

# Black Swan Capital – January 2008 Newsletter

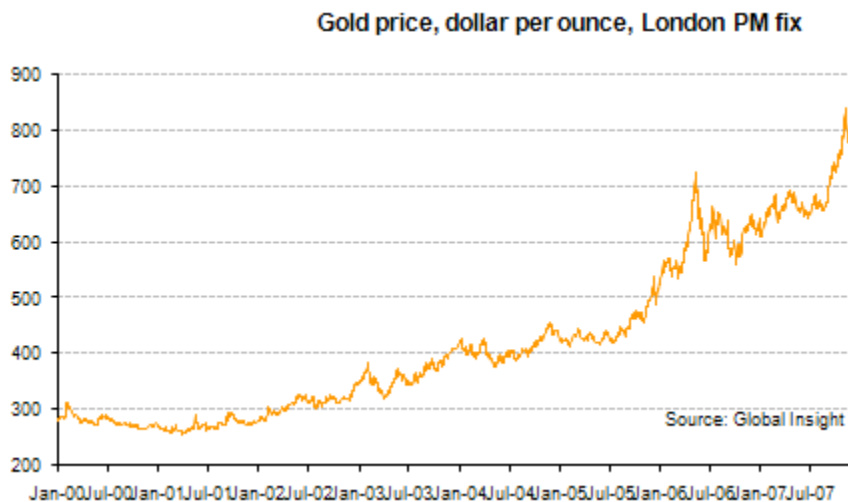
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## Buy gold

The yellow metal is pushing new highs at the moment – intra month it last peaked at US\$850 per troy ounce back in 1980. But wait a moment, look closer. That’s the price of gold expressed in US\$. Back in 1980 you could buy a lot more with those dollars – or an ounce of gold – than you can today. If you take into account the corrosive effect of inflation on the US\$ over the last 28 years or so, the previous high water mark of gold in today’s terms is well over US\$2,000 per troy ounce! So what we’re saying now is that the real price of gold is only about a third of its previous inflation adjusted high - which makes it seem pretty cheap.



(Chart data derived from [www.gold.org](http://www.gold.org) (World Gold Council))

On Thursday the Financial Times quoted the head of commodities research at Deutsche Bank in London as saying, “We see fresh money flowing into commodities in 2008”, and a precious metal strategist at

UBS in London as saying, "People seem scared of a number of factors – an inflation spike, further US dollar weakness, or systemic financial risk." We agree with them.

Or is it that they're agreeing with us... because this is what we've been telling our clients for the last four years! City Trading Post has been recommending the Merrill Lynch Gold & General fund to appropriate clients since 2004, during which time the price of gold has doubled.

The macro economics behind the gold price is very simple: Supply is limited, yet demand is rising. Therefore the price is going up. On the supply side, there's a physical limit to how much of the stuff can actually be mined. And central banks around the world who store gold bullion in their vaults can only sell it once, and then it's gone. (NB: As the gold price is so high in nominal terms, and UK public finances are in such a state, perhaps now would be a good time for the UK government to start selling off some of their gold reserves... oh, but apparently the UK government sold off half our gold reserves at all time lows back in 2000. Well done, Mr Chancellor of the Exchequer, you should be Prime Minister. Oh, you are!)

On the demand side, not only is gold rapidly increasing in popularity as a safe haven as the US\$ plummets, but India and China, massive emerging markets, are also developing big appetites for the metal.

So, against this backdrop, gold is still only about a third of its previous inflation adjusted high. Therefore, we think it's going up. It's not rocket science.

If you would like to have some exposure to gold in your portfolio, please contact us for more information. Gold funds can be bought directly, or through an ISA, or personal pension, or SIPP.

## Don't buy the US dollar

2007 was a very scary or exhilarating year from a markets and economics point of view, depending on your perspective. In the US the easy credit party finally came to an inglorious but inevitable end, and the hangover is now setting in.

It's simple, really. If you spend more than you earn, you have to borrow the shortfall. You borrow from the bank and your credit card company, and they all borrow from each other and ultimately they borrow from the government. The US government has largely been borrowing from China, Saudi Arabia, and a few other major trading partners. Now that the US property market has gone into reverse, and the US\$ is falling, these lenders are less keen to keep on accumulating American debt. Basically they're starting to worry that perhaps the US could become a bad debtor, like – horror! - Mexico or Argentina...

