INFLATIONVILLE

BIG PICTURE – Today, the economic news is scary and investor sentiment is awful. Therefore, if you are a long-term investor, this is the time to be greedy. Remember, when it comes to investing, nervousness is your friend, comfort your enemy.

There can be no doubt that the developed world faces some serious funding problems and yes, parts of Europe are in trouble. However, this does *not* mean that the long-term outlook for all businesses is dire. Quite the contrary; several companies are announcing superb operating results and they are trading at reasonable valuations. And over time, the market will surely recognise the expanding earnings of these businesses.

It is worth noting that a stock is a claim on the long-term cash flow of a company and as long as the underlying earnings are rising, the price of the stock will eventually reflect this reality. At least this is how the financial markets have worked since the beginning of time and there is no reason to expect a different outcome in the future. Accordingly, despite the exaggerated market volatility, we are staying faithful to the vast majority of the companies in our portfolio.

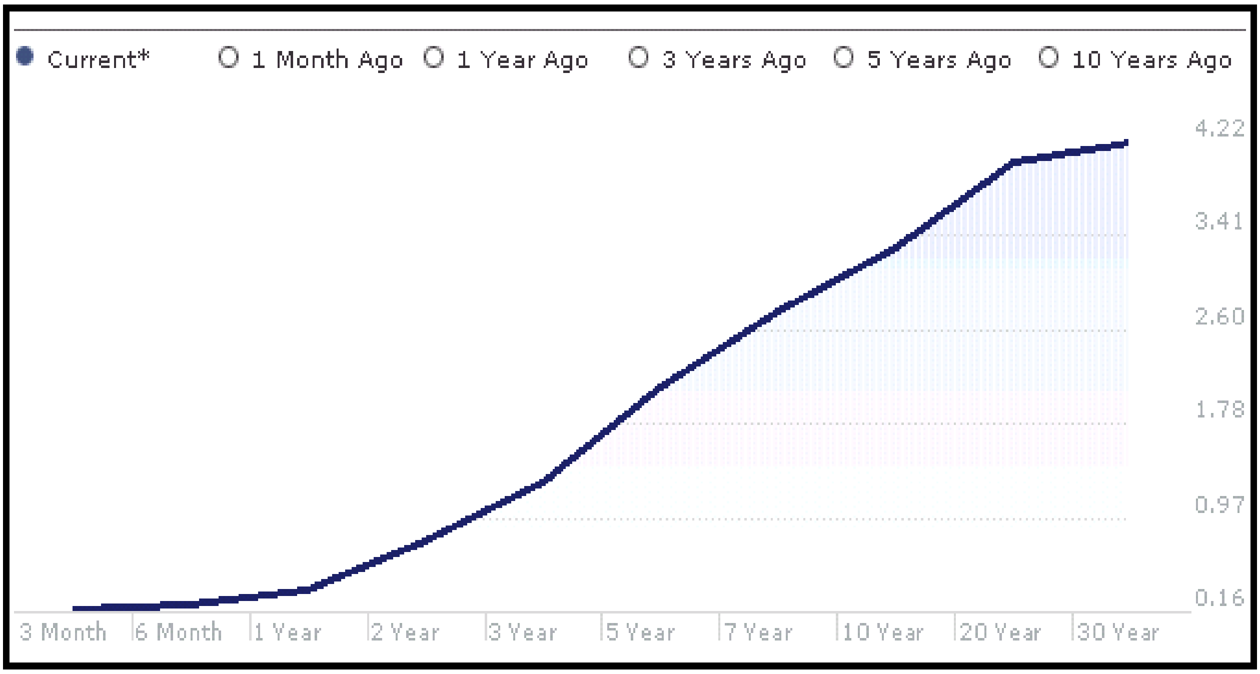
Now, given the state of the developed world, we are convinced that deficit-spending, quantitative easing and monetary inflation will intensify over the following years. Needless to say, these endeavours will further diminish the purchasing power of each unit of money, thereby causing the general price level to escalate. Under this scenario, a steadily growing earnings stream from sound companies should provide better investment results than the fixed income stream provided by cash or debt instruments.

