

NEWSLETTER

January 2010



The current consensus is that the US recession has ended and that the major stock markets have recovered from a violent crash inside of a secular bull market. I do not share this optimism. In 2008 we experienced the unfolding of a typical credit bubble, which burst with a magnitude equivalent to the size of its lunacy. The outcome is called a **credit crunch** and the undertakers are called margin clerks.

A credit crunch is the result of artificially low interest rates which creates:

- A period of strong expansion of careless lending which inflates, generally, a particular asset class to levels that are way above the historical long term average;
- The bubble bursts when reality hits and those cash flows are not adequate to service the debt. The yield curve reverses to steepening and credit spreads widen;
- All assets classes are hurt as margin calls force distressed sales and a flight to liquidity;
- Banks historically go bust due the leverage effect. Some form of nationalization takes place;
- Prices collapse. Trade flows stop .Small businesses go into bankruptcy. Credit is withdrawn;
- As life goes on, inventories have to be replenished. An economic rebound takes place;
- Unemployment tends to level off. The main asset prices remain under pressure as more often than not, as all bad loans or assets have not been disposed off. Individual deleveraging takes place, but slowly as income creation is impaired. Saving rates go up and demand down;
- Credit availability and credit demand both remain sub-par. The velocity of money goes down. Capex is delayed as well as new economic ventures;
- The economy goes though a prolonged period of slow growth inversely proportional to the rapidity at which bad debts are written off;
- It's called a depression and for some rather good reasons (asks the 10 to 14% Americans who have been out of a job for six months or more). A recession is a correction in GDP in the context of a secular economic expansion. The only secular expansion we are seeing is global government deficits soon to be followed by new forms of taxation.

DJIA:	10609.65
EURO:	1.4766
S&P 500:	1136.05
JPY:	88.10
Nikkei:	10764.90
Gold:	1138.40

The following empirical evidence tends to confirm this proposition:

- European exports declined in November for the second month in a row;
- The German Economic Minister declared that he expects the first quarter GDP to be flat (after a 5% contraction in 2009);
- Japan Bank loans decline for the first time in four years;
- The earnings of Alcoa in Q4 were 1 cent. The lowest number in the last recession was 16cents in Q4 of 2002. This result is being achieved as worldwide capacity is being ramped up!

- US Freight Rail Traffic in December was **down** 4.1% against Dec 08 and **17.6% against Dec 07**,
- Fannie and Freddie Mac lost \$188.4 billion over the last 9 quarters, more the AIG,

The following excerpts from the Federal Reserve Board Beige Book dated January 13, 2010 (Survey in the 12 Federal Districts) are compelling:

*Most Districts reported that consumer spending in the recent 2009 holiday season was slightly greater than in 2008, **but still far below 2007 levels**. Retail inventory levels remain very lean in nearly all Districts.*

*Manufacturing activity has increased or held steady since the last report in most Districts. Among Districts reporting on near-term expectations, the manufacturing outlook was optimistic, **but spending plans remain cautious**.*

*Home prices appeared to have changed little since the last Beige Book, and residential construction remained at low levels in most Districts. **Commercial real estate was still weak in nearly all Districts with rising vacancy rates and falling rents***

Loan demand continued to decline or remained weak in most Districts, while credit quality continued to deteriorate.

- This coincides with the latest University of Michigan **consumer confidence survey which remains at levels normally associated with recessions** (January data: 72.8) *and not at all with a turning point (average 78 +) or a new expansion (average + 90)*
- Frugality might still be in. A survey show that a 15% savings rate would be desirable for a large part of the population
- The Household debt to disposable income is falling but still at 123% (in 1982 it was 62%). Deleveraging is not over!
- Tax data show that income tax, withholding tax , sales tax , and corporate taxes were **all down** in Q4 2009(The King report 12.01.10).

Finally, for those who still doubt that the US consumers is not of major importance to world growth, the following 2008 data from the IMF, based on GDP per capita, should be of interest :

Washington DC	\$164,295
US average	\$47,440
EU Average	\$29,423
Switzerland	\$43,196
Netherlands	\$38,955
Germany	\$35,539
France	\$34,205
China	\$5,970

Well, who would have thought that France, if it were an American State, would rank 48 out 51! http://2.bp.blogspot.com/_otfwl2zc6Qc/S1C7-ttdD0I/AAAAAAAMeo/CpePjzdmx1o/s1600-h/eu2008new.jpg).

