

OCTOBER 2008

Karl Marx-to-Market

America has really done it this time. Having essentially “nationalized” our finance industry, far too much of our Gross Domestic Product will now be generated from enterprises guaranteed by the Government. If the coming years witness a similar takeover of healthcare in America, this will add Washington oversight to another 16% of our economy, bringing us closer to a socialist economic model. Karl Marx himself would no doubt be amazed at the speed of this transformation in fundamental economic policy, but he would also be as surprised and perplexed, as some of you may be.

The recent actions of our Government are just the beginning of the wrenching process of change now taking place. That’s why we are devoting this newsletter to those changes that America will make to restore financial health and free enterprise and the implications for investors. With that in mind, let’s take a look:

WHO LET THE DOGS OUT?

The strength of our democracy is its system of “checks and balances” which leaves decision making refreshingly stymied. We freedom lovers prefer this to a “benevolent dictator” who might exercise power without delay – but could never be trusted for longer than, say, an hour. Thus, Americans have largely benefited from capitalism’s innovation and efficiency while accepting periodic distortions caused by Washington’s all-too-frequent inaction over growing problems – 9/11 and the current debt crisis being the two most recent examples which inexcusably caught us flat-footed.

The recent collapse of global banking mechanisms is the latest example of what happens when greedy capitalists and politicians take advantage of Washington’s intentions to “do good” with someone else’s money. As is so often the case, America ignored years of warnings about risks from experts in real estate finance and allowed obvious problems to fester as both parties were taking care of “friends,” and because decisive correc-

tive action is only palatable to politicians when the masses are in “crisis mode.”

QUICK FIX VS. A SOLUTION

At Hamilton Point, we normally research subjects like corporate earnings estimates and strategies. Our recent work shows that some stocks are unbelievably inexpensive right now. However, this matters little unless solutions to this global debt crisis become clearer. Sure, the latest draconian bailout measures may unfreeze lending on a short term basis, but it also adds untold trillions to our national debt and by no means magically solves many of the underlying problems.

You might say that we have revived the patient with massive quantities of intravenously administered smelling salts in order to withstand serious undefined surgery later.

A VOTE FOR TRANSFORMATION

In our view, the real medicine needed by the developed world is a massive, disruptive, expensive, but ultimately healthy transformation – the likes of which has never been witnessed in our history. As was foreshadowed in our last newsletter, America is in “turnaround mode” and, in our opinion, is up to the challenge. Before setting out further thoughts, we are reminded of a joke that goes like this:

QUESTION: *How many psychiatrists does it take to change a light bulb?*

ANSWER: *Only one, but the light bulb has to really want to change!*

Make no mistake: with dropping home and portfolio values, and depositor runs on banks, America is definitely a light bulb ready for change.

If we have the will to transform, do we have the cash flow as a country to make economic reforms and jumpstart our own Perestroika? Can we make this move toward socialism temporary and restore private market leadership in order to compete globally in coming decades? The answer is yes, but only if every segment of America reinvents itself.

By our calculations, America needs to wring out and/or generate another \$1.5 trillion per year from our \$14 trillion economy to make ends meet. The process will probably result in temporarily high unemployment, much higher taxes, and fees on just about everything. The cash to pay for these items will likely come from common sense efficiency maneuvers by government entities, not-for-profits, corporations, the entire healthcare system and each individual consumer – in other words, all of us.

A SILVER LINING

Quickest to adapt will likely be the everyday family who can control their budget by eating more meals at home, cutting back on cell phone and cable TV options, and perhaps foregoing the insurance expense that enables their teenager to drive. By our estimates, a family with a household income of \$75,000 per year could probably save \$3,600 per year just by implementing these suggestions. If 80 million families took similar action, our economy would contract by about \$300 billion (i.e. recession). Interestingly though, one could argue that these budget-minded families may actually be better off using these austerity measures because families that dine together at home and watch less TV may wind up happier and healthier!

Hmmm ... it seems America has come to the point where we can actually improve our quality of life while reducing our standard of living and our debt. The same phenom-

enon of “constructive contraction” can be experienced by government, non-profit and corporate worlds: all must hunker down, collaborate, consolidate and stop thinking money either grows on trees or can be borrowed at a whim.

WHAT IT MEANS FOR INVESTORS

The point for investors is this: Get out of the way of the global de-leveraging process now underway! It may ultimately be a healthy transformation, but it will crush untold numbers of business plans in the meantime.

Global growth may still be positive over the next few years, but only after accounting for negative recessionary results from developed countries. While some emerging markets will suffer from lower exports to now contracting developed economies, recall that these new economies began this period with strong finances and far better consumer growth prospects. We continue to feel that the best long term investment opportunities will be those companies serving emerging markets with consumer or infrastructure products and services.

The recent huge market rally, preceded and followed by precipitous declines, is just another sign of unprecedented volatility – something we expect to see more of as we sort through these troubles. We remain light on equity exposure and very cautiously opportunistic in adding to equities. Portfolios are more diversified than ever in assets like gold, inflation-protected securities and foreign bonds.

Given the nationalization of so many banks and brokerages, we at Hamilton Point cherish our independence more than ever. We further commend the bankers who did behave responsibly in recent years, only to get caught up in the mess created by others. We look forward to the day when these responsible bankers can lead our banking industry back into the private sector and keep Karl Marx in his proper place: the past.

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*Contact us for a complimentary review of your investment portfolio in the context of these uncharted markets.
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