Basic Points

TWENTIETH ANNIVERSARY ISSUE

October 26, 2012

Published by Coxe Advisors LLP

Distributed by BMO Capital Markets

BMO Financial Group BMO Capital Markets

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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TWENTIETH ANNIVERSARY ISSUE

OVERVIEW (and announcement)

When *Basic Points* was born in Toronto twenty years ago…

The S&P was at 410. Ten-year Treasurys yielded 6.25%. Bill Clinton was winning in a three-man race for the Presidency. The Triple Waterfall Crash of Japanese Equities was not yet three years old; the Triple Waterfall Crash of Commodities, that had begun in 1980, still had nine years to go. China had emerged from its Maoist nightmare and was beginning to make a modestly measurable impact on global economic statistics.

From the Bond department of Nesbitt Thomson in Toronto came the first issue of a somewhat idiosyncratic strategy journal dedicated to covering both bonds and stocks. It was called *Basic Points*—as a play on the basis points of bonds and the author's belief that long-term investing should be rooted in the basics of history.

It has been a great run.

The Tech Boom morphed into the Tech Bubble, which morphed into the Tech Mania after Long Term Capital Management's collapse, and then came the Asian crisis and Greenspan's reflation. The Millennium brought the Technology Crash, 9/11, and the ensuing wars in Afghanistan and Iraq, but it also unleashed China's astonishing dash to second place among global economies, and its role as *primum mobile* in the greatest-ever commodity boom—which continues—after interruption from a Crash caused primarily by the wretched excesses of a few big banks.

The S&P is more than three times higher than it was at *Basic Points*' birth, while long Treasurys yield just 38% of what they offered then. The national debt—and the prices of oil and copper—have roughly quadrupled, and gold has nearly quintupled.

The biggest story of our investment career: At *Basic Points*' inception, US GDP was $6.3 trillion, and China's was just $488 billion. Last year, those numbers were $15.29 trillion and $11.44 trillion, and their relative GDP growth rates this year, mean the gap has narrowed further.

As we assured readers from the beginning, we have tried to focus on the "big picture" stories that future economic historians would write about, not the short-term jiggles and trading tips that tape-watchers tend to crave. This attitude came from the author's background as an historian, tempered by years of experience in fund management and sell-side strategy on both Bay Street and Wall Street.

Our perspective was framed by our belief that the insights and enthusiasms of Western civilization were at the core of global progress toward greater liberty, greater growth and greater prosperity. Because of its dynamism and intellectual curiosity, and as the inventor of capitalism and the primary promoter of free trade globally, the West had, for two centuries, been the crucial contributor to the growth of personal economic liberty across the world.

It began sharing that economic leadership role as the Millennium arrived, with major Third World nations evolving rapidly from poverty to progress, an historically momentous process which soon became the biggest investment theme chronicled in these pages: "We are living through the greatest efflorescence of personal economic liberty in the history of mankind."

That view of global evolution articulated 14 years ago remains our core equity investment theme. It has been under assault—on and off—for much of that time from some traditional American strategists who yearn nostalgically for the old days that will never return

On this anniversary, we, Januslike, look both backward and ahead, as we prepare to cease publishing this journal, and begin thinking about how our research views will be disseminated in the future.

The world has changed, and much of the change has been bad news for Western economic leadership—and, for belief in some of the core tenets of Western civilization. Leading American universities have closed programs of studies in Western Civilization, often in response to political correctness. Those insights have drifted out of favor with most political and intellectual elites and most Western governments. It is, we suggest, no coincidence that economic growth rates have been declining, unleashing a desiccating process that seems destined to accelerate, given the sterility of most political debate—as in the US election campaign.

Investment research priorities have also changed. *Basic Points* has always tried to engage in a dialogue with clients who are interested in Big Picture themes discussed in leisured, literate style—not bullet points. In an era of high-frequency trading and a tipster TV culture, our journal may not be as much of "a must read."

In December, we shall release the final issue of Basic Points and with the Eve of the New Year, our last weekly conference call for BMO clients.

We are grateful to Mike Miller and his colleagues in BMO management for having given us strong support and full freedom to write about what *we* considered important and intellectually stimulating, even when—as was often the case—our enthusiasms and viewpoints often diverged widely from Street fashions and trends. The strong, deep BMO research department, which we have been proud to serve, has the people and resources to meet clients' new needs. We wish our successors well.

Our role as advisors for our Funds will not change—we will continue our collaboration with BMO Global Asset Management for the suite of commodity equity funds distributed in Canada and the US and, more recently, internationally. The Funds' strong team of investment professionals, and the impressive investment performance we have collectively been able to deliver, are sources of intense pride for us.

We shall continue researching and commenting on the global capital markets. Four decades of experience in developing and delivering different kinds of investment products and services is addictive. We have an open mind about which opportunities and associations will come next.

In conclusion, we thank our clients for those two decades of support for a publication that never sought to emulate Street research styles or priorities. You have been wonderful, and we hope we have fulfilled your trust.

Don Coxe

Comments from the Capital Markets Group at Nesbitt Thomson Inc.

Basic Points

WAR IS PEACE

WEAKNESS IS STRENGTH

WARM IS COOL

October 14, 1992

Overview

In this, our first **BASIC POINTS**, we discuss why we believe clients need to rethink their investment policies.

Although everyone agrees that the 1980s are gone, most of the discussion focuses on "greed" and excess, suggesting that the 1990s may simply be more virtuous and restrained.

We believe that the key to understanding the 1980s capital markets was the global safety net of international arrangements facilitating the flow of goods, services, and capital.

Those safety nets were built during the Cold War. They show signs of unraveling during the post-war era.

So we have chosen contradictions as our theme for 1990s investment.

In each issue, we'll also include some current bond trading ideas. John Rountree of our New York desk looks at the opportunities in the wild volatility of Canadian bonds.

Read on...

Two tumultuous decades after we published the first issue of this publication, what have we learned that is useful for investing now and in the future?

S&P 500

October 25, 1992 to October 25, 2012

Gold

October 25, 1992 to October 25, 2012

Nasdaq

October 25, 1992 to October 25, 2012

Crude Oil

October 25, 1992 to October 25, 2012

Toronto – S&P/TSX Composite Index

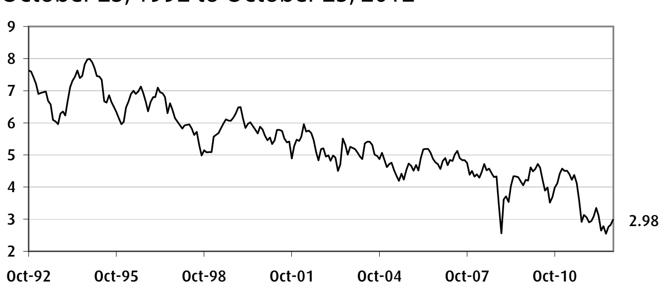
October 25, 1992 to October 25, 2012

Copper

October 25, 1992 to October 25, 2012

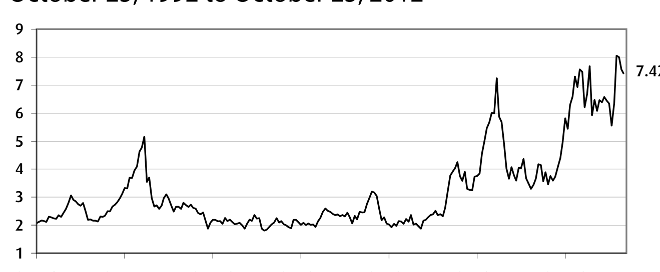
30-Year Treasury Bond Yields

October 25, 1992 to October 25, 2012



Corn

October 25, 1992 to October 25, 2012



The delicious novelty of endless strong growth accompanied by low inflation became dubbed "The New Normal." ...

It was, alas, too good to last.

We believe that the primary value for investors in looking back, is to assist in making sound decisions for portfolio construction. Those charts will doubtless provoke rueful reflections about opportunities missed or trend-driven investments that should have been cashed out before the enthusiasms were exhausted.

A casual observer glancing at the charts of equity indices might conclude that the 90s were ridiculously easy for investors: Buy and Hold was the winning strategy until the Millennium dawned; the Long-Term Capital Management and Emerging Markets panics were just short-term corrections in a raging bull market. Nasdaq's record-busting Triple Waterfall run-up began in September 1990 with the index at 340, and became history's biggest mania, driving the S&P to new heights.

