



*“Oh, the dashboard melted but we still had the radio.”*

Modest Mouse  
*“Dashboard”*

## SLUMDOG TRILLIONAIRES

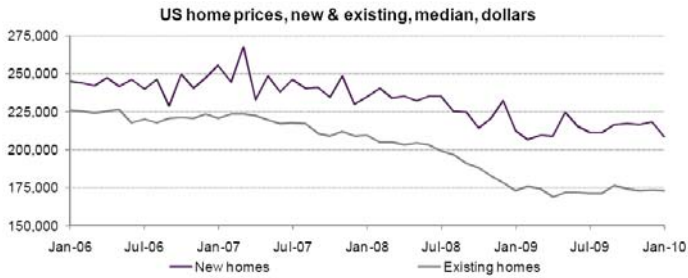
Earthquakes, tsunamis, riots, floods, winter Olympics with no snow, guys blowing up their underwear on airplanes – what planet did I wake up on? I long for the days of Dan Quayle, when it was only them and us.

After the bloodbath of 2008 and early 2009, global leaders determined that a reversal of fortune was required. In fact, they were right, as the global financial system was on the precipice of a disaster. Beginning in March of 2009, world leaders cobbled together a patchwork of almost 800 bailouts, guarantees, takeovers, stimulus packages, and interest rate cuts. As the crisis required a short term solution, neither the underlying problems which led to the crisis nor the future consequences were seriously considered. Now, we are faced with the aftermath.

As global markets were stimulated by the aforementioned measures, the financial markets responded favorably. Equities, commodities, and junk, which were previously repulsive, suddenly became attractive, without regard to any change in fundamental values. Ignored in the manic stampede was the fragility of the global banking system, still reliant on

government lifelines, the moribund state of the U.S. real estate sector (as opposed to soaring property values in Asia), and the continual shedding of workers.

Greece is an interesting case in point. With a relatively small economy, it has transfixed the world with concern over the possibility of default on its government’s debt. Since much of the debt is owed to European banks, the situation has become fractious within the European Union, while the rest of the market participants watch to see how the situation is resolved. Were Greece the only problem, the situation would not be so consequential. Exacerbating the issue is that Portugal, Spain (unemployment rate of 17%), Ireland, and Italy are in potentially similar situations. The specter of sovereign defaults, previously relegated to a few renegade nations like Ecuador and Argentina, now preoccupies the financial markets. Rumors of potential downgrades to the credit status of the U.K., Japan, and even the U.S., have surfaced, as their balance sheets are not dissimilar from that of Greece.



Source: Lombard Street Research Daily Notes, 26 February 2010

Chart A

In the U.S., massive injections of liquidity and guarantees have failed to reignite the economy or stimulate hiring (see Chart A). The authorities know that if they continue to print money to prop up the system, the value of the dollar will plummet and interest rates will rise, as foreigners (the largest buyers of U.S. debt) would avoid purchasing additional paper and might start liquidating their already large positions. The Chinese have already lowered the amount of their purchases of U.S. debt. With a mid-term election looming, it is not unlikely that even more money could be printed for stimulus, irrespective of the ultimate consequences.

Much of the newly created liquidity has failed to reach Main Street, as it has been gobbled up and hoarded by large banks that must shore up their balance sheets to protect against future expected loan losses (see Chart B). Some

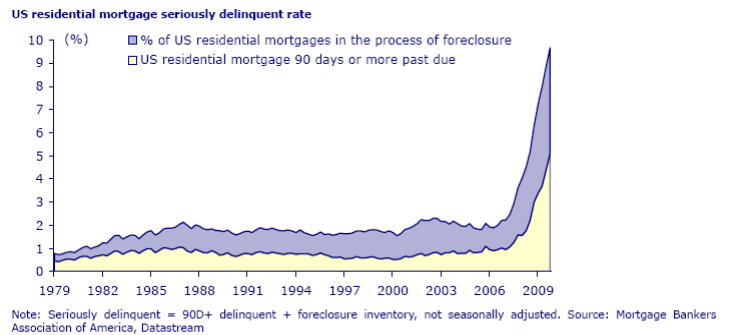


February Source: Andrew Hunt Economics, Ltd., Global Weekly Review, 26 2010.

Chart B

has gone into attempts to save the failing auto industry, with little success. AIG, Fannie Mae, and Freddie Mac have consumed immeasurable

amounts. Thus, small and medium sized banks, the bulk of the credit for small businesses, have not received assistance. In fact, many of these banks have their own problem loans, and are in a precarious state. Last year, the FDIC took over 120 banks. As of the end of 2009, the FDIC categorized 702 banks, with over \$400 billion in assets, as “problem” banks. The FDIC has almost no money left and will have to go to the Treasury or dramatically increase fees it charges member banks. The fear of bankers, large and small, is the looming problems in the commercial real estate sector. Vacancies in retail, office, industrial, and hospitality are high and rising. A thirty-three month supply of unsold housing units (a record) overhangs the market (see Chart C). So, despite all the monetary largesse thrown at the problems by the government, little has found its way to borrowers who need it.



