

Basic Points

The Year of the *Rats*

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Basic Points

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The Year of the *Rats*

Overview



Basic Points has been basically bullish about basic materials for six straight years. Each time the commodity and stock markets rushed to take profits, amid claims from prominent pundits that “the commodity bull market was over,” we reassured clients that the best was yet to come.

That conviction about a record commodity bull market started with the mining and oil companies. In October 2006, as we were preparing for our trip to India, we added agricultural stocks to the list of attractive commodity sectors, and then sharply upgraded the group after three weeks spent mostly in rural North India. Last summer, we upgraded the precious metals stocks to a strong Overweight position when we concluded that the US faced a financial crisis amid rising inflationary pressures.

This year, the story of *financial markets and the US economy* (but not necessarily the story of the global economy) will be about the outcome of two encounters: First, Wall Street’s meeting with Main Street in housing mania mode, that led to unprecedented looting of homeowners by financial sophisticates; Secondly, the shock to global liquidity when the financial dimensions of Wall Street’s crimes and slimes were suddenly displayed.

In retrospect, we remained optimistic for too long that the subprime crisis would be resolved without triggering serious recession risk. This was because of what now seems a naïve faith that the Street would not kill the next economic recovery the way it had terminated the last—by wiping out trillions of dollars of savings accumulated by the middle and lower classes.

We are leaving our very cautious Asset Mix unchanged. The US economic outlook is now correlated to the ultimate economic value of trillions’ worth of complex derivatives which were manufactured and marketed by greedy and reckless financial elites. We have revised our Recommended Commodity Stock weightings to reflect the fast-developing inflation/financial outlook, and the relative attractiveness of gold and grains to other commodities.

The Chinese Calendar proclaims this as The Year of the Rat. Something approximating a Plague may be in store for the US financial system.

Recommended Asset Allocation

Recommended Asset Allocation (for U.S. Pension Funds)		
	Allocations	Change
US Equities	26	unch
Foreign Equities		
European Equities	7	unch
Japanese and Korean Equities	5	unch
Canadian and Australian Equities	8	unch
Emerging Markets	11	unch
Bonds		
US Bonds	7	unch
Canadian Bonds	4	unch
International Bonds	11	unch
Long-Term Inflation Hedged Bonds	10	unch
Cash	11	unch

Bond Durations		
	Years	Change
US	4.50	unch
Canada	4.75	unch
International	4.25	unch

Global Exposure to Commodity Stocks		
		Change
Energy	29%	-4%
Agriculture	28%	+3%
Precious Metals	25%	+5%
Base Metals & Steel	18%	-4%

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

The Year of the *Rats*

Bank Stock Index (BKX)
January 2006 to January 2008



The Plague wiped out roughly 35% of the population of Europe, and the financial crisis is probably slashing US GDP by a comparable percentage.

In the Buddhist calendar, the rat is a respected creature, noted for his canniness.

The rat has a different reputation in Western tradition. In particular, rats have frequently been blamed for transmission of diseases—notably bubonic plague. They are also associated with grinding poverty—a rat-infested tenement being the archetypal locale of urban misery.

We suggest that calling this “The Year of the *Rats*” is a helpful way to reflect on the works of those respected, canny geniuses on Wall Street who enriched themselves by inflating a housing bubble and then creating a global financial crisis—and probably a US recession. To compare subprime-based CDOs to the Black Death might seem like rhetorical excess, but in economic terms there is a parallel: The Plague wiped out roughly 35% of the population of Europe, and the financial crisis is probably slashing US GDP by a comparable percentage.

The major difference is that rats were routinely slaughtered when they became too populous, whereas those CEOs, investment bankers, mathematicians, and hedge fund managers who have actually suffered some minor indignities for the disaster they unleashed are either still employed or have eased painlessly into retirement lifestyles resembling those of rapacious Third World dictators who fled to Monte Carlo, Riyadh, or Switzerland.

We apologize in advance to Buddhist and Asian readers who could be upset at the implied insult to the helpful Rat, by comparing them to this toxic breed of *nouveaux riches* who have helped themselves to outsized rewards. Those payoffs came at the expense of the economy—and homeowners.

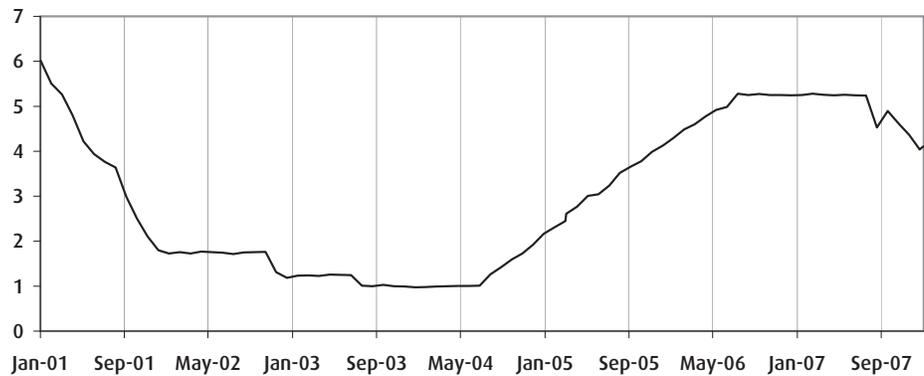


...the subprime, SIV, SIV-lite, Cov-lite, and CDO infections continue to impair the health of the international financial system

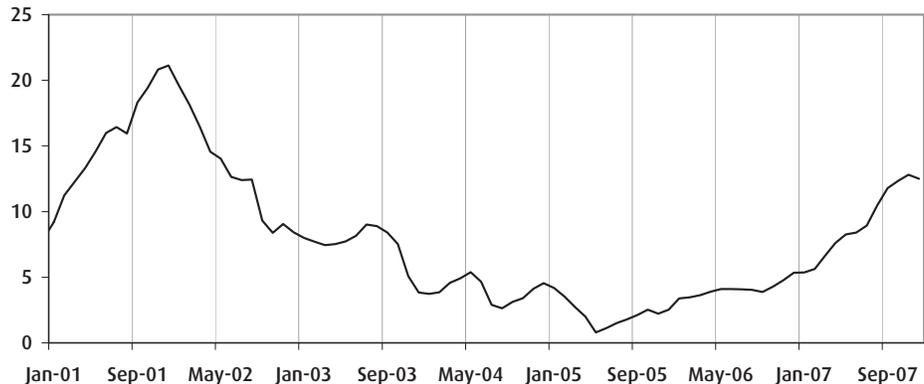
Many, if not most, of those people who now face foreclosure just wanted their share of the American Dream after finding their earlier dreams dashed by the offerings of Wall Street's Shills & Mountebanks.

But "the evil that men do lives after them," and the subprime, SIV, SIV-lite, Cov-lite, and CDO infections continue to impair the health of the international financial system—by handcuffing the Fed, and, to a somewhat lesser extent, other central banks from doing their basic jobs—fighting inflation, and letting the capitalist system work by letting bad bettors lose their money. Forcing Ben Bernanke and colleagues to revive the Greenspan Put, thereby sending gold to record highs, could well spawn an economic plague. Fed Vice-Chairman Donald Kohn, in justifying the Fed's reliquification, spoke of the bad decisions made by financial lenders and borrowers, who did not deserve to be rescued. "At the same time, however," he went on, "In my view, when the decisions go poorly, innocent bystanders should not have to bear the cost."

**US Fed Funds Rate
January 2001 to January 2008**



**Growth in MZM Year-over-year Change
January 2001 to January 2008**



Basic Points

Six months ago the leading Western central banks—the Fed, the ECB, the Bank of Canada and the Swiss Bank—were unanimous that (a) inflationary pressures were rising; (b) they would nip them in the bud by raising rates; and (c) when leveraged lenders and speculators experience pain because of bad bets, to bail them out would be funding morally hazardous behavior.

Sadly, the central bankers have been forced into injections of all-time record amounts of liquidity. Jim Cramer and some other prominent apologists for Wall Street glitterati screamed, “The Fed doesn’t get it,” and demanded bailouts for their buddies who faced demotion from Croesus status to morally cretinous status. The biggest beneficiaries from these bailouts were not overstressed homeowners, but the biggest, baddest, borrowers who had made the biggest, baddest, bets through use of complex derivatives. Imagine if the problem were a financial crisis within the US branch of the Mafia because too many of its overstressed borrowers, no longer fearing cement kimonos due to police crackdowns and jail sentences for dons and *capi*, weren’t paying up. Supplying emergency funding to the Mafia would not be an appropriate Fed strategy, (even though it were shown to have been used to beneficial effect on the economies of Calabria and Sicily on many occasions).

The Fed and its central bank brethren have been forced by the large-scale malefactions of the very rich to reliquify the global financial system just at the time that food inflation is joining fuel inflation as a challenge to price stability. What James Grant calls “Socialism for the rich” is being practiced anew.

