

# Global Portfolio Strategy

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## Basic Points – The Devils & The Deep Blue Sea

### Part I: The Devils (Are in the Financial Details)

#### *Vlad the Investor*

It took a long time, but it finally happened.

Fannie Mae and Freddie Mac, the government/private sector companies that for so long operated on business models in which the huge rewards went first to their top officers, then to powerful Congressmen, and only then to their stockholders, while the risks were covertly assigned to the taxpayers, finally had to be saved from collapse. They are now wards of the nation and bigger contributors to the total national debt than all the wars since WWII.

Those cheery, American-as-apple-pie names—Fannie Mae and Freddie Mac—helped to disguise the slick, cynical organizations that managed to accumulate and peddle an astounding \$5.2 trillion in debt across America—and across the world.

Back when the Bush Administration was so self-confident that it believed it could take Iraq in months, it summoned up the courage to take on foes who were, in their own ways, almost as shameless as Saddam—the managements of Fannie Mae and Freddie Mac (herein called F&F). The Administration shocked the Congress's wayward offspring by insisting that these "Agencies" had to begin publishing accurate financial statements. That provoked a war with the companies and with their powerful Congressional allies, but the Administration won Round One. F&F were forced to admit that they could not publish accurate statements because they had been overstating profits for years. They whined that it was really unfair to subject the people who did so much to fulfill the American Dream of home ownership to rules that should apply only to selfish banks.

As this domestic war ground on, and more and more accounting chicanery was revealed, some of us were naïve enough to be-

lieve that F&F's wings would be clipped, or at least, the insiders who'd been paid gigantic bonuses *based on non-existent profits* would be forced to refund their ill-gotten gains or face prosecution. About the time that al Qaeda and other militant groups were destroying Bush's illusions of "Mission Accomplished" in Iraq, his Administration's victories over F&F vanished—along with tens of billions in stockholders' equity.

Although F&F's accounting cover-ups were on a scale that made Enron look like a five-and-dime store, Fannie remained unspanked, and Freddie was not punished by being forced to stand in a corner. Their stocks stayed listed, their bosses got richer, their AAA-rated lobbyists managed to maintain their top ranking as ultra-generous donors to Congresspersons, despite McCain-Feingold....

**And foreign central banks bought \$947 billion of F&F debt to help keep the American Dream alive.**

When, in recent weeks, the yield spread between their debt and Treasuries began to widen out in ominous fashion, the possibility of market discipline on historic scale emerged from the shadows.

It didn't happen.

With the stroke of a Paulson pen, the real national debt leapt from \$9.5 trillion to \$14.8 trillion, and those foreign holders could breathe more easily. The rest of us should be breathing more rapidly.

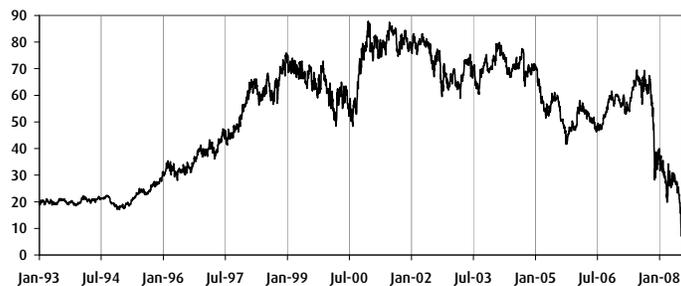
The folks who built the monsters too big to fail, got bail—and not jail.

But the sheer scale of their rescue lays bare the seaminess and social diseases in the US financial system. Led by F&F's wealthy bosses, their partners in Wall Street, and their backers in Congress, the ethical underpinnings of the sometimes-steamy relationship between Wall Street and Washington have moved from A-rated to X-rated. The morally humiliating deal

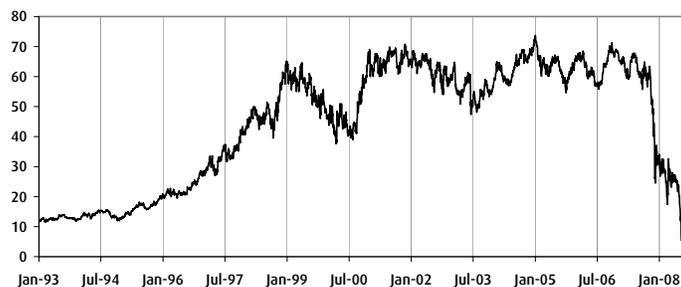
imposed on Bush by Congress moves the US financial crisis from Wall Street and environs into uncharted territory. Some wise students of history think this will be ranked as *the* scandal of the post-Depression era which should now be transfixing Washington, the Commentariat and the electorate. Instead, it has spawned a robust rally...*in financial stocks*. “Why No Outrage?”, an indignant James Grant asked in a front-page *Wall Street Journal* essay.

Why, indeed.

**Fannie Mae (FNM – NYSE)**  
**January 1993 to August 2008**



**Freddie Mac (FRE – NYSE)**  
**January 1993 to August 2008**



**How We Got Here**

Federal National Mortgage Association—FNMA—was one of the Roosevelt Alphabet Soup brews of the late 1930s—an agency to help Americans get mortgage financing. It was re-chartered thirty years later as a stock company with no direct government ownership. Its initials sounded like Fannie Mae. It declared that its mission was to help millions to share The American Dream. (It turned out to be very good as a dream-manager. Dreams are part illusion, and part delusion, and Fannie has been Triple A in both those roles. Its skill in making dreams come true has been most conspicuous in making its politically-connected top management’s dreams of vast wealth come true.)

The smaller, and less flamboyant, Federal Home Loan Mortgage Corp. was originally conceived by Lyndon Johnson as a “War on Poverty” baby, but it didn’t get chartered until 1970.

The stated purpose of these two organizations was to supply liquidity to the home mortgage market. They have not lent directly to homeowners, but bought mortgages from banks, S&Ls and other mortgage originators and repackaged them for sale to investors, or to hold on their own balance sheets. In addition, they guaranteed home mortgages. One way or another, they are involved in roughly half the home mortgages in America. Because they had direct access to low-cost borrowing (because of the presumed Washington guarantee), they always had an advantage over other mortgage investors, which led to periodic gripes and lobbying campaigns from bankers that these “socialist” entities were subsidized competitors. The Wall Street banks, with their expertise in corporate finance, weren’t vocal about this competition in a product line that wasn’t (until recently) crucial to them. They left the campaign to protect the ethical purity of the financial system to the regional banks, which was as effective as leaving the defense of France to the Belgians.

Since regional bankers were traditionally Republicans, F&F made sure that their most vocal political supporters—mostly Democrats—were well looked after. Congress was under Democratic leadership most of the time from Freddie’s incorporation until Newt Gingrich’s Common Sense Revolution put Republicans briefly into power in 1994. By that time, F&F were so well woven into the fabric of residential mortgage financing that the grumbles of a few Republican bankers had little influence. Indeed, Fannie Mae became a virtual Democrat fief during the Clinton years, as prominent Democrats like Clinton’s budget boss, Franklin Raines, and Deputy Attorney-General Jamie Gorelick moved into the top jobs and prospered mightily during the stock option era. Raines was CEO during the years when the worst abuses occurred, and Gorelick was there most of that time. Both of them were winners because of the billions in phony profits created during their tenure. Their compensation packages included bonuses tied to reported earnings. After auditors finally untangled the mess, they found that Raines’ overpayments amounted to \$52 million out of total income of more than \$100 million. In Gorelick’s six years as Vice-Chairman she earned more than \$26 million. Neither has been prosecuted and neither has refunded their overpayments. (There are rumors that Gorelick is a candidate to be Obama’s Attorney-General. She has obvious negotiating skills as a lawyer, because she got to keep all that money, so she might be a good A-G. She might well have acquired considerable knowledge of securities legislation. We would, however, be concerned were she considered for Treasury, or for overseeing the F&F overseer.)

For decades, as F&F grew rapidly, their only official overseer was the most toothless that Congress could devise. Even after Alan Greenspan complained publicly that the duo were unfairly representing themselves to foreign borrowers as being backed by Treasury guarantees, the new overseer—OFHEO—showed no signs of finding any signs of serious misdeeds. F&F were left largely alone. Whenever the feckless Bush Administration or other critics questioned the sales pitches behind the marketing of F&F paper to government funds abroad, Democratic Congressmen and leftist pundits screamed that they were trying to protect the banks from healthy competition.

