BETWEEN DOG AND WOLF

As daylight shifts to the soft blues of twilight and daytime sounds take on primeval meaning, our eyes and minds begin to play tricks. What we think we hear may not be so; what we trust is challenged; what things we think we see shape-shift into our nightmares or daydreams. It is the time of twilight – the time when distinction fails, when confusion reigns – the time, as the French so elegantly describe it, "entre chien et loup" – between dog and wolf.

Twilight* has arrived in the world. To date it has been a country here, a country there. This time it's global, but with some to do better than others working through it.

Many cases can be made that disaster awaits: It is a time of debased currencies, debased leaders, debased ethics and debased morals. Little is sacred beyond power and greed. Success is measured in currency. Expectations, dispassionate judgment, delayed gratification, respect – all are rarer by the day. Religions beget war, wars beget profits, and profits breed contempt, entitlement and abuse. Doomsayers predict total financial collapse across the world, predict riots, and speak of stockpiling guns, food, and gold. Total loss, they say, faces those with possessions; deliberate punishment awaits the very rich. The poor will have their day. And then? (One would think such perfect clarity about the future could also tell us the totality of outcomes).

I wrote long ago that many of us don't know *what* we believe. New information arrives constantly. We don't think. Instead, we collect information. Lacking any sort of historical or religious or economic grounding, we are lost; we have no idea what to do with the information, so we stumble in two directions: collect more and then seek interpretations. Leaders tell us what it all means, tell us what we think. This is fertile ground for the opportunist, the politician, the morally weak businessman, and always, the doom peddlers.

And yet . . . .

In 1980, just 1.7 billion people were paid for their work, with nearly half of that on farms. Globalization struck and, in 2010, nearly 2.9 billion people were on payrolls. They were responsible for most of the increase in non-farm payrolls – some 900 million – with 400 million from China and India alone. Change of this magnitude was bound to create abuses and dislocations, especially absent the order of law and contract.

Millions stepped out of a poverty that few can understand. In rich and developing countries, however, competition from these millions of new, unskilled laborers pushed

*Twilight has 3 definitions: Civil Twilight, when the center of he sun is 6 degrees below the horizon; Nautical Twilight, when the center of the sun is 12 degrees below the horizon; Astronomical Twilight, when the center of the sun is 18 degrees below the horizon . . . Sunrise is easier: The upper edge/limb is tangent to the horizon [90.8333] (or) the center is 50 minutes below the horizon (plus or minus 1 minute).

wages down. Simultaneously, rich nations invested heavily in technology, ultimately replacing many semi-skilled workers. Skills are still badly needed, though, and to this end an estimated 184 million college graduates will arise over the next two decades from just China and India. Some argue the locus of human capital and innovation will shift to Asia as a consequence. [McKinsey Global Institute]

But that's not the whole story. The larger issue is a rapidly aging workforce in nearly all of the advanced economies. Retirements will pull 12 million college-educated workers out of the work force here by 2030. Very rapid productivity growth is therefore critical just to maintain growth, particularly in Southern Europe where the labor force is quickly shrinking. Europe's population will peak around 2035 – and be much older. The European population cohort aged 60 and older is expected to grow from its current 18% to 30% in that time frame. By 2050, France and the United Kingdom will have a larger – and younger – population than Germany. The increased demand for skilled workers, reduced population and relatively unproductive south of Europe will reduce Europe's political and economic influence. Immigration attitudes will shift. [*Europe's Shrinking, Aging Population* – Stratfor]

Every major, modern nation and every developing country has low or falling birth rates. Japan and Poland see 1.3 children per woman, Brazil and China 1.9, Pakistan down from 6.6 just 30 years ago to 3.6 today. Here in he U. S? Nearly 2.1. Our affluence is reflected in those among us who can – who choose – to have many children. Currently, over 80 million of us are under 20 – over 25% of our population. As "replacement" birth rates continue to fall below the 2.1 per woman rate, global population will likely shrink from 7 billion today to 3-4 billion by 2300.