Wall Street Meets Main Street

In previous financial crises, the big banks in New York and London were the big story. Most denizens of Main Street watching plunging stock prices wondered what the panics were about. Example: Who—or what—is Long-Term Capital Management?

What happened in this decade is that the Wall Street elites who had profited from the destruction of middle class savings by selling them grossly-overpriced tech stocks apparently decided that the last big asset left for many of those suckers was their home. They found a way to hook up with a wide array of mortgage lenders on Main Street to peddle newfangled mortgages that would entice millions into buying their share of the American dream with little or no money down. For a while, everybody profited from the easy money and easy terms.

The biggest beneficiaries from these bailouts were not overstressed homeowners, but the biggest, baddest borrowers who had made the biggest, baddest bets...



Then the bubbles burst.

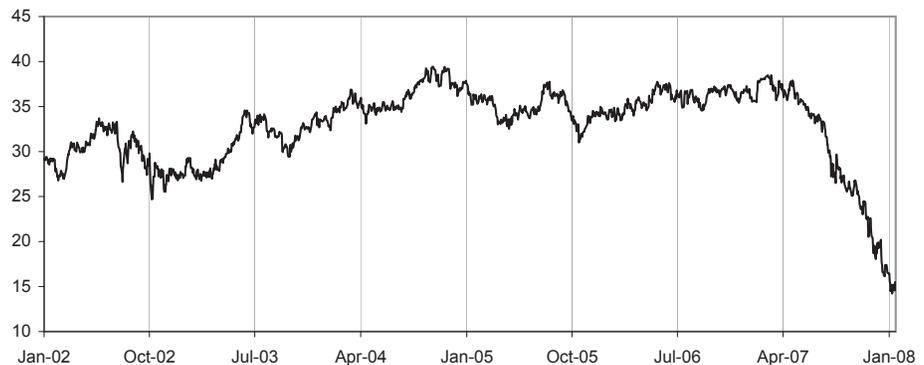
Then the bubbles burst. Although our clients are fully aware of what has happened to the share prices of the big Wall Street banks that created the CDOs and other exotica, many of them may not be fully aware of what's happening on Main Street USA.

Here are the charts for three well-established banks with large home mortgage operations that have a big presence in Chicago:

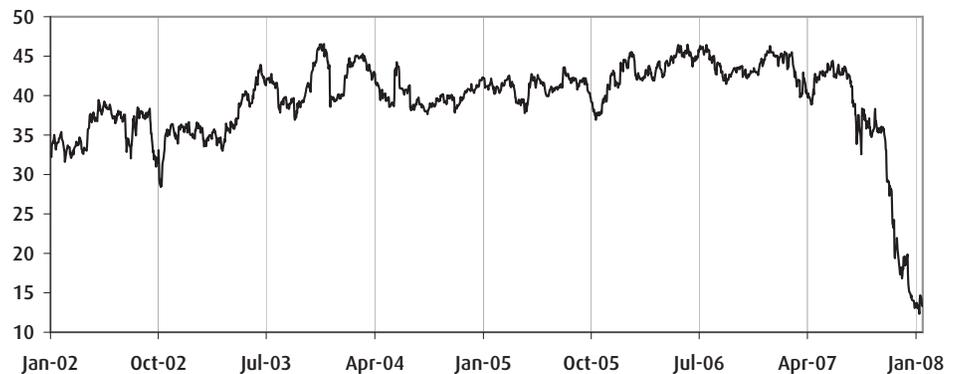
**Fifth Third Bank (FITB – NYSE)
January 2002 to January 2008**



**National City Corp. (NCC – NYSE)
January 2002 to January 2008**



**Washington Mutual (WM – NYSE)
January 2002 to January 2008**



Basic Points

Fairness compels us to note that Wall Street's biggest bettors and their mortgage-lending minions were not entirely to blame. Anna Schwartz, who was co-author with Milton Friedman of *A Monetary History of the United States*, recently told *The Sunday Telegraph* that Alan Greenspan and the Fed were greatly to blame. By keeping the fed funds rate at 1% long after the recession was over, and blaming the liquidity growth on the "Asian savings glut," they were "bound to encourage all kinds of risky behavior," said the redoubtable 92-year-old who still works at the National Bureau of Economic Research in New York. We were so derisive of the Greenspan Fed for so many years—especially during that period—that we didn't think it necessary to revive that argument today. However, since Ms. Schwartz has thrown down the gauntlet, and since we have seen none of her remarks quoted in the US media, we felt that we had to include them here.

...why haven't the other spokespersons for the poor and oppressed gone after the egregious payouts to some of the egregiously disastrous CEOs on Wall Street?

Those Bank CEO Compensation Packages

Although populist politicians rail against the pay packets of CEOs of oil companies, arguing that they drive up gas prices, they have been strangely silent about Wall Street compensation.

John Edwards, whose foam-flecked war cries against oil and pharma companies which "strangle our children" enlivened the debates, gives the Street a pass. That tolerance could, perhaps, have something to do with the fact that he is a multimillionaire trial lawyer and an advisor to the Fortress hedge fund.

But why haven't the other spokespersons for the poor and oppressed gone after the egregious payouts to some of the egregiously disastrous CEOs on Wall Street?

Raghuram Rajan, finance professor at the Graduate School of Business of the University of Chicago, penned a piece for the *Financial Times* that should be required reading for those who actually seek to strengthen the US economy and protect investors and homeowners. "Banks have recently been acknowledging enormous losses, yet those losses are barely reflected in employee compensation," he notes.



...the Lake Wobegon principle—all CEOs are above average.

He then analyzes how financial institutions generate returns. “The typical manager of financial assets generates returns based on the systematic risk he takes—the so-called beta risk—and the value his abilities contribute to the investment process—his so-called alpha.” After explaining how alpha is hard to produce, he points out that a “manager who bought AAA-rated tranches of ...CDO in the past generated a return of fifty to sixty basis points higher than a similar-rated corporate bond. That ‘excess return’ was in fact compensation for the ‘tail’ risk that the CDO would default.... If all the manager had disclosed was the high rating of his investment portfolio he would have looked like a genius, making money without additional risk, even more so if he multiplied his ‘excess’ return by leverage.” He then goes on to note how big bankers blew holes in their balance sheets, after having received big bonuses for their demonstrated genius. It took some months for their folly to show up, but they have not been asked to return their excess payouts for assuming undisclosed levels of risk.

We have long complained about the system of CEO rewards, which pays bosses based on the comparative rating of “independent consultants.” It is based on the Lake Wobegon principle—all CEOs are above average. Boards must, therefore, ensure that all these “above average” get above-average compensation. They must align management compensation with the outlook for shareholders by giving them enough in stock options and bonuses to get them to come to work in the morning and create wealth for the stockholders, who just sit passively on their assets. (Coming to work includes, of course, frequent time on the golf course with other executives, clients and prospects.)

However, that aligning is asymmetric: in periods of robust financial liquidity, when just about any bank CEO who is not a certified dolt can show profit growth above the average for the S&P, the incentive compensations deliver spectacular payouts for those bosses who pushed the risk envelopes hardest. When liquidity contracts, and the real risk they took is exposed, those above-average performers may suffer somewhat—by taking early retirement with wealth that would have staggered their predecessors who mostly retired with moderate pensions, and who passed along the leadership of strong banks with good dividends and good reputations.

Basic Points

CEOs and CDOs have both been benefiting from ratings systems that ensure that nearly every CEO—and nearly every CDO—is topnotch. In both cases, the “independent external ratings” generate big fees for those independent experts. Consider the process at Megabank Inc.; both the CEO and the CDOs it issues and holds, (partly on its own balance sheet but mostly in an undisclosed SIV), are certified AAA, and they live together happily.

Until the defaults occur.

When the unthinkable occurs, neither the compensation raters nor the bond raters are asked to give refunds. Today’s Wall Street barons bet big, using the shareholders’ equity accumulated during the Dark Decades before independent compensation firms existed—when bankers received moderate salaries, stock option plans and bonuses.

Martin Wolf wrote a trenchant essay in the *Financial Times*, entitled “Why regulators should intervene in bankers’ pay.” He thinks bankers have a tendency to cause more trouble than their boards understand:

No industry has a comparable talent for privatizing gains and socializing losses. Participants in no other industry get as self-righteously angry when public officials—particularly central bankers—fail to come, at once, to their rescue when they get into (well-deserved) trouble...Bankers are able to take the economy and so the voting public hostage. Governments have no choice but to respond...These are virtually the only businesses able to devastate entire economies; second, in no other industry is uncertainty so pervasive; and finally, in no other industry is it so hard for outsiders to judge the quality of decision-making, at least in the short run.... By paying huge bonuses on the basis of short-term performance in a system in which negative bonuses are impossible, banks create gigantic incentives to disguise risk-taking as value-creation.