F&F's record in selling their paper abroad was one of the great American success stories of this decade. As central banks and Sovereign Wealth Funds began developing stomach pains from engorgement on Treasuries with small nominal yields and minuscule real yields, the offer of US government paper that was (nod, nod, wink, wink) really as good as Treasuries—while offering higher yields—was snapped up on majestic scale.

That China became one of the world's biggest holders of F&F instruments is not surprising. Because of what we have called "The Great Symbiosis," Beijing and Tokyo needed to manage jointly their currencies' value to the dollar, and keep the yen from falling to levels that threatened China's competitiveness. That currency regime began in October 1998 and virtually replaced Bretton Woods as the explanation for the valuation of the dollar and the financing of the US Current Account. Roughly three years ago, these partners switched from a pure-Treasury policy in their exchange stabilization accounts to concentration on F&F offerings. China and Japan might well have assumed that they could take on some risk in their purchases, because their money was buttressing the boom in housing—the driving force behind the US economy, their biggest customer.

Russia was a relative latecomer to the F&F transfusion process, but it didn't take long to become a major backer of The Dream Team.

***By June of this year, foreign exchange accounts of nations abroad held \$947 billion of F&F paper.***

This would be astonishing even if these companies were well-run and published pristine financial statements. But the great rush into F&F paper began *after* it was disclosed that neither of these dreamy companies could get its financial statements certified by auditors, and many prominent critics questioned both the competence and candor of F&F management.

This situation has dragged on for years. By traditional capitalist standards of accountability, the managements were either incompetent or mendacious.

To us, the most arresting statistic in all the media coverage of the F&F bailout was that ***Russia was holding a cool \$100 billion*** of their dreamily dubious debt.

Why?

Remember that Russia was effectively broke as recently as 1998. The real boom in oil and gas prices that swelled its national treasury came quite recently.

F&F's shaky legal and financial position was abundantly clear after Greenspan's public rebukes to F&F and to Wall Street banks that were peddling their paper.

When The Second Most Powerful Person in Washington was repeatedly issuing *caveat emptor* warnings to investors, the ambiguities about the guaranteed nature of F&F products would certainly have been enough to raise profound concerns in the Kremlin.

A decision to invest such a huge portion of the Forex reserves in non-Treasury debt issued by companies whose stockholders' equity was falling almost as fast as Bush's and Congress's approval ratings for a mere 35 basis points above Treasuries could not, we believe, have been made by clerks on a Kremlin trading desk.

Imagine if F&F had defaulted and their paper were selling at 90 cents—or less—on the dollar while the Administration and Congress were fighting about the details of a rescue. If some *apparatchiki* had bought that \$100 billion based on discussions with Wall Street salespeople, and had not cleared the purchases—all the way to the top—what would their prospects be? The gulag? Polonium in their porridge?

Such a gigantic bet on such controversial paper could only have been made with Putin's express approval. This is the leader who said he was managing Russia based on "The dictatorship of the law."

Last week, he told the management of Norilsk Nickel, which owns the former Gulag nickel mine in Siberia, that their new CEO was to be *his* nominee. The new boss has no experience in the mining industry, but he certainly had connections with the previous operators of the mine during his 11 years running the KGB in Leningrad. Putin is also the man who, when asked

why he appointed so many ex-KGB agents to top positions, replied, “There is no such thing as an ex-KGB Agent.” Only last week, he announced that the Kremlin would be seizing control of Russia’s grain exports, and European leaders were immediately alarmed that he might be planning to politicize food the way he had politicized gas. He also collapsed the stock price of a leading Russian steel company by unleashing a broadside of investigations and threats that it was overcharging Russian companies for its products.

Remember that Putin’s air force is now flying Backfire Bombers equipped with nuclear weapons, and his fighter planes have been buzzing US Navy ships. He is also said to be negotiating a new deal with Castro which could involve advanced weaponry.

Putin’s purchases have more than repaid the US for Lend-Lease and for all the subsidies Nixon gave the USSR in the Great Grain Robbery.

So why was he spending so much of his nation’s treasure on subsidizing these companies—and the US housing market?

Who knows? And why isn’t anyone telling?

And why isn’t a Congressional committee holding hearings about the circumstances surrounding the sale of the \$100 billion of F&F fodder?

Imagine Putin at the Crawford Ranch, telling his buddy Bush how his minions were buying billions in F&F paper, and Bush asking, “Why, Vladimir?”

“Well, we’ve been told you’ll back them with the full faith and credit of America, and we can relate well to their management structure: Their top people get their jobs because of government connections, not because they know anything about running a company. That’s the way I do it in Russia. The difference is that they get named by Congress—not you, whereas I name the CEOs in Russia. But I think, George, those guys in Congress may be tougher than you, and I like the way they play the game.”

What was on Secretary Paulson’s mind on the evening of July 13<sup>th</sup> as he proclaimed the panoply of rescue operations for the duo from dreamland? He categorically ruled out any attacks on the managements, and insisted there would be no search for blame. Tens of billions of losses, negative net worths, years of phony accounting—and nobody deserves criticism?

Whom did he fear most?

Hu Jintao?

Or Putin?

Or, perhaps, Barney Frank and Chris Dodd?

Mr. Paulson needed legislative support from powerful Democrats for this and, perhaps, future unprecedented (and apparently illegal) rescue measures as he and fellow fireman Bernanke rushed to pour cold liquidity on new financial fires. The surest way to arouse fury from such heavyweights was to raise questions about the competence or ethics of F&F management.

If the delay, default, deception and dreamy accounting that put the nation’s basic balance sheet and its relations with major foreign powers at risk are hostages to the very political process that created this crisis, then why is the stock market so convinced that the credit crisis is nearly over?

On July 13<sup>th</sup>, nearly a year after the financial crisis began, it plumbed its greatest depths to date.

Ben Bernanke helped to justify his unprecedented level of interventions by raising new warnings about the outlook for the economy. In analyzing why a Republican Administration has expanded the concept of a “social safety net” to include investors in major financial organizations, George Will wrote:

Ben Bernanke’s statement last week that economic conditions are ‘skewed to the downside’ was the most muted assessment of a dismal situation since Emperor Hirohito, in his surrender broadcast after Hiroshima and Nagasaki, said, ‘The war situation has developed not necessarily to Japan’s advantage.’

In explaining how Bernanke, Paulson, *et al.* may be helping Mr. Obama, Will concluded, “McCain is losing recourse to conservatism’s core message about the rationality of government minimalism that allows markets to inflict their rigors.”

Not long after Will published those words, another supposed champion of free markets came up with yet another protective device for managements of mismanaged financial institutions. SEC Chairman Chris Cox, who had a brilliant career in Congress as a principled conservative, announced bans on “naked” short-selling of F&F and 17 other financial big names. Not surprisingly, those stocks had sensational rallies.

Investors who were getting killed on their shorts of F&F and other underfunded financials must have been wondering whether the entire financial and governmental system was being ar-

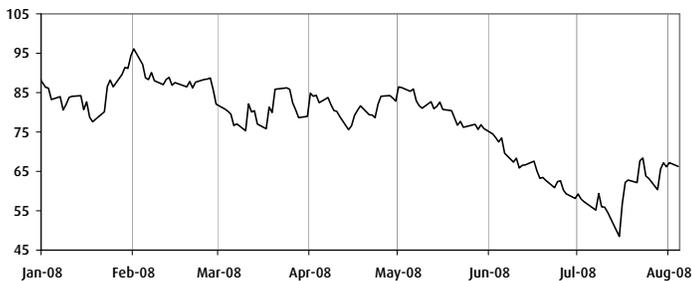
rayed against them in the name of protecting financial markets. This was the Treasury’s version of the Vietnam strategy: “We had to destroy the village in order to save it.”

From our perspective, we believe that capitalism as a fair, rational doctrine for promoting human freedom and economic progress has rarely suffered greater indignity or shame. The people and organizations—primarily in New York and Washington—who together inflated the housing bubble, profited indecently through record-breaking bonuses and payoffs, caused a financial recession and bear market, and put the global financial system at risk, not only go unpunished: they have backed their limousines up to the Treasury and can now replenish their coffers by direct access to the taxpayers.

