Perspectives: January 2009

An Economic Overview:

Implications for U.S. Investors of the World Economy and Monetary Stimulus Efforts

As the recession continues into 2009, investors are asking many questions: How do we preserve capital? What are the best ways to invest for the long-term? And how do we walk that fine line between participating in future upward market moves while controlling our exposure to current recessionary problems?

We at Van Hulzen Asset Management have been asking the same questions ourselves. And after an extensive search for reliable answers, we believe that a number of sound opportunities do exist for investors. In this "Perspectives" commentary we will explore a number of long-term trends that will impact the investment environment many years.

I want to say right up front that many of these new opportunities will look much different from most of the traditional investment practices of the past. And my general advice for the future is that investors assume the worst, hope for the best, and prepare for any occurrence in between.

Let's explore our findings in more detail.

I. Historic Perspective

Each time U.S. equity markets have experienced a "major price disruption" (also known as a market crash), such as the drop experienced in the fall of last year, a number of similarities have occurred in the years that followed.

First, cumulative market value (stock price levels as quoted in daily trading) of all companies traded well below the cost to replace the assets held by all companies on their balance sheets. In other words, the market value of assets could be purchased for "pennies on the dollar."

Second, markets tended to trade in a wide, sideways range for years after the price drop.

While there are rallies off bottoms, the market took on average 14 years to go through the entire cycle. If we started the current cycle in 2000, we are entering the ninth year of this current cycle.

A real rally (the start of a new bullish growth trend) is marked by a rise in demand at reduced prices in key industries. In our present economy, housing,

technology and autos would be major industry examples. Third, the last sell-off in a downward trend typically saw credit improvement rather than credit deterioration.

So where does this leave us today?

Major price disruptions typically accounts for a significant amount of the declines that occur in the cycle. That event occurred in October 2008 and the economy has since begun to recover.

Valuation levels have dropped considerably from an all-time high in 2000 when the total market value of all companies was priced at around 2.6x the replacement value of all the assets. The current level is approximately 0.9x. In other words, the entire market is now selling at a discount to net assets.

This is good! Now we must see a rise in the value of those assets and increased demand for products at lower prices.

Demand is still falling and key asset prices for cars and homes and technology are declining. But credit has improved dramatically in the past four weeks of this rally. We are watching the bond yields and credit markets very closely to see if that improvement holds during any future market weakness.

II. Implications of the Market Disruption

Looking to the future, equity ownership in U.S. companies will require a good deal of patience. However, as you will read, we believe there are some very good investments available to us that have great potential to help our portfolio values outside of stocks.

Let's start by taking a 30,000 foot view of the current situation. From up here we can see that the U.S. economy is in a recession, American workers are losing hundreds of thousands of jobs each month, sub-prime credit problems continue to spread to more traditional lending institutions effecting companies, families and governments that used leverage for various activities. (Leverage, of course, is debt or borrowings, including credit cards, mortgages, and bonds to name a few.)

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Households who borrowed to buy real estate or use credit cards for purchases realize the risk of leverage. Companies issued as much debt as they wanted and bought insurance protection believing they could control the risk. Many are filing for bankruptcy or asking for a government bailout.

Our government has used financing (debt) to meet our country's imbalances, entitlement programs and economic bailouts. When debt levels are high (as they are for the government, companies and many citizens), liquidity from further borrowing is a necessity in order to hold onto assets like houses, cars and to maintain social programs.

A credit crisis is a major event for a debtor society. Over the past 20 years, we as a country and as a society have learned to rely heavily on liquid and massive credit availability.

The impact is already being felt by states. California has stated it will issue IOUs in place of state refunds and the homebuilders association is asking for $150 billion in cash. Everywhere, liquidity is in short supply.

It's worth noting at this point that there must be buyers of any debt (bonds) that is issued by any entity. That debt is currently being bought primarily by other countries, with the vast majority of the purchases coming from Asia.

The Federal Reserve has responded forcefully to the situation by reducing lending rates to historic lows. As I write this, the Fed Funds rate stands at just 0.08%!

On the one hand, rates that are essentially zero should provide economic stimulus and be helpful in mitigating recessionary pressures, but it is also appropriate to note that if the market does not respond as expected, there is no remaining interest rate actions for the Federal Reserve to take.

Future actions may be focused on monetary supply and printing more money.

III. From Recession to Recovery

What will things look like as America and the other economies of the world begin to move from recession to recovery? Here are the five conclusions we draw from the research we have conducted.

Conclusion #1: The government has shown that it will act aggressively by adding money to meet the growing list of capital needs. Auto bailouts will not be the end of the spending. It is more likely to be the reason even more industries and states receive money from the federal government.

In order to finance the proposed stimulus packages, to bail out states that have revenue shortfalls (also could be called spending excesses), to stabilize the housing market, and to support industry needs, the size of the governments balance sheet will grow to massive proportions. Let's not forget that all this stimulus and support is being financed with more debt issuance (bought by Asia) and will result in more dollars in circulation (resulting in a weaker currency).

