Private Wealth Advisory

A Phoenix Capital Research Publication January 25, 2012

Two Markets and How to Play Them

Short-Term Trends
-No QE 3, the Fed disappoints.
-End of the month performance gaming in full effect.
-The risk-on trade is intact… for now.

Intermediate Trends
-Greece to default within two months.
-The EU to break-up within six months.
-The US to enter a new recession within the next three months.
-Increased civil unrest and potential riots.

Long-Term Trends
-Global debt implosion.
-New alignment of politico-economic powers.
-Trade wars and very likely REAL warfare.

This issue is going to be divided into two parts. The first will focus on presenting a clear macro-analysis perspective of the US economy and the opportunities that will be present in the future (there will be great opportunities for those who are willing to think creatively).

This portion of the issue will be published today, Wednesday, January 25.

The second portion of this issue will be devoted to analyzing the Fed FOMC release today and the impact it will have on the markets and various asset classes going forward.

This portion of the issue will be published tomorrow, Thursday, January 26.

The coming years will be marked by a seismic change in the economic landscape in the US. Firstly and most importantly, we are going to see economic growth slow down dramatically. Jeremy Grantham, an asset manager I respect, believes we'll see global growth at 2% over the next seven years. Personally I believe it could be even lower than that.

The reasons for this slow down are myriad but the most important are:

1) Age demographics: a growing percentage of the population will be retiring while fewer younger people are entering the workforce.
2) Excessive debt overhang.
3) A return to more frugal "common sense" spending patterns in the developed world.
4) Political and Geopolitical uncertainty.

Regarding #1, Europe is the most glaring situation. According to Eurostat, between 2004 and 2050, the number of people of non-working age relative to those of

working age will increase dramatically. In the EU in 2004 there were approximately four people of working age (19-64) for every person of non-working age (65 and older). By 2050, this number will have dropped to only *two* people of working age for every person of non-working age.

Over the same time period, Europe will also see a tripling in people considered to be "elderly" (80 or older) from 18 million to 50 million.

These numbers alone go a long ways towards explaining why Europe is facing a budgetary Crisis of epic proportions. All of these retirees will be expecting various Government/ private sector outlays whether they are pensions, healthcare, or various other social services.

These issues are, for the most part, left out of most current analysis of Europe's debt crisis. Indeed, while the vast majority of commentators are well aware of Europe's official Debt to GDP ratios, when we include unfunded liabilities such as the Government outlays or social programs I detailed above, it is clear that the situation in Europe is far, far worse than is commonly known.

Jagadeesh Gokhale of the Cato Institute presents the situation with an interesting data point, *"The average EU country* ***would need to have more than four times (434 percent) its current annual gross domestic product (GDP)*** *in the bank today, earning interest at the government's borrowing rate, in order to fund current policies indefinitely."*

The situation is not quite as profound in the US, though we will be seeing a dramatic increase in the age dependency ratio (the number of people of retired age relative to those of working age) between 2010 and 2030 as the Baby Boomers retire: in 2010 there were 22 people aged 65 and older for every 100 people of working age. By 2030, this number will have grown to 37 people aged 65 and older for every 100 people of working age.

However, while the ratios are not as poor in the US as in Europe, the unfunded liabilities the US faces are truly astronomical. *USAToday* puts the number at $61.6 trillion in unfunded obligations, an amount equal to roughly $528,000 per US household.

However, Japan makes both the EU and the US look tame. In 2009, Japan already had 35 people aged 65 or older for every 100 people of working age. However, by 2050, this number will have swelled to an incredible 73 people aged 65 or older out of every 100 people of working age. This among other things sets Japan as a ticking time bomb, which we will assess in the next issue of ***Private Wealth Advisory***.

The EU, Japan, and the US comprise $36 trillion of the global $64 trillion economy (roughly 57%). So this debt overhang will have a profound impact on global growth particularly in the developed world going forward.

This debt overhang will result in several developments from a political perspective. For one thing, the social contract between Governments and retirees will have to be re-negotiated, as the money promised by the former to the latter simply isn't there.