Actually these lenders have a vested interest in not allowing the US economy to seriously crash, because Americans keep buying their stuff. But the bottom line is that the US economy is seriously indebted to the likes of China and Saudi, and they simply cannot keep on borrowing. They have to get their economy back into balance. One way to achieve that balance is through a humiliating and painful currency devaluation.

Our view is that the slide in the US\$ is only just getting underway. There are still far too many people who think that the current US\$ weakness is a buying opportunity in a cyclical downturn. Well that's certainly not our view! We believe that this is a permanent shift from one equilibrium to another – from the one where the US\$ is the global reserve currency, to one where it's a lot cheaper and it is **not** the global reserve currency.

This isn't just about financial markets either – the credit crunch and the US\$ slide are starting to have a big impact in the real world. Economic indicators in the US are starting to look ugly: car production, job creation, the property market, Christmas retail sales, and so on. And what are the Asians doing with all their spare cash that they've accumulated from selling stuff to the Americans who they've funded by lending them the cash in the first place? Answer: They're buying American assets while they're cheap. It's almost like revenge, because that's exactly what the western economies did to the Asians in the aftermath of the Asian financial crisis back in the late 1990s. What goes around comes around.

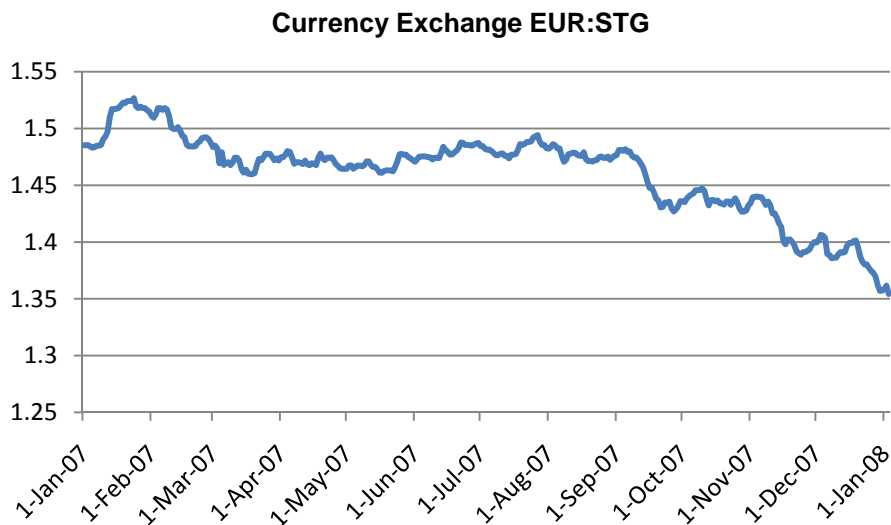
So, the final analysis is this: The US economy has peaked and is coming off in quite a nasty way. Their economy is highly indebted, and the US\$ is heading down towards a level where there can be some sort of trade balance and a new equilibrium. There is still some considerable way to go. It's a big economy, so it's going to take years to shake out and settle down. In the mean time, steer well clear.

### And the UK economy?

There is in fact a country in the world that is in even more debt (in relative terms) than the US. That country is, unfortunately, the UK.

Luckily for us the UK is increasingly integrated with the EU, and reaping the benefits of an enlarged and relatively local new market to interact with, an abundance of cheap, mobile, educated labour, plus it also enjoys the rather dubious status of being a tax haven for Russian oligarchs. For the rest of us, the tax burden seems to get heavier and heavier.

Just as in the US situation, debt eventually has to be repaid, and the cure is likely to include a devaluation of Sterling. That possibly explains some of the recent Euro strength relative to Sterling.



### Currency Exchange US\$:STG



(Chart data derived from [www.oanda.com](http://www.oanda.com) (Oanda FX))

We expect further Sterling weakness relative to the Euro, because while the UK is fully developed and heavily indebted, the Euro area, while it is home to a few economic dogs (or should we say *chien* and *hunde*), has incredible unrealised potential for structural efficiency gains as the newer members integrate and grow from their relatively low bases.

What this means is that you could enjoy a double benefit from investing carefully in the Euro zone: Not only does it have growth potential greater than the UK, but you could also benefit from further appreciation of the Euro relative to Sterling.

Alas, the inclusion of Wales within the Sterling zone is not likely to have a comparable benefit to the UK economy due to its small population.

### **What does all this mean for the US and UK property markets?**

Well, in short, it means that the US and UK property markets are likely to be weak for the foreseeable future. No surprises there – the markets have already started falling and liquidity has dried up significantly since the summer of 2007.

