BLUE WATER'S Market Perspective

January/February 2012 Blue Water Capital Advisors, LLC

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We welcome back all of our long-term readers, and in addition we extend a warm welcome to those who are new readers. We will present our usual review of the economy (authored by Wilson), market trends (authored by Sivalingam and Wilson), and a segment on wealth management (authored by Pavlovich and Wilson), and once again a brief discussion of a special topic (authored by Wilson). This time the special topic for discussion will be "The Oil Crisis: Episode Three." We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions.

For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bimonthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions.

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Special Topic:
The Oil Crisis: Episode Three

By Kevin M. Wilson

What's Driving Oil Prices?

I was a petroleum geologist with Phillips Petroleum during the first great oil crisis, back in 1979. It ended in 1986 when prices collapsed due to "demand destruction" (i.e., prices causing people to change their consumption, and causing industry to make more efficient use of energy), and improving political conditions that permitted supplies to increase. This first crisis was triggered by two supply shocks, the first in 1974 during the Arab Oil Embargo, and the second in 1979 as a result of the Iranian revolution and hostage crisis. The second great oil crisis began around 2003 when demand from the booming global economy put serious pressures on the system, causing global spare production capacity to plummet and prices to soar. This second crisis ended in July, 2008 due to demand destruction and the market collapse associated with the Great Recession, which started in late 2007. It now appears, based on higher prices and research work we've seen, that a third crisis may be in the offing. World crude oil production has temporarily fallen by over 1.3 million barrels per day due to political problems or wars in Libya, Sudan, Syria, and Yemen. Today (February 29, 2012), U.S. crude oil is priced at $107.07/barrel on the near-month futures contract, and gasoline costs about $3.58/gallon in Duluth. For comparison with the present situation, on April 22, 2008, just before the peak in the second oil crisis, US crude oil reached a price of $119.90/barrel on the near-month futures contract, and gasoline in Duluth cost on average $3.45/gallon.

The inflation-adjusted (based on CPI) price of oil at its peak in the first oil crisis back in 1980 was $101.26, according to the International Energy Agency (IEA), so we are again seemingly paying a pretty steep user fee for energy that is slowing down overall consumption dramatically, right when the opposite was needed by the world's economies. The question arises as to what has driven prices to such an extreme from what were already pretty high costs a year ago. The answer is complex but worth examining if we are to understand what's happening in global terms. I will try to provide a (hopefully) fairly complete answer to this question. It makes sense to start by evaluating global supply and demand, and then to continue the analysis with an evaluation of the additional factors controlling prices. Worldwide

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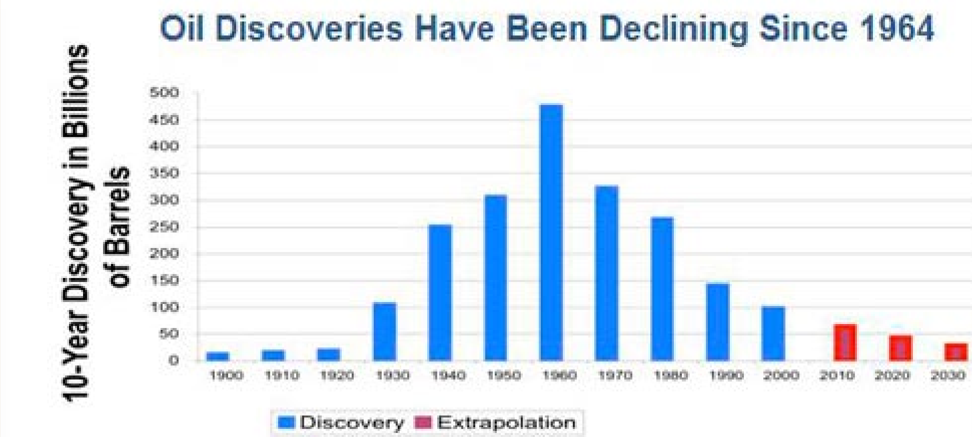
The Oil Crisis (Continued)

oil demand is growing at a pace of 1.1%/year (or 0.98 million barrels/day/year) according to the IEA, and currently we are burning 89.3 million barrels per day. Goldman Sachs, Yardeni Research, and many others believe that this demand is being driven primarily by the growth of developing economies such as those in China, India and Brazil.[24] However, there are also contributions to global oil demand growth from continuing global population growth, but there is decreasing demand from the developed economies like those in the U.S. and Europe. In spite of the modest growth rate for global oil demand, the continuation of the current demand trend will require us to add the equivalent production of a new Saudi Arabia (250 billion barrels) to world oil reserves every ten years or so. This has not happened in the last 20 years, and it is unlikely to happen in the next 20 years either.

