Dear Readers

We are approaching 5 years of Quarterly Letters and I hope you enjoy something in each as much as I enjoy writing them.

Global economics have changed rapidly in that time, and the pace has become both quicker and more extreme. I began, a few months back, to write a Weekly Outlook because I felt the Quarterly Commentary just wasn't doing it. These Weeklies go only to my clients and fill in details that this Quarterly piece hasn't the room for. The Quarterly sets a framework and the Weekly updates it . To that end, I invite you to become a client, if perhaps you are not.

Should you wish to continue receiving this Quarterly piece, as my clients will, I ask that you please either drop me an e-mail (jamesnoland42@sbcglobal.net) or call me at (408)318-2010 and let me know. Not hearing from you, I will be shortening my now out-of-hand mailing list and I will assume that you, like me, are already overwhelmed with information.

What follows is the basic skeletal form for going forward. Thank you.

DOMINOES OR POPCORN?

Robert McNamara died recently. The one time "whiz kid" played a huge positive role in saving Ford Motor for young Henry Ford II and, sadly, will be remembered more for Vietnam than for saving Ford.

Mr. McNamara viewed problems as merely a process of collecting data, analyzing it and implementing a plan. He was a hell of a planner and we are told he had little time for human emotions, failings or needs. We paid dearly for his mechanistic style.

One aspect of the logic of those years was the domino theory – that as Vietnam went, so went Southeast Asia and that contagion would spread to such a degree that the Communist world would be revitalized. The domino theory and its stepchildren have stayed with us through the years and in a moment we'll look at it again in a different light.

This inter-connectivity, though, does persist today in economic terms. In the 60s and 70s – and even before – political factors were seen as the friction points among nations. It took Isolationism in the 30s, I think, to drive home the importance of economic linkages and today we see the impact of nations that import but don't really export (us?) and nations that export but don't really import (Germany?). We are seeing the impact of cross border lending as British banks and Austrian banks gag on their loans to Eastern Europe while mortgages on homes in Des Moines drive the values of derivatives held by banks in Ireland. We see oil as a weapon until its price falls, thus, once again, teaching the laws of supply and demand to yet another would-be world leader. Above all, though, we see somewhere between 37 and 73* weak or badly run governments failing or failed world wide – a record [Krasner] – as bad economics, state controlled to be specific, takes its toll. (In the good news column, the existence of the European Union at least keeps that group of nations from exercising their individual sovereign rights – for now.)

*How you measure: Corrupt? Military? State economy? Socialist? Agrarian dictator? Think Pakistan, Argentina, Venezuela, Russia.

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This current crisis exacerbates bad government or, to put it less delicately, it predates Obama, Bush, et al. When the Congressional Budget Office – as non-partisan as any Washington body can be – says 2014 before we see full employment, you know the causes are long, deep and cumulative. So this critique is not so much about a Pelosi Senate or a Bush tax cut or Barney Frank idealism as it is about where we go from here after a 40-year, credit-fueled binge.*

In the short run, we have the loss of $14 trillion (Fed data) of individual wealth – be it a 50%-60% loss in your 401(k) or a similar loss in your home value, concurrent with $13 trillion of debt which is some 3 times the level of just 20 years ago. (This data, and a bit of the following, from an M. D. at a bulge-bracket bank.) Credit cards are seeing record charge-offs (in May: 10.6%!) and balances are falling at a 20% annualized rate. Our national debt is approaching a number equal to 100% of what we produce – our GDP. S&P downgraded England's Sovereign Debt when they hit 100%. (We are at 80%+ and will hit 100% in a year – maybe 18 months).

Market economies work, though - look at the United Kingdom, Germany, France, Japan, Denmark, etc. Each has a larger government role than we have and each is and will remain, I believe, firm believers in personal choice, wherein lies their continued success. What we seem to lack is focus – focus on what creates rising wealth and well being. The tendency to compare the rate of wealth and growth in the U. S. to China, to me is specious as they started only 20 years or so ago from an agrarian base we left behind over 100 years ago. (China has no economic model – they are state driven producers to the world with little or no proportional internal consumer demand and less personal choice.) The point is that emerging nations' growth rates, although greater than ours historically, and likely for years to come, reflect their evolution from near-stone age settings, not some discovery we should copy. Our issue is: Where do we go from here? How do we stimulate yet another era – a century – of wide-spread wealth? Can we, with the debt load we carry? Will we, if taxes rise as expected? Is pseudo socialism the answer?

The political parties propose, of course: Tax cuts – national health care – alternative energy – defense spending – better schools and teachers – they have marvelously long lists, each of them. Take the stimulus package – something both George Bush and Nancy Pelosi agreed on: $787 billion. The plan was $185 billion this year (so far +/- $30 billion). How has it been spent?

44% temporary tax cuts and welfare
23% education programs
26% government services
7% public infrastructure

Stimulus works only when idle resources are put to work making something. In the list above, only the public infrastructure does that – like $23 million to Amtrak (John Cogan-Hoover Institute). So far then, we have doubled (tripled?) the national debt, taken government spending to nearly a quarter of GDP and are about to tax the top 2% to help the poor. We failed to reform Social Security or Medicare. And in this mess, we are to invest?

We haven't even touched on the inflation that will occur when the Fed tries to pull back the $1 trillion of (excess) money they've pumped in at the same time the U. S. Treasury tries to float $1.8-$2 trillion in new debt to cover the deficit. Here's a thought: J. Taylor calculates that to get back to debt as "only" 42% of GDP (last year) requires 100% inflation for 10 years. In this mess we are to invest?

*One interesting tidbit: the so-called American spending binge of the last 10 years was, in fact, substantially spending on health care and energy – consumption, ex-medical and energy, was virtually flat. Health costs were paid via employer plans and governments.