**Are We There Yet?**

The stock market initially treated the July 13<sup>th</sup> “rescue” with enthusiasm. Shares of the biggest, baddest banks joined Fannie and Freddie in robust rallies.

**Bank Stock Index (BKX)  
January 2008 to August 2008**



The mid-July rally in the banks was one of the greatest ever. The always-vocal Jim Cramer was screaming that investors should buy the banks. Gold prices fell more than \$60 an ounce, as traders took off their “Long Gold and Oil/Short Banks” trade. (The pellucid purity of this money-making concept had been that the investor went long the purest of financial assets and short the most debased.)

This dramatic turnaround naturally produced some anguished calls from our clients. Some asked whether this meant the commodity bull market was over. (We said, as we have said on the other dozen or so occasions when anguished clients asked us that question, “Definitely not.”)

Others asked whether this rally meant the end of the equity bear market. As readers are aware, we have long insisted that most

modern bear markets have been led by Financials, which have so often acted as the canary in the mine, warning of coming crises. When they begin pulling the entire market down, a full-scale bear market begins. It can be a Papa Bear Market—the kind that foretells the advent of recessions. Papa Bears bottom out when the recession is near its nadir, and are rallying strongly before the “All Clear” has been sounded by the economists who certify recessions. Or it can be a Mama Bear Market that not only foretells a recession, but grinds on, to wipe out a huge percentage of total equity values—think 1973-74.

The clear exception to this pattern was the Technology Triple Waterfall Crash which led to a recession. The banks actually rallied during 2000, peaking out at a new high in early 2001. Then they entered a sharp bear market, and, in effect joined the Techs as co-market leaders. Only when they bottomed out in 2002 did the new bull market begin in earnest.

This time, there is no doubt that the Financials have been the lifeblood of the bear market.

Based on past history, we have been telling clients that the overall bear market will continue until the Banks outperform the S&P for at least six weeks.

One week doth not a bottom make.

That theory may be about to be tested: the spreading conviction that Washington has driven risk from the US financial system could mean that investors will cease worrying about the problem that launched the bear—the banks’ balance sheets. If all bad banks are too big to fail, then the Treasury is telling you to throw caution to the winds because you can’t lose. This new investment concept—Absolutely Riskless Reward—could have legs.

And the best part is that a supposedly conservative Republican Administration has unveiled this radical strategy: No Pain—All Gain—And, Free Market Believers—Vote For Us Again.

One contributor to the rush to buy the banks was ISI’s argument that past financial crises were deflationary events that triggered lower interest rates and higher stock prices.

They were right about the recent financial crises. They occurred during the 21-year Triple Waterfall collapse of commodities—a period of falling inflation and falling interest rates.

We have a hard time believing that the current fed funds rate of 2% is headed so low that equity investors should rush back in. It’s not really that far to zero, and the model for that kind of

market would be Japan during the 1990s.

During the early stages of Japan's Triple Waterfall, interest rates fell all the way to zero...

And stayed there...

Stocks fell sharply....

And stayed there—for a long, long time.

We agree with ISI that the 1970s financial crises did ultimately lead to a happy ending.

But the 1970s are no argument for buying banks *now*. After a decade that was mostly agony, Paul Volcker finally eased interest rates—with real rates on the Ten-Year Note at 12%. That's what it took to squeeze inflation out of the system. The "All-Clear" signal was sounded 26 years ago this month.

Today the real yield on the Ten-Year Note is a tad different: it's a *negative* 85 basis points.

That doesn't necessarily mean that the Fed's monetary policies are dangerous—at least on a comparative basis. There are negative real interest rates on long sovereigns almost everywhere except in Brazil and Canada.

Volcker, Reagan and Thatcher believed that inflation pressures could only be suppressed through high real interest rates.

History has proved them right.

But only a couple of major central banks seem to agree with them.

We'll side with the minority.

But, we must admit that as long as investors believe that the White House and Congress can make them all rich without assuming risk, such historical analysis is irrelevant.

Happy Days Are Here Again!

(Sorry, that song came out in 1929.)

**'Too Big To Fail' Reconsidered**

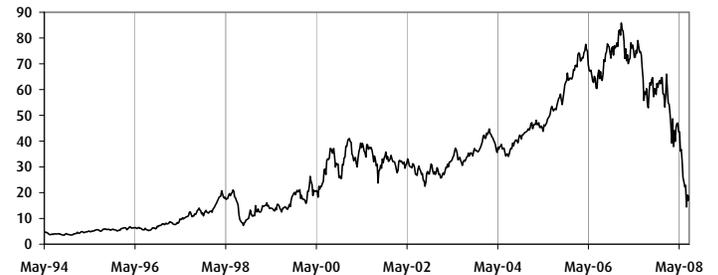
What are the limits on Fed and Treasury rescues?

The eminent John C. Bogle, founder of the Vanguard Funds, told *The New York Times'* Gretchen Morgenson that "The banks are too big to fail, whereas the man on the street is too little to bail."

Bernanke and Paulson justified the Bear Stearns' bailout on the basis of potential runaway counterparty risk. Indy Mac Bankcorp could not be saved, in part because depositors were already lining up for blocks to withdraw their funds after Senator Schumer called a press conference to leak his letter to the Treasury predicting Indy's demise. He made a great call. (*The Wall Street Journal* called him the \$5 billion man for that pronouncement.)

At the moment, market action suggests that many investors think the next investment bank to be a bailout candidate is Lehman. Like the Bear, it was conspicuously well-run for many years, but got into trouble in the late stages of the mortgage bubble. The problems of Merrill Lynch have received greater publicity, but that bank is raising funds by selling its minority interests in Bloomberg and BlackRock, and still boasts its industry-leading retail brokerage operation. Its problems were created by Stanley O'Neal's decision to get Merrill deeply into mortgage CDOs late in the cycle, including the purchase of mortgage originator Franklin Corp—the equivalent of buying Nortel at a 50% premium in March 2000. With O'Neal gone and successor John Thain tending to the firm's core competencies, it should be able to avoid making the late-night call to B&P Firefighters Inc.

**Lehman (LEH - NYSE)  
May 1994 to August 2008**



Indy Mac Bankcorp became one of the nation's biggest mortgage lenders by concentrating on Alt-As—later known as "the Liar's Mortgages." With its slender capital base, it needed to keep finding institutions with deeper pockets run by bigger fools to offload its increasingly risky products.

There were two aspects to the CDO, Subprime, and Alt-A manias that peaked in early 2007. First, the availability of endless supplies of mortgage funding to a level that equaled and often exceeded selling prices naturally drove home "values" far higher. Secondly, that final orgiastic rush to the price peak meant that a record percentage of mortgages issued during the late stages of the mania were destined to go into default. As the

defaults spread and foreclosure rates climbed, whole sections of communities have become blighted. Those families who actually make their mortgage and tax payments, mow their lawns, and fix broken windows watch in dismay as their community becomes a slum.

The Congressional responses to the crisis are partly aimed at propping up house prices. But even such an ardent leftist as Paul Krugman says this is wrong-headed, because house prices are still, on an inflation-adjusted basis, “far too high.” Those young families saving to buy their first home who expect that they will soon find affordable bargains will have to wait, while Washington maintains its price-maintenance programs in a Canutesque attempt to hold back the tides.

This history of delusions and deceptions means more bailouts must lie ahead—because the mortgage rate resets have only begun, and because Washington is apparently committed to saving anything whose demise could unleash systemic risk.

As a measure of the degree of overvaluation of the banks still standing which are stuck with large holdings of the Street’s new-age mortgage products, consider Countrywide Financial’s condition. After the Bank of America’s staff had completed examination of the affairs of its big acquisition, they reported on their evaluation. Countrywide was probably F&F’s biggest partner and was, apart from the vast F&F lobbying operations, the most active lobbyist on F&F’s behalf. BAC reported Countrywide’s net worth, after applying appropriate reserves for outstanding loans, was \$100 million, **on an asset base of \$172 billion**. Loans were marked down by 15% in aggregate, on top of previous reserve allocations of \$5 billion.

