Basic Points

"Naught's Had; All's Spent"

May 26, 2011

Published by Coxe Advisors LLP

Distributed by BMO Capital Markets

BMO Financial Group BMO Capital Markets

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Don Coxe

THE COXE STRATEGY JOURNAL

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published by
Coxe Advisors LLP
Chicago, IL

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Basic Points is published exclusively for BMO Financial Group and distributed by BMO Capital Markets Equity Research for clients of BMO Capital Markets, BMO Nesbitt Burns, BMO Harris Private Banking and Harris Private Bank.

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“Naught’s Had; All’s Spent”

OVERVIEW

The long-overdue correction in equities has begun.

As we have been warning clients since February, the sustained underperformance of US bank and financial stocks was clear warning that the overall ebullience of the leading indices driven by zero rates could not continue without support from bullish behavior in the financial sector. Happy Days are Here Again for the Wall Street bosses who, with huge assistance from Congress and the Fed, gave us the real estate bubble and the Crash. Big bankers are getting big bonuses and buying back large quantities of their stocks using cheap government-guaranteed deposits.

If this sharp divergence within US markets were not replicated in other major global indices, then optimistically-inclined investors could argue that the problems are confined to the ongoing necrosis in US banks' balance sheets from the mortgage and derivative disasters.

However, the serious—even existential—risks facing so many Eurozone banks because of the stench of PIIGS' sovereign debts in their portfolios give this pullback a whiff of 2007 with a brand-new level of investor risk—a serious challenge to the Capital Asset Pricing Model.

QE2 is fading, and other OECD central banks are reining in their money growth. Government stimulus programs that made national debts expand to elephantiasis-style grotesqueness are expiring, largely unlamented. Yet CPI growth rates in the US and much of the OECD are shrinking—along with equity prices.

That melancholy outcome of money printing and profligacy explains our choice of title for this issue: these are Lady Macbeth’s words of despair at the outcome of their murderous kingship strategy—they broke the rules to get what they wanted, but this hasn't led to a secure, happy monarchy.

This month we discuss the investment outlook, beginning with the new challenges to the Capital Asset Pricing Model, concluding with the significance of the sharp divergence within commodity markets, as foodstuffs remain strong amid pervasive weakness elsewhere, and the dollar bear market shows signs it may be ending.

We are adjusting our Recommended Asset Mix, reducing equities sharply in favor of bonds and cash. Among commodity stock exposures, we are placing greater emphasis on agricultural stocks—the group with the best risk/reward ratio in a world awash in paper money and short of food.

"Naught's Had; All's Spent"

Why, governments and central banks must be asking themselves, haven't those massive bailouts, handouts and monetary explosions brought us stronger private banks and stronger economies? What can we possibly do for an encore?

Those astonishingly bold interventions of the past three years should have not only worked—but be seen by the voters to have worked.

Now, although economic growth in Europe and the US is slowing, governments are being told by voters and the IMF that they must reduce their deficits, and major central banks' monetary growth rates are set to shrink.

The reasons for restraint differ on the two sides of the Atlantic.

The European banking system has achieved the astonishing feat of undermining the theoretical base for the Capital Asset Pricing Model...

1. The Model Currency Zone Upends the Model

The European banking system has achieved the astonishing feat of undermining the theoretical base for the Capital Asset Pricing Model—the foundation of major pension fund investment strategies. It is a feat in the pension universe of Copernican and Galilean proportions.

Copernicus and Galileo showed how the solar system actually worked—not as Ptolemy and the Catholic Church said it functioned. European bankers, through their imprudent buildup of holdings of dubious-quality Eurozone bonds showed how the European economic and political systems actually worked—not as the Euroelites said they worked.

It is to a wit at Goldman Sachs that we owe the splendid acronym that is at the core of this revolutionary insight: PIIGS.

Until that useful term came along, all 28 members of the Eurozone were deemed equals—or near-equals. The rules of the Basel Accord exempted all Eurosovereign bonds from the capital risk allocation rules that are the foundation of bank ratings systems. A bank that chose to buy a Greek bond allocated none of its precious Tier One capital, because corporate bonds have always been classed as inherently riskier than sovereign credits—according to the equivalent version of the Capital Asset Pricing Model used by the Basel Committee.

The result of this PIIG-headed application of those models and rules was that bonds of Portugal, Ireland, Italy, Greece and Spain yielded less than quality corporates...

That had the crucial advantage for credulous bank portfolio managers that they could buy bonds issued by Eurozone governments whose yield was slightly higher than Germany's and thereby earn higher returns than risk-averse competitors who emphasized credit analysis in their work. The Basel Accord rules exempted all Eurosovereign loans from the capital risk allocation rules that are the foundation of bank ratings systems. A bank that chose to buy a Greek bond allocated no capital, whereas if it bought a Unilever or Nestle bond it had to allocate capital, because corporate bonds have always been classed as inherently riskier than sovereign credits—according to the equivalent version of the Capital Asset Pricing Model used by the Basel Committee.

The result of this PIIG-headed application of those models and rules was that bonds of Portugal, Ireland, Italy, Greece and Spain yielded less than quality corporates...and encouraged those countries to borrow more. Much, much more.

Not far behind sovereign credits under Basel and other long-established Rules were home mortgages, because that asset class had performed nobly for decades. So European banks were delighted to lend gigantic amounts to Spanish and Irish banks which were lending gigantic amounts to Spanish and Irish homeowners, whose home values were soaring.

The first *soupçon* of doubt about Euro-invincibility came when Iceland nearly melted into the sea…but Iceland wasn't a EU member and the borrowers were Icelandic banks.

When the financial crisis hit, European banks needed government support—not because of Continental financial disasters, but because of their huge exposure to subslime American mortgage products.

The real challenge came as Europe was emerging from the global recession, and it gradually became apparent that the governments in the eurozone outliers adjoining the Mediterranean were not participating in the comeback. As details emerged, it became apparent that Greece had used fraudulent financial data to gain entry to the Eurozone, allowing it access to low-cost bond financings on a scale that was irresistible temptation for irresponsible fiscal managers. It was as if Mt. Olympus had been moved to Strasbourg, and Pluto, the god of wealth, were trying to make up for two millennia of lost time.

Greece's most recent experience with internal cohesion, good government and strong international competitiveness came 2335 years ago during the reign of Alexander the Great. Today, it is uncompetitive in almost everything of commercial value except olives, "The Glory That Was Greece" tours to ruins and shrines, and its seascapes and islands.

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Euro vs. US Dollar

January 1, 2010 to May 24, 2011

Greek GDP is barely 3% of the eurozone's, but the euro nearly collapsed in the Greek crisis of 2010 until France, Germany and other heavyweights, working with Dominique Strauss-Kahn and the International Monetary Fund, arranged a series of bailouts and rescue packages for Greece, and, within months, for the next pair of squealing PIIGS—Ireland and Portugal.

There have been some highly-publicized hiccups in recent months, but until last week, most investors had come to assume that there would be no systemic crises until late next year at the earliest, because the Growth & Stability Package that had been hammered together supposedly covered those countries' financing needs until then.

The narrative was that more bailouts might eventually be needed, but they could be handled; what the Eurozone and many of its biggest banks could probably not withstand would be a deep Spanish recession that would force it into the PIIGSty. This consensus chose not to ponder the likely outcome of sustained Spanish youth unemployment exceeding 40% in a country whose banking system was imperiled as the plight of the *cajas* (regional housing lending institutions) worsened.

The euro... is backed only by a theory, and is therefore the utterly perfect opposite to gold and silver— a Keynesian dream and a hard money believer's nightmare.

As recently as May 14th, no gut-wrenching challenges loomed, the euro was firm and gold was weak. The European Central Bank was still backstopping the ravenous demands from banks in Greece, Portugal and Ireland—to the tune of nearly a quarter-trillion euros in credits. The appointment of Mario Draghi of Italy as Jean-Claude Trichet's successor as ECB head had been given community-wide assent, even from the Geermans. Angela Merkel was going to meet with Dominique Strauss-Kahn to put finishing touches on some rules, protocols and programs to keep Greece free from insolvency and still in the Eurozone.

Then something **really** unexpected happened in New York...

The clearest winners from last year's Eurozone's problems with on-again off-again crises have been gold and silver. Each time Greeks rioted, precious metals reached new peaks. When Greeks seemed to be behaving, not rioting, and frantic rescue packages were implemented, amid confident promises about tax collections and better governance, precious metals would sag.

What many investors weren't noticing was that the main force driving precious metals higher wasn't the travails of the dollar, which had for decades been the epicenter of investors' currency concerns. The newest of major currencies had quietly become the newest of currency problems and the newest argument for owning precious metals.