What few investors realized in 1999 was that much more than a calendar page was turning. The end of the Cold War had also ended the conservative era of Thatcherite and Reaganesque defense policies based on "Peace through strength," which won the Cold War without firing a shot, unleashing "The Peace Dividend," as military budgets were slashed. The other component of their policies—economic growth based on free market principles domestically, and free trade internationally—laid the foundation for economic growth and soaring corporate profits almost everywhere except in Cuba and North Korea.

The delicious novelty of endless strong growth accompanied by low inflation became dubbed "The New Normal." Its dividends allowed a Democratic Administration to work with Congressional Republicans to "End welfare as we know it," while swelling retirement savings for Baby Boomers and pension plans.

It was, alas, too good to last.

As the old millennium died, unnoticed by revelers in Times Square, was the emergence of a mighty new economic power across the Pacific, which was consciously emulating many of the core principles and strategies that had historically enriched capitalist economies, without the politically-driven excesses that triggered recessions. Chinese exports were already beginning to drive down prices of consumer goods across the industrial world.

Nasdaq's plunge unleashed the first equity bear market in a decade, triggering a brief economic downturn, which was extended for a year by the trauma of 9/11, although the actual recession was one of the briefest on record.

This swift recovery, widely credited to the credit created by the Royally-dubbed Sir Alan Greenspan, served to reinforce faith in "The New Normal."

Thanks, in part, to the sustained downward pressure on consumer goods prices from Chinas' relentless expansion, the era of non-inflationary growth and bullish bond markets unleashed a new equity bull market that would reach new peaks with only a modest contribution from the 1990s tech darlings that had been the big names in the manic phase. In this century, Apple and Google have been the stars: at Nasdaq's peak, Cisco at $70 was the most valuable stock on earth; today it sells for $19. Mighty Microsoft sells for half its peak price.

Trillions in balance sheet exotica and erotica were spawned...

The end of the Tech Boom did not trigger a deep recession, because easy money and the alchemy of collateralized debt obligations triggered a housing boom that soon made the Tech Boom look like a rather localized affair.

For years, the best and brightest math and physics graduates from top schools were drawn to Wall Street, where new billionaires were popping up like garish weeds in untended gardens. Dismissed with scorn were the concerns of those (like us) who questioned the soaring prices of big bank stocks amid the levitating leverage that soon made previous bank excesses look trivial.

We had advised readers, as Nasdaq was plunging from its 5,000 peak, that this was a case of collective idiocy that might not be repeated for another millennium.

We were proved wrong within a mere six years.

The new mania never quite achieved epidemic proportions. Apart from spawning a breed of new mortgage-lending companies, which concentrated on borrowers with weak or non-existent credit ratings, it was confined mainly to the managements of the biggest banks in Wall Street, London and Switzerland. Trillions in balance sheet exotica and erotica were spawned and engorged by those diversified institutions as they drove their leverage from 20-1 to 30-1 and, in some cases, 50-1.

Wall Street, which had envied the glamor, dynamism and large-scale spawning of *nouveau-riche* Boomers and Gen-Xers during the tech mania, was determined to outdo Silicon Valley.

Skeptics (like us) who warned that the big banks were getting themselves into deep trouble were airily dismissed: according to the Basel Rules, banks did not need to allocate risk reserves for mortgages and financial instruments that bundled mortgages, because they were rated Triple-A by all the ratings services—and home mortgages had a splendid safety record as bank investments. (The memories of the previous millennium's pristine record in housing finance were somewhat selective: The collapse of the US Savings & Loan industry had, briefly, been a Big Story that gave birth to what would become Wall Street's Special Friend—the Greenspan Put.)

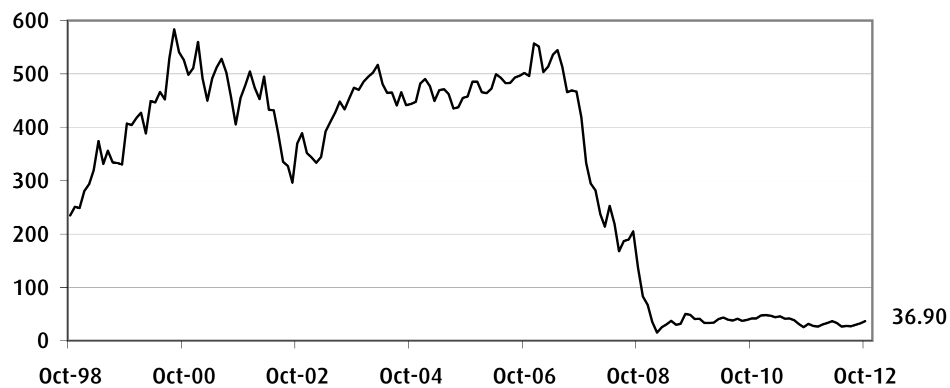
President Obama has found it convenient to exempt all these members of the 1% of the top 1% club from prosecution...

The Big, Bad Bankers Blow It

Contributing to investment banking's new image as a creator of riches for investors and bank executives was the repeal of Glass-Steagall, which gave retroactive approval to the creation of the new do-everything global bank, Citigroup. Robert Rubin, who had acquired a reputation for creativity and probity as *the* cautious Clinton White House *habitué*, joined Sandy Weill and John Reed in the troika of top management of this glamorous confection.

Then came the inevitable crash.

Citigroup
September 12, 1998 to October 25, 2012



Mr. Rubin earned $140 million or so from giving advice to top management of Citigroup, which included recommending it substantially increase its exposure to Collateralized Mortgage Bonds, whose collective value soon fell almost as fast and far as Citi's stock price. He joined those other Clinton insiders—Franklin Raines and Jamie Gorelick—who left to take top jobs at Fannie Mae, from which they exited with Rubinesque payouts prior to the Crash, thereby becoming founding members of an exclusive club: key execs who got to keep the astonishingly large compensation they received in astonishingly short time from financial institutions which the taxpayers bailed out an astonishingly short time later.

To date, none of the Wall Street *glitterati* who collectively caused the worst Crash since 1929 have been hauled before any court. President Obama has found it convenient to exempt all these members of the 1% of the top 1% club from prosecution. He simply and shrewdly—week in and week out—blames

George Bush. The strategy has been working well: polls show that most voters blame the Bush Administration for the crash and recession, and are ready to give Obama a pass for spending trillions to revive the economy with minimal results.

But Bush misunderestimated big time...

His charge against Bush is, in fact, partly accurate. Bush did, for several years, go along with the pressure from Barney Frank and other Congressional liberals to induce banks to make loans to minority applicants with weak or non-existent credit ratings. Bush cited Margaret Thatcher as his justification for promoting "the ownership society." But Bush misunderestimated big time: What she had done was arrange to sell thousands of inner-city "Council Houses" to their tenants on favorable terms, believing (correctly) that if they had a stake in their community they would look after their run-down buildings and be more inclined to seek jobs than live on welfare. But the famously frugal Thatcher wasn't putting the taxpayers at risk, because those humble houses had low book values, not prices inflated by aggressive lenders, and financed nearly or in full, through complex instruments that mixed toxic loans, dubious loans and healthy loans in the apparent belief that the ensuing stew would be healthy for both Wall Street and the economy. Bush came to his senses early in his second term and tried (weakly) to rein in Fannie and Freddie, but Barney Frank was able to block all those efforts through his control of the House committee responsible for housing policy. Therefore, Bush was partly to blame for the disaster, just as a bartender who is cajoled by a somewhat tipsy customer into pouring two more drinks is at least partly responsible if a fatal car crash ensues.

The global economy has still not recovered from that totally unnecessary crash.

After the Fall: Feelin' Mighty Slow

Despite more than $5 trillion in deficits on Obama's watch, and a dramatic transformation of scale and the nature of the Monetary Base by the Bernanke Fed, the US economy sputters. GDP growth has been declining for two years after spiking upward from the recessionary trough. Although Obama routinely cites the drop in unemployment since he took power, the great majority of new jobs created in the private sector is, as in Europe, for persons over age 55, and the unemployment rate has fallen to seemingly acceptable levels partly because of the increase in the number of persons receiving disability benefits—8.8 million, up from 7.5 million when he took charge.

Food Stamps... the biggest expenditure category in the Farm Bill, a catchall for subsidies and special interest benefits...

The US is, in this, as in some other trends, catching up (if that is the correct term) to the eurozone, where the weakest economies are heavily populated with those who qualify for government benefits for the disabled. (In parts of Southern Italy the disabled exceed 25% of the workforce.)

