Robert Wiedemer’s New Warning:

Is U.S. Debt Still Triple-A? The Evidence You Must Not Ignore — For Your Portfolio’s Sake

Editor’s Note: Financial Intelligence Report has asked best-selling author of Aftershock and sought-after consultant Robert Wiedemer, an adviser to top corporations and private investors, to tackle the thorny issue of America’s debt and the risk it represents to investors worldwide.

Markets have staged a remarkable recovery since the lows we saw in March 2009. The uptick in our stock markets, however, masks a deep and well-entrenched threat.

Wiedemer warns now that the next few years could decimate your wealth and that of most Americans — if you don’t safeguard yourself.

Starting in this issue, Bob periodically will share his invaluable expertise as we navigate the turbulent economy and markets to come.

Important: FIR subscribers can renew their annual subscription and get a free copy of Bob’s book, Aftershock: Protect Yourself and Profit in the Next Global Financial Meltdown — a $28 value (shipping included free). To take advantage of this valuable offer, call 800-485-4350 ext. 2139 or learn more online at www.newsmax.com/robert

By Robert Wiedemer

A few years ago, everyone thought triple-A mortgage bonds were triple-A risks. Many investors, especially overseas investors, looked at highly rated mortgage bonds as being as good as Treasury bonds but paying a higher rate. What could be better?

Of course, we know how that turned out. The entire mortgage-bond market melted down when home prices collapsed. The fundamentals of mortgage bonds were bad before 2008 — it was increasingly obvious that declining housing values meant that the value of the collateral backing those loans was worth much less.

From subprime loans to so-called “liar loans” — based on little more than the borrower’s unverified claim of a high income — to prime loans, the financial fundamentals of mortgage bonds were bad and getting worse from the time housing prices stopped going up in late 2005 until the mortgage market cratered in late 2008.

Psychology alone seems to have supported bonds up from 2005 to 2008. People simply wanted the housing bubble and its related bubbles
to keep going. Plus, many people just didn’t think it was possible that so many triple-A bonds could go bad, partly because the consequences of such a crisis would be monumental. History, too, helped hold up demand for mortgage bonds. Home prices never had turned sharply downward for any lengthy period in any large part of the United States during the entire 20th century.

Momentum also held up bonds. It takes time for reality to sink in. So, it took until late 2008 for people to see that so many triple-A bonds really weren’t triple-A.

Do we face the same situation with Treasury bonds today? Are the fundamentals so bad that only psychology, momentum, and history hold them up?

Let’s look at the fundamentals. Unlike mortgage bonds, there is no collateral backing up Treasury bonds. They are essentially unsecured loans, like credit cards, whose value depends solely on the borrower’s ability to pay them off. There is nothing to foreclose on if the loan isn’t paid.

So this is a fundamentally riskier type of loan. And many government loans have gone bad in the past — just not U.S. government loans. But just being unsecured isn’t a big problem, as long as the borrower has the income to pay it off.

Loans to some governments are based on oil revenues or other non-tax revenue streams, but with the U.S. government, the only significant revenue stream is its ability to tax its people.

**Simple Math Shows We Are In Deep Water**

Could our debt be paid off with tax revenues in a reasonable period of time? Let’s do the math. Assume that a “reasonable” period of time to pay off a debt is 30 years. That’s actually a pretty long time for unsecured debt. Mortgage loans are typically for 30 years, but they are backed by a physical house that could be sold if necessary.

Let’s also assume that our debt has risen to $15 trillion when we start paying it off (it’s nearing $14 trillion right now). That means we would need to pay $500 billion per year for 30 years to pay it off.

However, before we can pay down the debt, we have to stop adding to it. Right now, we’re adding about $1.3 trillion to the debt every year. So we would need to come up with $1.8 trillion ($500 billion plus $1.3 trillion) to start paying off the debt over a 30-year period.

How does that compare with our income? This year, our income will be about $2.1 trillion. That means it would take almost 100 percent of our income to pay down the debt over a very long period of time. Don’t forget, we have other expenses, such as Social Security, Medicare, and the military. Those expenses run about $3.5 trillion per year.

How many businesses would get a loan that requires almost all of its revenues — not profits — to service? Under those terms, there wouldn’t be any money to pay employees or vendors. In fact, no business could get that loan from a sanely run bank.

That scenario presumes a fixed rate. In reality, much of our debt is effectively at an adjustable rate since it is short term. This means that the amount needed to pay that loan could go up dramatically if our incredibly low interest rates go up.

At 10 percent, our interest costs would more than double and, since our debt is so monumental, that would mean paying off the debt in 30 years would consume more than all of our tax income. Again, that’s not including the fact that we have other expenses besides paying off the debt.

Such a payoff, if possible, would be devastating to our economy — both the massive spending cuts and tax increases needed would bring the economy to its knees. It certainly would pop the remainder of our bubbles in stocks, private debt, consumer spending, and real estate.

By any standard, the fundamental situation of our debt is that it is a toxic asset. It is so huge now relative to our income that we can’t possibly pay it off or even make much of a dent in it. It’s not
triple-A debt. It’s like the mortgage debt, but worse. At least with mortgages, there is an asset of some value behind the loan.

Nevertheless, U.S. Treasury debt still is rated triple-A. Why? Because we can roll it over. We can pay off our old debt and then issue new debt to replace it, adding massive amounts of new debt. But that ability to roll it over and add to it indefinitely is largely due to psychology, not our fundamental financial situation — just like the mortgage bond market before it melted down.

Take all those issues I mentioned earlier that held up the mortgage bond market after 2005, psychology, history, and momentum, and multiply it several times. The Treasury market has all three in spades. Psychology will be much more powerful in helping the U.S. debt market stay alive than it was for the mortgage market.

**We Can Roll Over Massive Debt, But for How Long?**

We’re already running into problems. In the spring of 2009, in response to the financial crisis, the Federal Reserve had to begin buying our own debt with printed money to make sure everyone was confident that U.S. debt was triple-A and that interest rates on that debt would stay low.

The Fed has just started printing money again, partly to keep interest rates low and partly to pump up our stock market and real estate bubbles. They call this round of money quantitative easing, part two (QE2).

So far, QE2 has been effective at both of its goals. It has been more effective with the stock market, which has risen more than 10 percent since Fed Chief Ben Bernanke first announced in late August that he would be printing more money. But it also helps keep the real estate market from falling more dramatically, given the downward pressures it faces from foreclosures and lack of buyer interest in homes, thanks to the continuing decline in prices.

But printing such massive amounts — the latest round of printing means we will have increased our money supply almost 300 percent — is also the beginning of the end. Yes, it helps short term, but eventually it will create inflation, and that inflation will increase interest rates.

Even small changes in interest rates of a few percentage points kick off the first part of the scenario for mortgage-bond style problems in the Treasury market. That’s because small increases can make a big difference when interest rates are so low.

Higher interest rates increase our deficit, making it harder to pay off our debt. Most importantly, though, high rates burn investors who bought bonds while they were at low interest rates.

The values of five-year, 10-year, and especially 20- or 30-year bonds drop dramatically as interest rates increase. That makes those bondholders very unhappy and makes it much more difficult for the government to get repeat customers for its bonds.

The Fed can overcome this problem by simply buying the bonds that other people don’t buy. But that kicks off the second part of the scenario — the beginning of a vicious spiral of Fed bond purchases to soak up more and more bonds people are less willing to buy because they were burned before by inflation.

**Entering a ‘Death Spiral’ of Debt**

Of course, since the Fed is using printed money to buy those bonds, it will only cause more inflation and hence more concern among bond buyers.

The first and second parts of this scenario are the inevitable result of interest rates that are too low and
the Treasury overloading the market with too many bonds to finance massive deficits and to refinance our rapidly growing debt. Again, even small increases in interest rates pop the low-interest bond bubble, which is developing thanks to the massive number of low-yielding bonds being sold.