The euro is the first paper currency without the specific, unconditional backing of any government, taxation system, army or navy. It is backed only by a theory, and is therefore the utterly perfect opposite to gold and silver—a Keynesian dream and a hard money believer's nightmare.

When Germans and other Northern Europeans began reading about the true debt and deficit status of the 28 eurozone partners—data that made the 3% deficit limit of the Maastricht Treaty agreement look like The Impossible Dream—they began reviewing their personal financial situations. They had long understood that the eurozone was a professedly permanent partnership, with no provisions for exit—the currency equivalent of the Roach Motel.

As the citizens of the economically strong countries (and citizens with wealth to lose across the entire Eurozone) reflected on their personal financial conditions, they recognized a new, fundamental risk: Their pay-checks, pensions, life insurance, bank deposits, bond investments, and cash were euro-denominated.

What, (they must have begun to wonder) if the euro, which is merely the creation of the intellectual elites, were actually the currency equivalent of the Emperor's New Clothes?

Result: they began buying gold bullion if they could afford it, or coins of gold or silver if they couldn't. The European industry that has been experiencing nonstop demand that forces it to work at capacity week in, week out is minting precious metal coins.

"Take back your mint"?

What can the euroelites do to make these frightened skeptics take confidence and revert to respect for paper money in an attitude shift that could be summed up, "Take back your mint"?

The euro had been strengthening this year and the dollar weakening as speculators thought the US outlook was becoming worse than Europe's—amid robust economic growth in Germany and France. One result: a 6% pullback in gold and a collapse in silver. Those who still thought gold was tied only to the dollar were in shock.

Then came the SofiTell-All IMF story that made the world's front pages. It sparked a gold recovery, even as other commodities—including oil—were still declining.

Gold

January 1, 2010 to December 31, 2010

Gold

January 1, 2011 to May 24, 2011

The IMF, as the flag-bearer for the international economic priesthood is, perhaps, following the precepts of the Papacy...

What may have helped the euro and hurt gold’s recovery rally was Europe's fast action to nominate a replacement for Dominique Strauss-Kahn—Christine Lagarde, France's Finance Minister.

Since the financial crisis hit Europe and America—but barely seared China, India and Brazil, the IMF's brilliant and savvy CEO had been devoting much of his time to arm-twisting Euroelites into rescues for PIIGS and European banks—a task for which Christine Lagarde is eminently qualified. She is a lawyer, not an economist, but that shouldn't be an insuperable handicap because the IMF is reported to be staffed with 3,000 economists.

How could we ever have doubted its forecasts? That must be close to the number of slaves who built The Great Pyramid.

The irony is that France may keep the post it prizes—Managing Director of the IMF—even though the suddenly-departed boss was French, and he quit amid embarrassing circumstances. Europe, by convention, sends one of its finest to rule the IMF, and the US does the same for the World Bank. No other nation among the 187 members in the IMF seems—at the moment—to be in the running, because Europe is rallying around Ms. Lagarde.

The Third World has been making noises that it was about time that one of their representatives was considered for the job that had, until very recently, been mostly concentrated in giving loans accompanied by lectures to Third World countries to manage their finances as prudently as Europeans and Americans. (But that focus shift has been amazing: according to the *Financial Times*, 79.5% of IMF credit outstanding is to Europe.)

The IMF, as the flag-bearer for the international economic priesthood is, perhaps, following the precepts of the Papacy, which had been successful with a solely Italian membership for more than four centuries until the saintly John Paul II of Poland was selected. (One justification for that unanimity could be that the last time the Vatican admitted a non-Italian—a puritanical Dutchman—he smashed the Vatican's superb collection of Michelango nude statues.)

The latest blow to the euro’s credibility came in Sunday’s Spanish local elections, in which the ruling Socialists lost to the center-right Popular Party, receiving their lowest percentage of the vote since the end of the Franco era. Prime Minister Zapatero said he’s going to fill out his term, which expires next March. Yields on PIIGS bonds rose sharply.

Observers say that one reason the euro was hit by the result is that observers believe there has been widespread fudging of local governments' financial reports, and when the real financial situations become clear, Spain's overall government debt level will soar. One widely-practiced wheeze is to stall on payments to suppliers, reporting operating costs on a cash basis only.

Fortunately, there was a buyer of first and last resort—QE2, as traditional buyers were gagging.

Conclusion:

The eurozone will be the focus of crisis fears in coming months, and how the IMF and ECB respond to pending defaults will be the biggest factor in gold prices—and a powerful influence on equity prices.

2. Sovereign Risk Moves West

US Dollar Index (DXY)

May 24, 2010 to May 24, 2011

The Eurozone's problems are not the only existential challenge to the Capital Asset Pricing Model: the bonds at the very base of the risk-free classification in the Model—Treasurys—have come under critical concern since it began to appear that the record-breaking US fiscal deficits won't be seriously addressed as long as investors can be found somewhere in the world prepared to buy Treasurys. Lots and lots and lots and lots of Treasurys.

When Obama's State of the Union speech included no budget proposals apart from the hoary pledge to control costs and waste, and when the Obama budget that followed included no provisions for dealing with entitlement programs—and included higher pay increases for government employees than some analysts had expected, bond managers globally began voicing concern—and selling the dollar.

Fortunately, there was a buyer of first and last resort—QE2, as traditional buyers were gagging.

That the raters remain in business at all is a demonstration of Mr. Bumble's expostulation, "The law is a ass!"

China reduced its Treasury purchases, Bill Gross announced he was not just out of Treasurys—he was short—and then S&P announced that, if Washington didn't do something soon about its multi-trillion-dollar deficits, the US would lose its AAA rating.

In one sense, a downgrade from S&P should be no problem for the USA: what credibility can one assign to such ratings? S&P and other ratings agencies happily assigned Treasury-equivalent ratings to more than a trillion dollars in putrescent derivatives issues masquerading as desirable mortgages. That the raters remain in business at all is a demonstration of Mr. Bumble's expostulation, "The law is a ass!" Friendly judges have dismissed lawsuits against the rating agencies—who were paid far more than their services were worth for saying that the mortgage products they were examining were worth far more than they were worth.

The judges accepted the ratings agencies' arguments that penalizing them for exercising their opinions would unconstitutionally penalize their right to free speech. It turns out that free speech that doesn't come for free, but for fat fees, is as worthy of Constitutional protection as—we were going to say quoting the Bible in public, but that might get an American into *real* legal trouble these days. As a colleague remarked, "If a doctor sent you for an MRI, and it revealed four tumors, and he didn't tell you, you or your heirs could successfully sue him. What's the difference?"

So, according to a series of court decisions, demonstrating, on majestic scale, something between outright sloppiness and outright venality—that was a major contributor to the worst financial crash since the Depression—is protected behavior. Those who relied on those fee-for-service appraisals and then lost hundreds of billions go uncompensated. The investment banks who peddled the putrid products with the AAA ratings haven't been forced to recompense their clients, the Congressmen who used their full power of office to force banks to make loans to borrowers who couldn't service the debts haven't been voted out of office, and now the rating agencies have been given a pass by the courts.

So nobody—not bankers, not politicians, not raters—is legally to blame for the disaster which has already added more than $2.5 trillion to the national debt.

If no Americans are to blame for a financially-caused global recession that began in the US, why should overseas investors trust the US to remain the world's best credit?

We believe it highly probable that the US's fiscal problems will not be seriously addressed for at least two years, and that Obama will be resoundingly re-elected in a campaign demonizing Republican budget proposals. All polls show that most Americans believe the deficits can be eliminated without any cuts in Social Security or Medicare.

We would expect that, in a year or less, long Treasurys will trade at higher yields than many high-grade corporate credits.

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In other words, we believe the Capital Asset Pricing Model is being driven into a ditch by reckless governments on both sides of the Atlantic, and *that* means endogenous risk within pension funds could be much higher than trustees realize.

3. The State of the States' Finances

While investors at home and abroad wring their hands about the parlous state of the nation's national debt and deficits, another set of states with finances in grim states has emerged.

As investors sized up the results of the midterm elections, with their vigorous repudiation of big government programs, and big unfunded liabilities for government employees, they began to conclude that another level of government credit was at risk: state and municipal bonds.

Many Canadian and European investors we meet are astonished to hear that the most of the fifty states and many of the biggest cities have PIIGS-style financial problems.

Apart from the state and local governments' recession-related operating deficits, unfunded liabilities for pensions and health care for public employees are at levels which threaten the solvency of many states and municipalities. Illinois, where we live, ranks at the bottom of the nation for the funding level of its state pension plans, with Pew Center estimates of $54.4 billion underfunding. There is no conceivable way the high-tax Illinois economy can grow fast enough to fund those liabilities.

