

Basic Points

The Cradle That Rocks the World

January 27, 2012

Published by Coxe Advisors LLP

Distributed by BMO Capital Markets

BMO  Financial Group BMO  Capital Markets



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Don Coxe

THE COXE STRATEGY JOURNAL

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January 27, 2012

published by
Coxe Advisors LLP
Chicago, IL

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Basic Points is published exclusively for BMO Financial Group and distributed by BMO Capital Markets Equity Research for clients of BMO Capital Markets, BMO Nesbitt Burns, BMO Harris Private Banking and Harris Private Bank.

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The Cradle That Rocks the World

OVERVIEW

We have been basically bearish on equities since last May, because we could not see the likelihood of a painless resolution of the eurocrisis. That caution was initially vindicated, but in the past three months, global equities have been rallying, led by the S&P, which nearly retraced its loss.

This month, we lay out a road map for an equity recovery—showing the key indicators we were watching to return to our previous—and more characteristic—bullishness. We find good reasons for some optimism about US equities and commodities now, primarily because of heightened Fed Fright, which means the financial heroin will be gushing for years. We are therefore raising our Recommended Equity exposure.

Our over-arching concern continues to be the euro-crisis in the Mediterranean region—the cradle of Western civilization—where conditions continue to deteriorate. Worse problems may lie ahead. We suggest clients should begin to think about economic and political troubles occurring in both the North and South Shores of that sea as having the potential to become interlinked—as they were two millennia ago.

On balance, we think the odds favor a positive year for non-European equities—particularly commodity stocks. Massive monetary expansions on both sides of the Atlantic usually raise prices of commodities—particularly foods and fuels—faster than prices of other goods and services. However, existential risks remain imbedded within the global financial system—particularly in Europe—despite four years of legislators' and regulators' attempts to force big banks to cleanse both their balance sheets and their business models.

We are adjusting our Recommended Asset Mixes accordingly, increasing equity exposure from 40% to 47% in pension funds—plus the previously recommended 10% allocation to dividend-paying stocks within the "Income" section of pension funds.

The Cradle That Rocks the World

I. When the Bough Breaks, the Cradle Will Fall

The classic lullaby that seeks to soothe the baby with the assurance that when the wind breaks the bough, "Down will come baby, cradle and all" strikes us as faintly macabre.

The relevance of "Rock-a-Bye-Baby" to our discussion is that it contemplates the fate of the cradle on which a baby's life depends.

The global financial crisis is really about the euro, which is really about the crises in the Mediterranean membership: of the five "peripheral nations" (the euro-elites' euphemism for PIIGS), four are located on the northerly shores of that sea. Ireland's crisis has been contained—at great and embarrassing cost—but the southern PIIGS' plight has been growing more serious each month, despite massive ministrations.

The euro-elites sought to mask the expanding necrosis, rather than impose radical surgery. The disease therefore spread across all the Mediterranean countries in the eurozone, a process of denial that could yet bring down the global economy, according to The World Bank.

The result has been a disproportionately negative influence on the world economy for a group of economies that had been growing less competitive since the arrival of the euro.

We suggest that future historians will look at the PIIGS' crisis within the context of the crises occurring along the southern and eastern shores of the Mediterranean. By unhappy coincidence, the order prevailing across the Mediterranean world for decades is crumbling everywhere except in Turkey, Algeria, Morocco and Israel.

That kind of simultaneous shock across the region has not occurred since the fall of the Roman Empire—which unfolded over many decades.

The euro-elites sought to mask the expanding necrosis, rather than impose radical surgery.

The Cradle That Rocks the World

The Mediterranean in History

This is both non-historical and misleading.

History buffs would argue that it is impossible to understand the effects on the world from a Mediterranean roiled by crises occurring *simultaneously within both the eurozone and the Arab nations* today without looking back to the Mediterranean in history.

The "Arab Spring" has focused the world's attention on the South Shore of the Mediterranean. However, most commentators on the successive revolutions supply maps of each of the states, but almost never a map of Mediterranean civilization. This is both non-historical and misleading.



Because none of the city states or countries bordering on the Mediterranean was self-sufficient in everything necessary for a secure and civilized existence—food, wine, weaponry, tools, clothing, papyrus with texts of literature, poetry, military strategy, and agriculture, and the best artefacts for praising the gods—trade was a necessity.

Since ancient times, the states and empires of the Mediterranean region have not just fought and conquered each other—but have traded with, and influenced each other.

The Cradle of Western Civilization—Then and Now

For nearly two millennia, such significance as Greece enjoyed internationally was mostly for its beautiful isles and ruins, and the Romantic dream that the gods, heroes and geniuses embodied in "The Glory That Was Greece" somehow lingered in Olympus, Delphi, and Athens. Recently, it became the source of the Olympic Flame. Even more recently, it became the first of the overindebted underachievers to go broke because of its own profligacy.

In the six centuries before the Christian era, Greece was the leading intellectual and cultural force of the Northern Mediterranean. Alexander the Great spread that influence as far East as the borders of India. His legacy also proved decisive for Egypt.

The Ptolemy dynasty which continued to Egypt after his death until the suicide of Cleopatra, staked its claim to divinity through descent from his mother. In the three centuries of Ptolemaic rule, Alexandria became the intellectual and artistic capital of the Mediterranean and, in its library, the pre-eminent storehouse of Greek culture.

When Julius Caesar's nephew Octavian was given the title of Emperor Augustus, there were three major culture centers—Athens, Alexandria and Rome—of which Rome was the least distinguished. His rule ended the Hellenistic era which had begun with Alexander—the golden age of Grecian cultural dominance of the Mediterranean.

The Romans called the Mediterranean "Mare Nostrum" (Our Sea)—both as an assertion of Rome's ability to project military power across it, and their hope that Poseidon would treat Roman shipping favorably—the Mediterranean being notably storm-tossed, particularly during the winds of winter.

Julius Caesar conquered Britain and Gaul, but could hardly wait to come to Egypt, staying in Alexandria for nearly two years. It was not only the near-divine cultural center of the Mediterranean—but was Rome's biggest grain supplier. Rome hadn't been able to feed its citizens and legions for centuries. It relied on conquests and trade—and trade was usually more reliable.

Rome annexed Egypt when Octavian won the sea battle over Antony and Cleopatra's fleet at Actium in 31 BC. Until then, Rome had to form shifting alliances with the powers in Egypt and the Near East.

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**Bitumen, you may ask?
Isn't that what they
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Egypt had a great navy, which it used in trade—and in power bargaining.

King Herod played off the various players in Roman politics, including Caesar, Cassius, Brutus, Antony, and Octavian, because he controlled the Dead Sea, which produced bubbles of bitumen.

Bitumen, you may ask? Isn't that what they mine in Fort McMurray? What possible importance could it have had in ancient times?

Bitumen had long been used for lighting lamps, but it became a strategic resource when the Egyptians discovered it could be used to waterproof its ships. (The Canadian Cree and Dene aboriginal nations of Alberta made the same discovery for their canoes.)

As Stacy Schiff explains in her splendid new biography of Cleopatra, even remote Judea was important in the Mediterranean power and trade calculus—as a potential route for Roman armies to attack the troublesome Parthians (the successors to Darius), but also because of its monopoly on bitumen.

Rome was the home of the consuls and generals who devoted themselves to expanding the empire—thereby generating the foodstuffs, ideas and wealth that Rome lacked. But it was a dirty city with mostly uninspired architecture and few centers of learning until the Augustan Age. Augustus and his successors eagerly adopted Greek culture, and the vast financial resources of Rome meant that Greek traditions found their greatest funding in the Roman Empire.

The tradition of democracy that had been the intellectual font for Athenian rise to power and influence faded. Rome's constitution had a modest democratic component with its tribunes and an aristocratic senatorial system. But when times got tough, the structure was abandoned in favor of the appointment of a dictator for a one-year term—which was frequently extended. Julius Caesar was granted dictatorship for life, an affront to senatorial power that was a key factor in his assassination.

Nevertheless, the concept of rule by the people had become rooted in the developing DNA of Western civilization and survived as an ideal through the Roman Empire, the Dark Ages, the Holy Roman Empire and the rise of nation states in Europe. However, when it was reborn in Britain, Holland and Switzerland, and gradually spread across the Continent, it had trouble becoming established in the North Shore. During the 20th Century, Fascist and Communist groups vied for power across much of the region.

Prior to the rise of Islam, the Mediterranean was the center of the known world, and could be described as one huge—albeit diverse—community, which included citizens resident across the region. That was how Saint Paul saw it: when captured, he announced, "*Civis Romanus Sum*"—gaining the right to trial in Rome. The Catholic Church became the great unifying force across the region when Rome entered decline.

La dolce vita rests on reliable cash flows.

Then Islam swept through the South shore, and West and East shores, being thrown back only after centuries of struggle.

Today, the Mediterranean is two civilizations in simultaneous, rapidly-unfolding crises. To date, those crises have been largely unrelated. That may well be about to change.

On the North and West shores, it is a nominally Christian community in which the church is a declining force. On the South and East shores, apart from Israel, it is an Islamic community in which religion is a stronger political and social force than at any time since the Ottoman Empire entered decline.

An equally important divide is demography. Europe is in the middle stages of demographic collapse on the Japanese model, with a fertility rate of approximately 1.3 babies per female—far below the replacement rate of 2.1—each new generation is roughly 60% of its predecessor, making the third generation roughly 40% the size of the first. That loss of the basic dynamism of human progress is an insuperable force for declining economic activity: GDP is output per worker multiplied by the number of workers. During and after the Baby Boom years, this meant annual growth in the number of potential workers and first-time home buyers. Today, that shrinking and aging population is a downward drag on real estate prices and employment opportunities, since home building and servicing are such huge job contributors.

For many years, tourism was the most reliable source of income of Mediterranean PIIGS as their economies became less competitive, but the demographic decline among the Northern European nations and the strong euro have proved painful for hotels, tour operators, sailboat charterers and restaurants. *La dolce vita* rests on reliable cash flows.

The Cradle That Rocks the World

In the South, education is a double-edged scimitar.

The third major divide within the Mediterranean region is education. On the North shore, literacy is near-universal and higher education trains millions of young people for the jobs global economic growth offers. That so many millions of them are unemployed is due to slow economic growth, guild and union laws, and other over-regulation that stultifies competition and progress.

In the South, education is a double-edged scimitar. Illiteracy is widespread, which means a huge percentage of the population is destitute or on the edge of economic disaster—like the poor Tunisian street vendor whose self-immolation launched the most dramatic geopolitical developments in the Mediterranean since a Serbian anarchist killed Austria's Grand-Duke.