Governments will try to deal with this in one of two ways: by raising taxes on high-income earners/ any other potential avenue for raising revenues and by reneging on the promises made to retirees.

The impact these moves will have on the political landscape will be profound. Among other things we will be seeing more protests both at the ballot box and in the streets (Greece's riots are a taste of what's to come for much of Europe and eventually the US).

To picture how a cutback in social programs will impact the US populace, consider that in 2011, 48% of Americans lived in a household in which at least one member received some kind of Government benefit. Over 45 million Americans currently receive food stamps. And 43% of Americans aged 65-74 are Medicare beneficiaries.

Consider the impact that even a 10% reduction in these various programs would have on the US populace.

With that in mind, people will have to make do with less. This will have a profound social impact, as it will force many more traditional values to come to the forefront of American culture again. Among other things I believe:

1) Divorce rates will drop as people cannot afford to divorce anymore.
2) Individualism will give way to more community focused lifestyles: whether they be food co-ops, neighborhood watches, or simply having to live with relatives, the nuclear family and local community will become increasingly important as an emotional and economic support.
3) Savings will increase and entertainment expenditures will become more frugal (Netflix vs. going to the movies, camping vs. more expensive vacations, etc.)

More importantly, the political process will change dramatically in the developed world, as politicians will no longer be able to promise social benefits and other handouts in order to incur votes. The impact of this will be very dramatic both in terms of campaigning and lobbying efforts in DC.

From an economic growth standpoint, these age demographics and their accompanying debt overhangs will act as a drag in the developed world. Regrettably, this will likely lead to increase geopolitical tensions (much as we saw in the Arab spring) as times of economic contraction usually result in increased conflict both in terms of trade (the US and China) and actual warfare (the Middle East).

This issue will be the focus of a future report from ***Private Wealth Advisory***, as this issue in particular is complicated due to the fact that modern warfare will feature technological innovations (cyber-warfare) not seen before. Also, the US military is going to face budgetary cuts as a part of the deleveraging process. This will have a profound impact on how the US navigates geopolitical risk.

As for the debt loads themselves, these will be dealt with in various ways (default, inflating it away, reneging on promised social benefits, etc.), as we enter a period of prolonged deleveraging. This deleveraging process will occur on a national, corporate, local, and individual scale.

We've already assessed the national impact this will have. Let's turn our attention to the corporate impact this process will have.

While much has been made about Corporate America's massive cash hoard (now estimated to be roughly $2 trillion), few if any analysts bother to note that this increase in cash has been accompanied by an even greater increase in debt.

In 2005, US corporations had $1.5 trillion in cash and $5.5 trillion in debt. As of 2Q11, they now have $2 trillion in cash and $7.3 trillion in debt. Put another way, US corporations have in fact become *more* leveraged during the financial crisis.

