Snowden Perspectives: *Speculation on the New Year 2012*

January, 2011

> ***If you do not expect the unexpected, you will not find it; for it is hard to be sought out and difficult.***
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> ***- Heraclitus***

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About Snowden

Snowden is a global, independent financial services firm. We provide wealth and corporate advisory services to high net worth individuals, families, institutions, and governments. In the end, each of our clients is trying to get from Point A to Point B — Snowden provides the pathway from point to point.

The year 2011 was characterized by continued market volatility around the world. While defensive assets such as *US Treasuries* and *gold* outperformed broader markets, US equities managed to finish just about flat for the year despite roller coaster moves. Most global equity markets were not so fortunate, finishing well into the red. Structural issues in the global economy abound and solutions are still to be worked out. Unprecedented and continued actions by *Central Banks* like the *Federal Reserve* and *European Central Bank* have made the task of investing that much more complex, since government policy intervention often distorts market pricing mechanisms and behavior.

Given our clouded outlook, we seek inspiration from an ancient European source, the *Presocratic* philosopher *Heraclitus*. If anything should be expected in this coming year it is the *unexpected.* That, ladies and gentlemen, is never an easy task. With this in mind, we invite you to survey some potential developments and issues that we believe may impact global capital markets in the coming year.

China Floats the Yuan

If China floats the *Yuan* (or *Renminbi*, RMB), as a freely convertible, market driven currency, it would be a candidate to be included in the IMF's SDR (Special Drawing Rights). It would also become a global reserve currency in its own right. China would develop deeper capital and debt markets beyond the banking sector. This would, in turn, create mechanisms for more efficient allocation of capital and resources. It would also help to put global economies back on a market based path of rebalancing.

Political concerns within China and a new leadership in 2012, as well as growing off balance sheet debt problems, and slowing global growth all contribute to a lower probability of any major change regarding the Chinese currency. Thirty six percent (36%) of China's GDP is driven by the consumer and this remains among the lowest in the industrialized world. The export economy still commands a disproportionate level of economic growth and employment. While Chinese leadership recognizes that the consumer needs to play a more important economic role, change remains problematic since the model for growth has been driven by exports for quite some time, even as global aggregate demand slows.

One reason given for the low participation of the Chinese consumer, relative to GDP, is that there is *no social safety net*. Looking forward, we see companies like GE (General Electric) moving its medical imaging unit to China which will ultimately be a bigger market than the US as spending on healthcare increases. GE also avoids potential tariffs by producing in country. In the interim, if the export lobby in China holds sway and growth falters due to decreased global demand, a *depreciation* of the RMB cannot be ruled out. The highest probability in our view remains a slow appreciation of the currency and gradual preparations for more market based approaches.

Trade War with China

In the end, currency may have very little to do with trade imbalances but with the US overall employment figure *U6* staying above 15%, fears of structural unemployment are taking hold. Politics may trump good sense and trade tariffs may escalate between the US and China. Social stability requires employment and full employment has been a long standing goal in China. The *Roman Empire* practiced the art of *bread and circuses* to keep the people well fed and distracted from other issues. This approach creates a certain dilemma. As Chinese Vice Premier *Wang Qishan* duly noted recently, "Cheap Chinese goods have been a subsidy for the poor in the U.S., and now the U.S. government wants to eliminate such subsidy while it's having difficulty creating jobs." This is the *Catch-22* of a *Walmart effect*. US consumers are offered cheap goods which leads to a higher standard of living, while the jobs producing those goods are lost. Without jobs, even the cheapest of goods will create deficits and eventual erosion in the standard of living. Capital chases the cheapest labor inputs and those inputs have been in emerging markets. Unfortunately the abundance of cheap credit also helped to fuel overconsumption and the bill has now been passed from consumer to the national debt which continues to grow. The situation is unsustainable.

In the end, a trade war will be costly to everyone involved. Martin Wolf of the *Financial Times* counter intuitively suggests that the deficit country maintains the upper hand, since it is the debtor who supplies *aggregate demand* for the surplus economy's goods. While the Chinese economy attempts to rebalance internally to a higher degree of consumer consumption, it would be forced to accelerate that pace in light of a trade war and a rapid change of pace would have unforeseen consequences that the current leadership would like to avoid. The US economy would also suffer most likely with rising inflation and decreased corporate profits.