Low interest rates are viable only if there is little perceived risk in those bonds. Inflation destroys that fantasy and greatly increases perceived risk. In addition, massive money printing also lowers the value of the dollar, further scaring the foreign buyers who have been critical in funding our massive debt.

The third and final part of the scenario is an increasingly difficult situation for the Fed to maintain. It’s essentially a death spiral of printing money to buy bonds that other people won’t buy, which only creates more inflation.

The Fed could try to postpone inflation by paying banks interest to hold on to their excess reserves rather than lend them out. (When the banks lend out money, it speeds up the onset of inflation, what economists call the “multiplier effect.”)

Of course, the interest being paid to banks comes from printing more money, so it ultimately sparks inflation. The higher the interest rate that the Fed has to pay banks to hold on to their reserves, the more money the Fed has to print, further fueling inflation. By now, the Fed is fighting fire with gasoline.

Ultimately, though, as this spiral of printing more money continues, government debt service and rollover of past government debt will become entirely the Fed’s job. It’s just like the mortgage market, which the federal government took over after it collapsed.

Of course, such a situation will produce unbelievably high inflation. That has the advantage of inflating away much of the debt, making it much easier for the government to stop interest and principal payments, and hence, any rollover of the debt. Since it has lost its ability to borrow, default at that point becomes a less costly way to deal with the debt than continued high inflation.

It’s very much like a consumer who finally files bankruptcy, even though it will hurt his credit rating, because his credit rating is already too low to allow borrowing and the cost of trying to maintain the payments on his various debts has become so high that it no longer is worth it. The United States will have lost all financial credibility at that point. It won’t be able to borrow a dime.

Of course, this is not a cost-free exit for the economy. Such high inflation will have devastating effects on pensions, savings, life insurance, stocks, and real estate. We definitely can inflate our way out of our debt problem, but not without serious consequences.

The problem the government faces is that, increasingly, it is boxing itself into such a scenario. Inflation is the easiest route to take now.

The other option is to pop all the bubbles now and throw the economy into a much more massive recession and, possibly, a depression.

Neither the politicians nor the voters are likely to make such a decision. Instead, they probably will try whatever avenue is open to them to keep the bubbles alive. In fact, the only avenue that is open to them now that would maintain the bubbles is the one just described: printing money.

This scenario I describe makes it sound easy for the U.S. government simply to let our debt collapse, but it really isn’t. Let’s be clear: We are no banana republic. It takes a very unusual set of circumstances for something like this to happen.

Those circumstances include:

- A massive debt (seven times our annual tax income)
- A massive deficit (almost half of the government’s annual spending is borrowed)
- Very low interest rates on our current debt
- A very slow-growth or no-growth economy
- Massive asset bubbles in the stock market and real estate
- Massive borrowing from foreign investors to fund government debt

We’ve never faced a situation like this before. Accordingly, the United States never has defaulted on its debt. It has never even come close. This time, however, the circumstances really are different. These circumstances box us in.

For example, if we print money to keep interest rates low and offset our massive sales of new bonds for rolling over old debt, that will create inflation.

We can’t do what we did in the 1980s to reduce our inflation (reduce the money supply) because it will cause a huge spike in interest rates, as it did in the ’80s, which will pop our stock and real estate bubbles. It also means we won’t have the money to
buy all those bonds. We will have inflation. The problem with inflation, though, is that it ultimately will pop all of the asset bubbles and the government debt and dollar bubbles in an even more spectacular fashion than if we let it happen now by not printing money.

Plus, with slow economic growth, there is little new revenue coming in, which means we are running a very high deficit. That makes the problem even more difficult to solve. It’s like packing a house full of explosives.

We Are Now General Motors

Imagine a business that has too high of a cost structure, falling revenues, and too much debt — much like the old General Motors. It was once the greatest company on earth but ultimately found itself reduced to total bankruptcy.

General Motors could have changed earlier to avoid bankruptcy, but not by starting down that road just three or four years before it went bankrupt. The changes would have to have been made over the past couple of decades. The same is true for the United States itself.

Like GM, we have boxed ourselves in, and it is difficult to see an easy out. It is very easy to see how we can prolong the problem, just as GM did, and I think I have laid out a valid scenario for how that will happen in this article.

But printing money doesn’t solve the problem; it is simply the final chapter in a long sequence of highly unusual events in U.S. history that led us to the situation we face now.

Fortunately, there is an exit for investors. There are plenty of ways to protect yourself and even profit, if you see it coming. The key is to recognize the problem now and then act before the real problems begin.

I look forward to more conversations on this and other issues we face over the coming year.

By Christopher Ruddy

Like you, I usually give credence to experts who have been right about things before.

One such expert is David Skarica.

I met David at the memorial service for my friend, the late Sir John Templeton. The service took place in Sir John’s adopted home of Nassau, in the Bahamas.

It was not a sad occasion, as Sir John was a man of God. Jack, Sir John’s very able son and a great man in his own right, was there, as were many of the legendary investor’s family.

I also met a young man in his 30s who had moved to the Bahamas from Canada to follow in the Great Contrarian’s footsteps. It was David.

Based on our conversations, it was clear early on that David offered brilliant insights into the market.

Skarica follows Sir John’s footsteps, employing similarly unconventional, yet highly prescient, analysis.

For instance, the market hit its most recent intraday low of 6,469 in early March 2009. Many warned that the Dow had room to fall. Yet Skarica had a much clearer vision of what was ahead.

In fact, only a month before, writing in the February 2009 edition of FIR (“Market Rally Ahead, Bear Will Remain”), Skarica told investors to expect a 50 to 100 percent market bounce up from that bottom, retracing a good portion of its previous high above 14,000.

Stocks just did that, putting back on more than 62 percent before peaking again in the past few weeks.

FIR investors who ignored all the gloom-and-doom folks and followed Skarica made significant profits as stocks roared off the bottom.

With such a track record, it was no wonder that, when I recommended David to a famed New York book publisher, John Wiley & Sons, it snatched him up with a contract to produce his first major book.

Important: FIR subscribers who would like to renew their annual subscription can get a free copy of David’s The Great Super Cycle: Profit from the Coming Inflation Tidal Wave and Dollar Devaluation — a $28 value (shipping included free). Please call the Newsmax customer service line at 800-485-4350 or learn more about the offer online at www.newsmax.com/david.
Christopher Whalen: The Crisis Is Still Ahead of Us

As major Wall Street banks imploded and huge car companies went belly up in the crash a few years back, the solutions came fast and furious from the Treasury and the Federal Reserve.

Money was pumped into bank balance sheets, and losses were absorbed in exchange for cheap stock. While painful and costly, the fix seemed to work. We avoided — or at least postponed — a financial Armageddon.

Or did we? The TARP bank bailout cost has been minimized dramatically, but the car companies stagger along. Now the housing mess has resurfaced in the form of millions of questionable foreclosures.

The FBI is investigating. Congress is calling for answers. If banks cannot prove they own many of the homes they sold in the form of securitized bonds, we’re back to square one in the credit crisis. One or more major U.S. lenders could go up in smoke.

Into this wild blame game flies Christopher Whalen, a co-founder of bank ratings adviser and consultancy Institutional Risk Analytics. Whalen also is the author of several books, including his most recent, Inflated: How Money and Debt Built the American Dream, published by Wiley and available now.

Whalen says we’re nowhere near done with the banking mess precisely because we haven’t really dealt with the mortgage fiasco underlying it all. Essentially, bank bondholders are in the cross hairs, he says.

The problem is that the bondholders in question are pension funds and other middle-of-the-road savers — basically, the American people.