However, most of the Arab revolutions were launched by educated young people who could not find worthwhile employment in their largely dysfunctional economies. Cell phones and computers are ubiquitous, but there are few new manufacturing and service industries emerging. Young people envy the fast-developing prosperity of their generation across so many emerging economies, and blame their sclerotic regimes for their lack of opportunities.

Paradoxically, the biggest political winners from the sacrifices of the local youthful educated elites are the parties with no coherent economic growth agenda, just the mantra that "Islam is the answer." These parties were minor contributors to the miracles of Tahrir Square and its neighboring countries. But the dedication and organization of the Islamist parties, including the 8th Century purist version called Salafists, has meant that the divisions among the varying liberal or moderate factions have given power to them in Egypt.

In the Egyptian elections, the Islamists won 72% of the votes, with the Muslim Brotherhood receiving 47% and the Salafists 25%. Although the Brotherhood insists it is pluralist and tolerant, its highest-profile liberals who were so visible in its rise to power are now, according to numerous press reports, losing ground to hard-liners.

As we wrote in *Basic Points* while enthusiasm for the Arab Spring was running high across the world, the record for autocratic regimes toppled by idealistic liberals includes all too many tragedies. Examples: the *Girondistes* and their liberal allies in France lost power—and, in many cases, their heads, to the Jacobins, who were succeeded by Napoleon, who became Emperor; the Mensheviks and other liberals in Russia who seized power from the tsars in February 1917 were deposed in October by Lenin and his Bolsheviks, and were systematically annihilated thereafter.

Among the most conspicuous Egyptian victims of the Fall of Mubarak are the Coptic Christians (nearly 10% of the population), who were well-established in Egypt centuries before Islam was born, and who form a disproportionately large percentage of the educated and business-oriented citizenry. Their churches have been burnt—sometimes with worshippers inside. They have been brutalized by mobs while soldiers watched placidly. The brazen attack on the Israeli embassy in Cairo also appeared to have been organized with support from elements in the army: soldiers stood by until the mob had broken through all the external barriers.

**Remarkably, the other
big divide between
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faith in democracy.**

Predictable effect: tourism, Egypt's biggest foreign-currency earner, is collapsing. Foreign direct investment—heavily tourist-oriented—is on hold. Despite its massive problems, Egypt had been making modest economic progress until the army arrested Mubarak and embarked on an erratic program of crisis management, which has triggered double-digit inflation and a sharp fall in the nation's modest forex reserves. Its decision to reject an IMF loan in June, because the terms were "insulting" has forced the interim government to borrow locally, thereby draining liquidity from the economy. The new Muslim Brotherhood government talks of modernizing the economy, but long-range planning and investment cannot be implemented in a crisis. The Salafists were elected by the poorest of the poor, and they are adamant that the food and energy subsidies that are draining the treasury must continue.

Remarkably, the other big divide between North and South is faith in democracy.

The unifying cry across the South Shore has been the demand for democracy, for which thousands of mostly young and mostly liberal people suffered imprisonment, torture or death.

Such idealism is at bay on the North Shore: the two cradle nations of Mediterranean democracy—Greece and Italy—which were democratic while Spain and Portugal were still dictatorships, have been forced by the eurocrisis to forsake rule by elections. They have fired their top political leaders in favor of elite Eurocrat replacements acceptable to the European Central Bank and Brussels.

Even when Alexander the Great was conquering the eastern Mediterranean and Southern Asia, the lives and fortunes of most people on earth were unaffected.

Not today. The so-called "Cradle of Western Civilization" is rocking amid strong winds from both sides of the sea; if it falls, the economic and geopolitical effects will be enormous.

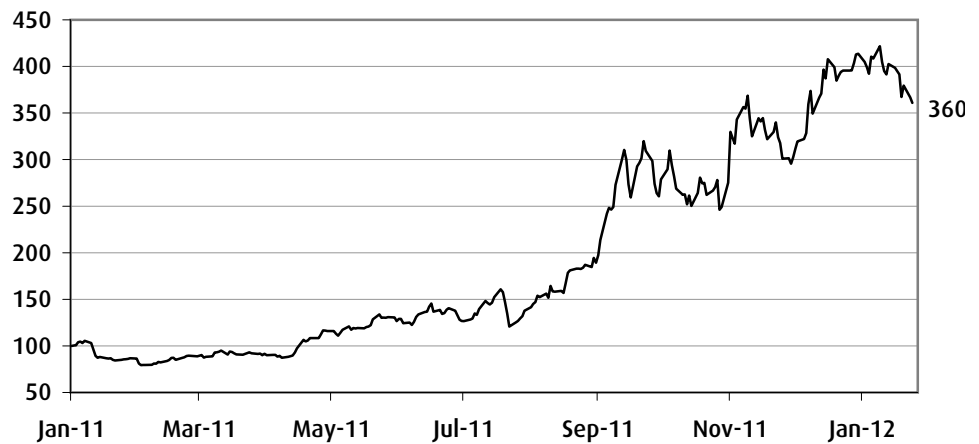
The Bond Market as Ruler

Clinton adviser James Carville now has actual proof of the accuracy of his famous appraisal of power: he said that if he died and came back to earth he would want to be the bond market, which rules everything.

...the bond market rules...

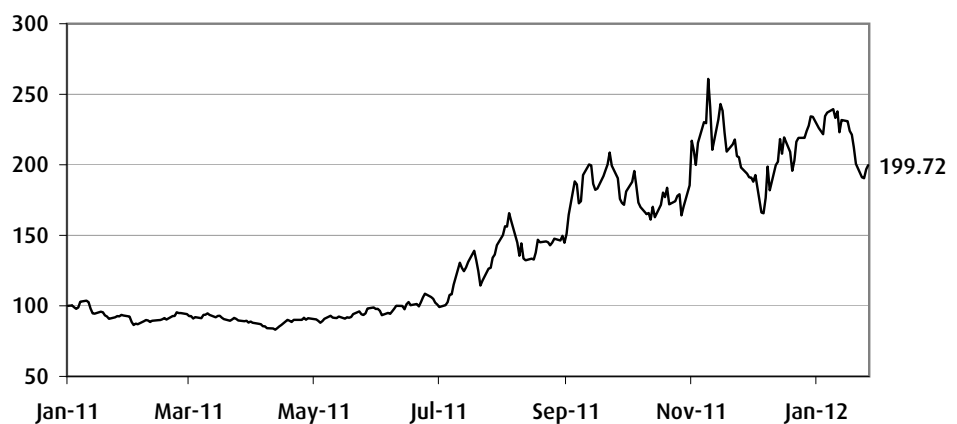
Greece 10-Year Yield relative to Germany 10-Year Yield

January 1, 2011 to January 24, 2012



Italy 10-Year Yield relative to Germany 10-Year Yield

January 1, 2011 to January 24, 2012



That the bond market rules is being confirmed as the benchmark for success proclaimed by the two eurocrats who were given power in the cradle nations. These imposing gentlemen imposed on struggling democracies boast reassuring resumé's, pleasing the bond market.

Italy's Mario Monti says flatly that his only chance of gaining support for his reforms and cutbacks is sustained low yields on Italian bonds. Greece's Lucas Papademos (formerly a VP of the ECB) informed an interviewer from *The New York Times* last week "If Greece did not receive 100% participation in a program in which bondholders would voluntarily write down \$130 billion from Greece's unwieldy \$450 billion debt, the country would consider passing a law to require holdouts to take losses."

He stated that foreign lenders hadn't acted quickly enough when the debt problem first arose, and they should have included "growth measures" along with austerity in the program they were seeking to enforce on Greece.

A day later, Greece unveiled its proposals for bondholders: they would swap their existing bonds for long-term securities with an initial coupon of 3%, rising to 4.5% as the bonds neared maturity. According to some reports, this would constitute a 68% writedown, but would somehow not constitute a default triggering payments of Collateralized Debt Swaps.

Predictably, many institutional investors are strongly opposed and threaten lawsuits.

Greece's first scheduled debt repayment is March 20th, and the government needs this "haircut" deal to meet that deadline.

Conclusion

The eurozone's problems and the Arab Spring have, to date, been discussed in the media as discrete occurrences.

However, for the first time since the Second World War, most of the nations in the region face crises simultaneously, which suggests huge potential instability.

The key reason Italy broke its long, lucrative Libyan relationship, and enthusiastically supported the NATO attacks was the flood of Libyan refugees pouring into Italy. Libya's cash flow problems could be temporary, because its substantial production of light crude oil should shortly resume, but in its attempts at nation-building it faces the same internal conflicts between liberals and Islamists as Egypt. Already, pro-Gadhafi supporters have taken over one town and proclaimed a rebellion.

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The Cradle That Rocks the World

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Sadly, it is almost inevitable that the North Shore will soon face serious refugee problems as the non-oil South Shore nations are torn with internal divisions the dictators had suppressed, and their fragile, uncompetitive economies implode. Iran managed to survive as a brutal Shia theocracy because it inherited a society of well-educated men and women—with a strong agricultural and trading base in which entrepreneurialism flourished—and because of its immense reserves of oil and gas. (Fortunately, Iran is unlikely to be a major meddler in the Mediterranean crises, because the populations are largely Sunni.)

Beleaguered governments frequently resort to distracting their citizenry by blaming foreign enemies. Israel has been blamed for nearly all Mideast problems for decades—by Arab propagandists and by the global Left. It has peace treaties with two neighbors—Jordan and Egypt. The Egyptian Army rulers were careful not to suggest that the Israel treaty should be torn up, as some of the candidates for office were demanding, partly because of American aid. However, it was to be “reviewed”. We saw Jordan’s King Abdullah being interviewed on US TV and he expressed concern about demands from radicals to revoke the Israel treaty, but said that it was crucial that Israel re-start its negotiations with the Palestinians, because the one issue uniting “all Arabs” was insistence on settling that question for once and for all.

Good luck with that.

The eurocrisis has been front and center for nearly two years, during which time the economic and financial fundamentals have continued to deteriorate. “The Arab Spring” came suddenly, in a series of outbursts of optimism. It may have come at the worst possible time for the beleaguered nations of the North Shore.

The Mediterranean has entered one of the stormiest periods in recorded history. It is the major contributor to risk in global equity markets. It is too soon to predict how these crises will end.

The Cradle of Civilization is rocking amid an array of winds and storms.