If Illinois were alone, then perhaps the Obama White House could step in to help its close friends and allies. (Democrats not only have run Chicago forever, but have long controlled the legislature in Springfield, and in recent years have also held the Governorship. Republicans are roughly as numerous and politically powerful in Chicago as Greens in Houston.)

State and local governments account for 13-14% of US GDP—twice as much as the entire industrial sector.

State and local governments account for 13-14% of US GDP—twice as much as the entire industrial sector. Since they are now collectively in shrinkage mode, they will increasingly become millstones 'round the neck of the national economy. The Pelosi-Obama $900 billion stimulus package was supposedly based on shovel-ready programs to build the infrastructure for which communities across the land yearned. The amount actually spent on roads and bridges proved minuscule. But what really did help the economy was the hundreds of billions of dollars allocated to local governments to support jobs for *unionized* employees. (It may be coincidental, but government employees' unions were—by far—the largest funders of Democratic candidates last year, dwarfing the contributions to Republicans from those dark and obscure special interests which dominated media coverage of the elections.)

Keeping many thousands of unionized employees at work meant that the government sector was a source of strength to the economy as it plunged into—and then began to emerge from—the recession. In retrospect, that so many millions of Americans with health care plans and pension plans that were far beyond those in the private sector kept their jobs while millions were losing theirs has backfired on the powerful public sector unions. Ambitious Republican candidates singled out the public unions in their campaigns, knowing they wouldn't get money from them even if they used them as objects of governmental excess. However, the unions didn't get those over-generous and underfunded benefits by themselves: politicians—not all of whom were Democrats—granted them.

With the House in Republican hands and serious attempts to stanch the fiscal bleeding under way, the state and local governments know they won't be getting Washington's easy money to help finance their employee benefit costs.

Worse, the Republicans are demanding that states that issue bonds in the public markets (i.e. all of them) must include full reports of the actuarial soundness (or otherwise) of their benefits plans. This has upset the unions, because the numbers being published are, in so many cases, so scary.

The result of these interactions can be politically explosive. Forced to tell the truth—in many case for the first time—the governments may find their access to public bond markets disappearing.

Conclusion: the municipal bond market is becoming a minefield. We expect many states' general obligation bonds will trade—if at all—at yields far above lower-grade corporates....the next challenge to the Capital Asset Pricing Model.

4. The Financial Stocks' Performance Spells Trouble

KBW US Bank Index (BKX) relative to S&P 500

May 24, 2010 to May 24, 2011

KBW US Regional Banking ETF (KRE) relative to S&P 500

S&P 500 Financial Index relative to S&P 500

Never has so much money been lavished for so long to so few by any government.

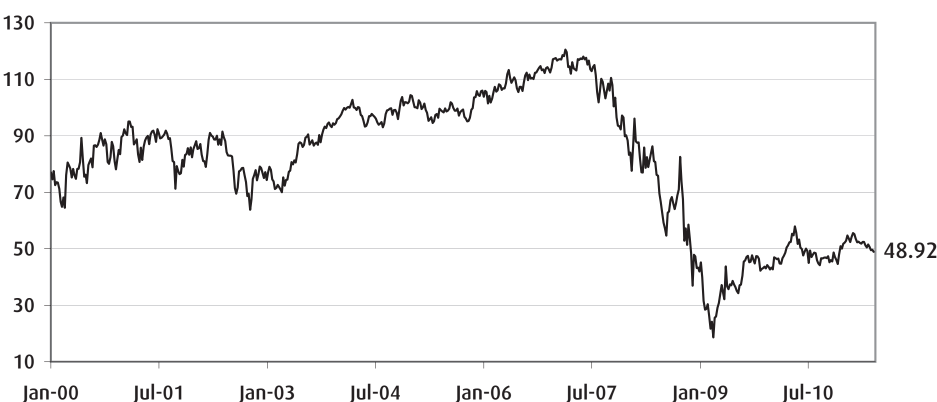
The BKX is the chart for the big banks—the ones collectively known as "Wall Street." The KRE is the chart for regional banks in all fifty states, collectively known as "Main Street." The S&P Financials is a diversified index that also includes insurance companies, money managers and other diversified financial organizations.

We shall soon be celebrating—if that is the correct term—the Third Anniversary of zero interest rates.

Not only have the banks been able to borrow from the Fed at near-zero cost, they have been able to forgo sharing Fed largesse with their customers by paying near-zero rates on their deposits which carry FDIC guarantees—the second subsidy. Never has so much money been lavished for so long to so few by any government. Yet many high-profile bank CEOs, who have cashed huge profits on stock options granted in the depths of the crisis, publicly voice outrage at criticisms leveled at them from time to time by Obama and Congress.

Here's how those big bank stocks performed in this millennium:

KBW US Bank Index (BKX)
January 1, 2000 to May 24, 2011



Many of those banks would not even be alive today without the TARP program, the government-guarantee on deposits with them, and the Fed’s massive creation of zero-cost reserves.

Some major banks have been found guilty of submitting—on large scale—seriously misleading documentary evidence to courts backing their foreclosures—including robo-signed mortgage applications.

This is becoming, from a reputational standpoint, American banking's worst decade.

Bank of America's management, heirs to one the most storied and respected names in American finance, bought Countrywide Financial, the Rosemary's Baby monster child of Angelo Mozilo, and could barely believe how many tens of billions' worth of its loans were underwater from ethical boat-holes that could have been recognized by all but the blind. Why did Ken Lewis, one of the brightest bankers in the land, plunge into this nightmare?

Bank of America's management...bought Countrywide Financial, the Rosemary's Baby monster child of Angelo Mozilo...

Mostly because the bank had gone through so many mergers successfully that it was running up against a federal regulation that barred any bank from holding more than 10% of the nation's bank deposits. Countrywide had vast deposits but its charter was as a nonbank, so BofA could get around that limitation.

Pity Ben Bernanke, Hank Paulson, and Tim Geithner.

These public servants did more for the survival of big US banks than all the top managements of those organizations collectively over the past two decades. They worked (as the book and HBO show, *Too Big to Fail* document) under incredible emotional and time pressures, fought angry Congressmen and right-wing publicists, and saved all but Lehman from collapse. (For deciding that the most tuberculous beast in the herd could not be saved, they are reviled in many quarters to this day.)

TARP worked brilliantly, and the taxpayers will get back most of their money. Yet political critics and TV peddlers of gold still scream about the hundreds of billions of dollars the rescues cost taxpayers.

Thereafter, Ben Bernanke continued the healing with incredibly easy money—a process that will probably have to continue indefinitely, even though it may have passed into the point of diminishing returns.

Congress finally got around to passing complex legislation to prevent a replay of 2008. It let the big banks off surprisingly easily, and let Barney Frank, Fannie Mae, their high-profile Democratic political executives who had been paid hundreds of millions, and the ratings agencies, off altogether. The legislation has turned out to be one of the biggest stimulus packages of the Obama era, because it is so vast and so complex that the legal, accounting and lobbying professions end up with the biggest windfalls of all.

Likeliest outcome: a pall over housing, a stall in new sales, and a fall to even lower depths for house prices.

We were assured by the President in his vigorous campaign for financial reform that the new regulations and controls would rule out bailouts. But by the time the lobbyists had done their work—and the midterm election costs had been suitably addressed with appreciative banking contributions to both parties—the resulting monstrosity has not convinced most analysts or major institutional investors that bailouts have now joined passenger pigeons and dodos on the extinct species list.

Why rehash that horrid history now?

Because unburied corpses and polluted income streams remain as hazards to the financial environment—and investors sense it.

Last week's announcement that April housing starts were down 10% confirmed that the brief uptick in the housing market was kaput. Real estate analysts estimate that half of all existing homes for sale are either foreclosures or distress sales by underwater owners. Since April was to be the month that would usher in the peak home-buying season, the gloom among real estate brokers is palpable. Buyers don't want to plunk down the meaningful deposits now required for mortgage qualification when they see foreclosures driving down values in areas where they might wish to live.

According to *The New York Times*, "the nation's biggest banks and mortgage lenders…own more than 872,000 homes as a result of the groundswell in foreclosures, almost twice as many as when the financial crisis began in 2007…Over all, economists project that would take three years for lenders to sell their backlog of foreclosed homes."

But the situation may be about to get worse. The Attorneys General of all fifty states are united in a campaign to extract $20 billion from the banks and mortgage originators to halt proceedings for the frauds, forgeries and misrepresentations that courts have been finding in foreclosures. That $20 billion would go to homeowners and homebuyers to create equity values for them. The banks are trying to negotiate a much lower settlement. But the Feds are also contemplating proceedings against the mortgage originators and banks, and some state governments are contemplating pulling out of the national partnership to proceed against violators in their own states.

