



FINANCIAL ADVANTAGE, Inc.®
for a better life®

The *Blue Sheets*®

Our quarterly commentary on the economy and securities markets

Summer 2006

Bling-Bling and the Optimist (Part I)

Murph's big meeting

As he wheeled back from his big, cluttered desk, George Murphy looked a gruff sort of character with unkempt, bushy gray hair topping a six foot frame lavished with twenty surplus pounds. A fixture in Wall Street's private dining rooms for over 50 years, Murph still manages conservative money from spacious but anachronistic offices on the 23d floor of the venerable Equitable Building in lower Manhattan. Over the years he has hosted dignitaries here, interviewed the reigning cognoscenti and grilled into discomfort a wide assortment of Warren Buffett wannabees.

This particular morning, Murph watched Consuelo, a young Guatemalan and probably the 20th ambitious immigrant to have cared for these rooms in as many years, to see if she had understood his broken-Spanish request to pay a little extra attention to cleaning today. Yes, the coffee tables were shiny, the knick-knacks looked orderly, and she was spray-polishing the cracked cushions of the old brown leather club chairs Murph had acquired from The NY Athletic Club during its last renovation. He was expecting company for the whole day and he wanted the place to look decent.

Last week, as trading slowed to a snail's pace the way it always does in late August, the old veteran had become particularly pensive. He'd spent hours alternately cruising the internet for fresh data and staring west through the slits in the skyline toward the Hudson river, mentally sorting and weighing dozens of scenarios, hundreds of securities and thousands of numbers. The more he sorted and weighed, and the more he compared the current environment with all the cycles he'd navigated over the years, the less conviction he had about the wisest way to structure his portfolios.

George Murphy was not used to indecision; it made him uncomfortable. He could usually size up the economic realities, scan the valuations of stocks and asset classes and place his bets with confidence. Even when the environment was hard to read, at least he knew how to hedge the risks.

But this environment felt different. The risks seemed more ominous; the opportunities more contrived. So Murphy decided to get some help.

He had invited two market veterans, old friends holding totally opposite world views, to spend an entire day together kicking around the data, and postulating future possibilities free from the scrutiny of kibitzers.

Signaling that she was about finished, Consuelo pushed the “on” button on the Mr. Coffee and looped the electric cord around the eight pound Oreck. “Muchas gracias, Consuelo”; Murph handed her his usual thank-you envelope and held the door for her as she wheeled her equipment into the corridor. “This will be a good day,” he thought to himself as he closed the door. Glancing around the office, he enjoyed the neatness and the lemon fresh aroma mingling with the smell of fresh coffee.

He knew it would be a fun day; he hoped it would also bring renewed conviction.

B.B and Rosy

First to arrive was Howard Graff, long-time publisher of Hard Assets, a gold and energy monthly with a serious intellectual flavor. The newsletter boasts more than 50,000 fiercely loyal subscribers who apparently share Howard’s skeptical view of the universe, especially of governments and government-sponsored currencies. Pulling in \$150 a year per subscription, Graff modestly calls Hard Assets a “nice business”.

In the late 1990s, when oil and bullion prices were bumping along the bottom of a 17-year bear market, Graff’s detractors from the buttoned-down stock and bond universe had sarcastically labeled him “Bling-Bling” after the hip-hop term for flashy gold jewelry. To everyone’s surprise, Howard actually liked the allusion and began to wear a 30” bulky gold chain around his heretofore unadorned neck; dangling prominently from the chain is a gold dog tag with the diamond-encrusted letters B.B., which is how Graff now signs his newsletters. Now that gold has tripled off its low, the Bling-bling thing has helped boost BB to celebrity status. Appearing as a guest on TV’s Mad Money one evening, Jim Cramer spontaneously greeted Graff with, “Booyah, BB!” He loves it!

Murphy, while doggedly contrarian as an investor, is a big believer in American capitalism, traditional with respect to his haberdashery, and politically conservative. BB, on the other hand, is a dour perma-bear, an in-your-face libertarian and given to linen blazers and splashy sport shirts. While these unlikely buddies were catching up, a knock at the door announced the arrival of the final member of the day’s brain trust.