While US growth rate has slowed down markedly, it has become the view that by 2019 the combined GDP of the BRIC's will have outgrown the US. In the last decade China has been the big winner. Its GDP has grown from roughly \$1.1 trn to close to \$4.3 trn. In comparison US GDP grew from \$9.2trn to 14.2trn (source: Bloomberg). But will China's high export growth continue in the next 10 years? To begin, its cost base has doubled in Yuan terms since 2007, while its main customers are still on life support. Second, the rebound has to be put in relation to the downturn. Third, protectionism is coming back with force. Will China build road to nowhere? A good question, but they are clearly ramping up their (over)-production capacity in steel and aluminum (a bright future for Alcoa?). The BRICS consumers are expected to take over, but the question is when. The numbers are just not adding up right now.

The world's governments are trying to induce a new inflationary bubble through the largest fiscal and monetary stimulus in economic history, together with unprecedented bank bail-out's and support for autos and housing. Is this working?

It is remarkable to see that the most sophisticated investors, such as the Harvard Endowment Fund, are basically invested for this reflation trade. On the other hand the public, despite dire warnings from Mr. Buffet, continue to buy bonds. This can only make us reflect on the Japanese example: 20 years of stimulus of all kind have not been able to create GDP compound growth of over 1% P.A. This follows one of the most amazing real estate bubble of all times, and if I remember well, buildings in the Ginza district in Tokyo used to sell in 1988-89 at USD 100,000 per sqm (*the highest price paid for a luxury condo in London in 2007*). The Nikkei topped at 38,915 in December 1989 and is currently at 10,855 (*during this*

period there were 5 rallies, which took the market up, from the respective lows by: 39%, 52%, 59%, 61% and 140%, so opportunities were available)

The good people of Japan have been since buying bonds, despite 10 year rates varying between 1 and 2% since 1998. So deleveraging can take some time and the public is not always wrong.

Stock markets

The consensus, as far as it is represented by 12 of the leading US financial institutions buy side and sell side strategists, is that the S&P 500 target for the year is between 1350 and 1120. EPS should reach \$80 to \$66 (Bloomberg average \$76). Interestingly, this gives the market a PE of 16.6 -16.9 on the high and the low side of the estimates.. Current EPS estimates have moved up and stand at \$55 per share implying a market valuation of 20.6X, somewhat in line with the 18X average since 1982. Where there is some question, is the possibility for the market to reach the expected 2010 EPS of \$76. This means that S&P 500 earnings would have to grow close to 40%. Is this possible, when the average expectation for US GDP growth is 2.6%?

On a technical point of view for 2010 I could see a bubble high of 1350 on the S&P 500 and a low of 850-900.

Currently the market shows some signs of fatigue. It could be ready for a slightly greater correction than seen in the last quarter, but contained at the 100 day moving average, close to the 1080 level. Note that the outlook is quasi universally bullish for the first and second quarter, with several leading experts expecting a correction only by mid-year as fear of government tightening take place.

It clearly will make for some volatility, but the world will continue to grow and opportunities arise. Man's capacity to create has never ceased to amaze me. It is unfortunate that this brilliance is hampered by the agenda of those who have chosen the political sphere to achieve their ambitions. But it always has been so, and will remain that way. We shall continue to cast our vote through our investments and will be sanctioned by our performance.

So what are the practical consequences?

The global equity portfolio was up 47% in 2009. The absolute number is satisfactory, especially that as of June 2008 we had advocated 100% cash. This was then reinvested in mid March 2009 at 80%, but the cash portion was again increased in July and August, so we lost out on a good portion of the last move.

The portfolio was run as a model for RAM Capital (www.ramcapital.ch). Our collaboration has led to the creation of RAM Capital Value Fund which is being launched at the end of the month. The Fund intends to use a basic value approach for stock selection, integrated with a global macro review which I endeavor to define in these monthly letters. The help of the RAM team, which has had an outstanding performance in the last 12 years, will bring some added clarity and discipline to the process.

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