THE GOOD OLD DAYS . . . . . WEREN'T

Doing it to excess has become the American way. Whatever it is – clothing, reality shows, horsepower or greed, we've refined it to an art form. We've had a tech stock bubble, a housing bubble, a credit bubble, an oil bubble and an ethanol bubble – all in less than 10 years.

The rapidity of these events leaves one with the dropping elevator feeling. . . . Will the cables hold? The rate of change of the rate of change is positive – for you math types.

And then there is the media drama bubble. Media from NPR to FOX seem to feel that loss, violence, greed and failure, sells. They are, of course, right. Two entire generations have been raised on 30-minute life segments where issues are all resolved just before the last commercial. How else could you hold such an audience save with drama?

Lost in all the noise from the two coasts are the daily lives of the fly-over people – people who work, pay, play and pray and could care less about Britney Spears' melt down. They are watching the housing problem, for example, in Sacramento or Las Vegas or Detroit, not in Columbia, Missouri or Des Moines, Iowa.

There are over 126,000,000 households in the U. S. I read that as many as 3,000,000 have the "potential" to default on their mortgages. Home prices that have tripled in the last 10 years have lost "1/3 to 1/2 of their value." Homes that, broadly speaking, rose 2% to 4% a year for the prior 50 or 60 years suddenly were expected to rise many times faster "because." The math is easy: Cut by 1/2 its value, the house that tripled still appreciated faster than inflation for the same time period. Since 1917 or so, the median home price for our great majority of workers was – and still is – 4 1/2 to 5 times their annual salary . . . . but the house has doubled in size. (House $189,000, salary +/- $39,000)

Over the last 25 or 30 years the high school educated worker in the non-managerial job – the "average guy/gal" has had to work 11 to 13 minutes at their job to buy a gallon of gas. If regular gas hits $5.00 a gallon, they will have to work 14 minutes. <u>That</u> is an inconvenient truth.

Entitlement used to be reserved for fourth-generation scions of families with buildings named after them, but has become, it seems to me, the disease of our time.

At this point, I suspect you are asking yourself what this all has to do with an outlook for the economy and thus the markets.

I believe the link is solid: The disgruntled, who feel they have been screwed by oil companies, the government, the banks and their employer, well, it would seem that their overdeveloped sense of entitlement might be clouding their thinking and causing them to long for the good old days . . . which never existed. Whine if you must for the rapidity of

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events or the fact that gas was slow to adjust to your increase in salary, but spare us the tales of how it used to be. This citizenry has never been richer, better fed and in better job potential than today . . . . and I won't mention all the toys we've accumulated.

Underneath all the media hype is an economy with two real problems – a weak dollar and irresponsible consumers. Yes, the financial stocks and housing stocks and auto stocks are being forced to close their doors and yes, their mis/mal/non-feasance brought it on themselves. They are a large part of the economy which, in spite of them, continues to grow, albeit slowly.

The dollar has fallen vis-à-vis the Euro, primarily because we all are viewed accurately, by the world, as a high-tax, poorly governed, debt-riddled society. If we raise taxes further or fail to reduce the corporate tax rate, the dollar will likely weaken further. The consumer, however, is getting it; consumer spending is cooling, house prices are trending back to normal levels and small revolts against tax increases are in the wind. The two political parties, however, aren't anywhere near it yet. Both candidates have an abysmal understanding of basic economics and the Fed – well – the Fed is fighting yesterday's war.

If the dollar was at parity with the Euro, instead of needing about $1.60 to buy that Euro, oil would be about $80 a barrel. Put less nicely, we brought this on ourselves and neither political party has the courage to say so and deal with it. As I see it, however, and to paraphrase Churchill – the end has begun. Foreigners have committed trillions to dollar-denominated U. S. assets because of the weak dollar. It's in their best interest to see the dollar strengthen . . . . and don't think they won't push for it. A too-weak dollar makes U. S. goods too cheap (a new thought) and foreign manufacturers will suffer local market share loss to . . . . us. The dollar is still the world currency in spite of its price – we still have the broadest, deepest legal and economic environment extant. I expect to see Asian currencies, in particular, continue to relax their artificially-set exchange rates . . . . mostly to protect their investments.

So we may fiddle in Congress and posture for the elections, but does anyone really believe that the countries who supply our oil (Canada being the largest single supplier) want us to cut consumption or find new energy sources when they have built whole lifestyles on our profligate ways? The final outcome, I believe, will be a fall in the Euro over the next very few months – from the $1.60 range to the $1.35 range. This will assist in a decline in the world price of oil as oil is traded in dollars.