Why is this important? Because a young, healthy, growing, affluent country yields economies of scale – overall lower costs and higher quality of life. Demographics already in play set the stage for America's century. Don't bet against it. [Ben J. Wattenberg]. For the record, let's count youth and positive demographic and educational trends as positives for America.

And yet . . . .

"What is America but beauty queens, millionaires, stupid records and Hollywood?" [Adolf Hitler, 1940] At the time, it fit. We were in a double depression, industry was in idle mode but, as Arthur Herman at the American Enterprise Institute points out, we nonetheless responded to President Roosevelt's call to arms. By 1942, our war output already exceeded that of the combined Axis powers (Germany, Italy, Japan). By 1944, we were building a plane every 5 minutes, 50 merchant ships a day and 8 aircraft carriers a month. Herman goes on to point out that this did not come from an interventionist Roosevelt administration. No, business heroes such as Knudsen or Kaiser "towered" as Herman

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

describes it. Both had humble origins, both reflected the independent, self-starting mentality that seems to run through our collective genes. Government wisely let the business world do what it did best and kept its focus on funding with War Bonds and keeping morale up. Were there abuses? Of course, but the broken spirit, high unemployment and shallowness of the late 1930s quickly gave way to focused, near-obsessive attention on winning, to say nothing of the post-war boom.

We talk of an American spirit – a mentality of individualism, of personal responsibility. It is the very individualism of this country's people that, when pushed or threatened with loss, spawns kickback. Here entitlement, defined as the right to be, to live free, seems never to fully fade away. It's there, it's threatened today and it is not to be bet against. Let's record legitimate entitlement as almost solely an American advantage, if but long nascent and now rising. Another point to America because of its diverse, entrepreneurial individualism, its legitimate sense of entitlement to its historic freedom.

And yet . . . .

Financial repression – mandating very low interest rates to near-force Government Bond purchases and ease the cost of deficit financing – continues to hurt savers, retired workers and asset pools like pension funds and insurance reserves. How can the demographic and entitlement spirit function? Quite well, actually. First, the return on investment is lower when the alternative in near zero. Second, productivity, or innovation if you wish, is subsequently encouraged because of these lower hurdles. Third, the now forced discipline of reducing your credit card balance by more careful consumption is compelled by flat to down personal income – too long have we relied on "guaranteed" salary increases and rising home equity that could be used for consumption. Fourth, the real pension costs will rise and force significant downward changes to that retirement debt <u>and</u> expectations, particularly in the non-private work force. Fifth, consumers are near-forced to buy the low-interest government debt for lack of a better yield on traditional savings vehicles, easing that debt-financing issue. (Easing, not solving.) Sixth, and last, with wages under pressure, jobs scarce and labor costs rising for our global competitors, the inducement in this country to "do something" becomes a personal choice as the government's ability to bail you out is now greatly diminished.

Repression, I believe, will contribute to igniting the legitimate entitlement noted earlier and hopefully induce both a rise in real education (trades and professional) and longer-term thinking. Remember – it's an increasingly younger population here, spiked with the one thing we do best: be a magnet for immigrants who still believe in us as a country. Put repression down as a bitter, short-term pill for a long-term recovery. Point to America, again.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

And yet . . . .

As a persistent voice for the arrival of inflation, I'm forced to acknowledge that event is delayed – a lot delayed. The principle reason is the pressure the Fed has placed on holding interest rates down. Low wages further bring lower demand for goods and that takes pressure off prices, for now. That and many more good reasons for deflation all said, the monster under the bed of a ridiculously huge supply of money just hanging out there cannot be ignored. It <u>will</u> go into circulation, the Fed <u>cannot</u> soak it all up in any practical way and inflation will show itself. How, you ask? Should our election bring a party change and Europe fall into making a few semi-correct decisions, global confidence will grow, sentiment will swing more positive and demand for money will rise – quickly. Banks and corporations now sitting on trillions will be induced to loan, to spend, to invest. That will trigger price rises in goods and services, be they from actual unmet immediate demand or speculators sensing the trend. Stocks will follow.

