BLACKSUMMIT FINANCIAL GROUP, INC
A Registered Investment Advisor
132 Riverview Drive, Suite D Flowood, MS 39232
601.714.1034 Office 601.714.1038 Fax
www.blacksummitfg.com

REMEMBERING THE FUTURE
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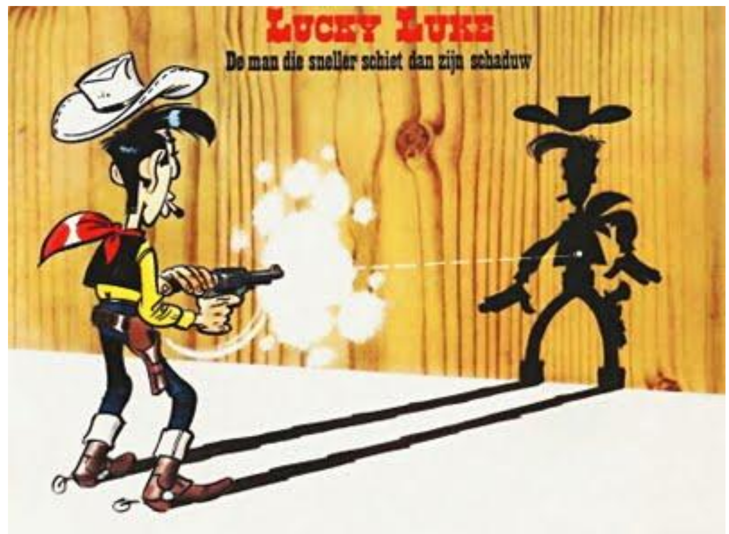
In the Shadows of Financial Unraveling: The Realities of a New Approach to Asset Allocation

John E. Charalambakis Ph.D., Chief Economist

Introduction

This month's newsletter will focus on two things, namely: The scenarios and possible solutions to the debt hangover that rises from the EU; and the options for asset allocation under the prism of the unfolding new reality called instability inflated by assets whose value is questionable.

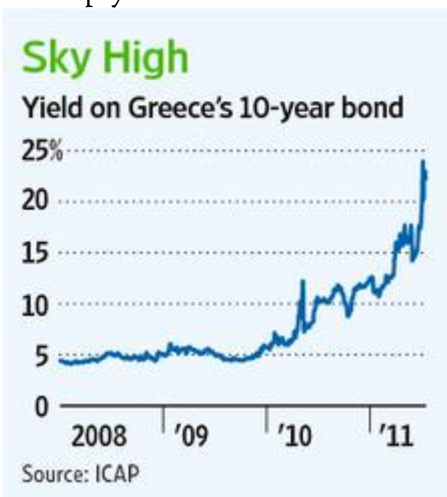
However, before we start we believe that we owe it to our readers to say just a few words regarding the scientific announcement that came out of the CERN experiments in the last couple of weeks. In a nutshell, scientists told us that special particles called neutrinos can travel faster than light, since they can cut corners by traveling in other dimensions besides the known ones. If that were true, it could mean a lot of things and could unravel huge scientific turnovers and launch new applications. For us and this newsletter it could mean two things: First, it could testify to our title, i.e. we could remember the future. Second, the famous Lucky Luke could indeed shoot faster than his shadow, and hence the following picture. If Lucky Luke can shoot faster than his shadow, then instability is the new game in town, and the investment outlook will take a new form for the foreseeable future.



A few weeks ago we wrote in our commentary series about the gamma ray burst (GRB) phenomenon in financial markets that creates black holes and destroys values. We applaud the great magazine The Economist for putting a picture of a galaxy with a black hole in the cover of the October 1st issue. This GRB-supernova phenomenon allows us today to see a star that went supernova 21 million years ago. In the new era that is unfolding for financial markets, portfolios that can shoot faster than their shadows will survive and possible prosper. The rest, oh well, they could just play the role of the Lucky Luke's shadow…

The Eurozone Crisis

Greece seems to be the tip of the iceberg and a candidate for a scapegoat of what follows a potential orderly haircut of 50 or more percent of its bonds. Markets seem to anticipate a haircut in Greek bonds of at least 50% in the next few months, as both yields and CDSs imply.