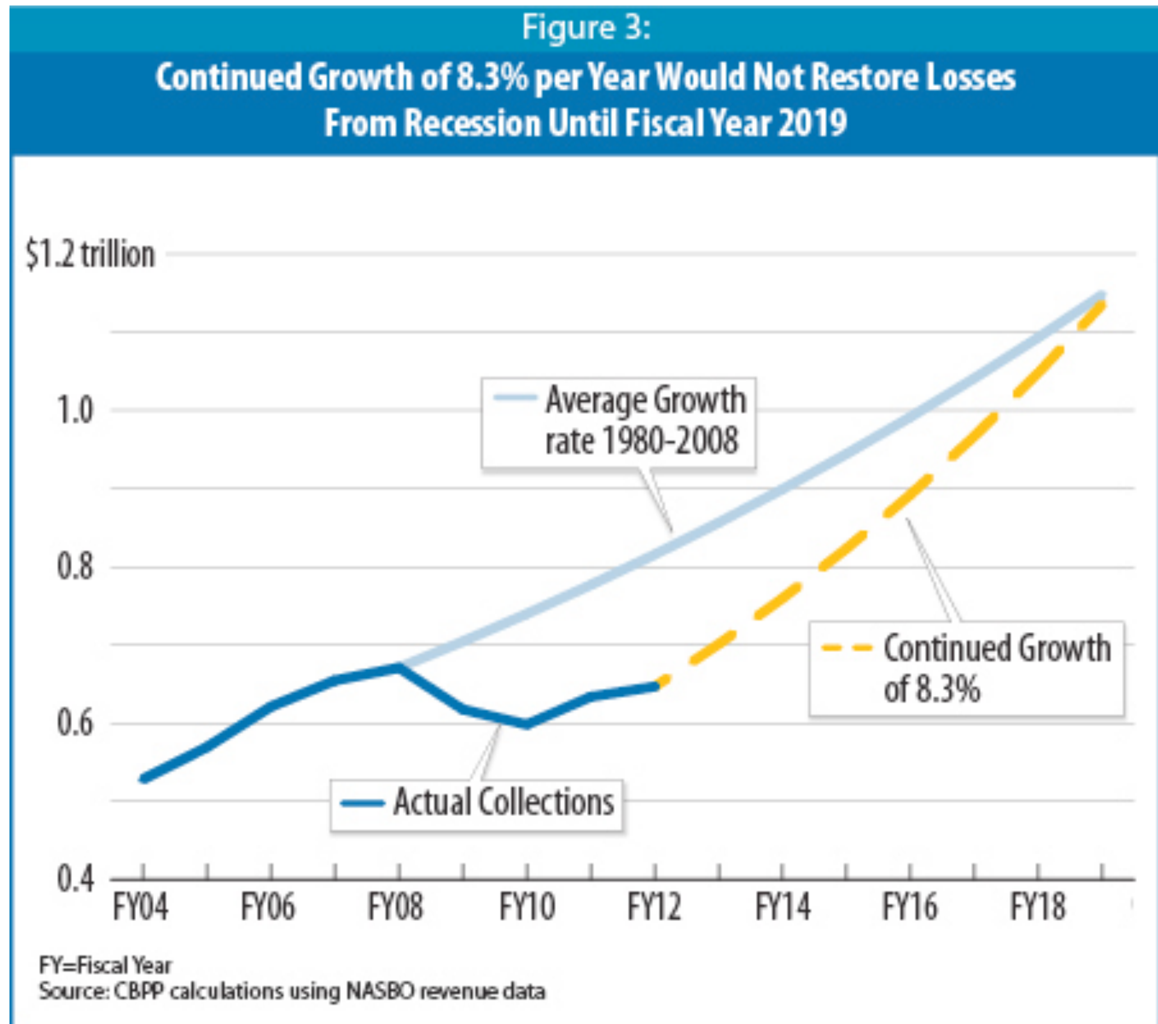
This is just one of several reasons why the US Federal Reserve wants to keep interest rates near zero. Any rise in interest rates would see a large increase in corporate debt payments, which in turn would eat into corporate profits, which would likely lead to more lay-offs and other cost cutting measures… as well as an increase in corporate defaults.

On a state and local level, the deleveraging process is already in full-swing. Since 2008, states have faced $530 billion in budgetary shortfalls. They were able to close these gaps with spending cuts and ample use of federal stimulus dollars.

Indeed, it was largely Uncle Sam that got states through the last few years (Federal Stimulus covered roughly 30-40% of state shortfalls). Whether the Federal Government will be able to continue this trend is in doubt as budgetary issues and stimulus spending are some of the most heated topics of the Presidential 2012 election.