Digging our way out is not going to happen via market forces or simply over time, Whalen says. The government has to get back into firefighting mode. Here is the interview with Christopher Whalen:

In the book, you provide us with a fascinating history of how we have gone through repeated cycles of boom and bust, thanks to excessive credit. If the past is any indication, what is your take on where the U.S. economy is headed next?

I think we are headed into restructuring. We’ve bought some time since 2008 when we had the big crisis in the financial markets, but the U.S. economy is restructuring despite the efforts by politicians in both parties to pretend that we’re not.

You are going to see the banks under a lot of pressure for the next couple of years and I think also home prices, commercial real estate — the whole 10 yards is going to continue to deflate simply because there’s not enough income, real income, in this economy to justify the valuations. Laurie Goodman at Amherst Securities — I quoted her recently saying that 1 in 5 residential properties in this country may go into foreclosure.

So we’re talking about a crisis that’s still very much ahead of us. We’re not done yet, and that’s really the key message I want your readers to take away. We’ve got a lot of work to do.

“Low rates takes trillions away from savers.”

U.S. debt seems to be the new bubble. Is there any chance of rates staying low for years as we dig out?

I don’t think so, and the reason is that the Fed has been doing this for two years. They are going to have to let interest rates go up eventually, or everything in this economy — pension funds, insurance companies, banks in terms of their investments — are going to have zero yield.

The trouble with having low interest rates to help leverage entities like banks and hedge funds and the rest of them is that it kills savers. You’re taking income, trillions of dollars a year in income, away from savers — retired Americans — on anything that earns interest.

So your more conservative investors, the public sector pension funds, are being punished by this Fed interest rate policy, and that’s why I think we’re going to have to let rates go up within the next year or so. If we don’t, we’re Japan. We will replay Japan larger.

Do you see a GOP win as helping or hurting stocks in the economy?

Historically, it has not helped. I think if the Republicans, though, start to address the public’s hunger for honesty and their hunger for people who are actually competent in finance and can discuss these issues with specificity, then I think it could
be good for stocks. We actually may reverse the historical trend.

I sit on the advisory committee of my little village of Croton-on-Hudson, N.Y., and let me tell you that the issues they are dealing with are exactly the same as the issues that are coming at every single municipality and state in this country, which is the attack on the property tax base which underlies everything.

Every community in this country is supported by property taxes. So if the housing market keeps going down, if we continue to see no leadership from the Obama administration on restructuring the government housing complex, then I think we’re going to have a very difficult time in all markets. It won’t matter, stocks or bonds.

Why haven’t companies put more of their cash back into the economy by now?

For two reasons: One is low Fed interest rates. If you are a treasurer and you are making zero yield on your cash, what do you do? You keep more cash. You’re not really getting an economic return.

The other thing is that big corporations, even the largest corporations like General Electric, were shut out of the money markets in 2008. They remember that. So your typical corporation is now keeping twice as much cash on hand as they used to and the reason for this, very simply, is that big companies have to be able to finance their customers.

If they sell you something, they are usually going to give you terms, at least 30 days. So they have to be able to finance that sale and right now, it’s very hard for them to get the markets to help them with that. They can’t sell that piece of paper that evidences your amount owed to an investor right now, the way they used to in the commercial paper market.

So your big companies are now self-financing, and it’s kind of unfair, I think. It’s typical politics for the government to say, “Oh look at all of this corporate cash. We’ve got to get them to invest.”

They’ll invest when they see demand, and right now they are not seeing a whole lot of demand from customers. So there are really three or four factors behind that issue.

You monitor the banks. Do you see Europe’s banking system stabilizing soon — or a collapse?

They’re not going to collapse all at once, but they are definitely going to restructure. We wrote a note for our clients a couple of weeks ago about Anglo Irish, a bank that goes back to the colonial period that’s being wound down by the Irish government.

We suspect that the Irish government is going to try and subsidize the bondholders, who have escaped the pain so far, as you know. But I suspect that in that case EU government is going to say to the Irish, “No, you can’t subsidize the bondholders. They have to take some pain.”

So I think the next phase of the crisis — not just in Europe, but also in the U.S. — is going to have to be governments talking to the bondholders, the other stakeholders in these enterprises, and asking them to contribute to the restructuring because the losses in that bank are going to wipe out the equity several times.

So you have to start having a conversation. Is the government going to pay for this? Or are the bondholders going to take some of the pain? Because really, since the failure of Washington Mutual and Lehman Brothers, you have not had bondholders of large organizations take a hit. It’s only been the little banks, the community banks in the U.S., that are subject to market discipline and, meanwhile, we subsidized the big guys.

I think that’s the issue ahead of us: Are we going to keep subsidizing the bondholders at public expense, or are they going to take a hit, too?
Especially in Europe.

So what do you think is the risk of a banking collapse here in the United States?

I don’t characterize it as a collapse; I characterize it as “shrinkage.” We’re using the old Gilded Age term from the 19th century. Simply, we’re going to watch their balance sheet contract. I’m helping clients right now invest in community banks, and it’s a tough process because to mark them to market right now you’re talking about pennies on the dollar.

So for shareholders of banks, this is not a good time. I think that, you know, honestly, the big four — Bank of America first off, followed by Wells Fargo — they need to be restructured with government help. They have too much of what I characterize as an avalanche of foreclosures still coming at them.

Some of my dearest friends are Sylvain Raynes and Ann Rutledge, both of whom are structured finance professionals. They both worked at Moody’s. I asked them, “How far are we through the problem?” And they said “Less than 25 percent.”

So, in other words, the biggest part of the foreclosure problem in residential and commercial properties is still ahead of us. Do the math: The U.S. banking system has $1 trillion in tangible equity. We’re talking about trillions of dollars in losses. Clearly the government is going to be involved.

You have argued that banks have no incentive to refinance mortgages to lower interest rates, as the government wants. What is the solution here, considering the millions of foreclosures ahead?

A couple of things: We have to refinance everybody out there who has got a floating-rate mortgage and are current. In other words, the government has just got to tell the banks: Refinance them at current rates.

See, people don’t understand mortgage pricing. In the boom, when you were getting a mortgage, your lender was maybe working for half a point. Today, that same lender, when they offer you a mortgage, is working for 4 to 5 points. That’s how much additional fees, credit enhancement, and everything else they put on top of the loan to protect themselves and to increase the profitability of the mortgage banking.

We’ve got to cut to the chase and tell the banks that they can refinance everybody for a point — not five points — and that they ought to be moving this process along because, even though it will hurt their profitability in the next quarter or two, if we save mom and dad from defaulting on their loan next year, that’s going to be much better for the bank.

In fact, the bank is better off. Let’s say they have a loan to you and you have a second mortgage, too. The bank is better off writing off the second mortgage if the house is under water. It can’t be sold to pay off the primary mortgage.

Write it off and restructure the primary mortgage and, if the obligor performs, it’s a home run. The bank is going to be close to getting their money back in nominal terms and that’s what we ought to be targeting now, because if we continue to see a progression of homeowners going into default and foreclosure, the U.S. government is going to end up as the biggest landowner in the country.

They already are, but they are going to go back to where they were a century ago, and the banks are going to be illiquid, too, because they are going to own real property that they can’t sell. They are going to become landlords.

We’re going to turn all of the banks into REITs [real estate investment trusts].

These are the issues, frankly, that we need to be talking about in Washington right now, and we’re paralyzed at the moment because the narrative, the language we use to talk about these issues, is still 10 years behind.

You know, we ought to think about the U.S. as though it was 1920 and that we were facing secular deflation. Then I think the policy choices would be obvious. But, yeah, I do think that rates have to go up. That’s how we’re going to tell consumers that the dollar has value.

You have said that the Fed is feeding deflation by keeping rates low. Can you elaborate on that?