It should be noted that such haircut – which will trigger execution of the CDSs – would have already been undertaken if it were not for the fear of the consequences on EU banks, insurance companies, and pension funds. It seems that preparations are underway to construct a firewall for the pending haircut and its effects on financial institutions.

Assuming that Greece will remain a member of the Eurozone (the opposite scenario has limited chances and would imply a disorderly bankruptcy that would devastate the markets) would lead to a constrained default which in turn will have the following consequences in Greece (among others):

- The GDP will fall by more than 15% (some estimates talk about a fall of over 25%)
- Unemployment will increase by at least 7% from the current 18% level
- Banks balance sheets will suffer significant damages, and thus
- The Greek government may nationalize banks
- Liquidity will suffer dramatically from its already depressed levels
- Corporate bankruptcies will skyrocket
- Asset prices will suffer significant losses
- Political instability will feed social unrest
- Consumption and investment spending will collapse
- Solvent companies will struggle to survive as sales and profitability will decline
- Liquidation of assets will further depress prices
- Greece will depend on EU financing since the markets will be closed for Greek paper
- Some investment opportunities will arise, and depending on the response to the crisis a turnaround strategy – which will be based on the fact of lower debt and attractive asset prices as well as improved competitiveness through internal devaluation achieved via lower wages – may become a cornerstone for growth and for a sound new beginning

The main fear in the EU is about its banking sector. In the last two months several well- known banking institutions have lost significant portions of their market capitalization, as the figures below show.

Societe Generale (US ADR)

BNP Paribas (US ADR)

Barclays Bank

Deutsche Bank

The EU leaders are primarily afraid that such a Greek haircut/default may have – among other – the following consequences:

- Start a domino effect where markets will consider defaults in other countries unavoidable
- EU banks, especially some French banks with significant exposure to Greek bonds will suffer dramatically.
- Once the banks of a major-core EU country start suffering, a financial tsunami will begin that will shake the foundations of most EU banks
- The need to recapitalize EU banks will shake all economic sectors throughout the Euroland, and will create a major liquidity squeeze
- Asset classes will suffer and investors will be seeking safe havens
- Some EU governments may be forced to nationalize financial institutions
- Recession will return in the EU – if it is not already there – spending will contract, unemployment will rise, profitability will decline, and lending will all but disappear
- Asset prices will fall and corporate defaults will rise
- Social unrest will coincide with political instability
- Given the more than $4 trillion of bank paper that needs refinancing in the EU, the banking sector will need a massive injection of recapitalization and we cannot exclude drastic political measures
- The EFSF (European Financial Stability Fund) may start buying directly sovereign nations' paper and also adopt Secretary Geithner's proposal for leverage in order to contribute directly to banks' recapitalization
- The EFSF needs more funding and assuming that this takes place – previously we wrote that its capital needs to be increased to €2.2 trillion – it may become the initial institution that will eventually lead to joint EU bonds and a common Treasury for Eurozone

members, leading eventually to a common fiscal policy
- We should not underestimate the risk that the Euro may lose its appeal as a sound currency, and thus a form of euro restructuring if not disintegration may occur at a speed that would resemble Lucky Luke's shooting

In the midst of this unraveling chaotic situation characterized by the burdens of debt, contraction, austerity measures, and toxic assets we could point out some possible solutions that are on the table or could be on the table soon.

- Toxic paper will be swapped with bonds issued by the EFSF, while banks will be taking losses at current market prices of the toxic paper they carry on their books
- The financial institutions will continue suffering tremors until deep catharsis takes place in the form of cleaning up balance sheets of nations and financial institutions, and a program of bank recapitalization takes place
- The ECB guarantees the paper and stands behind the EFSF while targets the yields of bonds susceptible to significant increases as market tremors continue
- The bonds issued by the EFSF become the prelude to joint EU bonds
- A set of differential interest rates, according to the economic needs and circumstances of the particular Eurozone subgroups
- Current/trade account imbalances are treated in a framework of transfers between Eurozone subgroups
- Restrained Inflationary expectations – in conjunction with intragroup transfers, differential interest rates, and internal wage devaluation- are built into the system by releasing reserves and allowing the money multiplier to rise

The uncertainty that rises from the above analysis cannot be viewed in a vacuum. Energy concerns and geopolitical risks are also rising in the eastern Mediterranean seas, and we would not be surprised if a conflict arises in the region due to claims on what seems to be a very rich area full of natural gas and possibly oil, capable of solving Western nations' energy needs for decades to come. We shall revert to this issue in an upcoming commentary.

