Global Portfolio Strategy

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Don Coxe
(312) 461-5365
don.coxe@bmo.com

Basic Points – The Hinge of History: Part II

1. Wall Street Devours the Nest Eggs

Many forecasters argue that this recession will be brief and mild, like the 1990-91 downturn, which was caused by the implosion of what remained of the US Savings & Loan industry plus a relatively few major banks, including Citicorp. These forecasters overlook a major difference: Back then, middle class Americans had substantial savings.

It took 15 years, but Wall Street's pros and mavens (aka crows and ravens) managed to devour and destroy trillions of dollars worth of those nest eggs.

That means the Baby Boomers are a dozen years older, and have little time left to accumulate the wealth needed for the retirement lifestyle they assumed was their birthright.

The first looting of Boomer savings came when Wall Street joined up with Silicon Valley in Nasdaq's dash to the Triple Waterfall peak. There were two steps in that wealth destruction: (1) the Street drained trillions from America's savings pool; and (2) the stock market collapse triggered the recession of 2000. In what would become the business model for Wall Street in this decade, the CEOs and other top insiders from the Street and the Valley gained gigantic rewards during the boom, ***and continued to reap big profits during the first year of the collapse***. Capitalism's basic moral principle—reward for results, punishment for failure—was junked with the kind of sneer that many elitist professors routinely give to the religious and secular beliefs of the nation's forefathers.

After the Fall, which healthy nest eggs remained for Wall Street's predators in this decade? The shrunken 401(k)s were unlikely to produce a new crop of Street billionaires.

What did the suckers have left?

Answer: homes.

The clever strategists rightly concluded that all that was needed was to goose up a housing boom by gutting most of the constraints on mortgage lending and convincing the Boomers that their last chance at a genteel retirement would come by levering up to buy more housing than they needed, and using rising house prices to finance the lifestyle they'd previously been told tech profits would deliver.

Having set the demand-side forces in motion, all that remained was to find ways to finance soaring house prices at a time of near-zero American savings. Answer: give high-paying jobs to hundreds of Ph.Ds in mathematics and physics, then put them to work developing opaque new products designed to evade the disciplines of the market. Should the math prove to be wrong, it would force a Fed bailout, like Long Term Capital Management got, and the worst that could happen would be that the exit bonuses for the bosses might be crimped marginally.

But markets cannot be fooled forever. The toxic interaction of bad math and sleazy lending practices eventually wiped out trillions in asset values and triggered the second unnecessary recession in eight years. Despite non-stop rescues from Washington, the unwinding process continues to siphon off much of what is left of American savings into *nouvelle vague* cesspools. Meanwhile, recession spreads from Main Street USA to Britain's High Streets, Spain and other bubbly housing markets.

Our thesis: Financial markets must reprice risk based on the observable reality that leading global bank stocks can no longer be classed as low-risk investments, while leading commodity stocks should be classed as core investment-grade securities tied to real growth in the economies that are the world's only hope for avoiding a serious economic downturn. Wall Street banks, as a group, offer unknowably high levels of risk and minimal reward—except for their bosses. Real stuff that people really need that cannot be synthetically spawned in unlimited quantities by amoral Ph.Ds will prove to be the cornerstone of wise investment portfolio allocations.

When history turns on a major hinge, political, financial and economic power relationships are transformed. Investment principles of risk and reward that have previously governed investment policies should be revised.

Sadly, much of what has worked for three decades is now, like aging aircraft which receive inadequate inspection and repairs, not only obsolete, but downright dangerous.

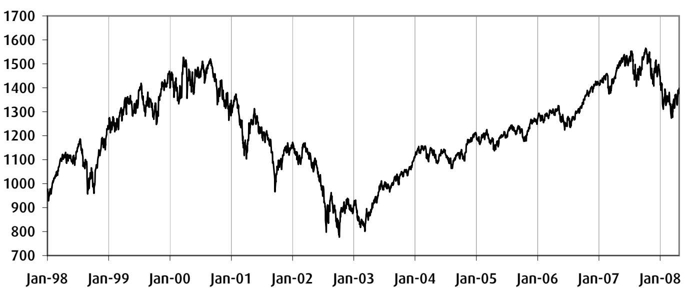
2. Wall Street Changes Its Spots

We begin with 1998, the last time Wall Street tottered because of the failure of sophisticated investment models.

That sell-off came from the collapse of one of the most mislabeled financial institutions in history—Long Term Capital Management. It was renowned for having two Nobel economists in its management group.

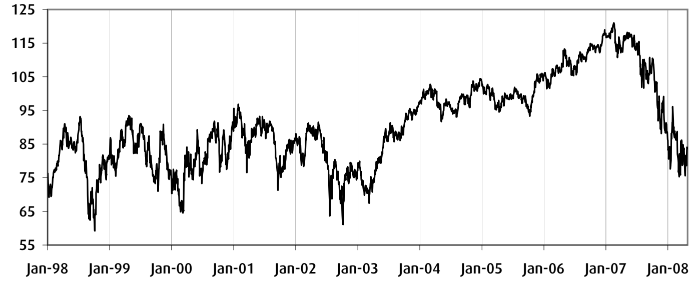
Alan Greenspan helped to orchestrate LTCM's bailout, and then proceeded to flood the system with liquidity, ensuring that The Greenspan Put would succeed. Part of his justification for this seemingly unseemly behavior was that the tech boom was making the industrial world so productive that deflation—not inflation—was the primary challenge to the price system.

S&P 500
January 1998 to April 2008

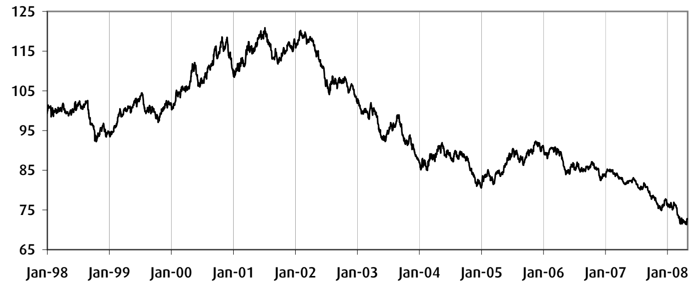


Nasdaq
January 1998 to April 2008

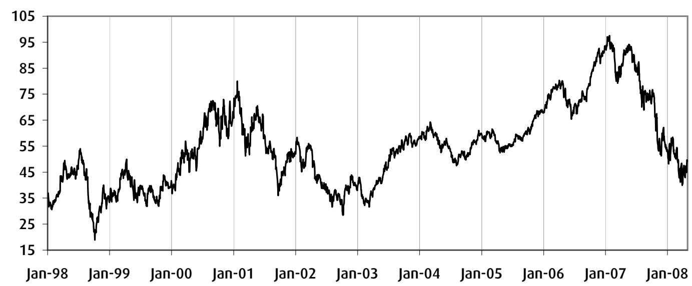
Bank Stock Index (BKX)
January 1998 to April 2008