Let’s go back to the effect on savers. If you’re talking individual savers, low interest rates by the Fed are taking something like half a trillion dollars a year in income out. So that’s money that grandma doesn’t have to spend on the grandchildren, she doesn’t have to spend on groceries, whatever it is. She is going to reduce consumption.

Then you look at corporate savers, people who invest in government bonds, agency securities,
basically your school district or your state. A very safe, risk-averse investor.

They’re losing $300 billion to $400 billion a year in income that should be going into corporate treasuries, public sector savers, your school district, or whatever it is. These people all need income off of their investments. They’re not getting it.

So I think the Fed, unfortunately, even though they are trying to help the banking system and they are subsidizing the banking system to the tune of trillions of dollars a year, they are killing the real economy in the process.

I just think that there has to be balance. That’s why I think that rates have to go up. The Fed should stop letting the banks park $1 trillion in excess cash at the Fed in New York and force them to buy private-sector assets and maybe we can get this thing moving again.

But everything I see right now is feeding deflation, which is lower revenue, lower GDP, and lower home prices. Those things are going to kill us if we don’t change them.

Former Fed Chief Paul Volcker recently warned Fed Chairman Ben Bernanke to watch out for inflation. Do you agree?

Well, I agree in the medium term, but right now the problem is deflation. Remember, (former Fed Chairman) Alan Greenspan didn’t cause this problem. You have to go all of the way back to Richard Nixon and really ponder the increase in debt, the increase in government spending in the U.S., and the attempts by the Fed to make all of this work.

The Fed has been the facilitator of a drug addict, and the drug addict is addicted to debt. If the Fed were really run honestly, they would be saying “no” to Congress every day. They would be lecturing them on fiscal issues, and they would push rates higher in anticipation of the inflation you asked about.

That’s what we need in our central bank. We need somebody who has a spinal cord because the last two chairmen have been just pathetic. They are not serving the public interest. They need to go back and study Chairman Volcker and his predecessors.

I’m especially thinking of Marriner Eccles and his successor, Chairman (Thomas) McCabe in 1950 who told Truman to take a walk even as the Chinese were attacking us in Korea. That took courage.

Ben Bernanke has no courage. The whole Federal Reserve Board ought to resign, in my view.

Could U.S. capitalism work with, say, a European approach to housing, with 50 percent down and very limited mortgage access?

We had zero percent down, as you know, and 20 percent equity has been the target. I think if the U.S. just went back to a more honest pricing and 20 percent down, that would be such a radical change that we would have to stop there and see what impact it had on the economy.

Fifty percent down would almost be Danish in terms of mortgage underwriting. But what you have to understand is that, during the boom, your typical mortgage, the price of the mortgage was 92, 93 cents on the dollar, and then they would pad the rest of it with fees, insurance, all kinds of other stuff to essentially help an inferior borrower get credit.

So what you’re really saying with your question is that we’re going to take that opportunity away from those 5, 6, maybe 10 million American households that got credit in the last 10 years but certainly wouldn’t apply under that regime.

Those would be tenants, and that’s a big change, socially. You’ve just changed the definition of the American dream, in political terms, by doing that.
The deterioration in the global monetary situation has continued. The latest crisis is once again — and perhaps fortunately — in Ireland, one of the world’s smaller economies.

In Ireland, as in the comparable case of Iceland, the debts of a small country have spread out into the broader, global banking system. A small country cannot afford banks that behave like casinos.

In the case of Ireland, the debts threaten the stability and perhaps even the survival of the euro. Only a couple of years ago, after 10 years of the euro, the euro countries were congratulating themselves on the success of their currency, comparing it with the greater problems of the United States and the United Kingdom.

The euro had risen in exchange markets against the dollar and the pound. Germany, which is the industrial motor that pulls the eurozone, had record exports of manufacture, comparable in scale to the exports of successful Asian countries and higher in quality. The whole of the eurozone had the benefits of relatively stable prices and low interest rates. The currency seemed to have been a success.

Now, in a strange turnaround, Ireland, one of the smallest of the euro countries, tried — in an Irish way — to avoid being rescued by its own partners. The other euro countries were more or less convinced that Ireland would need a bailout if the Irish are to remain in the Euro system.

One can give a list of the most vulnerable euro economies. Greece is the weakest and just had to admit that its debt figures are even worse than originally stated. Ireland at the moment is the next weakest, though not facing an immediate cash crisis.

Portugal is probably next, followed by Spain. Spain is a cause of particular worry because its economy is much larger than those of the other three weak countries. Germany wants to defuse the danger that the small countries will be unable to stay in the euro, because that would set a precedent for withdrawing.

Bailing out Spain would be a quite different matter. Germany found that the bailout of East Germany took 10 years to complete and cost Germany most of the growth that might have been expected in the 1990s.

Spain not only has a problem of sovereign debt but also has Banco Santander, a major asset but a comparable liability. It is one of the biggest banks of Europe, one that expanded very rapidly in the last decade.

Like Citibank in the United States, it is presumed to be “too big to fail.” The three largest European economies are Germany, Britain, and France, with the U.K. and France about equal size. Because of traditional connections between Britain and Ireland (for centuries they used the same currency), Britain, which does not belong to the eurozone, decided to contribute a significant portion of the Irish bailout.

The United States has no responsibility to bail out Ireland, and indeed has enough to do bailing out the finances of U.S. banks. Yet the United States does have an interest in the stability of the euro, one of the world’s major reserve currencies.

The big global currencies are the dollar, the euro, the yen, and the Chinese yuan. There is a crisis in the Euro, a conflict between the dollar and the yuan, and a long-term problem of low Japanese growth, which affects the yen.

These problems are unlikely to be resolved without risk of inflation. The world of currencies is still sick.
Federal Reserve Chairman Ben Bernanke suggested during an interview on the CBS program *60 Minutes* that it is a myth that quantitative easing implies printing money. With all due respect, Mr. Bernanke, if it looks like a duck and quacks like a duck, it is a duck!

Bernanke argues that his policies do not amount to printing money, as neither currency in circulation nor money supply has increased. This analogy is a bit like giving a loaded gun to a kid, then telling your friends that it’s not a deadly weapon because the shots that have been fired haven’t killed anyone.

Granted, we are exaggerating here because, after all, it’s only money we are talking about. Yet, printing money may destroy one’s purchasing power and thus one’s life’s savings.

Indeed, the Fed doesn’t print just money but “super money.” The money the Fed prints is more powerful than currency in circulation. It’s money made available to the banking system. When the Fed buys government bonds, or any other security, from a bank, the Fed credits the bank’s account at the Federal Reserve, with the amount due.

That “money,” however, is merely an entry on the computer system at the Fed — it’s literally created out of thin air. It’s printed not physically but electronically. A bank with cash in its hands can create new loans; those loans may be deposited elsewhere by the person taking the loan.

Thus the money the Fed creates out of thin air can have a hundredfold multiplier effect by the time it makes its way through the economy. The loaded guns are not water pistols for kids but automatic weapons!

The kids, of course, are the banks. So far, their latest scolding (the 2008 financial crisis) remains fresh in bank managers’ minds, so they are rightly reluctant to release the safety on those arms. But make no mistake about it: The banks are being handed potent weapons.

Indeed, the Fed would love to see the banks pull the trigger by handing out more loans. But it turns out that the banks are not finding enough creditworthy borrowers.

Truth be told, the money does find its way somewhere, and the Fed cannot control where the money flows. (Have you ever tried to control a little kid?) Instead of flowing to where the Fed would like to see all that freshly printed money go, it ends up in assets with the greatest monetary sensitivity: precious metals and commodities, as well as outside of the U.S. dollar. Courtesy of the Fed’s “mythical printing,” gasoline is now as high as $3.50 a gallon at some gas stations in California.

