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The stock market went up 5% in the first half of the year even though we sailed through some pretty stormy seas. Why didn't it recede in fear of the financial-political impasse we are witnessing here in America? Here is a short list of the potent dynamics:

- 1) Six Middle East nations are in ferment, of which five have people risking their lives in the streets and the sixth, Iran, still has an overwhelming tendency to suppress demonstrators violently. A seventh, Iraq, may become an unsteady but workable democracy, but the current party led by the angry Muktada al-Sadr may be in line to seize power if US resolve withers. Ferment is bad news, but stock prices withstood the pressures, giving evidence of resiliency.

There is room for positive outcomes in the region when things finally settle down, but nasty surprises are still possible. And there is nothing new about prospects on the Pakistan and Afghanistan fronts, both still unstable but revitalized by our evolving technology in remotely operated unmanned weapon systems. Bullets against arrows, again.

The people of these countries are experiencing a surge of hope to be free of oppressive dictators and able to reach for a modern lifestyle. Computers, the internet and hand held devices were a key enabler of the spontaneity in the street. Apparently, the only organized interest group in the region is the Muslim Brotherhood, some of whom are jihadists biding their time. President Obama, after having chastened the Israelis by directing them to start negotiating at the 1967 borders, is now reaching out to the Brotherhood in an exploration somewhat like hand feeding a cobra, in that a bad result would not be much of a surprise. If something good comes of it such as abandonment of their goal to destroy Israel, that would be a surprise and markets would respond favorably.

- 2) Weak finances in six troubled European nations. The old world got used to long vacations, early retirement, government medical care and living on the dole, but financing these social programs with borrowed money has run into a wall of reality: The EU is confronting a profound decision: whether to take up responsibility for the debts of its over borrowed members, complicated by the fact that much of the debt is owned by European banks. The idea of letting Greece default and watching Ireland, Italy, Portugal, and Spain do the same, leads to fears of economic depression and misery.

Our evaluation is that any national borrower unable to service debts should be seen as unworthy of borrowing, holders of such debt securities should realize losses, and the national publics forced to confront reality by rejecting the destructive path favored by their leftist parties. That, however, seems too much to expect of the EU mentality and we would predict, instead, a series of temporary patch jobs rather than curative action. It may become possible to pressure governments to spend what is affordable. Unfortunately, such imbalances worsen by postponement so that a Greek default would be a positive first step, in our opinion. The amount of discomfort brought on by reduced social spending would be dwarfed by that of a destructive inflation.

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- 3) Financial imbalance in the United States, brought about by the illusion that it is a good and wise thing to help people to borrow and buy beyond their capacity. "To roll the dice a little" in the words of Barney Frank, a generous policy maker favoring unethical lending to borrowers who are unable to afford to service their debts, all in the name of "fairness." As a consequence, the US commercial banking industry has come under the operating control of the government, along with much of the investment banking, insurance, auto making and medical care industries. This major extension of centralized power will be short lived if we are correct in projecting decisive change in the 2012 election.

Government subsidies to vast and growing numbers of claimants, the retired, disabled and needy, plus others who have found a way to game the system, are overwhelming the nation's financial capacity. Balance must be reached by reduction of outflows, and allowing the natural growth of inflows. The reason, though unacceptable to the current government, is simple: The financial health of the economic structure is being impeded by current high levels of taxation. Increasing taxation further would increase economic suppression which, according to some socialist strategists, is not necessarily a bad thing, as the destruction may facilitate the creation of a new society on the wreckage of the old.

- 4) American attitudes are becoming less friendly to concentrations of Federal power and the most energized segments of the spectrum are on the political right. Within the Congress, the "Tea Party" wing is playing the role of spine stiffeners.

An anemic version of economic recovery is now underway partly because of the near absence of home building as a basic contributor and partly because business decision makers are smart enough to sit out uncertainties about tax rates, international trade, energy, green subsidies and carbon dioxide policies, and the extent to which federal government power can control business decision making such as where to site industrial plants. We expect to see continued slow growth in economic activity and employment this year and next and an acceleration thereafter.

If we are incorrect, and America votes to retain the left, our investment strategy would have to be revised to reduce emphasis on stocks, which we now regard as the most attractive investment, and increase reliance on ways to cope with inflation, such as inflation protection bonds, precious metals, certain corporate bonds and high cash flow REITs if and when their prices and yields become attractive. Aside from that, we are decidedly positive in our outlook.

Best wishes,

John May