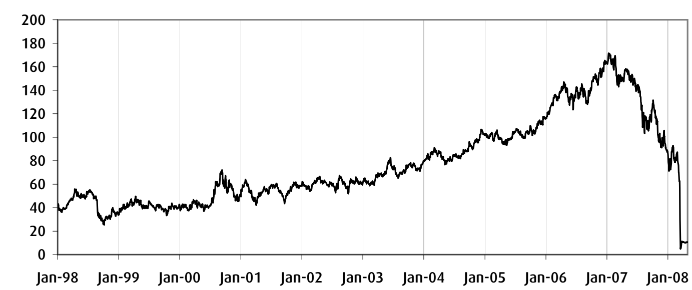
US Dollar Index
January 1998 to April 2008



Merrill Lynch (MER – NYSE)
January 1998 to April 2008



Bear Stearns (BSC – NYSE)
January 1998 to April 2008

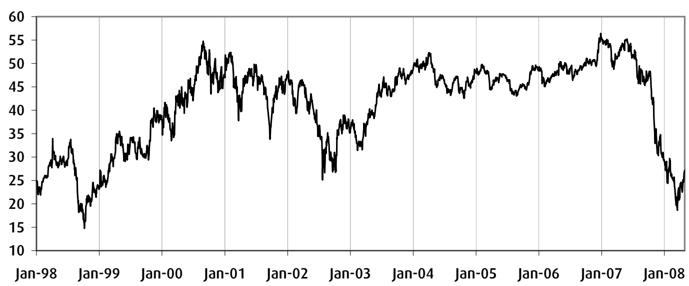


Investors assumed that if The Maestro was so infatuated with tech stocks, then their stratospheric P/Es and sleazy accounting practices didn't matter. Greenspan's sustained injections of greenbacks helped transform Nasdaq from raffishly risky status into the most overvalued stock market of all time.

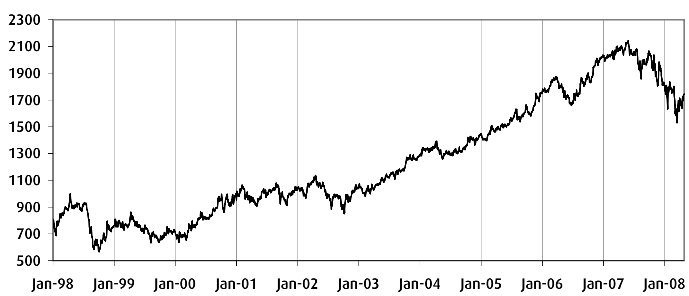
In 1998, the world's biggest mega-bank was formed, as Sandy Weill merged Travelers into Citicorp to create the new financial model that would arouse merger lusts across the banking system. Glass-Steagall was repealed within months. Among those who reacted most vehemently to this creation of new Street elites were Canadian banks, which increased their lobbying efforts to try to convince Ottawa that they should be allowed to merge to achieve enough scale to survive.

Well, the question of survival is back on the table, but it isn't about those supposedly undersized Canadians. Instead of affirming the principle that Big is Better, Wall Street banks seem to be competing with each other to avoid proving anew a different adage—the Bigger they come, the Harder they fall. (The unwillingness of global banks to lend to each other at the fed funds and other target rates suggests just how concerned those banks are.)

Citigroup (C – NYSE)
January 1998 to April 2008



TSX Bank Stock Index
January 1998 to April 2008



What happened between the birth of the world's mightiest bank, the disappearance of the umbrella logo, and Citi's trips to (1) Prince Al-Waleed for another rescue, and (2) the Fed's new handout windows on Wall Street is, of course, well-known to our readers.

First to come were the off-balance-sheet, secretive vehicles, known by various names—including conduits and Structured Investment Vehicles (which would later become SIVs—and leak that way). With the massive and magisterial Paul Volcker no longer patrolling the banking system, Citi and many other banks displayed their creativity with these new ways to borrow short and lend long without having to disclose them. (Volcker, who may well be regarded by historians as the greatest civilian American public servant of the 20th Century, has recently growled publicly about these sneaky backdoor violations of the regulatory and reporting regimes he created.) Whether they were, in fact, modeled on Enron's Special Entities (SPEs), or whether Enron modeled itself on the SIVs will doubtless lead to a thicket of theses that will qualify many new Ph.Ds.

We have to confess to deriving some guilty pleasure from the stories of these leaking SIVs. Like many other critics of market misbehavior, we revel in tales of bankerly cupidity and bankerly stupidity. These SIVs will become treasured tales for future historians, if only because so many of them managed to achieve the banking double play: losing by borrowing short to lend long, *and* losing by borrowing short to lend badly. Apart from outright theft, or rogue traders, those are the only two ways banks can go bust, and the SIVs proved to be splendidly efficient at combining both blunders in one package, thereby saving on staffing costs.

Not that the SIVs were complete failures: they achieved one of their two goals: they inflated returns-on-equity (because they weren't disclosed on the balance sheets). Demonstrated growth in ROE has been a crucial component of the compensation systems that have in recent years transformed the valuations of seemingly ordinary bankers into reincarnations of the Medici, J.P. Morgan, Rothschilds and other heroes of banking history. The Lake Wobegon system used by the "independent" compensation consultants decreed that all CEOs and CFOs were above average. This sudden explosion of certified brainpower at the top triggered pay packets that dwarfed the compensation arrangements of previous eras, when bankers tended to be paid modestly compared to successful entrepreneurs, mafia dons or movie stars. The new millennium's league of brilliant bankers got record-breaking pay for their ability to disclose pleasing earnings which were, in major measure, derived from undisclosed entities, and instruments that only Ph.Ds could understand. Warren Buffett recently observed that valuing one single CDO could involve more than 700,000 calculations. Daunting as such complexity might seem to ordinary mortals, these creations were ranked AAA by the financial equivalent of the "independent" pay packet people—the ratings services—who were well paid by the issuers for poring over those fiendishly complex creations. The powerful stock performance of Moody's showed how rewarding it was to reward the financial alchemical creations with near-Treasury ratings. Time was, that AAA financial paper was as rare as vulgar displays of wealth by bankers. By 2007, it was almost as common as corn in Iowa. (In retrospect, value investors should have invested in the corn, not the derivatives.)

As "Woody" Brock notes, another characteristic of this decade has been an unprecedented growth in leverage, including the liabilities disclosed on balance sheets, the off-balance-sheet SIVs, the $60 trillion in default swaps and other derivatives, and the symbiotic arrangements with sponsored hedge funds.

As Wall Street's software shops kept disgorging hundreds of billions in new exotic instruments like so many Sorcerer's Apprentice's pots and mops—little of which was issued directly into the markets—how could the Street maintain a pricing system for securities which only Nobel Prize economists and other certified geniuses could value?

Answer: find thousands of new buyers. New hedge funds began to multiply like rats in Hamelin. Prime brokerage became a major profit center for the issuing investment banks, because the banks were able to sell their formula-valued product to managers who used the same formulas. Like Babel citizens before the Tower got too high, these parties—issuer, hedge fund and rating agency—spoke to each other in identical languages—through their computers.

And then the shared Babel became mere babble.