Another big growth in expenditures has come from Food Stamps, as the number of recipients has climbed from 32 million to 47 million. This program draws support from across the political spectrum, because it is the biggest expenditure category in the Farm Bill, a catchall for subsidies and special interest benefits that has historically gained support from urban liberals and rural conservatives. Remarkably, when the bill came up this year for its 5-year renewal, conservative Republicans rebelled and it has yet to be renewed.

The most recent quarterly US GDP growth reported is 1.3%, which is stronger than the eurosocialist economies whose policies are so admired by so many American liberals, but is considered inadequate by most Americans. That cactus-like growth rate seemed not to spook complacent institutional investors, as stocks rose to multi-year highs—until this week.

By a twist of fate, Jimmy Carter's *grandson* is credited with creating and disseminating the tape of a Romney fundraiser which included his complaint that 47% of the population was beyond his reach because they were exempt from income taxes and dependent on the panoply of government programs. Amid torrents of TV ads mocking Romney's greed and insensitivity, Obama's poll rating climbed roughly four points to a seemingly commanding lead. Pundits said the election was over. Then came the First Presidential Debate, in which voters got to see the demonized Romney in person. Surprise!

The race tightened: *Intrade* had been showing a 79% probability of an Obama victory, but the punters were betting 61% as we went to press: still a big margin, but close enough to make this a real race to the finish.

That surge comes despite a little-remarked problem for the challenger: Charles Lane, Editorial Page columnist for *The Washington Post* recently wrote that polls show that more than one-fifth of the American population admits to real problems about electing a Mormon. (Billy Graham's Evangelistic Association, like other revivalist groups, has long listed Mormonism as a cult, not a Christian sect; it deleted that label last week, provoking some indignant reactions from supporters.)

The Euro: The Currency That Couldn't

In reviewing the history of *Basic Points*, the euro has been a Big Theme.

We first raised doubts about it in February 1997, when we reported on the work of the committee set up under the Maastricht Treaty to choose the European heroes and heroines whose faces would appear on the new banknotes that would displace all those eurocurrencies. The challenge was to pick the Europe's greatest contributors to civilization, demonstrating the Continent's gifts to the world—in arts, letters, science and peacemaking.

The euro is thus a currency born, not in realism, but in the elites' conviction that more than a millennium of rivalries and wars could be repealed by a committee.

After two years, the committee announced it had given up: it could not reach unanimous agreement on any European worthy of being engraved. This evoked disbelief. What about Beethoven? He dedicated a concerto to Napoleon. What about Leonardo? His personal sexual practices were deemed too controversial. What about Mozart? He was a Mason. Marie Curie? She did atomic research and look what that led to!

We asserted that if those Europeans collectively couldn't agree on any European that, through history, hadn't deeply offended some other Europeans, then this currency would probably not survive a serious recession.

More recently, we have discussed its endogenous risk as the only tradable currency that is not specifically backed by any government, taxation system, army or navy. It is a postmodern meta-currency, like a Pirandello play, or to take a recent Irish literary example, David Mitchell's *Cloud Atlas*, which is a challenging *tour de force* set in the past, present and future. (To our amazement, it has been made into a movie, which we can hardly wait to see.)

The euro is thus, a currency born, not in realism, but in the elites' conviction that more than a millennium of rivalries and wars could be repealed by a committee.

It recalls for us a classic European military blunder created entirely by elites.

This week, exactly 158 years ago, (Another Anniversary!) in the Crimean War, due to the gross incompetence of British officers, the six hundred members of Britain's Light Cavalry Brigade charged into the main Russian cannons at Balaklava. A disbelieving French officer memorably said, "*It is magnificent, but it is not war.*" (One might make the same observation about the euro.)

As for the longer-term impact of that military horror, it proved to be primarily sartorial: the two top British blundering officers gave their names to British sweaters—Cardigan and Raglan—and the woolen helmets of the British troops knitted by British ladies who wanted to help the brave soldiers were called balaclavas. It also inspired one of Tennyson's more memorable poems. Whether the euro will leave such harmless legacies is doubtful.

A key difference is that the slaughter of the British Cavalry was over in minutes, whereas the euroelites keep doubling down on their disastrous decisions...

A key difference is that the slaughter of the British Cavalry was over in minutes, whereas the euroelites keep doubling down on their disastrous decisions made more than a decade ago.

Lately, they haven't had to confront panicky capital markets, because confidence in the euromechanisms has been rising.

Mario Draghi of the European Central Bank averted the expected summer sell-off of European bank stocks and the euro with the announcement that he would do "Whatever it takes" to defend the beleaguered currency and avert a seemingly inevitable banking crisis. That promise ignited a huge rally in European bonds and bank stocks, and the enthusiasm spread across the Atlantic as the S&P rose sharply. The Eurobond rally he unleashed continues, with Spanish bond yields at new lows for the year.

He was backed by his board, with just one dissenter—Jens Weidemann of the Bundesbank. What "Super Mario" has undertaken, is to back beleaguered banks to encourage them to back their countries' bonds. He is also improving banks' liquidity by lending them money for up to three years at the bank's overnight rate.

This show of strength has encouraged the policymakers of the EU bailout team. As of writing, they are keeping Greece alive, and are preparing a bailout for Spain.

Those responses came when it had again begun to look as if the euro would finally succumb to the sum of all its fears:

Euro
January 1, 2012 to October 25, 2012

There were two other headline news stories that encouraged eurofans recently:

1. Angela Merkel made her first official trip to Athens as the legislature was voting on the latest draconian bailout package. Her arrival produced a mob, including burners of swastika flags. But she was unflappable, firm, and friendly;

2. The Nobel Committee awarded its Peace Prize to the European Union for 60 successful years promoting peace in Europe. This was swiftly derided, notably by London's irrepressible mayor, Boris Johnson, who noted that Norwegians have always opposed joining the European Union, and wondered where they had found enough of them to vote for the prize; he said (and we strongly concur) that Margaret Thatcher deserved it, because of what she achieved to (1) strengthen European defenses and win the Cold War, and (2) expand European economies through freer markets and freer trade. Other notable recent winners, with our (possibly-inaccurate) reasoning for them: newly-installed Barack Obama, for not being George Bush and for closing Guantanamo; Al Gore, for opposing George Bush and for fighting global warming; Jimmy Carter, for opposing Reagan; and Mikhail Gorbachev, for ending the Cold War (and for restraining Thatcher and Reagan from launching a nuclear war). The announcement of the award was greeted with joy in Brussels. It came at a time when good news was particularly appreciated: a senior Flemish politician announced he was going to launch a secessionist campaign for his party's half of the country.

The euro is the currency equivalent of the late Holy Roman Empire—without the Austrian army, or, for that matter, without Napoleon.

Until these recent cheering developments, the main support for the euro seemed be the gigantic short position on the currency.

Had there been a way to short the Holy Roman Empire when Napoleon took charge of France's campaign against Austria in 1796, it would have been obvious, logical, and seemingly inevitable—and very, very costly. (The Empire endured until 1806.)

The euro is the currency equivalent of the late Holy Roman Empire—without the Austrian army, or, for that matter, without Napoleon.

As this is written, Spain is moving into the crisis-managers' headlights. Its economy is weakening—along with the constitutional glue holding the nation together. While the eurocrats struggle to keep all members in the eurozone, separatist forces in Catalonia and the Basque region are re-asserting themselves. For decades, Spain has historically dealt with its separatist forces

...for the first time in many elections, there wasn't a word about climate change in the Presidential debates.

by granting more and more subsidies, and more and more political control to the regions—the kind of policies Canadian governments have pursued toward Quebec and, more recently, to what are now called "First Nations." In Spain, as in Canada, the more the central government cedes to the separatists—the more the local leaders whose jobs depend on making demands—demand.

The euro's effect on the rest of the global economy ranges from nuisance to threat to peril. As long as the various eurocrats and politicians occupy themselves in holding meetings and in creating new bailout agencies, the euro is a mere nuisance. If interest rates on bonds issued by Portugal, Spain and Italy climb to levels that begin to hammer European bank stocks and send gold skyward, it becomes a threat. If some nation other than Greece defaults and the share prices of dozens of large European banks collapse, then the euro becomes a peril for the entire global economy.

We had not been fretting excessively about the euro's being more than a nuisance in the near-term, but now that the EU has won the Nobel, we wonder whether something wicked this way comes. Robert Merton and Myron Scholes won their Economics Nobel not long before their strategies at Long-Term Capital Management based on their formulas led to its collapse and bailout; Gorbachev was driven from power soon after winning his Nobel; Anwar Sadat was assassinated by Arab terrorists in less than three years after he won the Nobel for reaching a peace treaty with Israel; Barack Obama's poll standings have never regained their Nobel peak; Al Gore has put on a lot of weight, but lost a lot of influence, since winning his Nobel—and, for the first time in many elections, there wasn't a word about climate change in the Presidential debates.

