

Black Swan Capital - December 2008 Newsletter

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The worst may be over, but the road to recovery is likely to be long

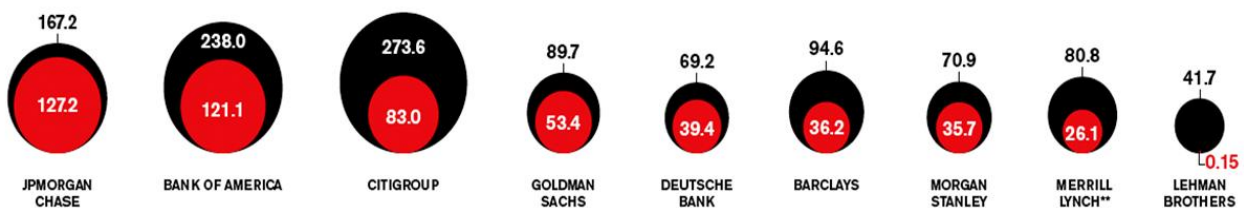
Let's start with a little story about monkeys: Once upon a time, in a village, a man appeared and announced to the villagers that he would buy monkeys for £10 each. The villagers, seeing that there were many monkeys around, went out to the forest and started catching them. The man bought thousands at £10 and, as supply started to diminish, the villagers stopped their effort. He further announced that he would now buy at £20 for a monkey. The villagers renewed their efforts and they started catching monkeys again. Soon the supply diminished even further and people started going back to their farms. The offer increased to £25 each, and the supply of monkeys became so small that it was an effort to even find a monkey, let alone catch it! The man now announced that he would buy monkeys at £50! However, since he had to go to the city on some business, his assistant would now buy on behalf of him. In the absence of the man, the assistant told the villagers, 'Look at all these monkeys in the big cage that the man has collected. I will sell them to you at £35, and when the man returns from the city, you can sell them to him for £50 each.' The villagers rounded up all their savings and bought all the monkeys. They never saw the man or his assistant again, only monkeys everywhere.

Now substitute the monkeys for 'collateralized debt obligations', a.k.a. 'subprime mortgages'. The man in the story is, collectively, mortgage intermediaries and real estate agents, and his assistant – who is really the mastermind of the whole scheme – is the investment banks. There is no regulator in the story. The villagers are the public.

What the markets are now going through is a rapid and painful unwinding of several years of the silliness described above – the cycle of borrowing and spending funded by extracting equity from appreciating assets has come to an abrupt end as the ultimate borrowers - who are the Chinese, the Saudis, and a few others – have said 'enough is enough'. It has certainly been a wild ride, but our view is that the worst is now over.

Enormous liquidity has been pumped into the system to try to get the banking system working again. It will, although it will take time. The world's banks have paid a very high price for their recklessness, having been shrunk, taken over, nationalized, and in a few dramatic cases just killed off. The diagram below illustrates to what extent the big financial names have been scythed down to size –

MARKET VALUE IN BILLIONS OF DOLLARS
 ● END OF 2006 ● NOW*



Data: Bloomberg Financial Markets

*AS OF SEPT. 15, 2008 **AGREED TO BE SOLD TO BANK OF AMERICA ON SEPT. 15, 2008

It's taken something like US\$400bn to recapitalize and shore up battered bank balance sheets globally so far. Some commentators (let's not call them analysts, because it really is just guesswork at this stage) believe that only half of the actual bank losses have so far been declared. There probably (hopefully) aren't going to be any more really big failures, but there is still a lot of unwinding and unravelling to do, which will take years – lot's of work for accountants and lawyers.

There appears to have been a concerted and coordinated effort by governments to address the immediate liquidity crisis that was paralyzing the system, and the worst of the recent market volatility

seems to be behind us. Now that the US elections are out of the way, a large source of uncertainty has been removed from the equation. Our view is that Obama will be good for the global economy, because he is more likely to view and tackle the US's economic problems as an integrated global issue, whereas McCain would have been bad, because he would have been more likely to start fights and lead the US towards isolation and protectionism (more on that below).