At a recent John Mauldin event in California, another speaker was kind enough to congratulate me on my condemnation of Wall Street's fall from capitalist grace. He told me that he ran a hedge fund that specialized in collateralized loan obligations (CLOs). He took the top-rated pieces. He once asked a major underwriter about the hedge funds that bought the smelly stuff further down. Answer: These are prime brokerage customers of the bank and were, he was told, levered as much as one hundred to one.

Regrettably, the supply of such useful future zombies was not equal to the growth in CDO and CLO offerings, so hundreds of billions in CLOs remain moldering on banks' balance sheets. They were used to finance the other mania of this decade—Private Equity. Because of the seemingly infinite supply of money that didn't even ask for payment covenants, the big PE firms switched from their longstanding practice of buying steady cash-generators and leveraging these acquisitions to increase their productivity and competitiveness. But the temptation of easy money was too great: Some of the PE barons began to wallow in the Congoesque flow of liquidity like so many hippopotami. They no longer waited to get their cash returns by building up the businesses slowly over time: they gobbled them up, then loaded them up with debts at record-high cash flow multiples. The proceeds didn't go to finance capex, R&D or inventories in the acquired companies, they went to pay huge signing bonuses to the acquisitors. The larger economy benefited to the extent of their enormous expenditures on self-congratulatory gala events. From press coverage of some of these events, it was clear they were on a scale one associates with Roman emperors.

I flew back from that conference seated next to an executive of an orthopedic devices firm which has long competed with industry-leader Stryker. It was acquired by one of the new PEEs—Private Equity Emperors. He described how the company's corporate staff meetings that used to focus on R&D and new product development, now began with the CEO telling attendees what the weekly interest charges were. The firm had previously carried small debt loads used to finance inventories and some capex. Now the debt payments primarily go to pay for Their Masters' Vices.

(Memo to self: Buy Stryker: Short the PE company. Shed a tear for American global competitiveness.)

The financial debauchery in this decade is on a scale that even a Marx or Castro would find improbable. As Martin Wolf notes in the *Financial Times*, the banking industry has been conspicuously successful in privatizing profits and socializing risk.

At the recent IMF-G-7 finance ministers' meeting, a committee of the biggest bankers met with ministers and global regulators. They were told, by representatives of the central banks that have rushed to their rescue, to raise new equity capital and submit to greatly increased regulation.

The bankers were indignant. They shouldn't be expected to sell their stock at these depressed prices, and the industry was fully capable of regulating itself without interference.

Their reply was classic chutzpah. In reviewing their presentation, Martin Wolf cited Willem Buiter of the London School of Economics: "Self-regulation stands in relation to regulation the way self-importance stands in relation to importance."

Whatever credibility Wall Street had after Bear Stearns' collapse evaporated in Washington. The group of fat cats that caused a collapse, a crisis and a recession just wants to be left alone—except that it demands emergency infusions of lending in which its own odoriferous paper becomes the security for government financing. It's bad enough for poor Ben Bernanke that he has to keep bailing out a group of guys who've been paid grotesquely large bonuses—that they aren't refunding: But what he gets in return for his absurdly cheap loans is stuff they haven't been able to peddle anywhere else. Lender of Last Resort is an honorable central bank concept dating back to Bagehot's time. Lender on Lousy Paper is only slightly more seemly than Printing Press Enthusiast.

But investors who don't need to be part of this process can exit from this never-ending game in which the government and taxpayers take the risks and the people who caused the problems continue to take the rewards.

A prudent investor should presume that those big, bad banks aren't going to begin to behave in stockholder-friendly fashion until their CEOs are no longer paid fortunes for creating misfortunes.

As long as the banks and near-banks remain the major equity asset class with the greatest endogenous risk, the stock market will be struggling. In good times, banks trade on their income statements; in bad times, they trade on their balance sheets. Absolutely nobody knows what the banks' real stockholders' equity is after deducting the inevitable writedowns for the unhealthy, gaseous CDOs, CLOs and CMBSes (commercial mortgages). Indeed, a fair question is, "Are they worth anything if house prices fall a further 15%?" Such a drop is hardly of Black Swan proportions. Indeed, some experts who predicted this disaster say that US house prices will continue to decline for at least two more years and could lose 25% of value.

If so, then the Bear Stearns' story will be just the first chapter of an ongoing horror story—with the major carnage yet to come.

You have to look elsewhere to find balance sheets you can believe in, assets you can trust, managements who reward stockholders at least as well as themselves, and earnings outlooks tied to growth in the most dynamic economies on earth—where high leverage is the exception, not the lifestyle.

You have to look at the asset class that was despised and rejected during its Triple Waterfall Crash that began 28 years ago and ended in 2001.

After Purgatory, we are told, comes Heaven.

The miners, oil producers and farmers were involuntary subsidizers of the other sectors of the global economy for nearly a quarter-century.

Now it's payback time.

The Greatest Commodity Boom

Major equity bull markets start in despair, move to deep doubt, then doubt, then optimism, then confidence, and eventually, excess enthusiasm.

Commodity bull markets share some of these characteristics, but there is a major distinction: historically, soaring commodity prices triggered cutbacks in consumption at a time producers were bringing on major new supplies.

This time, the global economy kept rolling along as industrial commodity prices soared. There had been dire warnings of slowdown when oil broke through $50, and, after Hurricane Katrina, when natural gas prices briefly reached the teens. When copper and steel suddenly became expensive, a few forecasters warned that inflation was coming back.

We remained confident that an inflationary shock would not derail the express train, reminding clients that the 1970s were the decade of stagflation *primarily* because of soaring food prices. Because China and India were today's key drivers of global growth, we felt comfortable that those—and most other—Emerging Markets would continue to boom, because food was still both cheap and readily available for the hundreds of millions of people who were moving into dwellings with indoor plumbing, electricity and basic appliances—and buying cars. We kept reminding clients that only when foods and fuels rose together would commodity inflation reach painful levels. A thousand years of historical evidence had proved that an energy price shock was not—by itself—a progenitor of *sustained* inflation.

As we prepared for our leave of absence trip to India in 2006, we began to examine the evidence that the world's farmers might be ready to join the miners and oil producers in prosperity. In October, just before leaving, we suggested that investors should begin investing in agricultural stocks. Upon our return a month later, we told clients that we thought food would be *the* big story of 2007. As the year unfolded, and the global supplies of grains continued to shrink alarmingly, we began warning that a global food crisis was out there. By yearend, we asserted that policy-makers should stop worrying about an energy crisis or a global warming crisis and start preparing for a global food crisis.

It has arrived.

The first to be hurt are the poor—as people and as nations. Engel's Law is back in force: when food prices soar, the impact is felt inversely to incomes—both for families and nations. The rich will always be able to afford food without cutting back significantly on their lifestyles.

It is different for the poor. In recent months, there have been food riots in 30 Third World countries.

