On My Radar

November 9, 2012
By Steve Blumenthal

As I dive through a broad range of independent research each week, following are several ***bullet points*** I found important: This weeks focus is on Currency Wars and coming Inflation.

Every day around noon I get a call from my daughter Brianna as she walks either to or from class. She is a sophomore finance student at Penn State. Today's call left me laughing. "Hey Dad, I learned about the Fiscal Cliff today." She paused and added "we're screwed!"

Maybe I should tell her that we (the U.S.) also owe $16 trillion, plus another $60 trillion (the present value of Social Security benefits, Medicaid expenses and expected costs for Medicare) and that we are counting on her generation to pay the bill. This is a gigantic 500% of GDP (source IMF and CBO).

I'm more worried than I have been in some time. The world central banks are out of control and engaged in a dysfunctional debasement of currency that I believe will end in inflation. My mind tosses from austerity driven deflation to inflation to stagflation as there is certainly a precedence for all three. Which is it and when? I find myself in the 'inflation is coming and will be big trouble' camp. We'll keep our eye on some important charts. In any case, I do believe we are in a bond bubble that will end badly.

- **Bond Bubble**
  We don't need inflation to make interest rates rise. I see everyone loading up on the wrong side of the bond trade and at record low yields. This is concerning as most investors don't believe they can lose money in bonds. They don't realize that interest rate risk is highest when starting yields are low. This is what happens at the tail end of a 25 year decline in interest rates.

  What is clear to me is that the bond market is the next big bubble to pop (following Tech in 1999 and then Housing in 2006). Of course, I could be wrong; though, if I am wrong I certainly don't believe the record low yield (i.e. 1.63% 10-year Treasury note yield) is worth the risk.

  The following chart shows how much gain an investor will receive if rates drop to 1%, as some analysts believe, and how much risk you have should rates move higher by 1%, 2%, 3%, 4%, and 5%, as others believe. The risk reward just doesn't add up. I'm in the rates will be significantly higher in 3-5 years from now camp. If you have 40% allocated to fixed income, especially in bond funds and ETF bond funds, be concerned.

10 Year Treasury Bond assuming a 2% Coupon with a 1.63% yield to maturity

Yield to maturity	1.00%	1.63%	2.63%	3.63%	4.63%	5.63%	6.63%	7.63%
Price	109.494	103.401	94.492	86.433	79.137	72.530	66.541	61.109
Change in Price	5.89%		-8.62%	-16.41%	-23.47%	-29.86%	-35.65%	-40.90%

30 Year Treasury Bond assuming a 3% Coupon with a 2.82% yield to maturity

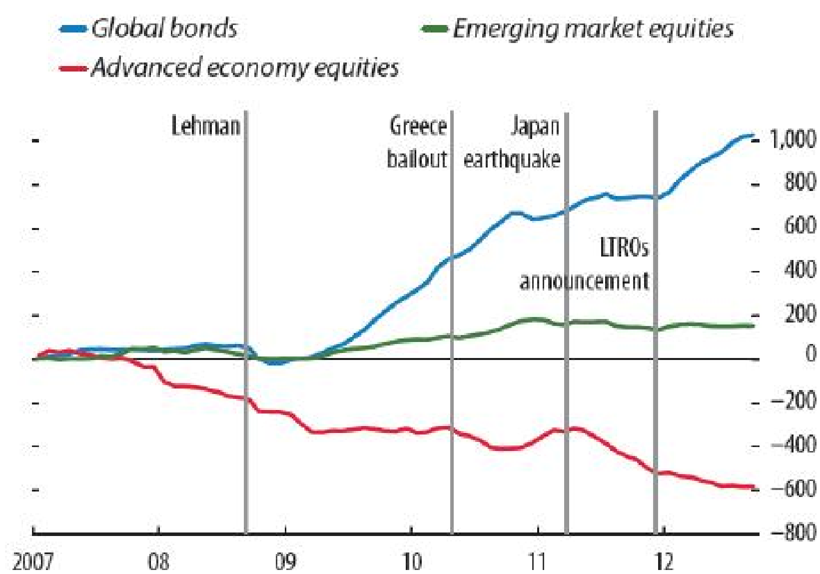
Yield to maturity	2.00%	2.82%	3.82%	4.82%	5.82%	6.82%	7.82%	8.82%
Price	122.478	103.628	85.432	71.287	60.213	51.479	44.535	38.967
Change in Price	18.19%		-17.56%	-31.21%	-41.89%	-50.32%	-57.02%	-62.40%

Current 10-yr yield 1.63%
Current 30-yr yield 2.82%
11/7/2012

Source: CMG Investment Reserch

The next chart from the IMF Global Financial Stability Report, October 2012 shows where the money if flowing. I believe it is important to "sell when everyone else is buying and buy when everyone else is selling". Note the blue line.