Let there be no doubt, all the stimulus packages announced over the past two years are highly inflationary and throughout history, fiscal deficit-spending has always been followed by higher taxation. After all, governments do not earn any money from their own productive efforts. Instead, all their spending efforts are ultimately financed by the public. In order to fund the increase in spending, occasionally the governments raise the tax level but more often than not, they levy the most insidious form of taxation – inflation. The reason governments choose the inflation tax is due to the simple reason that this form of taxation is covert and does not result in widespread resentment.

Today, politicians are running monstrous deficits and they are inflating the money-stock like there is no tomorrow. Unfortunately, without realising the longer-term ramifications of these bailouts, the short-term oriented masses are applauding this mindless inflation. Regardless of the consensus view, it is clear to us that under the guise of 'stimulus', the policymakers are in fact confiscating private-sector wealth and steering the global economic ship towards Inflationville. Finally, it goes without saying that this reckless inflation of the money-supply is disastrous for those who have their nest eggs in cash or fixed income assets. Allow us to explain:

At the time of writing, the yield available on short-term cash is near-zero and a 30-year loan to the US government provides an annual yield of 4.2% (Figure 1). Now, although it is true that both cash and Treasury Bonds are 'risk-free' assets (they guarantee the return of capital in nominal terms), in an inflationary environment, they are not viable long-term investments.

Figure 1: Treasury Bond Yields



Source: Morningstar

For starters, cash and fixed income investments are vulnerable to sudden currency debasement. More importantly however, high inflation poses serious problems for money lenders (bondholders). When the value of a currency deteriorates year after year, a security with income and principal repayments denominated in that currency is not going to be a star performer. Surely, you do not need to be a brain surgeon to figure this one out.

During an inflationary era, instead of cash and fixed income securities, what you want is an asset which will either benefit from currency deterioration or increase its earnings yield so that you can at least maintain your purchasing power. Hard assets (metals and energy) fall into the first category whereas companies with the ability to raise prices come under the second. Furthermore, it is our contention that over the next decade, businesses which are *not* capital intensive and still able to generate high returns on invested capital will provide the best growth.

Bearing in mind the above, we have invested our equity portfolio in world-class businesses across a wide spectrum of sectors. At present, roughly 30% of our capital is allocated to various energy companies and we also have exposure to healthcare firms, retailers, industrial manufacturers and other businesses with favourable long-term economics. Figure 2 provides a snapshot of our equity portfolio and confirms that on a weighted basis, our companies are trading at less than ten times earnings. This represents a 39% valuation discount compared to the S&P500 Index. Moreover, as you can see, our equity portfolio is projected to produce 5-year earnings growth of 14.43% per annum, which is 1.54 times the 5-year projected earnings growth for the S&P500 Index. Last but not least, Figure 2 reveals that our companies generate a higher return on assets than the S&P500 Index; a major plus in this inflationary environment.

Figure 2: Fundamentals of our equity portfolio

	Your Portfolio	Relative to S&P 500		Your Portfolio	Relative to S&P 500
Price/Prospective Earnings	**9.36**	0.61	Projected EPS Growth - 5 yr %	**14.43**	1.54
Price/Book Ratio	**2.07**	1.00	Yield %	**1.13**	0.60
Return on Assets (ROA)	**10.69**	1.50	Average Market Cap $mil	**11,801.67**	0.26
Return on Equity (ROE)	**19.03**	1.03			

Source: Morningstar

In summary, despite the prospects of superior earnings growth, our equity portfolio is currently trading at a *significant* valuation discount when compared to the broad market. Therefore, we firmly believe that our deeply undervalued holdings are likely to outperform the broad market over the following years.

Apart from running our equity portfolio, for our smaller accounts, we also manage a fund portfolio whereby we allocate capital to our preferred investment themes via the best externally managed funds. At present, our fund portfolio is invested in our favoured macro-economic themes such as developing-Asia (China, India and Vietnam), precious metals mining stocks and energy (crude oil producers and renewable energy).