II. Shoring Up the Banking Systems of the North Shore

Last year, global equity markets behaved schizophrenically in response to news from the eurozone.

When a crisis was smashing the eurobond market, bank stocks would lead broad equity markets in sharp selloffs.

Then a new meeting of the political leaders would be quickly called and would announce a support measure that would solve the problem.

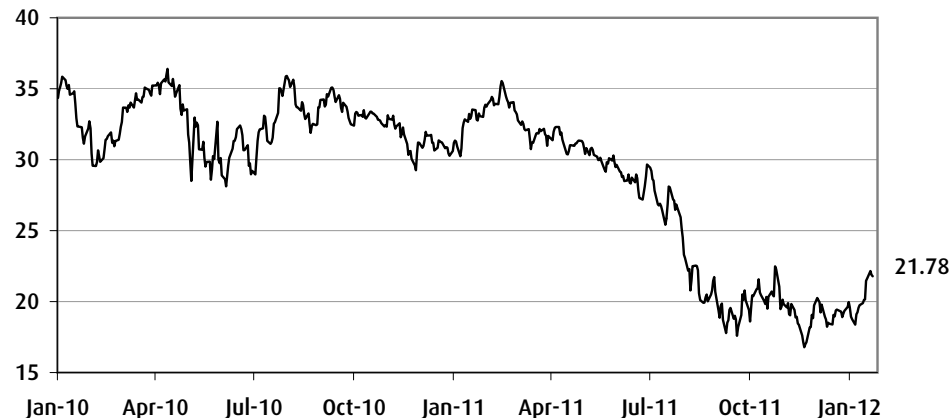
And stock markets would soar.

This risk on/risk off pattern that bedeviled global markets has, more recently taken an impressive turn for the better, as measured in the upside breakouts in European bank indices—the kind of rally that grabs our attention:

This risk on/risk off pattern that bedeviled global markets has, more recently taken an impressive turn for the better...

KBW European Large-Cap Bank Index (KEBI)

January 1, 2010 to January 24, 2012



KBW European Small / Mid-Cap Bank Index (KMBI)

January 1, 2010 to January 24, 2012



The Cradle That Rocks the World

...a process "in which insolvent governments support insolvent banks which support insolvent governments."

Mario Draghi of the ECB and Mario Monti, now leading Italy, are dubbed "Super Marios" by the gushier commentators. Mr. Draghi is living up to his label since he took over from Jean-Claude Trichet the day after Halloween.

His first act was to cut the ECB rate from a crushing 1.5% to a more bearable 1%. (For those readers who wonder why we suggest 1% is even modestly restrictive, we note that American banks get Ben Bernanke's money virtually for free, and even his biggest and baddest banks tend to have better balance sheets than Magnanimous Mario's array of walking wounded supplicants.)

His most spectacular maneuver has been the Long Term Refinancing Option (LTRO), which supplied €489 billion in three-year loans to 523 gasping banks against a rollover from short-term notes of various kinds. Walter Bagehot, who wrote the Victorian book on banking would applaud. Moreover, another rollover is coming in February. As Martin Wolf writes in the *ft*, "The balance sheet of the ECB is about to explode."

That largesse—with promise of an estimated €400 billion more in LTRO funds in February—has given him freedom to resist pressures to lower his rate again this month, a soothing sop to gobsmacked Germans.

The bond market heaved a collective sigh of relief, with yields on Italian and Spanish bonds shrinking, and share prices of distressed European banks soaring.

These rallies, which have kicked off equity rallies globally, came even though S&P stunned the markets by downgrading the formerly AAA bonds of France and Austria a notch, lowering Italy to BBB+ (Better But Bad in sovereign terms) and downgrading poor Portugal to junk. (The other services are standing pat at the moment.)

Mr. Draghi and the other eurocrats are engaged in a strategy that the wise people at Bridgewater call a process "in which insolvent governments support insolvent banks which support insolvent governments." It recalls the model proposed by a perceptive 19th century economist of an economy in which everyone was somewhat anxiously employed in taking in each other's laundry.

We aren't yet convinced that these LTROs and the Greek bailout will end the crisis, because the problems of Portugal, Spain and Italy collectively constitute such huge challenges to an overall program of enforcing austerity on recessionary economies. The optimistic deficit targets are unlikely to be met, and Germany and France have set firm limits on their participations in the funding programs.

"Woody" Brock, one of the most perceptive analysts of our time, sees the eurozone problems in an even broader context. He wrote recently of the problems of democracy in the eurozone rooted in unaffordable compensation and benefits programs for government employees and similarly unaffordable social programs. The voters have been told these were their basic human rights—like freedom of speech. He notes that the US is not immune to these attitudes, as is demonstrated in battles over public employee benefits and the refusal of both parties to face up to the real costs of Social Security, Medicare, and Medicaid.

**...the eurocrisis is
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Pricing Model (CAPM).**

Nevertheless, this is the first time since the eurocrisis began that the ECB has resorted to Fed-style crisis management, and it's enough to raise investors' hopes.

If the current Italian trucking crisis can be resolved without Monti being forced to resign and if the euro retains its modest strength amid these massive monetary floods, the eurozone could probably withstand a Greek default—and eurobond markets would stabilize.

The CAPM's Own Crisis

As we have been maintaining for the past year, the eurocrisis is the second great existential challenge to the Capital Asset Pricing Model (CAPM).

The first was Wall Street's large-scale offering of poisoned chalices in the form of AAA-rated Collateralized Debt Obligations loaded with low-quality mortgages. Banks in the US and Europe were enticed into absorbing trillions of dollars' in stated value of supposedly liquid assets that were supposedly good for investors' financial health.

Astonishingly, no high-ranking officer from the big banks' managements has faced even a civil—let alone criminal—prosecution for spreading poisonous products across America and Europe. There have been prosecutions of small fry but the men (they were almost all men) who, with the connivance of the well-paid rating services, Fannie Mae and Freddie Mac, Barney Frank and other politicians, nearly destroyed such storied institutions as Bank of America, and launched the biggest financial crisis since the Depression. It should be of great interest to students of how American politics really works that Clinton insiders Franklin Raines and Jamie Gorelick, who got so astonishingly rich from running Fannie Mae when it plunged so deep into sub-primes, aren't being prosecuted but their non-political successor who simply continued their catastrophic policies, is in the dock.

Like its predecessor, the eurocrisis is rooted in systematic, cynical perversion of the principles of the Capital Asset Pricing Model.

Andrew Haldane of the Bank of England recently delivered an interesting speech about American bank practices. He noted, “In 1989, the CEOs of the seven largest US banks earned on average \$2.8 million...almost 100 times the median US household income. By 2007, at the height of the boom, CEO compensation among the largest US banks had risen tenfold to \$26 million. That was over 500 times the median US household income.” He later noted that the increase grew at the same rate as the increase in bank leverage. [Memo to all bank directors: to constrain risk that could lead to disaster, don’t even *think* of tying bosses’ pay to return on equity—instead of return on assets at actual value.]

What remains is the many trillions' increase in national debts arising from the bailouts and the recession, and a fragile financial system kept afloat by sustained injections of financial heroin in the form of cheap or free money.

This prolongation of zero returns is spreading sickness among previously-healthy pension plans—public and private—across Europe and North America. The next set of crises is on its way as the actuaries update their analyses of the real health of plans. Far too many public and private plans have been using 7% – 8% assumed rates of return for their funding. Stock markets have delivered negative returns in this millennium, apart from dividends, and the only bonds offering yields that could meet those 8% assumptions could be almost as risky as those Frankensteinian creations of Wall Street's apparently mad PhDs.

The eurocrisis came before markets had time to recover from the sublime era.

Like its predecessor, the eurocrisis is rooted in systematic, cynical perversion of the principles of the Capital Asset Pricing Model.

This time, the toxicity is in the other risk-free asset class—government bonds. The reason why the PIIGS' offal offerings were sold as if they were financially nutritious was that, under the Basel rules' version of the CAPM, banks buying government bonds did not have to allocate any of their scarce (or theoretical) capital.

The arrival of the euro was greeted ecstatically in the PIIGsties. They were able to issue virtually all the bonds they wanted to finance all the benefits their public sector unions and retirees wanted, at interest rates barely above those available on German bunds. In effect, gold-plated lead was sold—in size—to banks at almost the price of pure gold—and the banks could report it to their regulators as being gold-equivalent.

Step right up, ladies and gents! Everybody wins!

Until the carnival stopped and the carnivores started shorting bank stocks.

