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Serving Your Personal Investment Needs Since 2003

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PORTFOLIO UPDATE – THE GOOD NEWS (HYPERINFLATION, TSUNAMI, LIBYA, NUCLEAR MELTDOWN, FREEDOM)

This is called a "Tongue in Cheek" headline…..
The real question is "What else can happen now??" After weeks of unrest in the Middle East and Northern Africa, it was time to get war and unrest off of the news "front burner" and move on. However, no one would have wanted to predict the next news event taking place in Japan.

This will be an unusually long letter. Please forgive its length, and respond with your questions.

Let's break down the issues for discussion. (1) I have had several questions about the potential for hyperinflation, or even just "inflation", and how to protect our investment portfolios should we begin to see runaway inflation. (2) What will happen to the global economy when such a large component of that economy is shut down for a period of time by natural disasters – earthquake and tsunami; and then, that economy loses 25% of its energy source thru nuclear meltdown! (3) In the heart of the oil production world, unrest, demonstrations, and civil war threaten to limit the availability of oil for world use, driving up prices and increasing global energy costs. (4) And then, as if that were not enough to deal with, the global community faces tremendous stress, caused by extremely high government debt loads, such that there is serious concern about the viability of the global financial system as governments are no longer able to service their debt – Japan, U.S., Great Britain, The European Union.

Needless to say, I can hardly do an in-depth analysis of these topics within this brief investor letter. That being said, I think that I can provide a decent overview such that some of your most immediate questions and concerns are dealt with.

Hyperinflation, as a function of the huge amounts of money added to the U.S. financial system by the Federal Reserve, seems to be the question most asked today. Is it likely that the U.S. economy will see the kind of runaway inflation that has occurred in the past – Germany after WWII, Argentina, Brazil, and elsewhere? The real question to ask is "what causes inflation?" Essentially, inflation is caused by too much money in the system, chasing after goods to purchase. This money comes from the U.S. Treasury, and, theoretically, from the Federal Reserve Bank. The government, through the U.S. Treasury, borrows money to pay its bills. The Federal Reserve Bank can buy that debt directly from the Treasury or in the secondary market, from private holders of Treasury debt. Most questions I receive are related to the Fed's so-called Quantitative Easing strategy, whereby the Fed buys government guaranteed mortgage securities and Treasury debt. Basically, this is the Fed monetizing the government debt. Too much of this and inflation will occur – even hyperinflation! A secondary issue, and one that is more subtle, relates to the reserves that are building up in the banking system. Banks lend against these reserves. Thus far, banks have allowed these reserves to grow, choosing not to lend against them. When lending occurs, this adds money to the system. Lending increases the supply of money – potentially causing more inflation. Most of the concern I hear about inflation relates to these two issues – bank lending potential, and Fed monetizing actions.

In fact, both of these kinds of system actions are controlled by the Fed. Should inflation become a factor to be dealt with, The Federal Reserve Bank has the tools to put a stop to the inflationary process – by draining money out of the system: selling its assets, draining bank reserves, raising interest rates. We know how to manage inflation, and how to prevent hyperinflation. Don't expect to see hyperinflation, or even inflation rates that greatly exceed the Fed's targets for inflation.

(1) Up to certain levels of inflation, we can protect our investments from inflation. We do this by investing in equities, and by reducing our investments in fixed return assets. This strategy increases volatility in the value of our investments. A better strategy is to find a stable currency and invest in that country's assets; to diversify investments so that risk is lowered, volatility is reduced, and a concentration in any single investment strategy is limited, in order to prevent large losses from occurring. Preservation of capital becomes an investment strategy. Should runaway inflation take hold in the U.S. economy, we will recommend moving into hard assets and diversified, stable, foreign currency investments. (In fact, a well designed investment portfolio already holds these kinds of diversified assets.)

Bottom line: I don't expect runaway inflation, and certainly don't see hyperinflation in the future for the U.S. economy.

(2) As terrible as the disaster in Japan is, and as important as the Japanese economy is to the global economy, the economic distortions caused by these disasters are likely to be short lived, as the global economy adjusts to the distortions occurring in Japan.

(3) Oil prices are going higher in the coming years until they reach a point in time when this country, and the world itself, develops an energy policy that limits exposure to the supply and delivery of oil. In this country, it is time to move away from imported oil as an energy source. After 40 years without an energy policy, we are at last getting something that has the potential to wean this economy off of oil imports. Gas pipeline infrastructure is being developed, that will allow for internal U.S. supply and delivery of natural gas, to energy distribution points. The goal is to bring U.S. net exports into a breakeven status, i.e.: imports minus exports equal zero or are slightly positive.

(4) The most serious problem facing the U.S. economy today is the level of our Federal Government debt. Today, 40% of our total annual government expenditures are paid for through borrowings. This cannot be allowed to continue! What this means is that government expenditures must be reduced dramatically, to where income and expenditures are balanced! NOTE: That does not mean that this can happen immediately! **An immediate, sharp cut in government expenditures will only force another recession/depression, putting more people out of work, and lowering the revenue side of the government balance sheet equation. There must be a consistent, but determined, budget balancing schedule put in place that walks a fine line – a Federal Government policy that shrinks the deficit, while avoiding the distortions of another economic contraction.**

Summary:
It is this last point - # (4) - that will very likely control our longer term economic future. If we fail to achieve a balance between revenue and expenditures, at the Federal Government level, our personal investment portfolios will not survive unless we hold mostly "hard" assets – gold, commodities, stable currencies outside the U.S., and investments in those emerging economies with long term growth momentum.

If you study our recommended investment strategy, you will see that there is a significant move in this direction – to higher levels of international category investments, emerging market investments, and even a move into gold, silver, and the Swiss Franc. Preservation of capital is the most important investment strategy goal; Consistent and predictable growth through interest and dividend paying investments – government guaranteed mortgage backed securities, relatively short term corporate bonds and mortgage backed bonds, and some longer term preferred stocks – holds a high priority in our investment strategy; and finally, a growth strategy that reflects the need to consider current and future marketplace risks, as outlined in points # 1-4 (above).

How will we know whether we are making the right investment decisions? That is always a difficult question to answer. I think that we have the tools in place to manage the risks we are considering. However, you as an investor, must make your own decisions as to how much risk you are comfortable with taking. You have us to talk to whenever you are concerned about the future and how it affects your investment strategies. This is what we do. We use our years of experience, to guide you and to test your concerns. We are here to help you do just that – preserve, protect, and grow your investments, making them achieve your lifetime goals.

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