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REMEMBERING THE FUTURE

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Asset Allocation, Uncertainty, and Portfolio Management

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Introduction

This is the introductory newsletter of a new publication, which aims to assist individuals in their asset allocation. However, these are not ordinary times. Since the summer of 2007 we have been experiencing a market earthquake that has changed the financial landscape.

In previous publications, as well as in presentations made up until May 2007, at the University Club in Jackson, MS we had issued appropriate warnings about the market collapse. Those publications are available upon request.

In the current publication, we will be focusing on macroeconomic trends and their effects on asset allocation. We will have a theme in each issue. Thus, for specific suggestions, regarding securities and portfolio management – based upon the analyzed trends – we encourage you to call the office at the number listed below in order to discuss possible options for your portfolio with our advisors.

We feel sorry that the developments have vindicated our view, because the market collapse has cost just US households alone at least $11 trillion, and the government has made at least $12.7 trillion in implicit and explicit guarantees to the financial sector. The latter will come back to haunt us in one form or another, as we will be explaining in this and future newsletters.

The Crisis and our Response: Have you Seen the Rain?

Starting in August 2007, the markets have gone in reversal, as we pointed out back then. At this point, we believe that a new era is being unfolded, and thus the purpose of this publication is to prepare its readers for the developments that may be taking place in the next few months and years, by remembering some fundamental lessons and plotting them against the future.

We are experiencing the death of an era. This is the death of an era that is characterized by over-extension of credit and leverage, over-collateralization of assets (unfortunately of paper-assets too), by over-securitization, but most importantly by fiat money where the vessel of the global economy was sailing the seas without an anchor. No wonder then, that it faced rough seas and damages in its voyage.

Some have claimed that this is the end of the era of globalization. We believe they are wrong. Globalization is here to stay, simply because the river does not go back. Some others have claimed that this is the end of the era for the US influence around the globe as well as for the USD as the international reserve currency. We believe they are wrong too. The US will remain the main power (economic, political, and military) because of its flexibility and elasticity to adapt in changing circumstances. The European Union lacks direction, leadership and focus; thus, we believe the Euro cannot threaten the USD status, at least for the foreseeable future. Certainly we need to learn to live with other rising powers (e.g. China, Brazil, India, Russia.) However, neither the status of the US is being threatened, nor will the USD as the

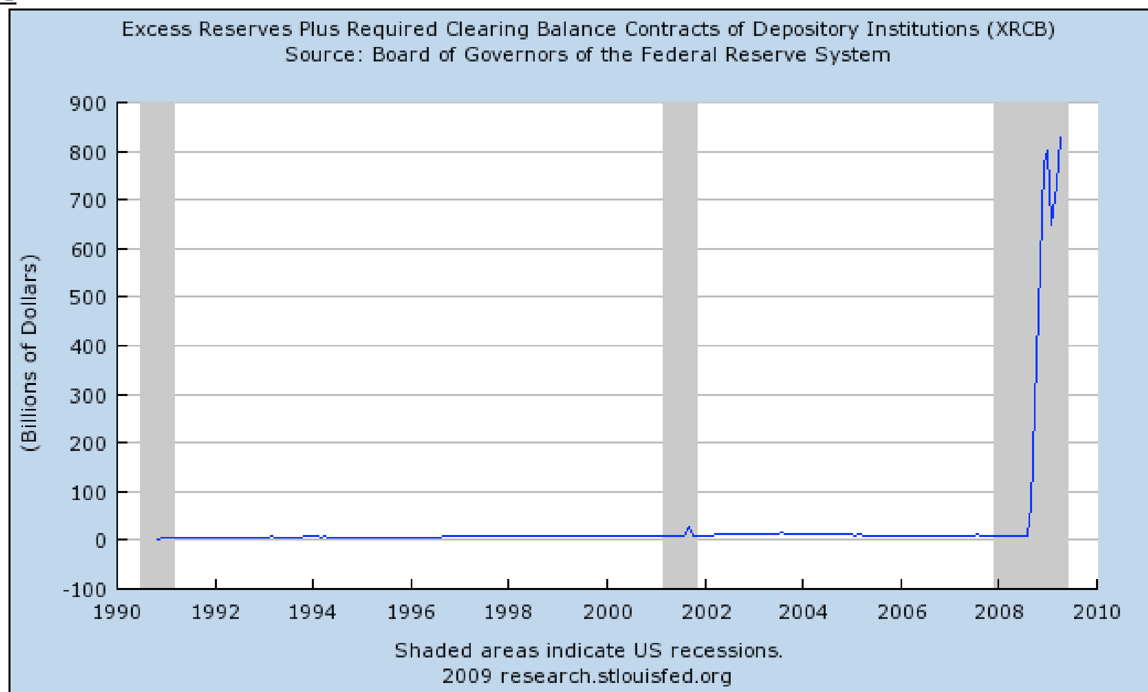
international reserve currency will be challenged in the near future (this does not mean that the USD will strengthen against other currencies, it's simply a statement of its reserve status.)