The main point is this: The worst of the corporate implosions seem to be behind us, and there are signs of liquidity returning to the financial markets. Volatility should ease, and perhaps markets have finally found the bottom. The recovery and reconstruction will be slow and tentative, and the commercial and financial landscape is going to be very different, but things are now at a turning point. We hope.

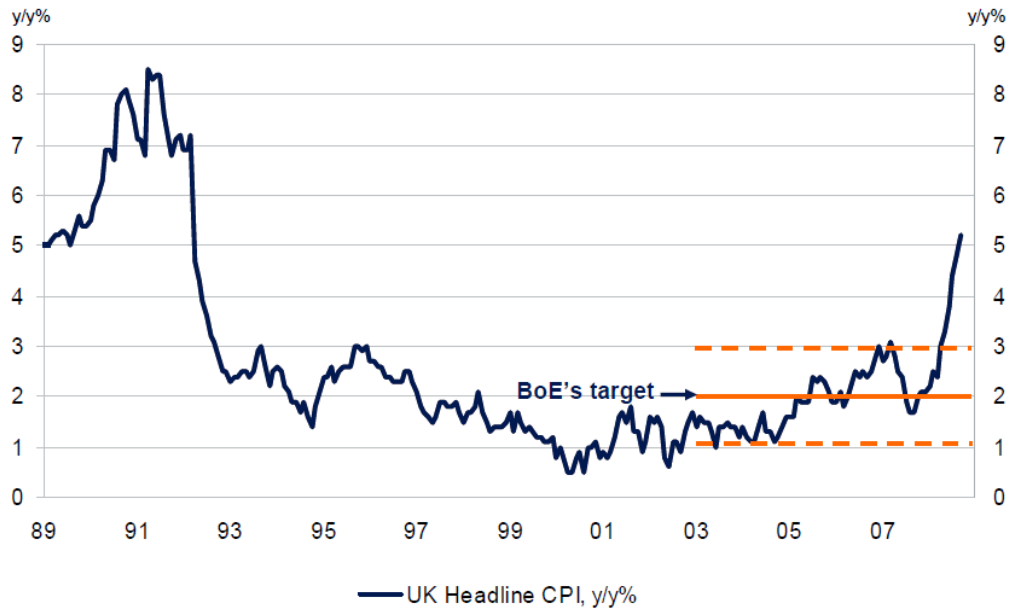
If you have surplus cash, and if you believe that the worst of the financial crisis is behind us, consider deploying your funds into the markets while they are at a low ebb. Black Swan Capital can help you devise a portfolio of investments to suit your objectives, time horizon, and attitude to risk.

Inflation is coming, in spite of current deflation fears

Inflation surged across the world during 2008 – in the US it nudged 5.6%, in China it exceeded 8%, and in the UK it reached 5.2%, ending a long period during which the Bank of England had been generally regarded as having done a good job for keeping inflation under control and within set limits.

As commodity prices have slumped over the last few weeks, inflation fears have subsided and been replaced by deflation fears. In spite of the slowing economy, at Black Swan Capital we believe that an inflationary surge is coming – because we believe that a commodity price surge is coming; not in the short term, but beyond the short term when the recovery sets in.

As the large emerging economies recover and start growing again – which they will – their ravenous consumption of commodities will resume. It is unlikely that commodity supply will grow as fast as emerging market growth rates. Commodity prices are therefore likely to be ramped up as demand outstrips supply. Commodities being globally priced, this will be inflationary everywhere. As a consequence, the Bank of England and other financial institutions around the world charged with control of inflation are going to be facing a very difficult task, especially as the counter-deflationary measures that they are currently applying will have created ideal conditions for inflation to take hold in.