Likeliest outcome: a pall over housing, a stall in new sales, and a fall to even lower depths for house prices.

Karl Rove is the pundit who can always be relied on to express sympathy for banks which are being subjected to firm regulatory procedures, and to heap scorn on Congress, the Administration and bank regulators. He is, incidentally, also deeply involved with various Republican fundraising vehicles. Read any of his *Wall Street Journal* op-eds on the subject of the dangerously punitive regulation of banks to grasp how self-righteous these people can be.

But wise persons have minimal expectations of such scabs on the body politic, and are rarely surprised or shocked by anything they're caught at.

What, one wonders, will it take before they admit that (1) their lending practices were reckless—Ninja loans (no income, jobs or assets) grew even faster as home prices rose; (2) their derivatives packages crafted by PhDs who should have been performing economically useful services to improve American global competitiveness were hopelessly flawed; (3) their ongoing refusal to write down their derivatives and loans to reflect actual market conditions is a denial of basic market principles: what kind of capitalist is it who absolutely refuses to let the market set prices? (4) After the foreclosures began, they found out that vast numbers of their loans were poorly documented or were robo-signed by clerks, and could not withstand judicial scrutiny.

True, they couldn't have done the damage they did without Congressman Barney Frank, and Franklin Raines and Jamie Gorelick of Fannie Mae. But wise persons have minimal expectations of such scabs on the body politic, and are rarely surprised or shocked by anything they're caught at. Investors have traditionally held big bankers and businesspeople up to higher standards.

Ben Bernanke has to be deeply frustrated by the results of more than two years of pumping out zero-cost money to help the banks build bulletproof balance sheets for the next recession—while the bankers shoot holes in his program by launching big buybacks of their insipidly-performing stocks, thereby letting them cash their stock options profitably.

It is an ominous sign for the economy and stock market that bank stocks underperform the S&P consistently despite (1) these massive stock buybacks, (2) zero-cost funding and (3) a steep yield curve that would have made Alana Greenspan proud.

Are we exaggerating? Isn't Citigroup stock trading at $41 when it was only a buck in 2008? Isn’t its CEO getting a big bonus package for his success? Who says there aren’t good times at the Citi that used to weep?

The term "reverse stock split" is, of course, oxymoronic— an adjective that sounds rather like a word that describes big bank management practices during the boom times...

Well, here's the performance of the Wall Street Titan over the past five years, adjusted for a reverse stock split of one for ten:

The term "reverse stock split" is, of course, oxymoronic—an adjective that sounds rather like a word that describes big bank management practices during the boom times when stock splits always went the other way.

When Citigroup was put together by Sanford Weill in 1998, it was the world's #1-capitalized bank.

At its depth, its market cap was smaller than all five of the big Canadian banks.

The Canadians remain among the world's strongest—and Citi doesn't make that short list.

The Selloff

The current equity selloff is not just driven by disturbing economic news in the US and Europe and a slowing in China's growth rate. There is disappointing geopolitical news:

The fear premium in oil is a new tax on the struggling global economy.

1. The Arab Spring that was evoking such joy when we published our last issue has turned into a hot, hate-filled summer.
2. In Egypt, which was the scene of some of history's most moving displays of liberal revolution since the Fall of the Wall, many Coptic Christians are being murdered, and their churches are being torched. The Islamic Brotherhood, which delighted so many pundits abroad by promising not to offer a candidate for the Premiership, now promotes one of its conservative elitists for the top job; it is widely agreed that the new regime will abandon its friendly policy toward Israel, and will promote Shariah Law which forbids Christian participation in government. (Coptic Christians form 10% of Egypt's population, and were protected against Islamist fanatics under the now-deposed and disgraced Mubarak. He and his family now face charges that could jail them for life. Why didn't the US or some other Arab nation accept them as refugees when they resigned? What signal does this give to other beleaguered leaders?)
3. Syria is killing, imprisoning and torturing its subjects on a scale reminiscent of the old, bad Assad, who was, you might recall, the mass-murdering father of the good, reformist Assad.
4. The Libyan non-war drags on and Gadafhi, financed, 'tis said, by vast gold holdings, remains in power. Libyan light crude production is down, but not out—yet, but WTI, which spiked from $86 to as high as $114 when the Libyan crisis erupted remains near $100, while Brent, which spiked from $105 to $125 remains at $112. The fear premium in oil is a new tax on the struggling global economy.
5. In Bahrain, the benign Khalifa regime, though Sunni, has ruled an overwhelmingly Shia ministate for more than a century. It has been one of the most liberal of the Arab states—a sharp contrast to Saudi Arabia. Iran has long coveted it, and its radical imams have been spewing their venom on Bahraini TV for years. Led by Saudi Arabia, the Gulf Cooperation Council (GCC) has moved in troops to quell the protests that strangled the city center. The state of emergency is due to end next week, but at least some of those troops will stay for an indefinite period.

When the biggest commodity story became the public offering of Glencore, we braced for a commodity selloff.

6. Yemen is in a state of civil war. Its leader, Abdullah Saleh, one of the US's crucial Mideast allies, has been in power since 1990. He promised to depart once the demonstrations and fighting stop, but last weekend he not only refused to sign an exit deal negotiated by the GCC, but his henchmen locked up the delegates for several hours. It is unclear who—or what—will succeed him. It is, however, abundantly clear that Al Qaeda of the Arabian Peninsula, which is headquartered somewhere in the Yemeni desert, will be a big winner from the current chaos. Anwar al-Awlaki, the US-born internet-smart revolutionary who was counselor to the Fort Hood assassin and the Christmas Day would-be bomber, may eventually move to the global leadership of Al Qaeda; all it will take will be one more spectacular success on US soil to make him Osama II.
7. Saudi Arabia has responded to the revolutionary situation by lavishing more than $125 billion on its inhabitants. The Kingdom's accounting practices apply the costs of governing to receipts on oil sales. This suggests that the "ideal oil price" of $70-$80-per-barrel cited by the Saudi Oil Minister last year has to be raised to the $85-$95 range—the price of peace in the most crucial Mideast state.

The optimism of winter that was felt by equity investors and young, liberal Arabs is beginning to unravel, and the risk level in a crucial section of the world will remain elevated.

The S&P Forms a Top

As economic growth slows almost everywhere, those optimistic earnings projections look less and less achievable. Eurozone's flash PMI came out below forecasts this week, with some manufacturers reporting slowing demand in exports to emerging markets. Equities are responding to the bad news, rather than merely flying in response to the easy money.

What does this mean for commodities—the only asset class that—so far—is widely claimed to be crashing?

"The Commodity Crash"

When the biggest commodity story became the public offering of Glencore, we braced for a commodity selloff.

Not only was this a gigantic offering, which meant many investors would reallocate some of their commodity exposure into Glencore stock, but the

new narrative was that, since these heirs to Marc Rich were the world's smartest and most successful commodities traders, if they were selling now they must believe commodities are peaking. (Until then, the only basal fear for commodity investors was "If China is peaking, duck!")

So the smart strategy suddenly was to emulate these slick geniuses—and sell commodities and commodity stocks. It helped that the overall equity markets were also showing signs of acrophobia.

Some commodities have been spared this Glencarnage.

To date, that reasoning seems to be validated.

Of interest and (we confess) amusement to us was that, although Glencore was supposedly almost as heavily oversubscribed as LinkedIn, it traded at a discount within days. Marc Rich's impudent powers may have dwindled a dozen years after Bill Clinton gave him that scandalous last-minute pardon for a million bucks and a few useful connections with dictators in commodity-producing countries. (For the record, we note that Glencore and Xstrata managements deny any connection or involvement with Marc Rich, and we have no evidence that he has been directly involved in those companies for many years since he sold out his position to them. They are, it seems, just near-neighbors in an idyllic Alpine setting right out of *The Sound of Music.*)

Which Commodity Group Has Fared Best Amid the Worst Commodity Market in Two Years?

Some commodities have been spared this Glencarnage.

The Page 16 story of the tumultuous second week of May was one line in the US Producer Price Index for April: "Crude Foods and Feeds year-over-year inflation rate 30.1%."

That is a Seventies-style number.

Back then, crude food prices took off first, (after the collapse of the anchovy catch due to the giant El Niño, and some weather-induced grain crop failures), followed shortly thereafter by food inflation at the consumer level. Then came the oil shocks and the excessive monetary expansions as governments tried to offset the price increases of foods and fuels.

We have been warning clients that food commodity price leaps were ominous signs that pervasive fears of deflation would turn quickly into new fears of inflation.