Joel Rosen grew wealthy as a dot-com analyst in the 1990s and for the past 5 years has managed a \$1 billion private equity pool out of Silicon Valley. Still in his forties, though barely, Joel has never met a “concept” stock he didn’t like. He is widely read, smart and articulate, and in ten minutes will convince you that biotech and nanotechnology are almost certain to banish hunger and disease from the planet in ten years, that automation is driving the cost of manufacturing toward zero so the meanest wage-slave will soon be prosperous, and that stocks have never been cheaper. Media pundits have labeled him “Rosy” after the sort of glasses through which he is reputed to peer into the future. **Could it really be different this time?**

The three professional investors filled their coffee mugs and settled into the big leather club chairs around an oval glass table with brass legs shaped like tusks and heaped with assorted Danish and poppy seed bagels. “Fellas,” Murph began, “I can’t thank you enough for coming into town to spend the day with me. As I explained in my email, I am having an unusually difficult time reconciling economics and valuations into a satisfying investment strategy. I feel like the patterns and cycles I have experienced over the years do not match up very well with everything that’s going on. We all know that serious investors get nervous when someone says, ‘It’s different this time.’ But I have to say, it sure *feels* different.”

You both read voraciously, so I am sure you are aware of all the unlikely pairs of data that I am seeing; combinations you wouldn’t expect to see concurrently. You know, like:

- low unemployment co-existing with stable inflation;
- 90-day yields the same as 30 year yields;
- small cap stocks soaring along with oil and gold prices;
- US Treasuries yielding more than Euro bonds;
- Russia and Brazil paying off their IMF loans while the US trade deficit gets bigger every year;
- house prices doubling while wages stagnate.
- And then there’s the stock market yawning at frightening geopolitical news... terrorist

bombings, invasions, nuclear threat mongering, oil-as-weapon policies.

What do you guys make of all this?

Rosy, do you really believe that technology can earn a high return on capital in a volatile, dangerous world threatened by mad dictators? In a world where most demand growth will be in centrally-planned economies that disrespect intellectual property rights? In our own country aging consumers keep piling on debt to buy stuff; what's the limit? Now housing starts are down 21% year to date... is this the start of a recession? Could it be a whopper? And how do you figure that stocks are cheap when they sell at 16 times peak earnings vs a history of maybe 9 times at cyclical peaks? How do you stay so optimistic?

And BB, you're the big inflation guru, right? And for a couple years oil and gold prices have been going your way. But don't you wonder why core inflation is still well under 3%, and why the dollar hasn't really buckled when we have trade deficits like a banana republic? Are you surprised that the world's central banks have actually been pretty responsible in managing money supply? Do you ever wonder if your gold philosophy is out of step with the computer age? And while terrorism would seem to play to your view that gold is a safe harbor in times of instability, all the bombings haven't really upset the economic apple cart, have they? Don't you ever wonder whether the scary guys are just fringe players and the heads of important nation states will find ways to compromise so they can provide some economic stability to their citizens and hold onto power? Even the thugocrats understand "bread and circuses" don't they? So maybe it doesn't all blow up.

You two are good thinkers. Your research is thorough. But you almost always come to opposite views of the future. So I thought you are just the right guys to help me work out how to defend my clients' estates while pursuing opportunities like a good capitalist.

I propose we have BB give us the bad news first, while we interrupt for clarity. Then Rosy, you can tell us why everything is gonna be alright while we try to test your enthusiasm with a few worries. Does that work for an informal agenda?

The two guests shrug their shoulders, and their expressions suggest, "Sure; why not?"

The world according to Bling-Bling

BB: OK. You guys are a couple of real Pollyannas; but I like you! So let me give you a well-meaning wakeup call.

Hello!! This is not 1945, the dawn of America's golden age! It's a very different world and our dear United States is fast losing control of its destiny. The twenty-first century belongs to Asia. China & India are the story. Over 2 billion souls yearning for a better life that they can legitimately aspire to for the first time in history. Armed with increasing technical competence, they are producing manufactured products and services cheaper and often better than we can. I know, in China people are not really free, and India's political structure is definitely clunky. But they are growing two to three *times* as fast as we are! There's information in that.

To make matters worse, we need them more than they need us. We are closing down factories because WalMart refuses to pay domestic prices. We are exporting good service jobs to India, creating a growing consumer economy there. And every year our government and personal debts grow faster than our economy; total debt is now more than three times our GDP! That's not to mention something like \$75 trillion of unfunded liabilities for Medicare, Medicaid and Social Security. Somewhere there's a limit to our credit boom, and it could be around the corner. Former Fed Chief Paul Volker bemoans the prospect that government won't deal with it, so it will eventually be settled by a financial crisis.

Each year our trade deficit plunges us \$700 billion deeper in hock to our overseas suppliers. So far they kindly lend it back to us by investing in our bonds and stocks. That's kept our currency afloat, but my

guess is a reversal is right around the corner; this July, our foreign capital inflows were the lowest in over a year. When the dollar goes, Katie bar the door!