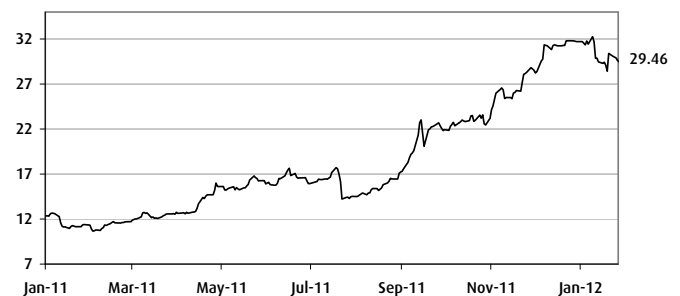
Italy 10-Year Bond Yield

January 1, 2011 to January 24, 2012



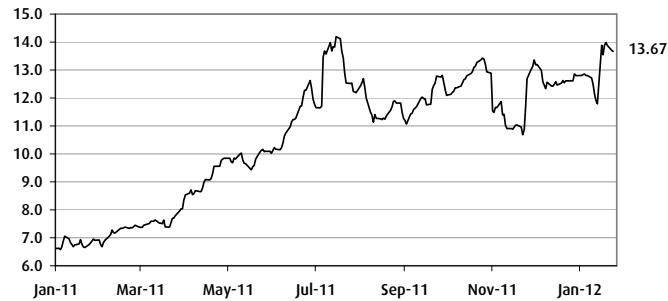
Greece 10-Year Bond Yield

January 1, 2011 to January 24, 2012



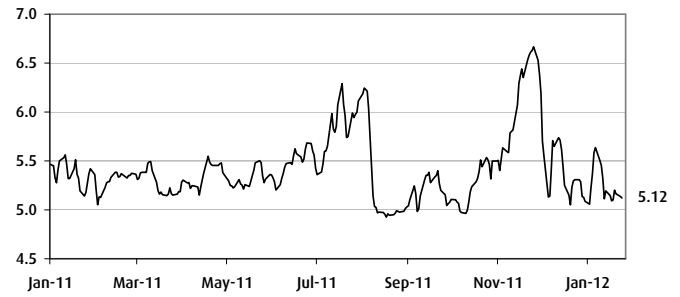
Portugal 10-Year Bond Yield

January 1, 2011 to January 24, 2012



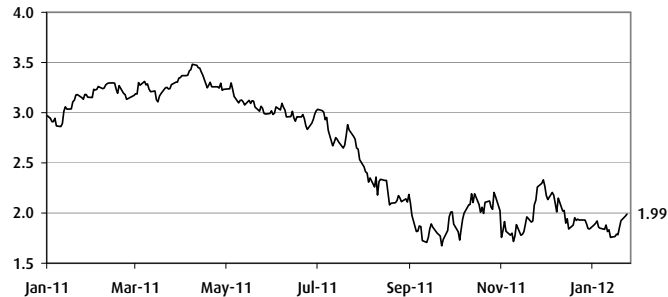
Spain 10-Year Bond Yield

January 1, 2011 to January 24, 2012



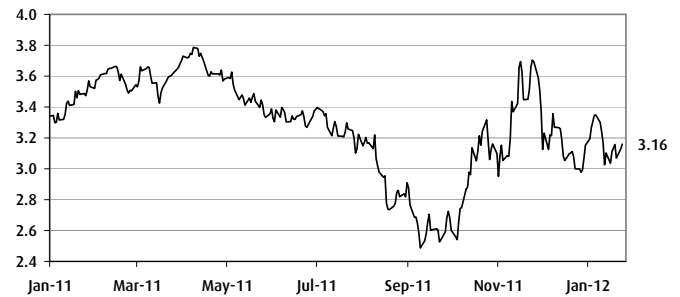
Germany 10-Year Bond Yield

January 1, 2011 to January 24, 2012



France 10-Year Bond Yield

January 1, 2011 to January 24, 2012



The euro's claim to being a store of value, even though it was backed by no government, no tax system, no army and no navy, was that it was based on a theory of fiscal and financial virtue from sea to shining seas—from the Atlantic and the Baltic to the Mediterranean. This creation of French Socialist *aristo* Jacques Delors was meant to displace the dollar as the store of value.

**...5B recovery mode—
Bank Bailouts
amid Bonuses for
Banks' Bosses.**

The central bank it created—the European Central Bank—lived up to its inflation-fighting promises, although (as it turned out), almost none of the member nations lived up to the fiscal purity promises that were the other part of this elegant theory. Admittedly, the Germans and French were nowhere near as profligate as the PIIGS, but the supply of supposedly risk-free bonds grew so much faster than eurozone GDP that it should be no surprise that the second great challenge to the CAPM was born while the pain and suffering of the first was still in 5B recovery mode—Bank Bailouts amid Bonuses for Banks' Bosses.

Thanks to the success of that formula, banks across the eurozone were eager to step up to the table to buy the bonds *du jour* that didn't require any capital allocation.

We predict that Business Schools will be allotting scads of future PhDs for theses comparing the real risk of a subprime CDO with a Greek or Portuguese bond.

The CDO class of certified risk-free investments was more elegant, because it was ingeniously designed to include, kaleidoscope-style, so many different properties with so many different levels of homeowner incomes in so many different communities with so many different levels of appraisal—and so many different levels of honesty—that it was a triumph of technology in the service of illusion.

The second is more straightforward. As Axel Weber, former boss of the Bundesbank remarked to a group in Chicago, "Why did a banker in Germany or France buy Greek bonds with yields ten points above bunds? Because of the model. It wasn't an investment decision."

If, out of the blue, a vast number of frequently-unemployed sots received random credit card solicitations from a bank offering \$100,000 at 7% interest, it is highly probable that (1) they would take the bank's money and (2) taverns in their locales would experience unexpected increases in business, and (3) the bank would eventually review the assumptions used in the model that designed the mass mailings, and (4) the bank CEO's bonus would not be affected.

The eurozone's basic bailout mechanism is called the European Financial Stability Facility and was blessed with a Triple-A rating. S&P, perhaps suffering some sleepless nights of conscience for the trillions in dubious or outright disastrous mortgage paper it blessed with the Triple A gold seal, advised last week that, because it has had to downgrade several of the nations guaranteeing the EFSF's paper, it could no longer give it top rating.

The proud eurocrats dismiss S&P's *lèse-majesté* in downgrading most of the members of the eurozone. Why should anyone believe these fools who blessed all that bad US paper that caused all that trouble?

Good point.

But a tad late.

We were asked at a recent public appearance whether we thought the euro would survive. We said we doubted it, but referred to Angela Merkel's comment that if some members couldn't comply, it would continue with "the core members." Axel Weber made the same contingent prediction in Chicago, referring to a core group like those who built the EU.

We quipped that if this meant all the PIIGS reverted to their former currencies, what remained could be called a Kosher Euro.

As these kinds of possibilities arise, we assume that more and more Europeans will quietly buy more and more gold.

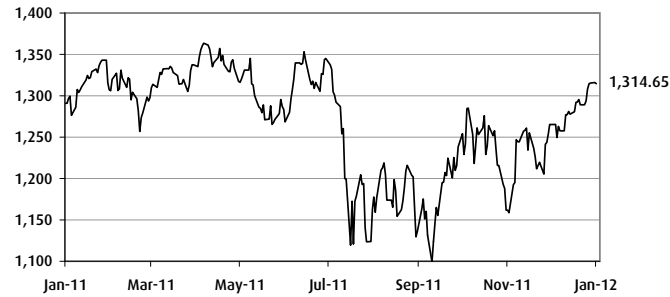
...if this meant all the PIIGS reverted to their former currencies, what remained could be called a Kosher Euro.

The Cradle That Rocks the World

III. A Change in The Wind

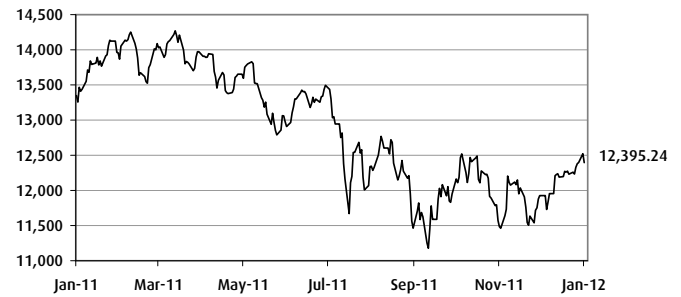
S&P 500

January 1, 2011 to January 24, 2012



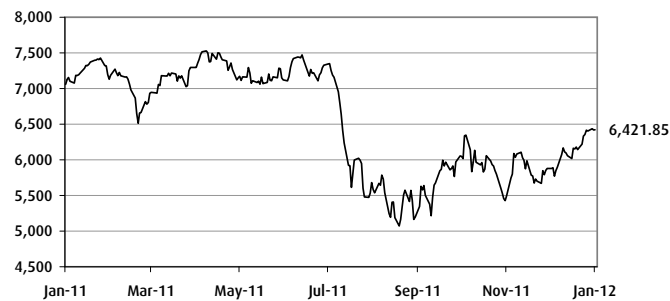
Toronto S&P/TSX Composite Index

January 1, 2011 to January 24, 2012



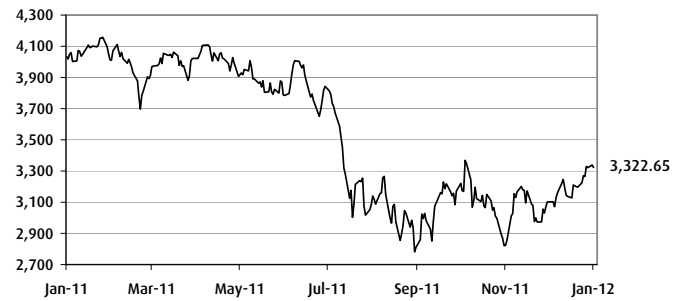
German DAX 30 Index

January 1, 2011 to January 24, 2012



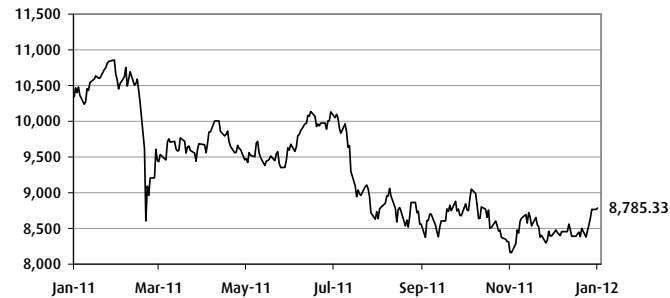
French CAC 40 Index

January 1, 2011 to January 24, 2012



Nikkei 225 Index

January 1, 2011 to January 24, 2012



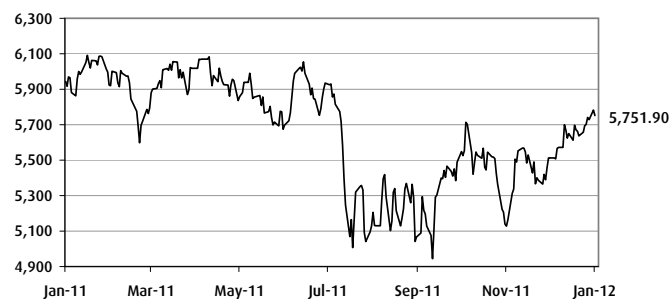
Shanghai Composite Index (SHI)

January 1, 2011 to January 24, 2012



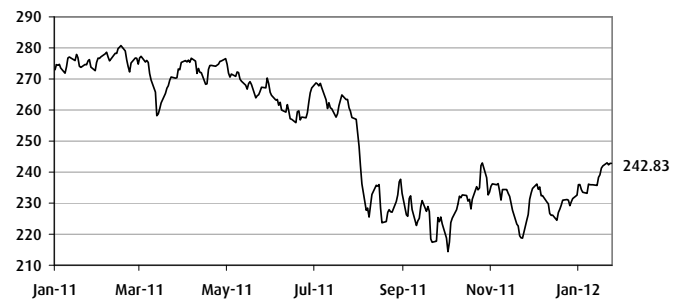
FTSE 100 Global Index

January 1, 2011 to January 24, 2012



MSCI All-Country World ex-US Index

January 1, 2011 to January 24, 2012



The S&P has of late been the star performer among global equity markets. It rather suddenly came to life in November, at a time it was trading at the same level it had reached 13 years earlier.

Back then, it was in the grip of tech mania as Nasdaq was gathering strength for its final orgasm, prior to its Triple Waterfall Crash.