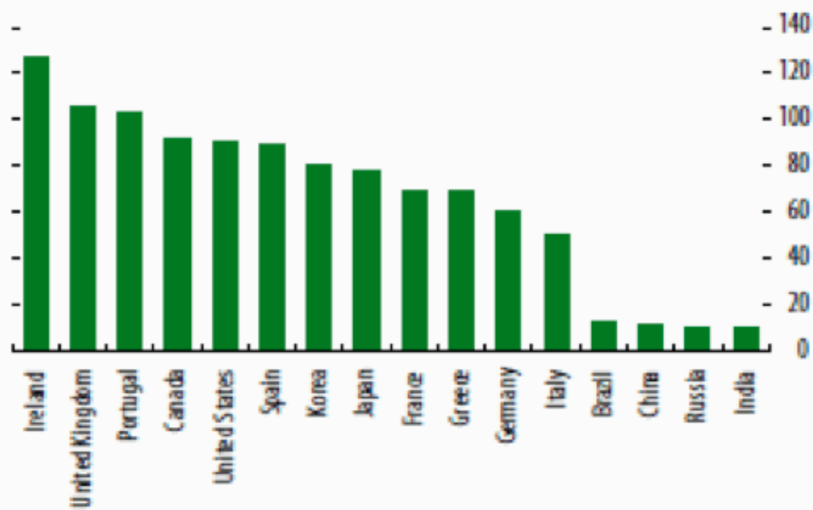
So I would expect more spending cuts, more local taxes, and more revenue increases on a state and local level going forward. Indeed, already some 29 states have projected shortfalls equal to $44 billion for FY2013 (which begins in July 2012). This number will grow as more budgets come in.

Indeed, according to the Center on Budget and Policy Priorities, even if state revenues grew at a rate of 8.3%, the losses from the recession would not be recovered until 2019.



Finally, we are witnessing deleveraging on an individual/ household level. This is happening globally across many developed nations: those countries in most dire straits (with household debt exceeding 100% of GDP) are Ireland, the UK, and Portugal. However, Canada, the US, Spain, Korea, and Japan and not far behind with household debts equal to 80% of their GDPs or higher.

Figure 1.22. Leverage Ratios: Household Debt as a Percent of GDP



Sources: Haver Analytics; national authorities; McKinsey & Co.; and IMF staff estimates.
Note: Various dates, but mostly 2010. In some cases, household debt includes debt issued by non-profit institutions serving households.

To put these debt levels into perspective relative to historical trends, US households need to write off between $4-$4.5 trillion in household debt in order to bring their leverage levels in line with their historic relationship to GDP growth. That represents a write-down of roughly 30% of ALL total household debt outstanding.

This is a truly massive amount of debt overhang for the US consumer to contend with. And it will have a tremendous impact on consumer spending patterns, home sales, retail, and the US economy in general.

For one thing, consumer spending patterns will change dramatically. Rampant mindless spending will end. Consider the recent holiday sales for instance. While Black Friday sales and Holiday sales in general were strong, we actually saw a *record* number of Holiday Sale *returns* in 2011 as well ($46 billion).

Much of these returns were consumers bringing back items to take advantage of the fact that after the holidays prices were 30-40% lower. Consider this change in consumer spending behavior: buying a gift for the holidays only to then return it and re-buy it for an additional 30-40% off after the holidays were over.

A secondary item that will affect spending patterns is the rise of inflation. While the world's central banks are terrified of debt deflation resurging in Europe and

elsewhere, they've completely missed the fact that inflation has already snuck into the financial system and is raising the cost of living.

This is happening both blatantly in the form of prices being raised…

> **Food prices hit record highs in 2011**
>
> The price of basic foodstuffs hit a record high in 2011, with the cost of cereals surging by more than a third over the last 12 months, the UN's Food and Agriculture Organisation said on Thursday.
>
> The FAO said that its monthly Food Price Index averaged 228 points in 2011, the highest level since records began in 1990, although prices did slide by some 2.4 percent in December. The previous high was in 2008 at 200 points.
>
> The Rome-based organisation said that its cereal price index -- which includes the cost of rice, wheat and maize -- averaged 247 points in 2011, up some 35 percent from 2010 and the highest since the 1970s.

http://www.google.com/hostednews/afp/article/ALeqM5gcfBxJe2n-ZPmGrv2cHMqFcrrZ1g?docId=CNG.d5ee67dd42d5a468e9ea68e927470560.301