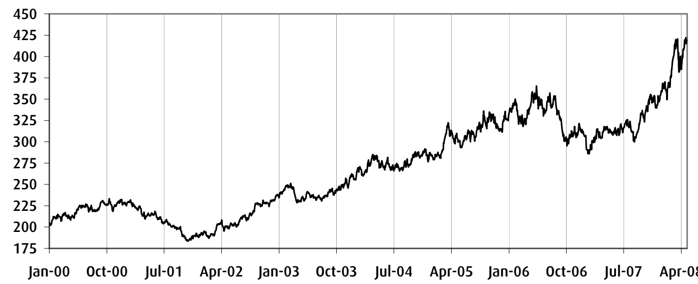
But the pain will not remain confined to the poor. In recent weeks, with food and fuel inflation reaching front pages, the impact on economic growth in the OECD is beginning to show. German engine drivers got a double-digit wage increase that the government conceded in response to polls showing a huge majority of Germans—Germans!—backed the boost because food inflation had reached 8% in the nation where atavistic fear of inflation is close to the heart of Teutonic angst.

Last week, *The Wall Street Journal* reported on a spreading wave of retail bankruptcies that, it predicted, would change the face of the nation's shopping malls and Main Streets. It attributed this slump to consumers' struggle to meet rising food and fuel costs at a time the housing collapse had eliminated their access to home equity loans.

The elites have, until very recently, remained relaxed, because their inflation index—Core Inflation—has remained quiescent, and they believed that the US recession would be deflationary. For them, the Phillips Curve is not a dead doctrine. The double-digit inflation and double-digit unemployment of the 1970s was an aberration. Ben Bernanke had expressed his concerns about that policy on several occasions, but only in November did the Fed announce that it would be tracking overall Personal Consumption Expenditures for its deliberations.

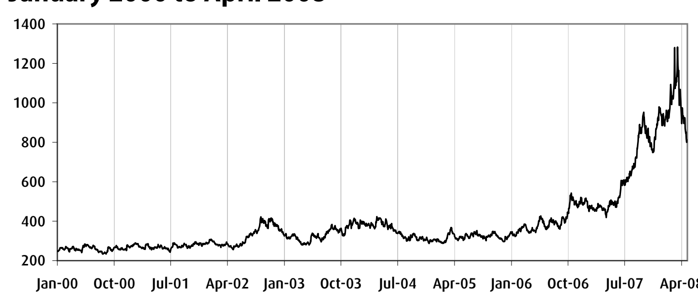
Perhaps they need a new term: the price of an apple is for the food content, not the core. That division becomes problematic when people are finding that their trips to the supermarket are increasingly costly—for the gas to get there and what they buy there—and they can no longer finance vacations, boats or restaurant dining with home equity loans.

CRB Futures
January 2000 to April 2008

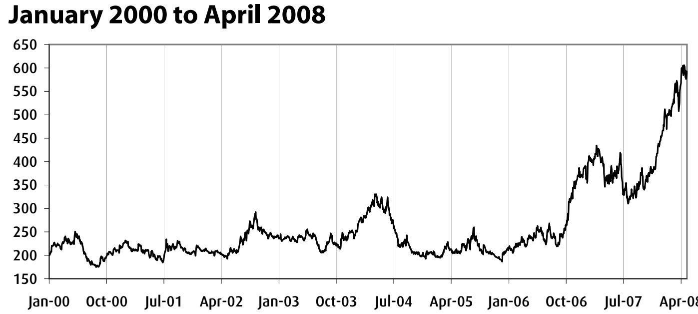


Natural Gas
January 2000 to April 2008

Wheat
January 2000 to April 2008



Corn
January 2000 to April 2008



As the greatest-ever commodity bull market keeps reaching new peaks, the Street's skeptics and naysayers grow even more shrill in their claims that the "the commodity bubble" is near—or already at—bursting phase.

By now, we have become accustomed to these oh-so-well-meant warnings from strategists and firms that failed to issue strong warnings about the uniquely high risks for investors during the late stages of the tech mania.

Since it is becoming apparent that the investment case for commodities is close to being the inverse of the investment case for Wall Street bank stocks, there are, to put it as politely as possible, institutional pressures against advising investors to buy commodities and commodity stocks at or near their highest prices ever when shares of some leading Wall Street banks are selling at or near their lowest prices of this decade. Proclaiming the irresistible value in beaten-down Wall Street bank stocks compared with commodity stocks after the sudden demise of the smart, scrappy Bear Stearns is now rather like trying to market vacation trips to Baghdad and Falluja by comparing their costs with the tab for swim and ski trips to Dubai.

If, as we regularly hear in calls from worried clients, it really is time to sell the commodities and buy the banks, then ***nothing less than a conviction that commodity prices face a huge, sustained collapse*** will justify that call.

Let's contrast the investment merits of these two bookends of the stock market:

Profits of most of the major Street banks soared in this decade by expanding the supply of mortgages packaged into increasingly opaque products. Since the supply of American houses inhabited by prudent persons of good character with reasonable savings practices grows only slightly faster than GDP, the only way for the Street to achieve robust earnings growth to justify robust earnings growth for its top managements was to expand the supply of homebuyers to include the imprudent, the incautious, the overindebted, the bankrupt, the unemployed, the fraudulent, and the unsophisticated. In this latter category were those who could be talked into borrowing beyond their realistic income expectations, and/or into assuming the Greenspan-recommended loans—floating rates—when they should have taken fixed-rate loans. (These loans were particularly profitable for the issuers, because of extra fees and charges that were, it would seem, explained inadequately—if at all—to millions of borrowers. Complexity was the hallmark of home finance for this decade. The Street issued newfangled mortgages to those who had trouble understanding their complexities, financed partly by Fannie Mae and Freddie Mac, who, to put it most charitably, had trouble understanding their own financial statements, but not the huge bonus incentives to those top execs who got their jobs through political influence. The rest of the Street's funding came from soaring sales of complex derivatives to those who didn't really understand them, and to hedge funds for whom the issuer was the prime broker.)

In contrast, the commodity companies' profits have soared not because of record growth in volumes, but in unit pricing. The oil companies have had trouble increasing their production, but soaring oil and gas prices have meant huge unit profit growth. The major mining companies have had somewhat more success in increasing their unit sales, because rising metal prices have turned marginal ore bodies into money-spinners, and because a handful of iron ore, coal, and nickel properties came on stream just as demand from the Third World made them profitable beyond all pre-production projections.

But the traditional supply-side response to rising minerals prices—excess production financed by excess indebtedness—hasn't occurred, despite nearly-unanimous Wall Street predictions of oversupply and price collapse.

Those predictions were based on the use and abuse of history. Using the OECD nations' records for cyclical growth in commodity demands, and traditional late-cycle of major new supplies, the Street—and most oil and mining company executives—overlooked the two crucial ways the Third World made those forecasts obsolete: first, they grossly underestimated the fast-rising commodity demands from the Third World (notably China and India) as it rushed to achieve OECD-style living standards; second, they grossly underestimated the new political risks from commodity-rich Third World nations—notably Russia, Venezuela, Kazakhstan, Congo and Nigeria. With fast-rising costs of replacing low-cost production from the great oil, gas, and metals deposits identified decades ago, commodity producers have been forced to reach for mostly remote and technologically-challenging reserves at a time the governments in those regions had begun rewriting or tearing up existing production agreements and demanding huge shares in any new deals.