The 20-year-long disparity between discovery volumes and burn rates means that we have had to draw down older fields for an extended period of time. Decline rates in the older, larger fields are accelerating, and the production lost due to these declining fields must also be replaced with new sources of supply, compounding the problem. Mexico's Cantarell Field has declined by over 1,000,000 barrels/day in just five years, and other super-giant fields in Kuwait, Saudi Arabia, Alaska and the U.K. have declined by similar amounts. All together we stand to lose over 4.7 million barrels of oil/day of existing production by 2015 due to declines in just 12 older fields, and there are many more that are declining. Recently, Saudi Arabia boosted its production to 9.8 million barrels per day, the highest in over 30 years,[25] Russian production has also risen to nearly an all-time high, and yet economic activity is not robust. Spare capacity is very tight and new production is being added very slowly outside of OPEC. Incredibly, the EIA recently projected future discoveries of 8 times current proved reserves in the U.S., 3 times current proved reserves in the rest of the non-OPEC world, and 2 times current proved reserves in OPEC countries over the next 20 years. There is little geological evidence to support such rosy projections, and even the EIA gives them a low probability. Indeed, the opposite is probably true: we will find ever smaller fields at ever greater expense, and baseline prices will have to rise to support the effort.



Note: World oil discovery over 10-year periods, by Association for the Study of Peak Oil and Gas.

The primary secular trend in crude oil supply can thus be summarized as follows: for the last 20 years we have been burning 25-33 billion barrels of oil (BBO) per year globally (and more almost every year), but have only been discovering 6-15 BBO per year. In the last few years, the discovery rate has occasionally exceeded 12 BBO as reported by the *Oil & Gas Journal*, with exciting deep water discoveries in offshore Brazil, Angola, Namibia, and West Africa. However, this discovery rate will need to exceed 33 BBO per year to halt the declining supply picture over the longer term. In any case it is important to remember that the new fields discovered will take 5-7 years of engineering work before being placed in production, so any new oil crisis will have ended before the major new field production can begin.

There are several reasons for this discovery rate shortfall. According to *Alexander's Gas & Oil Connections*, the world's major oil companies failed to replace their own annually produced reserves with new discoveries for most of the last ten years, in spite of record oil and gas commodity prices. This failure has occurred mainly because there are fewer and fewer good targets left to drill. The lack of targets is in part a political question, since some of the most prospective areas are not open to private sector exploration (e.g., Iran, Egypt, Libya) or for environmental reasons are not open to any exploration at all (e.g., Alaskan North Slope, U.S. East Coast). In part the paucity of targets is due to a natural consequence of capitalism, in that the larger fields were sought and found first, due to the easier economics involved in searching for "elephants". However, all this has left us with only smaller fields left to be discovered now in almost all countries. The exceptions are apparently West Africa, Brazil (where new discoveries indicate a world-class super-giant petroleum province has been discovered), and the deep Gulf of Mexico off the United States. The Arctic Basin is also viewed by some as having huge potential, but there is little evidence yet that this potential is real. All of these discovery areas, even if real, will require huge expenditures to explore. In the case of Brazil, the discoveries are coming in deep water from oil-productive formations lying beneath the Jurassic salt layer, which requires drilling to depths in excess of 20,000 feet at enormous ($100 million per well) front-end expense. Completion and production start-up costs a minimum of $1-$3 billion per field on top of drilling costs. Thus, although Brazilian oil potential may be huge, it is not at all cheap, and prices will have to remain high to justify such risky drilling and expensive production.

The shortage of good exploration targets is also due in part to the increasing nationalization and politicization of oil and gas production in recent years. This has resulted in ever more restricted access to foreign reserves for the majors and other large oil & gas exploration companies. Venezuela, Russia, Iran, Iraq, Libya, Mexico and Bolivia have all kicked out foreign oil companies at some point in recent years, and all have seen substantial long-term declines in production as a result. Additional factors affecting the discovery success rate have included things like increasingly conservative (risk averse) company managements, soaring service and production costs, and historically weak industry re-investment rates for many

The Oil Crisis (Continued)

years following the collapse of prices in 1986.

