



Essential Summer Reading – Desperate Households and More

By Michael Shamosh

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Summer reruns don't have to be boring and predictable. If we use a little imagination, televised repeats can depict the problems facing our economy and markets, and the storylines can become tantalizingly uncertain.

As summer rolls around, many of you might be catching up on entertainment you missed during the year. Maybe you are watching an old television show or catching a movie in between barbecues and trips to the beach. It's a fun thing to do on a hot evening when the mosquitoes are filling the air outside, or a thunderstorm douses the hot coals and makes you call for a pizza.

Occasionally, we at Corby Asset Management let ourselves wander into the world of entertainment too. We go to the movies, watch television and occasionally see a live show or concert. Not all the books we read are about economics and markets. But sometimes it seems we can't get our minds off our work, especially when what's playing on our Bloomberg screens can be far more interesting than what we see on our televisions or local silver screens. Here is some of what we will be watching this summer:

Debt Valley Days

The U.S. is suffering from debt drag as a result of policies that used debt financing to maintain a strong military and growth economy. While these policies did not originate with the Reagan presidency, their success in those years resulted in repeated later efforts to accomplish the same ends with the same policy.

That policy is no longer working — in fact it has now *inhibited* the economy from growing. Efforts to revive sectors of the economy using the tax system are nothing more than rehashes of the debt-financing system. We will be watching this summer as the debate on the debt ceiling reaches a crescendo. Rating agencies have warned us that the U.S. debt rating is subject to negative review unless the longer-term fiscal picture improves.

Can the U.S. political system, one that operates by giving away goodies using borrowed money, finally discipline itself? A team of 20 mules couldn't keep us from watching this great drama.

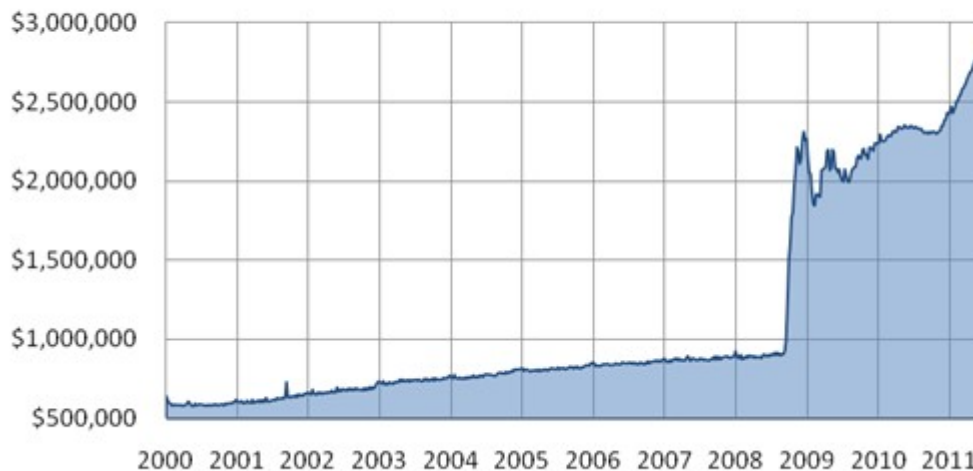
I Love Loosie

It's not just the fiscal situation that's gone wild. Our monetary system, which is now largely backed by nothing but debt, has no grounding either. That allows the monetary authorities to lower interest rates at will to counter the effects of any financial threat, real or perceived. With rates now at zero, they have resorted to printing money and tossing it at the banks in hopes that it will get lent out.

The problem is that the banks are carrying a slew of bad mortgage debts from the previous debt party. Instead of cleaning them up, the accounting authorities were forced to pass rules that allowed banks to carry these debts on their books at higher values than what they might be worth on the open market. This is more an episode of "Fantasy Island" than a display of prudent management, as banks can appear more solvent by pretending these mortgages are worth more than they are.

The balance sheet of the Federal Reserve is already swollen with a variety of assets, as our chart below illustrates. Will they grow it further if the economy turns down again? Can it continue to grow without damaging the exchange value of the dollar or causing the price of gold to go ballistic? Stay tuned, as the next episode promises thrills and chills.