Korean Unification

With North Korea's *Kim Jong Il* departed, what comes next? While *Kim Jong Un* has been nominated as his father's successor, a power sharing arrangement is obviously in place with the North Korean elite. At this point, the calculations begin regarding the political jockeying and motivations to maintain a belligerent and isolated stance or open new dialogue over the Peninsula's fate. Could it be in the ruling elite's interests to rejoin the South? It worked for Germany but that of course was contingent on the fall of Soviet hegemony in Eastern Europe. The Chinese Communist Party remains fully functional, even if dressed in suit and tie while advancing the Chinese economy to the world's second largest. A deflective shield against US interests in the region may remain as the familiar gambit in this ongoing game of *Real Politik*. A reunified Korea would eventually create a regional powerhouse above and beyond South Korea's current standing. It would potentially be a unified *nuclear* power which would likely create new, unforeseen consequences in the region.

Alternative Energy Gains Ground

Global energy production remains tied to fossil fuels like coal for electricity, oil for transportation and natural gas and oil for heating fuel. Nuclear energy has been confined to a model developed over 60 years ago around *light water reactors* which are highly dangerous in the case of a meltdown. Fukushima is the latest horrific example. Coal produces high CO2 emissions and other pollutants while oil production has arguably peaked. As the global population continues to grow and energy consumption grows with it, new, cleaner, sustainable methods of energy generation need to be brought on line. Data centers for *cloud computing* alone draw some 2 – 3% of electricity in the US. No one really foresaw this demand a decade ago.

Nuclear reactors that use *thorium* instead of *uranium* are highly efficient and are designed to avoid meltdowns. Thorium is a readily available mineral and designs were tested in the 1960s and 70s. Thorium reactors do not produce weapons grade materials but in fact can be used to burn *plutonium*. The nuclear industry and its regulatory bodies have almost uniquely settled on light water reactors. As electric cars become more practical with advances in battery technology, the electrical grid requires robust, clean and sustainable solutions. Why drive an electric car powered by a coal fired electrical plant? Solar prices have come down making solar power cost efficient. Wind turbines, wave turbines and space based solar generation are all solutions at varying stages of development. "Smart" grid designs and control, advances in materials science for construction and insulation and greater efficiencies in semiconductors, computers and mechanical engines all point to a greener future.

US Returns to Gold Standard

Ron Paul has spoken about curtailing the *Federal Reserve* and returning to a *gold standard*. Paul wants to curb the FED's appetite for *fiat money*. The Federal Reserve Bank's dual mandate promotes full employment and price stability. Since the start of the financial crisis, the FED has engaged in *quantitative easing* measures in order to fight deflation. The FED purchases fixed income securities in the secondary markets which helps to keep interest rates low and also adds liquidity to the banking system. The money used to purchase these securities is *simply created* and theoretically unlimited. An unwanted by product is commodity and asset price inflation, since liquidity tends to spur investments in "risk" assets like equities and commodities. The general fear is that loose-money policies will lead inevitably to one thing and one thing only, inflation. Once inflation crosses a certain threshold it may become uncontrollable and blossom into *hyperinflation*. A return to the gold standard would put an automatic circuit breaker on the ability of the central bank to add money to the banking system and thereby remove the threat of hyperinflation. Proponents of free markets also add that central bank policies and *fiat currencies* have created distortions in markets which inhibit the efficient allocation of capital and resources.

Congressman Paul has better than even odds of winning the Iowa caucus according to *Intrade*, the online prediction market (www.intrade.com). It's doubtful that Mr. Paul makes it to the White House. In the interim, gold remains an alternative choice to fiat currency and central bank policy / intervention. Whether a return to a gold standard would be practical or not is moot, since the very consideration of such a route brings monetary policy under closer scrutiny and sets the stage for greater transparency of central banks and their monetary policy.

Vox Populi –The End of 15% Tax on Carried Interest

The US National Debt is $15.1 trillion. The fiscal deficit is $1.3 trillion. These are staggering figures. Debt can be paid back, inflated away or defaulted upon. Using more debt to solve debt problems is a flawed strategy. One answer is to impose austerity measures on spending. Another is to raise taxes. Austerity means biting the bullet now and economic pain. Raising taxes would most likely inhibit small business growth and hiring and therefore be of questionable utility.

The tax debate is a symptom of the wealth divide in the US. A well-known billionaire / private equity manager was recently quoted saying that a proposed tax increase on *carried interest*, taxed at the long term rate of 15%, was similar to the *Nazis invading Poland*. While this gentleman later apologized for his remarks, it was indicative of something larger. Marginal tax rates for the vast majority of the "1%" are more than twice as high as the rate applied to *carried interest*. The outrage expressed demonstrates a sense of *entitlement* regarding riches, even while paying less tax on a percentage basis than one's housekeeper(s). As a counter weight another well-known billionaire has suggested that the super-rich pay their fair share of tax in line with the current progressive tax system.