The results of these four major supply and demand trends (lower exploration success, declining older fields, political risks to production, and increased demand) are finally having an impact on us. I believe we will see the beginning of a global production plateau sometime within the next 5 years, at which point conventional oil prices may increase really substantially (think $250/barrel oil) in the intermediate term. Fear of this event has already crept into the long-term pricing scenarios of the markets, and may once again be responsible for some of the price rise in the last few months. Market forces have already provided the encouragement for a series of technological breakthroughs, such as the successful exploitation of expensive to drill but lucrative oil shale plays in the U.S. (e.g., the Devonian Bakken play in North Dakota). These have turned U.S. production upwards (with 500,000 barrels per day of new production) for the first time in many years, which should ameliorate the problem a bit over time. However, it will probably take ten to twenty years or more to exploit the new U.S. oil shale plays, and during the transition period between now and then there may be a continuing problem.

The Role Played By Speculators

Given the fear present in the markets, there is yet another factor to consider in understanding what's driving prices: the role played by speculators in the commodity futures markets. BCA Research and Deutsche Bank Research have noted recently that cash inflows to energy commodities as an asset class have reached somewhat higher levels this year. However, the amount of combined open interest in the energy futures markets is actually 63% lower than it was in 2008, suggesting that the level of speculation is not really very high. This new money has certainly helped to drive prices higher, but they do not appear to be the main factor driving the crude oil markets. Still, many observers have complained recently in the pages of financial newspapers and journals about the fact that supply and demand fundamentals right now only appear to justify a price of about $80/barrel for crude. I would just point out that straight-line supply/demand charts haven't worked as predictive tools since 2003, so it is unlikely that anyone knows for sure what the price should be. It would seem that we are ripe for a short-term rally in oil prices based on a continuation of the recent price surge, ongoing supply/demand issues, and the partially speculative nature of the run-up. In the intermediate term, the global economic slowdown may end this oil price surge with a substantial drop at some point fairly soon (perhaps by mid-summer).

Yet another factor, which has in fact driven many speculators, is the continuing decline of the U.S. dollar. This has had the effect of pushing oil prices higher over time due to the fact that oil is everywhere priced in dollars, and no one who operates in the global oil market is required to accept the losses associated with a weaker dollar. Right now, it appears that unless there is a worldwide recession to slow demand down, oil (and eventually natural gas) prices will continue to rise over the short- to intermediate-term. It is also important to remember a lesson learned in the first energy crisis during the mid-1970's: oil prices can actually go up in the midst of a deep recession, if supply drops faster than demand, as actually occurred in 1973-75. Indeed, the relative inelasticity of demand is a remarkable feature of the current oil supply/demand regime. For the investor, this brief review of the factors behind the energy sector's surging prices demonstrates that there may be a real opportunity going forward, assuming that the investor is willing to take risks. It nevertheless behooves risk-taking investors to remain wary of the ever-changing supply and demand dynamics of the energy sector, and the role of speculators when investing in it. ■

Market Summary: Solid Fundamentals Weakened by Poor Political Leadership

By Dheenu V. Sivalingam and Kevin M. Wilson

Global equities continue to grind higher, albeit in low-volatility channels that may present heightened risk profiles to many market participants. There are a few important take-aways to consider here: First, this rally is a trader's rally – large institutions, mutual funds, and retail investors have stayed passive or even pulled money out throughout the rally from the October low.[20] Second, this rally has recently shown signs of exhaustion, and the recent highs achieved by the S&P 500 and the Dow Industrials have not been ratified by the Dow Transportation Index, the Russell 2000 (Smallcap) Index, or Treasury bond yields, indicating that a pullback is likely. Third, an important tactical element to observe is that the usual batch of "risk-on" stocks (cyclicals and energy) have been going up the most. This element points to strong underlying buying conviction for the market story pushed by traders. The current rally story is based on yet another dose of central bank (ECB) money-printing, which has made high risk, leveraged trades cheap to do, and set the stage for a more protracted trader's rally. Based on market structure and technical "swing" (turning point) geometry, there is a fairly high probability that any weakness in major indexes will be seen as an opportunity for traders to add to long positions, or to initiate new exposures by market participants. This may lead to elevated index levels in the near term. However, the fourth take-away is that the current low-volatility environment is a complicating factor, because low volatility is a contrarian indicator, suggest-

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Solid Fundamentals (Continued)

ing a correction is likely imminent. (Note that volatility has recently cratered no matter how you measure it: implied volatility from derivatives, short- and intermediate-term historical (realized) volatilities, intraday volatility measures, and range-based measures all tell the same story.)

