

“Fate is not satisfied with inflicting one calamity.”

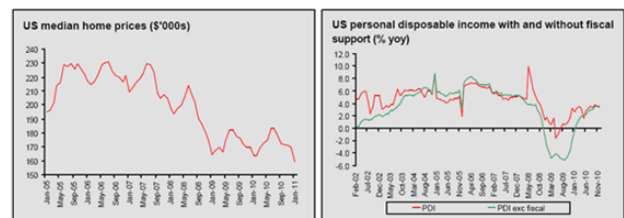
Publilius Syrus, 1st Century, B.C.

The Revolution Will Be Televised*

Wildfires, earthquakes, tsunamis, floods, drought, sleeping air traffic controllers, twittering porno congressmen, diplomatic attacks on hotel maids, attacks of killer bean sprouts in Europe, a shooting massacre in Norway (Norway?), and Dan Quayle’s son is still a congressman. Time to head down to the shelter with Twinkies and Diet Coke and ride this one out.

We can’t really ride this one out, though. It follows us on our little hand held devices and our big screen TV’s, where spammers and hackers intersect with the information and communication craving public. In some cases, the existence of the digital world has actually enhanced communication and may have contributed to revolutions. No doubt, digital communication in North Africa and the Middle East energized the young, tuned-in generation to turn to the streets. Despite China’s efforts to block the digital world, instances of dissent have been reported. Once the poor see how the corrupt leaders have accumulated wealth, they are willing to sacrifice a great deal for their “freedom” or better standard of living. This summer will continue to be a hot one (ask a Texan), and it is not over yet. For those of us fiddling with our apps, this has vast implications.

Now that the compensation and wealth of nearly every baron is reported without cessation, workers in developed and non-developed countries can see that the ordinary people are losing ground, in terms of income and home prices (Chart 1). With food and energy prices outpacing incomes, and with U.S. home prices continuing to shrivel, it is likely that the revolution will be live, with increasing public dissent in the U.S. and elsewhere. The sit-in in the Wisconsin state capitol building is just the beginning. Shooting massacres in normally quiet places like Norway, coupled with successful (Fort Hood) and unsuccessful attempts at bombings or massacres give us cause for concern. Is this some simmering correlated angst that has surfaced or are these just random events?



Source: Datastream, Independent Strategy

Chart 1

In Europe, where demonstrations and strikes are almost a daily occurrence, no matter what the scenario, we expect even more restlessness as the core countries (Germany, France, etc.) are asked to bail out the periphery (Greece, Portugal, Spain, Italy). At some point, Greece

will default and the world can stop pretending. The ramifications of Greece's problems will ripple through the global economy. European banks have huge exposure to the Greek backstop, so a deflationary credit melt-down is possible.

While the world watches the Greek drama, the lessons of globalization will soon be reverberating. U.S. money market funds have significant (approximately \$1 trillion) short term European debt.¹ (Chart 2)

Eurotrash?

The hefty allocation to European debt securities inside America's largest money market funds

Five Largest US Money Market Funds	Fidelity Cash Reserve	Vanguard Reserve Prime	Fidelity Institutional Prime Money Market Portfolio	Fidelity Institutional Money Market Portfolio	BlackRock Liquidity TempFund
Institutional Share Class	FDRXX	VMRXX	FIPXX	FNSXX	TMPXX
Min. Investment Assets	\$2,500	\$5,000,000	\$10,000,000	\$10,000,000	\$3,000,000
Percentage by Region					
US	30%	52%	38%	26%	35%
Canada	10%	10%	8%	10%	14%
Australia	9%	13%	7%	9%	3%
Japan	6%	1%	3%	6%	7%
Europe	45%	24%	44%	49%	41%

Source: Grant's Interest Rate Observer

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Chart 2

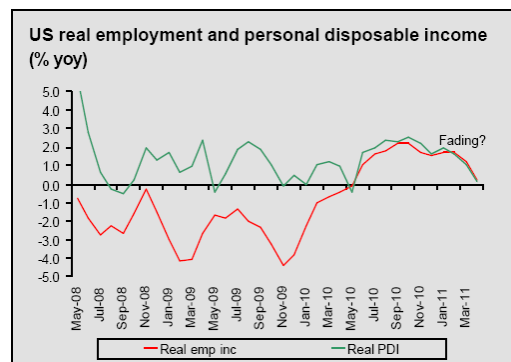
U.S. banks have approximately \$176 billion of exposure to the problem countries of Europe's periphery²—between \$18-40 billion just to Greece³, through loans or credit default swaps (insurance on European bonds). J.P. Morgan, which has recently reversed loan loss reserves into earnings, has approximately \$36 billion in exposure to the bad hair countries of Europe.⁴ While Fed Chairman Bernanke brushes the problem aside, he also admits that the Fed is keeping a "close eye" on the issue.⁵ Hopefully, it is a closer eye than they kept on the banks and the mortgage market.