One lesson the commodities companies learned from the 21-year Triple Waterfall collapse was that all new commitments had to be low risk and earnings accretive. Investors were collectively unwilling to pay market multiples for their gigantic earnings gains, let alone for possible returns from new production. As the former head of Rio Tinto's Australian operations told me as the sun set over the sacred aboriginal site of Uluru in 2001, "The mining industry for the last two decades has been run by men who wanted to prove their virility by opening bigger mines than their competitors, regardless of the effects on stockholders. Those big new projects may have been good for their egos, but they were bad for stockholders. They won't be able to show off their masculinity any more. They'll have to make money."

Wall Street's business model in this decade was based on trying to replicate the business model of most of the tech companies: create and sell trillions of dollars worth of new supplies.

Meanwhile, the commodity companies had been so savaged by their Triple Waterfall that they became fundamentally risk-averse just as the rewards for their undertakings climbed to new highs.

Wall Street learned from recent history that it could get rich by selling overpriced merchandise to greedy fools, and ignored the Hinge of History that was transferring real economic and pricing power to countries that, as recently as the Emerging Markets' collapse of 1997, were considered as mere primitive playthings for traders looking for high-risk short-term gains.

Being on the wrong side of history can be dangerous to your financial health. Putin and his KGB cronies learned after the Fall of the Wall that history had passed them by. They shrewdly moved to get on the other side of History's Hinge—and no longer had to report to Commissars who actually believed most of the Marxist claptrap. As Putin continues to consolidate his power, the remaining believers in his former faith are mostly to be found among Latin American terrorists, Nepalese Maoists, and tenured professors in Western universities. (One of the great quotes of this decade came when Putin was asked at a press conference, "Why is it that so many of those men around you are ex-KGB agents?" His terse reply, "There is no such thing as an ex-KGB agent.")

Wall Street's other big profit-generating activity of this decade came with the transmogrification of some leading Private Equity firms from being low-key, long-term, value-oriented investors to being takeover artists whose scale and personal rewards would have left the 1960's conglomerators like Jimmy Ling and Charles Bluhdorn awestruck with envy. They had once relied for capital on pension funds and other patient long-term investors. Then Wall Street showed them they could buy hundreds of companies virtually for free, using alluringly cheap borrowed money financed with the second Great New Thing of our time—Collateralized Loan Obligations—issued by banks eager to get their share of the fees for acting in the new takeover mania. It was the Barbarians at the Gates that signalled the end of the first PE boom, which looked picayune in this decade. Originally, the loans to PE acquisitors had the kinds of covenants that reflected the shrewd, careful practices of the Private Equity industry that survived the 1980s' mini-mania. But the torrents of cheap money and the greed of investment bank CEOs swept away such constraints. By 2007, there were few mid-cap cash generators left on offer, but the buyout money continued to flow. The peak came when PE's new hero, Stephen Schwarzman, bought the biggest office building REIT—Equity Office Properties—from Sam Zell, and a second-rate semiconductor company with an erratic earnings record, Freescale. The record of those who have grown much richer by buying when Sam Zell thought the real estate market had peaked, or buying semiconductor companies based on peak earnings, is as scanty as the record of those who won big buying gold at $825 in 1980, or buying Cisco the week it boasted the largest market cap in the world.

Shed no tears for the PE barons as the economy enters recession and many of their levered-up lovelies begin to lose their financial sex appeal. They continue to luxuriate in their Cecil B. DeMille-scale parties and galas, while leaving the big banks to hold hundreds of billions in CLOs—Cruddy, Lousy Obfuscations.

While all this excitement was occurring among the really rich on "Jurassic Park Avenue," few who really mattered devoted much time or money on what was happening in Pilbara, Australia, the iron ore and soybean fields of Brazil, the Grasberg mine in Indonesia, or in Sudbury, Voisey's Bay or the Chilean Andes—and most of those were in China and India and they were wondering how much they were going to have to pay for the output from those remote locations. History was being made in both sets of environments—the end of an era in which Wall Street was the epicentre of the universe, and the beginning of the era predicted by Chris Patten in which China and India would return to their former rankings as the biggest and second-biggest economies on earth.

The only highly-publicized commodity story was oil, and that was mostly a bad-news story, because the share prices of Big Oil weren't tracking skyward with crude prices, and the biggest winners were the leaders in Russia, Venezuela, Nigeria, Iran and the Arab oil states.

The most recent commodity success story—agriculture—has rather suddenly become the biggest bad news story. Soaring grain prices have set off food riots in at least 30 countries, and The Global Food Crisis is now a Page One story. Last week's *Economist* headlined this sad event. It flatly stated that *nobody* saw it coming.

Almost nobody.

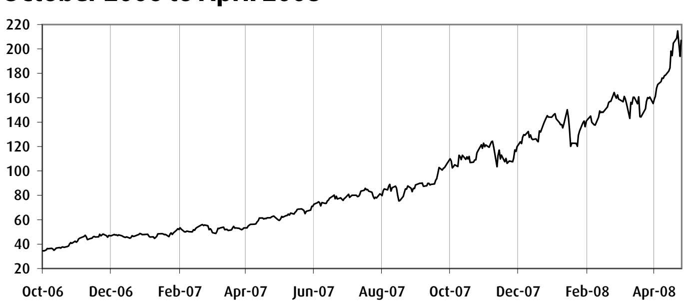
We are nevertheless glad that *The Economist* is right in what it meant by that grandiose conclusion: ***Nobody who mattered on Wall Street or among the political and financial elites saw it coming***. This is another Hinge of History: None of the important agricultural companies caught the greedy eyes of the investment bankers advising the Private Equity barons. This was an industry that didn't show on the screens of the Street's Best and Brightest.

For that, the world should rejoice.

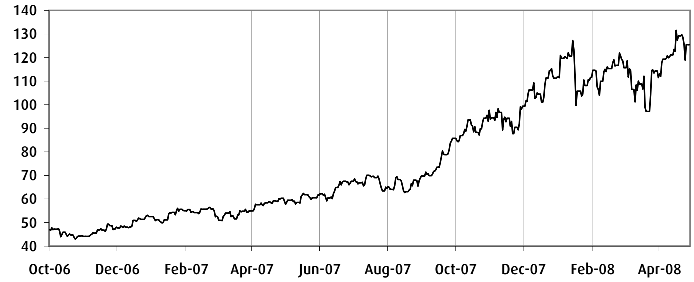
Millions of low-income people could face starvation in coming years if global grain production doesn't rise sharply. Had the top ag-companies been bought out, levered up, and subsumed by Wall Street's heavily-levered greedy glitterati, no large-scale private sector response to the world shortage of vegetable protein would be possible.

The following charts show what happened to some of the leading companies in the sectors of the agriculture industry most discussed in these pages and our Conference Calls since October 2006—a few months before the peak of the PE takeover mania.