In our view, the fast-growing economies in the East are likely to provide leadership and their stock markets should produce stellar growth. Amongst our preferred Asian markets, both China and Vietnam are currently on the bargain table and long-term investors should consider adding to their positions. Once the ongoing consolidation has run its course, both these stock markets are likely to appreciate, perhaps significantly.

Look. We are aware that the global economy faces many challenges and investor-sentiment is horrendous. Furthermore, we also recognise the fact that many prominent pundits are now calling for a chilling deflationary winter. According to the bearish camp, stock markets are on the verge of a collapse, paper money is about to disappear and entire nations are almost insolvent.

As much as we sympathise with these dire forecasts, we continue to believe that we are in a multi-year bull-market. In our opinion, when it comes to investing, monetary policy is the single most important factor and as long as interest-rates remain suppressed, asset prices are likely to continue their north-bound journey. As sure as night follows day, at some point in the future, interest-rates will rise and the monetary backdrop will (once again) become hostile towards 'risky' assets. When that happens, we will amend our investment strategy and re-position our clients' capital. However, for the next several months at least, we expect the monetary conditions to remain asset-friendly.

ENERGY – Without a doubt, the oil spill in the Gulf of Mexico is an environmental disaster. Unfortunately, as far as the global economy is concerned, Mr. Obama's six-month moratorium on new offshore drilling is an even bigger disaster.

Remember, the supply of crude oil is already struggling and in order to offset the ongoing depletion, the world desperately needs to find new oil-fields. Thus, by stopping new exploratory drilling in the Gulf of Mexico, the US establishment is wasting precious time.

Look. Crude oil is the lifeblood of the global economy and it is notable that over the past decade, most of the new oil-fields have been discovered offshore. Today, an increasingly large proportion of crude oil is produced from offshore fields, so banning new exploration in the Gulf of Mexico is a bad idea.

In a recent interview, the International Energy Agency's (IEA) Executive Director – Mr. Nobua Tanaka opined, *"The future potential for oil supply is offshore in deeper water and in the Arctic, so if offshore investment is going to be slowed down, that is a concern."* He added, *"We have to learn from the accident and we need a good supply from offshore in the future."*

For the first time ever, we are in total agreement with the IEA. After years of research, we know that ultra-deep offshore oil is our only hope to combat 'Peak Oil'.