The money doesn’t “stick” where the Fed would like it to because the Fed is fighting market forces. Consumers would love to get their house in order, quite literally. Without massive intervention, both fiscal (cash for clunkers) and monetary (credit easing, monetary easing), overextended consumers would downsize further.

**A Weak ‘Magic Wand’**

Yet the real problem is that policymakers’ massive and ongoing intervention led us to believe that there is a magic wand, including the Fed’s printing press, can fix our sorrows.

This leads us to the future: In our assessment, the Fed’s worst nightmare may well be that this mythical money makes its way through the economy. Bernanke says he could raise interest rates in “15 minutes” should the economy need to be tamed.

To us, it appears highly unlikely that the Fed will apply any such 15-minute policy to the U.S. economy.
It’s More About Politics Than Economics for Euro

The U.S. consumer has spent years rushing to the shopping mall to buy things no one needs without heeding the price.

Such behavior has been a mainstay of the global economy. Now, European Central Bank (ECB) President Jean-Claude Trichet also has revealed himself to be a U.S. consumer at heart.

Recently, the ECB rushed to the EU central bankers’ equivalent of a huge shopping mall — the EU government bond market — and bought things no one needs without heeding price.

The ECB’s attempts to rig the EU bond markets aren’t, of course, a bailout.

Trichet said the extension of both the nonstandard monetary measures to provide financial markets with liquidity and the ECB program to purchase government bonds were driven by “acute” tensions in financial markets.

He stated that an “overwhelming majority” of the governing council backed the “ongoing” purchase of EU government bonds (no doubt German Central Bank President Axel Weber disagreed!), that the purchases would continue to be sterilized, and that it remains a temporary program.

“It’s not quantitative easing; we’re withdrawing all the liquidity,” Trichet said.

During Trichet’s news conference, it was confirmed that the ECB was on the “bid” for Irish and Portuguese bonds.

Investors should keep in mind that the ECB has to purchase EU bonds of the eurozone because it can’t bail out eurozone governments directly.

This, of course, will cure the symptoms of the wider bond spreads, at least for now, but it doesn’t cure the underlying cause, which is that the euro doesn’t work.

We can say Trichet has succeeded in buying time — for now at least. If the macroeconomic data continue to suggest that the eurozone’s more stretched economies can grow enough to finance their debts, that time will be really helpful.

But if the economies in the stretched peripheral nations disappoint, the market probably will ask for more soon enough.

Nevertheless, the debt crisis once again has double-crossed the ECB “exit” strategy.

It is possible that, in the midst of a future crisis, European policymakers might make uncoordinated and even contradictory statements, potentially causing market distortions and jeopardizing funding access of individual sovereigns. To me, it is hard to see how even Italy and Spain can attract market funding at reasonable rates under new rules designed to promote stability.

New Lows Ahead

There is no doubt in my mind that the resolution of Europe’s crisis inevitably will involve a difficult political debate over apportioning the “cost” of a final and sustainable resolution. I don’t think it’s an exaggeration to say this crisis will re-emerge until it is definitively resolved.

Before coming to that, the crisis will manifest itself more and more in the political domain of the different sovereign eurozone countries.

For investors, it could and probably will become very difficult to understand what will be going on in the eurozone because it will be all about politics, not economics.

I certainly can see the possibility that the euro will make new lows relative to the October 2008 low of $1.23 and the June 2010 low of $1.1875. It would be rash, at least for now, to call it much further than these levels.
“Life is what happens to you while you’re busy making other plans.” — John Lennon

Every so often, there are pivot points in economies, moments when their future prospects are determined. Often, these pivot points are unannounced, and historians identify them only in retrospect. This is especially true, I feel, of the far-reaching, global changes in climate being set in motion by the mysterious dynamics of solar physics.

For example, the fall of the Roman Empire was not driven just by fiscal exhaustion, punishing taxation, and runaway inflation, as Edward Gibbon detailed in *The Decline and Fall of the Roman Empire*. It also coincided with a dramatic cooling of temperatures because of a cyclical decline in the sun’s energy output.

Incomes plunged because crop production fell away in an agricultural economy. The centuries known as the Dark Ages were not incidentally a period of traumatic cold, a time when the Mediterranean was so chilly that the Nile froze.

Another hidden pivot of history was the destabilizing impact on the global economy of the end of the Medieval Warming period with the arrival of the Little Ice Age, beginning around 1300. Suddenly colder weather shortened growing seasons in Europe. Among other things, this led to recurring crop failures, widespread malnutrition, and population collapse as weakened people succumbed to the Black Death.

More prosaically, the abandonment of grape cultivation in England (wine grapes once were grown as far north as Yorkshire) and elsewhere in Northern Europe dictated a dramatic shift away from wine drinking to beer consumption, especially among the European poor.

It happened elsewhere, too. The social and political instability informed by colder weather caused crop failures that destabilized the Mongol Empire, with particularly acute famines from 1333 to 1337. These calamities gave strong impetus to change in trade routes and the growth of Western empires in the Age of Discovery.

Because the Mongol Empire had been exceptional in welcoming foreigners, when Mongol rule collapsed — first at the periphery in Persia, and then in China itself, in 1368 — this resulted in closure of the northern overland trade route to China, (think of Marco Polo), resulting in much higher prices for oriental goods, including spices in Europe.

Higher prices for spices, particularly pepper, which was important for preserving food (or disguising rotting meat) before refrigeration, provided an impetus that led to Vasco da Gama’s voyage around Africa to India. The Portuguese opened a new route to import Asian spices to Europe, disintermediating the northern Italian traders who had controlled the spice trade in Europe for centuries.

The economies of the Venetian Republic and Genoa slumped, never to recover after da Gama returned to Lisbon in 1499 with a ship loaded with pepper. Portugal became Europe’s principal intermediary in the trade with the East.

Recalling these past pivot points is pertinent because they underscore the central role that climate change and shifts in trade regimes have played in determining who prospers and who does not. In this respect, the current global power grab associated with “global warming” is unusual in that it does not entail actual economic damage imposed by shifts in solar radiation but rather projected or imaginary harms that are anticipated to follow from use of carbon-based fuels.

In my estimation, the whole fuss over global warming was never very plausible, given the
huge mismatch between human energy usage and the solar constant, which is the amount of incoming solar electromagnetic radiation per unit area or, simply, the known energy input from the sun.

Global energy consumption in 2009 was calculated to be about 15 terawatts or 15 trillion watts, while the surface area of the earth is about 510 million square kilometers. This means that the average heating from all human energy sources is about 30 milliwatts per square kilometer, that is, 30 one-thousandths of a watt. Try roasting a marshmallow on that.

By comparison, the solar constant as measured by satellite is roughly 1,366 watts per square meter. In short, human warming of the planet from all energy sources is trivial in relation to solar heating.

Of course, solar energy reaching the earth fluctuates from month to month and from year to year. That’s why “climate change” is not a novelty but a constant feature of life on earth.

In a better world, you would not have to worry about how these issues could be misperceived. But today you do.

Notwithstanding sweeping Republican gains in the midterm elections in November, decisions already may have been made that will condemn you and your children to a future of falling living standards.

Risk No. 1 involves the climate change conference in Cancún, Mexico, from Nov. 29, to Dec. 10. A year ago, I thought the risk from future climate conferences had been mitigated by the revelations published Nov. 20, 2009, showing that scientists were pressured to fabricate evidence of global warming. As Alan Caruba recently wrote: “Nov. 20, 2009, is an important date because it was the day that ‘global warming’ ended . . . the day that a total fabrication, a hoax, was revealed to be the work of the IPCC [The Intergovernmental Panel on Climate Change, established by the United Nations and the World Meteorological Association], aided and abetted by a vast network . . . who sold their souls for grants and other funding.”

