

MAKING SENSE OUT OF THIS MESS

April 5, 2011

The first quarter of 2011 is over and about the only conclusion one can come to is the world is a mess. Revolutions in Egypt and Libya, accompanied with riots and protests in another ten countries, have rendered the political tapestry of our world unrecognizable. “Regime change” seems to be the operative phrase, but from what and to what? Regimes at risk run the gamut from democracies to totalitarian states. There is simply no discernable political trend involved with the instability.

A catastrophic nuclear meltdown in one of the world’s largest economies only adds to the disruption. The cost in money and material to rebuild Japan will assuredly add more wrinkles to the global economic picture.

At home, we have a federal government determined to borrow and spend beyond its means. We have a central bank (the Federal Reserve) equally determined to print money to accommodate the government borrowing. Meanwhile, in Washington and many state legislatures, newly-elected officials are attempting to stop this spending Goliath. After trillions have been spent, unemployment is still high, our dollar is still weak, and consumer confidence is dropping again. We find ourselves involved in three wars with no real end in sight.

With all the aforementioned concerns, our stock market is strong and trending higher. What gives? How does one make sense out of these conflicting signals?

Let’s start with riots, protests and revolutions. It is important to realize that different societies spend vastly different amounts on food. In the U.S. our average household spends about 7% of income on food (cooked in the home). In China, that number is closer to 30% and in India, it’s near 40%. Indonesians spend over half of their income on food. What might that number be to Egypt, Libya, or Syria?

Couple these facts with the fact that most food commodities are priced in U.S. dollars, and you find that our Federal Reserve and government policies are largely responsible for pricing food out of the reach of many who live in societies with weak currencies and economies. Wheat prices have more than doubled because of our weak currency and agricultural policies that subsidize our farmers to plant corn rather than wheat. Corn subsidies are for ethanol production. Imagine what the increase in gasoline price has done to the family budget in Yemen, Syria, Bahrain and Greece. Probably enough to take to the streets for.... The food and energy factor for countries with stronger currencies than the dollar is virtually a non-event, and political stability continues in countries like Australia, Canada, Singapore, and Switzerland.

What would a billionaire in these unstable societies do with wealth? Most probably transfer it out of the country, but to what currency? The Pound Sterling has been weak, the Euro is revealing some cracks, the U.S. Dollar is weak and the Yen is weakening as Japan prints more money to pay for the earthquake rebuilding. We believe that some of this recently frightened wealth will find its way to gold and silver. We also think some wealth in weaker currencies will continue to migrate to these traditional metals.

A look at your portfolio will show a significant portion committed to gold, silver, oil producers and aluminum. Foreign investments are focused in Australia, Canada, and Singapore; all strong currency countries with low levels of debt. Cash levels are still fairly high, as we plan to commit funds as opportunity presents itself.

The other half of your portfolio is committed to common stock, which have been selected for very specific reasons. Additionally, we have chosen to avoid specific sectors of the market and the economy because we feel the event or political risk is too high.

Our bullish position on equities emanates from three events which occurred over the last six months: the national election; the findings and recommendations of the special commission on the deficit; and the extension of the tax law featuring the Bush tax rates.

The National Election was important in that this new Congress will likely act as a governor on unreasonable regulation invoked by the many czars and governmental agencies. After all, regulations are a tax, and the ability to regulate is no different than the ability to tax. The proliferation of regulation over that last 3 years has had a negative effect on our economic recovery, serving to slow and inhibit growth. We can expect Congress to watch governmental agencies more closely and make new unreasonable regulations difficult to implement.

We can also look to the new congress to introduce more pro-growth initiatives and budgets and reject efforts to raise tax rates.

The Commission on Fiscal Responsibility (known as the deficit commission) was appointed a year ago to find a solution for our growing deficits. The recommended solution focused on lower tax rates for corporations and individuals coupled with large spending cuts. There is still much to debate about which spending to cut, but there is wide acceptance of lowering our corporate tax rate, which is soon to be the highest in the world. We feel that momentum will build to make our corporations more competitive, and the largest beneficiaries will be these corporations currently paying the highest rates. Many of your investments are high tax payers.

The Extension of the “Bush Tax Cuts” may be a misnomer, but it has effectively left the federal tax rate on dividends and capital gains at 15%. This compares favorably to an upper tax rate of 35%, paid by many on interest income from bonds and bank accounts. Hundreds of billions of dollars have flowed to the bond market over the last couple of years and we expect the extension of these tax rates to stem that tide, effectively serving as a catalyst to move more money back to stocks.

These then, are the reasons for our positive view of the market. Certainly there are other reasons as well, but these are the drivers behind the recent market advance.

A word of caution is probably appropriate to emphasize the precarious nature of all markets. The world is still very highly leveraged and the propensity for error and dramatic change is high. Perhaps the most critical issues that bear watching are the battle over the federal budget and the policies put in place by our Federal Reserve Board. It is not hard to find strong opinions about the “Fed” and the demise of our dollar. Yes, we also dislike the printing of money and the trashing of our financial house, but the weakening of the dollar vis-à-vis other currencies is not a guarantee. If others are trashing their homes to a greater extent, the dollar could rise, jeopardizing investments in many emerging markets. Don’t just “go foreign” as many would advocate. Be selective. A surprising King Dollar could hurt you.

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