II. Foods and Food-Based Fuels

Corn

January 1, 2010 to May 24, 2011

Soybeans

January 1, 2010 to May 24, 2011

Wheat

January 1, 2010 to May 24, 2011

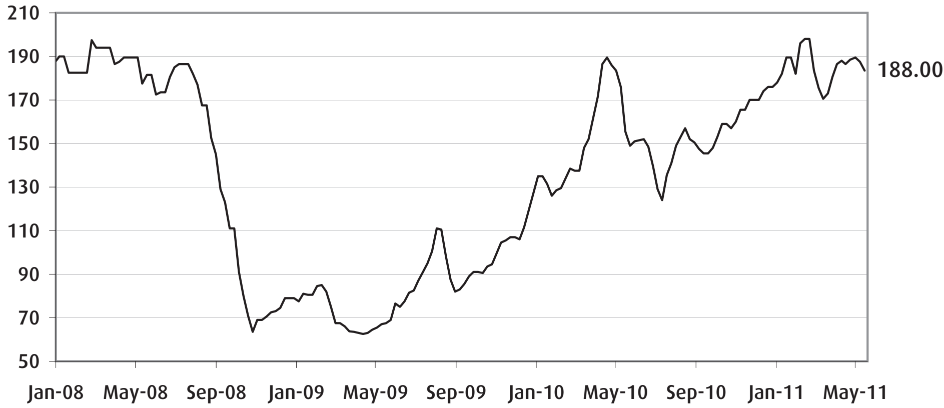
It may seem ironic that we are discussing commodity-driven inflation at a time commodities have been experiencing sharp corrections. Most commentators have focused on the big selloffs in oil and silver as proof that "the commodity boom is turning into the commodity bust."

This is roughly the twentieth time since the commodity boom began that big names in the stock markets have published commodity obituaries. Each of these deaths (apart from the capital markets crash of 2008) turned out to be a reprise of the funeral of Tom Sawyer. It took much longer for commodities and commodity stocks to recover from the Crash, but once they emerged from their crypts, most of them took on new lives of their own:

Most commentators have focused on the big selloffs in oil and silver as proof that "the commodity boom is turning into the commodity bust."

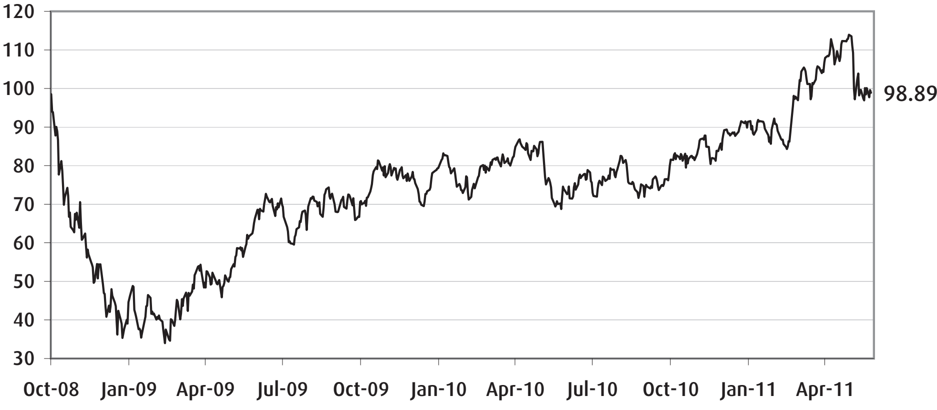
Copper
October 1, 2008 to October 1, 2010

Iron Ore
October 1, 2008 to October 1, 2010



Gold
October 1, 2008 to October 1, 2010

Oil
October 1, 2008 to October 1, 2010



The CRB Futures Index gives the overall commodity story from then to now:

RJ-CRB Futures Index
October 1, 2008 to May 24, 2011

Most economists deride the possibility of commodity-driven inflation, noting that in the 1970s, commodity price boosts were passed through to the broad economy through outsized union wage boosts, and today's heavy overburden of unused capacity in leading Western economies would rule out wage pressures.

We consider it likely that food inflation will prove to be more pernicious and durable this time than in the Seventies.

Although the US experience of unionization over the past four decades does not apply to much of the Eurozone, it is instructive: today, government employee membership in the AFL-CIO greatly exceeds private sector union membership.

This time, if commodity inflation is to work its way into prices of manufactured goods within the OECD, it must come mostly from the new global price-setters in Asia.

These nations are experiencing serious food and, to a lesser extent, fuel inflation, and their Consumer Price Indices are heavily food-weighted. Example: Food has a 35% weight in Chinese CPI, and that powerhouse has suddenly become the global leader in labor unrest that triggers large wage increases. Truckers have been shutting down Chinese ports, demanding price increases to cover fuel inflation. China's export prices have been rising for months—both as higher prices within China and because of the slowly strengthening yuan.

We consider it likely that food inflation will prove to be more pernicious and durable this time than in the Seventies.

Why?

Because, back then, food shortages generating food inflation were almost entirely caused by weather or crop diseases. Today, we still have problems with weather disruptions in key grain-growing regions, but pesticides and herbicides have dramatically reduced crop losses of earlier times. However, we now have man-made assaults on food supplies, and they have every indication of being both dangerous and durable. Politicians cloaking their personal political greed in green garb could easily create food shortages of Biblical proportions.

Ethanol's Share of US Corn Grows as High as an Elephant's Eye

The US leads the way in generating politically-created food inflation, because more than 30% of US corn is being allocated for ethanol production.

Ethanol was originally developed as a made-in-America way to protect consumers from OPEC's power.

Ethanol was originally developed as a made-in-America way to protect consumers from OPEC's power. The argument went that by producing home-grown, envirofriendly renewable fuels, gasoline prices would no longer be totally dependent on crude oil prices.

Since corn was nearly always in surplus, that meant that instead of enriching those greedy Arabs and oil companies, ethanol would protect family farms. Who could object to that—apart from those of us who decried the unsubtle racism in that formula?

As it happened, no Presidential candidate could.

Not since Jimmy Carter demonstrated that the shortest route to the Presidency lay through Iowa.

Mr. Carter was the politician who changed American political dynamics by coming out of nowhere to finish second (to "uncommitted") in the Iowa Caucuses in 1976.

His surprise performance became the springboard that catapulted him into the unofficial lead, and he went on to win the first real primary in New Hampshire and eventually the Democratic nomination. Since then, most wannabe Presidential candidates have braved Iowan winters to try to put themselves into a leading role before any of the important—and expensive—primaries arrive. Praising ethanol makes great sense in the nation's #1 corn-producing state. (We are therefore really impressed that Tim Pawlenty, from corn-producing Minnesota, chose Iowa to announce this week that it was time to scale back on ethanol—and wish him well.)

Al Gore, until recently viewed by the Most Influential Elites as one of the greatest politicians in the history of Western Civilization, has recently admitted that he gave the Environmental Seal of Sanctity to ethanol largely for political reasons. To us, this confession was quite probably the noblest act of his political life, although it may have produced gas pains among the members of the Nobel Peace Prize Committee, who seem to be experiencing some problems with their policy of doting on Democrats. (Obama's Peace Prize after 11 days in office was not discussed in any of the commentaries about his takeout of Osama—a superb operation that sold extremely well in Oshkosh, if not in Oslo.)

Ethanol from corn or wheat has *never* proved economic, despite decades of encomiums from the alternative fuels industry. Washington imposes hefty tariffs on competition from efficient sugar-based ethanol from Brazil, which won huge punitive damages from the US at the WTO after protracted litigation. It was the most conspicuous modern example of unfair US trade practice, and an embarrassment to all US attempts to rein in uncompetitive practices from such trade rivals as China. Many American export products in fields unrelated to agriculture or energy have been priced out of the fast-growing Brazilian market to pay for ethanolitis.

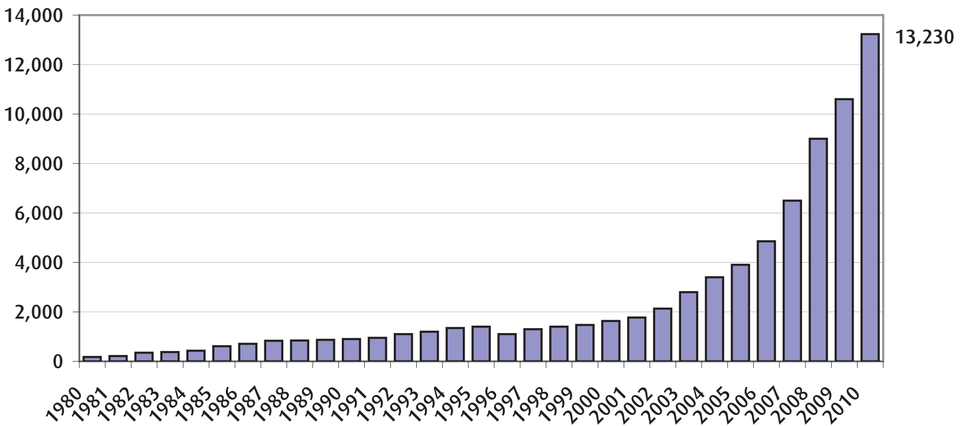
Ethanol from corn or wheat has *never* proved economic, despite decades of encomiums from the alternative fuels industry.