Conclusion #2: Regulation is right around the corner and perhaps may even include price controls and will include higher taxes (likely in 2010). With faith in the markets badly shaken, it appears that many are ready for increased government controls.

Stricter regulation may help mitigate problems but always has unintended consequences as well. Well meaning laws, tariffs, price controls and other means of trying to restore confidence can also result in lower productivity, loss of global power, and the erosion of confidence with trade nations.

When governments spend (and boy are they spending now!), the money has to come from somewhere. When a surplus does not exist, it must come from taxes or from increased debt. If there is more need for money than the appetite for buying debt, the printing presses must start rolling.

Conclusion #3: As we move through the current recession and on into the next economic expansionary cycle, inflationary forces will take on a higher priority. If we assume that government actions will have positive impact on an economic recovery, we cannot ignore the fact that inflation will be a part of the recovery.

I believe that the government's actions are loudly stating that they would prefer to fight inflation tomorrow than to have deflation today. Let's look at this point more closely.

Many of the ills in America today come from the decline in asset values and high debt levels against those assets. When a house declines in value but the mortgage or line of credit remains high, equity in the home is wiped out and could even become "upside-down" owing more than the value of the asset. Deflation could be very destructive in a debtor society.

The Federal Reserve is tipping its hand. It would prefer to inflate the value of assets in order to restore equity and higher asset prices. The implications will be higher costs in terms of (food and energy for example) inflation, a weaker currency and higher taxes.

Conclusion #4: American society would prefer to stop the current pain from getting worse even if that means a recycling of current problems in the future. Capitalism, in its purest form would prefer to see corrections happen on their own, for leverage to be unwound entirely and for excesses and weak companies to close down and for unemployment to reach high levels.

Reactions to current government efforts suggest that we (as a society) would prefer to weaken our form of "capitalism" in order to avoid further pain. Actions that reward those who take on risk (through leverage) and encourage more future borrowing will result in stimulating consumption and at the same time punish savers and investors.

The United States will opt for mitigation of the pain and worry about the consequences later. This is likely to keep us out of a major depression, but raises the stakes for the country in the future.

Bear Stearns and Lehman Brothers and many other financial institutions built huge businesses using debt. As the debt level rose, it became more and more important that all the "assets" they purchased with the borrowed funds remain solvent and viable. In 2008, subprime exposure was only a small fraction of total assets, but because of massive debt levels, the erosion of these assets brought down the entire structure.

The same is increasingly true for the country. We are borrowing money to buy mortgages that the private sector doesn't want to own, we are loaning money to industries that are facing severe problems, and we are doing so with funds provided by foreign countries. The current situation weighs heavy on government leaders and their decisions will need to be precise.

Conclusion #5: The dollar is likely to renew its weakness relative to most other currencies. The cost of stimulus, low interest rates, bailouts and a large money supply is directly tied to the currency.

In the short run, the dollar will strengthen while most of the world works through the economic downturn and fear drives investors to the safety of U.S. Treasuries. However, as the world begins to grow again, and investors move out of Treasuries to re-invest in their local economies and into other growth investments, the dollar will weaken.

There could also be a rejoined effort by many countries to move toward a basket approach of reserve currencies and move away from the dollar as the sole reserve currency and further erode demand for the dollar. In summary, more dollars are likely to be flushed into the system and foreign governments may reduce their demand for dollars, a double weakening effect.

IV. Designing a Road Map of Opportunities for the Future
With a number of long-term trends clearly defined, we can begin the work of building investments that are likely to benefit from the impact of the current recession and the actions the government is taking today.

Opportunity #1: Profiting from inflationary forces

- **Gold** – the precious metal is most often associated with an inflation hedge. This is because gold is seen as a storehouse of wealth when paper money is losing purchasing value.

- **Short Treasuries** – The yield on long-term Treasury bonds are now at ALL TIME lows. Anytime there is an ALL TIME low (or high), it is important to consider the ramifications. In this case, a combination of the Federal Reserve lowering rates to nearly zero and investors fleeing money markets for the safety of government bonds pushed rates to this historic level. When bond yields are at ALL TIME lows, prices are at ALL TIME highs. The opportunity is then to invest in a security that will profit from yields rising and prices falling back toward normal levels. Because the yields are at ALL TIME lows, the potential for profit on this trend is considerable.

- **Energy** – I could use many pages of commentary on reasons why oil prices will continue to have an upward trend over the course of time. Let's just summarize by saying that supply of oil remains limited while demand continues to expand. Yes, there will be alternative energy production and continued improvement in efficiency usage, but these only partially offset the fact that the global population consumption of energy far exceeds the efficiency gains and alternative offsets.

  With prices now of oil down by as much as 75% from last summer's highs, it is an opportunity for a long-term investment. Consider the fact that it costs many suppliers as much as $65 a barrel to produce the oil, and that equilibrium is likely around $80 per barrel. That means that oil can offer over a 100% upside from today's prices if it just moves back to normalized levels. If the global economy were to grow at a faster pace a number of years from now, that price level is likely to become even higher. The potential for profit in energy commodities (oil, natural gas, etc,) is higher than almost any other asset in the world today. **For investors who wish to avoid direct investment in oil, there are alternative investments that typically rise in value when oil prices rise and can offer good upside potential with the Obama administration's alternative energy focus.**

- **Fixed Rate Debt** – this opportunity is a non-portfolio item, but worth mentioning. It will be very important to make sure that all debts are moved to a low fixed rate and to remove variable-rate debt from your life entirely. This year is likely to provide a great opportunity to lock in some of the best rates ever.