Those who bought at or near the top in either market will have to be philosophical, and don't give up the day job. You've got to live somewhere. And anyway it's all a big cycle. The market will come back. The problem is that in the mean time, you're stuck where you are and you're probably going to be excluded from participating in healthier property markets elsewhere.

We're sorry – there's nothing we can do about this. However, if you are not yet in either of these property markets, or at least only in as deep as your own home, then we advise you to stay out of it as far as possible. Especially if you are a Sterling based investor, we strongly urge you to stay away from the US property market as you're likely to get whacked twice – once by the property market itself, and then again by the US currency.

Enough gloom. Where's good to put your money in 2008? We've talked about gold, which is a 'global' commodity. What regions of the world are likely to prosper in the years ahead and protect us from the weakness of our own economies and the follies of our own politicians?

### Have some exposure to China

China used to be the largest and most advanced society in the world. But the west industrialised first and rapidly caught up and over took them. The Cultural Revolution, which was partly a reaction against the consequences of western imperialism, was not a great time for the Chinese, but they're putting that behind them now.

China's economic progress over the last few years has been absolutely staggering, and on such a vast human scale. The population is so huge (and a lot of it still rural) that they're only able to estimate it to within about a hundred million or so; that is to say, it's about 1.35 billion people give or take a couple of UKs. But they're urbanising fast, and they're a lot easier to count once they're in apartments. Whatever the current population is, they expect to add another quarter of a billion within the next generation – that's an entire USA extra! No wonder they're having to expand their electricity production capacity by the equivalent of an entire UK each year.

Once again, China is expected to post double digit growth in 2008 – falling demand from the US is being replaced to some extent by increasing demand from elsewhere within Asia. The Renminbi, the Chinese currency, is appreciating, although the authorities carefully control it. Some economists reckon that the Renminbi could quadruple (or the US dollar fall to a quarter of its relative value) before it reaches a trade balanced equilibrium.

For those of our clients who bought property in Shanghai through City Trading Post back in 2005, you must be feeling very pleased with yourselves!

(By the way, we have another China property product up our sleeves – and there's 70% US\$ mortgage finance available too. Interested? Register early. We're just putting it all together.)

Our view is that China has a long, long way still to go. It won't all necessarily be smooth sailing, but there is so much upside potential still to be realised that for many investors the volatility and risk will be well worth it. City Trading Post has been recommending China funds (for example, the Gartmore China Opportunities fund) for several years now to our more adventurous clients. More recently, as China is becoming more 'main stream', we've started recommending at least a little bit of Chinese exposure to clients of a more conservative attitude towards risk. China simply cannot be ignored.

We can help you to achieve Chinese exposure through your ISA or pension. Contact us for more information. And we have that Chinese property product up our sleeves too!

### **And don't forget the other emerging markets, especially the big ones**

Russia, Brazil, India, and the countries of 'New Europe' all qualify as big emerging markets with potentially big futures. By investing in all of them, you're spreading your risk across vast regions, which will help to dilute and mitigate the risk of investing in any single country or sector. As western economies falter, or at least pause for breath after a breathless few years of credit fuelled exuberance, the emerging markets are rising.

Some observers are concerned that the demise of the US consumer may have severe negative consequences for many of the emerging markets. We believe there will be some impact, but that it will be limited, as long as the US avoids total disaster. And we do not think that the US is headed for total disaster – just a long and painful readjustment.

At City Trading Post we're also keeping a close eye on emerging markets closer to home, such as Croatia. Last year some of our clients invested in a property fund (some via their SIPP) that is developing property on the beautiful Dalmatian coast, and are expecting to see healthy returns on their original investment at the end of the project in early 2009. We are currently reviewing another Croatian property development opportunity, which will be available to our professional and more experienced investors very soon.

### **Beware of accelerating inflation – and don't trust the government numbers**

Slight change of subject, but related to the discussion above. How come, if the price of food has escalated by about 20%, the price of oil (which determines all our energy costs) is nudging all time highs, and the cost of property has doubled in just a few short years – how come the government is telling us that inflation is below 3%? It just doesn't stack up. Unless of course they're measuring inflation in the things we don't actually spend our hard earned and over taxed money on.