Nor does Washington's passionate solicitude for the corn belt end at the Tariff Wall. It also forces oil companies to include—at great cost—ethanol in a large and growing percentage of all US gasoline; it's currently 10% of the fuel Americans buy at the pump but it's headed for 15% by 2015—or even sooner if Obama's EnviroAmazon Carol Browner gets her way. (The Environmental Protection Administration has announced it is considering forcing the oil industry to install pumps with 15% ethanol for all cars manufactured after 2010, despite evidence that higher ethanol levels hurt car engines. In making this announcement, the EPA called ethanol "home-grown fuel.")

Even tariffs and mandates aren't enough for the Washington/ethanol conspiracy against free trade to achieve its goals: there are also many billions in subsidies for the ethanol industry.

All that aid from Washington has certainly made ethanol important to the Corn Belt:

Historic U.S. Fuel Ethanol Production
1980 to 2011 (millions of gallons)



Source: http://www.ethanolrfa.org/pages/statistics; The Renewable Fuels Association (RFA)

Result: The latest conspiracy theory about food inflation is that it's all due to commodity speculators.

The outlook for US ethanol has changed dramatically because Brazil's enormous success in sugar ethanol, with more than three-quarters of its growing automobile population consuming it, has meant that Brazil is now actually importing some US ethanol—70 million liters last year when sugar crops were disappointing. This is the modern equivalent of Newcastle importing coal.

Only some of the corn is consumed in making ethanol (50% of the kernel is starch) whereas sugar delivers a far higher conversion rate.

Result: Brazil's biofuel industry is an efficient marvel, while the US industry is a big contributor to soaring global food prices by sequestering so much corn for motor fuel. If those tariffs and subsidies went away, corn prices would fall sharply, as would—to a much lesser degree—prices for soybeans and wheat. But with 200 ethanol plants operating across the Midwest, ethanol has now worked its way into the fabric of the economy in too many states for Congress to revisit its folly.

The Commodity Investors and Speculators

Ethanol supporters are eager to blame anybody but themselves for skyhigh grain prices. They—and various consumer organizations—have been telling Washington that what's needed is investigations into grain speculation.

Result: The latest conspiracy theory about food inflation is that it's all due to commodity speculators. This time it isn't OPEC that's the villain, it's the CME and its counterparts.

It is true that institutions have invested enormous sums in commodity funds—notably the Goldman Sachs Fund—which roll over their futures exposures as front-month contracts mature.

Foodstuffs are not heavily-weighted in these funds, so it is unclear how much food prices are elevated from financial effects—rather than basic supply and demand. As more and more investors realize the futility of the commodity roll funds in a contango environment, the amount of sequestered food should shrink.

However, outright speculation in commodity futures could possibly become an inflationary process when food demand reaches—or exceeds—current production. The large scale of corn, wheat and soybean contracts on the CME might have had some influence on food inflation. However, the leap in open interest came after (1) Putin embargoed wheat (on a recommendation from Glencore, which was long wheat contracts—according to published reports), and (2) the US corn crop failed to live up to expectations. Speculators sold precious metals contracts to buy grains, and these herds of financial bovines doubtless drove prices higher than short-term supply and demand would have dictated.

The most obvious reason why corn and soybeans are in such demand is that not all the world is vegetarian.

As of last week, they were net short of wheat; we have not heard praise for their contribution to lower food prices.

Before Congress and Justice Department get too involved in demonizing futures markets, let's remember the basic reason why grain futures were developed and continue to exist: because they are crucial capital suppliers to farmers. There are, for example, only two contract maturities annually for US corn—old crop and new crop. Farmers need to have vehicles for hedging their risks when they purchase inputs, and to protect themselves against late season sell-offs should crop yields exceed expectations. The other side of farmers' forward sales is either food industry companies hedging their own risks or speculators. Speculators and industry hedgers are therefore the major external risk capital suppliers to farmers.

The reason corn prices doubled is that demand for feed and fuel continued to rise, while the US corn crop came in well below expectations.

The principle is called supply and demand.

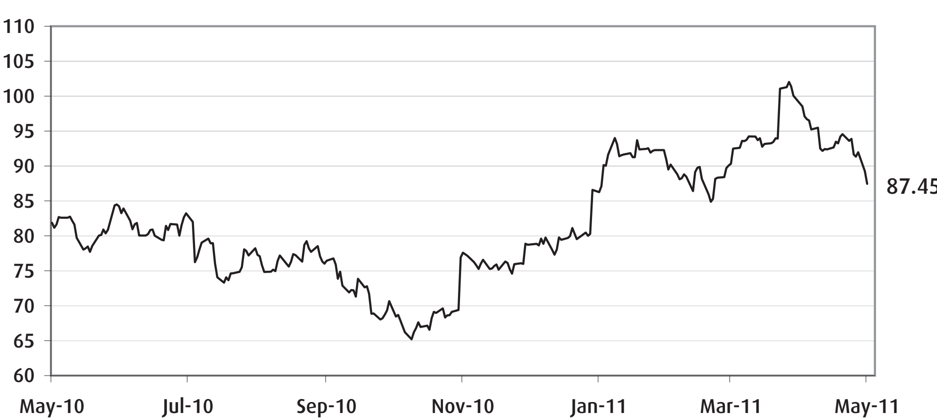
The most obvious reason why corn and soybeans are in such demand is that not all the world is vegetarian.

We saw the impact of higher-protein diets among even the rural poor on our trip to India.

The Meat of the Food Inflation Argument

Feeder Cattle
May 24, 2010 to May 24, 2011

Lean Hogs
May 24, 2010 to May 24, 2011



As more and more people in the dynamic emerging economies of Asia and South America increase the protein content in their diets, they turn to meat and milk.

Because it takes roughly seven units of vegetable protein to produce a protein unit in the form of beef, and five or six to produce it in the form of pork or milk, the feed demand for corn, soybeans, and, to a lesser extent, wheat pressures global grain supplies.

We saw the impact of higher-protein diets among even the rural poor on our trip to India. Many children whose parents were small and scrawny were tall and husky.

That didn't come from three bowls of rice a day.

As we have been saying since 2006, the growth in meat consumption is part of the much bigger story: "the greatest efflorescence in personal economic liberty in human history."

..."the greatest efflorescence in personal economic liberty in human history."

USDA: World Supply & Utilization of Major Crops, Livestock & Products,
1995 to 2011