This type of action – the slow, steady grind higher on contracting volatility – often generates a good deal of complacency, leading to a generally higher risk overweighting by investors on momentum stocks. When there is a decline, regardless of the catalyst, the subsequent selloff can be disproportionately large as “stops” (pre-positioned sell orders) are hit and a cascade of new sell orders drives markets sharply lower. In that regard, the all-time low in short position volumes (in which traders bet on the market going down) recently reported in news releases by TrimTabs, a research firm, underline the huge complacency in the markets at present. Practically speaking, this overweighting of risky assets means that many institutional risk models, which base their internal model assumptions on recent market history, may be understating the risk embedded in current positions. This is exactly what happened in 2008, with significant damage done to asset prices as a result. This does not mean that we expect another meltdown like 2008, but it does mean there may be more temporary downside by far than markets are pricing.[21]

In contrast to the consensus view, at BWCA we have decided to use our maximum permitted level of bond holdings and/or short positions under each investment portfolio’s mandate, in order to hedge our estimates of the downside stock market risk prevailing under current market conditions. Although we’ve made this move early, the only alternative is to do it too late; note that overall market risk at this point is very high, with conditions now amongst the worst 2.5% ever observed in market history.[22] Yet the market could grind higher for months on end in spite of this, making asset allocation decisions very tough. Our cautious stance is very painful right now, which is in part why we think we’re right (i.e., it is always painful to buy low or sell high). As a result of our views about risk, we’ve also maintained only our current minimum permitted equity allocations for each respective portfolio, in spite of the rally, because of the massive asymmetry of the risk/reward matrix right now (i.e., there is little apparent market upside and huge market downside at present). This will change once we get a significant correction, since the stocks on our buy list (which now includes over 120 stocks) will individually pass through their respective buy prices as the market falls, giving us the opportunity to add cheap stocks to our holdings. Though risk levels are currently elevated, the present market structure may offer good opportunities in energy and utility sector names, based on the probability of sustained high oil prices, and this has allowed us to increase our exposure in both of these sectors in most portfolios.

From a U.S. equity sector perspective, we continue to think the best broad sector earnings growth opportunities are to be found in Energy, Industrials and Consumer Services. However, we have made the tactical decision to emphasize high quality (low debt, solid earnings, positive cash flowing) stocks and high dividend-paying stocks in most of the portfolios as an effective way to reduce risk in a potentially challenging market over the next year or two. We have been somewhat cautious on the broad Technology sector, as much of the strength has been driven by a very few leading stocks. However, we will evaluate that strength on any pullback, and may at some point consider adding an overweight to this sector as well. We also continue to be very cautious (substantially underweight) in Financials, and would buy only non-credit risk financial stocks, if indeed we bought any financials at all. Even though the tactical picture supports pursuing short positions in this sector, we are staying away from such aggressive trades due to the nearly unlimited and highly unpredictable support lent to this sector by the world’s central banks. In a continuing deflationary environment, we will maintain allocations of significant assets to defensive sectors like Healthcare, Utilities and Consumer Staples.

In terms of non-U.S. global equities, the recent trend has been continuing EAFE (Europe, Asia and the Far East Index) underperformance relative to domestic equities. A number of tactical factors (i.e., bottoming technical market indicators in reduced volatility environments) support the notion that there could be a sharp rally in EAFE stocks at some point based on volatility expansion. This would be more likely in the event that market perceptions become focused on another overt attempt by the European Central Bank (ECB) to again “kick the can down the road” for most of the European debt issues. This actually seems less likely than it did a month ago, based on political commentary coming from Germany, France, Finland, Ireland, and the UK. However, if each additional stage of the Euro-zone crisis is met by still more money-printing, it will support further rallies.