Chart 3: Cumulative Flows to Global Mutual Funds (USD billion)

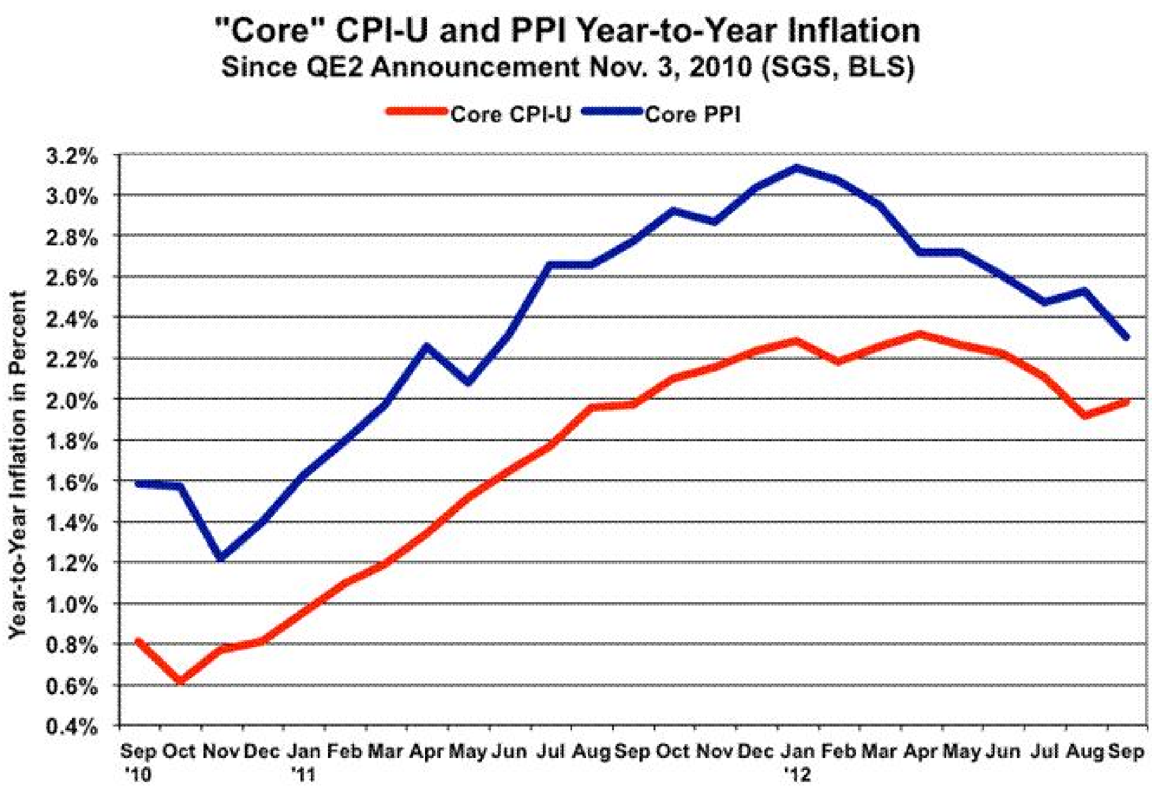


Source: IMF Global Financial Stability Report, October 2012.

- **Shadow Government Statistics – John Williams**
  http://www.shadowstats.com

  John writes frequently about the manipulation of government statistics and digs deep into the numbers. Below is from his October 16, 2012 commentary on Inflation.

  A Continuing Surge in Inflation. The headline September CPI-U monthly inflation number was 0.6% for the second month, reflecting some minor catch up in gasoline price inflation. Year-to-year inflation rose from 1.7% in August to 2.0% in September. Parallel moves were seen in the other series with CPI-W up by 0.7% for the second month, with annual inflation increasing from 1.7% in August to 2.0% in September. **Adjusted to pre-Clinton (1990) methodology, annual SGS-Alternate CPI inflation rose from roughly 5.2% in August to 5.5% in September**, while the 1980-based measure rose from about 9.3% in August to 9.6% in September, versus 9.0%.



- **The Absolute Return Letter November 2012 – Niels C. Jensen**
  http://www.cmgwealth.com/wp-content/uploads/2012/11/The_Absolute_Return_Letter_1112.pdf
  Niels details the probabilities around five possible outcomes from all of the central bank "tinkering". Is it deflation or inflation? He concludes that there are 5 possible outcomes.

  1) The expansion of the balance sheets of the Fed, BoE, the ECB and the SNB could ultimately lead to a rise in consumer price inflation in the U.S. and Western Europe.

2) Once central banks begin to shrink their balance sheets again, asset prices could come under pressure with interest rates going up as a result.

3) The crisis in the European periphery could spread to other countries as the true extent of the over-leveraged becomes apparent.

4) The crisis in the European periphery could begin to abate, causing investors to pull out of safe havens only to move back in to the periphery, causing spreads between the safe havens to narrow.

5) The crisis in the European periphery could linger on.

In had hoped to finish this month's Blumenthal Viewpoint this week in which I share my ideas about how to profit in the period I see ahead; however, while close, more work needs to be done.

I hope you find this information helpful. Have a great weekend!

With warm regards,

Steve

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PS: When I look at the world, I try my best to view it from a probability perspective. I read endlessly and have access to some outstanding hedge fund and independent investment research. Fortunately, if you dig deep enough you too have access to a great deal of information on the internet. This certainly wasn't the way it was in 1984 when I started in the business.

I believe we are in a challenging low return environment and that most individual investors hold higher return expectations; those expectations will not be met and investors will seek a better solution. I see an unprecedented opportunity for you to grow your advisory business.

With this piece I try to share some information that I have found to be important. To me the evidence is clear, but I most certainly could be wrong.

Whether I am correct or incorrect in my thinking, my overriding belief is that you can create and manage successful portfolios for the period ahead. This environment requires more work (mixing a diverse set of risk drivers and more active beta hedging) than exists in a secular bull market cycle, but also offers you the ability to separate yourself from the 98+% of your competition that is heavily weighted in the old 60/40 stock/bond construction model.

The good news is that the investment opportunity set has been greatly expanded and solutions exist. While risk is an inescapable companion in the investment process, I believe it can be quantified and minimized by expanding the asset classes you include in your portfolios.

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