

INVESTMENT STRATEGIES

When I last wrote, I discussed the coming inflationary cycle stemming from the combination of food and energy price increases. That was just at the beginning of the subprime mortgage crash and long before anyone began to talk of a recession in 2008. Now, given the impact of the mortgage market problems, economists are divided on the potential for a recession.

Gary Halbert reports that *The Bank Credit Analyst*, a well known economic publication, is calling on the Federal Reserve to cut rates several times in coming months in order to avoid a recession or even further financial market disruptions. They go on to say that the Fed is too preoccupied with inflation at the very time that they should be looking out for recession and the return of deflation.

Other reports are out saying that what began as a credit problem in the subprime markets is starting to expand into the much larger corporate debt markets. The complex and little understood credit default swaps, derivatives, and junk bonds – many highly leveraged in a manner similar to the subprime based Collateralized Debt Obligations and hedge funds – are starting to be strained due to the lack of liquidity in the financial system.

We will likely see the Fed comply with interest rate cuts in coming months. The risk to the economy from restraining liquidity is that we would likely see the financial markets seriously tumble, leading to the dire consequences that *The Bank Credit Analyst* discusses.

A recent article by Stephen Roach points out that seven years ago, the bursting of the dot-com bubble triggered a collapse in business capital spending that took the US into a mild recession. This time, the bursting of the mortgage market bubble seems likely to hit US consumption, which at 72% of GDP is five times greater than business spending was seven years ago.

John Maudlin writes that home equity cash outs as tabulated by Freddie Mac totaled \$151 billion in the first two quarters of 2007, funding 50% of consumer spending during that time. More amazing is that over the past 5½ years, \$1.1 trillion has been extracted from homes, funding 46% of consumer spending over that time.

Tightening credit standards and falling home prices will guarantee that this won't be repeated in the coming 5½ years. Mr. Maudlin concludes that slower consumer outlay growth can be expected for an extended period.

In my opinion, we will see a significant slowdown in the US economy. The US consumer will be seriously constrained in coming months due to limited liquidity and rising prices.

One of the primary indicators of the coming economic slowdown is the bear market in the US dollar. Investors understand that with the prospect for falling interest rates in the US, the dollar will decrease in value compared to other currencies. Mr. Roach writes that the negative savings rate in the US has required that surplus savings from abroad be imported to fund domestic growth. America must still attract \$3 billion dollars of foreign capital each business day in order to keep the economy growing.

There has been a lot of press about the falling dollar and how it makes the US manufacturing sector more competitive and increases corporate earnings for exporters. This is true. Yet, there is a flip side to this situation: we import nearly \$2.5 trillion of goods and services each year. A sharp drop in the value of the dollar is an inflationary event as it makes those items considerably more expensive for consumers. So far, the dollar's fall has not been an inflationary event (other than oil and gold) but given the likelihood of continued Fed rate cuts it will certainly play a part in the coming inflationary cycle.

Don Coxe reports that year-to-date percentage price increases from the September PPI Report show that food price increases are working their way into consumers' wallets. Raw food prices increased 26.3%, Intermediate Foods and Feeds increased 16.9%, while Finished Consumer Foods increased only 6.7% - producers are absorbing the increases for now, but that will not last forever. The inflation tidal wave of the 1970's inflation started with double-digit raw food price increases long before the Arab Oil Embargo and the Yom Kippur War brought energy price

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increases to the forefront. Be prepared for some shocked looks at the store.

The demand for grains coming from China, India, East Asia, and Latin America is due to rising fortunes in emerging markets. These consumers are able to demand more and better foods, meaning that grains are going to support increases in meat, eggs, and dairy. The demand for grains has resulted in the smallest global carryover of supplies in relation to demand on record.

It is not difficult to imagine a scenario where a supply disruption due to weather will cause significant price increases in grains. In fact, we saw wheat prices double primarily due to a severe Australian drought. Although it represented only a 1% drop in world-wide wheat production, it goes to show how tight grain markets are in being able to balance supply and demand. Today, we only have a six week supply of wheat on hand; its that tight.

Wheat is an inconsequential component in the meat, eggs, and dairy boom in emerging markets. Corn and soybeans are much more integrated in this boom. They are also key to the US and European governments' legislated increases in production of ethanol and biodiesel. In the US, the legislation states that gasoline blenders must use 4.7 billion gallons of ethanol this year, increasing to 7.5 billion gallons in 2012. Over the next five years, prices for raw foods will continue to increase at double digits rates based upon their legislated use in fuel and their increasing demand in the production of animal protein.

Don Coxe writes that we are at a time of momentous secular change. When we are at a time of rising demand and a stable to shrinking supply of oil, metals, and foodstuffs, the world becomes inflation prone.

From an investment management perspective, these events present the prospects for a turbulent 2008 stock market. *The Bank Credit Analyst* recommends that investors should reduce exposure to equities and raise cash levels to above normal levels. There is some merit to this suggestion, but that alone will not offset the damage to a diversified portfolio from inflation.

Since 2002, if you have read these Investment Strategies during that time, you will know that we have been an advocate of commodity stock investing. Initially, we began to overweight allocations to energy stocks. Next

came overweight allocations to metals and mining stocks. This time last year, we began to overweight agricultural commodity companies. In recent weeks, we have added gold producers to our list of commodity holdings.

We increased the first three allocations based upon the demographic changes in the developing world. The massive movement of people from subsistence living conditions to middle class lifestyles increased demand for energy, metals and foodstuffs. Now, the falling dollar and the coming inflationary cycle will make gold and gold miners a necessary holding in portfolios to offset the portfolio devaluation inevitable with inflation.

Through these first five years of investing in commodity stocks, the stock price increases we have experienced have come mainly from increased earnings. P/E ratios have remained staunchly in the single or low double digits, well below the S&P average. Investors have not yet broadly bought into the commodity stock boom, or they use it as a trading strategy.

With the coming inflationary cycle, investors will respond to it by including commodity stocks in investment portfolios as inflation hedges. Commodity stocks will begin to trade not just on their earnings but also on their ability to reduce portfolio risk. This new respect for commodity investments will lead to increased P/E ratios and continued profits for our clients. Energy and base metals will initially sell off in knee jerk reaction to a slowing US economy, but demand from outside the OECD countries will keep earnings strong and the sell off will be temporary.

We are maintaining our investment emphasis in our favored investment themes: energy, metals, agriculture, gold, biotech, infrastructure, and domestic companies with strong foreign sales. As the US economy slows, equity investments may come under pressure, and our favored sectors will sell off with the broader stock market. This will present a buying opportunity, much like we have taken advantage of over the past five years to enhance client returns.

Our results year-to-date for equity portfolios we manage based upon our investment strategy have returned on average 24.74%, far surpassing the return of the S&P 500 Index. If you are one of our clients, we sincerely thank you for your business. If you are not currently a client, we would love to help you achieve your financial goals. Please call Mark Ballard, John Clausen or Andy Thorman at (217) 351-2870 to get started.