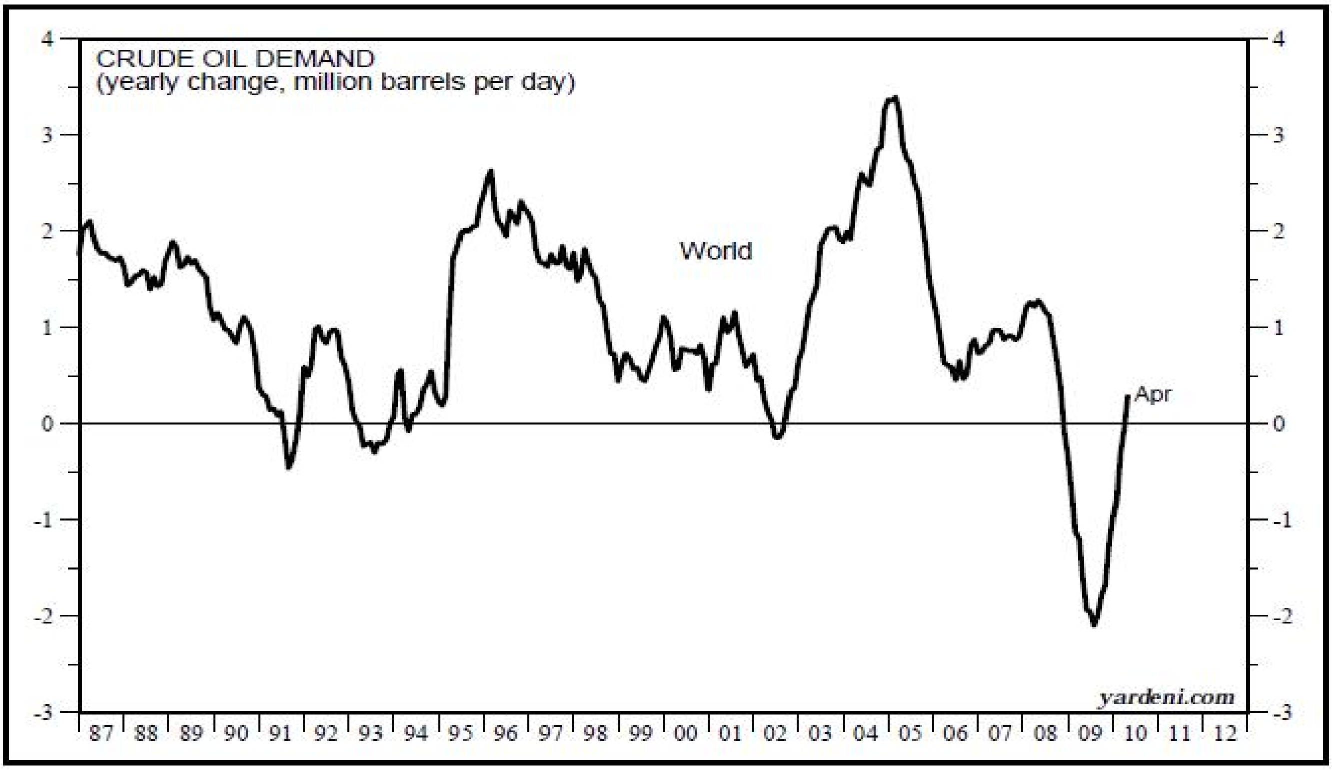
Yes, the Deepwater Horizon incident is an environmental tragedy but we should be realistic here. Given the unbelievable complexities of offshore oil exploration and production, the occasional accident is bound to happen. So, instead of punishing the energy industry, we should in fact remain grateful that such accidents do not happen more frequently. The truth is that the energy industry produces 86 million barrels of oil per day and it does so from *extremely* complex oil-fields. Therefore, rather than pointing our fingers towards the energy companies, we should all be thankful that such disasters are rare and isolated events.

In any event, the recently announced moratorium on new offshore drilling will further reduce the supply of crude oil. More importantly, if Mr. Obama's administration gets very tough with BP, then the other oil companies may think twice before attempting to tackle technologically-challenging projects. After all, if the risk of political backlash was high, why would any oil company take on a complex project in a new frontier? So, whichever way you look at it, the recent developments in the US are likely to depress future oil-production.

It is worth noting that in its 'World Energy Outlook 2009' report, the IEA confirmed that in order to meet energy demand in 2030, the world needs to invest a staggering US$26 trillion over the next 21 years! Well, given the reluctance of banks to lend, the suspension of exploratory offshore drilling in the Gulf of Mexico and the growing political angst, it is clear that capital spending will fall short of the required amount. Undoubtedly, this lack of adequate investment will further dampen future supplies.

As far as global oil usage is concerned, it is noteworthy that demand is on the rise again. Figure 3 shows that over the past twelve months, worldwide consumption of oil *increased* by roughly 500,000 barrels per day. This is an impressive feat when you consider that oil consumption in the developed world is still under pressure.

Figure 3: Global oil-demand is rising



Source: Ed Yardeni

Whether you like it or not, oil demand is surging in the developing world and this trend is likely to remain intact. Despite the economic problems in much of the developed world, the developing nations are burning more and more oil for the following reasons:

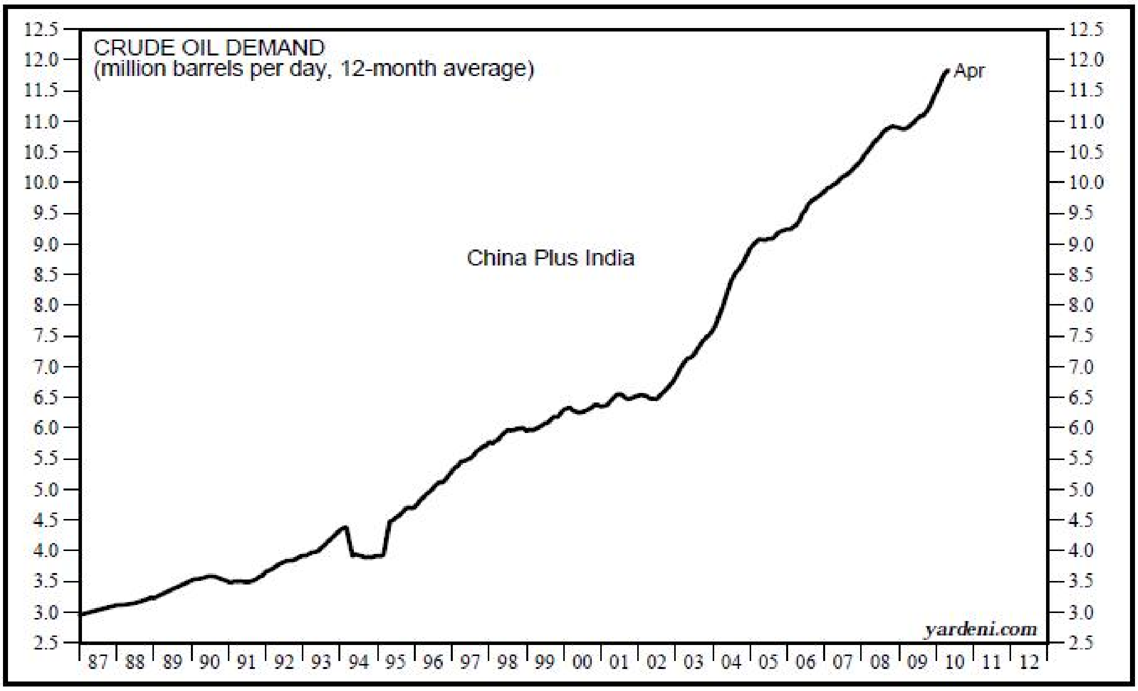
- Heavy government subsidies
- Extremely depressed per-capita consumption levels
- Expanding middle-class
- Growth in automobile-ownership
- Robust industrial activity and rising domestic consumption
- Massive public-sector spending on infrastructure (railways and roadways)

It is our contention that none of the above factors are likely to disappear anytime soon. Moreover, when you take into account the size of the population in the developing world, it becomes clear that if the supply permits, worldwide demand for energy will continue to rise for decades.

If you are still sceptical and have any doubts, Figure 4 should put them to rest. As you can see, the combined oil-consumption in China and India is at a record-high. Today, these nations' combined oil-consumption comes in at roughly 12 million barrels per day (14% of global usage) and what is really astonishing is the fact that demand has doubled over the past decade!

Finally, it is worth noting that over 2.3 billion people reside in these two Asian nations and most of them still do not own automobiles. So, as these people climb up the prosperity ladder, demand for energy in these two countries will continue to appreciate.

Figure 4: A third of the world is thirsty for oil



Source: Ed Yardeni

Bearing in mind these facts, one can safely state that demand for oil will continue to rise in China, India and other parts of the developing world. More importantly, given the sheer number of people in Asia, Latin America and the Middle-East, the demand growth from these developing countries will most probably offset the declining demand for oil in the developed world.

In summary, apart from short-term setbacks during recessions, global demand for oil will continue to rise. On the other side of the ledger, the ongoing depletion, lack of new discoveries and cutbacks in capital spending will put a firm lid on oil supply. Last but not least, when you take into account the ongoing debasement of paper money, it becomes obvious that the price of crude is set to rise, perhaps remorselessly.

After considering all the data, we maintain our view that as long as the global economy is in an expansionary mode, the price of oil will surprise to the upside and top-quality energy companies will announce outstanding operating results. Accordingly, every investor should consider allocating some capital to the energy complex.