QE II (quantitative easing by the Fed, which involved an injection of \$600 billion into the financial system) was supposed to support the housing market and stimulate the labor market. It has not had the intended effects (Chart 3).



Chart 3

Instead, Americans see their wealth slipping away, as low wages and inflation grind down the standard of living. (Chart 4).



Source: Daystream, Independent Strategy

Chart 4

Over the years, GDP has slowly eroded, reaching lower lows and lower highs (Chart 5). The Fed's addition of debt no longer moves the economy, but only increases deficits and debt levels. QE II leaked into the equity and commodity markets, causing inflation, which raised the level of global angst.

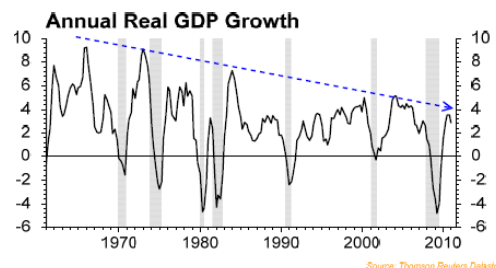


Chart 5

We view this as a rather precarious scenario. The Fed is running out of bullets and the economy is weakening—certainly not the "sustainable recovery" touted by the

administration. We have reduced equity exposure in our portfolios, as we expect increased fear and volatility. Investors may retreat to the sidelines.

Other investment themes continue to emerge from these issues. At the end of July, the global population surpassed the 7 billion level.⁶ Food and energy inflation continue to bolster our conviction that shortages and higher prices will continue to plague developing and developed markets.

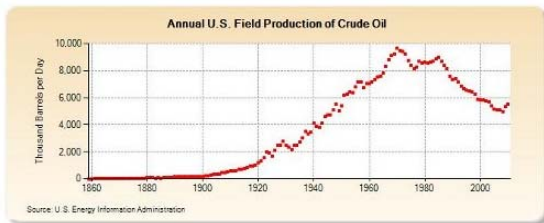


Chart 6

U.S. energy production peaked 40 years ago (Chart 6). Major oil finds have become rare (Chart 7). As a result of the Japanese nuclear disaster many countries (Germany, France) have announced that they will shut down existing nuclear facilities. We strongly doubt this; there are simply not sufficient alternatives and even fossil fuel production figures indicate disturbing supply demand relationships. (Chart 8)

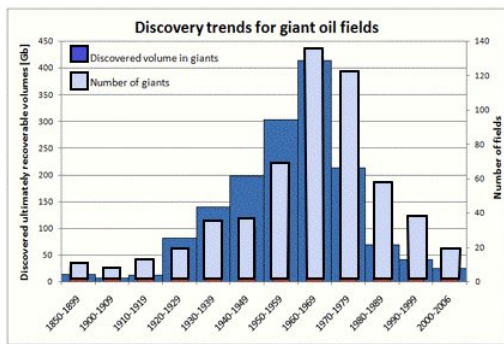


Chart 7

Our own indispensable gadgets have just added additional strain to an antiquated, insufficient energy grid.⁷ Small appliances, such as phone chargers and laptop power adapters suck energy out of the grid even when not charging.⁸ Cable

boxes, digital video recorders and other “always on” gadgets, (termed, “energy vampires,”) use more power than an energy efficient refrigerator.⁹