> **McDonald's 4Q net income jumps 11 pct**
>
> **Higher costs for ingredients also continue to be an issue, even though costs for some ingredients, like wheat and corn, have leveled off. McDonald's said it expects costs for most of its commodities in the U.S. to increase 4.5 to 5.5 percent in 2012,** in line with 2011's 4.9 percent increase. Last year, McDonald's raised menu prices three times, for a total price increase of about 3 percent, in March, May and November.
>
> Chief financial officer Pete Bensen said the company would continue to "strategically take increases to offset some but not all of our higher costs."
>
> http://seattletimes.nwsource.com/text/2017317381.html
>
> **Starbucks raises prices in U.S. Northeast, Sunbelt**
>
> Starbucks Corp (SBUX.O) raised prices by an average of about 1 percent in the U.S. Northeast and Sunbelt on Tuesday, making coffee-drinkers spend more in New York, Boston, Washington, Atlanta, Dallas, Albuquerque and other cities.

Shares of Starbucks, which boosted drink prices in some other U.S. markets in November, retreated to $45.30, down 1.5 percent, after hitting a new high of $47.04 in early trading.

Starbucks expects high costs for things like coffee, milk and fuel to cut into profits this year. Like other restaurant operators ranging from Chipotle Mexican Grill (CMG.N) to McDonald's Corp (MCD.N), it is raising prices to help offset some of that cost pressure.

http://www.reuters.com/article/2012/01/03/us-starbucks-idUSTRE8021N220120103

The State of the Economy By the Numbers

In Jan 2012 the average national gas price is $3.389 a gallon, an increase of 28 cents compared with $3.11 a gallon a year ago.
Historically this is fairly high for this time of year.

http://abcnews.go.com/blogs/business/2012/01/the-state-of-the-economy-by-the-numbers/

… however, inflation is also entering the financial system in a more stealthy mode as retailers begin to offer less product for the same price.

Indeed, as the below article summarizes, Kellogg's has reduced 15% of the cereal in its boxes. Snickers has reduced its bars by 11%. Haagen-Das has reduced content by 12.5%, Heinz Ketchup has reduced content by 11%, etc.

U.S. Companies Shrink Packages as Food Prices Rise

Large food companies have recently announced that they will raise the prices they charge grocery retailers for commodities-based products. For example, a chocolate bar will cost more soon: Hershey last week announced a 10% increase for most of its confectionery goods.

Of course, straightforward price hikes could cause consumers to buy less of those products or to choose less costly store brands. So in many cases, food companies are trying a different tactic: Keeping the price of an item the same while decreasing the amount of food in the package. The company recoups the costs of the rise in commodities and hopes consumers don't notice that they're getting less of the product for the same price.

http://www.dailyfinance.com/2011/04/04/u-s-companies-shrink-packages-as-food-prices-rise/

It's also worth noting that this trend has been in place as far back as 2008:

