar. The currency crisis that we wrote about last September hit the EU first, because of their greater weaknesses, such as not having as many assets, camouflaged deficits, and not being the international reserve currency of choice. However, it is our belief that it will hit the US currency as well in the not too distant future. The greenback has not gained ground because of strong fundamentals, but rather because it has been perceived as a safe haven and/or as less weak than the Euro. When the postman rings the bell again, it will be the time when the greenback will see its foundations shaken like never before.

It is our belief that at the core of the matter is the bifurcation between industrial and finance capital. As long as the two move together in a converging fashion everybody wins. When they start diverging, then it becomes a zero-sum game where usually finance takes the upper hand, industrial competitiveness declines, bubbles are created, trade deficits explode, fiat currencies are shaken, lives are destroyed and generations that follow pay the price. It needs to be pointed out at this stage that through successive bubbles, postponement of the dues may take place; however when the bill comes due it will be so big that may be unaffordable.

Speaking of unaffordable bills let's just review the case of GM. It was the unfunded liabilities that ultimately brought GM down, in a similar fashion to the Studebaker Corporation in 1966. The unfunded pension liabilities in the US alone are in the trillions of dollars, as the March 2010 issue of the Institutional Investor points out in its cover story. However, before we proceed with the bigger numbers – which as shown in Figure III below exceed 63 trillion dollars (4.5 times our annual GDP) let us review the unfunded Medicare liabilities enacted by Congress in 2003. According to the table below, that amount exceeds 7.1 trillion dollars. When the market takes that number along with the much worse numbers that follow, then it would be no surprise that it will discount the markets in general and the bond markets in particular, as well as the currencies affiliated with those liabilities.

United States Government
Statements of Social Insurance (Note 26), continued
Present Value of Long-Range (75 Years, except Black Lung) Actuarial Projections

(In billions of dollars)	2009	2008	2007	2006	UNAUDITED 2005
Federal Supplementary Medical Insurance (Medicare Part D): [14]					
Revenue (Premiums and State Transfers) from:					
Participants who have attained eligibility age (65 and over)	140	123	167	173	185
Participants who have not attained eligibility age	1,442	1,380	1,627	1,700	1,790
Future participants	618	604	611	492	572
All current and future participants	2,199	2,107	2,405	2,366	2,547
Expenditures for Scheduled Future Benefits for:					
Participants who have attained eligibility age (65 and over)	(595)	(581)	(794)	(792)	(880)
Participants who have not attained eligibility age	(6,144)	(6,527)	(7,273)	(7,338)	(7,913)
Future participants	(2,632)	(2,856)	(2,699)	(2,121)	(2,440)
All current and future participants	(9,371)	(9,964)	(10,766)	(10,250)	(11,233)
Present value of future expenditures in excess of future revenue [6]	(7,172) [1]	(7,857) [2]	(8,361) [3]	(7,884) [4]	(8,686) [5]

Source: The Financial Report of the United States Government, 2009

Debts, Bonds, and Projections: What Does the Future Hold?

In a January 2009 publication of the National Center for Policy Analysis we found – among other interesting facts - Table 1 and Figure II that follow, which

we consider eye-opening. They point (based on 2004 data - the situation now is worse) to the following facts:
First, the unaccounted and unfounded liabilities in the EU are on average almost 450% of their GDP.
Second, the respective figure for the US is also 450%.
Third, unless substantial reforms take place in both sides of the ocean, then either default will occur or taxes will eat away disposable income, thus lowering standards of living, while poverty and misery will occupy the headlines.
Fourth, the need for significant savings (recall that estimates are based in 2004 figures) amount to more than 8% of the GDP. Given, that none of the countries involved have a savings rate even close to that, the cost of re-financing their debt obligations will either increase substantially (see the Greek spreads) or currency debasement will have to take place.
Fifth, postponement of the needed measures add future generational pain to the tune of trillions of dollars (e.g. in the US case it adds about $1.5 trillion annually when inflation adjustments are taken into account).
Sixth, those who fund existing debt will either demand higher yields or abandon the bond market of the particular nations altogether (it may not be a coincidence that in the last few months the Chinese are net sellers of US bonds), with the result that the nations may be forced to debase their currencies and inflate their debts away.
Seventh, the problem could be pushed away for a few years by creating another bubble (that's where our comment below about a possible green energy bubble fits. Regarding the latter we have found the February 2008 article in Harper's magazine, very interesting and enlightening. You may access that article at the following link:
http://www.harpers.org/archive/2008/02/0081908).
Eighth, municipal bonds would also prove to be very shaky and risky as an asset class given that states' unfunded liabilities exceed 3 trillion dollars.
Ninth, the rational choice for individual and institutional investors is to turn their focus to hard assets and their valuations given the generational, technological, economic, and political developments.
Tenth, as asset classes are being revalued the macro global focus will shift to developing and emerging economies making the bifurcation dual, namely: in asset classes and continent-focus.