Opportunity #2: Profiting from a weaker currency

- **Global Government Bonds** – This is an opportunity on the horizon. When the dollar begins to weaken and the global economy begins to expand, we can re-allocate some investments to benefit from dollar weakness and still keep a high level of safety. At the right time, European government bonds could offer both a higher interest rate than US debt and could also benefit from Euro strength. The dual potential could make this relatively safe bond investment into equity-like returns in 2010. The last time we invested in European government bonds, we earned around 10% in a four month time period.

- **Cash Basket Approach** – another non-portfolio opportunity exists in converting some of your cash from dollars to Euros or other currencies now in order to finance future travel. If you are planning any travel outside the U.S. this could prove valuable.

Opportunity #3: Investing in a global expansion

- **Agriculture** – Global population continues to expand. Additionally, industrialization of many people leads to increased consumption of meats and grains. Once again, an opportunity arises out of an oversold condition of the recession. Some commodities are down over 80% from their highs and inventory levels are quite low. Major weather problems, supply or distribution disruptions, increased consumption or global expansion could all push prices higher. This investment has the added benefit of offsetting some of our own food costs if and when prices do begin to rise.

- **Strong Global Brands of US Companies** – This is an opportunity that will increase as we move through the recession and into expansion. There are large U.S. companies that have some of the most recognized brands in the world and are growing rapidly in Asia and Europe. Combine a weak dollar with a global expansion and these companies are likely to perform well.

  One side note is that we are looking specifically at companies that have shown the ability to continue to sell their product or service during recessionary times, pay a solid dividend, generate cash flow from their operations to continue to pay those dividends (that excludes most financials and industrials for now), and have a stable, proven management team.

- **China** – With the most populous country in the world modernizing, focusing on their own internal growth and stimulating their economy out of surplus of revenues (as contrast to our deficit spending), China is likely to propel their economy forward and become a stronger world power into the next expansion and at the same time cause US Treasury prices to fall as they sell US government bonds and spend it within their country for infrastructure, telecommunications and other internal projects. Their government has already stated this intention and has begun the process. China's index of largest companies (similar to our Dow Industrials) dropped 74% from its highs just a year earlier. Meanwhile, China has been adding favorable trade agreements to obtain resources from countries like Australia and have the ability to grow.

- **Resource Rich Countries** – Countries that have trade surpluses and also have significant natural resources will be winners for the next decade. These countries can control their own destiny in terms of supporting their own economies and can also trade profitably with growing, populous nations like China and India. There are many of these countries, but the two that are most likely to be represented in portfolios are Canada and Australia.

V. The Global, non-Traditional Road to Success Investing

In the future, investors will need to look both far and wide for the best opportunities. And as we have shown above, many of these opportunities will be global and non-traditional.

Current opportunities take us far and wide. While many of these are non-traditional in that they are not U.S. stocks and U.S. bonds, they have great potential and serve to provide reduced dependence on a US economic recovery, benefit from the looming impacts of the current bailouts, and offer exposure to the rest of the world, where growth will be strong.

The United States is still a strong nation and has great potential if the right things are done in the coming years. It is important that we do not entirely discount the ingenuity and resolve of American workers. There will be opportunities in the United States. At the same time, worldwide growth will become more centered on Asia and trends suggest that America will continue to be an important part of the world, but not the outright dominator.

VI. Implementation

I hope you have not become dizzy as our analysis has taken us from high-altitude perspectives to close looks at what is happening on the ground.

A view from 30,000 feet provides the perspective we need to get above the fray. It shows clear trends emerging from the massive sell-off and subsequent flurry

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of worldwide government actions. The trends favor the most basic of economic elements, our planet's resources. Consumption, low prices, supply disruption and inflation converge to create a long-term opportunity.

The United States is likely to recover slowly, but at the cost of a weakened dollar, while countries with cash surpluses (like China) and resource rich countries (like Canada) control their own destinies, affording them a higher chance to more robust economic growth.

Long-term trend opportunities can be entered into slowly and methodically to reduce price risk. But as I said in the introduction:

- **Assume the worst** (inflation, weak currency, gold standard);
- **Hope for the best** (revival of US earnings growth, stimulus, global economic recovery)**;**
- **And be prepared for every occurrence in between** (commodities and global investments should appreciate under most scenarios imaginable).

In times of high volatility, it is important to identify future trends, research how best to invest in those opportunities, and then to invest in them over time, using multiple entry points. The average entry will be very helpful in reducing the risk of finding a good investment and picking the wrong day.

I hope you have found this analysis helpful. We look forward to taking the next important step with you: Assessing how these developments relate to the investment decisions that are best for you!