PRECIOUS METALS – Let's face it, central banks are creating paper money as fast as the world is producing carbon dioxide emissions. Unfortunately, as the pace of monetary inflation is accelerating, the value of paper money is being destroyed all over the world. These days, the solution to every economic problem is even more money-creation and ironically, these crimes are supposedly being carried out in the best interests of society!

Make no mistake, the creation of new money is theft, pure and simple. This is so because each newly printed Euro or Dollar undermines the purchasing power of the existing money-stock. In other words, when any central bank brings new money into existence, every person with savings in that currency automatically loses purchasing power.

Remember, money which you have saved is a claim on the future output of other people. Thereby, in the act of saving a portion of your current income, you are deferring consumption and in an ideal world, your savings should then be able to buy you the same amount of goods and services at a future date. Allow us to explain:

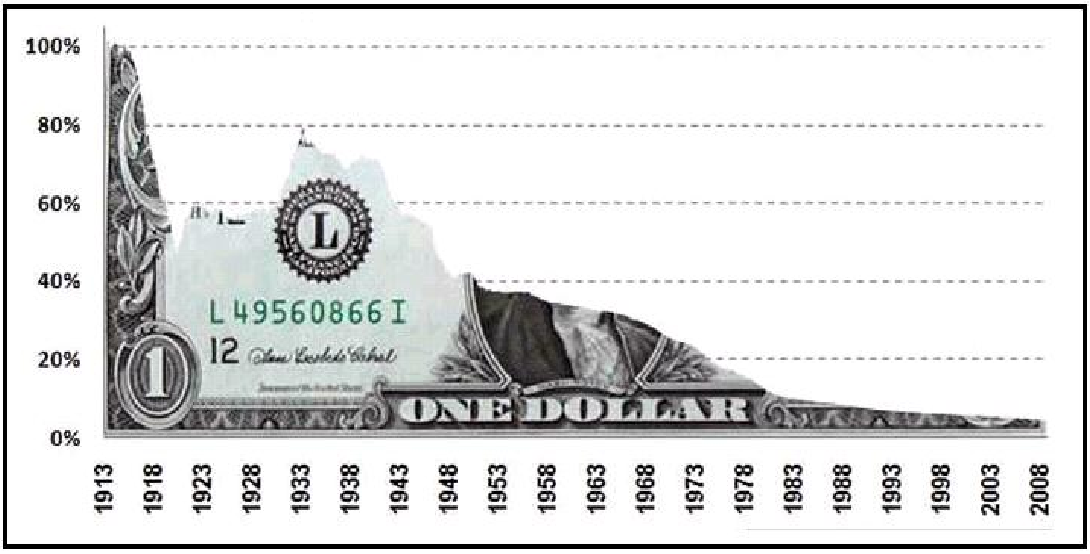
Suppose your monthly income is $500 and this month, after paying all your bills, you are left with $20. Now, you can either spend this surplus money today by buying your favourite shoes for $20 or you can save this money with the intention of buying the same pair of shoes a year from now. After all, money is meant to be a store of value (or so you assume), therefore the money which you save today should be able to retain your purchasing power.

Unfortunately, under a fiat-money system, whereby central banks create new money out of thin air, each unit of money does not retain its purchasing power. So, in a year's time, when you try and buy your desired pair of shoes, you may find that your savings may no longer be sufficient to afford them. Put simply, this confiscation of purchasing power is the real tragedy of the fiat-money system.

Due to the vagaries of monetary inflation, no amount of money is ever 'enough' and it has become impossible to plan for the future. After all, given the money-creation going on all over the world, how can you accurately predict how much savings you will need to sustain your lifestyle after retirement?

Figure 5 highlights the horrors of central bank sponsored monetary inflation. As you can see, since the inception of the Federal Reserve in 1913, the Federal Reserve's currency (US Dollar) has lost roughly 97% of its purchasing power! In plain English, what this means is that money saved a century ago is now almost worthless.