If there were an award for 2007’s shrewdest investor, Countrywide’s CEO Angelo Mozilo would certainly be in the running. He managed to pocket more than \$250 million in stock sales last year while he was ramping up Countrywide’s staff, buying back stock, and increasing the company’s mortgage exposure. Anyone who grabbed that much for shares in a company that would shortly be worth only \$100 million in total is really smart. He also displayed his public-spirited side, helping to arrange favorable mortgages for some prominent Congressional Democrats, such as Senators Byron Dorgan and Chris Dodd.

What’s not to admire about him?

### ***Is the Switch of F&F From Near-Death to the National Debt a Bearish or Bullish Development?***

Although the official line for years from F&F, their Congressional apologists and retainers, and the Bush Administration, always was that these companies would never, never, never have to call on the Treasury for aid, Wall Street has for years been peddling their paper as being “effectively” government-guaranteed. “Treasury Only” mutual and pension funds have for years held scads of F&F paper, (along with other “Agencies,” including such reputable icons as the Tennessee Valley Authority).

Even as the rescue was proceeding, spokespersons for both organizations insisted they were adequately capitalized to meet all their demands to help American homeowners. Barney Frank was only the most obvious of the passionately pro-F&F lawmakers who claimed that the companies were solvent and could handle whatever the markets required.

In the entire sweep of history since the story of “The Emperor’s New Clothes” was first told, this one may get recorded by historians as the biggest series of lies about “an Emperor’s” condition.

William Poole, esteemed former President of the St. Louis Fed, observes that, even according to its own formulaic valuations, Freddie was insolvent as of March 31<sup>st</sup>, and Fannie had a tiny and inadequate net worth. Their next reports are due in August, and the real value of their CDOs now is doubtless down big. Some summertime fun will come from seeing how these prodigal sons portray themselves now that their parents in Washington have taken them back. Mr. Poole rejects the idea that tighter regulation will keep F&F virtuous in the future, “because I know the extent to which the regulatory system is tied up in Fannie’s and Freddie’s political activities. Fannie and Freddie paid out more than \$170 million to lobbyists over the past decade—more than General Electric spent. Government departments cannot hire lobbyists or give money to campaigns—why should Fannie and Freddie, now wards of the government, be permitted to do so?”

The answer may come from the latest Zogby poll. Once again the President’s approval rating is a pathetic 25%. But the Congress of Reid and Pelosi’s rating is just 11%. *Vox populi, vox dei...* Both Bush and Congress have proved, with their costly F&F bailout, to be richly worthy of the voters’ disdain.

Ben Bernanke has agreed to expand his existing lending arrangements to the duo. Secretary Paulson is prepared to unzip the nation's wallet. He's even promised the Treasury would be willing to buy F&F preferred and common shares.

Why do we consider these developments so disastrous?

1. As more than one commentator has noted, the ultimate credibility of a nation's financial system is the printed promise of its central bank. Ben Bernanke has endorsed all the fictions about F&F credibility. He is already running low on his supply of T-Bills and T-Notes. Although the quality of F&F paper is probably superior to much of the dreck he's been absorbing lately from Wall Street, he can't be pleased that the pace of swapping the household silver for squashed beer cans is accelerating.
2. The Administration's bailout bill was, as noted above, summarily rejected by Messrs. Frank and Dodd, because it included a ban on legislative lobbying, and did not provide for a Congressional honey pot for community activist organizations like Acorn that provide financial help to some distressed homeowners, funding for Left-oriented groups active in local street politics, which provide support for "progressive" Congresspersons, and engage in large-scale voter registration of people deemed likely to vote Democratic. They sent the bailout bill back to Bush, adding in all the pork and payoffs they had publicly demanded. Bush said he would veto it.

He didn't use Reagan's response in similar circumstances, "Make my day!" Maybe that was the tipoff that Bush's surprising display of principled valor was nothing but bluff and bluster.

Bush caved.

It turns out that Bush's legions of critics have been right after all. When given a chance to show real leadership, he displayed the weakness they have been ridiculing for eight years.

*Perhaps he feared that there had been meetings made and promises given to Russia—and, perhaps to other nations.*

Putin plays for keeps. Everybody knows that.

But why did Congress feel *it* could play for keeps?

Why did Dodd, Schumer, Frank, *et al.*, in the midst of the greatest financial crisis of this generation, refuse to pass the emergency legislation unless it included the \$4 billion in Congressional

slush funds *and* the continuation of F&F's lucrative Congressional lobbying? Why were they so convinced that they could force the Administration into a humiliating capitulation? What, if anything, did they know about Russia's attitude toward this confrontation between the White House and the Hill?

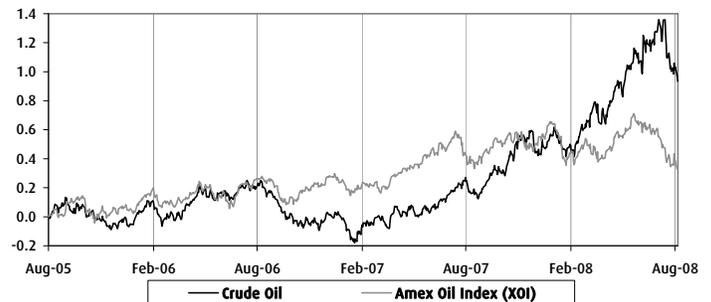
Maybe everybody agreed that it would be best for all concerned if the deals were done and no questions were asked publicly.

To us, these unasked and unanswered questions argue that investors shouldn't be rushing to buy US financial stocks. The crisis may not be over until the Administration and Congress do something truly radical:

Give full and fair disclosure to investors.

## Part II: The Deep Blue Sea

**Crude Oil vs. Amex Oil Index (XOI)  
August 2005 to August 2008**



Offshore drilling was originally restricted by Congress in 1981, when oil prices were falling, and oil imports were modest.

Bill Clinton issued an executive order banning all drilling in the US offshore in waters not under active development. Bush, perhaps eager to show that he was no ordinary Texan, continued that ban. When oil prices climbed sharply and the industry asked for a reconsideration of that ban, his brother Jeb, then Governor of Florida, publicly called for continuation, and the ban remained.

Why was there such a consensus, as the US bill for imported oil climbed sharply, year after year?

The BANANA environmentalists (Build Absolutely Nothing Anywhere Near Anyone) have been consistent in opposing any new drilling offshore, (and in most locations onshore) in the Lower 48 and Alaska.

They got a big boost from the Exxon Valdes disaster. This wasn't the failing of a small company that lacked adequate funding to lease secure tankers. It was the company NGOs had taught decent folks to hate, run by Darth Vader (aka Lee Raymond). Exxon was not only the biggest and richest oil company that was neither Arab nor Gazprom, but it was also the renamed Standard Oil of New Jersey, which had been a target for "progressives" before there was a Green movement.

If the offender had been British Petroleum, the emotional campaign might not have developed sustained legs. Under the leadership of John Browne, BP (as it was renamed) became the environmentalists' favored oil company. Browne had four things to make him lovable: he wasn't a Texan, he was a Labour Party supporter whom Tony Blair appointed to the House of Lords, he had transformed the company's image away from oil into envirofriendliness, and he was an early and consistent global warmist. The Greens stuck by him even when he was found to have cut maintenance budgets on the Prudhoe Bay pipeline and a major leak—bigger than the Valdes—ensued, and even when he slashed maintenance budgets on the aging Texas City refinery, which then suffered an explosion that killed 15 workers.

Each time the offshore drilling ban came up for discussion, the Left united in furious opposition. That Lee Raymond was so vocal in expressing doubts about global warming helped ensure that Exxon remained a hate symbol—and, by extension, the rest of "Big Oil." Few people noted that Big Oil was becoming a smaller and smaller factor in the global industry—partly because Big Oil companies continued to report robust Reserve Life Indices. Somehow, their accountants continued to accept the inclusion of Russian, Venezuelan, Ecuadorean, Khazakstan, Nigerian and Angolan reserves at their full SPE-approved levels, making zero allowance for political risks.

