Global Portfolio Strategy

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Basic Points – "Can't anybody here play this game?"

I. The Dynamic Duo's Midsummer Night's Play

When you've been Goldman's CEO, you probably have an inbred sense of superiority when analyzing the quality of management of most of the other Wall Street houses.

When you've been Princeton's star economist who has spent years studying past financial crises, you probably have an inbred sense of superiority when you look at the pay packets of bankers who mistake their ability to prosper during sustained liquidity gushes for sheer genius. When the Street's self-crowned Prince grinned as he talked about his dancing skills, you figured that the music was about to stop, and that would mean trouble for your program to rein in inflation without aborting the strong economic recovery.

The global saving glut was going to end sometime, if only because of the unending descent of the dollar that was driving up inflation rates in those desert nations whose currencies were dollar-pegged.

Deserts can experience flash floods. Then the sand absorbs the water, and sands once again take over. We recall our most unusual flight delay. We were scheduled to fly from Phoenix to New York, but all flights were delayed because the airport in the Valley of the Sun was underwater, due to a day of heavy rain. There were no storm drains, so nature had to dispose of the water by itself. It took a few hours, and then normalcy returned.

That's a useful trope for analyzing what happened to the banks holding trillions in mortgage-backed CDOs and LBO-spawned CLOs almost exactly a year before the Dynamic Duo rose to the rescue. All that perfumed paper was valued according to the kind of models that had slain Long-Term Capital Management nine years earlier, but, as Cicero sighed just before Mark Antony's thugs garroted him, "The people's memory is short." He was talking about the Roman elites. Those new American billionaires who celebrated their birthdays with Roman-style parties probably never learned Latin, or they might have left out the togas and fountains.

Why is it smart staffing to keep calling on Goldman CEOs to fill the Secretary of the Treasury slot?

Apart from the obvious fact that they are smart, honest, tough men who rose to the top of a famously competitive shop, there is another reality: they know where to find the weak points in the financial system that can be exploited when national policy requires dramatic intervention in markets.

It is too soon to write the history of the July 13th Commodity Massacre, but it is not too soon to analyze why Hank Paulson and his partner Bernanke decided they had to rescue the financial stocks and pummel the commodity stocks—and how they carried out these seemingly unrelated missions.

As of mid-July, Hank Paulson faced the following components of what was clearly Wall Street's biggest crisis since 1929:

1. Gold was once again threatening to break through the psychologically important $1,000 mark, as US CPI was soaring to 15-year peaks.

2. Oil was above $140 a barrel, corn was at $7.50, and soybeans were above $14. Cost passthroughs were being vigorously resisted, but food inflation was threatening to outpace fuel inflation.

3. The dollar was threatening to break down anew, through the 70 level. Despite spreading recessions across the Eurozone, the euro was threatening to break $1.60. European investment banks who had stuffed their systems with US subprime products had been protecting their balance sheet exposure to the sinking dollar by shorting the greenback, adding to the enormous pressure on the world's currency standard.

4. The Bank Stock Index had plunged in six months from 90 to 50. All those bank equity deals with Sovereign Wealth Funds were under water at depths that once looked to be open only to submarines.

5. The Fed's policy of swapping Treasurys for dubious CDOs valued according to the overlevered banks' own discredited models was imperiled: at the rate of degradation, the world's flagship Central Bank, whose promises are the sole backing for the nation's currency, would soon have a balance sheet whose assets resembled those held by the worst and weakest of Wall Street's discredited institutions. Already, the Fed was trying heroically to cut back on the inflow of model-valued paper, and this meant trouble ahead for Lehman and other overstressed institutions.

6. The European Central Bank was experiencing a similar problem, because many banks, particularly Spanish and German mortgage lenders, were swapping their illiquid assets for loans—in euros and dollars. Ben Bernanke was probably getting worried calls from Jean-Claude Trichet.

7. *The Wall Street Journal* and other leading publications were demanding that the Fed stop the rush to inflation by raising rates. In particular, *The Journal* insisted that soaring prices for gold and oil were driven by the descent of the dollar.

8. Fannie and Freddie (F&F) were on the edge of collapse, with hundreds of billions' worth of their paper held by government funds abroad, including $100 billion by Russia. If they went down, the housing bear market would become a collapse of potentially Depression proportions. There were anxious calls from treasurers abroad about the reliability of the unspoken promise of the Treasury to back F&F obligations. Barney Frank, the House kingpin on the F&F relationship, kept saying that they were financially sound and there was no government guarantee—nor would it ever be needed.

What to do?

Answer: take the pressure off the heavily-levered banks by putting pressure on the heavily-levered speculators and hedge funds that were short the banks and the dollar, and long the commodities.

With help from the SEC and the Commodity Futures Trading Corporation, Paulson and Bernanke sprang the trap.

They knew that, *in recent weeks*, there had been a big boost in "Long" speculative commodity contracts that had helped fuel the most recent runup in gold, grains and oil. This was a large deviation from the six-year pattern in the commodity bull market in which professionals and industrial participants had generally been the dominant forces in commodity pricing, as evidenced by the general pattern of backwardation, as opposed to a 1970s-style proliferation of contangos. (Backwardation means that the heavy participation of front-month players willing to take delivery dominates price movements. Contangos, could, as in the 1970s, show that bettors on future inflation are in charge.) They also knew that many big hedge funds had prospered mightily from the most popular trade—shorting the banks and going long the commodities and commodity stocks.

When should the trap be sprung to inflict the most pain on levered bettors against financials, the dollar and levered longs on oil, gold, and grains? Answer: Ideally, when Asian markets are opening on the weekend, before real liquidity returns to both the commodity futures market and, in particular, the US bank stocks. That would force panic short-covering overnight as markets opened sequentially, and the hedge funds would be in desperate positions when the Big Board opened to try to cover their shorts and unwind their longs.

Chris Cox of the SEC would add the icing to the cake: on Monday, he announced new, albeit temporary, rules against short-selling of F&F and leading financials. So, as the panicking hedge funds tried to cover their shorts, they would not face any offerings from other speculators as the beaten-down bank stock share prices were soaring…

The Sunday night announcement was timed for the opening of Asian markets. The supply of leading US financial stocks in Asian markets was thin, so they leapt dramatically. When Europe opened, that rally continued, so that by the time New York opened the stocks were up big, commodities were down big, and the SEC announcement let hedge funds know that Washington was pulling out all the stops.