Another year or so of deflation, however, will have further lowered prices well below prior highs. An early round of inflation will at first only bring prices back to prior levels (is it inflation, then?) and, lacking Fed action, on to new highs. The Fed knows this and more and will start to tighten almost immediately should inflation return. My issues around this topic are long: altering with how inflation is calculated, what is measured, how much is heuristic tinkering and whether 80% of consumers even care enough to find alternatives for pricey goods. For now, let's table it and give the point to America – she lacks the price escalation begun in China, Europe, South America.

And yet . . . .

Americans are, nonetheless, in the streets. The 99%, the Tea Party, Democratic or Republican activists, the anti/pro war, abortion, immigration, Arab Spring, union, religion – they're all out there now. Few have guns and rocks and fewer still are certifiable mental cases. In most instances, someplace deep down, there's a real grievance, but I doubt the grievances are universal – too much personal angst is expressed on the streets to call all protests homogeneous. I suspect these crowds feed those who see doom, death, violent riots – basically Greece or the Middle East – in our streets. But for all the call for change or for maintaining status quo, I sense self-imposed boundaries are in place. An old friend, having lived in Europe through two violent changes in government and two total losses of all he owned, said he came to be a millionaire many times over for one reason, " . . . when you have nothing to lose, you'll take the chances."

I find few in all of these groups with nothing at all at risk – protestors with iPads are a curious thing, I think. The boundary to total civil chaos is simple: what will it cost you personally to commit? Will you risk all you have? I believe the broad view is "let someone

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

else protest – I'm busy trying to make a living and keep what I have." We as a people have too much to lose to either ignore events or to resort to unbridled violence. Point to America for using the ballot box and avoiding a European or Middle Eastern melt down, while still effecting change.

And yet . . . .

If we retrench, delever, save, spend less, and do with less, who will buy our goods? This is a tightrope – but doable. China now has near 400 million in her middle class alone, is teaching them consumption to boost local economic development – and still her people prefer Western goods. They, and Indians and Taiwanese and Burmese and all of Asia are just stepping onto the consumption treadmill. They are also just seeing the early signs of a long upward spiral in their labor costs. We are only able to export what the world wants if either of two conditions are true: 1) the dollar is so weak, so trashed (as of late) relative to, say, the Yuan, that our goods are cheap to the world and we sell and sell a lot or 2) our dollar is stronger with all this internal forced discipline, but we are a lower-cost, far more efficient producer.

This later point, when set against an already recovering, highly-automated manufacturing sector with lower wages (and jobs for the semi-skilled), is the way I see it going.

Yes, a strong dollar, offset by low-cost production created by strong innovation and subsequent productivity growth is possible. Add in shale gas, something near and dear to me (see "Michigan, my Michigan") and fuel costs also become less a manufacturing issue.

Point to America for its higher innovation, productivity, needed goods, falling relative wages and young demographic. We don't need to consume all we make – we can become yet again a supplier, as we were for decades until we found credit cards. More jobs and higher wages will follow.

And yet . . . .

Sentiment is falling here – now 5 months in a row of weak University of Michigan Consumer Confidence data. Okay, but it's sentiment – that turns on a dime. It tends to reflect the moment – all well and good as the moments have been bad and are building to a head. Not to put too fine a point on it but, frankly, good – it's about time the population at large not just the unemployed, got a taste of real concern. It was a pretty bleak Sunday, back there in December of '41 – and this internal war with our lesser selves is at least as momentous. Do not both events speak to our national survival? We have met the enemy and (this time) he is us. Point to America where realism ultimately kicks in – name any other country harder on itself, more candid in its appraisal, more willing to address its flaws. Pioneers,

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

remember? Of course, we have down moments – only the disconnected are always up or always down.

And yet . . . .