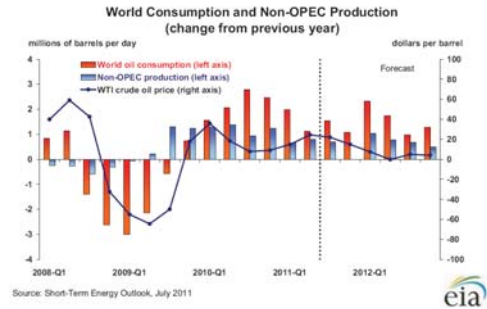
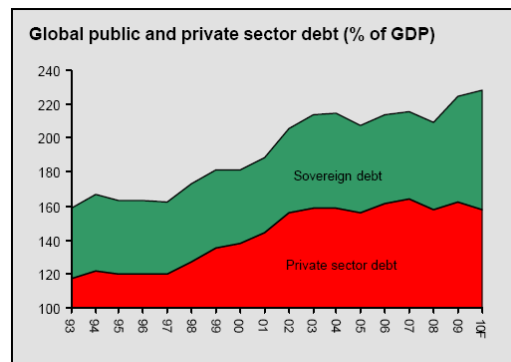


Chart 8

Due to peculiar weather patterns, droughts and floods have ravaged the Midwestern U.S., China, and parts of Africa¹⁰. We remain convinced that the dislocations of population, urbanization and unusual weather patterns, will create increased demand for stable sources of food supplies. Our investments in agri-businesses should continue to benefit, and we will expand our agricultural investment horizons as food supplies become more fragile, while the global population expands.



Source: IMF, BIS, Independent Strategy
Chart 9

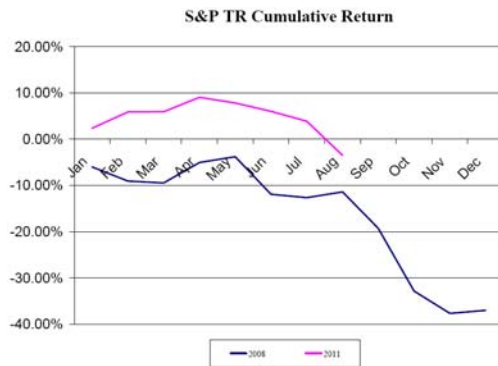
Political change, particularly rapid and messy activity (which will be televised) creates anxiety, contributes to volatility and dislocations in the financial markets. The public debt assembled to mollify the masses (Chart 9) causes us to conclude that the U.S. dollar, the yen, and the euro will have an ugliness contest, with a race to the bottom, as

each tries to beggar thy neighbor to become more competitive.

No other currencies are large enough to shoulder the fall of the big three. We believe that precious metals (gold, silver, etc.) and oil will be treated as currencies and we have increased our exposure to hard assets, the currencies of hard asset producing countries (Canada, Australia, Norway, Brazil), and further reduced our exposure to the dollar.

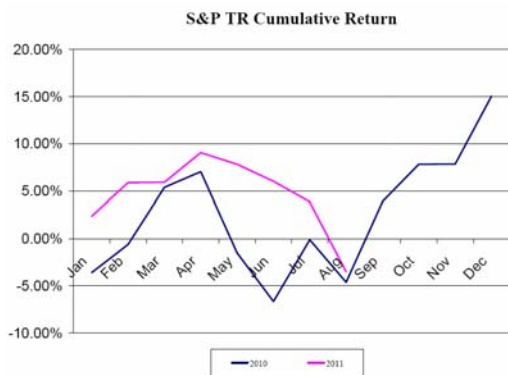
The Chinese, with trillions of dollars of U.S. government paper, have warned the U.S. that it is time for austerity and an end to deficit spending. The Chinese have started to diversify their vast wealth into other vehicles, including precious metals, oil, and non-U.S. currencies. Already, there is doubt about the ability of the U.S. to pay its debts, as the S & P and the Chinese rating agencies have already downgraded U.S. debt and the remaining rating agencies have put U.S. government debt on negative ratings watch.

We think that as conditions in the U.S. continue to deteriorate, the following scenario will occur. It will, in some ways, be a repeat of 2008 - 2010. (Charts 10 & 11) As food and



Source: Returns Provided by Morningstar
Chart 11

energy inflation continue, unrest will increase globally, shaking some oil producing regimes and emerging markets where food is a large component of spending. This will increase anxiety and commodity prices will react, as perceived threats to supply will roil the financial markets. Riots will appear sporadically. Europe will continue to be exposed as a flawed geo-political experiment, with perhaps a default by Greece. Since U.S. states must produce budgets mid-summer (and many state constitutions require balanced budgets), the dire straits of municipalities, counties, states, and public project finances will be laid bare, further increasing investor angst.