Our current macro perspective remains the same: As global deleveraging (debt reduction) continues in the developed world and primary developing economies feel lower export demand driven by the current weakness in Europe, we continue to see the main risks facing investors as political in nature, since policy holds center stage. A continued lack of political will in the wealthy world, and continued mercantilism in the developing world, have in combination exacerbated the imbalances in the global economic system. This may very well create the potential for today’s unresolved global debt crisis to act as a major long-term headwind to growth. The very poor leadership in the U.S. and Europe with respect to economic issues will continue to temper the general public’s enthusiasm for spending and investing. The delicate balance between exports and consumption that policy makers in China are attempting to maintain carries significant downside risk as well. Simply put, global fundamentals are still fairly solid, but are now weakening again because global imbalances have not been resolved. This is because global political leadership is so poor.

Wealth Management Commentary:
The Impact of Tax Law Changes on Investments

By Ted A. Pavlovich and Kevin M. Wilson

What effect would expected tax law changes proposed by the Obama Administration for 2013 have on investors? The upcoming presidential election could possibly change this, but for now these tax rate increases will have a tremendous impact on how we look at investment choices in the future. This is because the sun-downing of the Bush tax cuts could substantially impact your net income return on dividend paying stocks. Currently the dividends from stocks are taxed to individuals at a 15% marginal rate (i.e., $15.00 of tax on a $100.00 dividend payment) on your federal tax. This would change in 2013 if there is no extension, reverting back to the old 39.6% tax rate (i.e., $39.60 of tax on a $100.00 dividend payment) at the maximum tax rate. The percent increase in the maximum marginal rate is 24.6% if we simply subtract the two rates (39.6% minus15.0%) but the size of the increase is best calculated by dividing the difference by the lower (existing) rate, which yields a whopping 164% (24.6% divided by 15.0%) increase in your dividend tax owed to Uncle Sam!

The so-called "1%" would finally be paying what Warren Buffet's secretary is paying on her $500,000/year job! Politically this might fly pretty well with some folks, but it would in effect be penalizing older people who rely on dividend income to supplement their retirement. This latter group includes many in the so-called "99%", and most of the successful retired middle class people we know here in the Twin Ports. Note that this calculation doesn't even include the fact that there is double taxation of dividends under the tax code, since corporations pay tax on the dividend before it is paid out to you, the shareholder. The corporate marginal rate is 35%, allowing us to infer that at maximum rates, corporate dividends would be taxed a total of 64.1%.

Qualified dividends, as defined by the United States Internal Revenue Code, are ordinary dividends that meet certain specific criteria, allowing them to be taxed at the lower long-term capital gains tax rate rather than at the higher tax rate for an individual's ordinary income. From 2003 to 2007, qualified dividends were taxed at 15% or 5% depending on the individual's ordinary income tax bracket, and from 2008 to 2012, the tax rate on qualified dividends was reduced to 0% for taxpayers in the 10% and 15% ordinary income tax brackets. In order to be taxed at the qualified dividend rate, the dividend must: 1) be paid between January 1, 2003 and December 31, 2012; 2) be paid by a U.S. corporation, by a corporation incorporated in a U.S. possession, or by a foreign corporation located in a country that is eligible for benefits under a U.S. tax treaty that meets certain criteria, or on a foreign corporation's stock that can be readily traded on an established U.S. stock market (e.g., an American Depositary Receipt or ADR); and 3) meet holding period requirements: you must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock is not entitled to receive the next dividend payment. When counting the number of days you held the stock, include the day you disposed of the stock, but not the day you acquired it.

For dividends that meet the above criteria, the effective qualified dividend tax rate is determined by the date on which the dividend was paid and the individual's ordinary income tax bracket. After December 31, 2012, all dividends will be taxed as ordinary income, and ordinary income tax rates return to those in effect in 2000. The following table summarizes the taxation of qualified and non-qualified dividends in the United States from 2003 forward.[23]

Dividend Taxation in the United States:

2003-07			2008-12		2013-		
A	B	C	D	E	**F**	G	H
10%	10%	5%	10%	0%	**15%**	15%	15%
15%	15%	5%	15%	0%	**28%**	28%	28%
25%	25%	15%	25%	15%	**31%**	31%	31%
28%	28%	15%	28%	15%	**36%**	36%	36%
33%	33%	15%	33%	15%	**39.6%**	39.6%	39.6%
35%	35%	15%	35%	15%	**39.6%**	39.6%	39.6%