This time, the S&P is responding to some distinctly encouraging developments.

1. Economic Pickup in the USA

The US economy has finally started to generate some encouraging data—not the stuff of rejoicing but significantly better than most industrial economies abroad.

At a recent public gathering, we advanced an explanation of this performance, suggesting that Milton Friedman and John M. Keynes met for a chat in Heaven:

Keynes: Milton, sometimes it gets frustrating up here, watching governments on earth struggling with their economies, but we can't go down like Scrooge to give them even a hint.

Friedman: John, I know what you mean. But think about it: my follower, Ben Bernanke, who gave me the tribute on my 90th birthday, said they had learned from me and wouldn't make the same mistakes. Look, he's increased the Monetary Base by 311% since that Crash caused by those idiot bankers and politicians, and he's kept interest rates at zero for 3 years without getting serious inflation. What more could he do? Yes, I remain unconvinced that such astonishing paper-printing won't trigger bond market collapses and new inflation, but we have to admit they've been a success to date. Long Treasury yields are at alltime lows!

Keynes: Precisely, Milton. And Obama is running deficits of \$1.2 trillion a year—more than even I would consider prudent, but that blowhard who keeps citing me, Paul Krugman, says it isn't nearly enough. Sometimes I wish Obama had targeted the spending to productive ends, rather than showering most of it on his political backers. But I did say that even paying men for digging holes and then filling them up again was better than just watching the economy collapse, so I guess I shouldn't be critical. That the economy is reviving despite their wastefulness tends to prove that throwaway line of mine!

The S&P ...rather suddenly came to life in November, at a time it was trading at the same level it had reached 13 years earlier...

The Cradle That Rocks the World

"Government isn't the answer: it's the problem".

Friedman (chuckling): Well, these expensive remedies won't last forever. Then what?

Keynes: Ah, Milton, as we have both learned, even up here, we can't foretell the future.

Friedman: Well, John, all we can say is that since they're doing down there simultaneously what we *both* recommended, there should be a good US recovery, and the latest news says that's exactly what's happening. That will mean that all our followers will be able to take credit for the success. Isn't that a Heavenly outcome?

We then sought to quantify Obama's deficit for this Canadian audience by noting that last year US farmers had their best net income year ever—\$100 billion. That is a major US industry employing millions even in these days of advanced technology—and Obama's deficit *every month* is as great as what all farmers earned in a year. Stein's Law must eventually hit the economy with earthquake force: if something cannot go on forever, it will stop.

Not that the Congressional Republicans can be relied on to enact sound policies, because they are a diverse, quarrelsome group. They are divided among old-style "country club" Republicans who loathe deficits and "big government", and want to bring sound management principles into the "chaos" of Washington, Tea Partiers who have a horror of deficits but can't figure out what to do about them, (except that Medicare and Social Security are off-limits), self-styled Reagan Republicans (who would mostly appall him) whose monomaniacal article of faith is "no tax increases ever", Ron Paul libertarians who want to scrap the Fed and bring all the troops home, evangelicals who are more upset about abortion and gay marriage than the deficit, and foreign policy-oriented Reagan "hard line " Republicans who care far more about the risks to the nation from abroad than from economic problems at home.

So one of Reagan's classic lines applies anew: "Government isn't the answer: it's the problem".

2. Encouraging Pickup in Money Supply Growth

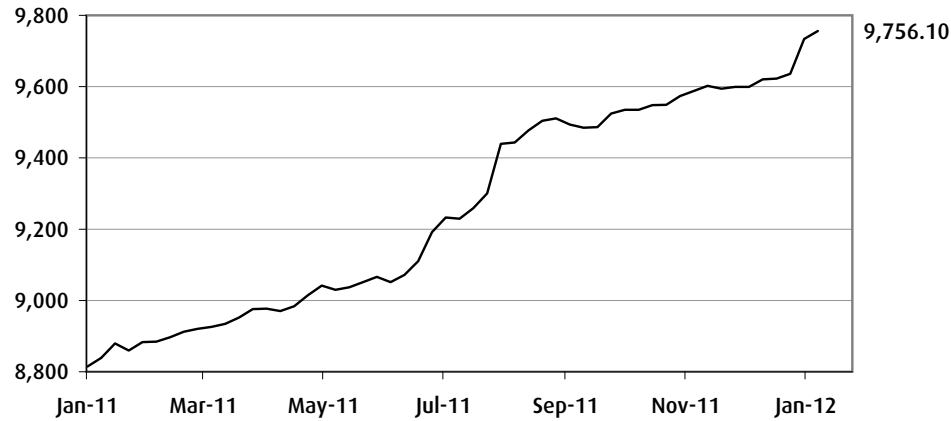
Washington's ability to throw more money at the economy is not infinite.

Like most observers, we have been awaiting solid evidence that Bernanke's audacious Monetary Base, easing and "Twist" policies were at last working through the banking system and beginning to translate into faster monetary growth.

**Washington's ability
to throw more money
at the economy is
not infinite.**

US M-2 Money Stock

Billions of Dollars, Weekly, Seasonally Adjusted
January 1, 2011 to January 9, 2012



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis

For too long, his expansion of the Base by creating bank reserves didn't trigger the kind of money supply growth of which real recoveries are made. The banks seemed content to lend the money back to the Fed, thereby boosting their beleaguered balance sheets.

But there is a change in the wind:

The good news is that in recent weeks, money supplies have begun to climb robustly, after 4 months of insipidity. As the chart shows, the spike in M-2 growth is almost lock-step with the upward rush in stocks, making January performance of the S&P one of the strongest in recent history. Friedman's spirit must be rubbing its ghostly hands with joy: "It's working!"

The Cradle That Rocks the World

The TED Spread's sudden, startling widening last summer was a sign that the massive reliquifications in the US and Europe were inadequate...

"Classic" TED Spread

(3-month Eurodollar yield vs 3-month T-Bill yield)

January 1, 2011 to January 24, 2012



The TED Spread's sudden, startling widening last summer was a sign that the massive reliquifications in the US and Europe were inadequate for the extreme stresses in the system. That coincided with our recommendation to clients to go to minimal equity exposure.

The still-slight improvement in the TED Spread is confirmation that liquidity across the banking system is improving. If the TED pulls back to the Twenties-range, the S&P should climb much higher—and some of the more bullish economists will be talking of GDP gains exceeding 3%.

Obama's career has been marked by sudden luck at crucial times. He's had a hot hand when the most was at risk. That luck may not have deserted him.

3. Stock Market Signals

All three of our key stock market indicators have now turned positive, led by our favorite—the relative strength of the KRX: the KBW US Regional Bank Index (also KRE).

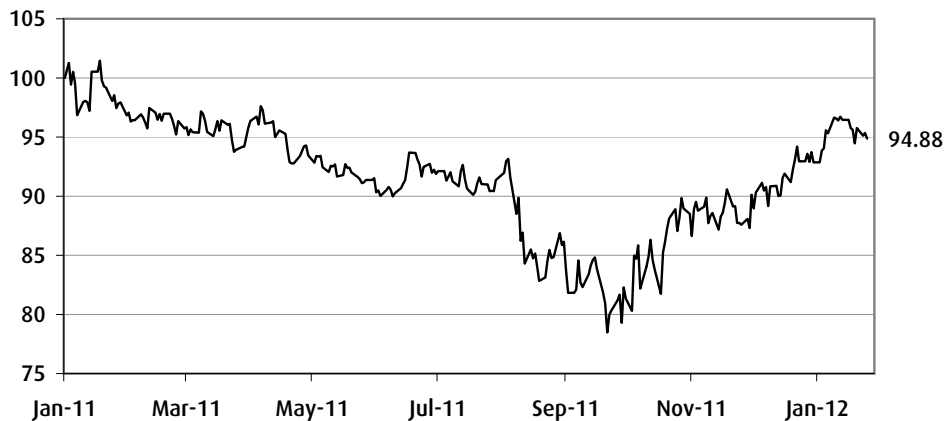
This is the index monitoring the banks on Main Street USA.

In contrast, the BKX is dominated by the B5—the Big, Bad, Bonused Bailout Banks.

**All three of our
key stock market
indicators have now
turned positive...**

KBW US Regional Bank Index (KRX or KRE*) relative to S&P 500

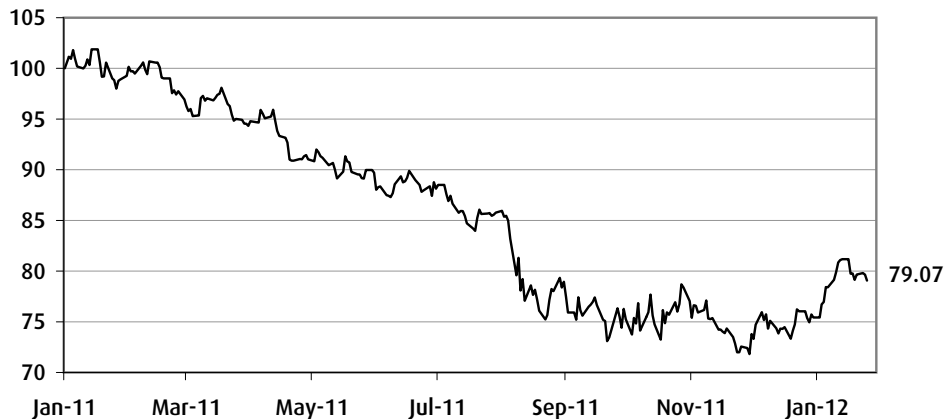
January 1, 2011 to January 24, 2012



*The KRX is the KBW US Regional Bank Index, an equal weighted float-adjusted market capitalization index based on the 50 mid-cap regional banking companies in the US. We also follow it using using the more easily available data for the KRE – the SPDR ETF based on the KRX.