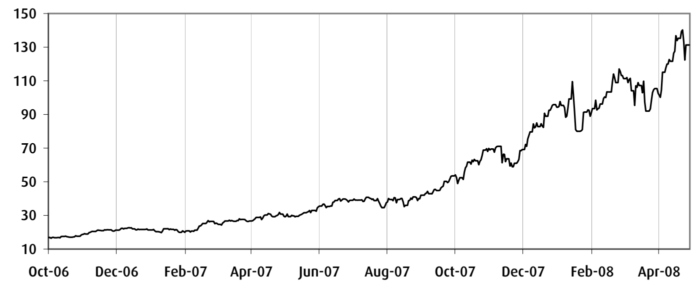
Potash Corp. of Saskatchewan (POT – NYSE)
October 2006 to April 2008



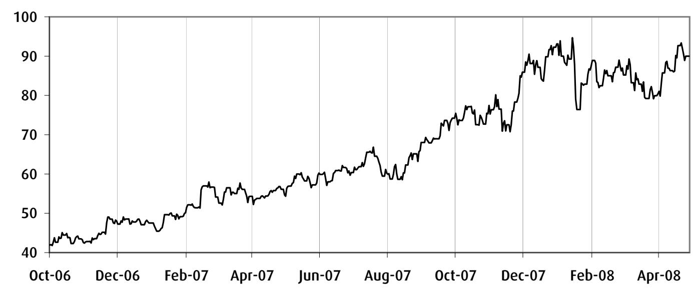
Monsanto (MON – NYSE)
October 2006 to April 2008



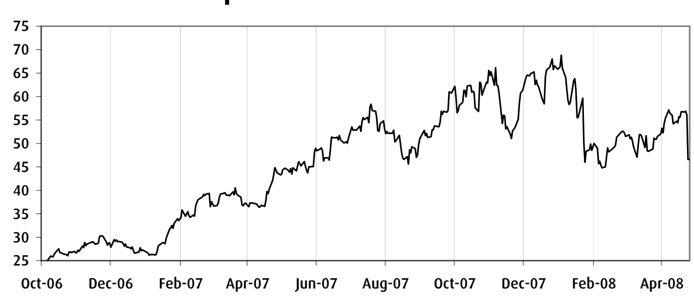
Mosaic (MOS – NYSE)
October 2006 to April 2008



Deere (DE – NYSE)
October 2006 to April 2008



CNH Global (CNH – NYSE)
October 2006 to April 2008



Thankfully, they are now (we hope) too big—and the potential acquisitors are too over-levered—for these fine companies to be acquired.

Surveying the wreckage on Wall Street and the bourgeoning growth among the commodity industries, we believe that investors should reappraise their standards for setting portfolio risk ratings.

Most of the models we have seen are long on short historical records: they document—to three decimal places—the risk-adjusted returns on portfolio investments since 1982. By those standards, the large OECD companies in such industries as banking, consumer credit, and leisure are core investments, and commodity companies are, at best, short-term cyclical trading vehicles.

Not any more.

Investment Environment

The Hinge of History is in the process of slamming the door on the investment primacy of a wide range of supposedly blue chip investments. But, as Maria said, in *The Sound of Music*, "When the Lord closes a door, somewhere He opens a window."

A secularist interpretation of that credo is that when one long-held investment policy becomes obsolete, another—which was discredited for decades—becomes the optimal course.

The OECD countries are aging rapidly and their population growth is slowing—rapidly. Their societies' collective balance sheets for health care, pensions, and social security programs are deteriorating, albeit at a genteel pace. The US has somewhat better demographics than most of the rest of the OECD, but its high current account deficits and negative personal savings rates make its challenges so daunting that one can only fear some sympathy for "the winner" of this year's Presidential election. That person's fate will surely be the political equivalent of Ben Bernanke's: His predecessor was, on the record, a really bad forecaster, but his timing in office was so fortuitous as to be near-supernatural. He inherited the disinflationary world created by Volcker, Thatcher and Reagan, the improving world of global banking created mostly by Volcker, the disinflationary benefits of WTO and the adoption of powerful new technologies—and left his successor a struggling banking system, and the greatest commodity boom in history.

That slow deterioration in OECD societal finances is currently masked by the more immediate problems of "the global financial crisis" which is really Wall Street's problem except to the extent it has managed to offload much of its worst paper on the rest of the world. Yes, houses in Britain, Ireland and Spain now look at even more over-priced than those in most American cities, but European savings rates and current accounts remain in positive territory. The US must remain reliant on importing mind-boggling amounts of capital to keep the creaky carnival going. However, most of the rest of the industrial world should be able to finance the unwinding of its excesses that occurred because it believed Wall Street's claims of investment merit based on mathematical models that were as valid as the phlogiston theory.

History's hinge shows where the new power and opportunities exist, now that Wall Street has destroyed its credibility by mulcting its clients on breathtaking scale—***for the second time in ten years***.

It was only three years ago that a leading Wall Street bank cited the four biggest Chinese banks as being in worse condition than Japan's biggest banks in 1990.

Odd, then, that when big Chinese banks have been privatized, they have proved to be among the best-performing financial stocks in the world.

And the Wall Street bank that made that semi-apocolyptic appraisal of China's banks has been one of the worst.

Inflation or Deflation?

While North American central banks keep cutting rates to deal with the deflationary effects of the US housing and banking crises, global inflationary pressures keep rising, fed by foods, fuels and, in recent months, rising wage demands.

Clients keep asking us whether we are sticking to the view we enunciated exactly a year ago—that the world was moving from a disinflation mode toward inflation.

Our thesis was:

Since 1981, when inflation peaked, the dominant trend was disinflation/deflation. Sound central bank policies from the new generation that had watched in horror as 1970s inflation rates soared to double-digit levels were assisted by the sound political policies of the Reagan-Thatcher revolutions.

The commodity Triple Waterfall plunge, which lasted 21 years, washed away the inflation pressures from foods, fuels, metals and other raw materials.

Labor remained in surplus, fed by the maturing demographics of the Baby Boom, weakening of union powers, and then by the onset of free trade in such breakthroughs as WTO and NAFTA. As China and then India moved from offstage to center stage in the global economy, eventually joining WTO, a global wage arbitrage based in Asia, the big industrial unions lost members by the millions.

We asserted that the decades of cheap food, fuel and raw materials had ended. Next to go would be cheap labor. Why? Because the collapse in birth rates across the OECD that began in 1971 meant that each new generation would be less than two-thirds as populous as its predecessor. This not only cut down on the supply of new labor force entrants, it meant that the basic driver behind rising real estate prices—the inevitability of increased demand from first-time home buyers—would not only disappear, but would turn negative. For a while, this was masked by second-home buyers, return of aging "empty nesters" from suburbs to cities, and by the false prophets of profits from housing.

Moreover, the generation of flinty central bankers who had learned their trade as inflation fighters were gradually replaced by those who, like the aging Alan Greenspan, were winning their spurs as economy managers and Maestros.

All it would take to put inflation back as Public Enemy #1 would be food inflation. We asserted that was only a matter of time. "Core inflation" would join Keynesianism and the Phillips Curve in obsolescence.

Clients pointed to the banking implosion and pricking of housing bubbles as deflationary forces that would overwhelm commodity-driven inflation.

Our answer has continued to be that asset inflation and asset deflation can move independently of economic inflation.

We entered the business in 1972, when the near-universal investment mantra was that common stocks were the best asset to own as hedges against inflation.

That was the advent of the worst bear market since 1929—and the worst inflation of the modern era.

How powerful was this combination of falling stocks and rising CPI?