This improbable award—designed to be a morale booster for a continent beset with gloom with winter coming on—could therefore become the bad luck charm that unleashes the worst eurocrisis yet.

Henrik Ibsen offers an observation the Nobelists should have pondered. From his play, *An Enemy of the People*, comes the line, "The strongest man in the world is he who stands most alone." Perhaps 'twill not be long ere the investment world believes that "The strongest currency in Europe is the one standing most alone—the Deutschemark."

Writing in the *Financial Times (ft)*, Gideon Rachman confirms what more and more observers have been suggesting: Berlin has become the center of European Union policymaking, replacing Brussels.

Nevertheless, colorful national and regional behavior patterns will continue to charm tourists with a sense of history. Major tourist magnet Italy will retain its charm. In a land where it is hard (and personally perilous for prosecutors) to send a *mafioso capo* to jail, the courts can still nail other malefactors. A court in Rome this week sentenced seven prominent seismologists to six years in jail for manslaughter for failing to warn people in an earthquake-prone region of a coming quake that would later kill more than 300 people. The spirit of ancient Rome lives. Soothsayers who failed to warn of coming disasters tended to have suddenly-shortened lives, because the gods had clearly rejected them. In that pre-seismograph society, *haruspices* often relied on the innards of owls, which, from time-to-time, gave bad calls. Impalement or drowning were frequently the fates for false prophets.

The Fed's policies are designed to take income from savers and give it to the overindebted—on a grand and continuing scale

This new judicial venture raises the alluring prospect that the Italians might try to jail bankers who profited from false formulas that led to the crash.

We hope the emerging Teutonic ascendancy across the eurozone does not eradicate such charming cultural traditions with such deep historical roots.

The Bipolar Global Economy

The new Millennium began for most investors with the bursting of the tech bubble, followed by the rapid inflation of the real estate bubble and its crash, followed by the panicky creation of a new bond bubble against the backdrop of record-low interest rates across most of the industrial world, as the near-Depression of 2008-9 was narrowly averted.

Those were the headline shocks for the capitalist world, and they first devastated most equity portfolios, and then slashed interest income on bank deposits, treasury bills, money market funds and bonds. As the Baby Boomers began to retire by the millions, the income prospects for the previously thrifty shrank to levels that threaten to create a new, huge class of impoverished people who had previously been members of the middle and upper investment income classes. Pension funds rolling over their bond portfolios found their incomes plunging to levels challenging their solvency. The Fed's policies are designed to take income from savers and give it to the overindebted—on a grand and continuing scale. That is a key reason why the Tea Party wants Bernanke dumped: these are mostly middle and lower income people with modest savings and their retirement plans have been devastated by the new Robin Hoods in Washington.

There are now two superpowers and their growth rates and interactions will be crucial for the global economy for decades.

As the Millennium began, the forecasters of global economic activity overwhelmingly concentrated their activity on the outlooks for the USA and Europe. The emerging markets crisis at the time of Long-Term Capital's collapse served to convince most investors that those exotic economies were not worth taking seriously—with serious money.

In fact, this was one of history's greatest buying opportunities. Within a dozen years, China would move from backward, high-risk status to #2 globally—both in GDP and in terms of oil consumption. India also moved into the limelight after the decades of barely visible growth in per-capita GDP under the modified socialist principles of "The Hindu Rate of Growth."

Leadership Changes

There had been only two big changes in global economic rankings since the onset of the Industrial Revolution, which began, developed and prospered in Britain, with "Nelson's Navy" there to protect the sea lanes for free-trade-based global trading hegemony. In the fifty years after the end of the US Civil War, the US moved to #1 global ranking, with newly-united Germany moving up to challenge Britain's ranking.

World War II established American economic hegemony. Most economists assumed that no nation would challenge US dominance until late in the 22nd century—if ever.

The European Union is ranked as the largest economy in the world, but that is a convenient meta-fiction whose most prominent acolytes are well-paid and generously-pensioned eurocrats.

There are now two superpowers and their growth rates and interactions will be crucial for the global economy for decades.

China's Growth Model

When Deng Xiaoping launched the Chinese economic revolution, he used as his models the US and Britain during the Thatcher and Reagan era, when the USA and Britain were rediscovering capitalist principles as the bases of rapid economic progress—and winning the Cold War peacefully. The Fall of the Wall and the implosion of the Soviet Union proved their insights, ideals, and strategies were what were needed for continued global peace and progress.

The advent of the World Trade Organization (which was, of course, bitterly opposed by the Left), meant that, even though China was not accepted as a member, global trade would expand faster than global GDP almost every year, and *China would be the fastest-growing participant in global trade year-in, year-out.*

...the Chinese model... was a perpetual motion machine...

So the Chinese model had two bases: exports to the rich—and increasingly uncompetitive—industrial world, and on using the net proceeds from exports and a high internal savings rate to finance capital spending and urban development on an audacious and unprecedented scale. The model was a perpetual motion machine as long as:

- the economies of the industrial world kept growing;
- the net cash flows from exports (after foreign exchange allocations in the Vendor Financing Program) remained high enough to permit rapid expansion of the Chinese banking system;
- China could continue to improve its competitive position by offsetting the demographic drag from its single-child policy through bringing in millions of workers from rural areas as tiny farm production units were consolidated into more-efficient farms.

After Reagan and Thatcher left the stage, the West rejoiced in the end of the Cold War, and the fruits of demilitarization; and the technology boom promised endless growth in wealth for all nations that modernized their economies.

Few politicians and forecasters fretted that the democratic socialist economies of most of Europe were no longer feasible over the medium—let alone the longer—term because of the most basic of all human statistics—births and deaths. Although the birth rate began collapsing across the industrial world in 1970, the progress in medical science amid universal health programs meant that the millions of unborn babies would not, for a few decades, drastically decrease populations—because the birth dearth would be largely offset by the death dearth. By the mid-1980s it became obvious that the industrial world was not replacing itself, and by the mid-1990s it became obvious that Japan, which had been the biggest global economic story of the Seventies and Eighties, was locked into an inexorable program of long-term extinction. By the late-Nineties, that demographic collapse erased the 1980s paranoia of the pending Japanese economic hegemony. (In 1989, the two top-selling business books in the US and Europe had predicted that Japan would rule the global economy within a decade.)

The armies of thrifty Asian ants keep the American grasshoppers jumping with joy.

China's astonishing success—double-digit growth year-in, year-out for more than two decades—made the fear of Japanese competition irrelevant for those who sought to earn riches by publishing dire forecasts for US and European economies. Oddly, the collapse of the Japan hegemonism forecasts was used by a new breed of skeptical forecasters who said (1) China would also implode and (2) its economic statistics were fraudulent. As we wrote in *Basic Points* from 2006 onward, the new breed of Sinoskeptic forecasters would enrich only themselves—through speaking fees and book sales: China was using capitalist principles to unleash the latent long-term ambitions of its people: as Deng Xiaoping had proclaimed in 1980: "To be rich is glorious," as he began replacing the Maoist booster posters across the land which had for decades enthused, "To work is glorious!"

Despite the dazzling growth of China, at all times there were two weaknesses in its business model: the industrial world had to avoid serious recessions that would derail Chinese industrial growth, and the outlying regions with one-hectare farms had to continue supplying workers to the cities. The single-child policy was continued past the point of necessity, to the point of rising risk, to the point of peril. Who would have predicted that the Chinese would choose to perpetuate a demographic process that will cause even more economic damage than the voluntary birth control policies of the West (which are collectively making Western social and benefit programs untenable, and slowing Western economic growth?) Why do China's careful, cautious rulers not look at the ghastly projections for the USA and Europe, and announce repeal of the most restrictive birth control program in human history?

Eight years ago, we coined the phrase *The Great Symbiosis* to explain the emerging economic/financial relationships among the three leading Non-European trading nations—China, Japan, and the USA…

"That seemingly spontaneous and undirected Vendor Financing process permits the US, Japan and China to grow faster collectively than the rest of the world through rapid increase in trade, much of which involves integration in supply chains. The core process is the financing of the US's Twin Deficits [fiscal and trade] by Asian acquisition of astounding volumes of Treasurys. That cornucopia prevents the dollar from crashing and keeps US interest rates at minimal levels, subsidizing overextended American borrowers (including Washington). The armies of thrifty Asian ants keep the American grasshoppers jumping with joy. One result is that the benchmark Treasury bonds…have become the Barry Bonds of the global bond market—outperforming with a lot of help from their friends."