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
												Million units				
Wheat																
Area (hectares)	218.8	230.2	228.4	225.4	216.6	219.3	215.2	215.0	210.0	217.2	219.7	213.0	218.2	224.7	227.1	222.5
Production (metric tons)	538.0	582.7	610.1	589.9	585.3	581.5	581.1	568.6	554.8	626.7	619.1	596.3	612.1	682.2	683.8	647.2
Exports (metric tons)	99.2	104.0	104.4	102.0	112.7	103.6	110.4	105.7	108.7	111.8	117.0	111.8	117.3	143.7	135.8	124.2
Consumption (metric tons)	543.1	566.4	578.7	578.0	581.2	582.8	585.0	604.3	589.3	607.6	622.1	616.1	616.8	641.5	652.6	662.3
Ending stocks (metric tons)	153.3	161.1	191.8	202.4	203.0	200.7	197.2	168.8	134.3	153.4	150.5	130.6	125.9	166.7	197.9	182.8
Coarse grains																
Area (hectares)	314.1	322.8	311.0	308.0	299.8	296.3	300.6	291.4	305.8	300.4	300.9	305.0	318.3	313.0	310.2	307.1
Production (metric tons)	801.3	908.2	882.8	891.2	877.5	859.9	892.3	873.4	915.9	1,015.4	979.5	987.6	1,080.0	1,110.2	1,108.3	1,084.1
Exports (metric tons)	88.1	94.3	85.8	96.7	104.8	104.4	102.0	102.2	103.2	101.0	107.3	117.8	127.2	113.0	123.2	115.0
Consumption (metric tons)	834.9	871.7	871.1	871.0	878.0	879.6	902.6	901.0	944.8	978.5	993.4	1,012.6	1,056.1	1,079.5	1,107.0	1,125.3
Ending stocks (metric tons)	151.7	186.0	197.0	217.0	210.6	188.1	175.8	171.9	143.0	179.9	166.0	141.0	164.9	195.6	196.9	155.7
Rice, milled																
Area (hectares)	148.0	149.8	151.1	152.5	155.1	151.5	150.7	146.4	148.9	151.3	153.4	154.2	155.1	157.8	156.2	158.5
Production (metric tons)	371.0	380.4	386.8	394.4	408.7	398.0	398.4	379.0	392.7	401.3	418.6	420.3	433.6	448.1	440.4	450.7
Exports (metric tons)	19.7	18.9	27.6	24.9	22.8	24.4	27.9	28.7	27.4	28.2	29.7	31.4	31.2	28.9	30.8	30.4
Consumption (metric tons)	370.9	378.4	379.3	386.9	397.7	395.2	410.4	408.9	414.1	409.0	416.1	421.7	428.1	436.9	438.0	447.4
Ending stocks (metric tons)	118.4	120.3	127.8	135.3	146.3	149.1	137.1	102.9	81.5	73.7	76.2	74.8	80.3	91.5	93.8	97.1
Total grains																
Area (hectares)	680.9	702.8	690.5	686.0	671.5	667.0	666.5	652.8	664.7	669.0	674.0	672.2	691.6	695.5	693.5	688.0
Production (metric tons)	1,710.3	1,871.3	1,879.6	1,875.5	1,871.5	1,839.4	1,871.8	1,821.0	1,863.3	2,043.4	2,017.3	2,004.1	2,125.7	2,240.5	2,232.5	2,182.0
Exports (metric tons)	207.0	217.2	217.8	223.6	240.3	232.4	240.3	236.6	239.4	241.0	253.9	261.0	275.7	285.6	289.8	269.6
Consumption (metric tons)	1,748.9	1,816.5	1,829.1	1,835.9	1,856.9	1,857.7	1,897.9	1,914.2	1,948.1	1,995.2	2,031.6	2,050.4	2,100.9	2,157.8	2,197.6	2,235.0
Ending stocks (metric tons)	423.4	467.3	516.5	554.7	559.9	537.8	510.0	443.5	358.8	407.0	392.7	346.4	371.1	453.8	488.7	435.6
Oilseeds																
Crush (metric tons)	246.4	245.2	264.3	278.4	247.0	254.2	264.8	269.4	279.7	302.2	319.5	328.6	339.9	338.7	357.3	377.1
Production (metric tons)	294.3	299.9	338.6	346.0	303.8	313.6	325.2	331.5	335.8	381.3	391.3	403.5	391.4	396.3	441.6	447.0
Exports (metric tons)	47.2	55.1	62.1	63.5	61.0	67.9	64.7	70.0	66.8	74.4	75.4	82.8	91.8	94.2	108.2	113.9
Ending stocks (metric tons)	23.4	20.3	30.2	32.9	35.2	35.7	37.0	49.1	45.0	57.8	64.5	72.6	60.2	55.0	70.3	70.6
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Beef and Pork																
Production (metric tons)	117.9	123.3	128.2	131.4	131.5	132.1	137.1	142.6	144.5	147.0	150.3	153.5	152.8	156.6	157.9	158.3
Consumption (metric tons)	116.2	122.0	126.8	131.1	130.3	131.1	135.6	142.5	144.4	146.5	149.4	152.4	152.2	156.0	157.1	157.6
Exports (metric tons)	7.9	8.5	8.2	9.1	9.3	9.3	10.4	10.2	10.7	11.4	12.3	12.7	12.7	13.6	13.0	13.3
Broilers and Turkeys																
Production (metric tons)	47.1	47.8	49.5	52.3	54.8	56.5	57.7	62.6	63.2	64.8	68.2	69.5	73.6	76.9	77.0	79.4
Consumption (metric tons)	46.6	47.3	48.8	51.7	53.8	55.1	56.0	61.9	62.7	64.0	67.5	69.3	73.3	75.9	76.2	78.2
Exports (metric tons)	5.6	4.6	4.7	4.9	5.4	6.2	6.4	6.2	6.5	6.6	7.4	7.1	8.0	9.1	9.0	9.2
Dairy																
Milk production (metric tons)	--	370.1	373.7	378.1	382.4	386.2	393.5	405.3	409.6	415.6	421.4	427.7	436.8	435.0	435.5	440.3

Source: USDA, Foreign Agricultural Service, Production, Supply, and Distribution Database.
Data compiled from charts Published April 2011 and 2004

We *cannot* produce enough food to meet global food demands, *and* a growing percentage of global fuel demands.

Conclusion

With greater use of advanced agricultural technologies, and a rejection of autarky in global grain trade, then, according to FAO statistics, the world can avert major outbreaks of starvation or undernourishment.

We *can* produce enough food to meet global food demands.

We *cannot* produce enough food to meet global food demands, *and* a growing percentage of global fuel demands.

The investment case for agricultural stocks is that these companies are the world's best hope for fighting hunger and food inflation. They are the commodity stock group that is least at risk from a slowdown in global economic growth, but, paradoxically, they are one of the commodity groups that stands to gain the most from a large increase in incomes in the emerging economies.

Agricultural stocks therefore have the least endogenous risk of any commodity sector, while still having great upside if economic growth improves.

INVESTMENT ENVIRONMENT

Some Street economists have responded to disappointing US economic data by cutting their forecast for US GDP growth this year from 3.5% to 2.8%.

Among the negatives:

...the dollar's descent may be at an end—for the near term...

- The Japanese earthquake's aftershocks continue: US auto manufacturers have been forced to cut back production because of parts shortages;
- state and local governments continue to downsize from lofty, unsustainable levels;
- as sales of new and existing homes slide, so does demand for appliances, and household furnishings; unemployment among real estate and mortgage professionals continues to rise;
- the dollar's descent may be at an end—for the near term; the eurozone's problems and internal contradictions limit that currency's appeal, and the Bank of Japan's explosion of yen aggregates may cap that currency; since the export sector has been a big contributor to US GDP, a strengthening greenback is a mild negative.
- QE2 is about to enter history and fiscal stimulus is becoming *passé*. Although there is fierce division among economists and strategists about the economic impact of the Obama and Bernanke policies, at the margin they must have contributed to modest growth actually experienced; what catalyst will take their place?
- US politics are threatening to become poisonous again, as the budget and ideological battles intensify; the union-launched battle in which the federal government is demanding that Boeing close a plant in South Carolina before it opens is a major shock to industrial plans for plant expansions, and will probably drive some needed capital spending abroad. As America's largest exporter, and with its Dreamliner production far behind schedule, this is a body blow to more than Boeing. When Virgin's Richard Branson heard of it, he asserted that if this edict went forward and his overdue planes aren't delivered according to revised schedules, he'll buy European. Is anybody in the Department of Labor listening?

If the US economy remains sluggish, or slows further, Europe outside Germany is unlikely to be able to pick up the slack.

The S&P’s powerful rally fed on itself and took little notice of the etiolation of much of the US economy.

China’s restraint policies are finally beginning to bite. We take an optimistic view on this sharp shift in macro policy, because:

1. China will export some of its inflation, thereby increasing inflationary pressures in the US and Europe; and
2. The world needs the Chinese economy to remain strong—but not to become so overheated it implodes; emerging economies, led by China have generated 40% of global growth in recent years.

However, in the near term, slowing of China’s breakneck growth will put pressure on global GDP, and will be a negative for prices of metals and coal.

On balance, we believe that the environment for equity investing is deteriorating, and investors should reduce their exposure. The S&P’s powerful rally fed on itself and took little notice of the etiolation of much of the US economy. European optimism—which was never ebullient—is turning back toward Europessimism. Interest rates may not rise amid such sluggishness within the OECD, but spreads should widen. The sovereign credit quality issue is a wild card in formulation of investment policies, and could muddle capital markets.

"Sell in May and go away" is, as our friend Jack Ablin, Chief Investment Officer at Harris Private Bank, has demonstrated, a maxim that has worked wonderfully.

This year, the formula has a clear and cogent reason for success: the faltering financial stocks, whose problems and performance recall what we were writing about in 2007, are signaling a top.

Late last week, we learned that Bank of Canada Governor Mark Carney delivered unsettling remarks to an off-the-record dinner. One of the participants, a Bay Street economist, violated the pledge. What Mr. Carney said was that the world is by no means out of its financial crisis and *won't be for years*. Systemic risks remain high. The US will not address its deficit problems until after the 2012 elections.

Mr. Carney has been ranked the world's best central banker for his management of the Canadian economy through the meltdown, and his role in drafting international reforms thereafter.

Investors in Canada and abroad should take his warnings carefully.

Some Thoughts on Gold

There is a new torrent of warnings of a "gold bubble."

We have been hearing that story from concerned clients, partly in response to George Soros's highly-publicized liquidation of his holdings of the gold ETF: GLD.