Federal Reserve Bank Balance Sheet
Total \$ Assets, in Millions

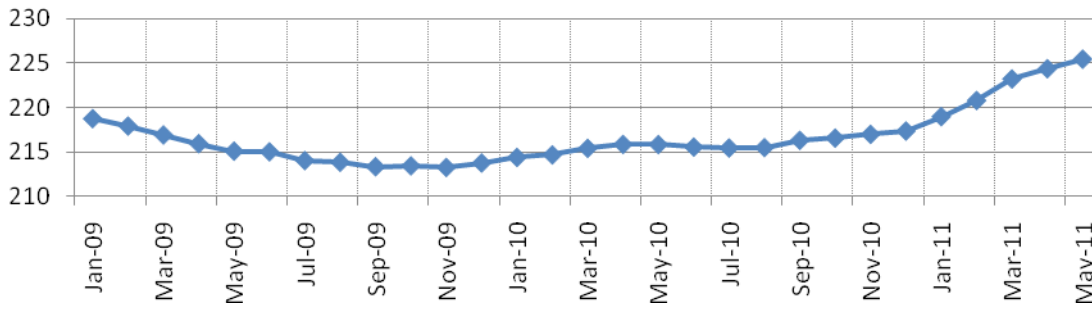


Desperate Households

Families are getting closer to Hysteria Lane as increasing costs of essentials like food and fuel and poor real wage growth are causing some real pain. Here's what we see on our screens:

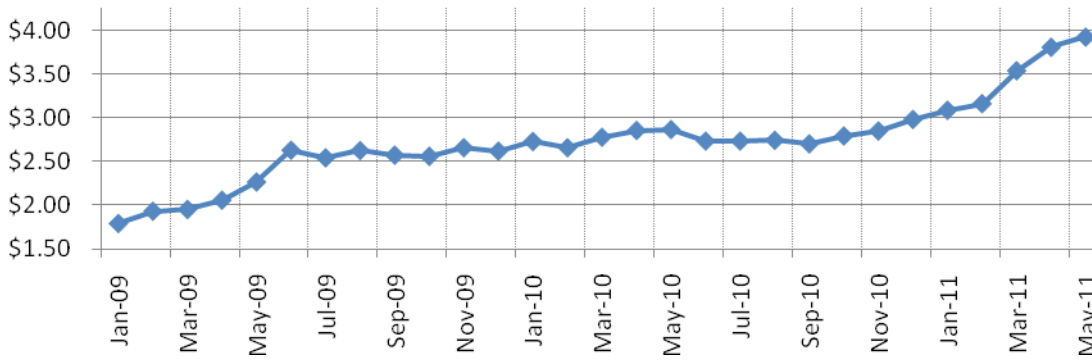
Food Prices

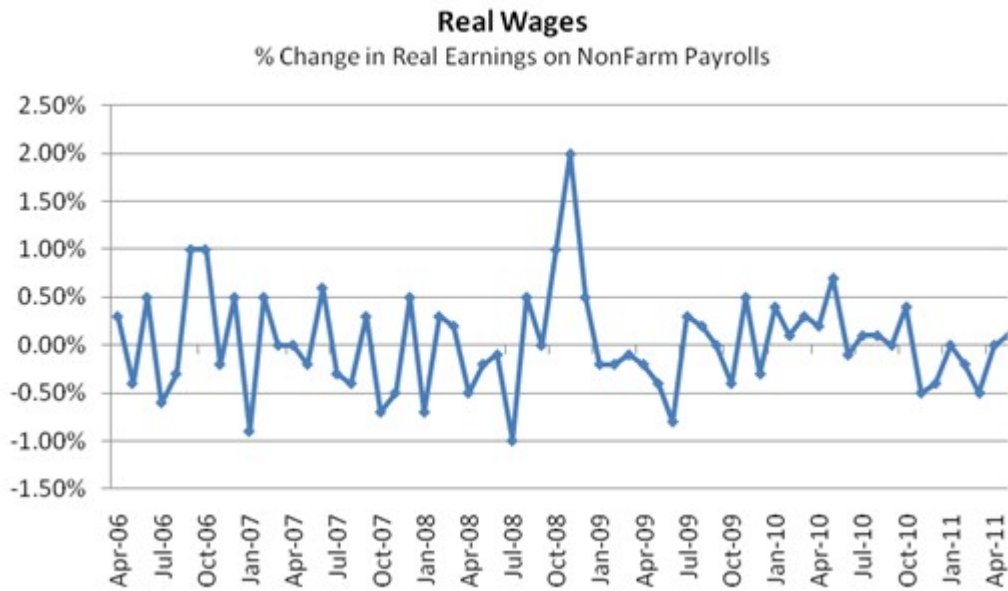
CPI Urban Consumers Food at Home Index
Index Base Year 1997 = 100



