

Our Macroeconomic View – What's Happened

The world has changed forever.

The world economy changed forever on July 17th, 2007.

On that day, when Bear Stearn's \$642 million HGSELF (*High Grade Structured Credit Strategies Enhanced Leverage Fund*) was declared worthless in a letter to investors, a new world began for investors and

Managing your business and investments has never been tougher.



business managers. The meltdown led to the failure of Bear Stearns itself months later, but more importantly, the great unwinding had begun. A 25-year pattern of steadily increasing financial leverage and unparalleled gains in the value of stocks, bonds, and other "paper" assets relative to real

assets had ended.

Secular, not cyclical forces are likely to dominate the next few decades.

But it isn't just the value of mortgages and 401(k)s that are in peril – the capitalist foundation of our entire economy has been under attack during the past two years of unprecedented government intervention in the economy and private markets. We can debate whether these actions represent foolish meddling after a predictable disaster or a bold and necessary step to save our economy from a random market disruption. But what is harder to debate is that secular macroeconomic forces are likely to play a much larger role in investing and managing a business in the coming years than the traditional cyclical microeconomic forces. How effective is a market-research-driven price increase of 3.5% when an abrupt 10% currency change or the bankruptcy of a huge customer undermines your profit strategy? Macro, not micro, is often most critical strategy to success in the current environment.

Both inflation and deflation are risks in the current environment.

Much current debate exists as to whether deflation or inflation is the risk in the current environment. In our view the answer is both – the tough question is whether these two will happen *sequentially* or *simultaneously*. We will likely have deflation as a U.S. debt and asset bubble of a magnitude the world has never seen continues to implode. At the same time, the massive quantitative easing and fiscal policies of nearly all governments around the world will combine with the rapidly expanding emerging market middle classes to cause a surge of inflation.

Our Macroeconomic View – What’s Next

There is an old joke that economic forecasting was designed in order to make weathermen look more accurate. That said, in our view it’s impossible to help businesses plan or ask investors to put up capital for investments without a plausible perspective on the future of the U.S. economy and markets. Despite the recent enthusiasm, the **outlook for U.S. equity markets remains highly uncertain**:

The Good News ("Green Shoots")	The Not-So-Good News
<ul style="list-style-type: none"> ● Subprime Mortgages Bottoming ● Mid-Low End Home Price Declines Slowing ● Slowing Rate of New Jobless Claims ● Growing Exports ● "Cash for Clunkers" Pop in Auto Sales 	<ul style="list-style-type: none"> ● Consumers <ul style="list-style-type: none"> ○ Non-Stimulated Spending Still Very Weak <ul style="list-style-type: none"> ▪ Growing Savings Rates ○ No Job Growth/High Structural Unemployment ○ Housing Price Declines Moving to Higher End Properties <ul style="list-style-type: none"> ▪ ARM and Alt-A Refinance Problems ▪ Growing Home Foreclosures ● Businesses <ul style="list-style-type: none"> ○ Impending Commercial Real Estate Crisis <ul style="list-style-type: none"> ▪ Weak Retailer Sales and "Dead Malls" ○ Weak Business Spending and Low Credit Availability ● Financial <ul style="list-style-type: none"> ○ Great Deleveraging Only 30-50% Complete ○ Shadow Banking System Still Frozen <ul style="list-style-type: none"> ▪ GSEs Are Sole Functioning Securitization Market ● Politics <ul style="list-style-type: none"> ○ Demonization of Capitalism <ul style="list-style-type: none"> ▪ More Regulation ○ Huge Deficits and Higher Taxes <ul style="list-style-type: none"> ▪ \$2 Trillion Deficit in 2009 ▪ Cap & Trade Energy Bill ▪ Government Health Care Program

We certainly hope for investors’ sake that the recent improvement in the markets does not turn out to resemble the 50% rally in the spring of 1930. That rally faded when the market realized that it had “baked in” far more growth than was actually likely for some time.