Source: Thomson Datastream

Add to that the fact that the money printing presses – in the west at least – are on overdrive. Hundreds of billions of dollars have been created over the last few months in an effort to solve the liquidity crisis and unfreeze markets. It seems, finally, to be working, but what will be the longer term effect? It comes down to simple supply and demand: If you increase supply faster than demand, then the price will fall. That applies to bread, gold, and cold hard cash.

The US\$ is an extremely important currency for a variety of reasons: The US economy is massive; in fact, it's as big as the next three economies combined (Germany, Japan, and China). It is an important trading partner for most other trading nations on the planet. Due to its size and relative stability, the US currency is regarded as a safe haven.

However, some of the US's biggest trading partners have been accumulating US\$ in the form of Treasury Bills for years and are now sitting on huge stockpiles of them. These trading partners are stuck between a rock and a hard place – they need to carry on trading with their main trading partner in order to keep their own export industries humming along, but at the same time they're feeling rather exposed to the US\$ and cannot easily diversify.

The reason they can't easily diversify is because of the sheer size of the problem – we mentioned in an earlier newsletter that if the Chinese were to diversify just 10% of their US\$ reserves into gold, it would absorb approximately two years entire global gold production (bear in mind that it takes about 10 years to set up a new mine and start delivering gold to the market).

If they just start dumping US\$ to buy, say, Euro, then the US\$ would crash – that would instantly destroy the export competitiveness of their own industry. It's a bit like that scene in the well known film 'Reservoir Dogs' where all the bank robbers have guns to each others' heads.

Let's assume that – unlike in the film – no one pulls the trigger. What happens next? Well, as we were saying, you can't just print money and expect its real value to be preserved. Printing money will eventually debase its real value – which is why all paper, credit based currencies throughout the whole of human history have lost their real value over time. Inflation is, in that sense, a symptom of the basic and unstoppable human inclination to consume more than is produced. The end result is that the US\$ and Sterling bail outs and liquidity injections that we have seen over the last few months

will eventually feed through to a debasement of those currencies: devaluation and inflation, which are just opposite sides of the same coin.

We believe that it will take a while for the inflationary consequences to feed through – but it is inevitable. Given the scale of the numbers involved, we suspect that when it does happen, it will happen fast: It's a bit like pulling very hard on a rope – initially the rope is slack and there is no tension, but suddenly when all the slack is taken up, there is a hard wrench.

In the nearer term, US and UK exports will become more competitive, which is good, but imports will become more expensive. Given that a lot of what US and UK consumers consume is made abroad, the cost of living will increase.

So, if you've ever fancied going on holiday to Asia or China, go now, because in a few years time due to relative weakening of western currencies such as the US\$ and Sterling, these will become increasingly expensive destinations.

Be wary of inflation, which will erode the real value of major currencies such as the US\$ and Sterling. There may be a couple of years of deflation ahead, but watch out for a sudden surge of inflation on the far side. Make sure your debts and mortgage liabilities are denominated in the currencies most likely to be struck down by inflation, and make sure that you are not over exposed to investments that will be harmed by inflation and rising interest rates, such as bonds.

The greatest risk to an orderly recovery is US protectionism

In 1802, US President Thomas Jefferson said, "I believe that banking institutions are more dangerous to our liberties than standing armies. If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around the banks will deprive the people of all property until their children wake-up homeless on the continent their fathers conquered."

To some extent he was right... the financial system needs to be better (not more) regulated – just as food manufacturers need to be carefully regulated so that they don't poison people. But his words also illustrate a US cultural tendency towards centralization, isolation, and protectionism.