TABLE I

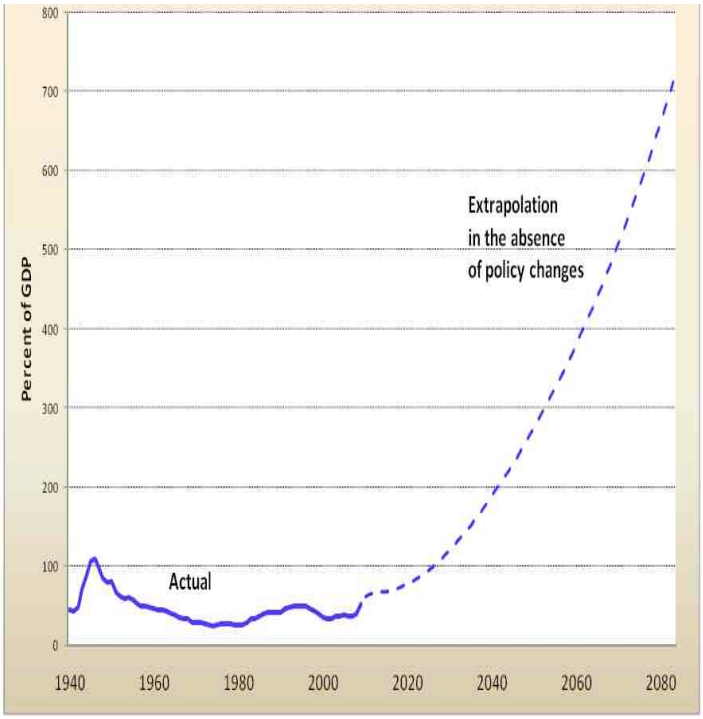
Fiscal Imbalance as Percentage of Annual GDP (2004)

Country	GDP 2005 (billions of euros)	FI (billions of euros)	As a % of Annual GDP
Belgium	288	854	296.50%
Denmark	197	754	382.50%
Germany	2,215	9,263	418.20%
Greece	168	1,470	875.20%
Spain	837	2,045	244.30%
France	1,659	9,111	549.20%
Ireland	148	600	405.20%
Italy	1,388	5,054	364.10%
Luxembourg	27	102	376.70%
Netherlands	489	2,556	522.80%
Austria	236	967	409.80%
Portugal	143	703	491.90%
Finland	152	820	539.30%
Sweden	282	1,215	430.70%
United Kingdom	1,734	7,666	442.10%
Cyprus*	13		
Czech Republic	87	514	590.80%
Estonia	9	41	455.60%
Hungary*	81		
Lithuania	18	90	497.20%
Latvia	11	68	619.10%
Malta	4	19	467.50%
Poland	204	3,163	1550.40%
Slovakia	34	391	1149.10%
Slovenia	26	197	758.50%
EU-25 Benchmark	454	1,971	434.20%

* Incomplete data available for Cyprus and Hungary.

Source: Author's calculations based on data from Eurostat.