KEY
A = Ordinary Income Tax Rate (2003-12)
B = Ordinary Dividend Tax Rate (2003-07)
C = Qualified Dividend Tax Rate (2003-07)
D = Ordinary Dividend Tax Rate (2008-12)
E = Qualified Dividend Tax Rate (2008-12)
F = Ordinary Income Tax Rate (2013-)
G = Ordinary Dividend Tax Rate (2013-)
H = Qualified Dividend Tax Rate (2013-)

Add in the phase-out of deductions and the 3.8% surcharge for high income individuals, and the maximum rate on individual dividend income would be 44.8% in 2013, about three times the rate paid now.

One strategy for adapting to this potential tax increase would be to look at dividend paying stocks that are currently paying a 1% to 3% dividend and have a history of increasing their dividend every year, as opposed to buying a company paying a higher dividend (e.g., 4% to 6%). The lower dividend-paying company could possibly offer you more growth over time, because it will not be paying out as much income as the higher paying stock, and long-term growth is taxable to individuals at lower capital gains tax rates. Next time in this column we will visit the impact of the new capital gains tax law, and how it could affect you as an investor.

Economic Commentary:

Global Slowdown May Trigger Massive Money Printing

By Kevin M. Wilson

European Troubles

One of the members of the so-called "Troika" (i.e., the EU, the European Central Bank [ECB], and the IMF) in Europe has leaked a confidential report to the *Financial Times* on the viability of Greece's economy once the new bailout has been put into operation. The report notes[1] that the Greek program may "remain accident-prone," and the very deep recession in Greece, made much deeper by the Troika-imposed austerity program, may "leave debt as high as 160% of GDP in 2020." Since the putative goal of the bailout was to drop the debt/GDP ratio for Greece to 120% by 2020 (which is nevertheless entirely unsustainable even at this hypothetically reduced level), the Troika has in effect agreed to a deal that will not work. It seems clear that the bailout is really just another attempt to buy time to save Europe's banks, at huge cost to taxpayers in the EU (and some cost to U.S. taxpayers via the IMF), and with the risk of a financial catastrophe for the average Greek citizen. Indeed, very little of the bailout money ($224 billion) will go to the Greek government; instead, the majority of the money will go to cover the costs of giving private investors (banks, hedge funds) new 30-year bonds in a bond swap (with a 53.5% nominal "haircut," or 74% Net Present Value "haircut") negotiated as part of the deal. The banks have probably been saved in the short run by the ECB's massive injection of cheap liquidity into the system under its Long Term Refinancing Operations (LTRO's) in December and February.[2] However, this funding, in spite of its huge size (a combined 1.0 trillion Euros, or $1.32 trillion), is not big enough to effect a permanent solution to the banking crisis. European banks have responded by buying up sovereign debt in their respective countries in what may be one of the better "carry trades" (i.e., cheaply funded leveraged bets on currency or bonds) ever. However, the viability of these trades depends on the value of the sovereign debt holding up, which is a rather heroic assumption in parts of Europe.[3]

Meanwhile, the Euro-zone has probably slipped into a new recession, with 10 countries already reporting negative GDP growth for 4Q/2011. This incipient recession has clearly deepened so far in 2012, based on negative manufacturing indices, rising unemployment rates, and falling banking activity throughout the Euro-zone. Although many expect a mild and short recession, there are two good reasons to expect worse: 1) the new recession is starting out from an already weak economic base everywhere except Germany, with many countries trending far below historic rates of GDP growth for several years in a row, and some already mired in their own deep recessions; and 2) the widespread adherence to austerity programs by Euro-zone governments fighting high debt has cut government spending right at the worst point in the cycle, which will make the recession deeper and longer than expected. Taking the important Spanish economy as an example, we can observe that unemployment in Spain is already north of 22%, it has already experienced negative GDP growth in 4Q/2011 and expects at least -1.5% GDP growth in 2012, its deficit has exceeded the target rate by 33%, and its debt/GDP ratio, in spite of austerity programs, will climb to 84% in 2012 from 70% at the end of 2011.[4]