Paulson knew:

- that the ultimate goal was to permit the banks to raise new equity, and that meant their share prices had to rise a long way; and
- that this would force a panic short-covering of dollar positions, setting off a mutually-reinforcing pattern of collapsing commodities, soaring financial stocks, and a rising dollar; and

- that a decisive break in gold, grains and oil futures, accompanied by the biggest dollar rally in years, would blow the inflation dragons away—at least for a while; and
- *therefore*, the Fed would no longer be under daily pressure to raise rates.

The genius in this strategy was that it relied on the excess leverage among hedge funds to take the pressure off the overlevered banks, which held huge exposure to F&F paper, guarantees, and preferred shares.

It worked…

Up to a point.

But, as Lady Macbeth cried, facing the necessity for more murders to hold the throne, "Returning were as tedious as to go o'er." Paulson and Bernanke hoped that F&F and other troubled institutions would be able to raise a big slug of new equity before they had to book further monstrous balance sheet write-downs. But it turned out there weren't new deep-pocketed suckers, and many of the SWFs managers had caught intense flak back home for their ill-timed aid to Wall Street. They weren't biting.

Their boost to bank stock prices was only a partial success, and F&F's problems were too huge for any set of investors, but the side of the hedge fund trade that Bernanke, Paulson & Co. has skewered continues to bleed. Commodities and commodity stocks kept going down, even after the bank stock rally topped out. This has doubtless been a source of great satisfaction to Bernanke, because now the columnists cite falling prices of commodities as signs of deflation that might induce the Fed to cut rates anew.

Of course, they haven't maintained the commodity bear market by themselves: Since the July 13th Massacre, Paulson and Bernanke have been helped by the spreading perceptions of a global slowdown that would be devastating to perceptions of intrinsic values of commodities generally. The Bank of Japan may have signaled this strategy when it published an analysis of commodities in the global economy and asserted, "Commodities are the thermometer of the global economy."

That is an interesting analysis.

Thermometers register temperature. But commodity temperatures can rise for one or two reasons. They can rise, as they did during this cycle, purely in response to faster economic activity, particularly in China and India. Or they can rise in response to rising perceptions about inflation—as they did during the 1970s, even when economic activity was erratic or recessionary. Gold is the classic inflation hedge, and can rise even when recessions hit, if inflation is still rising. Oil prices are driven primarily by economic activity, but oil futures prices can rise in expectation of future inflation—as they did during the 1970s.

Does this analysis mean that we believe that Paulson, Bernanke and Cox can manipulate commodity prices indefinitely?

Absolutely not.

What they have done is to force the excretion of leverage from exposure to commodities and commodity stocks, and to drive many highly-levered hedge funds to the wall.

This was a short-term shock that worked on a grand scale precisely because there was so much leverage in both longs and shorts, and the unwinding of those positions reinforced the moves on the other sides of the trades.

But, the Dynamic Duo quickly learned that it's easier to turn a commodity bull into a bear than to turn F&F into viable corporations. These spawn of Congressional and managerial greed were too perverted and diseased to be rescued by putting the squeeze on shorts.

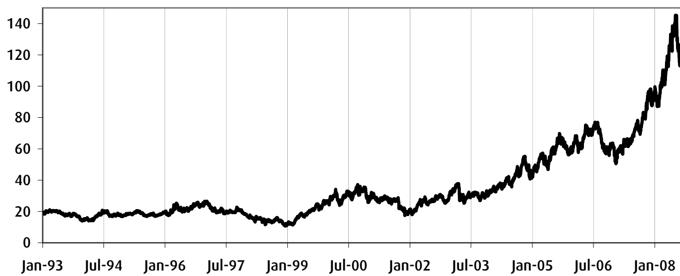
So, on September 6th, it was announced that the government will close out F&F's existence as unique capitalist/socialist creatures—financial mermaids or centaurs—and fold them into the national embrace and the national debt. The conservatorship means that the common stockholders will not be bailed out. This meant that none of the unexercised stock options slathered on the top executives as rewards for their book cookery would pay off and that was an occasion for the first joy we felt about this whole series of disasters. However, press reports indicate that Freddie's disgraced CEO is scheduled to get a huge going-away present, probably in pension form. We wondered idly whether the government should be investigating whether the pension should be calculated after deducting the costs to the taxpayers for maintaining him in jail. However, the reality is that there will be no investigations, no allegations, no charges, and no penalties. Those things happen to Enron people, not Washington insiders.

This is one-half of the potential good news in this sordid story. The other, we hope, is that F&F will no longer have funds to lobby Congress, and that the $4 billion slush fund which was shoveling out grants to favored "not for profits," "community organizations" and other promoters of "progressive" politics will have the same lifespan as the stock options of the people who were so eager to show their appreciation to the "right" Congresspersons by funding their pet projects which were so useful in ensuring re-elections for the friends of F&F.

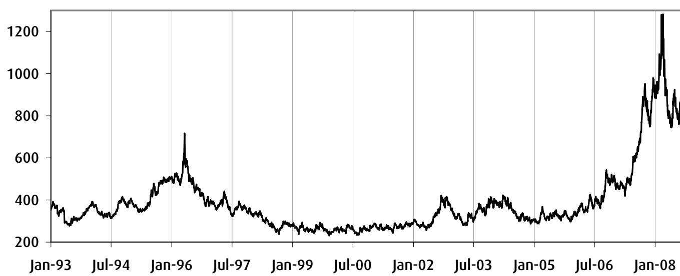
Now that the Dynamic Duo no longer has much reason to care about commodity prices and commodity stocks, what is the outlook for these Once and Future Kings of the Financial Markets?

II. Food and Fuel [In]Security

Oil
January 1993 to September 2008

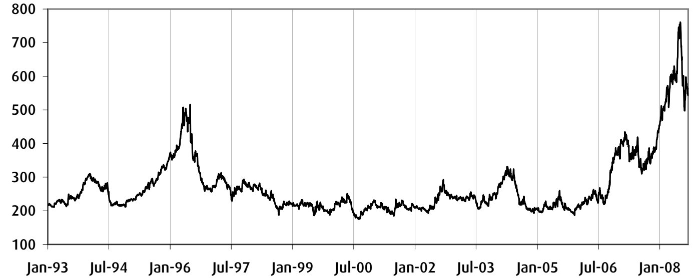


Wheat
January 1993 to September 2008



Soybeans
January 1993 to September 2008

Corn
January 1993 to September 2008



The 1990s were the decade after "The End of History." The West's triumph in the Cold War, the declaration of peace dividends by governments across the industrial world, the global boom in Internet usage, the advent of WTO, and the continuation of the Commodity Triple Waterfall collapse combined to give governments, businesses and investors confidence that stability and prosperity would become the new norms. The three great wars of the 20th Century would be the last global horror stories.