He goes on to recommend that all bonuses be made “in restricted stock redeemable over a run of years (ideally as many as 10).”

We are viscerally disinclined to recommend greater government regulation of the private economy, but the pain being inflicted on millions of US homeowners, and the likelihood of the second straight unnecessary recession (the last being because of the tech fiasco) argues for surgical cures that will still leave the financial system able to compete, to innovate—and to serve.

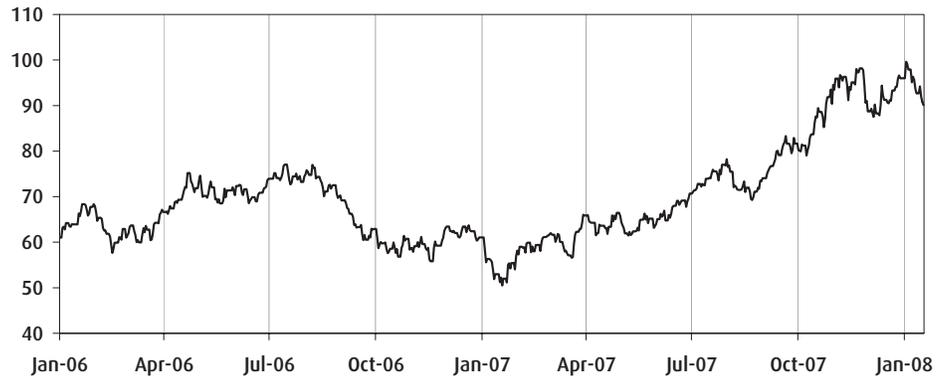
**...both the CEO
and the CDOs...
are certified AAA,
and they live
together happily.**



That Seventies Show?

...history showed that foods and fuels needed to soar together to cause crises.

Crude Oil
January 2006 to January 2008

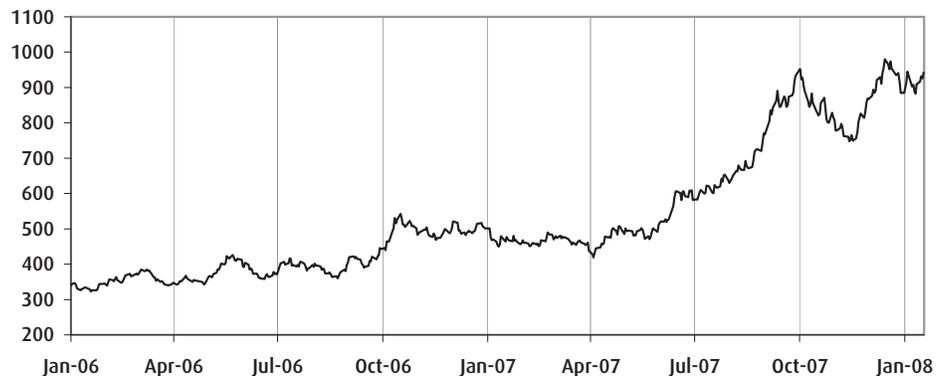


Who would have thought the Dow would be at 12,700 with oil threatening to break \$100? Time was that pundits warned that \$60 oil could trigger a global recession and higher inflation. Then, there were sighs of relief and we were told that \$75 oil would be too painful to endure. Now, \$92 oil has somehow become bearable.

We were never in the camp that high-priced oil by itself would unleash serious inflation. We always maintained that history showed that foods and fuels needed to soar together to cause crises.

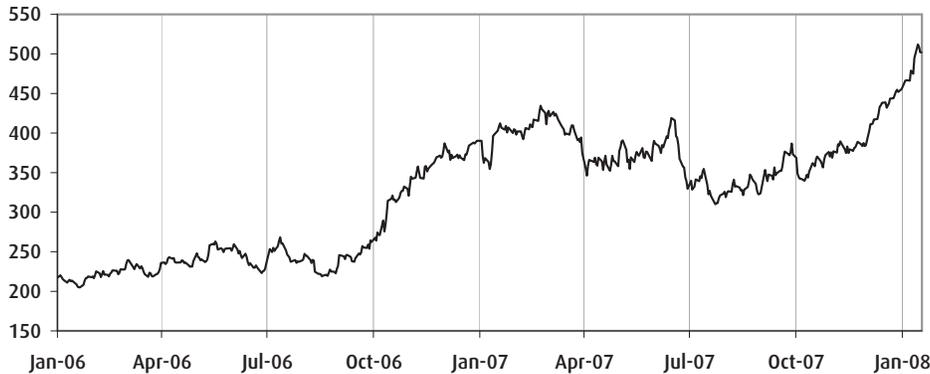
Well, speak of the Devil...

Wheat
January 2006 to January 2008



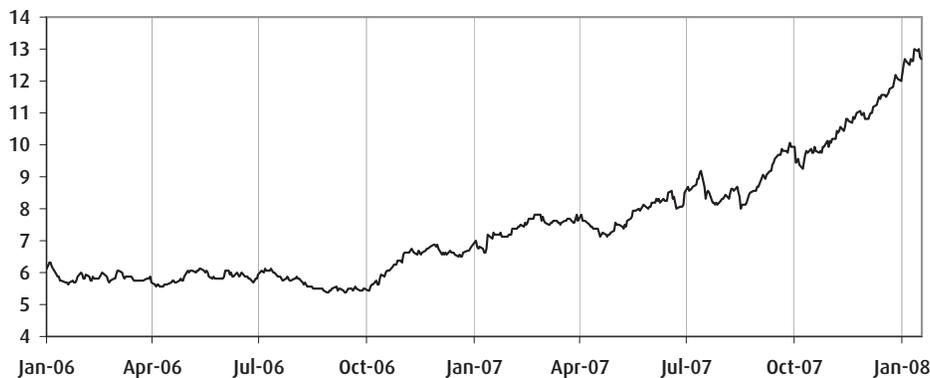
Basic Points

Corn January 2006 to January 2008



**Hubbert's Peak was
little more than the
ravings of a retired
Shell buffoon...**

Soybeans January 2006 to January 2008



Future Prices January 15, 2008

Wheat	Jul 2008	Dec 2008	Jul 2009	Dec 2009	Jul 2010	Dec 2010
	8.50	8.71	8.33	8.47	8.45	-
Corn	Jul 2008	Dec 2008	Jul 2009	Dec 2009	Jul 2010	Dec 2010
	5.32	5.29	5.41	5.01	5.11	5.01
Soybeans	Jul 2008	Nov 2008	Jul 2009	Nov 2009	-	Dec 2010
	13.37	12.85	12.97	12.55		12.85

In oil's case, the economic consensus, as reassured by the International Energy Agency, was that Hubbert's Peak was little more than the ravings of a retired Shell buffoon: There would always be more oil. Oil could not stay above \$35 for long without major wars that slashed exports from the Gulf.



This is beginning to resemble a replay of 1970s stagflation...

How can this be true of food?

The last time food and oilseed charts looked like those, was in the Seventies—and central bankers are once again pumping money into the system at record rates.

This is beginning to resemble a replay of 1970s stagflation: Everything old (and, sadly, bold) is new again for central bankers who believed the global economy had come in permanently from the cold chills of monetary-assisted inflation. Last time, they were printing money in a doomed attempt to insulate consumers against soaring food and fuel prices. This time, they are printing money in what may well be a successful attempt to prevent bank failures, thereby further enriching the greedy elites who created the crises.

Here’s why:

Until now, food crises were regional concerns and/or catastrophes, arising from weather-related crop failures, war or pestilence. With the advent of global free trade during the 19th Century, food shortages in one country were usually alleviated by imports from other countries. Agriculture evolved along the lines of Comparative Advantage enunciated by David Ricardo: Nations emphasized production in foods in which they had a comparative advantage. A century ago, for example, Argentina was richer (per capita) than Canada, primarily because it was a successful agricultural exporter, particularly of beef products.

The FAO reports that the total area devoted to crops worldwide has increased by about 0.3 percent per year since 1961, to 3.8 billion acres in 2002 and growth has slowed markedly in the past decade, to about 0.1 percent per year.