The major oil companies declined to discount their reserves according to the terms of production-sharing agreements with host countries. During the 1990s, as the multinationals struggled to compete with OPEC producers, they went around the globe, cutting deals with governments eager to join the oil producing club. By an interesting coincidence, all the majors set the same terms: 15% return at the wellhead based on an assumed oil price of \$20. The companies were convinced OPEC would always have huge excess capacity to prevent prices from going higher, except during brief shocks, such as the invasion of Kuwait. Therefore, they weren't interested in profit-sharing deals that would involve calculations of how much they earned on oil at varying prices.

The only area for bargaining was on the possibility that oil prices climbed sharply and stayed there. Since the majors thought that was a remote possibility, they agreed to deals in which the host country's share of production rose if oil went to \$35. These became widespread.

When oil defied the shared wisdom of Lee Raymond and Daniel Yergin by roaring through \$35, and then through \$50, host countries began to win, big time. Although the companies dutifully reported in their income statements that their net production was reduced because of those arrangements, they refused to slash their Reserve Life Indices to reflect the possibility that such elevated price levels would become the norm.

So we had little sympathy for the majors' complaints that their opponents should recognize that their percentage share of the world's output faced sustained decline. If they had been more candid in their financial reporting, then commentators would have been raising warning flags. Instead, they gave the Hard Left an easy basis for their screams of fury about "obscene" profits and their alleged failure to reinvest in new production.

That has changed. For four straight quarters, the majors have reported declining production due to production-sharing agreements and they have been reducing their Reserve Life Indices. Barclays estimates that the Second Quarter declines of the majors could exceed 600,000 barrels per day. Their upstream profits keep setting records, but they are earning more from less. Those robust earnings from \$140 oil attract attention (and fury), but they are heading down as oil consolidates lower. Meanwhile, their refining, marketing and chemicals profits have been slashed.

Exxon Mobil's Second Quarter report was typical. Although it reported record profits of \$11.7 billion, it also reported an 8% upstream production decline. It also announced \$8 billion in stock buybacks.

As oil ran past \$100 a barrel, Congressional Democrats subpoenaed Big Oil's biggest names for public flogging. Senator Barbara Boxer's rage was palpable. She demanded that the companies slash the compensation and pension packages for senior officers, to lower the price of gas. Senator Durbin wondered aloud how they could sleep at night in view of the misery they were inflicting on ordinary Americans. Senator McCain showed why so many conservatives show so little enthusiasm for his candidacy by denouncing their "obscene" (there's that word again) profits, and criticizing them for their failure to spend more on alternative energy.

But a funny thing happened. As gas prices climbed above \$4 a gallon, polls showed voters had begun questioning whether Democrats' energy proposals were really addressing what they now considered the biggest problem facing the US economy.

To date, the observable energy policies of prominent Democrats include (1) suing OPEC in a New York court under US anti-trust laws; (2) demanding an excess profits tax on oil companies, with the proceeds to be distributed among poor folk having trouble paying for gas, on the profoundly insightful principle that if the companies keep their money, they'll give it to their top executives, rather than producing more oil and gas; (3) lobbying to block additions to a Chicago-area refinery that is gearing up to refine Alberta Oil Sands crude oil; (4) promoting the building and subsidization of corn ethanol plants, which get a 51 cent a gallon subsidy plus a 54 cent a gallon tariff against imports of Brazilian sugar ethanol; and, (5) most importantly, introducing legislation to stop pension funds and other big "speculators" from investing in oil futures.

Of these various energy initiatives, the only one that has broad bipartisan support is corn ethanol. Among the relatively few Republican holdouts is Senator McCain, who justified the blogs' widely-used nickname of "McStupid" when he opposed the ethanol subsidies *in the Iowa primary*. (He finished last, of course.) Bush had also been a big ethanol backer, and authored legislation promoting extensive and expensive research on other potential biofuels, including switchgrass.

But \$125 oil, \$6 corn and \$13 soybeans shocked the Administration. President Bush announced what amounts to a *volte face*, calling on Congress to repeal the ban on offshore drilling for oil and gas. McCain immediately endorsed that call (although he continues to oppose drilling in ANWR, the Arctic National Wildlife Reserve.).

Why was the previously unthinkable suddenly being discussed?

1. The Chinese and Cubans will soon be drilling in the sea near the Florida Keys. Even Greenpeace can't stop those operations. And even Greenpeace might be willing—under pressure—to admit that American oil companies are more likely to be able to handle extraordinary offshore problems than the Chinese or Cubans.
2. The US Geological Survey estimates that recoverable reserves in the US sections of the Atlantic and Pacific and closed areas of the Gulf of Mexico could be more than 80

billion barrels. (It also believes that another 90 billion could be found in the Arctic regions, but those potential reserves are divided among the US, Canada, Denmark, Iceland and Russia.)

3. More and more analysts have pointed out the significance of the fact that Katrina, "The 100-Year Storm" that hit the producing platforms in the Gulf of Mexico, only triggered a 7.4 million barrel spill, which swiftly dissipated, despite inflicting billions of dollars in damage to the offshore producing facilities and the network of seabed pipelines. This, they argue, proves how far the oil industry has come. Its decades of experience in such challenging regions as the North Sea and Newfoundland have meant that the oil companies and service industries have the technology and skills to manage the risks from storms, icebergs, undersea earthquakes and hurricanes.
4. No new oil refineries have been built since 1978. Meanwhile, most of the new oil deposits being developed in the Mideast and Russia are heavy, high-sulfur crude. As supplies of light oil dwindle, the strain on refinery capacities increases. The only likely source of large-scale new production of light, sweet crude is offshore. (That's where, for example, Nigeria's prized Bonny Light comes from—when local terrorists permit.)
5. At current oil prices, the US is sending abroad roughly \$2 billion a day. This is a daily drain on American wallets, and most of it goes to countries that have little love for the US. Much of that money, as Thomas Friedman routinely reports, ends up financing Islamic terrorism training in madrassas, and recruiting and arming jihadists.
6. Mexico, long considered America's most reliable large-scale supplier, is running out of oil. There is still a lot of oil under its section of the Gulf, but Pemex, the government oil company that owns 100% of the nation's oil production and distribution, has to send most of its net earnings to the government. It desperately needs financing and technology to avert the rapid decline of its production, particularly from Canterell, at one time one of the three biggest oilfields in the world. The Mexican Constitution forbids participation in its oil industry by non-Mexicans. President Calderon is trying to amend that restriction, but the Opposition is whipping up nationalist sentiment against the Yanquis and Big Oil. Chances of reform are dim.

7. Canada is now America's biggest and most reliable supplier. Problem: all the growth in Canadian exports comes from the oil sands. Senator Obama endorses the environmentalist campaigns in Illinois against refinery modifications to process oil produced with what the NGOs claim are unacceptable levels of CO<sub>2</sub>. Obama has pledged himself to fight imports of Canadian "dirty oil." (Perhaps Obama needs to come to Canada; speaking to a vast, adoring crowd might help solve his apparent problem with Canada. He pledged that, when elected, one of his first calls will be to "The President of Canada" to inform him he's ripping up the NAFTA Treaty.)
8. \$4 gas—maybe headed for \$5. The US economy is already hurting, and, as US oil production continues to slide, there is no relief in sight. To the dismay of Greens and Democrats, there has been a huge swing in public opinion in favor of offshore drilling. Polls show two-thirds of voters now endorse it.
9. Offshore oil has been the only issue McCain has raised in weeks that got him both media attention and impact with voters. Whether by coincidence or not, as Obama was dominating US media with reports of his splendid tour across the Mideast and Europe, his lead in the polls among people actually eligible to vote shrank significantly. Last week's Gallup-USA Today poll of likely (as opposed to eligible) voters showed McCain slightly ahead. Pollsters said the Democrats' stand on energy policies had begun to hurt Obama.

When asked about offshore drilling, Obama played to his base, citing the fashionable lines about alternative technologies, ethanol, wind turbines, conservation, fuel-efficient cars, electric cars, bicycle lanes, etc. Even T. Boone Pickens endorses most of those proposals, but not because he's against offshore oil. He's a peak oil believer and he believes we have only a few decades before the world virtually runs out of oil, so we have to get all the technological help we can. (That, we should note, is our view.)