Global inflation rates continued in their decline from 1980s peaks. Japan, the first Asian industrial power to challenge the factories of Europe and North America, became the first industrial nation to enter sustained deflation since the Depression.

The millennium arrived with three bangs, while inflation rates continued to whimper. First came the Tech Triple Waterfall collapse—that sudden immolation of spuriously-based wealth which caused recessions in the US and other industrial nations. Then came 9/11 and a new—asymmetric—form of world war in which some of the major Western nations and numerous Third World countries were attacked on their home turf, sometimes by their own citizens or immigrants. The aggressors were shadowy fanatics based in primitive countries with weak governments who justified their slaughters with reference to a primitive parody of a great religion. The word *jihad* entered everyday speech as quickly as "atomic bombs" had 56 years earlier.

What yanked the world out of its fright and recession was the unexpected onset of history's most widely-distributed economic boom. If it had been up to the demographically inert economies of the OECD, the recession would have yielded grudgingly to a grudging, deflationary recovery that might have slowly and languidly Japonized the global economy.

But the vigor, vitality and newfound freedoms in China, India and other emerging economies created a new global boom that drove out global deflation by driving up the rate of global trade growth, while unleashing powerful commodity inflation. What we labeled "The Greatest Efflorescence of Personal Economic Liberty in History" turned hundreds of millions of peasants and urban poor into middle class producers and consumers in the blink of an historical eye. To move from hovels to houses with plumbing, electricity and basic appliances, and from bicycles, donkeys and camels to cars required purchase of energy and metals at sustained growth rates most industrial nations had experienced only during wars—that had always been followed by deep recessions.

What the internet and commodity booms shared was the sustained stimulus of globalization in an environment of unprecedented liquidity flows across national borders. For the first time since the late Victorian era, free trade promoted economic activity and lowered inflation across most of the world. The recovery was noninflationary, despite rising commodity prices, because of the broad deflationary impact from the new export powerhouses in the Third World.

One reason the commodity boom maintained its velocity was that it was not choked off by soaring interest rates—as had happened in all previous cycles. Consumers got the best of everything—seemingly limitless supplies of cheap credit to buy cheap goods—and increasingly expensive houses, whose price increases accelerated the growth of cheap credit in a magic monetary process.

The other reason was that the fastest-growing economies were also the fastest-growing users of commodities. OECD consumption of industrial metals continued its pattern of glacial growth, whereas Third World consumption grew rapidly. China, India, *et al*. took over the pricing of most industrial commodities because their powerful economic expansion generated the cash needed to bid globally for scarce raw materials.

Many strategists and most investors missed the mining boom because their own economies were not voracious consumers of iron ore, copper, nickel or zinc, so they assumed the "boom" was merely the newest bubble. (Many of Wall Street's biggest names, who had eschewed use of the word "bubble" for Nasdaq's moon shot, were quick to apply it to commodities.)

The good news for commodity producers in this decade came from headline-grabbing Third World *economic* stories—notably China, India and Brazil.

The bad news for commodity producers in this decade came from headline-grabbing Third World *political* stories—notably Russia, Venezuela and Nigeria.

Oil and Politics

Oil was a special case. As oil prices rose, the CEOs of Big Oil, and Daniel Yergin's Cambridge Energy Research Associates (CERA) kept attributing the price rises to speculation, predicting a return to $30. "There's plenty of oil in Russia and Venezuela," they assured doubters. Their caution seemed to be rewarded in late 2006, when prices fell from $78 a barrel down to $52.

Since 2003, *Basic Points* has been dismissive of their insistence that oil's price just had to stay low. On two occasions, we clashed at conferences with Cambridge spokesmen. They presented impressive charts showing the gigantic oil and gas projects that would not only drive down prices, but also hold them down. We kept maintaining that most of these mega-projects were in countries with risky—or outright poisonous—politics.

In effect, Big Oil and Yergin were implicitly basing their forecasts on the proposition that politics was irrelevant for commodity forecasting. Who really believed that?

At various times, OPEC spokesmen have piously asserted, "Oil and politics don't mix." Although that principle was followed by OPEC when it was convenient, it has become downright irrelevant in this decade. Russia would still be an unthreatening Third World state struggling with demography worse than Japan's were it not for becoming (probably briefly) the world's leading oil producer. Oil is also the reason why Iran's revolutionaries can finance membership in the world's nuclear club.

One reason why it became increasingly important for the oil majors to convince investors that oil was overpriced and due for a sharp, sustained drop was their growing dependence on production from reserves in Third World countries that were subject to production sharing agreements.

As the majors' production from established fields in politically-secure regions peaked and declined, they had no choice about protecting their Reserve Life Indices by cutting deals with Third World countries that were subject to these agreements

Production-sharing agreements were designed to deliver 15% returns on capital to the oil companies, assuming oil at a low fixed price, such as $25 a barrel. In the event of oil prices climbing above $35 or $40 a barrel, the host country's share of production automatically rose. Neither party to the agreements ever imagined that oil would, within a very few years, reach $100 a barrel, or that global Finding and Development costs for new oil projects would reach $65 a barrel.

Investors evaluate oil majors on their earnings prospects, dividends, and Reserve Life Indices. As the majors' production in established fields in politically-secure regions peaked and declined, they were forced to cut deals with Third World governments that included production-sharing agreements. As the price of oil rose, the majors' production fell, due both to declines from established fields and cutbacks in their share of output from the agreements—and so did their stock prices, despite huge stock buybacks.

Exxon Mobil, the industry leader—not just in size but in consistency of high return on capital over many oil price cycles—is the appropriate exemplar of the incredible shrinking Big Oil players. Its first quarter profits were announced as a record—for Exxon or any company—at $10.9 billion. That announcement caused some leading Democratic politicians to have public displays of sputtering rage. Meanwhile, investors sold the stock, because the giant also announced that it's a shrinking giant—with its oil and gas production down 5.6%.

