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REMEMBERING THE FUTURE

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Lessons from A Restless Tradition: Searching for the New Model

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Introduction

In our last month's newsletter we briefly reviewed the main cause of the financial crisis, namely the over-collateralization and securitization of assets at inflated prices that resulted in the over-extension of credit. As we have documented elsewhere, a few years ago we called attention to the role the derivatives markets played in the collateralization mechanism. We would like to recommend two books that explain in plain terms the role of the derivatives markets, and of the securitization process. They are: Fool's Gold, by Gillian Tett; and The Two Trillion Dollar Meltdown, by Charles Morris.

Both of these books elaborate on the fundamental causes of the crisis and articulate the position that the toxic paper-assets were the result of bankers who forgot a basic lesson, i.e. that it is the ownership of the means of production that advances the interests of nations, corporations, and individuals. Unfortunately, we separated the production interests from the financial interests, and this divergence ran amok between 2002-2008. The result was the production of paper toxic-assets whose value was not derived from an underlying hard asset, but rather from a mathematical formula that assigned values to paper-assets. It is then no surprise that in 2007 at the market's peak, the financial sector of the S&P 500 produced 40% of corporate profits, and accounted for 23% of the stock market's value[1]. Wealth is not created by printing paper, but rather by owning and enhancing the means of production.

Hence the theme of this issue: the restructuring of a portfolio by acquiring ownership in hard assets. Last month we told the story of gold and other (such as oil) commodities that in the current environment should do well. In this issue we discuss two other options in the hard-assets framework. However, before we explore those options, we would like to caution the readers there is a slim but real chance of a major currency crisis that may unfold in the next few months. More on that in a future issue.

The Globalization Link

Globalization is here to stay unless a major war breaks out that will suspend international trade and capital flows. This is not a crisis of globalization. On the contrary, it will be the different faces and aspects of globalization that will re-shape the US and other developed economies and which will contribute significantly in fixing international imbalances (such as current account deficits, and out-of-balance currencies) that have contributed to the current crisis.

We are in the process of a dual global face-lift, namely: re-balancing economic power, and discovering a new economic model. The US will be the prominent player in both acts of this play. In the first act of this play (re-balancing economic power), we simply need to learn to live along with other rising powers such as Brazil, the re-emerging Russia, India, and China, (the famous BRICs). These are nations that control hard assets, productive powers, and have moved beyond the critical mass needed to surpass the threshold level that moved them from frontier to developing countries. They are developing capital markets and the time is coming when we will see a thriving bond market denominated in their own currencies – required for fixing global imbalances. Therefore, owning a stake in those countries, and particularly in productive assets that they control, positions a portfolio to take advantage of the de-coupling that is in the works.

The second act of this play (new economic model), will take more time to be developed, but it is inherently linked to the first act. We believe that this second act will have three phases, which may be unfolded simultaneously at some point in time. The first one is underway, i.e. massive spending and debt accumulation on behalf of governments around the world (including BRICs). In that phase, the neo-liberal paradigm (minimization of the role of the state and uncontrolled deregulation) will be set on a back-burner, and the role of federal government will expand. In the second phase, the role of the dollar will decrease in importance, while capital markets in other countries are being developed and bonds that currently dominate the credit markets will be denominated in USD as well as in other currencies. In the third phase, global institutions such as the IMF will be re-shaped and given a much more prominent role in a global economy that will be characterized by devolution in some countries (similar to the historic break-up of the USSR or Yugoslavia into several nation-states) and assimilation among nations. That process will permit centralization of decision-making on a global scale, in a model similar to that of the European Union.

The economic recovery will take time. Already, profits and profit projections are disappointing investors. As we said last month, the unemployment rate will keep rising (let's not forget that the real rate is not 9.5% but exceeds 14%). The fundamentals cannot support the irrational market that has a run of about 25% in the midst of depressed earnings, depressed production, depressed sales, depressed orders, depressed asset values, and increasing unemployment. The capital markets are still tight, and the catharsis of the blood (credit) arteries still has far to go.