Note: Seriously delinquent = 90D+ delinquent + foreclosure inventory, not seasonally adjusted. Source: Mortgage Bankers Association of America, Datastream

Source: Greed & Fear Newsletter, Christopher Wood, 25 February 2010

Chart C

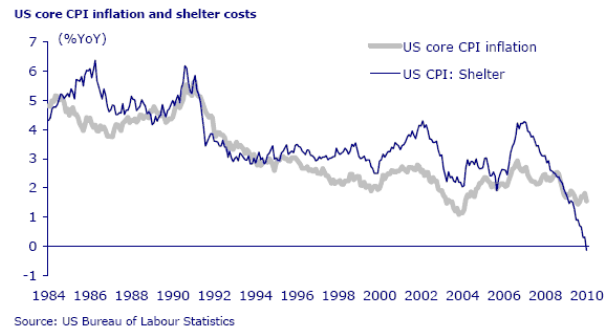
Fears of an asset bubble bursting in China, rumblings about nuclear activity in Iran, uncertainty about the future of the involvement in Afghanistan and Iraq, a lack of clarity about health care and domestic or foreign policies on the part of the administration, along with the feeble financial standing of virtually every state in the U.S. (California, the world’s eighth largest economy, has a credit rating lower than Kazakhstan, according to the State’s Treasurer – Borat would be proud), cast a pall over the psyche of investors. Some guy on an airplane sets his underwear on fire and the entire global airport security system freezes, and changes

rules randomly and frequently. Even the problems of once stalwart Toyota, like the setting sun of the Japanese economy, causes individuals to wonder if anything is really “safe”. The tremors in Haiti and Chile may resonate in the collective psyche of investors.

None of this has escaped our attention. As we watched the debacle of 2008 and early 2009 turn into a mania, we were skeptical until we determined that, with a worsening fundamental picture, the driver was liquidity, largely provided by the government. Equity participants want to believe the sustainable growth story, where economies can sustain themselves once government stimulus is removed. We believe they will be disappointed. Economic reports do not support the notion, nor does the prospect of higher taxes and consumer retrenchment, at least in the developed world. If growth continues, interest rates will increase and during the hand off, there will be a fumble. For this reason, we believe economic stimulus cannot be removed in Europe and the U.S., without creating havoc. While we have increased our exposures to the market, since the same problems still exist and continue, we will remain close to the exits.

Several of the same themes we have discussed in the past still seem sensible to us. The growth of developing nations has led to an increase in the consumption of food and energy. 2008 was the eighth year in a row that the world consumed more food than it produced, a metric that cannot continue. Energy consumption continues to grow, and new sources are not replacing diminishing supplies or new finds, particularly in the oil patch. Water resources continue to be a problem. We continue to consider these areas fertile grounds for investment.

The U.S. has set out on a course which includes huge indebtedness and large deficits. The likely result will be higher inflation and a weaker dollar in the future. Many of our



Source: Greed & Fear Newsletter, Christopher Wood, 25 February 2010

Chart D.

investments reflect that concern; although we recognize that, at the moment, many of these same issues are propelling forces of deflation (see Chart D) in the U.S., Europe, and Japan, that will weigh on the domestic and global economies for some time (see Chart E). Still, food and energy prices continue to rise, presenting an underlying inflationary force. Despite the problems of the U.S., the dollar still retains some safe haven status, and we have adjusted our portfolios accordingly, cutting exposure to foreign currencies and purchasing dollars. Ultimately, we believe that gold will be recognized as the true safe haven, as sovereign debt and paper currencies become increasingly suspect. We have kept a core position in gold and will add to it, at the appropriate time.

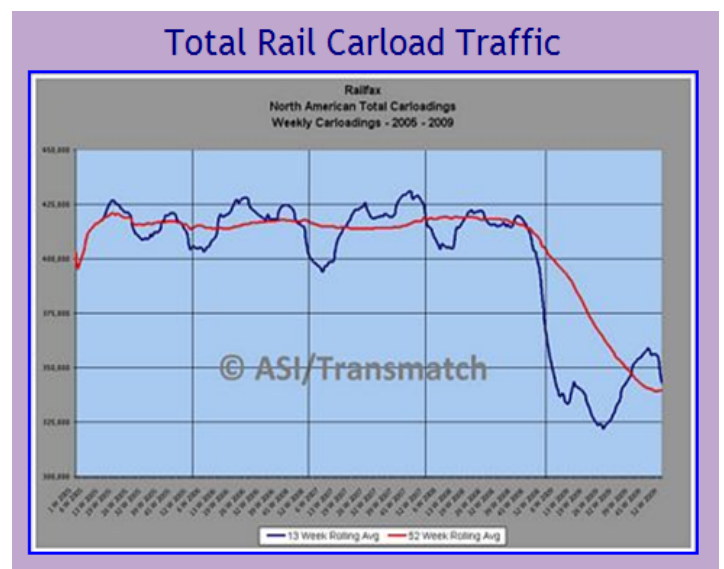


Chart E

The next few years appear to allow for little other than very slow growth (punctuated by dips and bumps), as the problems and debt levels of the developed world reach their endgame. Faster growth will come from developing markets, particularly those that have little debt and low manufacturing costs (China, India, Vietnam, etc.). Better fortunes lie ahead, as well, for resource rich nations like Australia, New Zealand, and Norway. We have focused our attention on these markets.

The poor slumdogs of the last century will end up owning this one, as they decouple from the debt laden, slow growing, developed world. China is fast approaching overtaking Japan as the world's second largest economy. In 2009 China purchased more automobiles than the U.S., despite the cash for clunkers escapade. Goldman Sachs even estimates that China will overtake the U.S. within twenty years. As an example, Coke recently announced its fourth quarter sales and earnings, in which revenues increased outside North America while decreasing in North America. Emerging markets made up much of the increase – new sales in China, Mexico, India and Brazil were the equivalent to adding another Germany, according to the company. This decoupling will not be imminent nor will it be without bumps. New democracies can be messy (as our own nation displayed) and new entrants into capitalism will make mistakes. While the exchange of fortunes will not be linear, it is coming. In the final words of the movie, which forms the title to this report, “It is written.”