U.S. Relative Economic Strength To Weaken

Those who would argue that the U.S. economy is relatively strong have a point, but for the wrong reasons. The recently strong U.S. manufacturing and unemployment data have been interpreted as signs of economic strength, but both are coincident-to-lagging indicators and imply nothing about the future. Indeed, it is common to see both measures improving for months in a row right before a recession begins.[5] Weekly initial unemployment claims have fallen for six months, greatly cheering the markets, but it is important to note that this pattern closely matches those in early 2010 and early 2011, both of which were reversed in the spring of each respective year, to great consternation.[6] Furthermore, the monthly unemployment data this year, as presented in the Non-Farm Payrolls report, have been questioned by some due to their unusually large seasonal correction factors, and the job growth they indicate has not been confirmed by tax withholding data.[7] The Goldman Sachs Analyst Index (GSAI), a proprietary economic indicator, has been positive in its last couple of reports; however, some of the components in the index, such as wages, capital spending, and exports, have fallen substantially over the last four months.[8] The economic coincident/lagging ratio published by the Conference Board is an indicator that is very useful at turning points; it has just fallen 0.2 point to 90.9, the lowest reading since May 2010 (just before double-dip fears smashed stocks that year).[9]

A number of authors have noted the fundamental dichotomy between Wall Street's enthusiasm for Federal Reserve and ECB money printing, and the real economy's trend, which directly impacts Main Street. For example, real Personal Consumption Expenditures (PCE) have fallen to a growth rate of 1.45% YOY, the lowest reading since 2007 and at these low levels, a fairly reliable indicator of impending recession[10] (8 out of 10 episodes with this level of reading were followed by recessions; the two exceptions experienced huge bear markets). **Real per capita Disposable Personal Income (DPI) has fallen to -0.73% on a five-year rolling average basis; shockingly, until now disposable income has never been down over a five year period since the 1940's.[11] Quarterly real consumer net worth has fallen YOY on an annualized basis, a phenomenon that has been associated with every U.S. recession since 1969.[12]** In addition, real GDP growth has fallen to 1.62% YOY, a level which has been associated with the onset of recessions in 11 of the last 12 economic slowdowns. Furthermore, real final sales growth, a measure equivalent to GDP minus inventories, has fallen to 1.4% YOY, a level associated with all of the last eleven recessions, with only one false positive.[13] Finally, in an ominous (but not new) sign for Main Street,

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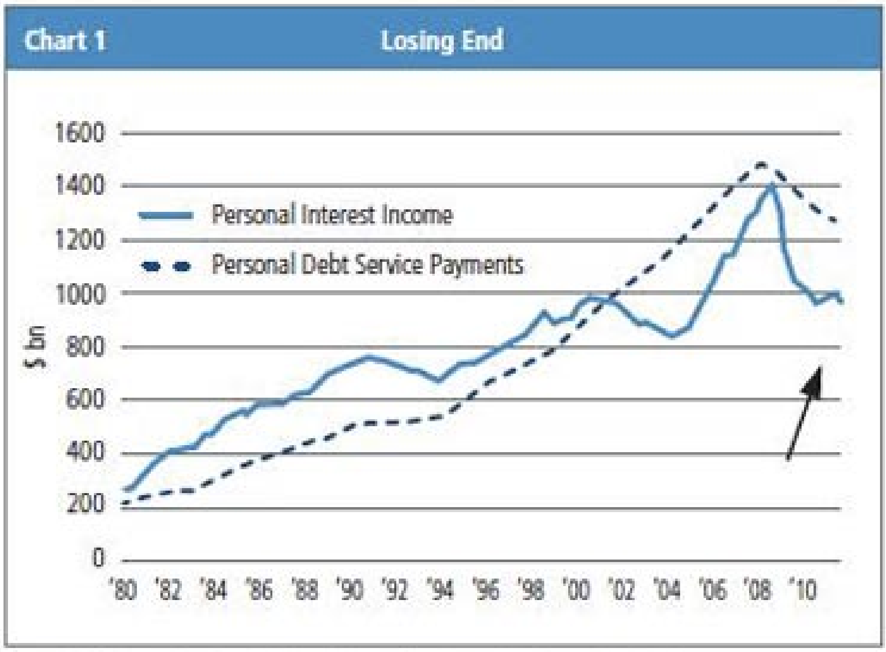
Global Slowdown (Continued)