Rosy: OK, BB, so we're supposed to buy Chinese stocks because there's 1.3 billion of them and they all wanna eat more chicken, drink Chinese cola, talk on cell phones and watch Indian movies on a big screen TV. Aren't you forgetting that US companies are the world standard in marketing and branding and retail distribution. Are we supposed to imagine that the Communist party bosses are a bunch of Jack Welches in funny jackets?

BB: Aw, c'mon, Rosy. We all know China's still a Communist country. And we know probably half their bank loans can never be paid back, and they aren't real great at honoring intellectual property rights. So I don't want to own their stocks, either. But you don't have to. You need to invest in the *consequences* of their growth.

Rosy: I know, hard assets, right?

BB: BINGO! Take oil for example.

Rosy: You mean the oil that's plunged from \$78 to \$62 in two weeks? That oil?

BB: Now don't get all myopic on me. We're not goin' back to \$10 a barrel, or even \$25. You gotta get the 1980s out of your head. See, the price spikes from 1973-1981 were due to politically contrived shortages; the Saudis withheld output from the market to inflate the price. In the several collapses of the '80s and '90s that excess production capacity came to market for various reasons; the cartel couldn't hold. Cartels never do. But the runup to \$75 this year has been due to an actual, legitimate, honest-to-God tight supply/demand situation; maybe a little extra for political risk, but hey, isn't that a permanent new reality?

Some of the world's biggest oilfields like Ghawar in Saudi Arabia, Cantarell in

Mexico, the North Sea, Alaskan slope, and the Permian Basin are in permanent decline. For almost 2 decades investment in exploration and production was very low because oil and gas prices didn't justify it. So now capacity is tight and the producers are in the driver's seat.

Along comes China thinking, "Hey, we need 10% more oil every year," or whatever. "No oil, no growth. No growth, millions of very unhappy farmers looking for work in the city. So, we gotta line up some crude or we'll have a revolution on our hands." So they're investing in oil fields all over the world with the billions of dollars we send them for microwaves and iPods; in return they're cutting long term supply deals with Iran, Venezuela, Sudan, Nigeria and the Canadians. (Notice that this is not a list of our dearest friends.)

With big chunks of *future* energy production being committed to the Chinese, the rest of the world will have to duke it out for whatever is left over! We are going to see a two-tiered market for oil, with us paying more than the Chinese who are out there making friends with our enemies.

Bottom line, oil prices will certainly be volatile because both supply and demand are inelastic in the short run. But it is a virtual certainty that the mean market price of oil and gas will keep rising over the next 20 years. Owning oil in the ground is the first way to play the unstoppable growth of China and India.

Rosy: Let me guess... the other way is gold.

BB: Rosy, I'm very encouraged! I think you're starting to get it!

Rosy: (*Rolls his eyes and purses his lips in an unmistakable smirk.*)

Philosophical basis of Gold as Money

BB: Here's the basic skinny on Gold. Very limited supply; growing demand drives up the price. PLUS... *nota bene*: this is the biggie... some very good reasons to think that demand will explode to the upside. And I mean *explode*!

Before explaining the supply limitations and the case for booming demand, I should start by mentioning for the uninitiated that the yellow metal has served mankind as the universally accepted medium of exchange and store of value since the memory of man runneth not to the contrary. (BB grinned, enjoying a chance to use this expression he learned in first year Law.)

To set the table, let me refer our august gathering to the observations of Alan Greenspan by paraphrasing his article in *The Objectivist* in 1966, before he was *somebody*. He said that money which is universally acceptable is the common denominator of all economic transactions. The existence of such a commodity is the precondition for a division-of-labor economy. If men had no means to store value, i.e. to save, neither long range planning nor exchange would be possible.

Whether the acceptable medium of exchange is gold, silver, seashells, cattle or tobacco is optional. All have served. Over time, gold has been the most acceptable medium because of its high value per unit of weight, making it very portable. And since it is relatively scarce and difficult to produce, it tends to hold its value.

Still, gold is clumsy as a form of exchange, which limits economic activity. A natural extension of gold's worldwide acceptability was the development of a banking system and credit instruments (bank notes and depositary receipts) which act as a substitute for, but are exchangeable into, gold. Because most depositors of gold into a banking system do not need to withdraw their bullion, it became possible to evolve

the modern fractional reserve system in which bankers may extend credit at an agreed upon *multiple* of their gold reserves.