Sophisticated investors now understand what Big Oil-bashing demagogues in America and Europe don't—that most of the world's oil reserves are located in OPEC and other Third World nations, some of which, such as Russia and Venezuela, have leaders with big geopolitical ambitions that must be financed with oil revenues, and are based in the power that comes from owning energy other countries need. They have updated Mao's dictum, that power grows out of the barrel of a gun—by dropping the last three words.

For decades, economists have spoken of "the curse of oil." This concept explains, for example, why Israel is a relatively rich and progressive democracy despite being just about the only nation in the region without substantial reserves of oil and/or gas. None of its oil-rich neighbors is democratic, and none has a functional economy apart from oil. (Golda Meir once observed, "Promised land? Why is this the only country in the region that has no oil?")

In this decade, "the curse of oil" applies to a completely new class of nations—those that *lack* oil and gas and become dependent on imports from some Third World autocracy that wishes to revive its lost hegemony. As applied to Western Europe, this is the equivalent of a Fortune Global 500 that moves most of its operations to Sicily, in response to an offer from the Mafia of credit and protection so good it couldn't be refused.

Mr. Putin has set about the process of the castration of policymaking in Western Europe and Eurasia. He is, in effect, pursuing goals set by Stalin. Lenin's heir took over Eurasia and Eastern Europe after Yalta, and would have taken much more—including Greece, France and Italy—had Harry Truman and Winston Churchill not united to resist the westward progress of the Iron Curtain. Their creation—NATO—proved to be the most successful military alliance in world history: it achieved its objectives without going to war.

Already, there is talk of a new "Cold War." Putin's front man, Medvedev, went public, saying, "Russia is a state that from now on must be reckoned with." In another appearance, he said, " Nothing frightens us, including the prospect of a Cold War, but we do not want this, and in this situation all depends on the position of our partners."

"A new Cold War" is a misreading of history. The Cold War was primarily an *ideological* struggle between the West and Communism. That Russian Bolsheviks were able to project their influence and power across so much of the world was not because of the economic dynamism of the USSR. It was because of their success in infiltrating and subverting intellectual and political movements in the Free World. What Lenin called the "Useful Idiots" in universities, leftist political parties and newspapers and TV networks sapped the West's determination

to resist Communist domination in Eastern Europe, or to contain Comintern operations in the democratic nations. The KGB had decades of "soft success," convincing non-Communist intellectuals of the splendid successes of Soviet-style socialism. Example: Canadian NDP leader Ed Broadbent took a tour of the USSR a short time before the Fall of the Wall and came back to proclaim that he didn't admire Communist politics, but he did admire their economics. As late as 1988, John Kenneth Galbraith and other liberal economists were insisting that the USSR's economic growth far exceeded that achieved in Reagan's America.

Of our many recollections of the KGB's propaganda successes, we recall a cover story on "Prague Spring" in *The New York Times Magazine* exactly 40 years ago. Recounting enthusiastically the outburst of liberalization in Czechoslovakia, the article went on to ridicule American conservative "Cold Warriors" who warned that Soviet tanks would crush the new freedom if the West didn't proclaim its determination to protect these newfound freedoms. As if on command, *National Review* came out with an issue the next Tuesday, predicting a Soviet invasion.

Within a week, Soviet tanks rolled into Czechoslovakia. Shortly thereafter, the leaders of Prague Spring were jailed, and a new Soviet puppet government was installed.

Within weeks, *The Times* and the other organs of liberalism returned to warning of the dangers from Right-Wing Cold Warriors. Most of the Vietnam protesters never paused: their leaders weren't interested in finding a new villain. Everything returned to normal on both sides of the Iron Curtain.

After it was all over, the Kremlin and its KGB operatives abroad must have chuckled at how superbly their concept of the inevitability of Socialist world domination had been confirmed. In Leningrad, the fifteen-year-old Putin saw this swift restoration of Soviet control as further confirmation that his best route to membership in the ruling class was with the KGB—whose professionalism had been triumphantly confirmed.

Remembering the KGB's glory years, Putin today surrounds himself with ex-KGB agents, whose professionalism is evidenced weekly. The KGB smoothly arranged for the distribution of Russian passports to South Ossetia's Russian population in preparation for a coup on the Sudeten-German model that had been the condition precedent for the takeover of Czechoslovakia thirty years before Prague Spring. The "accidental" killing last week of a reporter who was writing critical reports on the Georgian operation demonstrated to everyone who matters that Putin's will is law. (He characterizes his government as "The dictatorship of the law.")

But he can no longer rely on thousands of operatives abroad to do what is needed to influence or suborn foreign politicians and opinion leaders.

In truth, Putin's attempt to re-create Russian nationalism and adventurism on the Czarist model is not a concept that will enlist many recruits abroad. Other autocracies, such as Chavez's Venezuela, or Ortega's Nicaragua or Castro's Cuba, happily ally themselves with the Revived Russian Bear, but idealistic youths in most of the world will be unwilling to go to the barricades to back him.

The Cold War was a long war because Russia's leaders blended Russian autocracy and nationalism with socialism and made Mother Russia the keeper of world socialist keys—until Mao Zedong came along to claim that he was the purer form of Marxist-Leninism.

Putin's power comes not from his ability to *project his ideological influence abroad*, but to *withhold* the oil and gas on which anxious neighbors depend. Ukraine's Orange democracy is now facing Putin-pressure. The Russian minority there is being recruited by his agents, Russia's Black Sea fleet menaces Crimea, and the drumbeat of threats intensifies. As another new Western ally struggles to maintain its economy and independence, West Europeans who have built their careers on attacking American influence in Eurasia cower. Their new nightmare: Can there be a world leader who is far more dangerous than Bush?

But none of this revives the Cold War.

The New Autarky

What *is* being revived is a German-conceived policy that preceded both World Wars—autarky.

According to this policy, a nation state should aim at self-sufficiency in important products—food, metals, energy, etc. As national policy it is completely antithetical to free trade. Bismarck promoted this policy, which led naturally to Germany's late entry into colonialism in Africa. Hjalmar Schacht revived it under Hitler.

Putin has shown signs of autarkic principles in food, as have numerous other nations recently. Sometimes, the autarky seeks to reduce its nation's exports of a raw material: Argentina's Peronists have an ongoing struggle with their farmers because of their imposition of a punitive export tax on soybeans.

Why try to stop your producers from exporting? Don't all countries try to increase their exports? Wasn't that a major reason for the failure to get agreement on Doha?