Just to clarify, we at City Trading Post truly *want* to believe that the government wants to do the right thing for us – politics being, as Aristotle put it, the science of optimising human well being. The problem is, however, we don't think they're very good at it. Not that it's an easy job, we're sure. But surely they could do better at something as simple as measuring inflation, or at least explain to us why they insist that it's only 3% when all around us the price of everything, Christmas turkeys included, seems to be shooting up at double digit rates.

Or are they deliberately not telling us for our own good – if we believe that inflation is only 3%, then we won't be asking for much more of a pay rise than 3%, just enough to maintain the real value of our incomes (even though they seem to be taking more in tax...). That would be very tricky of them, but possibly an effective way of controlling our expectations of inflation, and thereby inflation itself.

No, actually scrap the conspiracy theory. We just don't think that the incumbent government is bright enough to be that Machiavellian. We think they're just counting the wrong thing.

Anyway, our view on inflation is that it is looming large, and likely to accelerate. If we're right, then that will serve to reinforce our forecasts for the UK, the US, their respective currencies and property markets, the price of gold, and the relative performance of China and some of the other emerging markets discussed above.

It will also eat into the real value of your income, and means that your investments will have to work harder to deliver the same benefit to you. Therefore, it's imperative that you optimise and maximise your investment strategy, and absolutely minimise your tax burden as far as legally possible.

### **Pay less tax – the legal way, of course; make the most of available tax reliefs**

You can get a lot of the tax you pay back from the government. Of course there are some catches, usually involving you locking up your investments for anything from 5 years, or even until retirement. But

the compound effect of tax free growth on the tax relief can be immense over long periods of time, and can make a serious material difference to your future wealth.

Here's an example: Suppose you invest £1,000 per month for 20 years and the investment grows at 5% per year. At the end of the 20 years you would have a fund worth £405,804.

Now suppose that you invest that £1,000 per month within a personal pension scheme where you benefit from basic rate tax relief of 22%, which boosts the monthly investment to £1,282 for no extra cash outlay on your part. After 20 years your fund is worth £520,262. That's 28.2% of extra value for zero extra cash outlay.

So, if you're saving cash and earning measly bank interest, or investing in an ISA which doesn't give you any upfront tax relief, ask yourself if you would be prepared to lock this money up in something that gives you some upfront tax relief to boost the value of your initial investment. You needn't take any additional risk – just benefit from the long term compound growth of your tax relief.

Pensions are not the only option either. There are Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EISs) too, which also provide upfront tax reliefs with less draconian holding periods than pensions.

If you think you would like to recover some of the tax that you're paying, please talk to us. We may be able to help you get much more out of your investments without asking you to put down any extra cash. Surely that's got to be worth thinking about! Remember, with inflation gnawing away at your income and your investments, you have to optimise and maximise. It could be the difference between retiring at 55 and retiring at 65.

### **Don't work too hard for your money – make your money work hard for you!**

Talking of pension funds, we are constantly amazed at how many people have pension funds that are either neglected or even totally forgotten about for years on end. Usually these are old 'preserved' pension schemes linked to previous employments. You move to a new job, join the new pension scheme, and the old one is half forgotten – you know it's there, but it's small, or at least not top of the agenda. Eventually you end up with a trail of old pensions as you move through your career.

Do you think that your former employers are carefully managing your money? Do you think that the funds in these old schemes are invested in gold, or China, or emerging markets?

Chances are that any old preserved pension schemes that you have knocking around are in 'one size fits all' balanced managed funds, UK focussed, and definitely nothing 'spicy'; cheap and cheerful.

If you have old preserved pension schemes, perhaps you would like to consider rounding them up into a single, properly managed personal pension scheme so that you can invest the funds actively and pursue some of the investment strategies discussed above.

Or you could be even more adventurous and put the funds into a SIPP (self invested personal pension) and take the reins yourself; there are lots of interesting 'alternative' investments out there, if you have the appetite for risk or a particular investment preference (e.g. overseas property development funds).

Let us know if this is something you would like to look into.

## General financial review

We hope that this news letter has been, at the very least, an interesting read. Even better, we hope that it has provoked some thought that might lead to some business for us and to an improvement in your financial circumstances!

If you would like to discuss any of the investment strategies in this newsletter, or if you would like to arrange a general financial review, please do not hesitate to contact us.

To contact Black Swan Capital about any of the issues raised in this newsletter, or to arrange a free, no obligations financial review, please call us on **+44 (0)844 888 0575** or send an e-mail to **[enquiries@blackswancapital.uk.com](mailto:enquiries@blackswancapital.uk.com)**

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