The day before Paul Volcker finally began easing the fed funds rate—August 12th, 1982—the Constant Dollar Dow, which deflated the Index's growth by CPI, touched its level of 1929: 53 years of performance of the best long-term investment asset class had been wiped out.

A more recent challenge to the theory that asset inflation is correlated to CPI is the housing bubble.

It came at a time when measured CPI and Core Inflation were at their lowest levels in decades.

In other words, we could well face bear markets in housing and stocks while CPI surges skyward.

We continue to believe that inflation is out there and will soon be a real problem. In 1972, US Crude Food PPI soared above 20%, and it wasn't long before CPI food prices were leaping at double-digit rates. In the past 12 months, Crude Food PPI is up 18.3%, whereas Finished Foods are up "only" 6.8%, led by dairy products and eggs.

How much longer will processors and retailers "eat" rising food prices?

Even the recent drop in meat prices has inflationary implications. Farmers who can't afford to feed their livestock are slaughtering them in desperation. That means serious meat shortages soon—unless vegetarianism suddenly becomes the dominant lifestyle.

The other argument we made a year ago was that the dollar was likely to enter a more serious bear market. In general, when the dollar is strong, global inflationary pressures are weak. Conversely, when the dollar keeps sliding to new lows, global inflationary pressures usually strengthen. That is the reason gold is inversely correlated to the dollar, the global reserve currency.

The standard view on price stability is that a US recession automatically means inflation will fall, because of reduced demand for labor, services, and goods. It didn't work that way during the 1970s, which included two recessions and serious inflation, giving the economic world a new word—stagflation. It didn't work that way for the first half of this decade, when the US economy was recovering strongly and inflation was stable or declining.

True, a serious recession means widespread inventory liquidation, which is clearly deflationary. However, the US entered this recession with the lowest inventory-to-sales ratio in history, because of the nearly-universal practice of maintaining low or “just in time” inventories. What vindicated this Japanese-conceived business management strategy and elevated it to the level of a stern secular religion was the 21-year Triple Waterfall commodity collapse. That meant the prices of raw and semi-finished goods were under continuous downward pressure, and businesses that ran “lean and mean” inventories prospered. The CEOs who joined the ranks of management demigods during the last two decades were unanimous defenders of this faith.

That the practice remained universal even when raw material prices were caught in a sustained roaring bull market proved that the idea had moved from the merely pragmatic to quasi-supernatural status. Else, why should managers get extra bonuses for scrupulously shrinking their raw material inventories when they would necessarily be replaced with higher-priced stuff? Only the high priests of corporate management knew.

So economic forecasters should be wary of predicting powerful deflationary effects from forced inventory liquidations. The very practices that damaged corporate profitability in recent years will tend to limit losses as the recession deepens.

Traditional Investment Strategies Have Become Archaic and Unrealistic.

Traditional equity investment policies based on analysis of the relative competitive positions of OECD companies are seriously challenged in an age in which formerly marginal Third World societies have collectively become the price-setters for a wide range of services and a growing range of manufactured goods.

Although that principle is widely understood, and global equity managers have long ceased to consider the competitive positions of OECD companies only against other OECD companies, too many investors have failed to understand the implications for risk-rating of global equity industry groups.

Commodity stocks have delivered lustrous returns even though most strategists and investors continue to classify them as risky cyclical stocks. ***With the US and many European countries already in recession, few investors are willing to reclassify them as core investments tied to the growth in the economies that are gaining market share in the global economy.***

China, India—and other important Third World countries—expect to achieve OECD economic status in a small fraction of the time it took today’s wealthy nations to escape from agrarianism and poverty to industrialization and prosperity. Everybody knows that, but many investors have failed to change their investment policies to reflect this new—and utterly crucial—weighting factor in predicting equity winners during the next two decades.

It took Taiwan and South Korea four decades to make that transition. They progressed from backwardness to global competitiveness and prosperity without forcing major disruptions in the OECD economies and without forcing major changes in the pricing of raw materials.

As they were escaping from poverty, China and India could only watch enviously. They seemed unable to escape from a Malthusian trap in which they were unable to expand their wealth in line with population growth.

China, which had been for 18 centuries the world’s largest economy, fell further and further behind its two relatively tiny neighbors because of the persistence of Marxist beliefs, the multi-million murders of Mao, the Great Leap Forward, and the Cultural Revolution.

India, historically the world’s second-biggest economy, couldn’t grow per capita GDP because of its founding fathers’ continuing grasp from the graves on politics and economics. Gandhi, Nehru and their followers booted the Brits out, but kept in power the effete Oxbridge socialist dogmas of the Labour government it had rejected—a singular example of policymaking based on throwing out the baby but keeping the bathwater.

For more than four decades, the defining characteristics of independent India were “The License Raj,” which was a shambolic system of stultifying bureaucracy, constipation of the courts, intricate webs of payoffs, and “The Hindu Rate of Growth,” which sought to distract the populace and the rest of the world from seeing India’s grinding poverty and economic stasis with boasts about the superiority of communal national values over the crass vulgarities and cruelties of capitalism.

China was the first of the giants to break away from decades of Marxism and economic failure. Deng Xiaoping became leader in 1979, at a time there were just 60 private passenger vehicles in the whole country. He would become one of the two or three most important leaders of the 20th century. He said he was following in Mao's footsteps, but he found some precepts in that mad leader's legacy that had escaped the Marxist purists, including a new marching order: "To be rich is glorious."

As the wise and innovative finance minister in the Congress government from 1991 to 1996, Manmohan Singh set India on the path to progress without overtly challenging the Brahmin socialist political ethos. He broke the mold, but the Congress Party was losing its vise grip on the political process. When his government fell, the Opposition BJP not only continued his reforms, but liberalized even further. Then, when the Congress Party regained power, it was under Singh's Premiership, which meant reform continued, despite the constraints imposed by a fractious coalition that included the unreconstructed Communists.

If China alone had escaped from socialist dogmatism and brutality and moved toward a "bourgeois, capitalist" economy, it would have been a major challenge to traditional OECD-fixated investment strategies.

But when India also began its rush toward full-fledged participation in the global economy, some investors began to note that equity market valuations would have to change. As we began to enunciate a new worldview six years ago, we summed it up as, "In general avoid investing in companies that compete with China; in general invest in companies which produce what China needs to buy."

When India's new middle class became big enough and rich enough to have an impact on the pricing of raw materials, the case for a drastically revised valuation of OECD-based companies and of commodity stocks became clearer. The OECD companies would be competing fo r market share in the slow-growth parts of the world—and against emerging manufacturers and service suppliers in China and India—while the commodity companies' output would be priced according to the vitality of those fast-growth economies.

Since then, demand for energy, food, and other raw materials has been accelerating in other emerging economies, including Russia, Brazil, Vietnam, and the Gulf states. (Example: soaring gasoline demand in the Gulf states is crimping OPEC export growth. There is even talk that Iran may cease to be a net exporter of oil—after deducting its gasoline imports—by 2015.)

The OECD might have been able to absorb the impact on raw material prices from China's revolution without severe disruption But adding in India and other emerging economies means that the world is increasing its population of middle class consumers far faster than it has been able to increase its output of energy, metals and food.