That’s what I thought. But I was wrong. The “global warm-mongers” have another ace up their sleeves. It now seems likely that the global warming hysteria will provide a convenient pretext for the imposition of Smoot-Hawley-style tariffs on U.S. goods by countries seeking to venture into protectionism.

Lord Stern of Brentford said in an interview with The Times of London that the United States “would have to start worrying about being shut out of markets because their production is dirty.” Lord Stern “advises several G20 leaders and is one of the key players seeking an international deal on emissions,” the newspaper reported.

In other words, the reluctance of Congress to slash living standards in obeisance to the progressive quirk of slashing CO2 emissions to halt supposed global warming could lead to internationally sanctioned protectionism against U.S. products.

Risk No. 2 involves the extension of the Bush tax cuts and the danger that rate cuts for the highest earners will not be made permanent. Not worried, because you are not one of them? Think again.

As Fed Chairman Ben Bernanke has proclaimed, “Inflation is our goal.” Usually, when the head of a central bank wants to create inflation, he has the capacity to do so. This could prove to be another disaster for upper middle-income households, equivalent to the alternative minimum tax (AMT).

Your Taxes Are Going Up

In case you’ve forgotten the dirty little secret of the AMT, it was introduced in 1969 on the pretext that it would target just 155 high-income households that had been eligible for so many tax benefits that they owed little or no income tax under the tax code of the time.

What began as a tax aimed at just 155 wealthy families has grown through the magic of inflation to target 20 percent of American households.

According to a Congressional Budget Office report: “In 2010, if nothing is changed, one in five taxpayers will have AMT liability and nearly every married taxpayer with income between $100,000 and $500,000 will owe the alternative tax. Rather than affecting only high-income taxpayers who otherwise would pay no tax, the AMT has extended its reach to many upper-middle-income households.”

The Obama-Bernanke program of quantitative easing to create inflation goes hand-in-hand with President Barack Obama’s plan to raise taxes on “155 wealthy households.” When they’re finished trashing the dollar, every cleaning lady will be in the top bracket. And so will you.

Don’t sleep lightly. We face an inflexion point on the way to higher taxes and lower living standards in the United States.
Stocks are about 20 percent higher since hitting their lows in July. Since our last review, the S&P 500, a broad and representative index of the stock market, gained 1.77 percent on a total return basis, which includes dividends.

In comparison, the diversified FIR portfolio rose by 0.50 percent since our last review. One cannot eat relative returns, of course, so it’s worth noting again that, for 2010, stocks in general have returned 12.49 percent, compared with 29.66 percent for the FIR portfolio.

Over five years, the markets have brought most investors 3.52 percent, roughly the rate of official inflation, effectively a zero return. Meanwhile, the FIR portfolio has averaged 14.42 percent in that time frame.

The Federal Reserve’s decision to proceed with a new round of quantitative easing, popularly known as “QE2,” has been the most notable economic trend in the domestic news.

In the United States, market participants clearly understand the details of QE2. Under this initiative, the Fed announced that it will buy $600 billion in long-term Treasurys through the first six months of 2011. The Fed also said it will reinvest another $250 billion to $300 billion in Treasurys that are scheduled to mature during that time frame.

Contrary to the view of the Fed’s economists, we aren’t so sure that QE1 really did push down interest rates. At the end of December 2008, the interest rate on the 10-year Treasury note stood at 2.24 percent. Fed data shows that rates rose significantly as the Fed bought securities in the open market, reaching 3.83 percent in March 2010.

One thing is very clear, though: Asset prices did go up as QE1 unfolded. The S&P 500 rose by more than 30 percent. Gold rose about 35 percent, silver by more than 50 percent, and copper more than doubled. The copper increase is especially troublesome, given that some economists feel that copper, a far more industrial metal than gold or silver, is one of the best indicators of future inflation.

Moreover, prices rose on almost everything during QE1. Only the dollar fell, declining by more than 3 percent.

Using rough calculations, then, each dollar the Fed created boosted economic activity by about 25 cents. Most of the other 75 cents probably went to overseas investors who profited from the dollar’s decline and were able to sell some of their Treasury holdings to the Fed.

This has been a well-known rule of economics summed up many years ago by the late Nobel laureate economist Milton Friedman, who noted that “inflation is always and everywhere a monetary phenomenon.” QE2 is likely to prove the genius of Friedman’s insights once again.

The FIR portfolio is tilted strongly toward positions that will do well in an inflationary environment, one in which the dollar declines in value. We do not know when inflation will pick up, but the destructive power it can unleash on your portfolio means it’s better to be early than to wait until the damage is under way.

**New Positions**

We continue to believe that inflation will be a problem in the long term. Countries such as Australia and Canada, rich in natural resources, should fare well in an inflationary future. By applying our stock selection discipline to these countries, we are adding several safe, large-cap companies to the portfolio. They are readily available to U.S. investors as American Depositary Receipts.

In Australia, mining giant **BHP Billiton (BHP)** has $12 billion in cash available and is shopping for growth. Long-term prospects are excellent for the
industry and this well-managed company. Foster's Group (FBRWY), an Australian brewer, makes the eponymous beer popular in the United States and around the world. The stock trades at half the valuation of industry leader Anheuser-Busch, based on next year's earnings estimate.

Canadian financial stocks avoided the worst of the global crisis because they did not participate in the subprime debt fad. Toronto-Dominion Bank (TD) has proved that it can grow through smart acquisitions. The bank is shopping for banks that the FDIC has shut down and has agreed to buy auto lender Chrysler Financial for $6.3 billion. Like us, the managers of TD seek value in their investments and are patient. This stock is likely to be in our portfolio for the long term.

**Closed Positions**

We sold PowerShares High Yield Dividend ETF (PEY) simply because we are confident that we can do a better job finding safe, dividend-paying stocks. The ETF uses an index approach to select stocks and seems to catching more losers than winners with this strategy.

Becton, Dickinson and Company (BDX) also was sold. With changes to the healthcare system coming in the United States and Europe, we want to limit exposure to this sector. BDX is a good company, but it is better to build a portfolio of great companies for the long term.