Japan was on the way to gradual exit from that triad by its continuing demographic decay and slow economic growth. It dropped out when the tsunami and nuclear disaster devastated its economy and forced the nation into longer-term higher energy costs.

We'll accept the implied suggestion that Chinese leaders can exaggerate their successes with at least as much gall as American leaders.

And Then There Were Two

It is now a bipolar world, with the eurozone not so much a competitor as a problem for both major powers. The demagogic election year-driven attacks on China—primarily from Romney, but also from Obama—are evidence that China, through continued rapid GDP growth and continued improvement in its higher education performance, has become the driving force in global trade.

If it were not for the dramatic growth in US production of oil and gas, the relative performance of those two giant economies would make it likely that, by 2016, the US would not just have its bonds downgraded severely, but would fall to second-place in global GDP rankings.

In other words, the economic activity created by Obama's $5 trillion of debt buildup was helpful, but the activity created by an industry that he routinely uses as a groan-getter when addressing Democratic crowds has been the strongest component of "The Obama Recovery." This is one of the greatest paradoxes of our time, and it is a measure of Obama's famed luck that it should be happening just when he most needs the jobs and GDP growth, and falling energy costs.

Last week, China announced its Third Quarter GDP growth was 7.4%, four times the recent rate of US growth. American analysts are falling all over themselves to challenge that number, claiming the real performance was closer to 5%. We'll accept the implied suggestion that Chinese leaders can exaggerate their successes with at least as much gall as American leaders—but even at the reduced rate, China is growing far faster than the US, despite the longer-term impact of the Crash on the Chinese economic model.

China's prime minister, Wen Jiabao, spoke approvingly at global gatherings of the work of Adam Smith.

This was nightmarish for most Western university departments in economics, political science and philosophy...

The Crash not only served to empower leftist demagogues in the US and Europe who proclaimed the end of capitalism, it was a brutal blow to the Chinese economic and political models: the industrial world would probably not resume strong enough economic growth to permit China to expand its industrial output at double-digit rates. Bizarrely, the revival of socialist propaganda across the US and Europe stimulated a rebirth in Maoism within China. Capitalism no longer believed in itself? Capitalism had failed! Maoist socialism was finally proved as the only true road to economic progress! A rabblerousing new contender for a place near the top of China's politburo, Bo Xilai, who inflamed the crowds with Maoist songs and distribution of the Little Red Book, infuriated the cautious leadership, as they prepared to hand over control to the next Politburo in 2012.

The Left Revives When Capitalists Fail

After the Fall of the Wall and the collapse of Communism in Europe and Russia, capitalism rather suddenly became more accepted across the globe than it had ever been.

The newly-emerging economies were basing their growth on using capitalist models in their planning: India scaled back its socialism—with spectacular results; China's prime minister, Wen Jiabao, spoke approvingly at global gatherings of the work of Adam Smith.

This was nightmarish for most Western university departments in economics, political science and philosophy, which had long since jettisoned or marginalized the classic liberalism of Locke, Berkeley, Hume, Smith and Ricardo. Since the West's prosperity had been widely associated with private enterprise and free capital markets, the Crash became a virtually unlimited supply of ambrosia for the Left everywhere. Look what capitalism has done to inflict misery on billions of innocent people across the world!

The Left has successfully used the story of the big bankers' bad bets as justification for its attacks on capitalism, and the need for social democracies in which greed is controlled, and the rich pay more to support the poor whose problems were—naturally—created by the rich.

If President Obama is re-elected, something approximating European Democratic Socialism (but lacking the German dedication to efficiency and productivity based on work-related education) could be the intellectual basis of public policy on both sides of the Atlantic for years to come. What makes it such a politically potent platform is that anyone who opposes focusing budgets and the economy on helping losers at the expense of winners is immediately denounced as greedy and antisocial.

At roughly $100 billion a month, the deficits are too picayune to succeed?

Canada, under the leadership of small "c" Conservative Stephen Harper, may now be the closest economy in the G-7 to Thatcherite and Reaganesque policymaking. However, Mr. Harper, like his American conservative counterparts, is under sustained attack from the mainstream media and the university publicists. In a surprising outcome of the last federal election, the opposition party in Ottawa became the enthusiastically-Socialist NDP. Opposition parties eventually get elected, so Canada's fling with a form of free enterprise may not endure for long.

This erosion of both belief in capitalism and the practice of it, is not only problematic for investors in US financial assets, it is also a very big problem for China.

Of course, this is not the way the Euro-Socialists and their American followers present themselves. They say the only way to stimulate the economy is for the government to put more money into more people's pockets. As Larry Summers writes in the *ft*, "[The] 'demand support view'...pushes for steps to increase demand in the short run as a means of jump-starting economic growth and setting off a virtuous circle in which income growth, job creation and financial strengthening are mutually reinforcing."

That's what he told us would happen from the Obama stimulus package and the other big spending programs during the depths of the recession when almost everyone agreed, "Don't just stand there! Spend something!"

Obama continues to spend nearly $100 billion more each month than he collects in taxes, thereby giving sustained meaning to one of mainstream economists' favorite words—jumpstart. That Mr. Summers, and Paul Krugman, and their brethren still use that euphemism four years into the Obama economic experience instead of "record levels for deficit spending" recalls Orwell's Ministry of Truth. (Krugman keeps insisting that the only reason the Obama stimulus programs haven't worked is that the deficits have been nowhere near big enough. At roughly $100 billion a month, the deficits are too picayune to succeed?)

...US (and European) growth rates continue to decline from the mildly positive to the positive to the insipid to the barely observable.

While the deficit spending continues at record rates, US (and European) growth rates continue to decline from the mildly positive to the positive to the insipid to the barely observable.

China has to be worried about the darkening outlook for the US and Europe. Although it is diversifying its export emphasis away from those mismanaged economies, it is now facing the social problems arising from those decades of sustained success.

Single children born into a poor society can be subjected to regimentation and sacrifices far more easily than those born into a society that is rich beyond the dreams of older generations. As a report in the *ft* notes, "Young men and women today have much higher aspirations than their parents did. Many psychotherapists employed at plants across southern China—partly in response to staff suicides—say the first generation to work in coastal factories compared their jobs favorably with their parents' labor on the farms. Their more consumerist children, however, tend to compare their situation with that of today's wealthy Chinese."

We think it likely that the Politburo will respond to the deteriorating outlook for the USA and Europe, and the impatience of Chinese millennials for higher-class lifestyles by diverting investment away from exports to consumer goods and recreation facilities.

While the industrial world was building up its debts at the governmental and personal levels to unsustainable levels, China's relatively modest debt levels—public and private—are supportive of a decade of catch-up spending. The government has announced major improvements in health care and some improvements in pensions, which will reduce the burdens on the young and middle-aged for their forebears.

The Sinoskeptics living in declining economies look at China's reduced export levels and eagerly forecast coming economic decline for the Middle Kingdom. In fact, China is diversifying its exports to include greater reliance on the other strengthening Asian economies—and away from the old, weakening economic powers of yesteryear. Domestically, having built enough airports and superhighways for a billion travelers, they must now find ways to ensure that the users come.

That is, we suspect, the plan that will unfold. The Chinese economy will continue to be far stronger than the US or European economies, but its output will be more heavily directed to Chinese consumers, and people in the other emerging economies with excellent growth.

A New Asian Geopolitical Crisis

What is of immediate concern is the rather sudden rise in Chinese fury against Japan for crimes committed in the 1930s. Across much of China, riots have forced major Japanese factories, distribution centers and retail operations to shut down.

Sparking this desire for revenge for brutality committed so long ago is a territorial dispute about some spots in the sea that relatively few Chinese have seen.

The Sekaku Islands, a few tiny offshore islets that most resemble those *New Yorker* cartoons of desert islands, are being promoted by radicals (with little, if any, restraint from the leadership) into a *casus belli* against Japan. That is bad enough news. But the Chinese rioters have inflamed Japanese nationalists. In a nation not noted for hyperbole, a former defense minister blusters that losing the islets—that may or may not have access to billions of barrels of undersea oil—would be like "losing the whole country."

The Sekaku Islands, a few tiny offshore islets that most resemble those *New Yorker* cartoons of desert islands, are being promoted by radicals... into a *casus belli* against Japan.