Figure I: US Government Debt Held by the Public



Source: The Financial Report of the United States Government, 2009

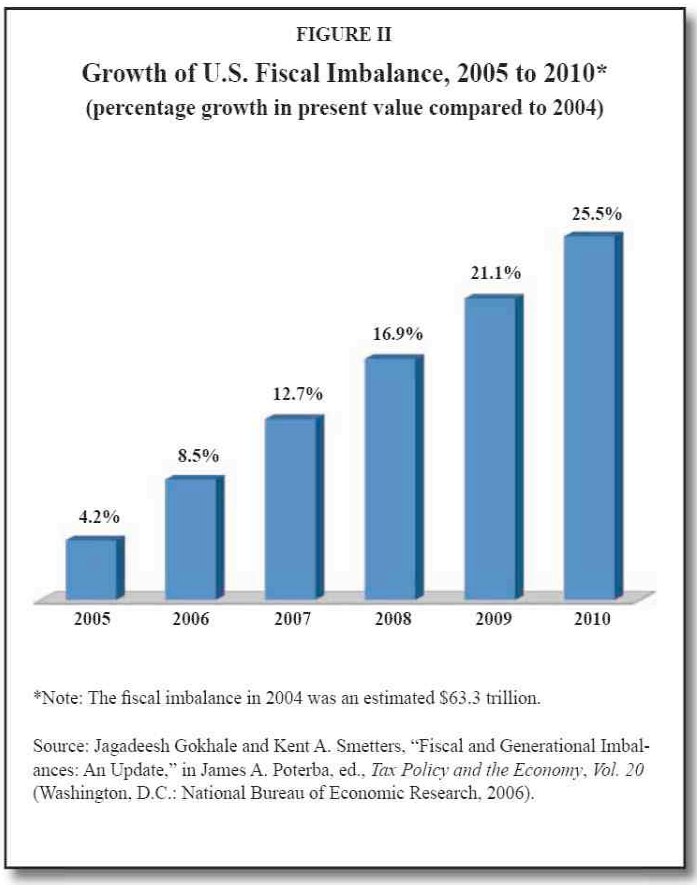
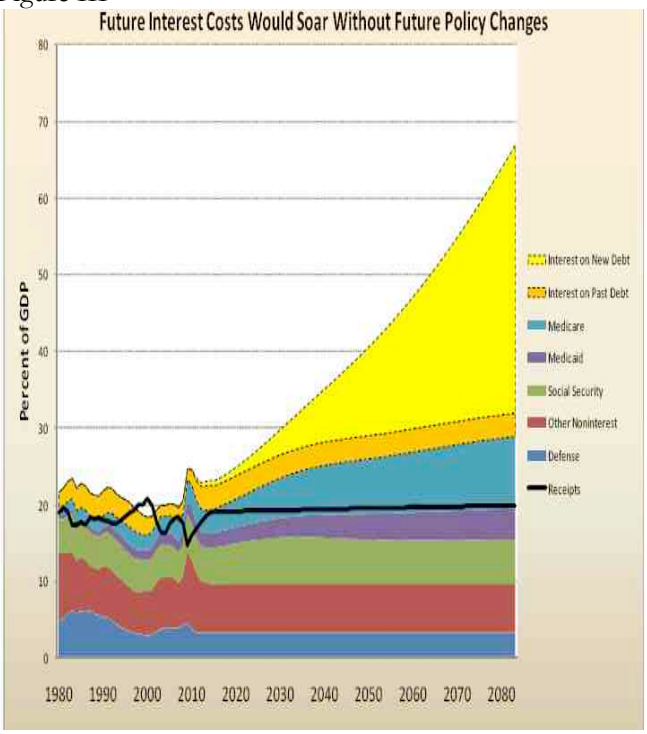


Figure III



Source: The Financial Report of the United States Government, 2009

At this stage and in a summary form regarding the unfunded liabilities, we would like to focus your attention on figures I – III above, and allow the Comptroller General of the United States Government to speak in an elegant and simple way where he expresses the dire situation we are facing as a nation, and as issuers of the international reserve currency (with its moral obligations around the world). The three figures point to the reality that the debt is unaffordable, that we are going broke, and that inaction today implies misery for future generations. Here is what the Comptroller General concludes in his remarks contained in the 2009 Financial Report of the U.S. Government:

> The federal government faces even larger challenges in the long term. As discussed in this 2009 Financial Report of the United States Government(Financial Report), the federal government is on an unsustainable long-term fiscal path driven by rising health care costs and known demographic trends. The Statement of Social Insurance, for example, shows that the present value of projected scheduled benefits exceeds earmarked revenues for social insurance programs (e.g. Social Security and Medicare) by about $46 trillion over the next 75-year period[9]. In addition, our most recent long-term simulations for all federal government programs show that absent policy changes, debt held by the public as a percentage of GDP could exceed the historical high reached in the aftermath of World War II in a little over 10 years[10]. Absent a change in policy, under this scenario, the interest costs on the growing debt together with spending on major entitlement programs could absorb 92 cents of every dollar of federal revenue in 2019[11]. Clearly, this is not sustainable.

