

## TRASHING THE DOLLAR

March 19, 2008

In late January, we, at Cadinha & Co., felt that markets were on the verge of a climactic unwinding. Further, we expected the less liquid foreign markets to exhibit even greater volatility, forcing investors back into the safety of U.S. markets, strengthening the dollar, and weakening the price of dollar-based commodities. This thinking was the reason for our sale of foreign currencies and gold in January. Within days after our portfolio changes, Fed Chairman Ben Bernanke initiated two large interest rate cuts aimed at preventing a stock market sell-off. The politicians simultaneously passed a near \$200 billion give-away, supposedly aimed at strengthening the economy. Both actions, although initiated through separate branches of Government, sent a negative message to foreign and domestic investors alike. It became apparent that the prevailing wisdom in all corners of Washington had not changed, continuing down the same path of accommodation and “bail out” that had made the crisis even worse. After a few days of dollar strength and gold weakness, investors began fleeing the dollar once again in favor of other currencies and gold. Likewise, we have been gradually reconstituting both, reversing our earlier decision by buying some gold and Swiss francs in many portfolios.

Last Friday, “Helicopter” Ben Bernanke was at it again arranging a bail out of Bear Stearns through an unprecedented Federal Reserve accommodation. On Monday, he cut the discount rate in an emergency step to provide liquidity to our financial system. Yesterday, he cut both the funds rate and discount rate by  $\frac{3}{4}$  of 1%. Today, OFHEO, with oversight responsibility for Fannie Mae and Freddie Mac, loosened the capital requirements for these large mortgage lenders by \$200 billion.

The chain of events over the last year has not surprised us. As I wrote in *Moral Hazard* last September: “We can expect high-risk, high-leverage investments to return to popularity and become an even bigger factor in the future. We should also be aware that corrections are apt to be quicker and nastier, prompting even bigger Fed bail outs. The long run effects are a weaker currency and lower standard of living for Americans.” What is surprising is the rapidity of these unfolding events and the continuous lack of concern for the dollar exhibited by policy makers in Washington.

Consider the economic effects of a weaker currency. Since last September, oil has surged from \$70 to \$110 a barrel. Likewise, the prices of dollar-denominated commodities and food imports have surged. Had the dollar maintained its exchange rate value since last September, oil would presently be somewhere in the neighborhood of \$70 a barrel. The weakness of the greenback explains much of the recent oil price surge.

The market action (prior to the Fed’s latest cuts) suggested that participants were running for cash as the perception of risk for almost every investment had increased. We could be getting close to a “cash is king” environment, and this is fine with us as our portfolios already have an abundance of cash and Treasuries. As in previous market declines, the government has ignited another rally on the backs of those issues that had suffered the greatest decline. Again, we prefer to be deliberate, waiting to see markets in their more natural state, without government interference or manipulation. The key question will be what to buy and when to buy it.

Looking ahead, the political polls tell us that Americans are attracted to candidates who advocate higher income taxes, higher capital gains taxes, and higher taxes on corporate dividends. We can expect the capital gains tax to

be much lower than the tax on income, thereby leaving capital gains as the only true remaining tax shelter. We can expect a market premium for companies with high internal growth rates compared to companies that pay high dividends. Presently, both dividend income and capital gains are treated the same under the tax code. The unmistakable trend toward higher taxes and more regulation does not augur well for our stock market and the dollar.

In this environment, you can expect us to “nibble” as bargains appear, favoring large self-financing, multinational growth stocks, which will benefit from a weak dollar. Companies such as Caterpillar, Boeing, and Deere are indeed interesting, but we are concerned about a global recession, so we will avoid these for the present. Instead, we will favor consumer staples that are less economically sensitive.

Expect a prudent and deliberate portfolio increase in foreign currencies and gold, as some degree of dollar hedge seems prudent; however, this will be done during periods of weakness.

Bonds will continue to be Treasuries, but we now include “inflation protected Treasuries” (more commonly known as TIPS). These bonds increase payments according to the change in inflation and serve as a hedge against weaker dollar inflation.

So far, our assessment of this environment has been accurate, with most client portfolios preserving values quite well. While we are confident there is a wonderful buying opportunity coming our way, we need to exercise patience and discipline over the near term, while keeping a watchful eye for a positive change in policy from somewhere in Washington...God forbid!

Until that happens, we will continue to expect more policy mistakes and invest accordingly.

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