Niall Ferguson, who takes these events very seriously, explains (in *Newsweek*) that those islets belonged to China until the Japanese took them after defeating China in 1895. The US administered them after 1945, and then handed them back to Japan in the 1970s. But neither China nor Taiwan agreed with that outcome.

This story will not go away easily, as trivial as it may seem to sophisticated internationalists. The new Politburo can hardly seem to be softer than its predecessor.

Those with long memories will recall that, for many years, Quemoy and Matsu were the two most dangerous little islands on earth. These seaspecks claimed by both sides were located between Taiwan and China and were covered with pillboxes, cannons, telescopes and rocket launchers. Day in, day out, the Taiwanese and Chinese would shoot at each other. Henry Kissinger once described this small spot in the ocean as "The most dangerous place on earth." Successive US Administrations feared they could be dragged into war if the Chinese actually tried to launch an invasion—as they routinely threatened.

When did they cease to be a threat to global peace?

We seemed to stop hearing about them after Nixon's visit to China.

We somehow doubt that Obama would willingly adopt a Nixonian strategy—or that the Chinese would fear American power enough to compromise.

China will inevitably become the world's largest economy... The only useful question is "When?"

Conclusion

China will inevitably become the world's largest economy and India will most likely become the world's second largest economy—as Chris Patten predicted a decade ago. The only useful question is "When?"

The economies of China and India will become less and less dependent on demand from the aging, flabby, handout-driven, "industrial economies" struggling with relentlessly expanding debts for the aging and unemployed, and for their pathetically underfunded public sector pension programs.

China's and India's biggest long-term problems are more likely to come from the erosion and implosion of the worst-managed economies of the industrial world than from their own inadequacies. Today the US already has a worse debt/GDP ratio and a worse deficit than most of the eurozone nations.

The important difference is that the eurozone nations know they are in grim shape, and are, in most cases, trying to do something about it. The US remains in denial.

The Investment Environment

1. The Elections

The race between Messrs. Obama and Romney remains close. The President atoned for his lackluster performance in the first debate with two strong performances involving vigorous, sustained attacks on Romney's wealth, greed and insensitivity; Romney mostly stuck to his campaign theme, that if Obama is re-elected, the economy will remain weak. The President's $400 million campaign of vilification of Romney was successful: he seems to have convinced a crucial percentage of the electorate that Romney's ill-gotten wealth is *the* issue in the election, not the four years of increasingly dismal economic performance. The received wisdom about elections involving an incumbent President is that they are always referenda on his performance. For months, it looked as if David Axelrod's strategy of painting Romney as a heartless plutocrat, devoid of human sensibility, would beat the odds. Even now, all polls show that Americans like Obama much more than they like Romney.

"The law, in its majestic equality, forbids the rich, as well as the poor, to sleep under bridges, to beg in the streets, and to steal bread."

Another reason Obama is more likely to win, is that as President he largely avoided issuing budgets, even when his party had supermajorities in both Houses of Congress. The one budget he did submit was voted down 97-0 in the Democratically-controlled Senate. That means he has never had to tell any of his key constituencies that they cannot expect to have in the future what they have now, without a far stronger economy and some personal sacrifices.

As for his beleaguered challenger, Romney's across-the board tax-cutting plans are scarcely credible. He rather weakly promises they will not be legislated unless agreement is reached on closing loopholes—and there is pickup in economic growth to generate more tax revenues. This is a tough case for a multi-millionaire to make. Listening to him in the debate as he promised to cut taxes by 20% for the rich and the middle class alike, we recalled Anatole France's dictum: "The law, in its majestic equality, forbids the rich, as well as the poor, to sleep under bridges, to beg in the streets, and to steal bread."

Romney's program is, essentially, a replay of Reagan's tax cut strategy, which did lead to much faster growth, but failed to collect the taxes so optimistically predicted. Voters are right to be skeptical. In a race between no detailed fiscal program whatever and one that is seen as detailed, dubious and self-serving, the detailed, dubious program probably loses.

The amount of cash sitting on the sidelines is the private sector equivalent of sequestration...

If Obama wins, and assuming the Republicans maintain control of the House and the Democrats hold the Senate, the "fiscal cliff" scenario will rapidly unfold in November, and the election will have turned out—like so much federal spending—a waste of money.

Same result if Romney wins and the Democrats keep the Senate by a small margin?

Not necessarily.

We think that Romney, whose essential moderation has finally emerged late in the election campaign, would have the better chance of enacting a program that avoided a crisis and sequestration, and launched the nation on a road leading to fiscal sanity. He is experienced in dealing with the other party, unlike Obama, trained in the hard-nosed single-party politics of Chicago, whose health care bill got zero Republican votes in the two houses. Those *ultima thule* Republican Congresspersons who have sworn vows never to raise taxes could be forced to break their vows if Romney and their favorite Young Turk, Paul Ryan, tell them that a proffered compromise is what is needed to save the nation.

The best outcome would be a clean sweep—the White House and both houses of Congress—by one party or another. The winner would have no choice but to face the music.

We shall know soon enough. The amount of cash sitting on the sidelines is the private sector equivalent of sequestration that could be unleashed into financial assets and capital spending if a modestly credible fiscal deal is achieved within reasonable time.

2. The Seemingly Immortal Bond Bull

We have in the past discussed what we call "The *Japonisation* of the Treasury Bond Market."

Ben Bernanke's "Twists" and turns have evoked howls from the Rand Pauls and their brethren that the Fed is printing money mindlessly.

Japan 10-Year Government Bond Yield
January 1, 1990 to September 23, 2012

US 10-Year Treasury Yield
October 1, 1990 to September 23, 2012

One reason that Treasurys are mimicking Japanese bonds is that the US economic recovery from the financial collapse has proved to be so lacking in vigor and sustainability. GDP growth is slower this year than 2011, which, in turn, was slower than 2010. *That is an eerie replay of the Japanese experience—and Japan's deficits weren't of Obaman proportions.*

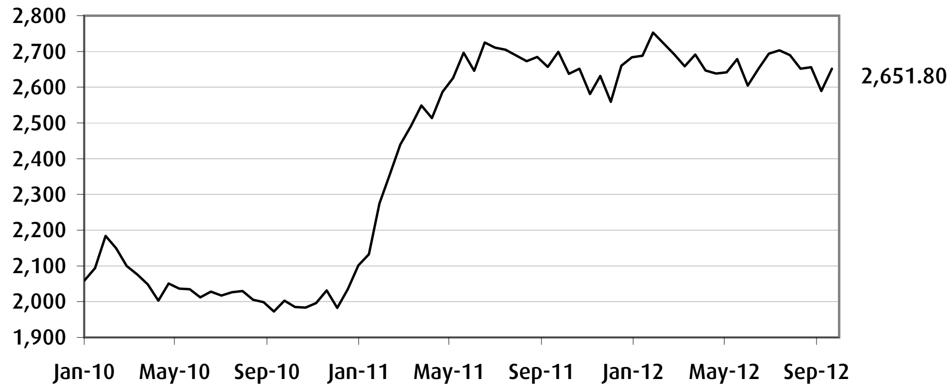
Yields on Japanese bonds kept declining without massive fiscal stimulus: the economy—and credit demand—functioned at the vigor of the septuagenarian Japanese political class.

And so it is with the US economy. Ben Bernanke's "Twists" and turns have evoked howls from the Rand Pauls and their brethren that the Fed is printing money mindlessly.

Meanwhile, the US is enjoying an energy boom...probably the only big economic success story of the Obama years, came despite the lack of support from—or outright opposition of—the Administration.

Not so:

US Monetary Base
January 1, 2010 to Sept. 23, 2012



Source: Federal Reserve Bank of St. Louis; http://research.stlouisfed.org/fred2

The Monetary Base has actually contracted in the past twelve months. The ingredients of the base change as the Fed finds new ways to stimulate the moribund housing market, but the size of the Base has shrunk.

The Bank of Japan can look at this chart and say, "You Americans are imitating us! You can't make the money supply grow, so all you do is change the duration and composition of the Base. Corporations hoard cash because they fear the future. Your manufacturers—like ours—continue to struggle with Chinese competition."