Consider the USDA’s satellite-generated reports on land under cultivation worldwide for the key grains:

World Land Under Cultivation for Grains

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	<i>Million units</i>									
Wheat										
Area (hectares)	225.1	215.4	217.6	214.7	214.6	209.6	217.7	218.4	211.9	216.7
Coarse grains										
Area (hectares)	308.6	299.7	296.8	301.5	293.2	306.4	299.7	300.8	303.6	314.4
Rice, milled										
Area (hectares)	152.6	155.3	151.7	150.6	145.9	148.2	150.5	152.6	152.9	153.6
Total grains										
Area (hectares)	686.3	670.4	666.0	666.8	653.8	664.2	667.9	671.8	668.4	684.7

Source: USDA Economic Research Service, Agricultural Outlook: Statistical Indicators, December 2007: <http://www.ers.usda.gov/Publications/AgOutlook/AOTables/>

Basic Points

Now consider the USDA’s statistics on crop year carryovers of key grains and oilseeds:

World Supply & Utilization of Major Crops, Livestock & Products

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	<i>Million units</i>									
Wheat										
Production (metric tons)	590.0	585.8	581.5	581.2	568.4	554.4	626.8	621.7	593.7	602.3
Consumption (metric tons)	579.1	585.1	584.2	585.4	603.7	588.4	608.6	624.4	617.2	616.5
Ending stocks (metric tons)	207.9	208.5	205.8	201.6	166.3	132.4	150.6	147.8	124.3	110.1
Coarse grains (corn and various feed grains)										
Production (metric tons)	891.0	877.7	862.5	894.1	875.3	916.0	1,015.7	977.5	980.6	1,054.3
Consumption (metric tons)	869.6	882.6	884.2	906.9	903.0	945.7	978.2	991.6	1,009.3	1,056.4
Ending stocks (metric tons)	237.5	232.2	210.5	197.7	170.0	140.3	177.8	163.7	135.1	133.0
Rice, milled										
Production (metric tons)	394.6	408.9	398.8	399.3	377.8	391.5	400.4	417.6	417.6	420.5
Consumption (metric tons)	388.1	399.7	395.0	413.1	407.5	413.0	408.1	415.5	418.9	423.9
Ending stocks (metric tons)	134.4	143.5	147.3	133.6	103.9	82.4	74.7	76.8	75.6	72.2
Total grains										
Production (metric tons)	1,875.6	1,872.4	1,842.8	1,874.6	1,821.6	1,861.9	2,043.0	2,016.7	1,991.9	2,077.1
Consumption (metric tons)	1,836.8	1,867.4	1,863.4	1,905.4	1,914.3	1,947.1	1,994.9	2,031.4	2,045.4	2,096.9
Ending stocks (metric tons)	579.7	584.3	563.6	532.9	440.2	355.0	403.1	388.4	335.0	315.2
Oilseeds (soybeans and others)										
Production (metric tons)	294.6	304.3	313.9	324.9	330.2	335.1	381.7	391.7	406.4	391.3
Ending stocks (metric tons)	34.5	38.2	39.6	41.8	48.1	44.3	56.7	64.3	70.3	54.5

Source: USDA Economic Research Service, Agricultural Outlook: Statistical Indicators, December 2007: <http://www.ers.usda.gov/Publications/AgOutlook/AOTables/>

History’s first recorded story involving large-scale carryovers of grains comes from the Genesis account of Joseph’s grand strategy for Egypt.

History’s first recorded story involving large-scale carryovers of grains comes from the Genesis account of Joseph’s grand strategy for Egypt. When the Pharaoh asked for explanation of his dream about fat and skinny cattle, and grain, Joseph not only explained what these visions meant, but how Egypt could protect itself against the coming future famine.

Egypt was—and is—a uniquely easy place to predict crop failures. The sole constraint on grain production is the extent of Nile flooding. If the Nile fails to swell far over its banks, famine is inevitable.

We now know that the key determinant of that flooding is Ethiopian rainfall during the summer rainy season in the Blue Nile region that begins in Lake Tana and the Atbara River. These two sources supply roughly 90% of the water that reaches the populated portions of Egypt. (The White Nile flows farther, but there is so much evaporation during its long trip to the sea that it is only a minority supplier.)

Joseph told the Pharaoh there would be seven fat years of flooding, followed by seven lean years. Historically, fat years stimulated heavy overproduction of grain, driving down market prices—which has been the farmers’ fate forever.



There is no historic precedent for today's food challenge...

Joseph proposed an elaborate savings program, based on buying grain from farmers and storing it (and, presumably, protecting it from rats). Result: Egypt had grain and was able to supply a portion for exports to other Eastern Mediterranean peoples—notably the children of Israel—when famine struck them.

In modern times, governments have mopped up food surpluses and then competed with each other to dump them abroad. Sometimes, as in US Public Law 480, these morally enlightened programs were used as handouts to fight starvation in the Third World. They also had widespread domestic political support because of the support they gave to US farmers' incomes. There were a few captious critics who pointed out that the free food held down farm incomes in the recipient countries, thereby preventing the development of strong indigenous agriculture. Welfare programs of all kinds are subject to The Law of Unintended Effects. Third World urban recipients of free food were the main beneficiaries, and Third World farmers were the main losers. Urban mobs are—almost everywhere—greater threats to political stability than frightened farmers, as has been the story of France for centuries, where the nation has drafted a multiplicity of splendid new constitutions that are later revoked by Paris rioters.

There is no historic precedent for today's food challenge: despite rising global grain production, documented worldwide carryovers are the all-time lowest in relation to current consumption—at a time of rising demand driven by the sustained increase in the numbers of the new Asian middle classes and, to a far lesser extent, the diversion of grains into energy production.

Almost every OECD practicing politician has known—from the time of his/her mother's milk (or supplement) that agricultural policy is all about the management of surpluses. The Iowa Caucuses are the latest example of this unanimity: only one politician who received measurable votes declared himself against the ethanol subsidies—John McCain—and his vote total was pathetic. The others reaffirmed their enthusiasm for subsidies to produce corn-based ethanol, and for punitive tariffs against Brazilian sugar-based ethanol. Those tariffs are needed because sugar is a staggering eight times more efficient per cultivated hectare for producing green gasoline than corn-based moonshine.

There have been some prominent critics of the ethanol subsidies, such as *Foreign Affairs* and *Fortune*, but they make another kind of mistake: they claim that ethanol alone is the cause of high grain prices.

Basic Points

The only major publication that has identified the new dietary demands of the new middle class in China and India as the progenitors of soaring food prices is *The Economist*, which surprised and delighted us last month with a beautifully-researched cover story proclaiming, "The End of Cheap Food."

The fast-growing Asian middle class who have given the world \$95 oil, \$3.00 copper and \$12 nickel is about to give the world a full-blown food crisis.

Here's why:

1. The supply of arable land under cultivation has not increased during this decade, primarily because of industrialization, desertification and urban sprawl across much of the Third World, particularly China and India.
2. When people by the hundreds of millions switch from a diet of rice and bread to three square meals a day, their protein consumption rises rapidly. That protein can come from dairy products and/or meat. Their physiognomies actually change—they're no longer skinny, and their children no longer stay small. Their caloric intake is transformed—along with their forms. (Form follows bodily functions.)
3. In *all* past periods of soaring food prices, major crop failures or wars were the sole cause. Once the droughts or floods, plagues of locusts, or wars ended, surpluses were again the norm, and food prices collapsed, forcing governments into further subsidies. Example: more than 40% of the EU budget goes into farmers' pockets, because raw food prices have so rarely been far above production costs.
4. Wheat prices doubled last year, and, as we are told (in such media as can find space to write about grains), that surge came because of crop failures in Australia and Eastern Europe. Nobody noticed it when the USDA reported that world wheat production was *up* 1% last year.

Can we trust the USDA? Its data come from a huge worldwide satellite system that monitors production everywhere. That system was first launched by President Ford, and his successor took money from the Defense Budget to beef up (no pun intended) the satellite surveillance. Why? To prevent a repetition of "The Great Grain Robbery," when Nixon sold the USSR virtually the entire US wheat crop in 1972 at \$1.65 a bushel, sending wheat up to \$5 a bushel, and triggering global food inflation. That was economically greater aid to the Soviets than Stalin got in any year under Lend-Lease.

In *all* past periods of soaring food prices, major crop failures or wars were the sole cause.



Either Wal-Mart is about to reconstitute itself as a tax-exempt charity devoted to feeding the poor and the lower middle class, or food prices will climb. Sharply.