...the most basic argument— that gold is not an investment, because it pays no income— that seeming tautology is, at root, inherently false.

Another factor has been the debate about Barrick's move into copper, which is being partially financed by a large bond issue. Despite Peter Munk's passionate and articulate defense of that strategy at Barrick's annual meeting, many observers seem to wonder whether this is a warning sign from the long-standing pre-eminent gold miner that gold's future is problematic.

The financial press has been including many sneering observations that gold is a useless speculation on inflation that is unlikely to occur. Why own an inflation hedge that pays no income?

We dissent from that tiresome scorn: those trained in Keynesian economics about the "barbarous relic" never bother to reflect that Keynes expressed almost childlike faith that central banks, acting pursuant to the Bretton Woods agreement of which he was a major architect, would always exercise restraint in monetary policies that would make gold *passé*.

The Seventies proved him horribly, hopelessly wrong.

But the Eighties and Nineties made it look as if he would ultimately be proved right.

However, the history of major monetary policies since then—and particularly since 2007—makes the case for gold appears as cogent as it was in the Seventies. This time, there's no chance the Fed will drive interest rates to double-digit levels to fight inflation and protect the dollar. It may be that, after years of getting by on Financial Heroin, the economy lacks the energy and *élan vital* to survive even normal interest rates—let alone Volcker rates.

As for the most basic argument—that gold is not an investment, because it pays no income—that seeming tautology is, at root, inherently false.

Gold has always been an alternative currency. It is resuming that role as central banks switch from the sell to the buy side.

A unit of paper currency pays no income.

The only gold bubble likely to burst is the bubbling ridicule of gold.

It can be exchanged for bonds, deposits or stocks that pay income, but a holder of a million euros or dollars in a safe deposit box earns no income on the hoard—just as a holder of a million dollars' worth of gold earns no interest.

The big difference is that the inherent value of the paper euros or dollars will fluctuate in response to the changes in those currencies' values against other forms of paper money, and all currencies must decline in purchasing power inexorably in response to longer-term inflation. According to our favorite skeptic on Received Wisdom, Stephanie Pomboy of MacroMavens, the S&P's performance since 2000 deflated by the gold price move in that time is a *minus* 82%, compared to the more reassuring nominal return.

Leading central banks now target inflation at 2%, saying that anything less could lead to deflation and Depression.

As Harry Truman, one of the most shrewdest and most candid of Presidents, observed in response to Keynesian demands that the US target an "acceptable" rate of inflation that would do no harm, but would be economically stimulative.

"You can't. That's like being a little bit pregnant."

Gold's market value most certainly fluctuates. But so does the purchasing power of paper money. Its inherent value almost never rises, but its slow decline can seem almost imperceptible. However, if commodity-spawned inflation comes roaring back, paper money's value will plummet.

With global money supplies growing at cancerous rates, this would not seem to be a propitious time for sneering Keynesians to dismiss gold's rise as "a bubble." How many of them warned that the Japanese bubble, or tech bubble, or housing bubble would burst with disastrous consequences?

Why do they argue that there will be no inflation from Fed and Bank of Japan policies—for which there are no precedents, and which make Seventies central bank policies look almost as tight-fisted as Paul Volcker?

Gold has—for millennia—been the one commodity that can always be used to buy other assets or goods and services.

It will always have that basic—and completely useful—function.

The only gold bubble likely to burst is the bubbling ridicule of gold.

Closing Thought on Portfolio Strategy

As we switch from a modestly positive to a modestly negative attitude on stocks generally, citing only a few data and reasons for the change, clients may wonder, "What use is a portfolio strategist who doesn't publish scores of charts and economic numbers to justify a viewpoint change?"

Runaway bull markets reward strategists who look only one way when they cross one-way streets.

We have long thought that there are two kinds of pedestrians, and two kinds of strategists.

Most pedestrians look only one way when crossing a one-way street. A few routinely look both ways.

We are in the second group—and are alive to tell you about it because of that habit.

Nassim Taleb writes of Black Swans. We try to think about what can go wrong when just about everything seems to be going right. Conversely, in the depths of the Crash, we saw (or maybe just thought we saw) beams of light and used up all the cash in our commodity equity portfolios.

Because we have been walking to work for decades, our habit of looking both ways at one-way streets has, cumulatively, cost us quite a few wasted hours.

Runaway bull markets reward strategists who look only one way when they cross one-way streets.

We may not see such stock markets again for a long, long time.

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation
Capital Markets Investments
US Pension Funds

	Allocations	Change
US Equities	16	–3
Foreign Equities:		
European Equities	2	–1
Japanese and Korean Equities	4	unch
Canadian and Australian Equities	5	–1
Emerging Markets	10	–3
Commodities and Commodity Equities*	12	–1
Bonds:		
US Bonds	16	+1
Canadian Bonds	7	+1
International Bonds	3	unch
Inflation Hedged Bonds	14	+2
Cash	11	+5

Bond Durations

	Years	Change
US	4.00	unch
Canada	4.25	unch
International	3.80	unch
Inflation Hedged Bonds	5.5	unch

Global Exposure to Commodity Equities

		Change
Agriculture	33%	+2
Precious Metals	28%	unch
Energy	24%	unch
Base Metals & Steel	15%	–2

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.

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation
Capital Markets Investments
Canadian Pension Funds

	Allocations	Change
Equities:		
Canadian Equities	16	–4
US Equities	5	–1
European Equities	2	unch
Japanese, Korean & Australian Equities	6	–1
Emerging Markets	8	–2
Commodities and Commodity Equities*	12	–1
Bonds:		
Canadian Bonds		
- Market Index-Related	23	+2
- Real-Return Bonds	14	+2
International Bonds	3	unch
Cash	11	+5

Canadian investors should hedge their exposure to the US Dollar.

Bond Durations

	Years	Change
US (Hedged)	3.90	unch
Canada:		
– Market Index-Related	4.00	unch
– Real-Return Bonds	5.50	unch
International	4.00	unch

Global Exposure to Commodity Equities

		Change
Agriculture	33%	+2
Precious Metals	28%	unch
Energy	24%	unch
Base Metals & Steel	15 %	–2

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.

INVESTMENT RECOMMENDATIONS

We are recommending a significant reduction in equities, with emphasis on US and Emerging Markets shares. The reasons for the US reductions have been covered. The EM reduction is because we fear that food inflation will worsen and this will have worse effects on EMs than on OECD nations. We remain of the view that Japan has probably completed its Triple Waterfall Crash that began 21 years ago. Canada and Australia are both commodity-exporting nations, but Canada has larger manufacturing and short-term tourism because of its ties to the US, which means that, on balance, it is less tied to commodity prices.

1. Reduce overall equity exposures, particularly to non-Canadian financial stocks.
2. Maintain commodity stock weightings in balanced portfolios, because their value proposition is clearer than that of most groups.
3. Hold high exposure to gold and gold stocks—the bad news investments.

   The protection they offer is going to be more valuable in coming months. It has been a long time since the stocks outperformed bullion but that could be coming: in the Seventies, it took years for the stocks to catch up. Silver and silver stocks are for those of speculative bent.
4. Maintain strong weighting in energy stocks, emphasizing oil and coal producers.

   Canada’s oil sands producers were in the winners’ circle after the Canadian elections, in which the electors voted for financial stability, good management, and economic growth. The oil sands companies are Canada’s biggest private sector capital spenders, and their strategic value to North America is becoming clearer to all but the idiotic.
5. It is no secret to our clients that we have been big boosters of agricultural stocks since 2006. The investment case for this sector is stronger than ever, and the problems for the economically-sensitive commodity sectors make food—at the farm gate—a particularly appetizing investment theme. Underweight exposure to packers and processors, who may have great difficulty in passing along their raw food costs.

6. The Canadian dollar should hold its own against the greenback as that beaten-down currency rallies from its lows, although we think it will have trouble outperforming. The US dollar can be expected to benefit from its comparison with the bleak situations in the heavyweight yen and eurozones.

   Canadian bonds have appeal for investors located anywhere, now that the election risks are out of the way. Canada's constitution asserts that the nation is dedicated to "Peace, Order and Good Government." This is a rather modest variant of the US promise of "Life, Liberty and the Pursuit of Happiness." From a risk-averse bond investor's standpoint, those Canadian goals are commendable and reassuring. That the loonie doesn't soar relative to the greenback should be a boon to much of the Canadian economy.

7. Scale back exposure to Treasurys in favor of quality corporate bonds. Avoid joining the mad rush to junk bonds.

8. The LinkedIn offering orgasm was not a sign of a market heading higher. When a stock can sell at more than 100 times the company's revenues, it is a sign that there's too much money around, and speculators are desperate to find something that works.

THE COXE STRATEGY JOURNAL

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