Personal Interest Income (from savings and investments) has fallen far below the amount needed to handle personal debt service payments, according to famous bond investor Bill Gross of PIMCO (see chart).[14]



Source: Bureau of Economic Analysis, Federal Reserve, Credit Suisse

Global Outlook Negative in the Short Run

Many forward-looking indicators around the world are signaling a substantial slowdown or even a global recession. For example, although most observers believe that China will be able to pull off a "soft landing" for its economy after fighting inflation last year, there is strong evidence that they are struggling. Chinese electricity consumption dropped 7.5% in January, indicating that a huge hit to GDP growth has already occurred.[15] Premier Wen Jiabao recently indicated that the goal for GDP growth going forward has been reduced to 7.5% per year. But the Chinese are currently experiencing the deflationary effects of a massive real estate bubble that is now collapsing, and their bank lending activity is down sharply. They also have over $1 trillion in bad debt, a very low household consumption rate relative to other countries, enormous over-capacity in a range of heavy industries, and a central bank balance sheet that has swollen to a surprising $3 trillion. Chinese fixed asset investment (i.e., buildings, bridges, etc.) has fallen sharply in the last three months, retail sales growth rates have fallen for over a year, and real estate prices have fallen for several months in a row in many large cities.[16] Chinese exports fell 0.5% YOY in January.[17] The Chinese economic slowdown, in combination with other external factors such as the effects of extreme weather, earthquakes, and tsunamis, has already impacted most of Asia. Japanese exports were down 9.3% YOY in January. Exports are also down throughout the rest of Asia.[18]

Looking ahead, there is also great uncertainty associated with U.S. and European national elections, the risk of much higher oil prices, and the risks of war associated with the international response to Iran's pursuit of its nuclear weapons program. There are also falling U.S. profit margins, still-falling home prices, and the perpetual European financial crisis (which will soon spread to Portugal and Spain) to think about. With respect to oil, Brent crude oil prices have remained above $100/bbl. for over 275 days in a row, dwarfing the run of 113 days that Brent crude exceeded a $100 price back in 2008. This is putting substantial pressure on the world economy, and can be expected to reduce GDP a little, even if prices stabilize at current levels.[19] Any significant increases from the recent Brent price of $123/bbl. will potentially endanger the global recovery, making a second recession a sure thing. This issue's special topic delves into the oil question in more depth (see discussion below).

Intermittent Central Bank Money Printing To Continue, Eventually Pushing Markets Up

Given all the negatives with respect to the economic outlook, and given the fact that a fierce money printing rally has already occurred this year, and that the Fed at least is on hold for a while, it is reasonable to assume that we will see a correction very soon, and we have been positioned for one for some time now. Whether this correction translates, instead of something minor, into a major sell-off or bear market depends on economic factors, but also on elevated market valuations, falling profit margins and earnings, and several other factors, as discussed in our market comments below. However, once a major sell-off is in progress, the Fed and other central banks like the ECB, Bank of England, and Bank of Japan will have the political cover they need to again follow their playbook and print trillions of dollars to support markets, provide excessive liquidity and subsidize massive risk-taking by the financial sector, all in the hopes of defeating deflationary pressures. The Fed and ECB in particular have taught markets since 1998 that they can rely on cheap money and massive injections of liquidity every time the market catches a cold, let alone a serious fever like a bear market. This pattern is extremely unlikely to change in an election year.

The ECB has already printed about $2.50 trillion in just the last year, and the Federal Reserve has printed about $0.75 trillion in the same period of time. Overall, the top central banks have printed over $10 trillion since the troubles began in 2007. China, which many believe has no insurmountable economic problems, has actually printed over $3 trillion since 2007. Thus, by the end of the year a much more positive note will prevail in the markets and perhaps in the global economy, due to this presumed next round of money printing. This will only delay the ultimate financial crisis that is expected based on global economic imbalances, but in the meantime it will provide plenty of fresh fuel for the speculative portions of the markets.

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Please attend our next "Monthly Market Review" if you can; we'd love to see you, your relatives, and your friends there. Scheduled meetings will be held at 5:00 pm - 6:30 pm on March 15, 2012 at The Kitchi Gammi Club, Duluth; and on April 19 at a location TBD. If you can attend in March, April or some later time, please RSVP to Blue Water. Business casual attire suggested.

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