5. The US Midwest, which prides itself on being “The Saudi Arabia of Corn,” has had 17 straight years without a significant crop failure—the longest winning streak on record. Although global warming could have contributed to that remarkable record (by lengthening growing seasons in the key northern states—Minnesota, Iowa, Illinois, and Ohio), history tells us that the good years for growing ears of corn don’t last forever. We in the Midwest have more than doubled the Joseph quota for great growing conditions, and are due for a reversion to the mean. When that happens, the world will almost surely face its greatest-ever food crisis.
6. “Greatest-ever food crisis?” Isn’t that hyperbolic? Famine has been one of the Four Horsemen forever. What’s different this time? Answer: In the past, supply pressures came from crop failures or war, and so were *local*. This time, the pressure comes from demand, which is *global*. (To give the reader some idea of the scale of the increase in demand as people get richer, the FAO reports that from 1981 to 2001, per-capita daily protein consumption in the US rose from 99 grams to 114, while in China it increased from 54 to 82. In light of the increase in Chinese incomes since then, that gap will, presumably, have narrowed further.)
7. The ethanol-biodiesel booms are driven by powerful political coalitions that include campaigners for “energy independence.” Brazil, with its vast production of sugar and soybeans, has managed to switch more than 70% of its motor vehicles to alternative fuels. The fact that corn ethanol has become a new example of government farm folly with \$5.00 corn doesn’t mean biofuels aren’t worth pursuing. The world’s shortage of oil is a fact—although one wouldn’t know it from listening to election-year demagoguery. Biofuels from other sources—including animal fats and cellulosic materials—will become increasingly economic. But there is so little well-watered land—and so much demand.
8. To date, the prices of food growing on stalks have soared like tech stocks during the era of another kind of moonshine-driven markets. Although food prices have climbed in many Third World countries—notably China—there has not been full cost pass-through to consumers in North America. Prices for eggs and dairy products are up in North America, but not as much as feed prices. Meat is still priced as if little of significance had occurred. US Grocers and food manufacturers are still eating higher raw food prices, in large part because Wal-Mart—with a 40% market share—continues to subsidize general merchandise sales with cheap food. Either Wal-Mart is about to reconstitute itself as a tax-exempt charity devoted to feeding the poor and the lower middle class, or food prices will climb. Sharply.

9. We are frequently asked whether it is reasonable to include India in this analysis of soaring Third World protein consumption. Aren't most of those teeming millions vegetarians? From our visit there, we learned that vegetarianism is indeed widespread, but many vegetarians consume eggs, fish, and dairy products. Taboos dictate which meats they eat: Muslims won't eat pork, but will eat beef, whereas non-vegan Hindus reject veal or beef, but will eat lamb, pork, or goat.

The Return of Inflation Fears

Food and fuel inflation combined during the 1970s to create a new economic concept: stagflation. Liberal economists, who were dominant at virtually every university except the University of Chicago, said that inflation was caused by capacity constraints and excessive wage demands that would come when fewer than 6% of the work force was unemployed. Monetary policy was virtually irrelevant, and commodity prices would rise only briefly, and then would collapse—as they had since the onset of the Industrial Revolution.

And, by the way, as Lord Keynes had asserted, gold was just a barbarous relic.

Since the days when Friedman, Volcker, Reagan and Thatcher proved that all those tenured economists would have been better employed, as Mao would have, on farms producing real food—rather than in producing tainted food for thought—most central banks have responded to the apparent end of inflation with nearly three decades of dumping their gold reserves. (We recall—with relish—William Buckley's observation four decades ago, that he'd rather be ruled by the first 200 names in the phone book than by the faculty of Harvard. The only development since then that has changed the validity of that observation is that the faculty is much more numerous, but, as Lawrence Summers can attest, collectively no wiser.)

Friedman was skeptical about the usefulness of central banks. We are more charitable: we are merely skeptical about their investment wisdom. Most of them spent all those years loading up on Treasurys and disgorging gold.

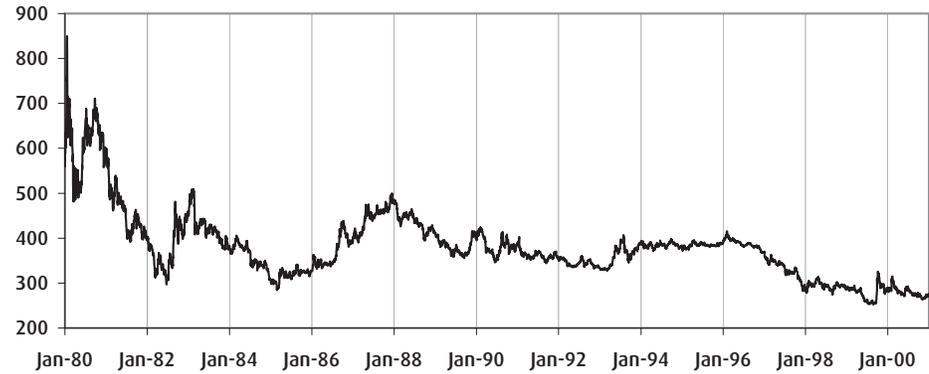
William Buckley's observation four decades ago, that he'd rather be ruled by the first 200 names in the phone book than by the faculty of Harvard.



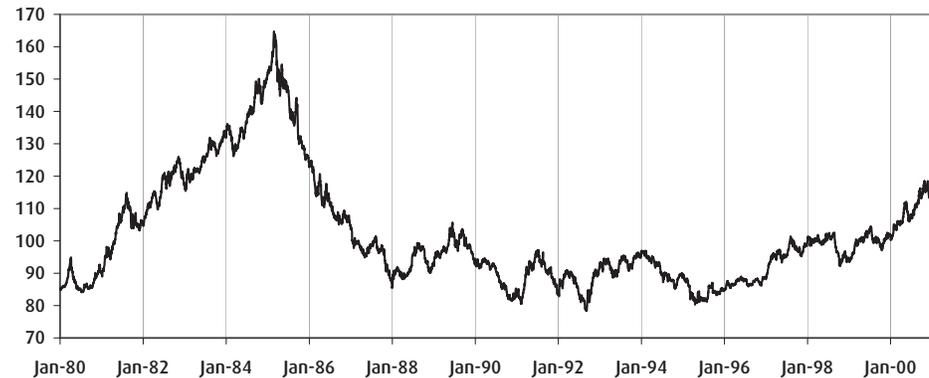
Those policies worked well—for an impressively long time:

And, if so, why?

Gold
January 1980 to December 2000



US Dollar Index
January 1980 to December 2000



The bankers who launched those switches from gold to T-Bills are now in retirement. Presumably, they didn't ask their employers to provide them fully indexed pensions. Or did they?

And, if so, why?

Gold: The New Global Currency?

Gold

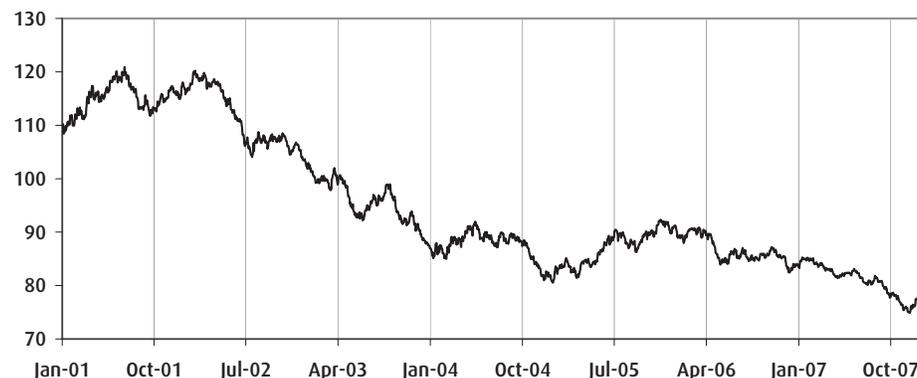
January 2001 to January 2008



...in April, for the first time in more than fifteen years, we recommended investing in gold as a hedge against rising inflation...

US Dollar Index

January 2001 to January 2008



After years of all-out enthusiasm for base metals and tepidness toward gold, we became more enthusiastic after our trip to India (November 2006). Seeing all those rural ladies wearing their dowries in the form of gold bangles showed us how Indian gold purchases could absorb all the central bank selling—and then some. We began recommending an overweight in gold-related securities.

On our return, as we watched the problems unfolding for the dollar, we became more vocal in our support of gold.

Then, in April, *for the first time in more than fifteen years*, we recommended investing in gold as a hedge against rising inflation during the next five years.



The dollar... has become increasingly etiolated, losing ground almost everywhere—even against the Iraqi dinar.

We became very bullish on gold in July, as it became apparent that the CDO/subprime mendacity from Wall Street threatened the financial system. Since then, we have “pounded the table” with recommendations that clients heavily overweight gold stocks and ETFs within equity and balanced portfolios.

As the declines in prices of banking and mortgage stocks accelerated, and the dollar kept breaking through to newer lows, we kept raising our target for gold’s price. Our argument: Gold is the only financial asset that is no one’s liability. As more and more financial assets on more and more financial balance sheets faced downgrades and writedowns, gold would become more and more attractive.

As keen as we had become on gold, we did not predict that one of the two major global financial newspapers would publish a lead editorial proclaiming, “Gold is the new global currency.” The January 8th issue of the *Financial Times* carried that leader, and it doubtless contributed to the \$18 rise in bullion prices that day. The editors stated, “As long as the dollar stays weak, gold’s bull run will last,” and “The US Federal Reserve’s aggressive, rate-cutting response to the credit squeeze has created a risk of a sharp rise in American inflation. That in turn creates the risk of a precipitous fall in the dollar and so makes gold more attractive as a hedge.”