The Lenses of Asset Allocations in an Unstable Environment

The current economic environment is characterized by a debt hangover that diminishes returns, expectations and growth. Given the tremendous increase of private and public debt and the interest-expense implications, we can understand that the productivity derived from each additional dollar of leverage is also experiencing diminishing returns with the result that we need more and more debt in order to achieve 1% increase in GDP. This is what the markets anticipate and drive financial stocks to the ground.

The unfolding environment involves stagnant if not declining growth, political uncertainty, increased social tensions and disillusion, lack of tools on behalf of central bankers to stimulate the markets, geopolitical risks, high permanent long-term unemployment, liquidity squeeze - and hence the temporary downward pressure on precious metals – and inability to rollover loans, slower growth in developing countries including the BRICS, spread of contagion risks, tighter profit margins, and declining confidence, among other problems.

The combination of public and private debt as shown below portrays that AAA-rated countries such as France and Germany are in a worse position than Greece.

Financial Debt & Pension Debt

	Pension Debt % GDP (1)	Financial Debt % GDP (2)	Total Debt % GDP	Taxes % GDP (3)	Disp.Income % GDP	Public Debt % Disp.Income
France	362,2	92,5	454,7	46,7	53,3	853,4
Italy	323,1	127,0	450,1	45,8	54,2	830,1
Austria	359,9	77,9	437,8	47,2	52,8	829,3
Belgium	296,0 (1)	105,2	401,2	48,4	51,6	778,1
Finland	301,4	52,3	353,7	53,6	46,4	762,0
Germany	338,6	82,0	420,6	43,1	56,9	739,5
Sweden	284,5	55,2	339,7	52,9	47,1	721,8
Portugal	298,3	90,9	389,2	43,5	56,5	689,0
Poland	361,1	62,8	423,9	36,2	63,8	664,3
Hungary	257,5	89,9	347,4	46,2	53,8	646,2
Greece	230,7	123,3	354,0	40,1	59,9	590,8
Netherlands	236,2	77,1	313,3	45,7	54,3	577,3
Spain	204,2	67,5	271,7	38,8	61,2	443,8
Czech Rep	201,4	53,1	254,5	40,2	59,8	425,9
Slovakia	210,5	43,0	253,5	32,6	67,4	376,0
UK	91,2	83,1	174,3	40,1	59,9	290,8

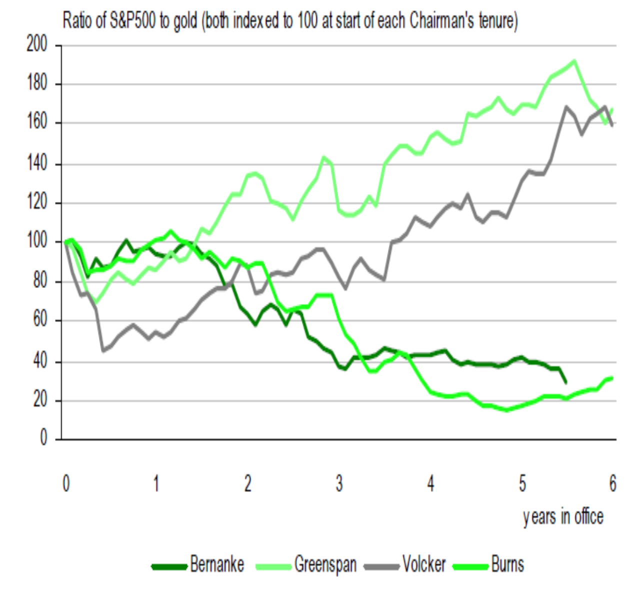
Based on the table above and the rushed assurances that France is spreading around that it will support banks like Dexia "with whatever it takes", we would not be surprised if France's credit rating is downgraded in the next few months.

The monetary policy that has prevailed over the course of the last 10-15 years has accommodated a culture of debt, where prosperity is being bought on credit. Moreover, it has created bubbles via overextension of credit, and has inflated asset prices, all of which destabilize the markets, and force prudent investors to seek safe havens. We are of the opinion that we may be entering a very dangerous zone where the Fed's and other central banks stimuli may be unable to do anything in the markets, at which point the bubble called bonds will burst.