A lot of people in the US believe that their economic woes are all someone else's fault – usually the scapegoat is China, or perhaps those in the Middle East. They're wrong, of course, but these people do have a voice, and a lot of people believe that the best thing for America is to shut the doors and protect American jobs. This would be absolutely disastrous for America and the world. If the US shuts out foreign imports – and specifically Chinese imports – then the Asian and Chinese economies will grind to a halt. These economies will then stop absorbing US debt. The US government would then not be able to raise money except by just printing it, or offering silly high rates on its Treasury Bills. Either route would be highly inflationary. The US\$ would collapse – holders of big US\$ reserves would start dumping it fast, and the death spiral would accelerate.

We don't think this will happen, especially with Obama in the White House, but US tendencies towards protectionism have to be watched.

The US\$ has recently enjoyed a bit of a comeback. But it looks topky... How exposed to the US\$ are you? Be wary. If you are long US\$ or US\$ denominated investments, now may be a good time to sell while US\$ are still worth something.

What's your number?

Not your phone number – we mean the amount of wealth that you need to accumulate in order to never have to work again? If you even know what your number is, do you have a plan to achieve it? Quantifying financial objectives is what Black Swan Capital's wealth management service is all about. Contact us to arrange a review of your finances

The best strategy is to focus on long term objectives.

Over the long term even nasty crises such as the one we're currently going through become just blips on the chart.

A lot of what we've discussed above is out of our hands. We're all passengers on a big scary ride. Therefore, all we can do is hold on tight and not fall off. Focus on the horizon: Your investment strategy should be based on meeting long term financial objectives, such as building up a retirement fund, or building up a school fees fund. Short and medium term volatility has to be dealt with, but it should not deflect you from your long term objectives.

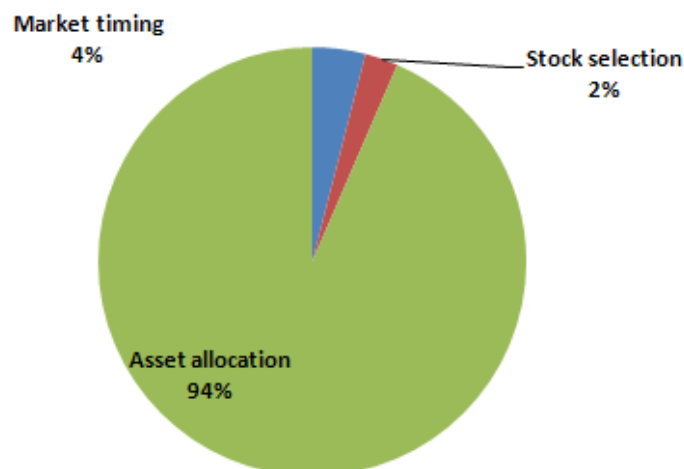
Clients often ask during these volatile times whether they should switch out of equities, or go to cash, or reduce their regular premium investments. The answer is no, no, and no.

Always remember the four non-secrets of long term investment success –

- ✓ **Asset allocation**
- ✓ **Diversification**
- ✓ **Regular investment**
- ✓ **Time**

Asset allocation:

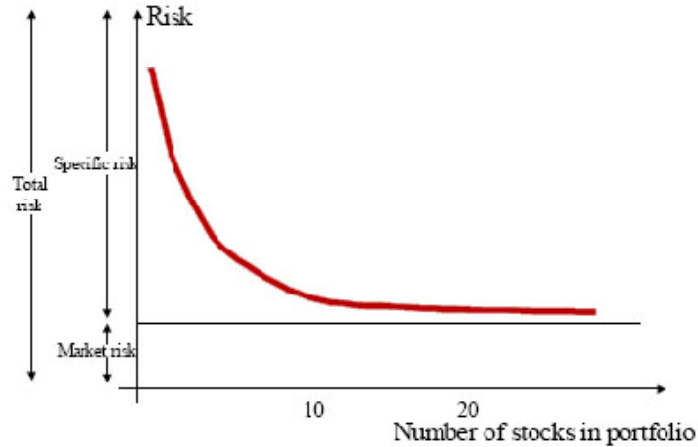
Strategic asset allocation is a concept derived from Nobel Prize winning economist Harry Warkowitz's research on portfolios. According to his research, around 94% of investment returns are a result of asset allocation, while only 2% of the return is down to specific stock selection, and only 4% results from timing.