What makes this comparison even more embarrassing for American policymakers is that Japan has one big problem that the US does not: Japanese energy costs climbed sharply because of the shutdown of the nuclear power plants and the nation's near-total lack of indigenous supplies of natural gas. Meanwhile, the US is enjoying an energy boom that dramatically *lowers* costs for natural gas to mere fractions of the rate Japanese pay, while creating good-paying jobs and rapidly lowering costs for electricity plants and chemical companies. This, probably the only big economic success story of the Obama years, came despite the lack of support from—or outright opposition of—the Administration. *Had Japan experienced the US's big drop in energy costs and the big employment gains from the oil and gas industry, its GDP growth recently would surely have exceeded US performance.*

Today's Treasury yields have not come from the subsidy of continued torrents of Chinese investing, as was the case in the early years of the Obama Administration. The Chinese no longer have stupendously large cash flows to invest in Treasurys, and they are diversifying their $3 trillion in forex funds away from near-total reliance on Treasurys—even tip-toeing into gold.

So today's low Treasury yields are *Japonais* yields,

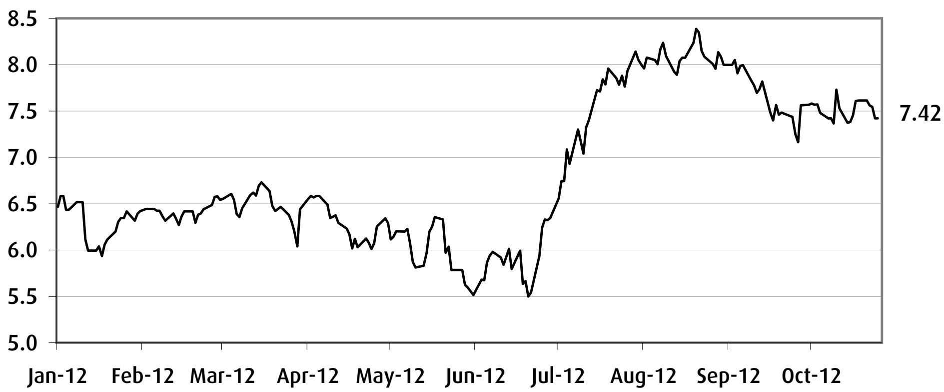
Nor have they been the result, in the past year, of massive Fed investments, because the Fed's balance sheet has actually declined modestly, and it has been concentrating its activity on mortgage products.

So today's low Treasury yields are *Japonais* yields, reflecting the kind of miserable economic performance that Japan has experienced for decades. Based on the last three years' experience, if Obama is re-elected and continues the policies of recent years, that is a reasonable prospect for the US—*apart from the oil and gas industry*. Japan led the way in terms of demographic decline, and it is leading the way in economic decline that continues despite record deficits.

3. The Drought Catastrophe That Wasn't

Corn

January 1, 2012 to October 25, 2012



Soybeans

January 1, 2012 to October 25, 2012

The Dust Bowl is part of the collective psyche of the Southern Midwest...

Wheat
January 1, 2012 to October 25, 2012

We attended a touching musical drama recently of the life story and songs of Woody Guthrie, the great 1930s Marxist protest singer, and composer of more than 1,400 songs, including *This Land is Your Land*, *Tom Joad*, *The Friendly Banker* and *Worried Man*. He grew up on an Oklahoma farm and the most heart-wrenching scene in the play was his lengthy description of the Great Dust Storm of 1935, which turned years of Okie poverty into outright disaster. His family's farm, including its implements and machinery, was totally buried—in hours—and he set out on the road to California, where he first achieved fame.

The Dust Bowl is part of the collective psyche of the Southern Midwest, and any climatic glitch that suggests something even remotely close to that disaster might be coming naturally evokes atavistic fears.

As the Midwest Drought of 2012 was unfolding, amid alarums from environmentalists that this was merely the latest example of the catastrophe of global warming, something happened: grain prices stopped rising. We began hearing daily anecdotal reports that farmers and USDA inspectors in many locations across the plains were reporting that crop damage had been overestimated. Then came scattered showers, and further pullbacks in grain prices.

At that point, the UN Food & Agriculture Organization announced that it no longer expected that this year would *not* be the third year in five in which it had to proclaim a Global Food Crisis.

Since then, we have been hearing more reports that a big contributor to the unexpectedly higher yields was the relatively strong performance of genetically-modified seeds. A few years ago, we had a conversation with the CEO of one of the major GMO seed companies, in which he said that they were developing seeds with low moisture tolerance that should outperform standard grains and oilseeds in drought-like conditions. We asked about the Dust Bowl and he laughed that off, saying, "Nobody can protect against that! But we'd expect our crops to do better than most under less extreme drought conditions. However, we won't know until we get a drought."

...the global crop carryover-to-use ratios are near all-time lows, which means the outlook for agricultural stocks for the next year is splendid.

We realize that even hinting at this will evoke wrath from the enemies of GMO. We recall giving a keynote speech to a major food conference where a large percentage of the crowd was anti-GMO. When the question period came, one indignant speaker after another denounced us, with some saying we were part of a conspiracy to kill people on a grand scale. We have had long experience with the Far Left and even the Idiot Left, but these paranoid fanatics were the worst ever.

So we suspect that the seed companies will continue to be cautious about making any claims that their products helped avert a global disaster.

Nevertheless, the global crop carryover-to-use ratios are near all-time lows, which means grain prices will remain high—which means the outlook for agricultural stocks for the next year is splendid.

Some analysts are telling investors that unless the farm bill is passed, the outlook for US agricultural investments is poor. Our research tells us that the only crucial component of the farm bill for grain farmers is renewal of crop insurance for next year's crops. The losses from this year's droughts are largely covered by insurance, and the higher prices for grain that was harvested.

4. Commodities and Commodity Stocks

Since the Great Commodity Bull Market began a decade ago, from time-to-time, strategists have proclaimed that the Super-Cycle is over.

Can Bill Gross and Ray Dalio be dismissed as gold bugs?

They are back in fashion, as one strategist after another sees the parade and rushes to get in front of it.

a) Gold

Gold tends to be a particular object of sophisticated scorn. People like us are dismissed as "gold bugs" for having recommended exposure to gold year-in, year-out since 2001. (That gold has gone up for 13 straight years is somehow overlooked.) Among the loudest skeptics are strategists recommending overweighting in bank stocks—particularly the big banks that we call the B5 (Big, Bad, Bonused, Bailout Banks). The critics' attitude makes excellent sense, given that gold is an obvious alternative to having money in the bank—or, for that matter, in shares of bailed-out banks that have promised to sin no more.

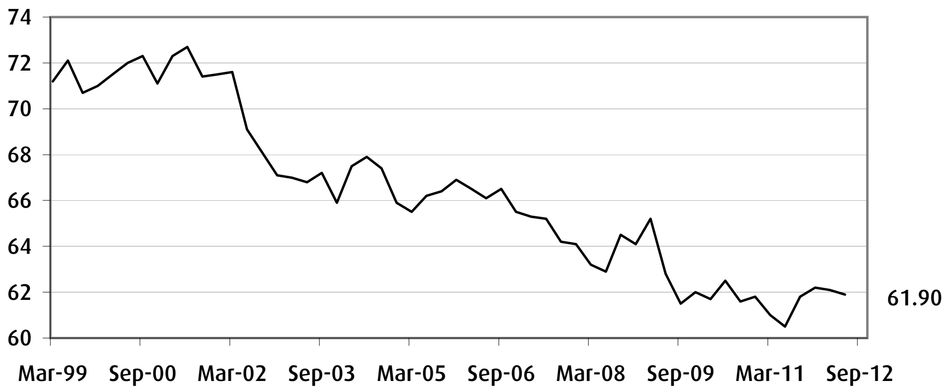
As this is written, with gold at 1716, the metal is up just 10% year to date, which means gold is having a mediocre year, and is actually underperforming the S&P, which is up 12% (not counting dividends, which have become the most significant factor in US equity performance). For Canadian investors, the relative returns are different, with the TSE up merely 2%, as it is for British investors, with the FTSE up 4%. Gold has been good to them—on a relative basis.

Admittedly, the story for gold stock investing this year has recently been less compelling, with the GDX virtually flat. However that index includes large exposure to stocks that we have never recommended to clients, because of significant political risks—mostly to African nations experiencing more than routine political turbulence. Since the gold stocks bottomed out last Spring, they have strongly outperformed both bullion and the S&P.

Can Bill Gross and Ray Dalio be dismissed as gold bugs? They both recommend meaningful exposure to gold. The respected Ned Davis goes much further, pounding the table about the need to have strong gold exposure in almost all portfolios.