Chairman Bernanke testified lately that operation twist is expected to lower long-term rates by 20bps! If trillions of dollars could not revive the economy which is full of toxic paper, how can we believe that a drop of 20 bps will revive the economy? It seems that all monetary policy has done in the last three years is to accommodate banks' needs to build a firewall (via recapitalization and easy profits through zero-rate loans and Treasuries' trading) for a potential financial tsunami – similar to that of the 1930s – that may be in the making.

The very unfortunate thing that history teaches us is that when monetary welfare is exhausted with no significant results to be shown, state warfare may take over.

We believe that the success of monetary policy can partially be seen in the performance of the market overall relative to gold, when the latter is mainly perceived as cash. When markets are confident and feel secured in the assets available to investors, demand for safe havens – the ultimate of which is gold - declines and assets that provide growth and yield exhibit higher demand. When insecurity prevails or is about to prevail (dotcoms, the bursting of bubbles, etc.) exactly the opposite is happening, i.e. demand for gold as an investment – and not as cash – dominates and gold returns become exuberant. The figure below, tells that story.



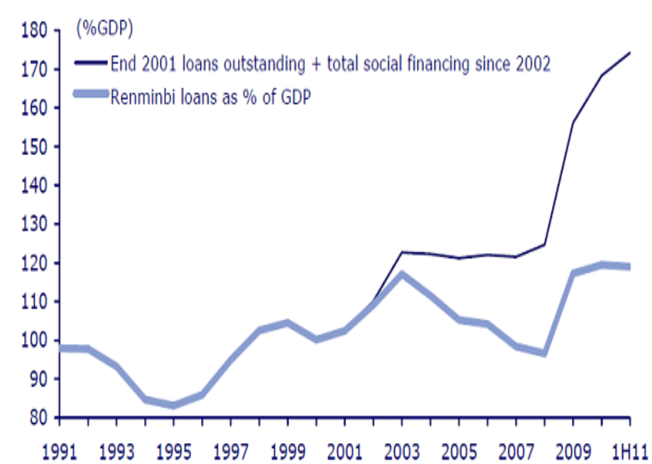
Source: Bloomberg and UBS

Moreover, we are of the opinion that the tremors will continue and may even intensify in China, if the following figures are of any guidance.

Annualised underground lending rate in Wenzhou

Source: China Reality Research (CRR)

China renminbi loans to GDP and accumulated social financing since 2002



Note: Based on PBOC's social financing volume data. Source: CEIC Data, PBOC, CLSA Asia-Pacific Markets

Under the prudent leadership of Chairman Volcker, inflation died, the markets recovered, optimism returned and no need for safe haven was sought after.

Under normal circumstances, the instability in the developed markets could be mitigated by higher returns in developing markets, assuming that the correlation between the two is not that high. However, nowadays with the tremors already being felt in China, emerging markets may not be a safe haven. In some of our portfolios we started shorting China about 10 months ago, following the publication of the September 2010 newsletter. The graph below shows the performance of that call.

<u>Shorting China in the Last Year</u>

The figure on underground lending in China tells us that liquidity squeeze is building up and that the Chinese efforts to slow down inflation has started making loans more expensive and possible scarce. The figure on loans relative to GDP should be seen using the lenses of total country indebtedness that we used before.

The very interesting fact is that South Korea reached a level of total indebtedness of 155% in 1997 and within a year collapsed. Japan reached a level of 197% in 1990 and since then its economy has been stagnant and its stock market has lost 75% of its value. The US reached a level of 213% in 2007 and the financial crisis started that year. The command-economy system of China may afford her a greater level, but for how long? Given EU financial troubles what would happen when domino tremors intensify?

<u>Concluding Remarks</u>

We believe that the secret to portfolio holdings in the foreseeable future is simply stated to perform a Lucky Luke stand. We need to get used to moves in parallel financial universes. Portfolios need significant structural adjustments given the expectations of major market turmoil. Cash should make up the largest percentage in the upcoming weeks and possibly months. Taking advantage of market declines - through shorting - mitigates risks and hedges the strategic positions that should be left (having a long-term view) in a portfolio. As strategic sectors and companies become cheaper, those positions will be enhanced slowly but steadily. In addition, a small fraction of a portfolio could be dedicated to aggressive acquisitions of positions having a medium-term view.

The times they are a changing and our Ode goes to catharsis!

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