Diversification:

Spread your investments over multiple asset classes, markets, regions, sectors, and fund managers in order to mitigate the volatility (risk) of any one investment going bad. This creates the opportunity to target higher levels of return for the same or lower overall portfolio risk. The more your portfolio is diversified, the lower your overall risk –

Diversification

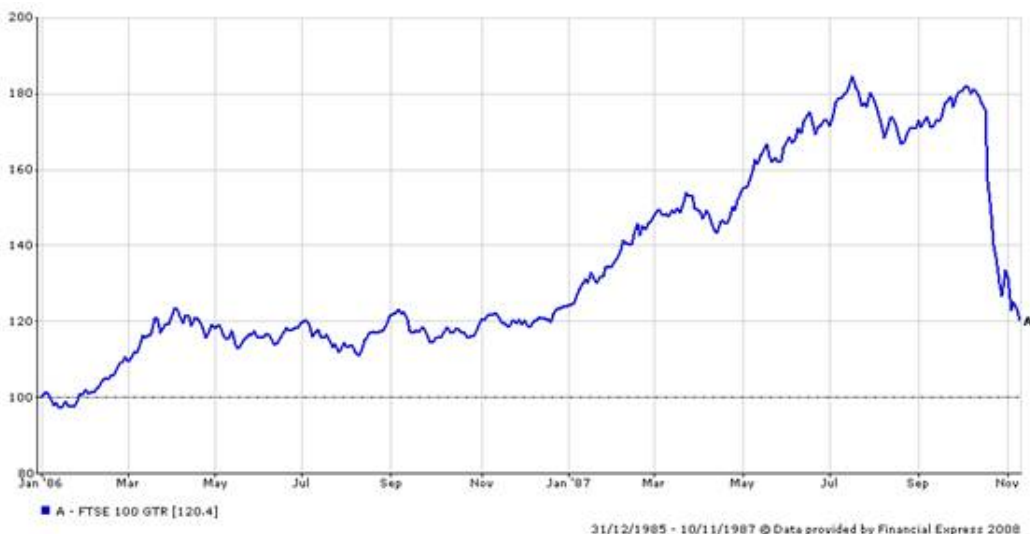


Regular investment:

As so little performance can be attributed to market timing, just forget about it. Instead, passively drip money in regularly over the long term. With regular investment, you also get to invest at low points in the cycle, and it is the units and shares that you buy at these times that are most likely to produce your best returns over the long term.

Time:

It all seems pretty nasty now, but look at this –



This is the 1987 stock market crash. Not pretty. But here's the following 10 years –



The crash turned out to be the best buying opportunity of the decade. It's always a cycle, and in a few years time people will look back at this period and see that it was the best buying opportunity ever.

Only forced sellers – or panicky investors – will lose out from this current financial crisis. Just ride it through, and ideally keep investing into it, and over the long term everything will be fine.

Buy low, sell high, sounds simple, but we feel the need to reiterate this 'golden rule' after a panicky couple of months.

Yes, sounds obvious, but too many people – none of our clients, thankfully – panic and switch to cash just when equity markets are at their lowest ebb, which is exactly the time when they should actually be buying as much as they can afford! We won't dwell on this point – it's common sense, which ain't so common.

Investors should take advantage of current market overreactions in expectation of a return to sanity at some point

Markets are low. Therefore, buy. Simple. Okay, but buy what?

The case for commodities: What stronger 'buy' signal could there possibly be for agricultural commodities than the fact that Afghan poppy producers are switching to wheat production? Or the fact that rat meat in Cambodia has already quadrupled in price as an inflation rate of 37% pushes other foods out of the reach of poor people. With the price of beef now £2.50 per kilo, rodent meat is a far cheaper option at 65p a kilo. Hungry locals have turned disaster to their advantage as flooding in the Mekong Delta causes rats to flee to higher ground, making them easier prey. Spicy rat stew, anyone?