Not when one understands autarky. The Peronists seek to suppress Argentina's food price inflation by forcing farmers to sell their output domestically at cheap prices, rather than selling it abroad at world prices. India has imposed some export controls on wheat, seeking to lower the cost of bread.

Autarky is not automatically a trend to be abhorred. Sometimes it makes real sense.

In the US, for example, T. Boone Pickens promotes wind power in slick TV commercials, and his motivation isn't to do something good for global warming. (He isn't a great fan of Al Gore.) His argument is that the US must get off its dependence on foreign oil—"the greatest wealth transfer in the history of the world." That is also a policy favored by Thomas (*The World Is Flat*) Friedman and many other liberals. They are right. Barack Obama also denounces dependence on foreign oil, but he has also opposed developing major new domestic supplies of oil and gas offshore—or in a national park in Alaska, and is opposed to building new coal or nuclear generating plants. (He has recently softened on offshore oil drilling, if it's included in a bill that imposes a windfall profits tax on oil companies and allocates $150 billion to government to develop new, clean energy sources.)

We cite the varying emerging forms of autarky as evidence that the free trade era has peaked.

That means investors cannot simply add up all the world production of some material, compare it to global demand, and issue a product price. They have been able to do that since the commodity boom began, but it's not so simple anymore. Both supply and demand will be coming under constraints as nations re-evaluate their policies at a time of high food and fuel prices.

Another important aspect of the revival of autarky: nations will be more inclined to try to line up supplies of needed commodities through purchases of control of production of needed commodities abroad. Most often, it will be done through buyouts. Sometimes it will be done through capital investment and production-sharing agreements that recall Big Oil's deals.

Examples: Sudan receives hundreds of millions of dollars' worth of emergency food relief from donors abroad. That food was meant for the starving people in Darfur and Southern Sudan. Sudan exports roughly the same amount of foodstuffs to Arab nations for cash. (There is little evidence of the food relief reaching the starving in Sudan.) Jordan, Saudi Arabia and other Arab countries that buy these exports are pumping billions into Sudan to expand its agriculture. Northern Sudan has good prospects for increase in food production because so much of the total length of the Nile flows through the regions dominated by the government in Khartoum.

The New Autarky is not, like its German predecessors, based primarily on building national might. It is based on the shrewd recognition that commodity scarcity is here to stay. Russia has more than enough oil, gas, and metals for its own needs. But Putin's policy isn't the simple enrichment of Russians from the export of the nation's mineral wealth. He is prepared to sell enough energy and metals to spur economic growth, finance the purchase of needed food, and generate the wealth to rebuild the military to Stalinist power. But the non-autarkic side of his program is to create Fear among European nations where none existed. Fear among the former occupied states of the USSR that the Red Army will return, and fear among customers dependent on his energy resources that he will, without notice, cut the exports back—or even cut them off. More than one-third of Western Europe's oil and gas comes from Russia—or through pipelines under Russian control. Europeans are well aware that he can plunge their economies into crisis and/or collapse. They recall how he celebrated New Year's Day in 2005—by briefly shutting the gas spigots.

His policies are exportable: Evo Morales, the Marxist leader of Bolivia, has followed the Putin model when he suddenly cut off gas exports to neighboring nations.

It all comes down to what we have believed since the commodity boom began. Contrary to what so many prominent experts have been asserting, and asserting—foods, fuels and metals are scarcity stories.

The New Commodity Economics: Scarcity and Demand

a) Metals and Oil

Invest on the basis of unhedged reserves in the ground in politically-secure areas of the world...

Most economic stories are about growth. Production of oil, gas and metals cannot grow in double-digit jumps—like tech gear or hot consumer products. Energy and metal production growth is constrained by limited reserves, limited production facilities, and limited distribution facilities. And the greatest of these limitations is reserves.

Right now, as commodity prices plunge worldwide, the prominent experts are breathing sighs of relief. After being so obviously wrong for more than three years, they can now confidently proclaim that commodity inflation was a short-term delusion. As has been true for centuries, higher commodity prices will inevitability trigger higher rates of production. Higher rates of production will inevitably trigger lower commodity prices.

Always have.
Always will.

The problem with this assertion is that it is selective in its use of history:

During the first two centuries after the onset of the Industrial Revolution, the share of national wealth attributable to commodity production declined sharply. Crop failures, pestilence, wars and economic booms would send commodity prices soaring, but then bumper crops, new mineral discoveries, disease and pest controls, peace and depressions would eventually drive prices down—usually to new lows. Long-term commodity price charts show that commodity prices—at least in real terms—have been falling for most of the past two centuries.

Example: when Britain chose to respect the North's embargo on Southern exports of cotton, British clothing manufacturers and workers suffered terribly. When the North won, frantic bidding for cotton drove prices to astonishing heights that they wouldn't see—in nominal terms—for more than a century. But by the time the South's plantations were back to full production, prices were once again low, and the South remained an economic backwater for decades. Nominal oil prices only reached *1870* levels in this decade. Even gold has been a poor long-term investment, failing to keep ahead of inflation after World War II until its brief bull market in the late 1970s, after which its price once again declined in real terms until 2004.

What history tells us:

1. Base metals have been poor long-term investments except when wars triggered large-scale acquisition of military hardware—the only important source of non-cyclical metal demand. When the Wall fell, copper, nickel and zinc were losers along with the KGB. Another aspect of metal pricing: Alone among the consumption commodity asset classes, base metals have to compete with their past: somewhere between one-third and one-half of refined base metal production comes from scrap.

   Example: Ipsco was incorporated in Saskatchewan after World War II in an attempt to compete with the big steel mills in Hamilton. It didn't rely on blast furnaces using iron ore: its feed was primarily derived from farm machinery left rusting in the fields from the Depression era. The government wanted to eradicate these sad reminders of the Hungry Thirties, so it assisted the development of a local steel enterprise.

2. Oil and gas come from subterranean reserves laid down millions of years ago. Once consumed, they are gone. Great oil and gas fields can go on pumping for decades, but at some point, they enter decline. It was long thought that oil production in the US, the birthplace of the global oil industry, would just keep on growing. But, at just about the time predicted in 1956 by M. King Hubbert, US oil production peaked and entered long-term decline. Coal supplies are far more plentiful and far more widely-distributed, but they, too, are not eternal. Think of the coal mines that were the backbones of the economy of Nova Scotia and Wales. The operators of those mines would not believe coal prices could ever reach current levels.