While the *Tea Party* tows a *Libertarian* line emphasizing self-reliance and smaller government, the *Occupy Wall Street* protests demonstrated a palpable level of anger from the "man in the street," over government largesse towards the banks and the well off. The wealth divide is highlighted in this debate. Sheer numbers in a *Democratic Republic* would seem to favor one set of entitlements (*Medicare*, *Medicaid*, *Unemployment* benefits) over another (the *Super Rich* and the ability *to lobby away progressive taxation schemes*, as well as *Multi-National Corporations* which reap profits offshore while exiting the *US Labor Market*). In the current system it would appear that for the very rich as well as the vast majority, *having your cake and eating it too* is coming to a reckoning rather quickly with the dinner bill.

Entitlements across the spectrum, including both those for the middle class as well as corporations and the very rich, all need to come under scrutiny. Whether or not this is done from a pragmatic and bipartisan approach or whether it creates greater divides remains to be seen. In the shorter term, look for cards to be played in the populist camp. A repeal of the special tax treatment for *carried interest* would be one such move.

Yield Seeking Proves a Crowded Trade

With US 10 year Treasury yields below 2%, the flight to safety has quite possibly corralled investors into yet another danger zone. Bond yields in the US have been driven down by a flight to safety by the ongoing European banking and sovereign debt crises, as well as *quantitative easing* measures by the Federal Reserve. The FED buys government securities in the market place, raising bond prices and lowering their yields. The bull market in bonds may have only so much further to go and increasing exposure means increasing *duration risk*. This is the risk of a mark to market loss on bonds as interest rates rise. Should the economic situation stabilize and then swing back into growth mode, bonds may sell off and yields rise as deflation fears evaporate and inflation fears reignite. The same "yield seeking" has been seen in 2011 with the so called defensive equity sectors in *Healthcare*, *Utilities* and *Consumer Staples* actually finishing well up for the year. While these sectors pay dividends and finished 2011 with strong capital gains, they have become expensive relative to S&P 500's valuation. As we said, if the economy stabilizes and switches to growth mode, bonds yields may back up, inflation may rise and the defensive sectors may sell off as money moves back into *cyclicals* who should at least keep pace with inflation. If growth does not leap back, inflation may still take hold leading to a *stagflationary* environment, where current dividend yields and bonds become less attractive. In that scenario, growth stocks would outperform and gold and precious metals would be attractive.

US S&P 500 Index Trades to the 1500s and New Highs

The incessant liquidity pumped into the system by the Federal Reserve in response to the deflationary forces of deleveraging and bad debt, along with the ECB and in fairly short order most of the world's central banks, may provide a tsunami of lonely funds in a low yield world, looking for a home. Several of Mr. Bernanke's speeches have referenced the wealth effect and the stock market as a gage of economic wellbeing. If the European crises stabilize over the year and the economic numbers coming out of the United States continue to surprise to the upside, markets may very well continue to rise. A rally to new highs might be debatable given the many structural issues of overly indebted developed markets and their trade relations with emerging markets yet extremely low interest rates and inflationary pressures in a certain equilibrium with deflationary / deleveraging forces may create a climate where economic numbers continue to surprise on the positive side. However, markets often move rapidly while the debate is taking place and the discounting of bad news already priced into markets may swing back towards US equities continued outperformance over the year. In the longer run and out several years, strong pushes of cyclical fits and starts are most likely. Policy largesse now will most likely require weaning later but an overshoot to the upside is that which is least expected at present.

European Markets Outperform

While the general perception remains that many of Europe's problems are intractable and that a recession is almost certainly priced in given self-imposed austerity measures, a turn up would surprise many. Other worries include a breakup of the *Eurozone* and the single currency due to one or several members defaulting on their debt and opting / being forced out of the currency. One must remember that it is generally a losing game to bet against an overwhelming force and Central Banks can be precisely that for a certain time period. If the *Federal Reserve* in combination with the *European Central Bank* has discovered a way to print money without calling it money printing, then the wall of money is indeed a formidable foe for the bears.

Animal Spirits? A most recent *Ifo Institute* business survey reflecting German optimism speaks loudly to this. The end game for Germany is to get fiscal spending under control across the continent. All the while, it would be unwise to fall prey to what can only be considered as disinformation regarding the ECB's position. Central Banks will continue to do what they have to do in the face of a continuing process of global deleveraging. The European situation is no different but it is tied to the effort to integrate fiscal responsibility more closely. If Central Banks continue to act in concert it is foolish to stand in the way and many quality European equities are trading at bargain levels. If the Euro falls into the dustbin of history, it will be due to political machinations gone awry and in that case, all bets would be off.

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Our wealth advisory services consist of:

- Investment Advisory
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Loyalty | Partnership | Uncompromising Global Standards | Social Impact

Questions or Comments? Please direct them to…

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