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By year end (5 months), $400 billion of commercial property debt has to reset – for further pressure on rates – and that assumes banks will lend at any price. (When commercial, private and government all compete for limited resources (money), guess why they call it "crowding out" and guess what happens to the price of money and guess who gets it.)

China won't be a savior. We are 25% of global GDP, China is 8%. If China grows "only" 6% instead of its historic 9%, that will absorb only a 1% decline in U. S. consumer spending and in global terms nowhere near an offset. A third of China's production is exported, nearly half to Asia, and they are still contracting. Think really idle resources, globally.

I know there are bullish folks on the economy, naysayers to inflation, believers that stimulus can save it all . . . and I believe, at best, it will only prevent a depression, but this recession is far from over. Consumers are behaving differently, are not returning to the malls in any amount that matters and are clearly enamored with saving. How long it lasts is a future paper.

Rod Campbell, the last of the true entrepreneurs, took me with him to the Hoover Institute for a few days of serious thinking. Much was focused on describing the current situation, how we got here, and the predictable offers of how to get out of this mess (tax cuts, stimulate production, less government, pay for performance at <u>all</u> levels, privatize) all worthy, each having consequences and meaty enough for another paper.

I was able to spend near an hour at lunch one-on-one with Ed Lazear. He pointed out that, as I was older, I should call him Ed, but geez, this guy mountain biked weekly with the President of the United States when not being Chairman of George Bush's Council of Economic Advisors.

He was refreshingly candid and acknowledged what they got wrong in the closing days of the Bush years, telegraphed a genuine sense of empathy for people (to contrast R. McNamara, in case you missed it) and coined a phrase that intrigued me and had me rethink many things. Late in his term, President Bush and his advisors feared the failure of the major banks – the Lehman's, Goldman's, et al. The issue was captured with an old phrase about the domino effect – if one went, the cross-collateralized deals, joint ownership of toxic asset, etc. would domino them all down.

Ed said ". . . we had it wrong . . . it was more popcorn than domino." He explained that each kernel of corn in a pan pops individually and unrelated to others. What was common to them was the heat of the pan, not some inter-relationship. Ed went on to elaborate what he felt was the heat of the bank pan and, in hindsight, he said, felt they addressed the wrong things. Leave aside the honesty, which is rare enough in politics, much less economics – I drifted back to Vietnam and saw the "heat" of Communism and poverty being solved, in only one of a series of choices. Drift forward to the Surge in Iraq: it worked when we became offensive, yes, as also it did when appeals to local leaders to repudiate wanton slaughter, provide water, medical care and, yes, Nancy, dialogue, was emphasized.

Lest you think I'm about to break into a kum-ba-ya moment, I'm not. Evil exists and terrorism must be met with firmness, not nicey-nice. But we are discussing economic heat in any case, and Ed made a strong case that would take more room than we have here to lay out, but will impact how I invest for my clients for years to come. Suffice it to say only 2 cardinal truths remain: (1) diversify and (2) risk and reward are still related. Out the window goes asset allocation, efficient market theory (it died years ago – bury it), sector weights, most mutual funds (they generally all still follow this stuff because – well – because "everybody" does and being alone is scary), "growth" or "income" strategies, large cap versus small cap, et al.

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Most, if not all, of the strategies listed above evolved during my 40-year career. I have tried most, if not all, as various times and conditions warranted (except the concept of beta – I always thought that was pure bull Nobel Prize notwithstanding). Ironically, the cardinal rules were about all that really mattered, day in and day out – all the rest was marketing.

What does matter? To my mind only productivity growth – the output per worker – makes us all better off. Peter Thiel at Clarium points out that only 3 things create increased productivity: leverage, volume growth (from globalization) and technological innovation. Well, the leverage game is over. Globalization has substantially run its course and we'll likely now see not the deflationary effect of excess labor and materials, but the inflationary (raw materials) effect of developing nations internalizing growth, building a consumer base and moving into the contemporary economic world. Innovation from technology is mostly hype. Looking at Cisco, Microsoft, Intel, et al, I see mass-production facilities, not innovators. Our recovery must wait for true innovation – technological, political and economic. One approach might be for-profit education. .Top down economic analysis is key, and top down economics say, to me, that U. S. growth will be poor for some time to come.

It would have been cheaper, Ed hinted, to let banks fail, do an S & L style restructure and place taxpayer money where and when needed. Second, and more important, stimulus, if any, needed to be directed only to idle resources. Neither of these happened nor, I think, will they. To my mind, "stimulus" is what we had and we don't need more debt to get out of debt. As our leaders attempt to reflate the bubble, they are, in fact, disrupting Schumpeter's maxim of creative destruction – the core of any free market economy.

Which leaves debt, the heat under the pan. Delevering will cause slower growth, higher interest rates and massive Federal debt for years to come. Concurrently, we will have higher taxes, more than half the population fiscally "idle" (to the degree of their sense of entitlement) and structural unemployment which will restrain wages. We are and will be the pre-eminent military power, dealing with petty tyrants worldwide (and generally alone) and lacking focus as to what to do as a people to snap this stalemate, this now embedded need to look to our political leaders for our future. Hope doesn't cut it. .

Worldwide, I believe young people will not find dictatorships of any kind appealing and that is core to long-term social, economic and political growth, to my mind. Other young, evolving nations will build the factories they need for their internal needs and slowly create products and services for themselves. The future, I believe, is in the assets of these countries that will prosper from the jump start we gave them.

So, in the short run, the heat gets turned down and a new set of investments moves into view. Me, I always feel better and optimistic when I can finally define the core of the issue. To that end, thank you, Mr. Lazear – Ed. Rest in peace, Mr. McNamara.

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