<u>Asset Allocation and Choices Under Bifurcation</u>

Having reviewed the above figures and also the conclusion of the Comptroller General, let us highlight two facts: First, this is not something that would hit us in the distant future. It will take place in the next ten years. Second, also in the next ten years the interest on the debt along with the entitlement but unfunded programs will be eating away 92 cents of every government revenue dollar.

Unfortunately, financial interests crowded out production and industrial interests. The former masqueraded and exploited unfunded liabilities passing them on as lovable securities that can make us wealthy. The reality is that those securities make our future and the future of our kids and grandkids insecure. It seems that we forgot the lessons of previous empires and hegemonic powers, that wealth is created and preserved via production of real assets and not by marketing toxic paper "assets". The bifurcation between industrial and financial

interests is a phenomenon of the developed economies, while developing and emerging nations such as China, Russia, Brazil, India, Indonesia, Malaysia, etc. allow the two interests to run in a parallel fashion. Therefore, the growth and income opportunities are higher in those nations and in the currency of nations (e.g. Australia, Canada) that allow such a convergence and parallel move to take place.

Faith in paper currencies a.k.a. fiat money is weakening and the signs of it abound. Things will become even worse when the postman rings the bell again. We do not know when the latter will take place, but we do know that it will take place and probably will be within the next two-four years. While we anticipate the markets to be going sideways in the next couple of years, contemplating a double dip in the midst of public and private sectors' deleveraging, a new force (and who knows maybe even a new bubble given that chameleon financial institutions know how to securitize and sell ice to the Eskimos) will be developing in the commodities and rare earth elements (REE). The countries that are endowed with resources in commodities and REE will experience significant gains, and such hard assets will anchor their currencies. Companies that are involved in these sectors (from mining to distribution and sales) could also benefit significantly.

The Financial Times on January 28, 2010 and then on February 11, 2010 published two articles on REE. At the heart of those articles is the reality of hard assets and the valuations we anticipate to start taking place in the near future. The February 12th article starts as follows: "China's leading producer of rare earth metals has been given government approval to build a strategic reserve, exacerbating concerns that Beijing is tightening its grip on the valuable minerals needed to produce green and high-technology products. China supplies about 95 per cent of the global market for rare earth elements used to produce everything from hybrid cars to iPod music players."

Prices of REEs have on average increased fivefold since 2000. Their extensive industrial usage (e.g. Avalon Rare Metals stated in a study that about 25% of new technologies rely on REEs) in combination with new technologies, and with new environmental and economic/social trends will put increased pressure on their prices. Thus, control of the REEs, hard assets, and of commodities in general may prove to be the most fundamental move governments and investors do in the next few years.

Currently, China controls 97% of REEs. Of course, as prices increase, mines in other nations, such as ours or in Australia, will start operating. However, the fact is that China will remain the big player in the game that is being drafted nowadays. China's quotas on REEs exports intend to attract foreign investors into the country for in-house operations, thus through synergisms and value-added chain of production Chinese growth can be sustained. Anthony Lipmann of Lipmman Walton, a UK-based trader says: "China does not want to supply rare earth elements to build a Prius or Volt car battery: it wants to build and market the vehicle."

In our case, the National Academies Report on REEs states that REEs "have a number of high-tech applications that are important for the economy because they are marked by a tighter degree of supply risk than the more traditional base and ferrous metals." No doubt then, that the Pentagon is contemplating stockpiling REEs.

Conclusion

Let us conclude this month's newsletter by first reviewing the financial conditions. In a new collaborative and comprehensive index recently created, Hatzius et.al., show that in the last few months the financial conditions in the country have started deteriorating again. This may be in anticipation of the Fed's intentions to suspend its extraordinary programs of buying paper from banks as well as in anticipation of reversals in carry trade that will be needed.