Bond prices are reflecting a coming depression say some. Perhaps only a period of deflation, but look back to the '30s and see what happened when deflation slid into a depression.

The differences between the '30s and today are beyond this short paper. Suffice it to say such things as Welfare, Social Security, Unemployment Insurance, pensions, monetary and fiscal policies all were either non-existent or new then. Bond prices today greatly reflect Fed buying – pushing prices up and yields down. The bottom in yields will very likely be when 30-year bonds yield about 1% and 90-day Treasuries yield, as they do now, about 1/10 of 1% or less. This range has, in many countries, signaled a "top" in prices – when the spread between long (30-year) and short (90-day) interest rates is about 1%. Called the yield curve spread, long bonds have a ways to go. <u>That</u> said, you must have a death wish to think they will stay that high in price – we continue to warn of inflation. The losses will be horrific: if you buy a new 30-year bond priced at $100 with a coupon rate of 1.3% and you wish to sell it in a world of say 5% interest rates, it will bring $42 or a nice clean 58% loss. Or, you continue to hold it, keep collecting your 1.3% while then-new offerings pay 5%. Don't confuse return <u>on</u> your capital now with return <u>of</u> your capital later.

Yes, low rates from deflation and Fed actions are here and, yes, they do facilitate financing our deficits, but the "after inflation" returns alone will be negative. Add in a rise in interest rates and it is worse. In the post-World War II years, rates were held low to pay our War Bonds down. With rates held down, bondholders still lost money as inflation quietly ate into their value. [By the way, we reduced our debt to GDP ratio from 122% to 33% by repression – holding rates down – it does work, but long bondholders paid that bill.] We can pull today's debt to GDP ratio, near 100%, down – and we will, but <u>someone</u> will pay.

My choice is stocks – if you can be a patient holder. I can't ignore the global productivity, demographic and social trends. Why buy long bonds? To trade for the last bit? Best of luck on that timing. Safety? Take a hard look at almost any government's balance sheet versus a cash-rich corporation paying rising dividends. Yes, dividend taxes are likely to be pushed higher, but net-net you are better off with a rising stream of dividends versus a fixed, lower rate from a bond or note. A truism I still hold is that stocks are risky in the short run and bonds are risky in the long run. Quality, diversity, good products – not much has changed in stock selection (including the need by too many to "make it quick" – creating the distortions that frighten off many who could benefit). Tax free income is a separate matter.

Point to America again, as the only country so far using repression well.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

And yet . . . .

We are told the Euro will fail because country diversity in Europe is too severe to allow common budgets, common bank rules, common much of anything, least of all austerity or a move away from government management. More likely a partial fail – with the PIGS (Portugal, Italy, Greece and Spain) thrown out over the next year, but still a serious hit to this country's exports. Likely so. It's not that trade deficits are all that new, however – rarely are we a net exporter, so we're talking degrees of worse. This loss, we read, will seriously hurt U. S. corporations. I doubt it.

The health of U. S. corporations has never been better. Flush with cash, lean after 4 years of dieting, heavily committed to automating all they use and, in classic creative destruction mode, subject to takeover or liquidation if they don't grow lean. Europe is not their only customer and as, for example, the Free Trade Agreement now being drafted with Asian Baby Tigers (Burma, Vietnam, Brunei, etc.) comes to fruition, those markets will create further new demand. Here, America for ½ point on the corporate health issue and corporate ability to weather an export slowdown. Germany did it all a decade ago – it works – they get the full point.

Twilight has arrived in the world. The Western world is questioning not whether there will be a dawn, but rather whether we will enjoy seeing it. Wolves are seen, say some. Doom, say others. Tomorrow will be worse than today, say most. I see chaos coming to a rapid political head here as we continue the transition to a far more realistic people. I continue to believe we are far ahead of the rest of the world in dealing with the New Economics and will benefit accordingly. Rough for a bit but not hopeless. China, Europe, the Middle East, all face a longer, harder road.

July 2012

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

SANSOTERRA GROUP LLC

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568