Nominal oil prices only reached **1870** levels in this decade.

3. Even gold has been a poor long-term investment, failing to keep ahead of inflation after World War II until its brief bull market in the late 1970s, after which its price once again declined in real terms until 2004.

4. Today's seemingly lofty grain prices are remarkably cheap in real terms compared to 1970s prices. Then, why aren't cash crop farmers totally dependent on government handouts? Answer: sustained technology gains have boosted yields to levels that would have seemed preposterous in the 1970s.

So how can anyone rationally assert that the basic case for commodity investing is scarcity? Wasn't scarcity cited as the reason for buying mines, oil properties and farms during all previous booms?

What's different this time?

We have made the case for commodities in this decade roughly a dozen times a year for six years.

Now, the commodity story has changed—it is no longer just a scarcity story. Scarcities become surpluses during recessions, and when massive new sources of supply come onstream at a time of slowing growth in consumption.

Right now, the nays seem to have it: oil and industrial metals may have entered a period of oversupply that could last until OECD consumption stops declining and Chinese and Indian consumption moves to even higher levels.

That shouldn't take long—within the context of a 25-year bull market.

b) Food

Food is another story. Despite the 17th straight year of good growing conditions in the US Midwest, carryover supplies of feed grains are well below normal levels (in relation to consumption), and wheat and rice inventories have only started to move back toward normalcy. Meat prices continue at levels which, if projected asymptotically, guarantee that there will be no packing houses left and we shall all become vegans.

Multi-century correlations of global temperatures with sunspot activity suggest that today's relatively long pause in solar irradiance could prove problematic for crop yields—at least in the Northern Hemisphere. Most astronomers who study sunspots are careful to point out that the connections with important increases in global cooling have not been proved—because they are unsure of the mechanisms that transfer solar energy bursts to earth's climate. However, they concede that history shows that the sunspot activity of 2007–08 is not only well below the experience levels of recent decades, but strongly suggests the likelihood of cooler weather.

That's great news for ski resort operators, but it's worrisome for farmers in temperate zones. The world has been blessed with impressively high levels of sunspot activity since the end of the 1970s—a decade known for the frequency and severity of crop failures. Indeed, for the entire four centuries astronomers have recorded sunspots, there have been few times as active as 1950–2006. Already, the delay in the return of sunspots after the down year, which comes in the eleventh year of each cycle, has aroused concerns among some astronomers. Not only do they not understand why the spots have not returned, they also have no certainty about when they will return.

There have been widespread press reports that August was the first month in 95 years in which *no* sunspots were identified. It now turns out that they were in error: although most of the observatories spotted no spots, one did find a small spot that appeared only briefly. So it is wrong to conclude that the current experience presages some incipient global climate crisis. Those scaremongers who suggest we are headed for a return to the Maunder Minimum and a new Ice Age are pushing the available evidence very hard to get a good story.

Nevertheless, the persistent paucity of spots should mean at least one more cold winter and one more late spring. That should be enough to keep corn and bean prices high.

So, from the standpoint of commodity stock investing is it just a matter of time before commodity prices are driven purely by supply and demand, and demand will return in force once the global slowdown ends, and the prices of the quality commodity producers will go to new peaks?

Could there be anything new in such an old, oft-told story?

Actually, there *is* something new...

Commodity Company Metrics

Some nations' ideas of strategic investing might well have enormous impact on the valuation of commodity producers' shares. The process of consolidation that became dramatically visible at the time of the takeovers of Inco and Falconbridge will probably accelerate now that commodity producers' shares have been beaten down so mercilessly. Predators of various breeds will emerge.

Consider:

1. The Indian government has been actively encouraging major Indian commodity companies to make acquisitions abroad. This is a change from previous policy, which rigidly restricted exports of capital abroad. Steel, iron ore, and aluminum have been among the industries in which Indian companies have established large global presences through acquisitions.

2. Chinalco (China Aluminum Company) surprised mining investors by joining with two partners to acquire 12% of Rio Tinto shares, in an apparent attempt to interfere in BHP's bid to acquire Rio. Chinalco is a public company, but Beijing has a large involvement in its affairs. Observers argue that the reason for the bid is to block a merger between two of the three biggest iron ore suppliers in the world. Like other iron ore-short countries, China has been shocked by the scale of price increases on large-scale forward contracts from BHP, Rio Tinto and Vale (the Brazilian company, which is itself partly owned by that nation's government).

3. Putin recently advised the management of Norilsk that it was to appoint as CEO his nominee, who used to run the KGB in Leningrad. He has no experience in mining directly, but he has extensive experience with Norilsk, the current operators of the massive Siberian nickel mine that was for decades the place where the KGB sent dissidents and other people it didn't like much to die from overwork and inadequate food and health care. Norilsk is currently being fought over by two oligarchs, one of whom is said to be close to Putin.

4. The Chinese are active in numerous Third World commodity-producing countries, with seemingly special interest in those with the most hideous records on human rights. (Clients interested in how the Chinese acquire mineral properties in such lands should read Dave Eggars' *What Is The What*—a powerful account of the ongoing horror story that is Sudan.)

5. After Putin's Georgian invasion, there is even more controversy about the proposed Nabucco natural gas pipeline from the Caspian Sea to Erzerum in Turkey. From there it could send supplies into Southeastern Europe. The US and EU have been keen to promote this pipeline as a counterpoise to Russia's seeming omnipotence in exportable gas. It could connect with an undersea pipeline to Turkmenistan. What makes this newly risky is that Russia opposes it, and offers a seemingly more direct route. PKK, the Turkish Kurdish Marxist rebels, blew up an oil pipeline recently, and the KGB could well have been involved, because the USSR supported the PKK during the Cold War, and Putin would likely have a former operative on his staff who has contacts with the rebels. Nabucco now seems more needed than ever, but financing for it has become more problematic, given Putin's hostility.

6. Xstrata's attempted takeover bid for Lonmin is opportunistic. With platinum prices down by nearly a third, and with his attempts at a deal with Vale coming to naught, this is a good time for the aggressive Mick Davis to buy a unique asset cheaply. Control of Xstrata is murky, and many observers still assume Marc Rich is involved.