Source: Returns Provided by Morningstar
Chart 10

QE II ended on June 30, and commodity and equity market volatility have already increased in reaction to this. Without the boost provided by the Fed's juice, liquidity will contract, further exacerbating markets, as investors are forced to withdraw capital. Deflation in real estate will accelerate. Labor markets will remain lackluster, as nervous employers delay hiring or capital expenditure, instead opting for cheaper, overseas labor (Chart 12).



Source: Japan External Trade Organization

Chart 12

The battered condition of the U.S. and European banking systems will become more apparent, along with their inability to lend, due to bad loans and increased regulatory capital requirements. U.S. consumers will slow purchases, while they restore their balance sheets, leery of further deteriorations in the employment picture and the housing markets. The Fed, which came under criticism for adding the liquidity, and with little political capital for another round of quantitative easing, will watch, as the financial markets churn and look for their usual liquidity and credit suppliers. Capitol Hill and the White House will dither about spending, taxes, and deficits, while voters become agitated. Ultimately, with an election year approaching, the public will become disgusted with government inaction as their wealth, as measured in the equity and housing markets, looks more perilous. Mr. Bernanke knows he will be subtly nudged to begin a stealth QE III, or even one that is announced and overt.

Indications of increasing money supply have already appeared (Chart 13). Americans are not yet ready for austerity, as they see what is being forced on some of the European countries and it is unpleasant.



Source: Boeckh Investment Letter, June 11, 2011

Chart 13

Meanwhile, the Fed is watching the stock market, which is sending out bad signs. The Fed would prefer the 2010 style market outcome, but there are no assurances. Better to kick the can down the road to another election cycle. Liquidity will be added, irrespective of the deficits and the damage done to the U.S. balance sheet. The Chinese and other large holders of U.S. paper will complain and perhaps even slow or stop buying large amounts of U.S. debt. The dollar will begin its downward crawl. Americans will not care, as they will have their crack. We all want our MTV and everything else.

It is at this time that precious metals, energy, and hard assets, which cannot be debased by government fiat, will start to climb. At first, equity markets will see this as a repeat of 2010 and like it, until interest rates start rising. Inflation and input costs will increase, and, with little ability to pass on cost increases, corporate profits will suffer. The stock market will then see that the emperor has no clothes. It will not be pretty. Defensive positions and beneficiaries of volatility will benefit. We are preparing for this. We have reduced risk exposure in our portfolios, as liquidity contractions result in price declines, as investors are forced to deleverage and defensive positions become attractive.

Of course, everything could work out well. We hope that it does. The U.S. is resilient. Just in case, though, we consider it our duty to protect against the horrific, even if remote, while opportunistically taking advantage of unfolding

events. Thomas Hardy said, “And yet to every bad, there is a worse.” We are ready for the bad

and we are preparing for the worse. And, yes, it will be televised.

* Sixties poet, Gil Scott-Heron, Whose work has been quoted in prior newsletters, and who past away in May, 2011, wrote the powerful poem, “*The Revolution Will Not Be Televised*”, from which our title is drawn. He will be missed.

- ⁽¹⁾ Mary Pilon and Jon Hilsenrath, “Unease Rises Over Funds,” Wall Street Journal, 22 June, 2011
- ⁽²⁾ Karen Brattell, “US Banks Have \$176 Bln Exposure to Greece, Others,” Reuters, 9 February, 2010
- ⁽³⁾ Investment Underground, “The Plague of Greek Debt Punishes Banks,” Seeking Alpha, 22 June, 2011
- ⁽⁴⁾ Ibid
- ⁽⁵⁾ Craig Torres, “Bernanke Sees Small Impact on U.S. Banks of a Greek Default, Bloomberg, 22 June, 2011
- ⁽⁶⁾ Nick Hodge, “Weekend: Population, Food and Oil,” Energy & Capital, 25 June, 2011
- ⁽⁷⁾ Report Card For America’s Infrastructure, <http://www.infrastructurereportcard.org/>
- ⁽⁸⁾ Oliver J. Chiang, “Surprising Home-Energy Hogs,” Forbes.com, 23 February, 2010
- ⁽⁹⁾ Elizabeth Rosenthal, “Atop TV Sets, a Power Drain That Runs Nonstop,” NY Times, 25 June, 2011
- ⁽¹⁰⁾ World Food Prices Hit Record High: UN Agency, <http://www.Breitbart.com>, 23 February, 2011