Figure 5: US Dollar's purchasing power since 1913



Source: Bureau of Labour Statistics

Turning to the present situation, the debt overhang in the West is so large that you can bet your bottom dollar that monetary inflation will accelerate over the following years. This confiscation of savings will be carried out via fiscal deficit spending and quantitative easing (outright purchases of assets by newly created money).

In our view, there is no way that the politicians and central bankers who run the world will suddenly have an epiphany and stop creating money. In fact, they cannot stop the inflation because if they start pursuing sound monetary policies, credit will collapse, banks' profitability will take a big hit and governments will be kicked out of power. And no self-serving banker will shoot himself in his foot and no politician will make unpopular decisions. Therefore, we are convinced that extremely high inflation lies somewhere ahead and savers are about to be taken to the cleaners.

Given our above prognosis, we maintain our position that every investor ought to allocate perhaps 10% of their capital to precious metals. In our contention, as the desperate acts of monetary inflation intensify over the following years, paper money is bound to lose further purchasing power against precious metals such as gold and silver.

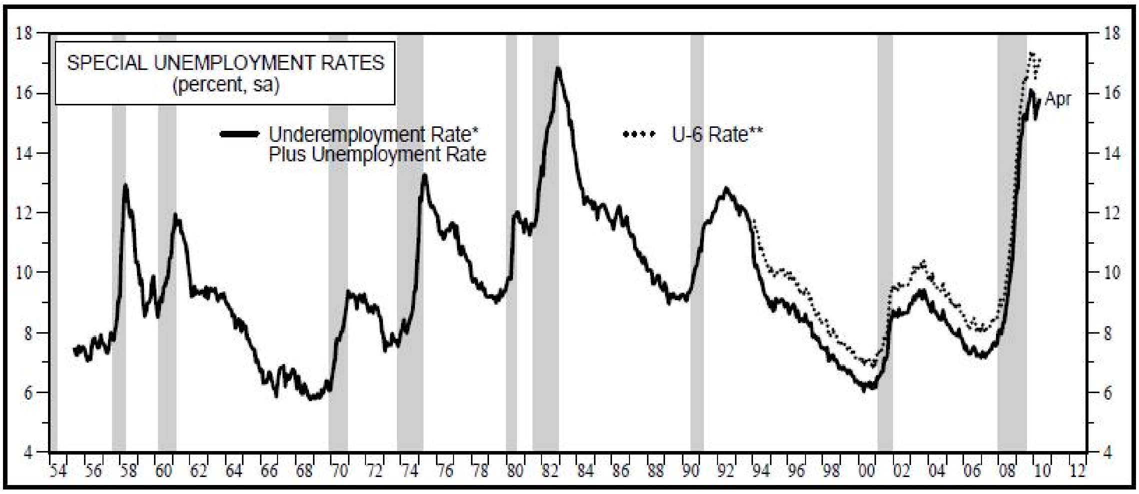
For ultimate safety, physical bullion is appropriate. However, those who seek a real return above the rate of inflation, should consider allocating some capital to unhedged gold and silver producers. As the prices of gold and silver appreciate due to currency debasement, the miners' profitability should sky-rocket.

Even though we are optimistic about the longer-term prospects of precious metals, we must mention the possibility that the prices of gold and silver may decline over the summer months. Throughout the course of this decade-long bull-market, precious metals' rallies have fizzled out in spring and this year may not be any different.

INTEREST-RATES – In the business world, the cost of capital is the single most important variable and the value of every asset is determined by the interest-rates across various maturities. When interest-rates are low and credit is abundant, the value of every asset appreciates. Conversely, when interest-rates are high and credit is scarce, every asset deflates.

At present, short-term interest-rates are exceptionally low in most nations and the yield on cash is poor. Historically, such benign monetary conditions have spawned big rallies in asset prices and this episode is no different. Now, given the high unemployment rate in the US (Figure 6), it is unlikely that the Fed Funds Rate will rise anytime soon. Therefore, despite widespread unemployment in the world's largest economy, the value of 'risky' assets (stocks and commodities) should continue to appreciate for the foreseeable future.