And if, as we have been telling clients for several years, the supply side response remains inadequate, then the gap will actually widen in coming years. (A client delighted us last week by summing up our view on the global food crisis as *Farmageddon*.)

What should be grabbing the attention of all serious global investors is that, despite a US recession, and a major credit crunch in North America and Europe, prices of raw materials continue to climb.

Almost nobody predicted $115 oil. Almost nobody predicted a return to $4 copper at a time of a slowing OECD economy. Almost nobody predicted $6 corn or $1,000-per-tonne rice.

Nobody predicted that these spectacular prices would come contemporaneously. We are not experiencing a sudden oil shock due to a Gulf war. We are not experiencing a sudden copper price increase due to a sustained strike in Chile. We are not experiencing soaring corn and soybean prices because of a major drought in the Midwest. We are not experiencing record rice prices because of a crop disaster in Thailand and Indonesia.

And we are not experiencing $890 gold and $1,950 platinum because of double-digit inflation across the OECD.

A new era for commodity-producing companies has dawned.

To date, most investors haven't noticed it. The Washington hearings about soaring grain prices are a replay of Congressional hearings on soaring gasoline prices. Nancy Pelosi and other leading Democrats blamed "Big Oil" and the salaries paid to oil company CEOs for $3.50 gasoline. The National Farmers Union is blaming hedge funds and other speculators for grain prices that soar so fast that farmers who sold their crops forward are getting margin-squeezed or going bankrupt.

The tech mania was about overvaluing companies in an industry with few barriers to entry that kept on expanding its output far beyond its ability to price profitably.

The boom in CDOs, CLOs and other exotica was about creating wealth from complex formulas.

The commodity boom is about surging demand for real raw materials in scarce supply. That demand comes from the new middle and upper classes in countries with large foreign exchange funds and high savings rates.

There are still investors who think tech stocks and bank stocks are of investment quality, whereas commodity stocks are lower-grade cyclical speculations.

That such investors still manage many trillions of dollars means that investors who understand the implications of the Hinge of History—and who act on that understanding—will continue to prosper happily—both in absolute and relative terms.

A New Page 16 Story—Sunspots?

Last week, *Investor's Business Daily [IBD]* ran an editorial discussing the surprising failure of the sunspot cycle to resume on schedule.

Since Galileo's time, astronomers have recorded the variation in sunspot activity. It is ordinarily a 10-11 year cycle. When sunspot activity shrinks to the near-zero or zero level, it has been associated with very cold weather, for reasons that are still not fully understood. *IBD* quotes an Australian ex-astronaut and a scientist with the Research Council of Canada who report that the previous cycle ended in 2007. According to the Goddard Institute, the global temperature last year fell 0.7 degrees Celsius, sending temperatures back to 1930-levels. Snow fell in Baghdad for the first time in centuries. Icebergs in Antarctica reached levels "not seen since James Cook."

This winter has been unusually cold in many parts of the Northern Hemisphere, and sunspot activity *remains at extremely low levels*.

This got us thinking back to the days when we studied economic history. Our professor devoted several lectures to the work of W.S. Jevons, the first economist to advance a theory on economic cycles tied to non-market events, and the founder of the first post-Ricardian school of economics, which became the basis for the work of Marshall, among the most famed of classical economists. Jevons explained the tendency in 19th Century Britain for economic downturns and financial crises to occur at times of low sunspot activity, which coincided with major crop failures and large-scale rural bankruptcies. He was an eccentric, and a something of a crank, but, as our prof. noted, his theories had the singular justification that they seem to have worked better than macro theories since then.

Why should today's investors bother with such antiquated theories?

Well, anyone who noticed that the sunspots weren't returning might have decided that the pure-play was gas:

Natural Gas
January 2005 to April 2008

Yes, this could merely be post *hoc, ergo propter hoc* reasoning and therefore unworthy of serious analysis—like hemlines or years ending in a certain number.

However, as the editorial notes, the sunspots failed to return on schedule as Napoleon was invading Russia, and that winter turned out to come sooner and be far more brutal than the "experts" had told the Emperor as he was planning the invasion.

It has been an unusually cold and wet spring here in the Midwest.

Full disclosure: Last week, we toured Western Canada in connection with the offering of our Coxe Commodity Strategy Fund. It snowed in Vancouver, Victoria, Calgary and Winnipeg. Maybe that's why we were so ready to think back to the despised Jevons.

Still, with grain carryovers at record-low levels, we'll feel better about the threat of the global food crisis if the sunspots come back soon.

(And, by the way, the reports we are getting on the honey bees continue to confirm that Colony Collapse Disorder is continuing, albeit at an apparently slower pace than last year. Just in case you were wondering…)

Investment Recommendations

1. In long-only equity portfolios, continue to underweight Wall Street banks and others that have been reporting high exposure to perfumed products of indeterminable value, including those which last year revealed—under duress—

high exposure to SIVs. Within the financials, emphasize those whose loan losses are of the traditional, cyclical variety—not in derivatives or in untraditional banking businesses. Good banks that have stuck to their knitting—and whose CEOs compensation has suffered along with their stock prices—should be retained.

2. In long/short portfolios, be long commodity stocks and short bank stocks that make headlines for untraditional losses. That trade hasn't been working lately, but it remains an overall portfolio risk-reducer. The list of banks that have shown great skill and profitability by going heavily into new kinds of products and new kinds of accounting is roughly as long as the list of major copper, oil and gas producers that profited by selling heavily forward.

3. A financial-led bear market within a financial-led recession can be particularly perilous if central banks run out of ways to reflate the system—and surprisingly benign if the central banks' rescues remain timely. To date, the central banks have been up to the job—if propping up a badly-behaving financial sector is a key component of their job descriptions. Result: the overall stock market has outperformed our expectations. We still don't like the risk/reward ratio.

4. Dividends become more attractive as central banks cut rates. The problem for investors is that many of "The Great Dividend-Paying Stocks" are financials that have been reporting ghastly blunders. In many cases, their payout ratios have climbed far above the 50% threshold that has made these stocks better investments than bonds. Opportunities remain—and dividends may be the only positive return most US stocks will deliver this year.

5. Although North American consumers have yet to see the cost pass-through in major foodstuffs of $6 corn and $8 wheat, it will come sooner or later. Based on past periods of food inflation, one of the first consumer cutbacks is on eating out. Restaurant stocks are especially unappetizing when food costs soar out of control.

6. Gold has pulled back from its high because the dollar stopped falling and the bank bailouts seem to be working. Remain overweight gold as a clear-cut hedge against further bad news on both those fronts.

7. The Canadian dollar decoupled from the euro, failing to rally to new peaks—which makes little sense to us. US clients should continue to use Canadian government bonds and Canadian short-term investments as alternatives to Treasurys and US cash.

8. Within the commodity group, continue to accumulate the leading agricultural stocks. Given the spectacular performance of the fertilizer stocks, the best bargains currently on offer are in the farm machinery companies. The global food crisis will almost surely cripple the opposition to GM seeds, which means the seed stocks have great upside room.

9. Within debt portfolios, continue to emphasize inflation-hedge bonds—preferably in strong currencies. Treasurys remain overvalued, despite the recent strong run-up in yields from barely-observable levels.