If it is suddenly chic to talk of gold as “the new global currency,” then asset classes that have benefited hugely from the vast expansion of paper money—stocks, bonds, and derivatives—are at substantial risk of downward revaluation. The dollar is the most obvious loser from such monetary retroism. It has become increasingly etiolated, losing ground almost everywhere—even against the Iraqi dinar. (The surprising strength of the dinar may, we note, *en passant*, have a modestly positive correlation to the poll standings of the pro-Surge Republican presidential candidate against Democrats. When Iraq was deemed a hopeless disaster, so was the dinar. As the Surge began to work, the dinar took off. In recent weeks, John McCain’s poll standings have climbed rapidly, and as of January 15th, he leads Hillary Clinton by four points and Obama by two. None of the other Republican hopefuls scores well against either of the Democrat leaders. Admittedly, these national soundings about what voters may or may not do in November are, of course, worth very little—probably not much more than out-of-the-money call options on leading US bank stocks.)

Needed: Recognition of the New Risk/Reward Ratio in Commodity Investing

That commodity stocks have been—by far—the best sector in major stock markets since 2001 is obvious.

This superlative performance has come because the companies themselves have outperformed all but a handful of corporations in this decade.

Yet investors have *still* not re-rated the commodity companies upwards to reflect their superb performance. They have not raised the industries' absolute and relative P/Es, nor have they adopted our valuation metric—unhedged reserves in politically secure areas of the world.

There are several reasons for this sustained caution about the companies that have done the most for their shareholders.

1. These stocks are viewed as “deep cyclicals.” Historically, once the US economy showed signs of slowdown, it was time to bail out of mines and oils.
2. Few of the majors are US companies, which means they receive less Wall Street coverage—and less coverage in US financial media—ranging from *The Wall Street Journal* and *IBD* to *CNBC*.
3. Most commodities have remained in sustained backwardation during the long bull market. Result: Street analysts cite the cheap stuff out there to justify their year-in, year-out insistence that earnings are peaking.
4. The demography of the institutional investor population dictates that few decisionmakers have personal experience with making money on commodity stocks, until very recently. Moreover, many were raised and educated (expensively) to believe that these are dull “sunset” industries. There's nothing cool about them, and, “Hey! the techs are coming back!”
5. The generation of corporate managers in charge of most commodity companies when this bull market arrived was in survivor mode. They couldn't believe that “it was different this time.” *Those who know it best, love it least, because they've been disappointed most.*

Those who know it best, love it least, because they've been disappointed most.



This is why 2008 promises to be the inflection point for commodity stock valuation.

6. The stocks usually sell off even more violently than the broad markets on days of panic selling. Yesterday morning was a vivid example, with major commodity stocks plunging as much as 5% at a time the Dow was down only modestly. Investors who have owned these stocks for even a few months will typically have excellent profits, so when the margin clerks call, they tend to be included in the sell programs. That leading agriculturals would sell off more heavily than bank stocks in a week that grain prices have touched new records shows that many holders are new to this game, and unsure of why they own them.
7. Most security analysis is afflicted with OECD-centrism. “The economic cycle” is the US and Europe. Yes, everyone knows that Emerging Markets are booming, but history shows that when the big economies catch cold, the Third World catches pneumonia. Because of OECD bias, there are strong tendencies in the financial community to look at booming stock markets and economies in the Third World as mere bubbles: the better they perform compared to the closely-analyzed established economies, the riskier they must be, which means investors should assume that their ability to keep bidding up raw materials prices is about to end—disastrously for commodity investors.

This is why 2008 promises to be the inflection point for commodity stock valuation.

Emerging Markets as Emerging Leaders

The US hovers on the edge of recession, and Europe and Canada are slowing down. The consensus among the Prominently Wise—who never warned of the tech bubble that would produce an OECD recession—is that commodity prices and commodity stocks are entering their most vulnerable period.

It takes a gutsy investor to assert that China and India—whose stock markets are certainly frothy—can come through an OECD recession without imploding.

We suggest that equity investors should look at the debt markets’ risk reappraisal: Emerging Markets’ yield spreads over Treasuries have remained remarkably low since the subprime/CDO mess move to Page One, despite all those warning signs about a global financial crisis and a US recession. Most importantly, the spread between US junk yields and EM debts has widened sharply—in favor of EMs.

Basic Points

A skeptic would assert that this is further proof that debt markets have gone crazy, and a crash is inevitable. There have been previous cycles where EM debt became very fashionable and debt peddlers proclaimed a New Era—and they all ended badly.

What is different this time?

People.

The economies of the US, Canada, Britain and the EU have simultaneously experienced huge real estate bubbles, and most of those sufflations have entered contractions at a time of economic softening. The populations of the countries are relatively prosperous, but their average wealth is not increasing by leaps and bounds. In past real estate booms, homeowners could always console themselves with the knowledge that when the fast-growing group of children and teen-agers matured, they'd bid up house prices.

This will be the first real estate contraction since after World War I, which begins at a time of a shrinkage in the numbers of twenty-somethings—the traditional first-time homebuyers. The demographic collapse that began 35 years ago will be a major factor in residential real estate pricing for many decades to come. Thanks to Latino immigration, the US has steadier population statistics than either Canada or Europe, but it too faces relative shrinkage in the supply of first-time homebuyers compared to earlier cycles.

By way of contrast, apart from Russia, the major Emerging Markets have powerfully positive demographic characteristics—hundreds of millions of first-time homebuyers and renters. There are not only more family formations, but the percentage of these nations' populations that can afford to buy or rent is rising even faster. Average levels of wealth are growing by leaps and bounds and it is this new middle class in these countries that has become the price-setting group for most global commodities. That role was filled by North Americans and Europeans in all economic cycles of the last century.

As Chris Patten remarked, for all but two centuries since the birth of Christ, China and India were the world's largest economies. They did not experience the Industrial Revolution until late in the last century. They will be the world's largest economies again within a relatively short period of time.

We suggest that the conventional risk appraisals of advanced vs. emerging economies should be reconsidered.

...the major Emerging Markets have powerfully positive demographic characteristics—hundreds of millions of first-time homebuyers and renters.



Gold prices could leap during a global recession, as they did during the stagflationary Seventies

As long as the EMs continue to outperform the advanced world, investors who own the materials that the EMs need for their growth should experience above-average earnings growth. Once upon a time, US housing starts were a major determinant of copper prices. If that relationship still existed, copper would be trading at \$2, not \$3.25.

In other words, this is the first economic cycle in modern times where stocks of companies producing commodities tied to economic growth in China, India and the Middle East should be inherently less risky than industrial cyclicals tied to economic growth in the US.

The Street doesn't see it that way. Indeed, one reads more and more commentary about high-risk commodity bubbles, and more and more suggestions that this downturn could be for commodity stocks what the 2001 recession was for tech stocks.

We strongly believe that those relative risk appraisals are outdated.

But it may take a US recession to make the case.

Moreover, a broad-brushed dismissal of commodity stocks as high-risk cyclicals says more about the ignorance of the critic than about the comparative endogenous risks within the commodity classes.

- Base metals—the commodities and the stocks—justly trade on the basis of demand from China and India, and slowdowns there would slash prices even if the US somehow managed to escape a recession. So far this year, base metal prices are down quite sharply, as the Street daily publishes charts showing the big breakdown in the Baltic Dry Index and warns that Asian economies must be faltering.
- Oil is also sensitive to demand from those regions, but oil prices are driven more by supply constraints than by demand considerations. The major oil producers are having trouble replacing their production. Example: if Cantarell's production declines continue to accelerate and Gulf of Niger terrorist attacks on oil production facilities accelerate, oil prices could remain very high even if there were a slowing of the growth rate in oil consumption in China and India.
- Gold prices could leap during a global recession, as they did during the stagflationary Seventies. If, as some economists predict, the Fed slashes its rate by 100 bp within the next few months, the dollar's decline could become a rout and gold could cross the \$1,000 mark.

- Agricultural commodities would appear to be almost immune to economic slowdowns. Now that hundreds of millions of Indians and Chinese have become used to a middle-class diet, they would have to experience true economic distress to go back to subsistence diets. With the grain carryover so minuscule, the world should be praying for Goldilocks amounts of rain across virtually all the grain-producing regions of the world. Already, a new kind of protectionism is emerging—autarky *redux*. Russia, India and China have imposed controls on agricultural exports. Grains are already scarce—and will be increasingly expensive, even if US unemployment rates reach 7% and house prices fall 25%. The era of surpluses ended two years ago, although only one candidate for Presidency was both smart enough to notice it and politically reckless enough to draw the right conclusion.

