



Income Builder Weekly

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From Fable to Nitty Gritty

We are witnessing, keeping with our forest analogy, a forest fire of massive proportions which threatens to engulf us all. The degree to which we survive and prosper in the next epoch will depend in large part to a transformation in the way we do things. This means that, without cooperation across countries and regions, we will sink together in the morass of previous excess. The Phoenix will surely rise again (keeping with the fire analogy) but our forest will have by then been burned beyond recognition.

We should ask, "How far along are we in the conflagration? Have we entered the healing process? What are the prospects for victory and survival?"

We can divide the conflagration into two territories: markets and economies form the main battleground, as it were. Markets are the canaries in the coal mine. The current crisis was first seen in the credit markets in 2006 and 2007. The medicine given was not strong enough, the problem too large that the trouble spread to other financial markets. For a time there was panic in both credit and financial markets (stocks and bonds) as uncertainty abounded. Then the perfect storm ensued. Virtually any excess that occurred between 1995 and 2006 became visible - trade imbalances, current account imbalances, commodity price distortions, economic nationalism, bank and non-bank recklessness, over-leverage, the carry trade - the list is long and infamous.

The good news is that we are well into the cleanup process, though fresh fires from prior excess are still flaring (the latest being Eastern Europe's imbalances). The bad news is that we have not yet begun to recover.

Why do we need cooperation? The lessons of the 1930's abound. Each country trying to maximize its circumstances results in the lowering of the value of the overall pie, as it were. This is similar to the effect that rational acts by consumers to cut back on consumption and to repay debt have on a national economy - they cause a demand drop of large enough proportions as to shrink employment (companies cutting back on no longer needed production) and to shrink the entire GDP pie. In the latter case, governments step in to fill the void of private demand slumping by enacting jobs programs, cutting taxes, building infrastructure - in effect re-stimulating the economy for long enough to take the place of the healing consumer. The healing process can occur without government action, but the liquidation of homes and other property causes a large toll in human terms. Thus, if you will, the law of cause and effect is mitigated a bit in its effect by governments.

In the case of the international economy, though, there is no "sovereign" empowered to print money and to expand its balance sheet enough to slow economic deterioration caused by private demand

falloff. What's more interesting, the problems in the U.S., England, Australia, Spain, etc. were caused by excess consumption.

The problems in China and Japan are caused by excess production (to satisfy the excess consumption). In this way, then, the unraveling of the world's economy has different causes but the effects are the same - a diminution of demand and output and unemployed people.

The Healing Phase

We are looking for enough bilateral and regional cooperation to offset the lack of an international sovereign. So far progress has been spotty at best. This said, we are hopeful that the lessons of the 30's, where protectionism and economic nationalism all but snuffed out international trade and "beggared" almost everyone, won't be repeated. This said, most country leaders serve at the pleasure of their citizens, not of the citizens of other countries. Altruism appears to be a product of being higher up on the Maslow hierarchy of needs. To the extent that we can somehow maintain enough commerce, enough order, enough cooperation we will muddle through this crisis. As we asked before, "Are we?"

We are faced with the necessity of choice - and necessity is the mother of invention. It may be that the International Monetary Fund will be forced to democratize in return for getting more money from relatively rich emerging nations to help other emerging nations cope (read Eastern Europe). The old international bodies, the G7 in particular, needs to be revamped.

Just as WW II was a catalyst for political peace, so is the current crisis a catalyst for economic peace and a new period of prosperity. That said, WW II had to end and the victor had to be visionary enough to help lift the losers from defeat to stability in the camp of the victor (of course).

We are nervous, but have so far seen nothing which violates our central thesis that we will muddle through okay, with patience. Last week we mentioned that we were about halfway through this crisis. The back half is the most dangerous, because all elements of society are engaged in feeling its effects - the real economy and not just financial markets is threatened with collapse.

Signs

Credit markets are more normal than they were a year ago. But credit is only needed to be available at a reasonable price. The world does not need more credit per se, just that it be available to those who can best use it (those who did not make excessive use of it in the prior cycle).