What is unknown is the kind of an economic system that will emerge out of the ashes of the old one. Life is full of cycles; death sometimes is welcomed and is a relief, especially when painful experiences are involved. Moreover, let's not forget that the seeds need to die in the ground for the fruit to emerge. In times of uncertainty – which we need to distinguish from risk – when we cannot quantify the probabilities of different scenarios, people are looking for safe havens.

Therefore, let's state that while we are listening to a requiem during a funeral, we need to start preparing the notes for our prelude, and no financial prelude is better than the one that sings to the tunes of hard assets.

The following is a graph of the excess reserves being held at US banks, since 1920s. As it can clearly be seen, the amount has been almost flat for about 80 years now. There have been some bumps on the road, especially during times of turbulence (1930s, early 21st century, etc.)

Graph 1



However, the experience of 2008 and early 2009 has never happened before. It has been raining money which is being hoarded as excess reserves in financial institutions. The credit faucets have been turned off. This is not a stock market crisis. The latter is a symptom of a greater cause. This is a crisis where credit is not being generated and thus is not flowing. Credit is not flowing because assets are not being collateralized and thus cannot be securitized and sold to the markets. This is a crisis of assets that cannot be inserted into the global system to be translated into credit, money, stocks, bonds, and other (exotic and synthetic) types of securities. Assets are no longer being collateralized because too many camouflages were used in the last several years, where paper assets used as collateral to create credit and circulate money. It was like having a small car where we are trying to put a 5.0 liter engine. Did you expect it to last?

For the time being, the central monetary authorities around the world (led by our own Fed) are circulating money to financial institutions; however the credit pumps are being kept shut off. The pumps need some type of filter. The latter began to be installed in the last several weeks. Once the filters are in place, the reserves will be authorized for circulation in the form of credit. The circulation of the excess reserves will put inflationary pressures on assets, which in turn can be used in the collateralization process.

So, what should we do? First, of all, I do not believe in the safety of bonds, for the immediate future. The bond market might be hurt by asset-price inflation, especially if it is leaked into the real economy (please recall that it was the leaking of the financial turmoil into the real economy which will make the recovery a dismal one for the next 18-24 months, as it is explained below.) TIPS (inflation-linked bonds) might be an option; however it seems a dismal option too. Actually, the bond market might prove to be a very poor choice given the debts that are being accumulated by nations and states.

The stock market has experienced significant gains since March; however I question the sustainability of those gains. It has been a rally alright, but it might turn out to be a sucker's rally a.k.a. bear-market rally. I question the sustainability because future profits will disappoint investors. Let's not forget that rallies like this have been experienced before in the midst of significant recessions and even during the depression of the 1930s. They are nothing new, but it seems that we do not remember the facts of financial history.

Although nobody can predict the future, we anticipate the current recession to slow down by the third quarter of this year (the famous second derivative), but the recovery will look like a silent but very strong recession. The output gap (the difference between what the economy can produce and what it will be actually producing) will take a long time to close, and thus the US as well as most of the economies around the globe, will be under-performing. We believe the credit mechanism will not be allowed to over-extend itself, the regulations being implemented will not allow asset camouflages i.e. limited credit creation, and the general lack of assets may not permit a strong recovery. In addition, de-leveraging will continue, low consumer spending will continue its pace, global trade will continue suffering as is reflected by shipping costs, and the production glut (including the real – residential and commercial - estate sector) may not allow a reduction in the unemployment rate. The latter will probably exceed 11% by summer 2010. If we count the partially-employed and the discouraged workers, then the full unemployment rate will exceed 15%.

Obviously, in such an environment we cannot expect the stock market to thrive. Of course, and as a disclosure, particular sectors and specific companies may do well, but overall the efficient market hypothesis and index investing seems to be dead in the water for the next 18-24 months. There is an endemic pathology in the markets and clinical analysis reveals that hard assets should be the allocation of choice.