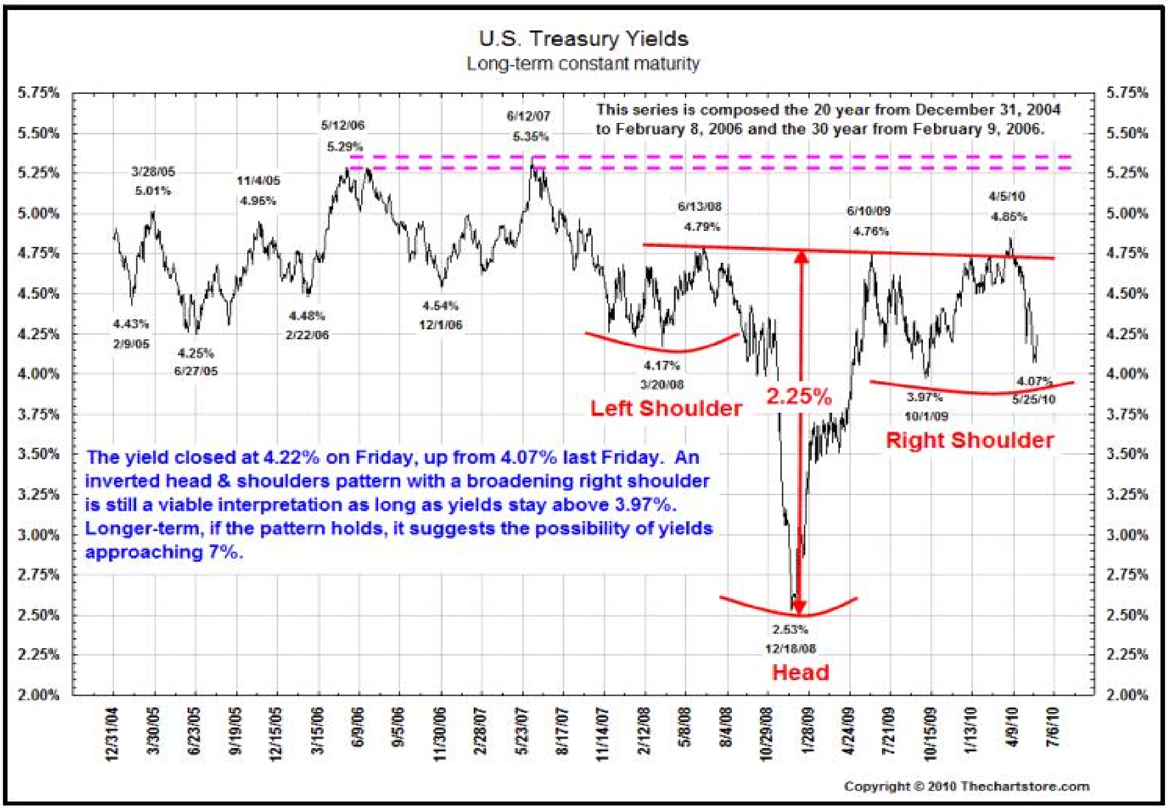
Figure 6: US economy plagued by high unemployment



Source: Ed Yardeni

As far as long-term US interest-rates are concerned, we are of the belief that the yield on the 30-Year US Treasury Bond bottomed out in December 2008. Conversely, the great bull-market in US government debt may have breathed its last during the height of the credit crisis. Figure 7 (see next page) shows that after making an important low in December 2008, the yield on the 30-Year US Treasury Bond has been drifting higher.

Figure 7: US government bonds – a new secular bear-market?



Source: www.thechartstore.com

It is notable that due to the ongoing Euro-zone debt worries, the yield has recently come down somewhat but it is still significantly above the low recorded in December 2008. Now, given the horrendous debt problems facing the US and the looming inflation, we expect long-term interest-rates to rise over the following months. Accordingly, now may be a good time to lighten up on long-dated US government debt..

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