We recently spoke to the strategic planning meeting of a major resource company. We discussed with them our view that, not since the commodity boom began, has the discount on prospective five-years' earnings for resource companies been so high:

- The stocks continue to be priced according to pessimistic estimates of the near-term prices of the commodities the companies produce, on the assumption that the industrial world and China are experiencing their first big slowdowns since the 2000-2001 recession. This is Short-Termism writ large.
- Corporate takeovers of smaller companies in the mining and oil industries will continue as companies with extensive reserves are acquired.
- Sovereign Wealth Funds have not yet shown an eagerness to use this short-term weakness as a buying opportunity. Chinalco's leap into the BHP-Rio Tinto struggle was not based on a beaten-down price of RTP, because BHP's bid has given support to the stock. When will the sovereigns decide they cannot afford to wait longer to buy great—or unique—commodity assets? They are starting to unload their holdings of Fannie and Freddie, and seem to have switched

into Treasurys. But why add to their vast Treasury holdings with the 5-year Treasury yielding a negative 2.25%? History has few examples of satisfactory returns on that kind of investment. We are, however, confident that Bush, Cheney and Paulson would willingly express their gratitude at the huge subsidy to the US economy.

- Desperately poor nations don't spend money on fertilizer—let alone on genetically modified seeds. Nations seeking to expand agricultural output to feed the many millions of people displaced from tiny farms to cities see the wisdom in chemical fertilizers. Since potash has become the iron ore of agriculture, it is reasonable to assume that China and, perhaps, India might wish to own the companies that have been sticking it to them in recent large-scale sales modeled on the take-it-or-leave-it approach made famous by BHP, Rio Tinto and Vale.

Investment Environment

Each decade has at least one US recession. The 1990s were book-ended by two recessions—the Bush I recession and the Clinton recession (which was blamed on Bush II because it began roughly on election day 2000).

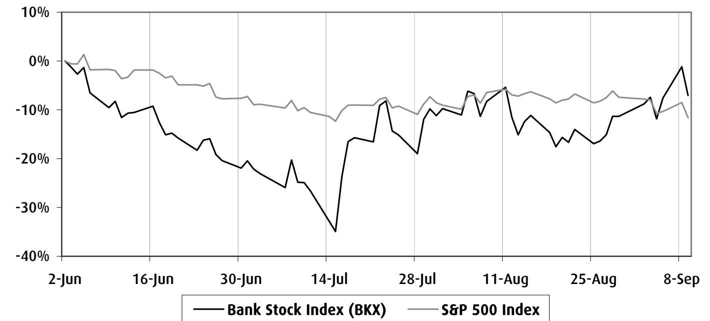
Warren Buffett says the US is already in recession, but he is America's richest Obama-backer and he could be biased. Second Quarter GDP numbers proclaimed that US growth was at normal levels, but many observers found them dubious. We are not economists, so we'll leave the parsing of the data to professionals.

Global stock markets are fairly screaming, "Recession!" The huge rally in financial stocks after The July 13th Massacre seems based in part on the growing feeling that the worst of the housing crisis is over. We wish we could share that optimism, but we have (as impossible as it may seem) even less faith in Wall Street balance sheets now than we had in March 2007 when we published *Don't Ask; Don't Tell; It's Subprime Time!* or in June 2007 when we published *Babel in Bond-Land*.

The rally in the bank stocks, as of the close on September 8th, has been so powerful that it met the test of a bear market bottom signal. As clients are aware, we have asserted many times that *a bear market led by the financials cannot end until the financials have outperformed the S&P for at least six straight weeks.*

Here is the chart showing just how robust this rally has been:

Bank Stock Index (BKX) vs. S&P 500 Index
June 1, 2008 to September 10, 2008



Note that the rally that produced an upside chart breakout came after the Dynamic Duo's Return.

We have been so insistent on this rule that many clients are asking whether it still applies, which means that the bottom of the overall bear market is at hand.

We love to live by the rules.

But we are hesitant to apply that previously-inviolate rule to the extraordinary circumstances of the Paulson-Bernanke-Cox "Massacre." This is the biggest governmental intervention in financial markets since Roosevelt's closure of the banks in 1933. Our rule is derived from the behavior of financial markets across decades, and is, therefore, a behavioral measure. Should it still apply if the government manipulates markets on unprecedented scale? And then follows up with a second gigantic intervention. Frankly, we don't know.

One of the best analyses of last weekend's takeover of F&F we read began with a quote from Chekhov: "If a play has a gun on the wall in the first act, the gun will be used before the end of the third act."

Bernanke and Paulson put the gun on the wall July 13th. They used it September 6th. But how many more bullets are left in that gun?

If the bank stocks manage to break out on the upside decisively, and establish a strong bullish pattern, we may have to say that we think clients may want to start rebuilding overall equity exposure for a new bull market.

Our hesitation is not pure cussedness. We still see further attrition in Wall Street's balance sheets. We are skeptical that the dollar rally will remain so robust.

However, we are aware that a big rise in global tensions usually stimulates a rush into greenbacks. The Georgian situation remains tense, and there has been no improvement in the Iranian and North Korean nuclear standoffs.

Summing up:

Commodity investors are suffering collateral damage from the Dynamic Duo's bold strategy to save Wall Street and F&F from the consequences of their own cupidity and stupidity.

We don't know what new Washington-generated shocks to the market system will come.

But commodities are produced and consumed every day, and ultimately they will be priced according to (1) Economics 101—supply and demand, and (2) the market interventions that come from the New Autarks.

China and India are hardly likely to abandon their plans for powerful, sustained growth.

These Washington-spawned shocks to commodity-producing companies will probably have the effect of reducing capital spending budgets. As their stocks get hammered, commodity companies' boards will doubtless tell their managements that there are higher and safer returns from buying their own stock back than in new capital spending projects.

Result: when the global slowdown ends and the next boom begins, commodity prices will be higher than they would have been otherwise, and returns to investors will be much higher. With global real interest rates staying negative in real terms, that recovery will not be delayed long.

The US Elections

The US election campaign remains riveting. The outlook for a Congressional Democratic landslide is even better now than two months ago, but the Presidential race keeps providing surprises. Just when it looked as if Senator Obama had finally begun to build a big lead in the polls, Senator McCain grabbed the spotlight with his invitation to Governor Palin to join his ticket. She is the most exciting new figure in American politics since… Senator Obama. When he gave the keynote address to the 2004 Democratic Convention, he marked himself out as a future star. She has done the same for Republicans—except she wants stardom *now*.