Already, a new kind of protectionism is emerging—autarky *redux*.

The Page One Story Almost Everyone Is Reading

From the time that most Presidential candidates begin their campaigning—unofficial and official—to the actual election roughly approximates the gestation period for an elephant. This could have been the model for the duration of Republican campaigning, but doesn't explain why the Democrats have been in campaign mode for more than a year.

Despite our fascination with American politics, we might have left this topic alone, except that (1) the Economy has become the most important issue in both parties' campaigns, which means there will be promises and accusations made that will have implications for financial markets, and (2) the poor US image abroad is politically-based; if it begins to look as if the next President will be a winner for America's image, that will be good for consumer confidence and for the dollar.

What looked to many political junkies to be an uninteresting Democratic contest now looks like what could be called a barn-burner—except that the primary states where barns are big have had their days in the sun. Hillary Clinton had cast herself as the inevitable choice, based on her record as an effective Senator respected on both sides of the aisle, and on her White House experience—and on the magic of the Clinton name.

But Barack Obama shocked her in Iowa—and nearly in New Hampshire—with the most dazzling display of charm and oratorical skills since the other Clinton—and, perhaps, since JFK.



Until last week, both parties' campaigns were dominated by voters' desire for Change

The Republican nomination is now up for grabs. A few months ago, it looked like a duel between Rudy Giuliani and Mitt Romney. Now, with Romney's win in Michigan, there are three contenders, and the contest could become a muddle if Giuliani wins in Florida on January 29th. The biggest surprise has been John McCain's return after the unanimous diagnosis of the political coroners that he was dead. The other surprise has been the strong performance of Governor Huckabee, who has inherited the evangelical constituency that put Bush over the top.

Mr. McCain is the Republican most admired by Independents and Democrats, who respect him as a true hero with a unique resumé, and a record for standing up for unpopular causes because he believes they are in the national interest. He is unpopular with the Republican establishment, who resent his numerous defections from party solidarity on key Senate votes and have been backing Romney. He has shown he can win primaries where non-Republicans vote heavily, but not in states that restrict participation to registered party members.

Until last week, both parties' campaigns were dominated by voters' desire for Change—however vague or imprecise that wish may have been. To our surprise, the business barons being demonized by Democrats were their party's usual villains—the bosses of Big Pharma and Big Oil—those whose vast salaries cause expensive drugs and gasoline. The scandalous behavior of Wall Street barons was given a pass. Yet each of the CEOs at the banks that have blown the biggest holes in their balance sheets was paid more than the combined compensation of their counterparts at Exxon, Chevron, and Conoco Phillips.)

The anti-business oratory to date has come largely from John Edwards and Governor Huckabee. We may be about to hear a lot more of it.

Now that pollsters affirm that voters don't want to hear about Iraq or energy, but about the housing crisis and the threat of recession, candidates are falling all over themselves with proposals to solve the housing problems and strengthen the economy. There has been a US recession at the beginning of each decade since 1960, so this one is coming early. As the defeats of Nixon (1960), Carter (1980) and George H.W. Bush (1992) showed, a recession is a huge advantage for challengers against incumbents.

Basic Points

In other words, investors are going to have to watch the political news closely.

A deepening recession amid increasingly poisonous anti-business rhetoric is a worst-case scenario—for the nation and for investors.

A modest slowdown amid bipartisan civility and absence of demagoguery is a best-case scenario—for the nation and for investors.

Until very recently, the Street believed a Democratic landslide was almost inevitable. Polls show that is still the likely outcome unless McCain somehow wins the Republican nomination.

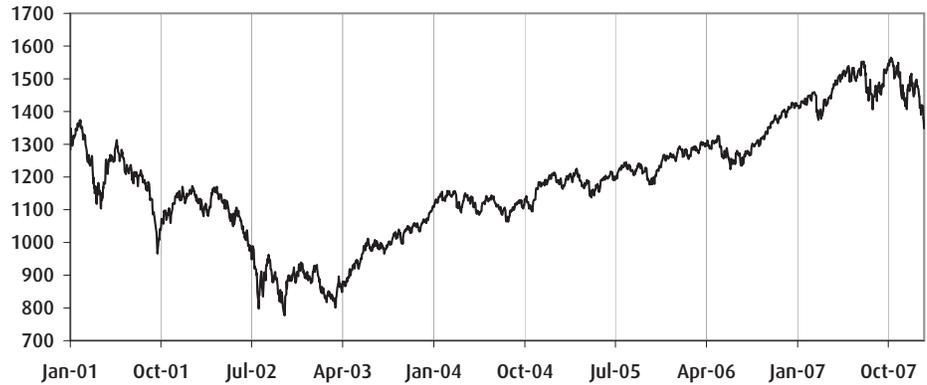
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INVESTMENT ENVIRONMENT

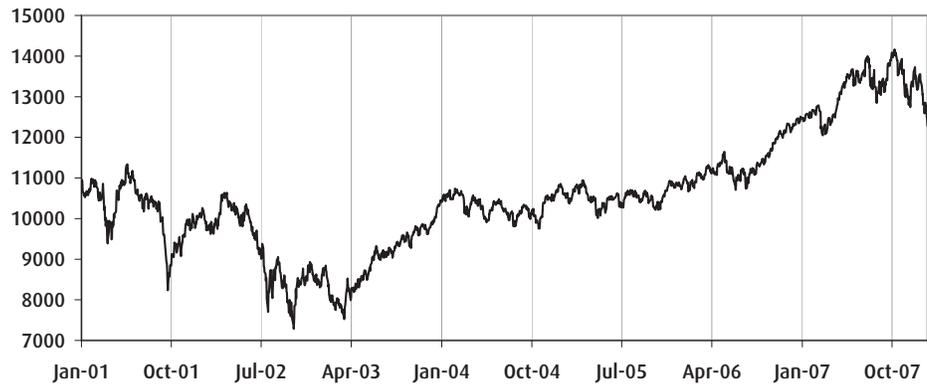
S&P 500

January 2001 to January 2008



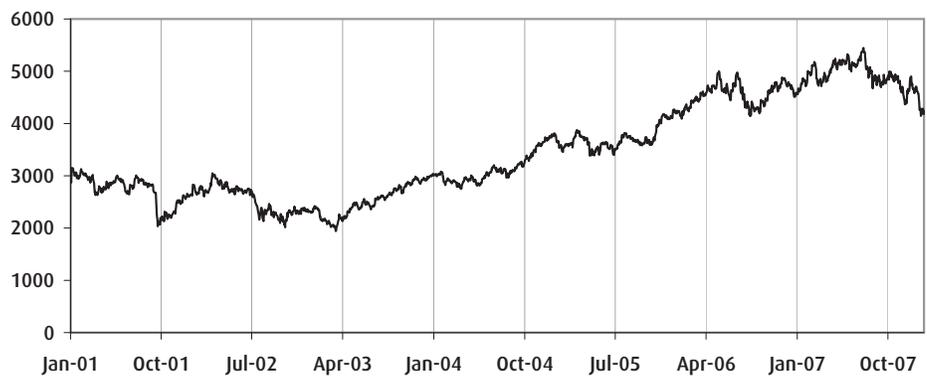
Dow Industrials

January 2001 to January 2008



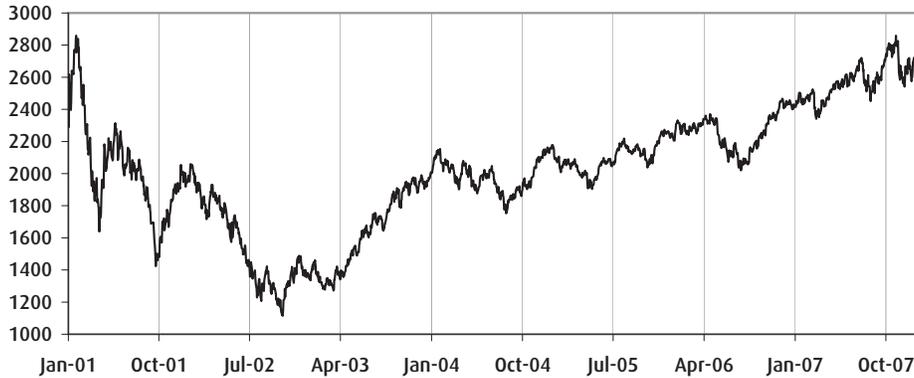
Dow Transports

January 2001 to January 2008



Basic Points

Nasdaq
January 2001 to January 2008

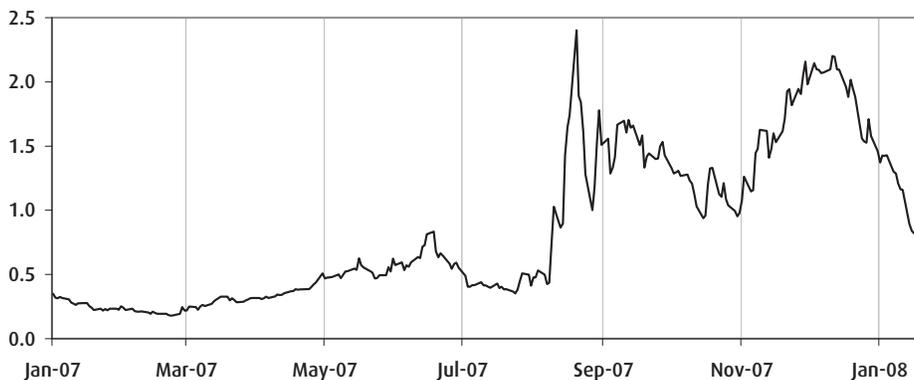


**We will be pleased
if the ultimate
downside doesn't
bring the total
declines to the
25% range.**

It is certainly not too soon to proclaim the onset of a bear market. We will be pleased if the ultimate downside doesn't bring the total declines to the 25% range.