The U.S. economy will face “secular headwinds” for many years to come and it is possible that traditional equity investments may move sideways even if they do not move down. U.S. fiscal policy may well remain stimulative long after most of the rest of the world returns to a more normal interest rate structure. **We believe the interest rate and growth rate differential between the U.S. and the rest of the world will impact U.S. dollar strength and ultimately drive inflation higher.**

We are focused on the **commodity, agriculture, food, and green energy sectors (CAFÉ)**. It’s important to note that inflation can occur in these sectors even if the U.S. economy is weak. Nearly all these sectors are produced and sold globally yet priced in dollars. CAFÉ inflation could happen simply as a consequence of a weak dollar.

Where will the wave of liquidity being unleashed in the U.S. and around the world go? Certainly in the short term to pay down debt and cover losses, which is why we currently have mild deflation despite the incredible stimulus investments. But ultimately when debts reach manageable levels this liquidity will look for a home.

The “liquidity inflation” options:

Sector	Inflation Potential	Rationale
Buildings and Equipment	Unlikely	Currently, very low capacity utilization and lots of excess capacity that will need to be “soaked up”
Higher U.S. Wages	Unlikely	Blue collar workers around the world are likely to see higher wages in dollar terms but will still be significantly below the U.S. - this will continue to pressure U.S. wage and income gains
Residential Real Estate	Unlikely	A generation chastened by a massive housing meltdown and will be highly cautious before embracing another one
Commercial Real Estate	Unlikely	A huge deleveraging is underway and excess capacity is likely to persist for some time
Commodities/Ag/Food/Energy	Highly Likely	Priced in dollars and relatively liquid; in demand globally, especially in developing markets with growing middle classes

So what if we are wrong and monetary and fiscal policy does not result in significant inflation in the CAFÉ sectors in coming years? The answer is simple – the 95% of most investors portfolio that remain in traditional stock and bond investments should do very well and a 5% allocation to these sectors will represent only a modest drag on portfolio performance. But if we are right the diversification that a modest allocation provides could significantly offset potential weakness in traditional investments.

Understanding the macro options for the US economic growth and inflation is key to deciding whether an investment in CAFÉ sectors is warranted. We see four distinct potential economic scenarios in coming years:

1. **“GEM” (Global Economic Meltdown)** – While still possible, we think a synchronized and protracted global economic downturn is increasingly less likely. **20% Odds**
2. **“Japan”** – The U.S. economy mimics that of Japan from the 1990 to 2008 with nearly two decades of weak growth. A key difference will be that in contrast to Japan, which has experienced periodic bouts of deflation, the U.S. will experience moderate inflation driven by a steadily weakening currency – the downside of being the world’s reserve currency. **30% Odds**
3. **“That 70’s Show”** – Like the U.S. experienced in the 1970’s, strong global demand for commodities from emerging markets (especially Asia) will drive commodity prices dramatically higher despite weak U.S. growth – look for a return of Carter’s “Misery Index”. **35% Odds**

4. **“Reflation”** – The economic equivalent a successful “Hail Mary” pass, global central banks will stimulate a synchronized global recovery and deftly remove excessive monetary stimulus before inflation takes hold. High growth rates will push commodity prices higher. **15% Odds**

Scenario	US Growth Rate	Global Growth	US Dollar	US Inflation
GEM	Low	Low	Stronger	Low
Japan	Low	Med-High	Weaker	Moderate
70’s Show	Low	High	Much Weaker	High
Reflation	Med-High	High	Slightly Weaker	Med-High

Of course, a possible outcome is some combination of these scenarios where some sectors of the economy may feel like “Japan” (e.g. commercial real estate) while other sectors (e.g. commodities) may feel like “That 70’s Show” and still others (e.g. industrial exporters) may experience “Reflation”.

In short, the future has rarely been more uncertain. Businesses could have a highly challenging time if they rely on microeconomic strategies alone. Investors who stick with a 60/40 stocks/bonds portfolio may experience additional pain, since inflation is not kind to either asset class.

Building (and investing in) robust private businesses in the commodity, agricultural, food, and green energy sectors (CAFÉ) is likely a great hedge for the coming years. A modest 4-7% allocation to these sectors can significantly improve portfolio performance if a high inflation environment develops.

Business managers need to build macro strategies to supplement their micro playbook, since most have spent the overwhelming majority of their careers managing in the past 25 years of benign inflation, low interest rates, and exceptional economic growth.