The Centurion Counselor

Third Quarter 2009

UNDERVALUED SECTORS
(CONSIDER!)

- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- MEDICAL DIAGNOSTICS
- METALS

OVERVALUED SECTORS
(AVOID!)

- JUNK BONDS
- EMERGING MARKETS
- TREASURIES
- BIG BOX RETAIL
- APPAREL

BULL vs. BEAR

The market has finished its best six months since the 1930's. The questions in most every one's mind is; what turned it around? Will it last and is the economy turning around?

The first question is easy, as we believe four things contributed to the turnaround; first, mark-to-market accounting was finally relaxed by FASB in the spring of 2009. Stopping the use of "exit" or "bid" prices to value securities, and allowing "cash flow" to be used instead, stopped the hemorrhaging of regulatory capital and ended the vicious downward spiral of collapsing banks and economic activity.

Second, the Federal Reserve has been running a highly accommodative monetary policy. Liquidity injections have provided a floor beneath nominal GDP growth rates. (See next article)

Third, the panic that was set off last September by the failure of Lehman Brothers, resulting in the $700 billion TARP plan has eased.

Fourth, and perhaps most important was the little heralded plan extending FDIC insurance to money market funds and to some corporate debt. This plan stopped in its tracks what was building into a full-fledged panic, giving some corporations access to the debt markets to refinance short term obligations that were coming due.

Broad stock market indexes are up nearly 50% from their lows as corporate earnings have handily beaten estimates. The improvement in earnings has been almost completely due to reductions in expenses rather than top-line revenue growth. If the economy picks up in the next few quarters, top-line revenues will accelerate, which will boost profits to even greater heights.

Market bulls argue that the economy is on the rebound, the stimulus plan is working and accordingly corporate profits will continue their rebound as they experience revenue growth and productivity gains due to cost cutting during the recession. Bulls additionally argue that the Presidents health and energy bills are dead in the water which will reduce the rate of growth of the deficit and reduce the need to increase taxes.

The bear market argument is that the economy is experiencing a dead cat bounce helped by one-time shots of adrenaline such as the Cash for Clunkers Program, and the temporary replenishment of inventories.

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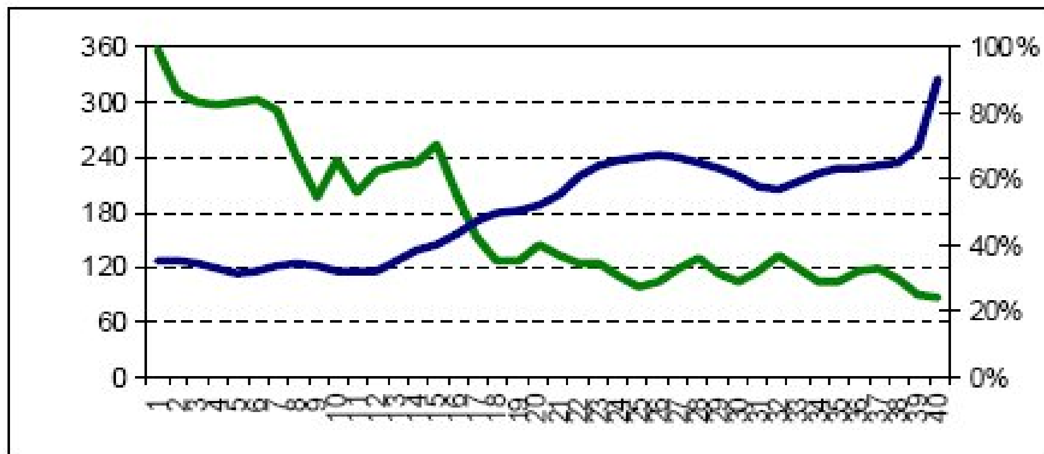
Bears argue that the ingredients for a durable and self-sustaining recovery are missing as an economic double-dip grows more likely in a climate of corporate cost cuts, elevated jobless rates, wage deflation and continued pressure on personal consumption expenditures. They argue the downturn of 2007-2009 has already been different in scope and duration. Bears view is that it will continue to be different this time as the typical self-sustaining economic recovery of the past will not be repeated for several important reasons:

- Corporate expenses can only be reduced so far and the Government stimulus is out of ammunition.
- The consumer entered the recession overleveraged and is out of gas, worried about jobs and their own net worth.
- The commercial real estate credit bubble has not yet burst
- While the housing market has stabilized, its recovery will be muted, and there are few growth drivers to replace the important role taken by the real estate markets in the prior upturn
- State and local governments are broke or near broke.
- Federal, state and local taxes will be rising as the deficit must eventually be funded, and high-tax health and energy bills also loom. In Oakland, California even the “high life” is being taxed as the city has recently passed a tax on marijuana sales and the state of California appears to be close in following Oakland’s example.

We align with the bears concerning the burgeoning fiscal deficit, the trashing of the dollar and the financial instability of our state and local municipalities as two of the most significant challenges that lie ahead. We believe that Uncle Ben Bernanke could go down in economic history as the man who killed the greenback on the operating table. After printing up trillions of new dollars and new bonds to stimulate the US economy, he is now boxed into a corner battling two separate monsters that could devour the economy; runaway inflation on one hand, and a perilous recession on the other.

Profligate spending comes at a cost, a cost that we will experience sooner than later. It is only a matter of time before policy makers address the financing of this accumulated debt and the great re-flation experiment of 2009 by raising taxes significantly. We have already witnessed the start of what is likely to become an avalanche of changing tax policy. We fear that we have just started down the road toward much higher taxes.

DOLLAR DEMISE



In the chart above, the **green line depicts prices** (left axis), while the **blue line captures debt to revenue** (right axis), during a time horizon of 40 years. Prices (green line) have been falling consistently over the 40-year time span, while leverage continued to climb. How sustainable is this entity's position? Would you be a buyer or seller? Can you guess the entity the chart represents? Answer: The United States. Specifically, the green line represents the Yen/USD exchange rates, and the blue line represents total federal debt to GDP. The chart depicts a steady decline of the US dollar against the Japanese Yen since 1970, accompanied by a consistent increase of our country's leverage. As a nation we have been borrowing more and more to finance our government's consumption needs. With our total federal debt to GDP ratio expected to exceed 90% in the near future, unless our trajectory changes significantly, the question is when will a currency crisis will hit our shores, not if.

While it is possible that the dollar has weakened against the Yen due to Japan's rise, the dollar has generally weakened against most major currencies and the majority of real goods in the global economy. For example, the dollar lost nearly a quarter of its value to the Euro in the past decade, and, when priced in dollar terms, gold is 28 times higher than in 1970. Over the past 5 years, the price of oil has increased significantly causing economic dislocations throughout the US economy. This has lead to calls for laws to curtail energy consumption via increased car fuel economy standards and higher taxes. But has the price of oil increased significantly in real terms?

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The chart below shows the number of barrels of oil required to buy an ounce of gold.

* Gold and Oil prices used for 1971-2008 are annual averages. 2009 prices used are based on Oct 6 close.

Notice that while there have been some ups and downs, the price of oil in gold terms today is basically the same as it was in 1972, right after the US abandoned the gold standard. It takes approximately 16 barrels of oil to purchase an ounce of gold. In real terms, the price of oil has not changed too much over the past 40 years when measured in gold terms, but has increased 20 fold when measured in terms of US Dollars. This systematic weakness in the Dollar combined with the US having exploding net trade deficits, is prompting many emerging countries around the world to intensify their efforts to move away from the dollar as the functional global currency. The most serious threat on this front is the major oil producing countries, which are rumored to be looking to establish a basket of currencies, possibly including gold to set the price of oil. These countries understand that continuing to hold dollars is too expensive. China holds approximately $2 trillion in US Dollar reserves. Year to date, the dollar's depreciation has cost China $400 billion measured against gold, and $100 billion measured against the Dollar index. Little wonder that China is becoming increasingly vocal in its displeasure regarding US financial affairs.

If the dollar is ultimately replaced as the global functional currency, the US Dollar will likely suffer additional significant devaluation as demand for the US Dollar based reserves plummets. This is just another reason we like the protection afforded by having assets in bonds denominational in other currencies.