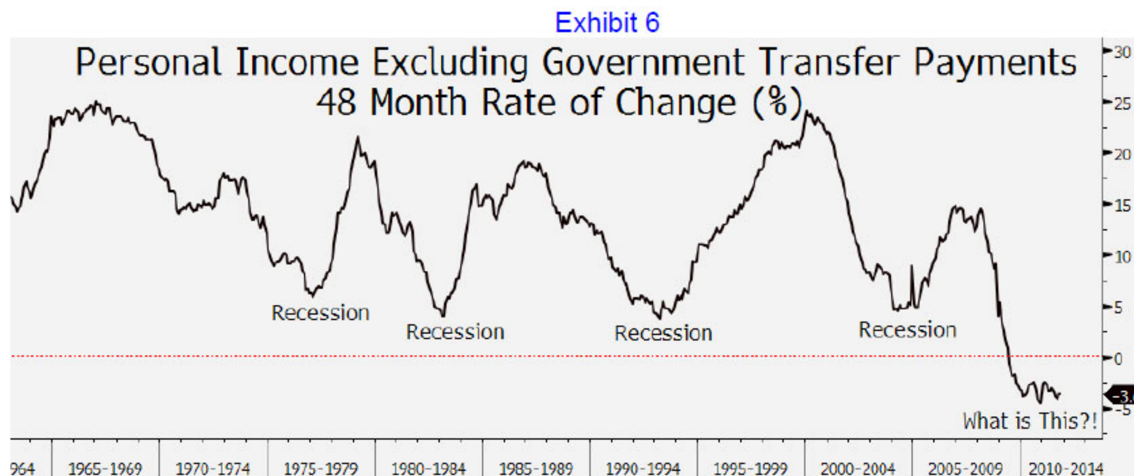
The incredible shrinking Doritos bag

PepsiCo is not alone in subtly cutting size as a substitute for raising prices. Kellogg (K, news, msgs), General Mills (GIS, news, msgs), Unilever (UL, news, msgs), Wm. Wrigley Jr. (WWY, news, msgs) and Procter & Gamble (PG, news, msgs) have quietly trimmed the amount of cereal, ice cream, chewing gum, paper towels and toilet paper you get. (See the slide show.)

http://articles.moneycentral.msn.com/Investing/CompanyFocus/TheIncrediblеShrinkingDoritosBag.aspx

It is a common misconception in financial theory that inflation and deflation are mutually exclusive. The reality is that today US consumers are being hit by both deflation (home prices, and incomes) *and* inflation (food and energy prices) simultaneously.

This is creating a tremendous squeeze on consumer wallets, which in turn will have an even *more* pronounced impact on consumer spending. Indeed, as the below chart from *Morgan Stanley* reveals, the size of the drop in incomes during this latest contraction is enough to make it clear we are in something far worse than a mere recession.



This is the global macro view that the developed world faces today. The core themes of excessive debt and aging demographics are combining to force a massive wave of deleveraging, a sharp fall in incomes, and a sharp rise in the cost of living.

Crisis Engender Great Opportunities For Those Who "Get It"

This backdrop is going to engender dramatic changes in the way people choose to spend their money. However, while the "across the board" perspective looks quite bleak, there are going to be truly outstanding opportunities for wealth creation available to those entrepreneurs and businesspeople who are able to think creatively.

The most critical aspects for all businesses going forward are:

1) Selling an experience, NOT a product.
2) Respecting your clients with the intention of building a long-term relationship with them.
3) Using innovation and creativity to navigate shortages of capital.
4) Passion, hard work, and determination.

Regarding #1, the days in which people will buy things simply for the sake of buying them are over. Having been to trade shows and other similar events since the Depression began, I always noted that those vendors who are offering a "widget" based solely on the idea that people have needed that widget before are going out of business.

However, those businesses that are attempting to create an *experience* for their clients, are finding that people are still willing to pay good money for something that has a strong emotional impact and/ or will provide them with memories.

I will give you a personal example from a dining experience I had in 2011.

Back in November 2011, my wife and I had dinner at *Michel* at Tyson's Corner, one of the most recent restaurants opened by legendary French chef Michel Richard.

The food was exemplary, a kind of French-American bistro gone uber-gourmet. However, the highlight of the night was the "chicken" we had for dessert, one of Richard's signature, whimsical dishes.

See for yourself.

This is a meringue, shaped like a hen, filled with luscious ice cream and sitting atop a nest of brittle sugar “straw,” whipped cream, and a pool of caramel syrup.

It was *extraordinary*. The combination of textures and tastes was beyond anything my wife or I had seen in a dessert. Adding to this explosion of flavors was the fun of eating “chicken” as a dessert food and this was possibly the most memorable dessert of our lives.

Indeed, this was more than just a dessert, it was a marketing tool for the restaurant as a whole: as soon as our order came out, every table around us ordered one too. By the time we left, I counted six other tables having “chicken” for dessert.

In plain terms, we ordered a dessert, but Chef Richard delivered an “experience.” My wife and I laughed and shared many delightful moments as we butchered our “chicken.” Because of this, I didn’t care that the dessert cost $12. In fact, I probably would have paid $17 or more for it and not even batted an eye.