The problem, of course, is that there are, at the moment, no quick fixes. Wind power suffers from interruptibility problems. (Moreover, some of the best locations, such as Cape Cod, are off limits because of the damage they could inflict on the scenery in beachfronts along the coasts, most importantly if they're near the playgrounds of rich, politically influential people who enthusiastically endorse turbine installation in Republican

venues. Thomas Friedman enthusiastically endorses Pickens' proposed windmill mega-project, which threatens the sensibilities only of folks in Texas, Oklahoma and Kansas. Speaking to *The New York Times*, Pickens explained that geographic limitation by stating that he would gladly locate turbines on the coast, but believed he could not get permits.

As a result of the President's initiative, the House was facing a vote on legislation to dismantle the ban, in agreement with local states, when Speaker Pelosi dissolved the session, sending Congress on vacation. That apparently killed offshore drilling for this year. She's as smart a head-counter as Washington has seen and she knew that some moderate Democrats would vote to repeal the ban, and others elected by narrow margins feared their chances of re-election if they were on the wrong side of what had suddenly become the hottest issue in this election. This is a question that the average voter can understand. He or she is frightened about talk of \$200 oil. The feelings run particularly high in suburbs located far from cities, where urban transportation is hard to get or completely unavailable. She also feared giving McCain's scant chances a huge boost.

In defense of her closing of Congress to avert a vote on drilling, she said, "I'm trying to save the planet."

But, unless the world switches swiftly from cars to bicycles, there will still be gasoline demand. Where will the oil come from? As Charles Krauthammer notes, since US production peaked in 1970, domestic oil output has plunged 47%, and demand worldwide has risen sharply. Where will the oil come from? Nigeria? With its enormous environmental and social problems? Venezuela? Senator Schumer calls on Saudi Arabia to produce an extra million barrels a day, which will involve "further exploitation of the pristine deserts." Ethanol and other biofuels? That means driving global food prices even higher, unleashing more suffering and starvation—and the destruction of more rain forests in Southeast Asia to produce palm oil for fuels.

Ms. Pelosi, Thomas Friedman, and other liberals have been ridiculing offshore drilling by pointing out—quite correctly—that it wouldn't deliver oil until the next decade. But that is true of every multi-billion-dollar oil offshore project—whether in Nigeria or Brazil.

But proving up major reserves and building in the infrastructure and delivery systems would produce jobs now and oil later.

The recession spreading across the nation is caused by lost trillions from Wall Street and triple-digit oil prices. An announcement of a major change in national energy policy based on finding and producing America's oil would not only generate capital investment and jobs *now*, but would also be a tonic for the nation's spirit. Nothing in the Green's energy nostrums will reduce American dependence on imports from unreliable or downright hostile countries. Those surveys showing that Americans think the nation is in decline always include data showing that people think back fondly to the days when America was self-sufficient in oil.

In any case, the drilling opponents demand multi-trillion-dollar expenditures to fight global warming that will not be a real threat to the world as we know it for many years (if ever). They issue lofty demand for high taxes and stronger government controls now for a long-term problem but bitterly oppose projects to produce more oil—and jobs—because the oil won't flow for years.

Actually, oil discovered now can help keep today's oil prices down. Oil for future delivery comes into the futures curve and influences oil prices back down the curve. What the elites dismiss as Future Schlock is really a mild dose of Futures Shock to runaway oil prices.

Approving offshore drilling doesn't mean spending one dime less on viable wind or solar projects. Problem is that the most-touted solution—biofuels—has proved to create more problems than it solves, and the enthusiasts still talk as if “growing our energy” is the solution that will give us “energy independence.”

And none of those vigorous opponents of offshore oil suggests approval of new nuclear plants. None of them wants new hydro dams. None of them wants to expand coal-based electrical production. None of them wants to approve expansion of shale oil. The global food crisis should have embarrassed them for their unqualified support of corn ethanol and soy diesel, and shown them that “growing gasoline” creates new problems. Solar power is clearly coming along, but there are numerous production constraints that have forced costs up sharply.

In other words, they oppose expansion of virtually all current forms of energy production—most notably oil.

It's about economic growth and jobs now—and in the next decade. It's also about huge profit potential for a major industry.

Demonizers beware: the American oil and gas industry isn't mostly owned by J.R. Ewing, the Hunts, the Bushes, and Dick Cheney. Its biggest investors include CALPERS, TIAA-CREF, Taft-Hartley plans, and mutual funds.

Approval for offshore drilling would mean, in terms of capital investment, the biggest oil rush the nation has ever seen. It would yank much of the domestic drilling industry out of its recession, and would mean huge demand for engineers, workers, pipe, steel, software development, sailors, land-based technicians, etc. It would restore America to global leadership in what will be arguably the most crucial technology for finding and producing oil in coming decades.

At a time when Americans are being told by the Left that their jobs are disappearing because of globalization, this would begin a renaissance of good jobs that must mostly be performed here.

No wonder the Left has been alarmed about this proposal that no pundit thought would be an election issue.

The first sign of an historic breakthrough came last Saturday when Obama stunned his backers—and the Republicans—by announcing he would back a compromise proposal from ten Senators to permit limited offshore drilling in parts of the Gulf of Mexico currently off limits. He declared that he is always open to compromise, as long as any legislation also included other aspects of his energy program, including the windfall profits tax. He also insisted that any oil discovered had to stay in the USA. (Presumably, there is a real fear that Big Oil would sell it to China or India.)

In response to this earthquake beneath her feet, Speaker Pelosi said on Sunday that she would consider a comprehensive energy plan that included some easing of the offshore drilling ban.

We read some of the environmentalist blogs on the weekend, and they are predictably apoplectic.

The battle has moved to a new phase.

There will not be blood.

But there will be a realistic national debate, driven by the most massive voter consensus on any issue in this campaign. That means the outcome will mean that a lot of money and jobs are going to The Deep Blue Sea next year...

And in all the years thereafter.

## Investment Environment

The American economy has managed to avoid a certified recession to date because of the big swing in its non-oil trade account. The fastest growth component is exports, which benefit from the weak dollar and strong grain prices.

We still believe we are in the early innings of the housing crisis. Those who tell us bank stocks are worth buying now insist the bottom for housing is near and that means the bank bear market is nearing bottom. They don't worry about the other excesses during the era when Greenspan was pumping out 1% fed funds, and China, India, Europe and Russia were loading up on Treasuries and F&F paper, LBO loans, Collateralized Real Estate debt paper, Auction-Rate Bonds, etc. The Paulson/Bernanke Fire Brigade is going to be busy until the partnership has to be dissolved because of a political event: assuming that Mr. Obama wins, one of his first appointments will be a new Treasury Secretary.

As for the major emerging markets, they have kept their economies humming with massive subsidies for foods and fuels. That has meant over-rapid monetary creation and fast-climbing inflation. History tells us that whenever a new economy enters a period in which its inflation rate is far above those in the established economies, something unpleasant happens to the new-rich.

Food inflation at a time of fuel inflation threatens the business model of the leading Third World economies. Since China and India together really set the prices for the base metals, the best things that could happen to demand for metals—for example—would be a drop in oil prices to \$75 a barrel, and in corn to \$3 a bushel. The former is more probable than the latter, but we aren't betting on either.

### **Banks Soar, Commodities Collapse**

Until July 13<sup>th</sup>, the strong performance of the commodity stocks was not based on such distinctions, but on the performance of the financial stocks. The popular trading strategy had been going long the commodities and commodity stocks, and short the banks.

Once investors began to believe that all banks whose ticker symbols they knew had suddenly become too big to fail, they looked at the stock prices of the walking wounded and decided that they no longer had to worry that they'd die. Result: they

bought the banks, generating a massive short-covering rally, and dumped the commodities.

But since heavily-levered hedge funds had been major winners from the commodity rally this year, they were the first and foremost victims of the 100% change in investor risk perceptions. And who was out there to buy commodities and commodity stocks when hedge funds were falling all over each other to raise cash to cover their shorts on the banks?

As we have repeated so many times, the real believers in the commodity story remain in a minority. And, conspicuous among the biggest believers have been highly-levered funds.

Result: when these big believers were forced to sell, there were few major pools of capital to absorb their selling. On August 4<sup>th</sup>, the day that the major US oil stocks should have been soaring because of Obama's change of heart on offshore drilling, they sold off along with all the other commodity stocks in a *saue qui peut* bloodbath.