Here comes the de-coupling process. We believe that the BRICs are developing a middle class with spending power. Their assets are rising in importance in the global credit mechanism. That means that those hard-assets will be collateralized and through the development of their capital markets, their financial infrastructure will enhance the consumption capabilities of those rising middle classes. Thus, while we may still be experiencing a recession, their economies will expand. Owning shares in the BRICs as a whole – through an Exchange Traded Fund (ETF) –or more specifically in companies that we believe will have a stellar performance, should be a wise move in a portfolio restructuring process. There are companies which have solid balance sheets, good management, are utilizing very efficient production techniques, whose prospects are very good, and are selling at a discount. The key for those companies is to be in sectors that will experience a surge in both domestic as well as overseas sales while controlling assets which are valuable to the global credit mechanism. We encourage you to call the office in order to discuss those options with us.

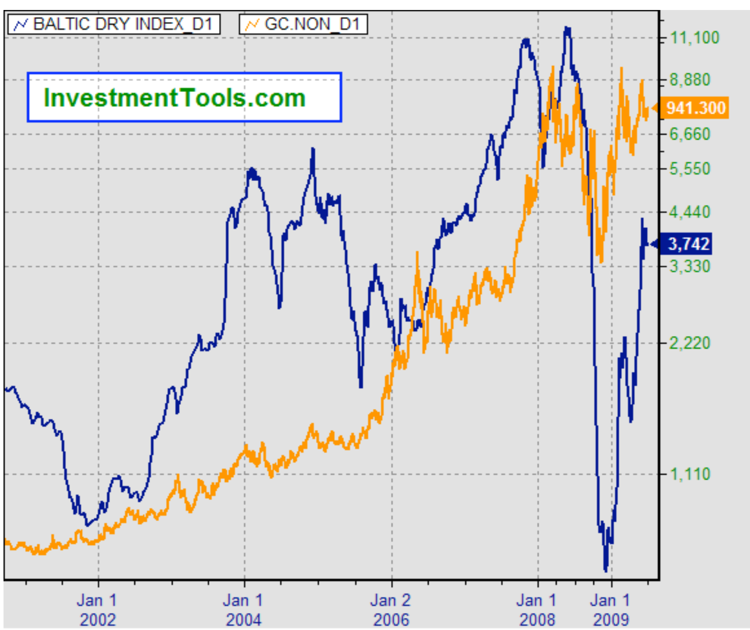
The previous points bring us to the second option, namely ownership of hard assets whose upside potential is significant under the circumstances described above. Again, we are looking for an asset class that takes advantage of globalization's prospects, the advancement of BRICs, has stakes in real tangible goods, has reached bottom, and has started showing signs of life again. We are talking about the shipping sector that involves primarily bulk carriers, dry cargo, tankers, VLCCs (very large crude carriers), and similar types of vessels.

The shipping sector is depressed. Hundreds of ships stay idle in international ports. Per diem charges by idle ships collapsed between mid 2008 and early 2009. Loan default rates increased significantly. Lenders are selling their portfolios. The largest player in the lending market (Royal Bank of Scotland) has been taken over by the British government, and is trying to clean up its loan portfolio. Lending has collapsed. Production of new vessels has been suspended. Orders of new vessels are being cancelled. The shipowners do not accept delivery of their finished orders. This might be the ideal time to get into this sector, especially if one understands the nature of risk and the fact that wealth is created under these circumstances i.e. when someone walks in when everyone else has walked out.

Allow us here to offer the convergence of two things: First, the linkage between what we said last month about gold's prospects, and second, the combination of fundamental and technical analysis. We will let the following graphs speak for themselves. But before we look at the graphs, a few comments are in order: China's imports since April are increasing at double digit rates; the number of idle container-ships has been decreasing in the last three months; and third, there is an amazing convergence between the famous "green shoots" and the shipping index. However, we also need to point to a word of caution here: Unless you have a long-term view, it might be beneficial not to be actively involved in this asset class.

The Baltic Dry Index (BDI) is the most-widely accepted shipping cost index. The index has increased by more than 200% year-to-date. As it can be seen from the graphs that follow, the index collapsed in early 2009. However, as it can also be seen from the first graph below, the index tracks gold prices quite accurately. Thus, given our theme last month and the rise in gold prices recently, we could conclude that the bottom has been reached for the shipping sector. In addition we have had private discussions with shipowners around the world, the great majority of whom have been experiencing higher shipping rates/chartering revenues (in some cases the increase exceeds 150%) since April of this year.