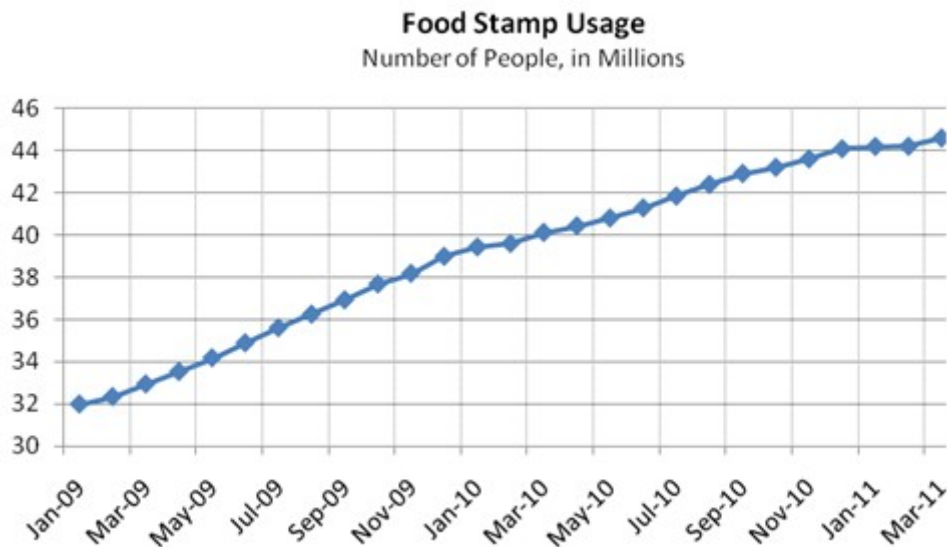
Gasoline Prices

\$ Price/Per Gallon





As costs start to bite, more are turning to government assistance.



This is a depressing show. Assistance is conditioned on the ability of government to borrow. Clearly, Americans are living beyond their means. We will be watching to see if their leaders tell them the truth or decide they just can't handle the truth. We are not encouraged by recent gestures that attempt to manage prices by first blaming speculators for the high cost of fuels, then raising margin requirements on the commodity exchange to



force some liquidation and, most recently, withdrawing oil from the nation's strategic reserve. This last move was a blatant attempt to temporarily lower prices, based on the incorrect assumption that we had a price problem and not a supply problem.

Twin Peaks

Even David Lynch couldn't come up with this one. After decades of steadily hovering in the 5-6% range, corporate profits as a percent of the nation's gross domestic product (GDP) jumped to over 10% in the mortgage bubble years from 2005 to 2007 before collapsing back to earth. Corporate America and the financial sector was garnering a disproportionate share of the nation's production.

Guess what? It's back to nearly 10%. Part of this is due to banks' changing accounting standards, but part is also due to the high margins that companies earn from relatively low labor costs. Strange only gets stranger in these times.



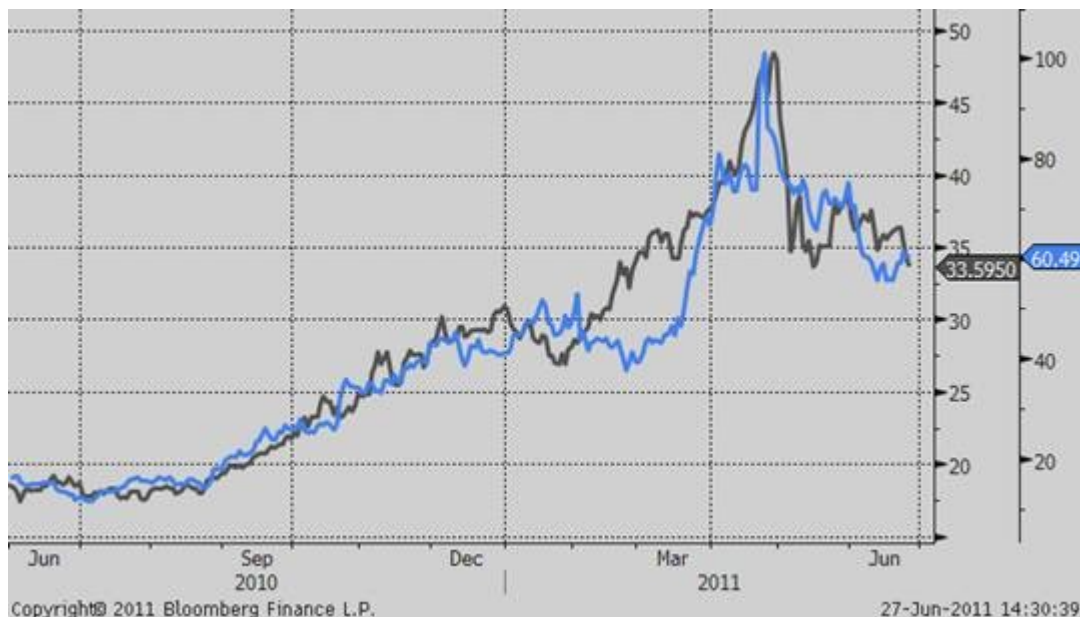
If the “Desperate Households” begin to see the “Twin Peaks” shown above, there will be social consequences — riots such as are now occurring in Greece should serve as a warning. At the moment the public is anesthetized by couch-potato government policies that keep them entertained while wealth becomes more concentrated. We will be watching to see if the pitchforks and torches come out and if and when the anesthesia wears off.