As Merrill's announcements last week showed, the reasons why financial stocks sold off so heavily haven't really changed, despite the big bailouts. The US and global economies remain at risk because of the fast-spreading putrefaction on Wall Street's balance sheets. Merrill raised \$4.5 billion by selling off the most marketable of the family jewels—its minority interest in Bloomberg. But it was paid just 22 cents on the dollar by a hedge fund for a few dozen coffin-loads of Stan O'Neal's ghastlier creations. (Actual cash was only a nickel per dollar: this was a vendor financing deal, because Merrill lends them the other 17 cents, and if the undead manage to rise past 22 cents, the entire profit goes to the hedge fund.)

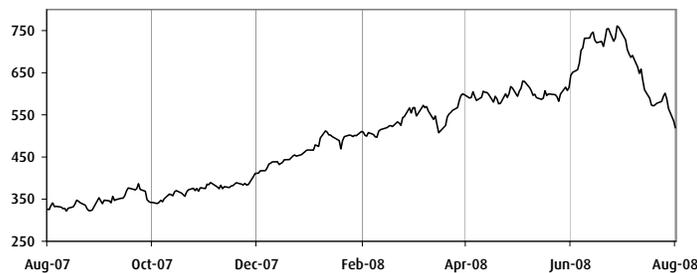
One reason for the current commodity stock meltdown is the rising concern among commodity investors about what happens to the Chinese economy after the Olympics. We have been maintaining that China wants to slow its breakneck pace, because of the potentially destabilizing effects of food and fuel inflation. So there will doubtless be a pause. However, the idea that the Olympics were themselves a glorious economic testosterone supplement that gave China misleading economic prowess is, to us, seriously wrong. According to a member of the US Olympic Committee we met recently, China's direct expenditures for the Olympics are \$47 billion. That has undoubtedly provided considerable direct and indirect economic stimulus, but in an economy of China's size, this non-recurring cost is not on a scale that would warrant some of the gloomy prognostications.

We also note that the government has been ordering shutdowns of smelters and coal-fired generating plants to try to purify Beijing's air, implying that commodity demand could actually rise this autumn. We also find it of interest that last week, for the first week in many months, the renminbi fell slightly against the greenback.

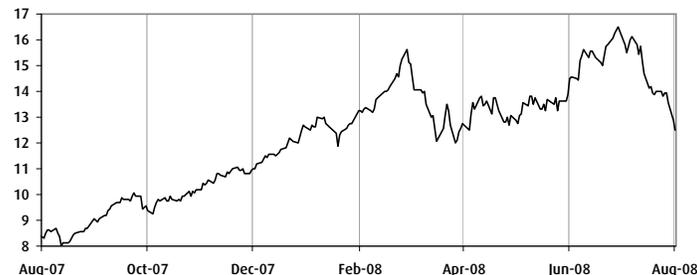
To us, one of the most interesting news items from China recently has been the report that the regime was able to prevent disastrous food scarcities after the winter storms and the earthquake because it released hitherto-undisclosed reserves of food. The USDA recently revised upward its figure for global corn carryover, triggering a 75 cent drop in corn prices. We rely on the USDA data for our work, and advise clients those numbers are the most accurate available data. That does not mean there aren't hidden reserves in various places around the world, but we were still impressed that the Chinese have such extensive supplies. Perhaps one of Deng Xiaoping's advisers had read the story of Joseph.

Grain prices have retreated sharply from their highs at a time that it appeared that a substantial portion of the Midwest's potential production of corn and soybeans had been washed out. Latest crop reports show a remarkable recovery. The production and yields forecasts have been climbing astonishingly—and grain prices have been falling as if we had re-entered the half-century of surpluses.

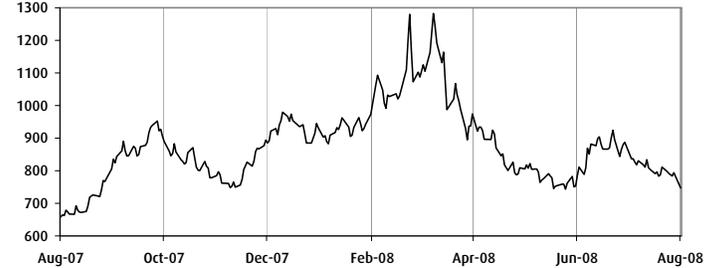
**Corn**  
August 2007 to August 2008



**Soybeans**  
August 2007 to August 2008



**Wheat**  
August 2007 to August 2008



This is good news for the world's hungry. But it could be a bit early to rejoice. The sunspots have not returned, which means there is a possibility that the Midwest could experience an early frost. Since the cold, wet weather delayed planting and flooding forced replanting, crops are maturing later than usual this year. An early frost would not be catastrophic, but yields would be reduced—perhaps dramatically. At this point, no one knows. Meanwhile, even the reduced prices of grains are very expensive for the world's poor. One bad crop year and the situation would correspond to oil. After soaring to \$75 a barrel in 2006, it plunged to \$50 and consumers breathed sighs of relief. Then... well you know what happened then.

That same cooling process has meant better rainfall in Australia, which means Australian wheat production and exports will be up substantially. Moreover, rice harvests in South Asia have been robust, and governments are freeing up exports after imposing controls. The global food situation looks less perilous now than six months ago, but remains the same in one key respect: one major crop failure in the US Midwest means a global food catastrophe. The grain carryovers are still going to be marginal compared to earlier years. Even \$5.50 corn is a huge moneymaker for producers—and still means that extra fertilizer give a big payback.

Last Friday, the *Financial Times* headlined a story, "Biggest dive for commodity prices in 28 years." The CRB Index had fallen 10% in July, its worst month since March 1980. Biggest decline was natural gas, down 31.4%, with corn down 19.2% and oil down 9.7%. The only big winner was lead, which isn't in the CRB, which leapt 25%. Because those drops coincided with the leaps in the financials, we aren't alarmed that the commodity boom is over.

But oil's run this year was clearly unsustainable at a time of slowing OECD economies. It was partly driven by the on-again, off-again stories about a possible attack on Iranian nuclear facilities that would trigger a closure of the Strait of Hormuz.

The commodity carnage, then, is driven by the futures shock as hedge funds rush to delever themselves to survive in a world in which F&F shares are suddenly safer than XOM's, and Federal Reserve transfusions make companies more robust than those with politically-secure long-life reserves in the ground.

*The world has gone mad today,  
And good's bad today,  
And black's white today,  
And day's night today.*

With new leadership coming to both Israel and the US, there has been more investor relaxation about that threat.

However, a greater threat may be about to disrupt global investors' comfort levels. It involves a potential crisis in Pakistan, which is far enough from the Strait of Hormuz that oil production and delivery shouldn't be affected, but it could prove to be an even bigger problem for the world than a short-term supply disruption in the Gulf.

### **A Bigger Risk Than Iran?**

Pakistan stunned the world in 1998 when it announced it had successfully tested a nuclear weapon. India had tested its first nuclear weapon in 1974.

Dr. A.Q. Khan, the national hero responsible for Pakistan's nuke program, got help from China and may have stolen some technology from Europe.

The reasons why the world worries more about Pakistan's bomb than India's larger cache of weaponry is that (1) Pakistan's democracy is coup-prone and fragile, (2) Pakistan is a Muslim state, with a powerful Islamist and jihadist minority, and (3) Not only is Pakistan's border with Afghanistan heavily populated with the Taliban, al Qaeda and other extremist groups, but also the state's security group, the Inter-Services Intelligence (ISI), which often seems to operate beyond government control, is heavily infiltrated with extremists.

A running sore between Pakistan and India is the beautiful mountain state of Kashmir. Although its population is mostly Muslim, it was handed to India after partition in 1947, and India has refused to hold a referendum on Kashmiri independence or union with Pakistan. Small wars, occasional massacres and various bombings over the last half-century have ensured the survival of bloodthirsty extremist groups in both nations.

During the last Pakistani election, the charismatic Benazir Bhutto returned to her homeland to run for the Premiership. She was under ISI protection during the campaign, but was assassinated. The killers made it look easy, and millions of observers believed ISI had been involved. Yousaf Gilani of her party ran in her place and was elected. President Musharraf remained in his position, but with reduced powers.