Whatever the cause might be for such deterioration, our position is that catharsis was not carried out, and like in old Greek plays unless cleansing takes place, new beginings will be defective, deficient, and could only postpone the inevitable, which is another crisis that is looming over the heads of individuals, institutions, and governments. Slumps follow booms when booms are created using inflated and artificial monetary stimuli rather than assets produced in the real economy. A house of cards will always be a house of cards. Figure 4 below shows the deterioration that is taking place in the last few months in the financial markets. Furthermore, the last figure (figure 5 below) also portays a similar picture. It demonstartes that the Asset-Backed Securities market has not been revatilized, and the issuance of new securities is almost as dead today as it were a yar ago. The credit (despite unprecentended Fed's moves) does not flow because it is used to cover up holes and counterparty risks, enhance the balance sheet of institutuons that are too big to exist, while being wasted in other similar unproductive purposes that do not create jobs, but rather perpetuate and worsen a sickening situation that destroys the real economy's moral fiber.

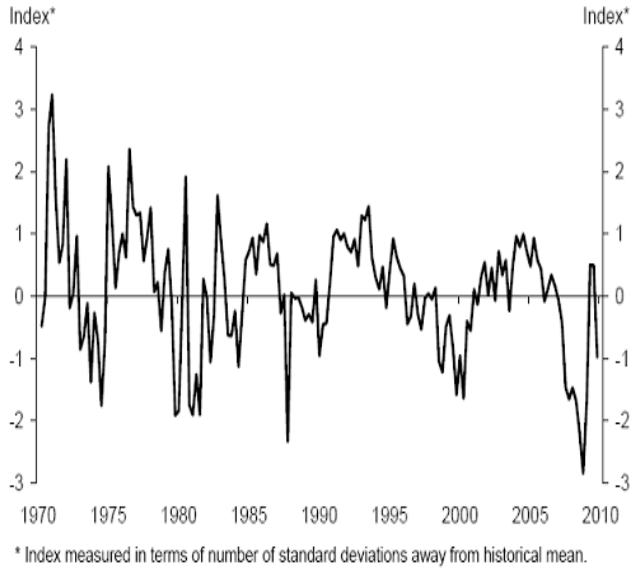
Our position is to stay with hard assets (see previous newsletters), REEs, and be invested in countries where real production takes place and in currencies that are linked with those economies. The era of commodities and of companies related to their production, distribution, and sales (gold, silver, oil, copper, palladium, zinc,

rhodium, uranium, aluminum, nickel, copper powder, cerium, neodynium, terdium, samarium, ruthenium, etc.) that encompasses the REEs may experience anew an upswing due to supply and demand conditions in general; due to people's understanding of what real wealth is and where it is produced; due to new technological, economic, and social trends; due to an expanding middle class in newly industrialized countries; due to forthcoming geopolitical tensions; and finally due to an emerging movement that central banks anchor their fiat currencies with real hard assets.

Feel free to call the offices of Blackstone Financial Group for a further discussion and specifics on the above.

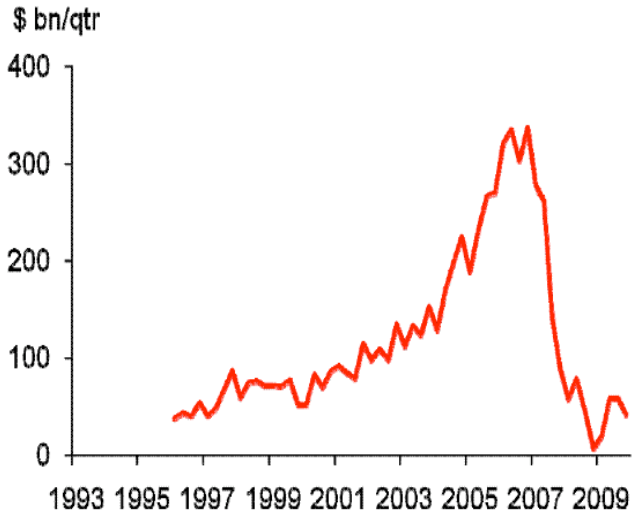
As always, it promises to be an exciting ride. Please enjoy it!

Figure IV: The Evolution of Financial Conditions



Source: Hatzius et.al. Financial Condition Indexes: A Fresh Look after the Financial Crisis

Figure V: Issuance of Asset-Backed Securities



Source: Hatzius et.al. Financial Condition Indexes: A Fresh Look after the Financial Crisis