Bond Markets

The only credit market going for a time was the government bond market - the federal one. State and local muni bond markets were almost shut down, money markets had almost been strangled by Lehman's collapse, corporate bond markets were languishing because no one trusted anything but government paper, and so on. The good news is that corporate bonds are well into a recovery, substantially off the lows (and buying opportunity) of October and November.

Stock Markets Are Another Matter

Globally, Asian stock markets (save those of Japan) are still some 15% from their lows - that of China is about 20% from the low. European markets are right at the early lows, as is most of the U.S. stock market. Yet, if you look at many individual stocks the picture is different.

Remember that indexes are snapshots of larger memberships. The Dow Jones Industrial Average (DJIA) has only 30 companies and is weighted in such a way as to give companies with higher prices more weight than the lower price members. So movements in GM (at a 71 year low) hardly budge

the Dow, whereas movements in IBM (still close to \$100) has a greater impact on the movement of the index overall.

What's even more interesting, since 2000 there have been 8 or 9 new members, among them Intel, Citigroup, Bank of America, Microsoft, Wal-Mart and AIG. The Dow masters chose companies near their peaks - only to see them fall to unimaginable depths. And so it is that one should not look to the DOW or even to the S&P 500 to get a reading on the health of the U.S. stock market.

Interestingly, the midcap (middle sized) companies and the largest 100 companies on the NASDAQ are faring the best in this latest downturn. These companies had been through the ravaging of the 2000 bear market and emerged leaner and more competitive.

In short, the DOW is moving to slightly new lows but the S&P has not yet followed. The NASDAQ 100 and some other indexes have not yet followed the DOW, either.

Thus, the progress of the stock markets, in the U.S. and in the world, has to be viewed as an "incomplete." These markets need certainty and they do not yet have it.

Feedback Loops

The interconnectivity of the global economy takes national and local feedback loops and creates a network of causes and effects that, essentially, transmit effects from one continent to another, one country to another. Government is working to prop up economies to lessen the effect of the major feedback loop - the lowering of demand to lowered production to laid-off people. There is talk of a World Bank fund of some \$25 billion to provide export credits to facilitate international trade that was basically halted because of the Lehman collapse and the mistrust that followed. But where does World Bank money originate? International Monetary Fund loan funds? They originate from sovereign countries, of course, controlled by the G7 (developed European countries and the U.S and Canada).

The list of negative feedback loops is too large to enumerate here but as a whole they are not finished with their nasty (or necessary) work. For example, housing prices are still dropping in most areas of most countries which experienced bubbles. The rate of decline may be slowing - a good sign. But until house prices stop falling, the value of mortgages written on them falls, negative equity ensues, jingle mail increases and overall the economy slackens further.

Arguably, there are people who bought houses and mobile homes who could ill afford them, even with teaser rates. Some further shake-out of mortgagees is inevitable, but we are heartened that government is actively moving to help. Government help is so far small relative to the number of outstanding mortgages, but the whole can be affected by the actions of a few. So we are hopeful that the housing contraction will level off, allowing a period of stability to grow.

Economic Indicators

No good news here, folks. The news flow just gets worse. That is to be expected, though. We are focused on several indicators which could indicate stability ahead:

- The copper price (bottomed, we think)
- The Baltic Dry Index (bouncing from a huge fall)
- Oil and natural gas prices (low prices help consumers but hurt overall)
- Coincident and lagging indicators (still not good)
- Stock markets (the jury is out, but expect further volatility)
- Currency exchange rates (rapid movement is dangerous)
- Sovereign bond downgrades (ouch; too many are occurring)

In short, we still think that we are halfway through the financial crisis and, thus, not even into the observable recovery stage. Were we right to stay in the fray and to maximize your income at the expense of the value of your accounts? Sorry for being so bold as to say so, but that is exactly what has happened. We have chosen to stay in investments which have lost mightily in price in order to collect steady income. Not that we have not been active - we have. But overall we still believe that our primary mission is to bring you stable, growing and high income. Like the tree which has been denuded of leaves, we believe that your account balances will recover in the next "market spring and summer). In the interim, we will continue to be opportunistic, to bring down your cost bases in portfolio holdings (thereby raising your income).

Thank you for investing with us.

Jim Pursley

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