Baltic Exchange Dry Index (BDI) & Gold (gold)



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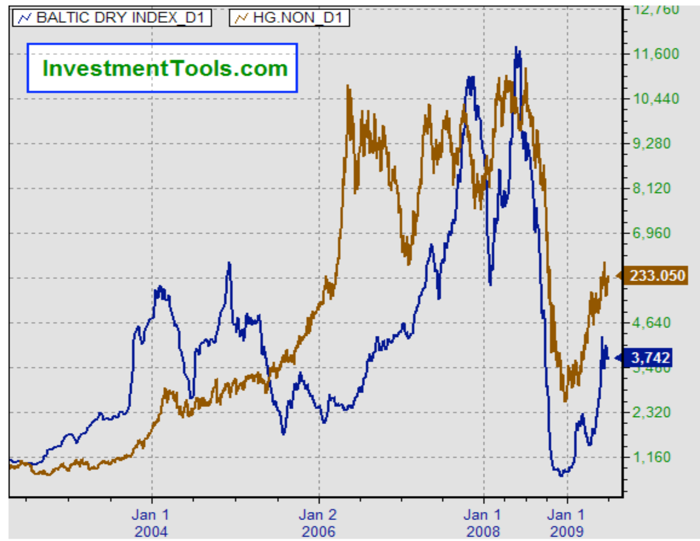
As we have argued elsewhere, we believe that copper has a Ph.D. in economics. When copper prices move downward, the economy is in trouble. The following graph links copper prices to the BDI. Copper has been experiencing significant upward trends. The conclusions regarding the shipping sector are yours.

Baltic Exchange Dry Index (BDI) & Copper (brown)



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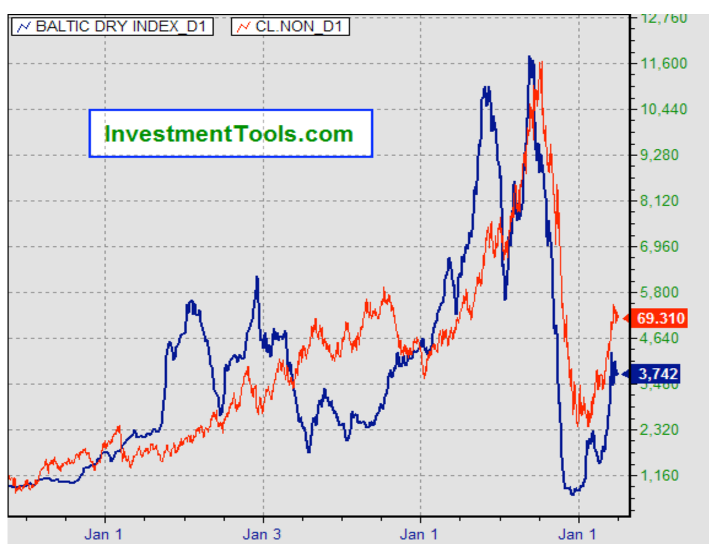
Last month, we also talked about the prospects of oil, expressing our belief that by year's end the price of crude could reach $85. The co-movement of oil and the BDI follows and the conclusions are again yours.

Baltic Exchange Dry Index (BDI) & Crude Oil (red)



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As for the prospects of the BDI based on smoothing averages, the following graph shows its trends based on a 200 and 20-day smoothing average. We believe that its prospects are for continuous upward movement, as the following graph demonstrates.

Baltic Exchange Dry Index (BDI), "Logarithmic Chart"

20 day exponential average in red.

200 day exp. avr. green

Chart created with NeoTicker EOD © 1998-2007 TickQuest Inc.

Before we offer our closing comments, allow us to share with you one more graph that shows that for dry cargo the upward trend is well in the works for different types of ships and charter time-frames.

Daily Chart for Cape/Panamax/Handy 4 TC AVERAGE Values

Conclusion

As we documented above, we are of the opinion that restructuring a portfolio in the face of global changes (in terms of shifting power and a new economic model) requires the acquisition of hard assets and of being an active participant in the de-coupling process that is under-way. That approach should guide investors to look for asset classes that will experience growth and will sustain earnings, even under challenging conditions. Moreover, investment decisions should look at whole and individual markets and companies that have hard and valuable assets which will in turn become the cornerstones of the new global economy that is knocking on our door.

Please feel free to call the office. We will be happy to review your portfolio and discuss with you specific suggestions.

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. John E Charalambakis is not affiliated with RJFS.

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.

One cannot invest directly in an index. Past performance does not guarantee future results.

[1]The Economist. January 22, 2009. Fixing Finance