On July 7<sup>th</sup>, terrorists bombed the Indian embassy in Kabul, killing 41 people. Then, last week, there was sustained gunfire along the border in Kashmir. India claimed Pakistani troops fired first, in what was the first sustained violation of the five-year truce between the uneasy neighbors.

On August 1<sup>st</sup>, *The New York Times* ran a front-page story claiming that US intelligence officers in Afghanistan had come up with proof that ISI officers had organized the Kabul bombing. The US had intercepted communications between ISI and the bombers on the scene. President Bush told Premier Gilani of this discovery on Gilani's visit to Washington a week earlier. Pakistan has dismissed the allegations.

The Kabul bombing follows a string of blasts across India last month that killed and wounded many people. They were well-synchronized, and were a departure from previous terrorist attacks which had the appearances of one-off local operations. Many observers have stated that they looked to be aimed at provoking a civil war between India's 827 million Hindus and its 140 million Muslims. The attackers are said to hope that Indian extremist groups, which have been responsible for many atrocities in the past, will take vengeance.

Why are these developments potentially destabilizing? Because Osama bin Laden and Taliban leaders are said to reside in Northwest Pakistan and could be planning attacks that would bring down the fragile Islamabad government, setting the stage for Osama and friends to get their hands on nuclear weapons (of which Pakistan is said to have 18 or 20).

A. Q. Khan remains off limits to all interviewers. He has apparently admitted to selling nuclear technology to Iran and North Korea, in violation of Pakistani guarantees to America and Europe.

**Conclusion**

We believe the risk levels for global investors continue to rise. Among the barriers to bullishness are (1) a sustained global banking crisis, (2) global food and fuel inflation, (3) recessionary conditions in the US, Canada and Europe, (4) Iran’s rush to go nuclear, and now (5) the prospect of tit-for-tat terrorism between Hindu and Islamist extremists in Pakistan and India, with the possibility that ISI extremists might decide the time had come to deliver nukes to Osama.

**Personal Notes: What I Read This Summer**

Clients frequently ask what I read on vacation. Here are books that I read and can recommend

1. *Northern Tigers* Dick Haskayne

Autobiographical books by successful business people can be disappointing, and are frequently so distorted by egotism that they become boring. This one, however, is a splendid read for anyone who wants to know the history of Western Canada’s move to global prominence. Mr. Haskayne has been a key player in an amazing percentage of Alberta’s major corporate growth stories. He also has takes the time to present enlightened views on corporate morality and philanthropy.

2. *What Is The What* Dave Eggers

I re-read this one because of being a co-group leader in a literary group. It is one of the more important books of our time, because it is an autobiography of a remarkable person who was one of the Dinka boys who was forced to flee Sudan because of the all-out assault from the Arab-led government in Khartoum. He is astonishingly balanced in his portrayal of the rebellion of the Christian blacks against the Islamists. He tells horrifying stories, but avoids sensationalizing. Dave Eggers is one of America’s best younger writers, and this is one you won’t forget.

3. *One Man’s America: The Pleasures and Provocations* George Will

Will is one of the best essayists—conservative or liberal—around. This collection of previously-published columns and essays is a treat for the intellect, and a consoling retreat from the banalities and sound bites of an election year.

4. *Morality Play* Barry Unsworth

Unsworth is an accomplished writer of historical fiction. This tale of a murder in 14<sup>th</sup> Century Yorkshire is well-researched. It is of particular interest for theater buffs, because of his detailed accounts of the techniques of traveling players, and how they created new dramas for performances in differing locations.

5. *On Chesil Beach* Ian McEwan

The author of *Saturday* and *Atonement* is able to charge full price for this novella. I’ve read virtually every book he’s published, and this isn’t up there with his best. However, most other living authors would be thrilled to produce such a literate, well-crafted tale.

6. *The Enchantress of Florence* Salman Rushdie

This was the highlight of my summer. I can’t argue that this is up there with *Midnight’s Children*, or that he deserves yet another major literary prize, because I was prepared to be fascinated by a novel about India’s greatest ruler—Akbar, and about his great castle, Fatehpur Sikri, that I visited two years ago. As if that weren’t enough, it also takes place in the Florence of Machiavelli, who was one of my favorite authors in college. So I admit to bias. Still, this is a remarkable account of two great civilizations that briefly intersected.

7. *The Omnivore’s Dilemma* Michael Pollan

This is the most-discussed book on food policy these days. It’s well-written and interesting and has a wealth of information. Mr. Pollan does strive—much of the time—to give a balanced presentation, and he’s an engaging personality. It will be cherished by the legions of believers that the food industry has it all wrong, that our diets are unhealthy, and that organic and other postmodern farming techniques are our best hopes for dealing with the food problem. Unfortunately for him, the book is already dated, because it is rooted in the view of the inevitability of never-ending surpluses and low returns to cash crop farmers.

8. *The Assassin’s Song* M.G. Vassanji

Vassanji’s prize-winning *The In-Between World of Vikram Lall* was a splendid account of what happened to the Indian community in Kenya after independence. This is a somewhat less engrossing story about a Sufi shrine in Gujarat, a boy who had a right of inheritance its curatorship, and the tragedies that befell his family during the horrific riots of 2002.

## Investment Recommendations

1. This is not the end of the commodity bull market. Bear Stearns, F&F and other crises will one day seem trivial. The new global middle class that is repricing commodities never will.
2. Remain underweight the banks and financial stocks that invested heavily in the asset classes that collectively created a global financial crisis. Despite the frantic efforts of the Fed and Treasury, new challenges appear each week. The deleveraging process is accelerating. Those peddling bank paper perversely insist that these writedowns and bailouts are now so gigantic that a turning point is near. We think serious investors should compare this sordid story to the SARS epidemic: When the number of infected people was rising sharply and rapidly, cautious flyers asked themselves, “Is this trip necessary?”
3. We recommend that clients begin taking preliminary positions in companies which stand to benefit most from the possible onset of realism in US energy policies. When—not if—offshore drilling finally gets the nod, the majors and service companies should benefit enormously. Arctic drilling could be next, from which some important Canadian companies would benefit, although the technological problems are formidable, and the pipeline issues are not fully resolved.
4. As for corn ethanol, the producers have been lucky: they benefited from \$125 oil, which has largely offset \$5.50 corn. They have also benefited from the plunge in natural gas prices. As if those weren’t enough to save an industry whose fundamentals had become so controversial, they also benefited from the collapse of Doha, because the embarrassing tariff against Brazilian sugar ethanol survived.
5. Natural gas supplies have exceeded expectations because of the Barnett Shale and coal bed methane booms, and because this summer has not been as hot as had been feared. We recommend the natural gas-oriented producers with above-average reserve life indices.
6. The fertilizer companies have delivered the most impressive earnings gains of any commodity group. Nevertheless, their share prices have fallen in recent weeks along with other commodity groups on days when traders have been buying banks and dumping commodities. They probably have the most predictable earnings of all the major commodity sectors, and should be cornerstones of any resource portfolio. As for the bricks, they are the farm equipment companies. The roof and windows are the logistic companies and seed manufacturers.
7. The continuation of the wide spread between Libor and the fed funds rate, despite the best efforts of Messrs. Bernanke and Paulson, suggests that the real US economy will begin to show serious strain because banks are cutting back on making traditional loans—they have squandered their resources in untraditional products they never really understood. Hoarding liquidity is like hoarding corn or wheat: it triggers shortages and punishes the weakest consumers.
8. Gold remains the asset that offers unique risk reduction features in equity and balanced portfolios. As to investment strategies, the ETF outperforms during gold bullion selloffs, but the stocks outperform when bullion rallies. We believe investors should have exposure to both kinds of asset, but leave the weighting to be resolved on individual portfolio risk/reward considerations.
9. We keep reading forecasts predicting falling inflation and gold prices because of a US recession, but insisting that the recession will be neither deep nor long. Recession actually proved to be an aphrodisiac for gold lovers in the Seventies: Each of the recessions back then was accompanied by higher inflation rates than almost any prominent economist predicted. We do not expect a recession so deep that it will stop the march to higher inflation, with the band music and drum beats coming from the major emerging economies. We remain negative on longer-term dollar-denominated nominal bonds. We prefer mid-term, inflation-protected bonds in strong currencies.