The Long Ranger

Investors riding silver in the last few months might have had reason to yell “Hi-Yo Silver,” but they did not expect to encounter a clear double standard and a further blatant attempt to mask the underlying inflation brought about by poor fiscal and monetary leadership. Politicians and others in positions of power do not like markets that are more powerful than they are.

The Soviets attempted to build a country around a men-over-markets ideology and failed. The U.S. is inching its way to the same place. This is illustrated by the differing fates of silver and Travelzoo stock. Travelzoo, an online marketer of travel services, saw its stock price go from about \$13 to over \$100 during the past year. The price of silver, a monetary and industrial metal, rose from about \$17 to nearly \$50 over the same period. The next chart illustrates just how similar these moves were.

Price of Silver vs. Price of Travelzoo Stock (Normalized)



Yet silver and gold represent threats to the current monetary order, because they are real assets and not figments of the paper system where the power in this economy resides. They, not the stock price of Travelzoo, are the report cards of the financial system.

Higher gold and silver prices tell us that the value of currency and faith in the financial system are ebbing. Left with a choice between respecting markets and their discipline or temporarily forcing prices down to hide the bad grades, our authorities chose the latter. As



with oil, the margins for metals prices were raised in early May, forcing leveraged speculators to liquidate positions. You can see the result.

One might ask why margins were never increased on Travelzoo stock. By admission, the head of the Federal Reserve wants higher stock prices to create a wealth affect and induce more spending. Travelzoo's stock price went down because of simple exhaustion, not margin liquidation. With Travelzoo's estimated price-to-earnings ratio of 38, one might argue as to whether Travelzoo or silver is more expensive, but one thing is for sure: We will never see a masked man riding off into the sunset yelling "Hi-Yo Travelzoo!"

We will be watching to see what other monetary and regulatory shenanigans are placed in front of the public to prevent the realization that power is corrupting. We want to see just what it will take before folks won't accept the "nothing to see here, move along" instructions. And we will be watching for signs that market forces are once again operating, despite what we might be told.

Home Improvement

Our office is always seeking the right tool for the right job. In recent months, we have begun to think about re-tooling our portfolios to reflect that the economy is not coming back in a major way. It's not going off a cliff either, although there is always a chance that policy errors could take us where they did in 2008.

Our original thesis — that the most sensible way to invest in these times is to seek income from a variety of currencies — is gathering more converts from the crowd chasing price growth. We are looking at more ways to increase the income level and ensure its survival into the next economic relapse. Recently, we have added to our infrastructure businesses, and we are planning to trim some other holdings on further price strength. Our best holdings this year include those in the health care and energy sectors, and we see those as good defensive choices looking ahead.

Our big problem continues to be the negligible return on cash. It is everybody's problem, and it is causing many investors to eschew their quality disciplines to get a return above inflation. Short-term bonds are now price-controlled by the Federal Reserve, a situation that wreaks havoc with the classic capital asset pricing model, which prices assets based on their prospects of return over the risk-free rate. The risk-free rate, essentially set by the Federal Reserve, can be defined as the yield on Treasury bills — which is zero. Since inflation is currently 3.6%, even returns over the risk-free rate could fall below inflation.

Therefore, an investor is forced to absorb increasingly more risk to beat inflation. We are rummaging around our tool chests every day to find a balance between risk and return, as we know the current situation cannot exist forever. Cash, despite its value-withering tendencies in this environment, may be a better choice at some point, especially when the prospective long-term return on equities falls further. One must always remember that



higher stock prices today signal lower future returns. The action of the Federal Reserve in designing higher stock prices is today's fashion, but it comes at a high price.

HFT Terminator — The Rise of the Machines

In a futuristic world, machines have taken over and want to rid the world of humans. This plotline sounds a lot like today's markets, where much of the trading is done by high-frequency trading (HFT) machines that are programmed to sense order flow and make bids and offerings that provide the appearance of market liquidity. Last year, humans were treated to a market "flash crash" when the chimera of liquidity was removed. We still get flash crashes on individual stocks occasionally for a nano-second or two, but we are told that everything is under control. Maybe these machines are not out to kill us — they just want to rob us.

Goldflinger

A guy named Bond fights with a large Asian man who wants to destroy the gold in Fort Knox and gain world monetary dominance. Bond throws a gold bar at him but can't stop him. While Bond won this fight in the early 1960s, the Asian man won't take any more of Bond now.

"My Big Fat Greek Default"

A Greek American meets an American of European ancestry. They get acquainted and after some bickering, get married. Then the European realizes he must support her entire family. So he hits up his extended family for loans and guarantees. They grumble when they realize her family used Windex to make their books look clean. We will keep watching to see what happens, but the story lacks a conclusion.

Enjoy your summer, everyone.

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