Why are we so bearish?

TED Spread
January 2007 to January 2008



1. After all previous financial crises, the TED Spread retreated to benign levels and stayed there, which meant investors could focus on earnings and dividends, without worrying about disaster. After a record time at bear raid alert heights, the TED has pulled back from its terror level—215—which is where it was on October 19, 1987, but it managed to stay there for a record length of time. That it has pulled back sharply in recent weeks is reassuring evidence that the massive injections associated with the year-end window-dressing of banks' financial statements are succeeding.



Reality: More punishment lies ahead. Serious sinners don't escape Purgatory until they begin to fear Hell.

(Typically, banks with extra liquidity cut back on loans to illiquid banks near yearend, and boost their exposure to T-Bills.) However, the real cost of those emergency injections into the financial ICU has yet to be counted. Nor have the patients been discharged from their IVs—and few of the creators of the pathogens have been discharged from their jobs.

2. Nasdaq marginally outperformed the S&P during the last half of 2007. Three decades' worth of experience with Triple Waterfalls tells us that when the asset class which is in a long-term crash begins to outperform the S&P, that is a warning rally that must fail. It means that there are still strong believers that the good times are a-comin' back. Reality: More punishment lies ahead. Serious sinners don't escape Purgatory until they begin to fear Hell.
3. Gold's leap is unalloyedly bad news for the S&P. When the oldest established store of value is outperforming the standard-bearers of the capitalist economy, hard times lie ahead. Unless we have entered a new Age of Gold.
4. At the moment, the stock market's only fears are for financial stocks and whether a recession will arrive. We think it is going to have to face something it hasn't seen in decades—rising inflation, led by foods and fuels. *That poisonous mix is the recipe for stagflation.*
5. The dollar weakness could turn into a rout if the Fed is forced into all-out panic mode and slashes rates mindlessly at a time of rising inflationary pressures. Foreign holders of US financial assets will not be pleased with the thought that beleaguered Wall Street bankers have seized control of US monetary policy. Jim Cramer might rejoice—but not for long.
6. The US image abroad is seriously tarnished. That has happened before—most recently under Jimmy Carter's stumbling Presidency. There is reason for hope that each party will choose a candidate who will once again surprise the world by demonstrating that American democracy remains vital and relevant. For example, a duel between Clinton and McCain would reassure the world that America was headed for moderate, experienced leadership. It may take a few months to know what the options are, and that kind of uncertainty at a time of a falling stock market and falling dollar would accelerate both those declines.

Basic Points

A year ago, we regarded the subprime/CDO situation as a manageable piece of folly. We were wrong.

Perhaps we are wrong again.

The fact that central bankers' bailouts have been sufficiently timely and sufficiently huge to avert a financial collapse during a period where the TED Spread was shouting "*Fire!*" could mean that stock prices will soon stabilize, and the US economy will not slide into six months of negative growth—the minimum period to qualify as a recession.

One crucial point about the US indices other than Nasdaq: As we have said, over and over, the excesses in this cycle were in the US debt markets, not the US stock market, other than the investment banks, mortgage lenders, and home builders. The US inventory-to-sales ratio hit a new alltime low at 1.24 months in December, and the unemployment statistics are not flashing a deep recession, with unemployment at 5% and claims remaining below worrisome levels. With the US dollar index at 76, the US net trade position is likely to continue to strengthen as domestic demand slows. It is probably already time to start looking for small and mid-cap stocks that stand to benefit competitively because so many important companies were taken over by Private Equity and burdened with excessive debts that weren't used for maintaining or building businesses. Also, soaring farm incomes and farm land prices mean companies tied to rural consumers will be prospering. What's bad for Wall Street and Silicon Valley isn't necessarily bad for all those "flyover states" that didn't share in the tech or investment banking booms.

Perhaps Mr. Obama will sweep to victory as a truly transformative president. Given that currency traders are massively short the dollar, that could trigger a huge rally in the greenback and a \$100 drop in gold.

Perhaps yields per hectare will set new records across the globe in this crop year.

Perhaps OECD economies will slow just enough, and oil production will increase just enough, to send oil back to \$60 a barrel.

We want to be proved wrong anew.

But we don't suggest clients bet their money on those outcomes.

...small and mid-cap stocks that stand to benefit competitively because so many important companies were taken over by Private Equity...



INVESTMENT RECOMMENDATIONS

1. The financial crisis is not centered in stock markets. Its primary locus is in financial derivatives, and in their impact on the stock prices of leading banks. Until the downward drift of bank stocks and the upward drift of derivative debt yields is reversed, the stock market will continue to slide. Keep overall equity exposure to minimums, and emphasize quality.
2. Bond investors face two risks: inflation and credit. Nominal Treasury bond yields are far too low, and quality corporates are too rare—with 71% of corporate debt junk-rated. Buy inflation-hedged sovereign bonds—preferably in major foreign currencies. Simplicity is Good: avoid complex products that are subject to drastic rating writedowns.
3. Commodity stocks are at risk to the extent that the financial frauds and foolishness are able to abort the global economic recovery. A US recession would be good news only for gold stocks. It would be bad news for base metal and steel stocks, and negative news for oil stocks. Agricultural stocks should not be hurt, except that major bear raids will likely spew blood broadly across stock markets.
4. Any panic-driven selloffs in commodity stocks is unlikely to take them off the top performers lists for more than a few weeks. They are not just fair-weather friends. Not only are most of the majors very cheap on a forward-earnings basis, but mining and oil companies which ordinarily search for resources in remote regions will take advantage of selloffs to acquire reserves in politically-safe regions at bargain cost. Coming out the other side of this slowdown, these stocks will experience big increases in their absolute and relative P/Es. Some day, a big SWF is going to decide that bailing out banks isn't as profitable as owning matchless reserves of minerals.
5. Food price inflation should strengthen through the year. It could be offset by broad price declines across the US economy as it struggles with recession, but it is becoming imbedded in the global economy, and will be a challenge for many years. It will produce a full-blown crisis when a major crop failure occurs.

Basic Points

6. The Canadian dollar trades right around parity. It might not climb sharply higher if a US recession is confirmed, because of the impact on the industrial sector and tourism. It remains a fundamentally strong currency, and the greenback remains a fundamentally weak currency. Canadian borrowers should borrow in greenbacks.
7. Gold's move has been dramatic, but retail investors in North America and Europe have not yet shown signs of true gold fever. That means there is still substantial upside. Soaring silver and platinum prices confirm that this gold move is no mere spastic twitch. The expression "As good as gold" in reference to Treasuries and other US debt instruments should be restricted to use as a warm-up joke at investment policy meetings.
8. Defense stocks have solidly outperformed the S&P for most of the Bush presidency. Iraq and Afghanistan have run down a wide range of Pentagon inventories and a new generation of fighter jets cannot be postponed much longer. No matter who wins the Presidency, these companies should continue to prosper.
9. Sovereign Wealth Funds have been buying US banks. Wall Street cites these purchases as evidence of great value in bank stocks. For nations which are overweight Treasuries in their holdings and underweight influence in American politics, swapping Treasuries for bank equities and convertibles makes sense. That does not necessarily mean that the stocks are great value for investors who cannot get other—unspecified—returns on their investments.
10. Use panic days to strengthen your equity portfolio, buying the agricultural, gold, and oil stocks you will want to own after the bear retreats to his cave—and selling stocks that are too dependent on US consumers. Retain your quality base metal stocks: they may well be taken out by other mining companies, or a Sovereign Wealth Fund.
11. The US smallcap bear market may be overshooting because investors haven't analyzed the likely improved competitive positions of companies whose principal competitors were bought by Private Equity or are Canadian or European companies hurt by the weakening dollar.
12. Be like all wise cottage owners: Protect your possessions from Rats.

Disclosure Statement

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