KBW US Bank Index (BKX) relative to S&P 500

January 1, 2011 to January 24, 2012

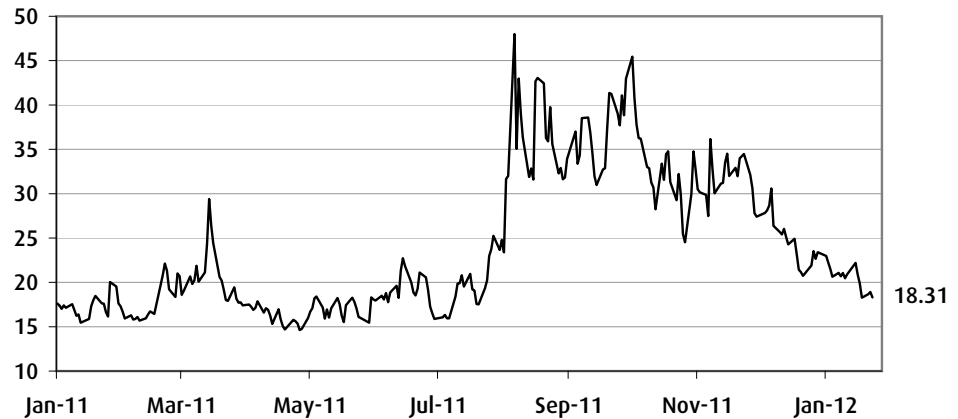


The Cradle That Rocks the World

...the only socially useful innovation in banking in 25 years was the ATM.

CBOE Volatility Index (VIX)

January 1, 2011 to January 24, 2012



As we have been telling clients for 25 years, when the bank stocks are underperforming the broad S&P, there will likely be troubles ahead; if the underperformance becomes prolonged and powerful—as it did last year—then it's time to scale back equity exposure sharply, because liquidity is evaporating and some financial institutions will suddenly go on the critical list.

The recovery on relative strength (RS) of the KRE in the past 3 months is dramatic and impressive. It is also reassuring that the BKX's RS has now turned positive, although it is sharply underperforming the KRE: Main Street is showing its heels to Wall Street.

Think of the KRE as the index—geographically spread across the land—of the banks that make their money the old-fashioned way—dealing with customers they know by name, most of whom live locally. They make mortgage and other loans to people they know and trust.

They are socially useful. As Paul Volcker told a gathering of B5 bankers who were protesting that the "Volcker Rule" against using customer deposit funds for proprietary trading would inhibit their ability to innovate, he told them that the only socially useful innovation in banking in 25 years was the ATM. Volcker remains the towering standard of what is best in America—and not just in banking.

If the BKX is outperforming the S&P, then even if one regards some of its membership as being managed by reckless and greedy people, it is good for the stock market that they are thriving. The unreformed Scrooge prospered during a great era for the city of London and the Bank of England.

The VIX is the stock market volatility index created and traded two blocks from our office. We use it as confirmation of the other indicators on which we rely in our analysis of financial stresses within the stock market. It is currently reassuring us that the stock market isn't skating on a pond whose ice is about to crack because of the mild winter.

The US stock market indicators have turned positive together and a positive attitude toward equity investing is now in order.

Before leaving this discussion of the financial system, we should comment on the collapse of MF Global. Its demise has been a devastating blow to many fine people who made the mistake of betting on Jon Corzine's ability to convert a century-old firm into a smaller version of the B5 banks. That was never a sound decision, because the last thing this nation needs is another big bank that may need to be bailed out because of its management's greed, leverage and incompetence.

However, long before MF Global attained the stature of systemic menace, Corzine had corrupted its objectives and bet the store—and the jobs of his employees—on dubious eurobonds. This was a fitting blunder for the man who, when campaigning for re-election in New Jersey against Chris Christie, appeared at a big union convention and passionately promised to fight for their pensions. New Jersey's public pensions had become hopelessly unaffordable, and Christie was elected in a Democratic state to save the taxpayers from disaster.

Nor were we totally dumbfounded that somehow \$1.2 billion in client trust accounts disappeared on his watch. We have no reason to believe Mr. Corzine is a thief, but his "bet the store" appeal to greed and fast results probably created a culture conducive to corner-cutting—and hostile to frightened questions from the normally scrupulous about whether proper accounting and risk-control procedures were being maintained.

The only good news about this sad story is that it happened now. Had MF grown far bigger as a result of some winning bets, its eventual—inevitable—fall would have hurt many more people. The man who wore no seatbelt in a limousine traveling far above the speed limit was psychologically disaster-prone.

For the nation at large, and the residents of New Jersey in particular, it was surely better for America that he was running MF into the ground: he would otherwise have been undermining the finances of the Garden State.

...Corzine had corrupted its objectives and bet the store—and the jobs of his employees—on dubious eurobonds.

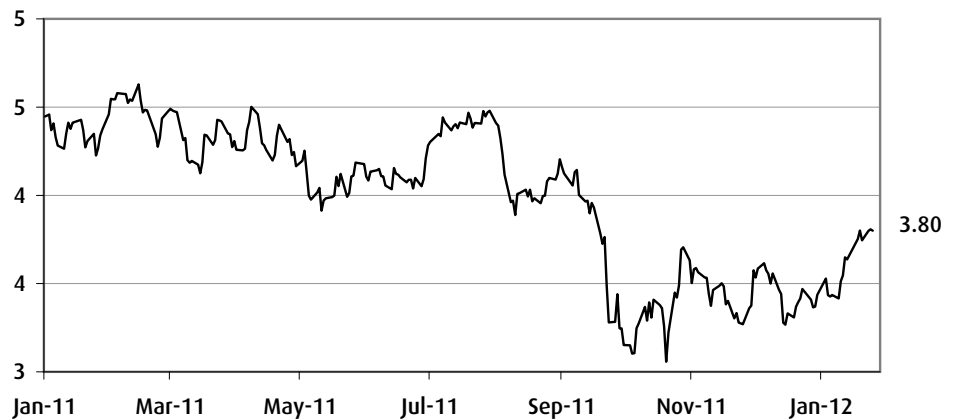
4. The Copper Signal

Copper has long been designated as "Dr. Copper, the metal with a PhD in economic forecasting." Most forecasters use the basic copper chart:

This chart confirms the other, which means it suggests the global economy may be stronger than most investors believe.

Copper

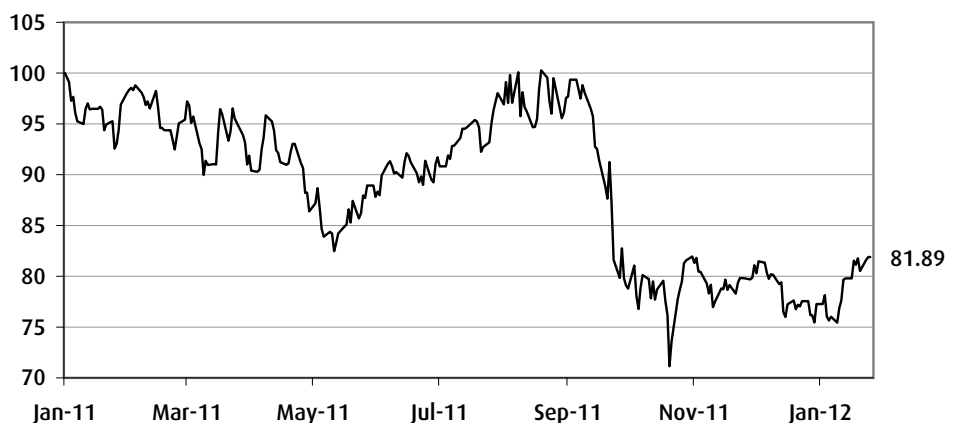
January 1, 2011 to January 24, 2012



This chart is certainly encouraging, and particularly when compared with the metal's huge selloff earlier, which came almost without warning in the summer—long after the KRE had warned of very bad times ahead.

Copper relative to S&P 500

January 1, 2011 to January 24, 2012

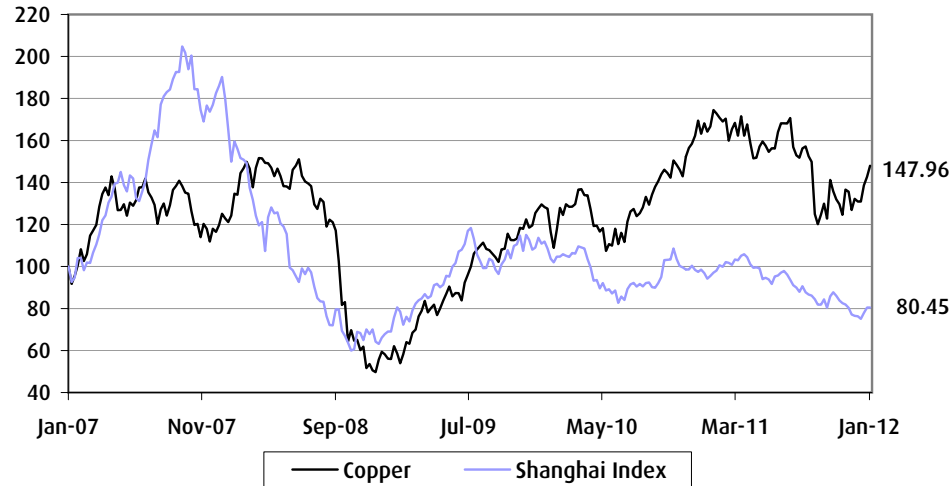


This chart confirms the other, which means it suggests the global economy may be stronger than most investors believe.

Since more than 40% of copper is consumed in China, we thought it might be helpful to compare copper's performance to the stock market of its biggest user.

Copper vs. Shanghai Composite Index

January 1, 2007 to January 24, 2012



...copper has been outperforming Chinese stocks for a very long time.

This long-term chart shows that copper has been outperforming Chinese stocks for a very long time. That may tell us more about the supply/demand features of copper than the relevance of the Chinese stock market for analysing the Chinese economy.

He is to the rostrum and teleprompter what Horowitz was to the piano and stool.

IV. Will the US Elections Mean Politicians Will Behave More Sensibly?

At all our public meetings, we are asked whether the upcoming US elections could prove to be good news for the economy and for stocks.

We say that we doubt it—partly because we doubt there will be substantial change. We continue to believe Mr. Obama will be the likely winner and we continue to believe that, despite his charm and energy, he will tend to be, on balance, a negative for US security abroad and for the US economy.

However, he remains a formidable campaigner. His State of the Union speech this week was truly impressive. He is to the rostrum and teleprompter what Horowitz was to the piano and stool. He was passionately moderate. He wowed his supporters and scared his opponents. He used the takedown of Osama bin Laden as the metaphorical structure for an arresting view of what has made American society great—and how it can be great again. His claims of impressive strength for US manufacturing and the US economy certainly overstated reality, but a President is expected to be a cheerleader.

If Mitt Romney and Newt Gingrich watched, they may each have felt they were fighting for the right to take on the political equivalent of Muhammad Ali in his prime.

No, he never once mentioned the pipeline that he vetoed. He would have had to push even his skills for exaggeration and obfuscation to their limits, and The Speech was hardly the occasion.