Conclusion: Hard Assets in Times of Uncertainty

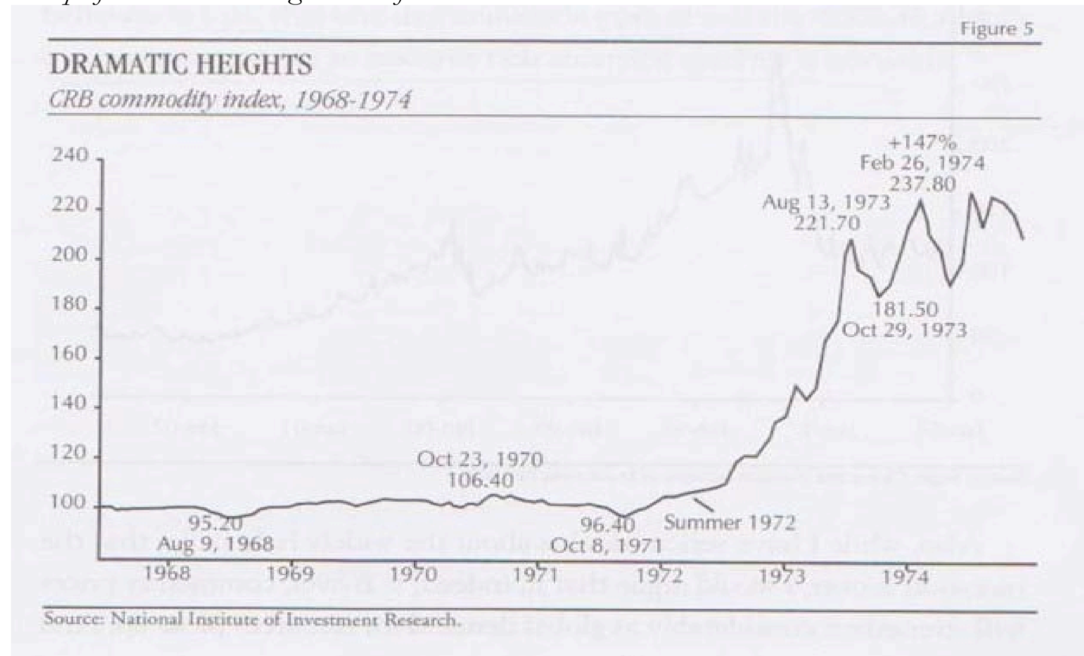
Let's state from the beginning of this section, that bullion gold (as well as gold-related assets) and oil-related assets would be the allocation of choice. I would suggest that at least 15% of an individual portfolio may need to be in gold-related (or precious metals) assets. An additional 15% could be in oil-related assets. These are the types of assets not only helped in times like these, but also have the potential of substantial appreciation when the flood of the excess reserves – as described earlier – materializes. Every investor's situation is unique and not all assets previously mentioned are suitable for everyone. Please contact your financial adviser before making an investment decision.

Both of these two choices have the following characteristics that are pertinent to the economic circumstances we are undergoing:

a. When confidence in financial assets is shaken, commodities like gold and oil have the potential to experience a geometric growth. They represent finite quantities, cannot be printed, and reflect values of real assets.
b. Precious metals performed well even in the midst of the depression.
c. Commodity bull markets follow after significant shocks take place in the financial sector which in turn leak into the real economy, as the following figure demonstrates.

Graph 2

Past performance does not guarantee future results.



d. The relative underperformance of these assets and the absence of substantial increases in their values, point to their potential.

e. The expected weakness in share prices is linked historically to higher commodity prices.

f. The liquidity injections and the expansionary policies may compel thoughtful investors to invest in commodities.

g. The political and economic weakness of the European economies may force surplus countries (such as China) to diversify their reserves not in Euros but in gold, a fact which by itself should force the price of gold to increase.

h. The emergence of developing but resource-rich countries will uplift their assets, among which metals and oil are the primary ones.

Enjoy the ride!

Gold is subject to the special risks associated with investing in precious metals, including but not limited to: price may be subject to wide fluctuation; the market is relatively limited; the sources are concentrated in countries that have the potential for instability; and the market is unregulated.

Investing in the oil sector involves special risks, including the potential adverse effects of state and federal regulation and may not be suitable for all investors.

Opinions expressed are those of Blake Headley and not necessarily those of RJFS or Raymond James. All opinions are as of this date and are subject to change without notice.

Commodities are generally considered speculative because of the significant potential for investment loss. Commodities are volatile investments and should only form a small part of a diversified portfolio. There may be sharp price fluctuations even during periods when prices overall are rising.

Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.