To assure the wide acceptance of their bank notes in trade, thus enhancing economic activity, sovereign nations would agree to buy and sell gold at a fixed price in terms of their unit of currency, such as \$35 an ounce (Bretton Woods, 1946). From WWI to the early 1970s the modern world economy operated on a gold standard. In 1972, President Nixon ended the US commitment to buy gold at a fixed price, and no major economy has been on the gold standard since then. Rather, the value of our dollar and other currencies is established in the currency market; governments routinely participate in markets to influence the relative values of their currencies.

Currencies not backed by a gold exchange standard are often referred to as "fiat currencies" because their value as a medium of exchange is established by each government's ongoing decisions about the available money supply. This makes it possible for countries to devalue their currencies by printing more of it, which is an abuse of the public trust. From 1972, when the U.S. government ceased being obligated by law to exchange \$35 for one ounce of gold on demand, the gold price has soared 8.5% a year to \$600 an ounce this month. Looked at from the point of view of a currency holder, his medium of exchange has eroded by about 8% a year. What would you rather store your savings in, dollars or gold?

Rosy: OK, we'll agree that a fiat currency lets governments water down their paper, which makes it easier to service their national debt; and that's a bad thing for the creditors. But a dollar deposit can at least earn a few percent in interest to help offset the depreciation. Gold, on the other hand, is a sterile asset.

BB: You're right, of course. But look at it this way. In 1971, you own a \$35 bank deposit and an ounce of gold. If your bank deposit

or government security earned 5% for the next 35 years, it would now be worth \$193. Your ounce of gold would be worth \$600! That's more than three times the buying power of the interest-bearing government security.

So my first point is that owning gold, a widely accepted store of value, can protect you against the government's irresistible temptation to water down the value of its paper currency through inflationary policies. If inflation in currency terms should get even worse than it has been, the demand for gold and other hard assets as a store of value could ramp up. WAY up!

Rosy: So you think inflation, or currency devaluation, is going to get worse? What about Murph's observation that central bankers have actually been rather responsible, holding inflation to a manageable 2-3% range?

BB: Well, first of all I believe inflation is already worse than suggested by the government-sponsored inflation data (a case of the fox guarding the hen house?) especially by using fictitious rent figures rather than the actual cost of home ownership, not properly adjusting for the substitution effect, and bizarre hedonic quality adjustments. Several studies show the CPI understated by 1% or more.

Then, looking forward, the consensus believes that we will continue to have benign inflation because of the benefits of globalization... like buying Chinese microwaves for about 1/3 of the cost of domestic production. I would point out that the Chinese are beginning to experience strong cost inflation pressures because of the diminished availability of cheap state-sponsored loans, rising wage demands and soaring world commodity costs. Now that they have become the world's factory, making most of the microwaves, cell phones, computers, lamps and so forth, they are now in a good position to raise their prices to us; we've already closed the U.S.

factories and fired the workforce, so we are in no position to respond competitively! Mark my words; we will soon see surging prices for imported finished goods.

As we hear our Congress debating ways to "protect" us from Asian imports and to "protect U.S. jobs", I get more concerned that G7 nations may fall into a vicious circle of competitive currency devaluation; "beggar-thy-neighbor" policies designed to cheapen a nation's currency in order to decrease its imports and increase its exports at other nations' expense. Such policies have led to trade wars in the past, and to surging inflation. Competitive currency devaluations can be one of the most potent stimulants to gold demand because paper currencies are *serially* devalued! Recent data may provide a clue: this July private foreign investors bought just \$32 billion of Treasury paper, down from \$82 billion in June. But foreign central banks *increased* their purchases from \$2 billion to \$23 billion, perhaps to boost the dollar against their paper!

And finally, but most importantly, I observe the reality that elected governments (and their appointed minions, in case you operate under the illusion of an independent central bank) are more afraid of deflation than inflation. This is increasingly important as our society becomes more and more leveraged. You've heard me say before that total debt in the U.S. is now 315% of GDP up from about 150% that was the norm from 1940 to the early '80s. That's higher than ever, including the FDR years when the government was employing a huge percentage of the civilian population in the WPA, CCC and TVA.

In August of this year, Mr. Bernanke's Fed stopped raising overnight rates despite palpable signs of resurgent inflation. My take is that the caretakers of the money supply are more worried that a bursting housing bubble will take down the economy than they are worried about inflation. After all, the government has \$8 trillion of outstanding debt to service; a deep recession

would precipitate widespread defaults, shrinking credit facilities, a sharp drop in tax revenue and a devastating deflation that would crush borrowers and creditors alike. If necessary, “Helicopter Ben” will come to the rescue; I say, “Fear the helicopter!”

So I see fed-assisted inflation first, and then deflation and a financial crisis. Either or both could raise demand for gold bullion as an insurance policy.