We wrote about the Keystone XL turndown last month, observing that Obama makes such decisions to appeal to his big backers in the NGOs, to the far Left in his own party, and in his own, pathetically-unshakable belief in Green energy.

Keystone was a particularly vulnerable application because it would be a shovel-ready product built entirely with funds supplied by a Canadian company, was vigorously backed by the Canadian government, and it would reinforce the development of the oil sands, with reserves of Saudi proportions. The US environmentalists are united in opposition to those projects, because they would have the potential effect of securing American oil supplies for many decades, whereas they want to get America off oil and on to Green energy, such as lithium-fueled cars costing the taxpayers more than \$50,000-per-car that seem to have a nasty habit of catching fire.

The American Left did its homework before uniting in the Battle to Kill Keystone. Some of those high-profile Hollywood environment experts who spent a night in Washington jails said that their objective was to shut down the oil sands: when access to the US was banned, the oil sands would be hopelessly landlocked because they expected Canadian aboriginals would block a pipeline to carry oil to China.

Prime Minister Harper has bravely announced that Canada will not let the international Left block the alternative to Keystone, the Gateway Pipeline to Kitimat proposed by Enbridge. Hearings to consider objections to the line have commenced.

Already, chiefs of the BC and Alberta First Nations have declared their opposition to the Enbridge proposals, which would cross territories they claim as theirs outright.

Fortunately, the American oil and gas industry is proving up vast reserves of shale gas and surprisingly large reserves of shale oil despite the White House and the Environmental Protection Agency... although you wouldn't have known that if you listened to the State of the Union speech. Mr. Obama now claims much of the credit for all those discoveries, saying they came from data prepared by government agencies at taxpayer expense. One is awestruck at his audacious restatement of history. But, as Napoleon observed, history is written by winners and Obama looks like a winner.

However, we can't let that breathtaking claim go unchallenged. The Republican takeover of the House meant that the industry's most vocal Congressional foe, Congressman Henry Waxman, no longer presided over the Energy Committee, and Nancy Pelosi was no longer able to get backing for favored green companies while battling both on and offshore drilling "to save the planet."

Result: the shale boom has proceeded without active Congressional opposition, and the Gulf is once again experiencing a pickup in drilling activity. (The headline you may not have seen, because it appeared on Page 16, was that even the EPA's investigators have admitted that they aren't finding new oil slicks in the Gulf, because microbes have apparently devoured much of the leaked oil from Macondo, and those microbes have become part of the food chain, which means the shrimp are back. Remember when we were assured by The Best Experts the Government Could Find that the Gulf would not recover for years, and the shrimp and pelicans might not come back in this decade? And have you seen the TV commercials from the Gulf states trumpeting their pristine beaches, saying "Y'all come down now"?)

**...as Napoleon observed,
history is written by
winners and Obama
looks like a winner.**

Suddenly, the Republican rhetoric switched from denouncing alleged Democratic Socialism to sliming Republican capitalism.

Mitt Romney looked to be cruising to a decisive endorsement as the Republican champion until Newt Gingrich and the mainstream media revealed that he had become remarkably rich through low income taxes paid on Private Equity (PE) investments that allegedly bankrupted good companies and killed American jobs.

Suddenly, the Republican rhetoric switched from denouncing alleged Democratic Socialism to sliming Republican capitalism. Could Obama ask for anything more?

Romney's claim to the nomination was always based on his record as a businessman, whereas Obama had no business experience and no Cabinet members or White House advisors with business backgrounds. That Romney rescued the Salt Lake Olympics from disaster proved he could apply his smarts to public projects.

We have many friends and clients in the private equity industry, and we are very familiar with the pro and con arguments about this sector of the capital markets. We are also aware that it is very tough to explain PE's value to the functioning of the economy to non-financial people. We have been critical of some PE firms (not Bain) for paying themselves with debt and then letting companies go bust. That universities, endowments and public sector pension plans are major PE backers is not enough to convince those who believe the basic business model is rapacious and inhumane. Those—like us—who have read Joseph Schumpeter's tributes to "Creative Destruction" are receptive to the idea that Bain Capital and its brethren are—most of the time—useful components of the capital markets.

Newt Gingrich (of Freddie Mac fame) turned the South Carolina Primary election into a referendum on Private Equity. His insistence that Romney release his income tax data sucked the air out of Romney's focus on the need to defeat Obama.

It worked.

Romney had a 12 point lead in South Carolina, and lost it within 5 days, finishing a humiliating 14 points behind Gingrich.

Romney released his tax returns this week and they certainly aren't shockers. He's rich and successful and, like Buffett, his income comes primarily from low-taxed capital gains. If Gingrich wins the nomination based on class warfare, the Republican Party will be decimated in November. (Nobody has noted that Buffett is committed to what amounts to the biggest tax avoidance scheme of all: he's planning to donate virtually all his estate to charities of *his* choice, not to Washington's priorities, which means his estate will be free of Death Taxes—the most punitive of all. From the grave, he becomes an even lower-taxed billionaire than in life.)

Even if Romney somehow manages to extricate himself from this Newttrap and win the nomination, he is wounded, and will have a tough time against the masters of gut politics—and *the* master of the podium.

From here, it looks as if the bane of the Romney campaign is Bain—and Obama will be the nation's biggest winner from private equity.

**...the bane of the
Romney campaign
is Bain...**

...a 63% haircut would seem to be the euphemism for something closer to a beheading than a modest trim.

V. Dividend Stocks

One of our more controversial recommendations of recent years has been our suggestion that pension funds should accept the emerging reality that the Capital Asset Pricing Model (CAPM) is too discredited to be used as the structure for long-term investing.

It seems that the CAPM is about to join the Black-Scholes-based risk models that disemboweled Long-Term Capital Management and the models used to confect the toxic debt that caused the crash. On the evidence, investors relying on conventional financial models should treat them with HazMat care.

Now that reliance on the CAPM has caused two financial crises, investors should run—not walk—away from the model.

In particular, since government bonds—as an asset class—are increasingly being recognized as the debt issued by debtors who can at best hope only to roll over their debts but whose politics virtually preclude the possibility that a commitment to fiscal reliability will be credible to ratings services.

For decades, the story of bond downgrades that hurt institutional investors was the story of deflowered debt in the corporate sector—most notably as a result of some private equity takeovers that were partially debt-financed on the credit of the bought company.

But for more than a year, the big story has been of market-driven downgrades of government debt—often with ghastly consequences for investors. For example, it seems that the Argentinean example of forcing haircuts on bondholders has spread to the Mediterranean. As we noted earlier, the new euro-installed premier of Greece is insisting on a major haircut for private sector holders (but not the ECB). The term "haircut" covers, of course, a wide array of styles, as any salon visitor can attest. But a 63% haircut would seem to be the euphemism for something closer to a beheading than a modest trim.

Sometimes, the government bond market seems to be as surreal as those funhouse mirrors that make you instantly fat or thin. One of 2011's highlights was S&P's downgrading of Treasuries, which was followed by weeping, wailing politicians' complaints, claims that mortgage rates would scream higher—and then by a new alltime low in Treasury yields that stunned even "The King of Bonds"—Bill Gross.

What it really signaled was that global bond investors exiting in panic from eurobonds were rushing into the most liquid product in the most liquid currency.

US Dollar Index (DXY)

January 1, 2011 to January 24, 2012



...the same CAPM that, until recently, rated Greek bonds as risk-free says that all equities are risky...

A Greek bond, which, you will recall, was rated high grade only months ago, offers the investor an instrument issued by a government that has been replaced by a technocracy which may well lack the power to issue orders to pay the principal and interest—denominated in a currency that many of its leading politicians say publicly should be abandoned in favor of the drachma.

By that standard, a Treasury bond is almost as good as gold (which we'll get to later).

So the first part of the case for what we have been calling "bullet-proof dividend-paying stocks" is that the same CAPM that, until recently, rated Greek bonds as risk-free says that all equities are risky—but that you are paid to assume that risk.

Since the S&P's compounded ex-dividend returns for 13 years ending November were zero, the model has not been making money for its users lately. Indeed, 30-Year Treasuries have been outperforming stocks since Volcker, backed by Reagan, slew the inflation demon three decades ago.

...the risk for 30-year Treasuries from the current yield of 3.1% is, we suggest, very large, but currently unknowable.

Nevertheless, the risk for 30-year Treasuries from the current yield of 3.1% is, we suggest, very large, but currently unknowable.

A five-year Treasury, issued by an Administration that has increased the national debt by more than \$1 trillion a year, yields .8%.

Bullet-proof dividend paying companies are those which have (1) increased their dividends every year for at least ten years, (2) are not US or European banks, (3) are not utilities, (4) have muscular balance sheets, and (5) do not spend egregiously in buying back their company stock. (Companies which have not been public for more than ten years but which otherwise meet the tests can also be considered.)

Note that we make no yield specification. Nor, for that matter, is there a clear-cut formula for stock picking. Indeed, using a model to build a great dividend portfolio could be problematic, because many high-yield stocks are high-risk investments and could only be considered better than bond equivalents when compared with junk bonds.

In other words...

You need careful research.

We are obviously concerned about the existential risks for global economic growth caused by the misguided policies of most leading governments, and American and European banks.

So dividends from the financially-pure sectors of the corporate universe are not only a reliable source of income, but they can turn a mildly negative return on a stock into a notably positive return when compounded over a few years.

We would rather own a great commodity-producing company which is in a growth phase, and is growing its dividends, but conservatively managing its dividend payout, than some aging organization that has run out of ideas about how to grow and is losing its competitive position—but has not yet run out of money to pay high dividends. On the other hand, a small, well-run, but not terribly ambitious organization that is squeaky clean and fills a real niche and has a generous dividend policy—but not necessarily a commitment to growing its dividends year by year—might also fit into a diversified dividend portfolio.

Paradoxically, some of yesterday's most glamorous tech stocks which used to regard paying dividends as an admission of senility are now high on almost any list of bullet-proof dividend payers.

John D. Rockefeller, loved and hated for creating and building the world's mightiest corporation, was once asked what made him happiest. He didn't say, "Watching a new oilfield come in" or "Opening a new refinery on the other side of the world." He said, "Watching my dividends come in."

That's the primary reason why people and institutions invested in stocks for more than a century until the growth stock era came along in the 1960s with Bernie Cornfeld ("Do you sincerely want to be rich?") and *Institutional Investor's* glamorization of the quick-trigger managers of mutual funds.