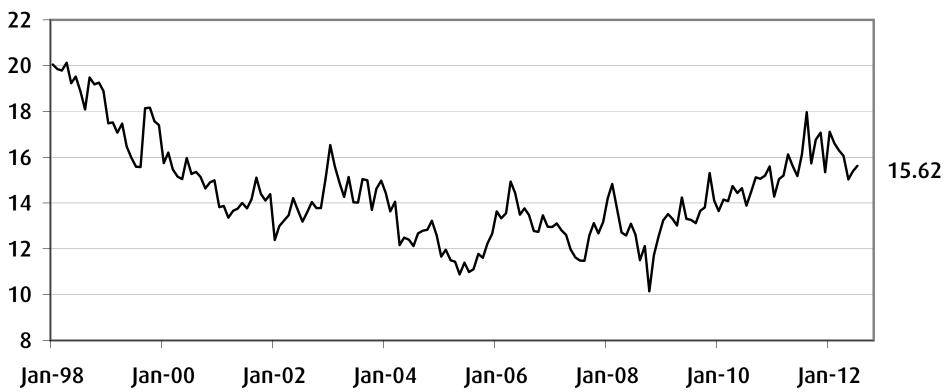
One relatively new aspect of the gold story is the change in the weighting of gold in global foreign exchange reserves compared with Treasurys. Our friend Stephanie Pomboy, the brilliant iconoclast of the indispensable *MacroMavens*, kindly agreed to let us use these charts from a recent issue of her publication:

US Dollar as % Global Forex Reserves
March 1, 1999 to October 23, 2012



Source: MacroMavens LLC.
data: IMF, Allocated Reserves

Gold as % Global Forex Reserves
January 1, 1998 to October 23, 2012



Source: MacroMavens LLC.
data: IMF, Allocated Reserves

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From experience at attending a relatively informal global central bankers' offsite weekend discussion on commodities and inflation, we came to understand that central bankers from the leading banks tend to see each other as members of *THE* global elite peer group. They all have to put up with their political masters, who keep getting replaced with inexperienced new masters, which means bankers tend to be very chummy with each other. When the kind of trend change shown in these charts becomes so well established, it is the signal of a momentous change in central bankers' global risk appraisals. No, they aren't gold bugs, but they are certainly no longer the slavish adherents of Keynes they had been for decades.

(b) Oil and Gas

The skeptics might seem to have a better case with energy stocks, because the gas glut in North America has been bad news for oil-prone investments.

However, speaking from personal experience, the universe of oil, gas, oil service and pipeline stocks is so vast that investors should never abandon it. One advantage for these commodities: unlike metals, they can't be recycled; gluts go away, and shortages always return.

This has been, we can attest, a great year to own the refiners and the better offshore oil operators.

c) Agriculture

We have already discussed the rally in grains, which remain up strongly year-to-date, and the stocks of companies supplying inputs to farmers, which have generally been very rewarding, not only this year, but over the longer term. Any product or service that helps to produce more food at lower cost is not just a boon to humanity, but a fine investment for those who do not succumb to investment faddishness against raw materials stocks.

d) Base Metals

Those same skeptics also point to the collapse in iron ore prices as evidence the commodity bubble has burst, and "The China Story" is dead.

But even with the pullback, iron ore prices remain vastly higher than they were a few years ago, and we remain of the view that those who think China is finished should insist that their clients start investing heavily in manufacturing companies in Europe and North America that compete directly with China.

Within a super-cycle there will be ups and downs. What's backing this one is billions—not of dollars or collateralized debt obligations—but of people...

As for copper, which has the second-highest correlation with Chinese industrial activity after iron ore, its price this year has held quite steadily near the levels it attained before all those big banks the commodity critics admired so much crashed. The crash wasn't caused by the implosion of China and commodities, of course, but like civilians in Syria, they were wounded in the fighting.

Copper is obviously facing problems as the global economy weakens. But it may not be that much riskier than much of the S&P.

Conclusion

Within a super-cycle there will be ups and downs. What's backing this one is billions—not of dollars or collateralized debt obligations—but of people emerging from poverty and becoming measurable participants in the global economy. That process—on a scale which makes it the most momentous in human history—is the most significant *investment* opportunity of our time. Their nations' rising competitive power is the second-biggest challenge to the sustained economic supremacy of North Americans and Europeans. The biggest is the deterioration in the realism of politics and economics of North Americans and Europeans. Any strategist who ridicules the idea that China, India, Indonesia *et al.* will continue to grow their GDPs far faster than the US and Europe is implicitly assuming that the kind of dynamism behind the growth of the US, Britain, and Northern Europe in the five decades after World War II still exists among today's soaring debts, deteriorating demography, and putrescent politics.

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation
Capital Markets Investments
US Pension Funds

	Allocations	Change
US Equities	21	unch
Foreign Equities:		
European Equities	1	unch
Japanese and Korean Equities	1	unch
Canadian and Australian Equities	3	unch
Emerging Markets	4	unch
Commodities and Commodity Equities (ex-Gold & Gold Stocks)	6	unch
Gold & Gold Stocks	6	unch
Income Generating Assets		
Dividend Stocks	15	unch
Bonds:		
US Bonds	11	unch
Canadian Bonds	4	unch
International Bonds	2	unch
Inflation Hedged Bonds	10	unch
Quality High-Yield Bonds	1	unch
Cash	5	unch

Bond Durations

	Years	Change
US	5.25	unch
Canada	5.25	unch
International	4.00	unch
Inflation Hedged Bonds	7.25	unch

Global Exposure to Commodity Equities

		Change
Agriculture	32%	unch
Precious Metals	28%	unch
Energy	28%	unch
Base Metals & Steel	12%	unch

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	unch
US Equities	5	unch
European Equities	1	unch
Japanese, Korean & Australian Equities	1	unch
Emerging Markets	4	unch
Commodities and Commodity Equities (ex-Gold & Gold Stocks)	6	unch
Gold & Gold Stocks	6	unch
Income Generating Assets		
Dividend Stocks	15	unch
Bonds:		
Canadian Bonds		
Market Index-Related	15	unch
Real-Return Bonds	12	unch
International Bonds	3	unch
Quality High-Yield Bonds	1	unch
Cash	15	unch

Canadian investors should hedge their exposure to the US Dollar.

Bond Durations

	Years	Change
US (Hedged)	5.25	unch
Canada:		
– Market Index-Related	5.25	unch
– Real-Return Bonds	7.25	unch
International	4.00	unch

Global Exposure to Commodity Equities

		Change
Agriculture	32%	unch
Precious Metals	28%	unch
Energy	28%	unch
Base Metals & Steel	12%	unch

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

1. The US election matters. If Obama wins, the Democrats should also hold the Senate, but the Republicans would probably still maintain control of the House. Virtually the only concrete budgetary proposal Obama has made in two years is that the rich must pay more. That will have only tiny impact on the deficit. Therefore, the asset that wins from an Obama-win is gold. If Romney wins, he will attempt, and probably succeed, in negotiating a deal with the Senate, which the Democrats would barely control—if at all. If a credible budget deal were done, it would be good for stocks and bonds, but bad for gold.
2. The outlook for demand for agricultural inputs from row crop farmers is probably the best of all time. Grain prices are high, and carryovers are at record lows. Crop insurance has prevented most US grain farmers from losing heavily from the drought. Expect farmers to invest heavily. Meat producers are being skinned alive at the moment, but by midyear will be benefiting from much higher prices for hogs and steers.
3. If Romney wins, Keystone gets approval on Day One. If Obama wins, there is no guarantee he will approve it in timely fashion—or at all. Ideology and big donations from tax-exempt NGOs will weigh heavily on his decision. Defer further commitments to oil sands shares until the election is over.
4. The area of Africa and the Middle East in which Islamic terrorism is intensifying its activities keeps setting new records by the month. Never has it been so strong and defiant. Assume increasing problems for Mali and Nigeria, and increasing risks for mining and oil companies across that vast region.
5. The US has been experiencing the biggest deficits and lowest interest rates of all time. Both the Keynesian and Friedmanesque stimulus policies are being employed on a scale never seen outside banana republics or the Weimar Republic. Yet the economy moves at the speed of an arthritic octogenarian. The eurozone's biggest contribution to the global economy is to make the US economy look good in comparison, thereby justifying the S&P's lofty valuation. We grow increasingly doubtful. Caution is in order.

6. We believe that gold will break through the $2,000 level within the next year. Picking gold stocks without regard to political risks becomes somewhat more challenging as bullion prices rise, because many governments see higher prices as a justification for higher taxes and/or royalties.
7. The Canadian dollar is driven up by fears of Obama and/or Bernanke, and down by fears about future rate reductions fostered by Bank of Canada Governor Carney. Canadian bonds look very attractive compared to Treasurys.

THE COXE STRATEGY JOURNAL

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