Now, compare this to your average dessert (brownie, sundae, etc) at most restaurants. How often do you find yourself remembering a random dessert you had months ago? From a business perspective, how many times have you found every other table around you ordering a dessert after they see yours?

This is what I mean by selling an experience. It's no longer about products, it's about creating memories and emotional experiences that touch people. That's where the money will be going forward.

I'll give you another example.

At a recent dinner party I struck up a conversation with a young entrepreneur who had recently attained an MBA from Harvard. One of his classmates was Will Dean, a former British counter-terrorism agent who competed in marathons, triathlons and the like.

Dean was bored with the average fitness course, so he decided to launch *Tough Mudder*, a 10-12 mile fitness course that is based on the kind of courses and challenges he had to overcome during his training for the British Special forces (we're talking about 12 foot walls, underground mud tunnels, etc).

The company's entire start up cost was probably less than $50K: all they had to do was rent a track of land and build and dig the obstacles (walls, tunnels, etc.).

However, people all over the country have lined up in droves for the experience of pushing themselves to the limit at one of these events. The whole thing is like an enormous playground for adults. It challenges you physically, mentally, and emotionally.

And people are willing to pay north of $150 per pop to participate. Spectators have to pay $50 *just to watch.* Small wonder that the company made $2.2 million in revenues in its first year and **$22 million** in its second year. That's $22 million in revenues, from a glorified fitness course, that was launched DURING the current Depression.

This is what I meant by innovation and creativity finding pockets of wealth. Will Dean saw a niche in the fitness industry (an event that was more challenging and less monotonous than traditional marathons and other fitness tests). He then moved to capitalize on that niche with minimal risk by keeping his start-up costs to a minimum. And today he's sitting atop a $20 million business with numerous corporate sponsors.

You can learn more about Tough Mudder here:

http://toughmudder.com/

Dean's story shows, in no uncertain terms, that if you're able to think creatively about pre-existing industries, you can make an absolute fortune, even during times of severe economic contraction.

The above two examples concern generating value for entrepreneurs. My final story pertains to seeking out wealth generating opportunities from an *investing* standpoint.

The financial markets today are heavily if not completely reliant on Central Bank intervention. We now have a time in which virtually every traditional asset class under the sun is overvalued and susceptible to a crash (this is even true for Gold if we get another 2008 event).

With that in mind, investors are going to need to look outside of the capital markets for opportunities to generate returns. Indeed, I fully believe that performing assets (things like lead mines, shopping malls or wood mills) will potentially offer better returns than stocks for instance.

I'll give you a final example.

A friend of mine is a master baker. Having trained both in the US and in France, he's now at the level that Yale and other large organizations hire him as a consultant to design their breads and pastries.

Recently my friend told me that he had decided to launch a new bakery (he sold his last one several years ago). Given his reputation, skill, and earlier success (he's run several very successful bakeries in the past) he would have little if any trouble raising capital for the business.

However, rather than seeking out loans from a bank or other financial entity that would want a claim on his private assets in return, he's chosen to raise capital from private investors. And he's offering a 10% yield on all loans.

This is a heck of a return relative to most savings accounts (0.15% at best) or even Treasuries (the 30-year yields less than 4%). And he's only looking to need the money for 1-2 years before paying it back.

Thus we have a serial entrepreneur, with a nationally recognized talent, offering investors a 10% yield on loans made to fund his latest venture. Having seen his spreadsheets and projections, even by extremely conservative estimates his business should be producing close to $500K in EBITDA within the first three years.

As I said before, there are opportunities to generate value in the real economy today, outside of the volatile and manipulated capital markets. With that in mind, all investors should devote some time over the coming months to seeking out investments outside of what's on Yahoo! Finance and CNBC. I fully believe some of the greatest opportunities available today will be in the real economy, NOT seen on a stock screen.

I'll be detailing them as I come across them.

This concludes this portion of this week's ***Private Wealth Advisory***. Tomorrow's section will be devoted solely to the capital markets and how to position our portfolios given the Fed's latest FOMC announcement.

Until then…

Good Investing!

Graham Summers