There is no "shortage" of oil any more than there is a new higher level of demand that equates to $145 a barrel. Put another way, the price rise also reflects the expectation of higher prices, not a shortage of supply or abnormal new demand. Yes, China and India are subsidized consumers and at the margin are severely impacting demand. But China, in particular, is showing declining earnings estimates, a stock market off 50% from its high, much slower export growth and its leading economic indicators are substantially all pointed downward. The folks at ISI also point out that Olympic host countries show slower growth after the Olympics, i.e. Japan in '64 down 5.9%, Mexico in

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'68 down 6.0%, Canada in '76 down 1.7%, etc. The one exception to date was Germany in '72 with a positive 0.5% change in the year after. Did I mention China is showing inflation problems? Or that recent high demand for commodities was in part Olympic buildings – and roads – and hotels.

To my mind, the price of oil will adjust down for any combination of the following: 1) pressure for a stronger dollar, i.e. even some fiscal discipline from either party; 2) foreign investors' fear of further declines in the value of their (new) U. S. investments; 3) permanent tax cuts; 4) OPEC, et al, fear we may, in fact, start drilling offshore here; 5) Barbra Streisand realizes Obama wants a tax hike to put her, as a California citizen, in a 60% marginal income-tax bracket; 6) slower global growth as China slows severely in the next quarter or two.

Commodities, ex oil, is much the same story. There, however, farmers <u>can</u> increase supply in spite of higher fuel and fertilizer costs because the ethanol lobby has doubled the value of their corn crops. I expect by next spring to see farmers, miners, etc. increase production as profits allow room to work here-to-fore less efficient projects. In brief, the <u>supply</u> of commodities, ex oil, can be changed and it has already begun. This is the next bubble in the making, by the way, and is the precursor to a round of deflation . . . . more later.

A word about corn. The Kansas City Federal Reserve Bank made two observations worth knowing: "Just four cents from a dollar spent on a box of corn flakes goes for corn" and "labor costs (are) the biggest component of the retail food dollar." Those ads cost money – not the corn. (We are talking about sweet corn – field corn is animal food.) By the way – when you make ethanol you leave behind the corn oil and proteins – ethanol uses only the starch portion.

So we come to inflation and right now it is impacting the markets. No bell has rung, but I believe we are easing past the credit "crisis" with only some small regional banks left to blow up. Some investors are beginning to see past the slowdown and find early values. The CPI, however, is bothering many more investors. Recall that food and energy, although only about 23% of the index, is both seasonal and volatile. Wages have not accelerated, rents have not accelerated and food we've touched on. Consumers are cutting back on gas consumption, but not i-phones – so go figure.

It's about choices: Food consumed at home ($) is declining, food away ($) is rising. Per-user cell phone costs have risen from $210 in 2001 to $524 in 2006. Food ads sell sugar, high calories, fat, etc. and only 2% of ads promote fruit, vegetables and grains. We spend more, per capita, on TVs, sound equipment, etc. than we do on education. In this data are both opportunities for investment and opportunities for loss. It continues to be true: The top 20% of Americans, by income, consume more than the bottom 60% - yet we persist in speaking like the media . . . . of "average Americans" who are at risk of foreclosure, etc.

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The thought I hope that I've developed has two parts: Demand <u>is</u> influenced by price (the best cure for high prices is high prices – Econ 101) and we all make choices and complain when they don't work out. The working poor, who <u>do</u> have a legitimate complaint in direct proportion to their lack of choices, are not the subject of either candidate's rhetoric or my criticisms. Milton Friedman, way back in the 60s, put it something like this: Legalize heroin and marijuana, use the money saved in enforcing morality to give milk, fruit, beef and bread free to <u>anyone</u> who wants it and watch what happens to crime and children's nutrition.

So – the market ends up for the year, I'm a short-term bear on commodities, oil, the Euro and gold, but long term I do see, with global economic recovery in late 2009 or 2010 (which the markets will reflect before it happens), an ongoing, more normalized up trend in oil and commodities. It ain't back to $2.20 a gallon but it really hasn't changed in price. Focus on any news about the dollar – good or bad – as an indication. Watch for a Euro weakening (same result) from European malaise and renewed nationalism, to say nothing of slower growth. Expect inflation to cool this winter (sorry) as demand slows and supplies increase. Left to decide, for me anyway, is if a recession occurs in 2009 because we elected Obama.

By the way – next time the duffer at the pump next to yours blathers on about how gas used to be 20 cents a gallon, remind him he made (if he was lucky) $40 a week and had to work the same 12-14 minutes to buy his gallon of gas. The data is from the Commerce Department Bureau of Labor Statistics.

July 2008

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