Yes, commodities have recently made a dramatic retreat from record highs – but our view is that with the world's population growing (leading to greater demand for food and energy in the face of already constrained supply), recent weakness in commodity markets will be a short to medium term phenomenon. We therefore see current commodity market weakness as a buying opportunity.

Who will ultimately win in the commodities game? Some countries have oil, some have agriculture, some have neither, and some have both. The winners are Canada, Russia, Kazakhstan (?!), China (actually they have coal rather than oil, but they have mindboggling shed loads of the stuff), and possibly Brazil and parts of Africa (if they get their acts together). Those who only have oil or agriculture can perhaps trade with each other. Therefore, perhaps investing in the equity markets of the winners might make sense too...

The case for equities: Ownership of companies via regional and sector funds continues to be a good long term investment strategy. They grow and they generate income – usually, except when there is a financial crisis, but as we've already said, it's a long term game. Equities provide protection against inflation. While individually risky, a diversified portfolio of equities can generate good long term growth and income.

As well as main stream developed markets, and to some extent because of the recent hammering, we are also still supporters of emerging market equities, which appear to have been oversold as the crisis has unfolded over the last few months.

The case for emerging markets: Developed market equities dropped in the region of 20-25% during the latter phases of the financial crisis, whereas emerging markets dropped around 30-35%. This relative underperformance is due to emerging markets' higher sensitivity to trade and foreign investment. As the global outlook recovers, the rebound should be strong.

The long term story for emerging markets is, of course, all about convergence of income and wealth. This will play out over decades rather than months or years, so investment in emerging markets has to be undertaken with a long term time horizon in mind. That said, investors in these markets are likely to enjoy considerably higher rates of return than in developed markets over the long term.

Just consider the fact that the US stock market 'free float' represents about 87% of its GDP, in the UK it is 96%. Whereas in emerging markets the figures are much lower: China 15%, Russia 22%, India 21%, and so on. Stock market participation and depth (and therefore liquidity and efficiency) in developed markets is much higher than in emerging markets. Assuming that as the emerging markets mature there is greater participation and depth in their stock markets, expect significant growth in demand for emerging market equities over the coming years.

After we have quantified your financial objectives, we will help you to build a coherent investment strategy taking into account our economic views. We employ institutional calibre software and analysis tools to construct an asset allocation model and select funds. The benefit to you is improved investment performance prospects over the long term, resulting in greater wealth at an earlier age.

In conclusion

Fear, like beauty, exists not in things but in the mind that contemplates them. Therefore, do not be distracted by market volatility. Focus on your long term investment objectives, set your course, and stick to it. As long as you have a plan and time, you will get there. Yes, you will have to respond to or at least be aware of the changing environment and make appropriate course adjustments as you proceed – but do not be a sheep, do not succumb to the madness of the crowd.

Let Black Swan Capital guide you towards financial enlightenment and enrichment. Call us now to arrange a review, discuss your long term financial goals, talk about investment strategy, and sort out your personal financial life.

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**

P.S. If you happen to have an old employers pensions scheme, particularly one with an investment bank, perhaps consider for a moment the plight of Lehman's pension scheme members. For some of these people there is very serious concern over whether the Lehman's scheme will be able to provide the pension promised. Perhaps now would be a good time to consider whether your pension funds should be somewhere under your control!! Black Swan Capital can help you consolidate them into a personal pension scheme vehicle under your direct control and not linked to any former employers.

P.P.S. Wondering where the core portfolio tracker has gone? No, we are not quietly removing it, but we felt it was cluttering up the newsletter somewhat. We are currently considering the best place to hold this information, perhaps on the website. In the meantime, if you would like an update on this, please get in touch and we will let you know how it's doing.

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