Despite the boost from Gov. Palin, Senator McCain can only win by the most massive ticket-splitting of recent times—which means the Presidential preference poll numbers showing a close race are somewhat suspect.

The old rule that a VP nomination can kill a campaign but not win a campaign is about to be tested. Her speech last week was widely considered a bigger hit than even the famously eloquent Obama's—because it was so unexpected, whereas Obama's splendid performance was expected. It isn't news when Tiger Woods scores a birdie.

It now looks as if McCain's choice set up a trap for the liberal media. The press and TV and organization blogs were so shocked by the Palin nomination that they unleashed their resources in what looked like an all-out campaign to destroy her. Example: on Sept. 2nd *The New York Times* ran three separate Page One stories about her daughter's pregnancy.

The next shocking scandal story to appall the nation was that Palin's husband had a DUI conviction. That it occurred 22 years ago when he was 22 was irrelevant. In column after column and story after story, Palin was portrayed as not just untried and inexperienced, but some sort of ultra-conservative backwoods hick chick.

As the columnist for Britain's *Observer* noted, "Chesterton said that when a man picks up a stick thinking any stick will do, it's usually a boomerang."

American fair play suddenly asserted itself. What the concerted media fury accomplished was turning out a TV audience for Palin's speech that was nearly as high as for Obama's, even though four fewer networks carried it. Her speech not only electrified the delegates, it also surprised millions who, based on the withering ridicule in the media, hadn't expected that she would be so smart, smooth, witty and combative. She lived up to her own self-description—a hockey mom is a pit bull with lipstick.

As of this writing, there has been a big swing in the polls, with McCain wiping out Obama's convention bounce and moving to a tie. In other words, the election remains how we described it three months ago—a tossup.

There are only two safe predictions: First, there will be more surprises, and this election will go down as one of the liveliest and most fascinating in history. The winner will have benefited from surviving such a concatenation of challenges, opportunities, stumbles, and shocks, and will be better-equipped to handle those that this increasingly dangerous world will be offering.

Second, the October 2nd Vice-Presidential debate will have the biggest TV audience since the Super Bowl.

Whether any of this can undo the core realities—that the US is in, or on the cusp of recession, that Bush is the most unpopular President in recent history, that Democrats are the majority party, and that McCain's economic policies ***other than offshore drilling*** won't win him any votes he didn't already have—is questionable. A fresh face from the frontier was obviously a shock after 18 months of electioneering, but fresh faces can fade from fascination.

The biggest reality is the choice at the top of the ticket. The most mesmeric Democratic candidate of the modern era, whose youth, oratory, gentlemanliness and style offer the nation the chance to make a big payment against the slavery debt in the nation's soul, runs against a 72-year old man who looks older than his age because of the bones broken from sustained torture he suffered in the war that divided the nation.

The Republicans are trying to close that yawning gap by presenting a VP nominee who, they claim, (with some accuracy), has more demonstrated government experience than Mr. Obama. But that is a reprise of Senator Clinton's campaign, and Mr. Obama's great claim now to relevant experience is that he came from way back in the polls to defeat the Inevitable candidate in a fair fight. The demonstrated ability to win is the most precious political asset. His victory against the Clintons will doubtless be seen by the electorate as a far more impressive feat than knocking off the corrupt old boys in Alaska.

Finally, as wise prognosticators always assert, people vote with their pocketbooks. As the economy continues to shrink, and as house prices and stock prices continue their slump, McCain's problems should soon reassert themselves.

If not…political historians will be writing about *this* campaign for centuries.

Investment Recommendations

1. The two most important forces in equity markets since July 13th have been powerful strength in financial stocks and pathetic weakness in commodity stocks. Since they have been inversely correlated for more than a year, investors should assume that the commodity stock bear market will continue until the financials roll over. The F&F bailout is merely the second act in a tragedy that has an unknowable number of acts to come.

2. When the financials do roll over, gold and gold mining stocks should move swiftly back into favor. Inflation remains above central bank target levels in the US—and in many other countries across the world. And any return to pronounced weakness among the bank stocks will be strongly bullish for gold.

3. With OPEC's token production cut failing to impress the markets, oil prices will fall further. It won't take more than a few days of even 750,000 b/d of production above consumption to drive oil prices down. Conversely, any outbreak of civil strife in Nigeria that affects offshore production could have a sudden upward price impact. We expect oil to trade in a range of roughly $80 a barrel to roughly $130 a barrel next year, but we have no great confidence in that forecast. We are more confident in predicting $150 oil within the next three years, as the next global economic recovery unfolds.

4. Barring an early killing frost, this year's US corn group will be a barn-buster. What next? Corn is in modest contango for the next two years' crops. Because contangos are so unusual these days, and because grains have such high producer/consumer participation across the curve, this is to us a sign that farmers and users are believers that high corn prices are here to stay. That means the fertilizer, seed and equipment stocks are cheaper now, relative to forward corn prices, than at almost any time in the past four years.

5. The pullback in oil prices and the dramatic bank rescues should have been enough to send the S&P back into bullish mode. It needs to break 1310 on the upside to take away its bearish condition.

6. The real yield on the Treasury 10-year is now a negative 145 bp. On a two-year hold, this means there could be more endogenous risk in nominal bonds than in most blue-chip non-financial stocks. The rush out of TIPs into Treasurys is doubtless driven by the unwinding of F&F exposures, but the long Treasurys are now seriously overvalued.

7. The biggest near-term upward surprise in commodity prices could be natural gas if (1) the sunspots don't reappear, and (2) the historic correlations of gas to oil reassert themselves.

8. The Canadian dollar is being hit by the commodity price plunges, deterioration in the trade account, the worsening economic outlook in Central Canada, and the uncertain outlook in the October election. Whether Tories or Liberals win in Ottawa, Canada's fiscal situation will continue to be superb compared to the US, particularly if Obama wins. We remain very positive on the loonie as an alternative to the greenback.

9. US election campaigns can be excuses for bold acts by foreign adventurers. Although President Bush was a non-person at the Republicans' Convention after he gave his brief speech by satellite, he's going to be President for four more months. The world should hope that rogue states think about that before deciding that Washington will be too distracted by the election to do anything about a surprise attack or invasion.

10. We have no clear idea how long it will be before we can look back to today's prices for commodity stocks and say, "Wow! I wish I'd loaded up then!" **We remain certain that day is coming.**