### January 2011 Portfolio

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Recommendation</th>
<th>Date</th>
<th>Entry Price</th>
<th>Current Price</th>
<th>Total Return</th>
<th>Latest Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>PPH</td>
<td>Pharmaceutical Holdrs</td>
<td>15-Sep-03</td>
<td>76.74</td>
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<td>Hold/Stop 60</td>
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<td>PFE</td>
<td>Pfizer</td>
<td>1-Aug-05</td>
<td>26.46</td>
<td>17.08</td>
<td>-19.13%</td>
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<td>RDY</td>
<td>Dr. Reddy's Laboratories (ADR)</td>
<td>15-May-06</td>
<td>33.55</td>
<td>39.82</td>
<td>19.54%</td>
<td>Buy</td>
</tr>
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<td>GSK</td>
<td>GlaxoSmithKline (ADR)</td>
<td>15-Mar-07</td>
<td>54.21</td>
<td>39.80</td>
<td>-15.12%</td>
<td>Hold</td>
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<td>NYS</td>
<td>Novartis AG (ADR)</td>
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<td>55.96</td>
<td>58.99</td>
<td>17.63%</td>
<td>Hold/Stop 42.79</td>
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<tr>
<td>DBU</td>
<td>WisdomTree International Utilities Fund</td>
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<td>33.38</td>
<td>19.98</td>
<td>-31.74%</td>
<td>Buy</td>
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<td>BRK.B</td>
<td>Berkshire Hathaway</td>
<td>12-Oct-08</td>
<td>52.40</td>
<td>79.55</td>
<td>51.81%</td>
<td>Hold/Stop 75</td>
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<td>MO</td>
<td>Altria Group</td>
<td>19-Dec-08</td>
<td>15.28</td>
<td>24.75</td>
<td>86.37%</td>
<td>Hold/Stop 23</td>
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<td>KMB</td>
<td>Kimberly-Clark</td>
<td>19-Dec-08</td>
<td>51.11</td>
<td>61.99</td>
<td>29.85%</td>
<td>Hold/Stop 59</td>
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<td>JNJ</td>
<td>Johnson &amp; Johnson</td>
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<td>57.8</td>
<td>62.57</td>
<td>11.69%</td>
<td>Hold</td>
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<td>SNY</td>
<td>Sanofi-Aventis</td>
<td>12-Jan-09</td>
<td>31.5</td>
<td>32.79</td>
<td>4.10%</td>
<td>Hold/Stop 24.65</td>
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<td>GLD</td>
<td>SPDR Gold Shares</td>
<td>2-Feb-09</td>
<td>92.63</td>
<td>134.70</td>
<td>45.42%</td>
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<td>GDX</td>
<td>Market Vectors Gold Miners (ETF)</td>
<td>27-Feb-09</td>
<td>33.36</td>
<td>60.99</td>
<td>82.82%</td>
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<td>DIP</td>
<td>Dow iPath AIG Commodity Index Tot. Ret.</td>
<td>26-May-09</td>
<td>36.23</td>
<td>46.63</td>
<td>28.71%</td>
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<td>NSRGY.PK</td>
<td>Nestlé</td>
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<td>57.15</td>
<td>50.59%</td>
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<td>GLD</td>
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<td>UltraShort 20+ Year Treasury ProShares</td>
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<td>PFLUX</td>
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<td>FPA New Income Fund</td>
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<td>10.98</td>
<td>10.83</td>
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<td>Buy</td>
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<td>BMO</td>
<td>Bank of Montreal</td>
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<td>12.83%</td>
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<td>COW</td>
<td>iPath DJ-UBS Livestock TR Sub-Idx ETN</td>
<td>29-Jul-10</td>
<td>29.63</td>
<td>29.22</td>
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<td>EMMF</td>
<td>Templeton Emerging Markets Fund</td>
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<td>20.4</td>
<td>22.23</td>
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<td>Buy</td>
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<td>FFX</td>
<td>Freeport-McMoRan Copper &amp; Gold</td>
<td>16-Sep-10</td>
<td>81.73</td>
<td>112.05</td>
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<td>BHP</td>
<td>BHP Billiton</td>
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<td>89.13</td>
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<td>FBRWY.PK</td>
<td>Foster's Group</td>
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<td>5.43</td>
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<td>TD</td>
<td>Toronto-Dominion Bank</td>
<td>15-Dec-10</td>
<td>72.27</td>
<td>72.27</td>
<td>0.00%</td>
<td>Buy</td>
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As of close Dec. 15 • total return adjusted for splits, dividends, and distributions
Financial Briefs

Jim Rogers: Let ‘Bankrupt’ Europe Restructure

Commodities guru Jim Rogers, chairman of Rogers Holdings, says some European countries are already bankrupt and should be allowed to restructure their debt.

“You need to let Ireland go bankrupt,” Rogers tells CNBC. “Why should . . . anybody pay for mistakes made by Irish politicians and Irish banks?”

“That is unbelievably bad morality, and it’s bad economics as well. Let the bank bondholders lose money, let Ireland reorganize and start over. Propping people up and carrying zombie banks and zombie companies is not going to work.”

Greece, Spain, Portugal, Belgium, and Italy are all teetering on insolvency, and the United Kingdom is totally insolvent, Rogers says.

“This is a serious problem we have in the West. Somebody’s got to deal with it,” he says.

Europe’s problems notwithstanding, Rogers says he owns and remains long on the euro. Even though the British pound is doing well, he doesn’t own it.

When asked about the United States, Rogers said the central bank’s money printing isn’t good for the world — but at least the government isn’t raising taxes.

“I think it is dumbfounding, stupefying, that we have a central bank in the United States that thinks all it has to do is print money,” he says. “That has never worked.”

Moreover, “the price of everything is going up — food, entertainment, education, healthcare . . . that’s called inflation.”

The Wall Street Journal reports that Federal Reserve Chairman Ben Bernanke has said the U.S. central bank will remain focused on keeping inflation risks low, while suggesting that quantitative easing could be increased to stimulate the economic recovery. (Moneynews.com)

Survey: Most Favor Social Security Taxes Based on Total Income

Most Americans feel Social Security taxes should be paid on all or most of the income workers earn annually, according to Rasmussen Reports.

The survey found that 60 percent agreed on paying Social Security taxes in such a manner, 21 percent disagreed, and 19 percent were not sure.

Americans now pay Social Security taxes only on the first $106,800 they earn each year.

These findings differ little from a similar survey in August 2008, when Barack Obama, then a presidential hopeful, first proposed higher Social Security taxation on the campaign trail.

Full Social Security benefits kick in at age 66, although some in Washington want to raise that age to 70 for future retirees.

Social Security costs will exceed tax revenue beginning in 2015, according to Bloomberg News.

Republicans, including incoming House Speaker John Boehner, want to raise the retirement age and either limit or halt benefits for higher-income retirees, which some Democrats oppose.

Yet one Democratic-led policy group, Washington-based Third Way, wants to raise the retirement age, trim or cut Social Security benefits for wealthier retirees, limit cost-of-living increases, and help young workers create private retirement accounts.

Other Democrats argue that any debt-reduction proposal must “achieve the goals of reducing the deficit, promoting economic growth, and preserving Social Security,” outgoing House Speaker Nancy Pelosi’s spokesman Brendan Daly tells Bloomberg News. (Moneynews.com)

Volcker: Fed Eventually Will Need To Head Off Inflation

Former Federal Reserve Chairman Paul Volcker, who is head of President Barack Obama’s Economic Recovery Advisory Board, said the Fed eventually will need to act to avert inflation after providing record monetary stimulus.

“The Federal Reserve will have to act in a timely way to head off inflationary consequences,” Volcker said during a panel discussion in Washington. “I think they understand the problem.”

Fed Chairman Ben Bernanke, who said he prefers inflation of “2 percent or a bit below,” is leading the central bank in a program to purchase $600 billion in longer-term Treasury securities to boost
growth and prevent too-low inflation. Republican lawmakers say the policy may fuel a surge in prices.

The Fed’s preferred gauge of inflation, the personal consumption expenditures index excluding food and energy, rose 0.9 percent in October from a year earlier. Including all items, the index increased 1.3 percent.

Although inflationary pressures are “not a problem right now,” Volcker said he’s concerned about the commitment of central banks to 2 percent inflation.

“The popular rule for central banks now is somehow price stability, but price stability interpreted as 2 percent inflation,” said Volcker, 83. Over the course of a generation, this rate of inflation cuts purchasing power in half, he said.

“It is not exactly my definition of stability, but that is the rule that has become central to central banks around the world,” he said.

While Fed chairman from 1979 to 1987, Volcker raised interest rates as high as 20 percent to tame an annual inflation rate approaching 15 percent.

Asked about the legislative overhaul of U.S. financial regulation, Volcker said, “There is some danger if the Federal Reserve kind of becomes all powerful.’

The legislation creates a consumer bureau housed at the Fed, places the Fed chairman on a council of regulators to monitor firms for systemic risk to the economy, and gives the Fed responsibility for overseeing “systemically important” firms.

(Bloomberg News)

End of Build America Bonds Threatens Municipal Market

The looming end of the federally subsidized Build America Bonds (BABs) program may push up yields in the $2.8 trillion municipal securities market and put more financial pressure on cash-strapped states and cities, investors said.

Senate Democrats backing the subsidy, which has helped finance bridges, roads, and other public works, fell short in a bid to get the program added to a bill extending the 2001 and 2003 income-tax cuts. That failure was the latest in efforts to keep the Build America program alive beyond its scheduled end on Dec. 31.