Rosy: So that’s the demand story? Debt is out of control, and the Fed as an agent of government will be more inclined to keep the game going than to control inflation, right? So tell us about the supply side of the gold equation. Why won’t a rising gold price stimulate mining output and bring supply and demand back into equilibrium?

BB: That’s where the difficulty of increasing the gold supply becomes significant. The total above-ground stock of gold bullion is approximately 153,000 tonnes, worth in the neighborhood of \$1 trillion. For perspective the total market value of global financial assets is roughly \$70 Trillion. So even though bullion has been accumulating for thousands of years (nobody throws it away and it doesn’t rot), gold is a little bitty fraction of financial assets. Some 51% of all gold exists in the form of jewelry! The next biggest category is central bank reserves, about 19%. Then 16% is held for private investment, 12% industrial inventories and 2% miscellaneous.

In a typical year, gold mine production adds 2,500 tonnes (less than 2%) to the above-ground stock of gold in the world. Annual demand by the gold jewelry industry absorbs virtually this entire output! Other sources of gold that come to market in the course of a year include old gold scrap, around 800 tonnes, and central bank sales, running around 500 to 600 tonnes in recent years, but tailing off dramatically of late.

Will a higher price bring more mining activity? Yes, but to a limited extent. In

2004, gold mine production had the largest *decline* in 39 years despite sharply improving prices. It takes from 5 to as many as 10 years to bring a big new property into production because of the governmental negotiations, huge environmental obstacles, the remote locations of known reserves and need to put major infrastructure in place. The industry recently projected a 3% production rise in each of the next 3 years, then a long-term decline.

If it does turn out that Russia, Japan, China and others have decided to *increase* the percentage of their official reserves that consist of gold bullion, it is entirely possible that the annual *supply* of gold coming out of central banks could flip into annual *demand*... resulting in a net demand increase of perhaps 20% or 30% of the annual new supply! For perspective, imagine what would happen to the *oil* price if demand suddenly surged 20%!

Investor interest is the other really big potential positive for demand. In 2004 world-wide investment demand totaled about 500 tonnes. Today a single exchange traded fund (GLD) owns approximately 500 tonnes, all purchased in the last two years! The creation of this simple way (ETFs) for individual investors to own certificates directly representing gold bullion stored in the vaults of leading banks is certainly contributing to the overall investor demand. And rising prosperity in cultures that value jewelry as a store of value and evidence of family status (e.g. Saudi Arabia, India, China) is another long term stimulant.

Rosy: How do you value gold? I mean in 1971 it was \$35 an ounce, \$200 in 1975, \$800 very briefly in 1980; then \$275 twenty years later, and over \$700 earlier this year. Can serious people get involved in this commodity? What is gold worth?

BB: If I knew that, I would be a wealthy man.

Rosy: Gimme a break, BB! For a guy who was wrong for 20 years straight, you're doin' pretty well!

BB: Persistence, my man. Persistence is the key to success! Seriously, you have correctly pointed out that there is a huge emotional content in the market price of gold; much more than with securities, if you don't count bubbles like the one that put *you* on the map! I think the best way to value gold is against the buying power of whatever currency you are trying to hedge. We have seen how well it has done against the dollar since 1972. What about measuring against a market basket of real goods? There's an old saying that an ounce of gold should buy a first class suit of clothes. Nordstrom's website shows suits from \$495 to \$895, so on that measure there's more upside than downside!

The Dow Jones Average, at the peak of the 1960s bull market, equaled 25 ounces of gold; today it's 19 ounces. In 1981 when stocks were very cheap and gold very expensive you could buy the Dow for 3 ounces. If the DJIA should fall to 7,000, at that ratio gold would be over \$2,300! How about valuing gold against its own price history? The high in 1980 adjusted for CPI inflation since then is over \$2,000 an ounce! These approaches make the forecast of \$1,000 gold made by Newmont Mining (the largest producer) look downright tame! Summary: if we should revisit the sort of inflation and investment fears that were extant in 1980, which I believe there is every reason to expect, gold is a three- or four-bagger!

Murph: Well give me some of that! I don't know about you, but BB's bad news has me exhausted and hungry. Lunch at Harry's is on me!

For the Investment Committee:
J. Michael Martin, J.D., CFP
September 18, 2006

DJIA 11,555 S&P 500 1321 NASDAQ 2235 30-yr Treasury 4.92%

Don't miss Part II with Rosy's optimistic take on the world, and Murph's sagacious synthesis in the Autumn issue of the *Blue Sheets*!