We have recommended that pension funds set up such a dividend fund but enclose it within a five-year shell—like an investment in private equity. They can either use the dividends to mark down the book value of their investments or, more appropriately, reinvest the dividends cost-free using the companies' dividend reinvestment programs, or use them to further diversify their portfolios. There are, in other words, few rules and many options in a dividend-oriented fund.

For private investors, one attraction of the dividend-payers rather than bonds is obvious: high after-tax income. Indeed, for investors in the high tax brackets, a strategy of owning only bonds to reduce risk rather than great dividend-paying stocks is an injudicious blend of caution and masochism.

Another reason for buying dividend-payers is that capital gains have been—how shall we say it?—elusive in this new millennium. Dividends are, in general, more predictable and reliable than capital gains—and both benefit from favorable income tax rates.

On balance, it is time for pension funds break out of the Procrustean classifications of the CAPM to reclassify the great dividend stocks as income investments.

**Dividends are,
in general, more
predictable and reliable
than capital gains...**

There is no investment environment in history in which gold has outperformed the world's leading stock market (with dividends reinvested) over four decades.

INVESTMENT ENVIRONMENT

There is no investment environment in history which includes zero or near-zero yields and economic growth. The Fed will have been at the zero line for four years when Americans vote in November, and this week proclaimed its intention to stay frozen at zero all the way to 2014.

There is no investment environment in history in which a country that had almost no indigenous equity markets and barely-observable per-capita economic growth had, in just 30 years become the second-largest economy on earth through its ability to sell into the established economies and expand economic opportunities for its citizens.

There is no investment environment in history in which nearly all the economies in the industrialized world operate under social and health programs that are not affordable (on an actuarial basis) even during years of strong growth and that, because of deteriorating demography, become less affordable every year.

There is no investment environment in history in which the second-largest economic zone operates with a currency that is directly backed by no government or taxation system, and is widely considered (in voter polls across the zone) to be at risk of disappearance.

There is no investment environment in history in which gold has outperformed the world's leading stock market (with dividends reinvested) over four decades.

There is no investment environment in the world in which the fertility rate in most of the leading economies has declined for four decades—with no sign of reversal.

It is different this time.

We cite these realities because we believe many investors have, despite the shocks of recent years, retained the faith that the long-term rates of return in equities must regress to the long-term mean within a reasonable period of time.

One reason we are now stressing the bullet-proof dividend-paying stocks is that so many of them have come through this entire four-decade period of unprecedented changes and convulsions, and have adapted so brilliantly, that they have maintained, or even improved, their rates of total return.

We believe the economic impact of demographic decay in the non-USA industrialized economies will intensify in coming decades. Japan is in the vanguard, as its demand for obstetricians collapses and demand for morticians climbs. The rest of the non-US industrial world—and China—will probably be in Japan's fix by mid-century.

Because of Latino immigration and Latino fertility rates, the US has managed to escape this long-term death spiral. Those (mostly Republican) politicians who bewail the presence of millions of undocumented Latino immigrants are missing the crucial point: without immigration from Mexico and Central America, the American future will replicate Europe in decline. The challenge for public policy is to improve public education so that future generations do not suffer the fate of so many of today's schoolchildren—losing out in global competitiveness to kids in Asian nations with superior education systems.

The case for long-term investment in US stocks vs. the rest of the world is *primarily demographic and primarily Latino*. At the moment, Canadian stocks are, on balance, more attractive than US stocks, but Canada has European-style demography and this will inevitably assert itself within a decade.

Commodity-oriented stocks have, as a group, outperformed during the first decade in which economic growth in China and India outpaced growth in the industrial world. Commodity producers have been selling globally almost forever, so they can naturally adapt to the changing global trade patterns.

Gold:

Finally, one of the most amazing aspects of "The Chinese Miracle" is that its citizenry has maintained a high savings rate at a time the nation, using an astonishingly productive state capitalism model, has experienced the fastest growth in the world. This is partly due to the fact that government-paid pensions and health care remain minuscule compared to benefits in what was once called "The Rich World." How individual Chinese save (at a time when their nation's monetary policies have been largely outsourced to Ben Bernanke), is therefore crucial for predicting relative performance of financial assets globally.

Recently, Beijing and the big banks have devised and installed programs giving savers the opportunity to acquire precious metals, and the sales growth rates would be considered ridiculous or over-stated or unsustainable if they came from any other nation.

The case for long-term investment in US stocks vs. the rest of the world is *primarily demographic and primarily Latino*.

We believe that the Bernanke and Draghi rescue policies for their bad banks and spendthrift governments make investment in gold by Americans and Europeans not just attractive—but necessary...

We believe that the Bernanke and Draghi rescue policies for their bad banks and spendthrift governments make investment in gold by Americans and Europeans not just attractive—but necessary—particularly for pension funds. The old arguments against gold were that it paid no interest and that enlightened, inflation-fighting central bank policies made it ridiculous.

When rates are frozen at zero for a monetary eternity, those arguments no longer apply.

Gold prices have risen for 11 straight years. This year will be the twelfth. Yesterday's Fed announcement of nonstop money at zero rates naturally produced a rush back into gold—and, at long last, into the great gold stocks. A friend sent us a chart showing that the increase in the gold price in recent years tracks the rise in Fed and ECB reserves almost perfectly, suggesting that maybe—just maybe—gold is already worming its way back into the monetary system.

The gold mining stocks have been lagging the gold price rise for so long that many strategists say it will last for as far ahead as the eye can see. What was most hurting gold shares recently have been the high-profile price plunges for shares of some high-profile producers with reserves in the ground in politically-risky regions. It is absurd that investors are selling shares of companies which have, as a matter of policy, avoided investing in those high-risk countries. These disappointments should lead to huge outperformance for the companies who have the least endogenous risk, and we believe that will happen this year.

The Cradle That Rocks the World

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation		
Capital Markets Investments		
US Pension Funds		
	Allocations	Change
US Equities	20	+6
Foreign Equities:		
European Equities	1	+1
Japanese and Korean Equities	2	unch
Canadian and Australian Equities	4	unch
Emerging Markets	5	unch
Commodities and Commodity Equities	5	unch
Gold & Gold Stocks	5	unch
Income Generating Assets		
Dividend Stocks	12	+2
Bonds:		
US Bonds	16	-4
Canadian Bonds	6	-2
International Bonds	4	unch
Inflation Hedged Bonds	10	-2
Cash	10	-1

Bond Durations		
	Years	Change
US	5.25	-1.75
Canada	5.25	-1.75
International	4.00	-1.00
Inflation Hedged Bonds	7.25	-1.25

Global Exposure to Commodity Equities		
		Change
Agriculture	30%	-2
Precious Metals	32%	-5
Energy	25%	+6
Base Metals & Steel	13%	+1

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation		
Capital Markets Investments		
Canadian Pension Funds		
	Allocations	Change
Equities:		
Canadian Equities	17	+3
US Equities	7	+3
European Equities	2	+2
Japanese, Korean & Australian Equities	2	unch
Emerging Markets	5	unch
Commodities and Commodity Equities	5	unch
Gold & Gold Stocks	5	unch
Income Generating Assets		
Dividend Stocks	10	unch
Bonds:		
Canadian Market-Related	25	-7
Canadian Real-Return Bonds	11	-1
International Bonds	3	unch
Cash	8	unch

Canadian investors should hedge their exposure to the US Dollar.

Bond Durations		
	Years	Change
US (Hedged)	5.25	-1.75
Canada:		
- Market Index-Related	5.25	-1.75
- Real-Return Bonds	7.25	-1.75
International	4.00	-1.00

Global Exposure to Commodity Equities		
		Change
Agriculture	30%	-2
Precious Metals	32%	-5
Energy	25%	+6
Base Metals & Steel	13%	+1

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

The Cradle That Rocks the World

INVESTMENT RECOMMENDATIONS

1. We recommend that balanced-fund investors increase their equity exposures from minimal to modest.

The risks of policy failure in the eurozone remain large and unquantifiable, but the ECB is, for now, performing like the Bernanke Fed—full-blown, damn the torpedoes, crisis mode. The Germans and other skeptics may permit the monetary expansion to proceed apace as long as the euro doesn't collapse. As long as the refinancing continue, PIIGS bonds' and eurobanks' status as financial typhoid carriers goes into remission.

2. The Treasury yields almost seem to be designed to push investors into dividend-paying stocks.

With recently-downgraded 10-year Treasuries yielding 2%—a negative yield in real terms, and a Bernanke pledge to hold spigots open for another 3 years, investors should seek alternatives. Bonds are historically priced for (1) quality of the issuer, and (2) the currency of issue, and (3) the attractiveness of the yield. Three strikes, Treasuries, and you're out.

3. Dividends are more predictable than earnings and, for the past year, great dividend-paying stocks have been far more fun and rewarding to own than those with unreliable or non-existent dividends. That trend will accelerate this year.

4. Spot natural gas is \$2.60, while nat gas three years from now trades at \$4.27. That contango is helping to finance the continued over-drilling of shale gas, because producers can lock in breakeven prices in the future. What the biggest shale producer, Chesapeake Energy (CHK) is doing is trying to get the industry to collectively cut back on drilling. There will be no Gaspec. We recommend you stick with oil. The long-duration oil producers still look very attractive, and their long-duration reserves will far outlive Obama.

5. Copper is on a roll. If it breaks \$4, then it should mean that China has completed its painful downshifting and has paved the way for the entry of the new regime at a time of resumed growth. We have been underweighting the base metal producers for more than two years, but we are now looking more closely at the possibility of an upgrade.

The Cradle That Rocks the World

6. The USDA's annual crop report was a shock to holders of grain futures. But \$6.40 corn and \$12 beans will still entice US farmers and their counterparts abroad to buy fertilizer and other inputs this spring. Remain overweight agricultural stocks.
7. Gold has in the past decade evolved from being a curiosity to a speculative investment to a sound investment. It is now becoming a necessary investment, as central banks print money prodigiously—and promise to continue. Emphasize the miners at the expense of the bullion ETFs.
8. Canadian house prices remain very strong, evoking warnings from the Bank of Canada's Mark Carney and several bank presidents. The widespread Canadian conviction that the US housing experience is irrelevant north of the 49th Parallel may prove to be a remarkable case of mass solipsism.
9. Apart from this potential major private sector problem, Canadian public policy continues to be better-managed than in the USA; Canadian bonds, high-quality preferred shares and the high-quality, high-yielding Canadian banks' shares are attractive investments for investors anywhere.

THE COXE STRATEGY JOURNAL

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