The securities, which carry taxable interest rates similar to corporate debt, have allowed state and local governments to access investors abroad and others who don’t buy traditional tax-exempt bonds. That has eased the supply of tax-exempt bonds and buoyed prices, which move inversely to yields, a trend that may reverse if the program is killed.

“It could get pretty ugly,” said Rob Novembre, managing director at Arbor Research & Trading Inc. in New York, who runs the company’s municipal-trading operation. “Whoever owns munis could potentially experience some pain.”

Build Americas were created under President Barack Obama’s stimulus legislation as a means of driving down borrowing costs for localities and funneling money to job-stoking construction projects. More than $179 billion of the securities have been sold since April 2009, funding clean-water projects in Ohio, highways in Kansas, dormitories at Rutgers University in New Jersey, and a new bridge spanning the San Francisco Bay.

“The BABs program has been a great success story,” California Treasurer Bill Lockyer said. “If Congress lets it expire, it will damage our economic recovery and inflict a multibillion-dollar injury on taxpayers, not just in California but in every state in the nation.”

California and local issuers in the state have sold about $36 billion of the taxable debt, he said. In an interview on Bloomberg Television’s InBusiness With Margaret Brennan, Lockyer said the Build America program has helped create “tens of thousands of jobs.”

Although Obama and other Democrats have supported prolonging the program, they have run into opposition from Republicans critical of the stimulus package. Extensions have passed the Democratic-controlled House twice only to stall in the Senate, where the Republican minority has sufficient power to block legislation. The U.S. government pays 35 of the interest costs on Build America bonds. (Thomson/Reuters)

TrimTabs: Bond Market Cracked, About to Crumble

Hedge funds and other speculators are lining up against the Fed on new debt, a signal that the government debt market is hugely overbought and set to stumble badly, according to new data from TrimTabs Investment Research.

TrimTabs told its clients that investors have been moving into bond mutual funds and exchange-traded funds (ETFs) while leaving stock funds.
Investors put a combined $708.8 billion into bond vehicles since the beginning of 2009 while taking nearly $100 billion out of stock funds and ETFs. That's too many people on the same side of the boat, experts warn.

“We now spot what we think might be telling cracks in the bond market’s foundation,” wrote TrimTabs analyst Vincent Deluard, reported Forbes.

Mutual-fund investors were selling their long-term Treasurys to buy Treasury Inflation-Protected Securities, Deluard wrote.

Meanwhile, speculators are building positions in expectation of a flight from U.S. debt.

“Bearish 10-year Treasury sentiment soared in our November survey of hedge-fund managers, and spec traders have large short positions on Treasury futures on both wings of the curve,” wrote Deluard.

While Federal Reserve Chairman Ben Bernanke is going on television to promise even more quantitative easing if necessary, many small investors are jumping ship now to get into stocks as the recovery at last gains traction.

The tax-cut deal now working through Congress may have been the final trigger.

Ordinary investors’ big move out of bonds has been a while coming, but ultimately it was a predictable trend, experts say.

“Investors who got out of stocks and went into bonds for safety and security thought they had it made in the shade,” Marilyn Cohen, president of Envision Capital Management, told the Los Angeles Times. “Well, they did for two years, but it’s over. A lot of retail investors who look at their bond funds have got to be freaked out,” said Cohen, whose West Los Angeles firm specializes in bonds for small investors. (Moneynews.com)

**Roubini: Bond Vigilantes May Have U.S. in Crosshairs**

President Barack Obama’s deal to extend the Bush-era tax cuts could have bond vigilantes — traders who demand higher yields on fears of deficit-related risks — targeting U.S. debt markets, says New York University Nouriel Roubini.

“Obama-GOP tax deal costs $900 billion over two years. U.S. kicking the can further down the road. Are bond vigilantes starting to wake up?” Roubini says on his Twitter account.

The White House and Republican leaders agreed to extend tax cuts to all Americans, including the wealthy as well as extend unemployment benefits. The bill passed and became law in December.

Both sides say the deal will spur economic recovery and lower unemployment rates, although some say the agreement threatens to widen an already gaping U.S. spending deficit.

Some say that the move won’t hurt the U.S. economy — at least not in the short term — while creditor nations such as China continue to lend the U.S. money cheaply.

Economic problems in Europe are focusing the world’s attention on that side of the Atlantic, which gives the United States a little time out of the hot seat and keeps the dollar safe, says one Chinese Central Bank authority.

“For now, market attention is still on Europe and for the coming six to 12 months it will not shift to the United States,” Li Daokui, an academic member of China’s central bank’s monetary policy committee, tells Reuters.

“But we should be clear in our minds that the fiscal situation in the United States is much worse than in Europe. In one or two years, when the European debt situation stabilizes, attention of financial markets will definitely shift to the United States. At that time, U.S. Treasury bonds and the dollar will experience considerable declines.

(Moneynews.com)

**UCLA Indicator: A Rise, but Hints Of Continued Weakness**

The Ceridian-UCLA Pulse of Commerce Index (PCI), a real-time measure of the flow of goods to U.S. factories, retailers, and consumers, rose 0.4 percent in November following three consecutive months of decline.

The growth, while positive, isn’t enough to offset the 0.6 percent decline that the PCI saw the previous month, nor the 2.1 percent decline experienced in the PCI since July.

Although the PCI is up on a year-over-year basis, the three-month moving average has been declining for four months, suggesting relative weakness within the goods-producing segments of the economy.

The PCI is based on an analysis of real-time diesel-fuel consumption data from over-the-road trucking tracked by Ceridian.

By analyzing payment-card data for the location and volume of diesel fuel truck operators buy, the PCI provides a detailed picture of the movement of
goods and materials across the United States.

“While the PCI’s most recent data show growth, it is not substantial enough to offset the loss from the third quarter,” said Ed Leamer, chief PCI economist and director of the UCLA Anderson Forecast.

“In short, November’s ‘up’ is relative to a low bar, so the growth is only mildly encouraging. The flatness we’re seeing with the latest PCI data reflects inventories in motion which seem to be signaling a weak fourth quarter.” (Moneynews.com)

**Forex Guru: U.S. Headed for New Recession**

The U.S. economy is headed for a new recession, said John Taylor, chairman and chief investment officer of FX Concepts, which likely should benefit the dollar and weigh on commodity prices.

“It’s a new recession. We’re already growing, but the numbers show that the U.S. government is still the primary creator of this growth,” Taylor said at the recent Reuters Investment Outlook Summit.

Taylor runs the world’s largest currency hedge fund with assets under management totaling about $8.5 billion.

“I would argue that, by the middle of next year, we will be in a recession and our fiscal hands will be tied,” he said.

Taylor has maintained in previous interviews that the Federal Reserve’s quantitative easing program, designed as a way to help jump-start the economy, won’t necessarily prevent a recession.

Banks in a recession tend to demand the repayment of loans, and if the debts are denominated in the U.S. currency — and in most cases, they are — then investors are squeezed as they scramble to find dollars to repay the debt. That should be dollar-positive, Taylor said.

This was what happened in late 2008 when panic in the markets — precipitated by the collapse of U.S. investment bank Lehman Brothers — drove the safe-haven dollar higher against most major currencies.

“It’s kind of perverse. When the U.S. economy is doing badly, the dollar goes up and when the economy is doing well, the dollar goes down.”

Taylor’s remarks dovetailed with Fed Chairman Ben Bernanke’s comments on the CBS program 60 Minutes in December.

Bernanke said the Fed could end up buying more than the $600 billion in U.S. bonds it has committed if the economy fails to respond or unemployment stays high.

The U.S. economy grew at a modest 2.5 percent annual rate in the third quarter. Stronger growth is needed to create large numbers of new jobs and make a dent in unemployment. (Thomson/Reuters)