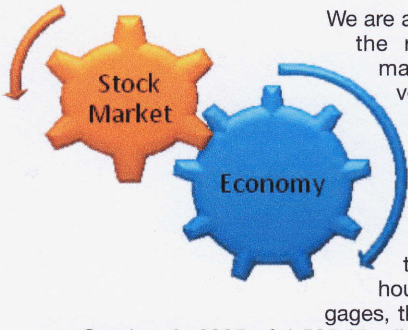
Gearing up for the Recovery is no Plain Sailing

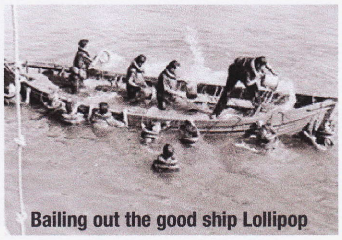
by IMCZ Treasurer John Henry Smith



We are all aware that from October 2007 the reflexive interaction of stock markets and economies fed a fierce vortex of global contraction. The media told us that the causes were a complex array of factors that had their origins in over-greed, malfeasance, and lack of regulation in the U.S. culture of over-indebtedness. Smelling the blood dripping from the housing market's subprime mortgages, the SP500, after reaching a peak on October 9, 2007 of 1,565.15, slid to its deepest point of 676.53 points on March 9, a fall of 56.8%, as the economic whirlpool spun deep into the U.S. economy.

Both the Bush and Obama administrations, with Congress in tow, sought to contain the damage at first in a hit and miss sort of way[1] and then with Paulson's controversial TARP[2], Bernanke's TALF[5] and Geithner's PPP[4].

These bail-outs were intended to stop the U.S. economy from sinking further, but will their hole-bunging properties be enough to prevent the good ship Lollipop[5] from being sucked down by the very currents it had itself created? To escape these perilous forces and regain economic sovereignty, any solution must address five priories.



Bailing out the good ship Lollipop

Priority 1 - Stop deflation

Jan Hatzius[6], the Chief U.S. Economist of Goldman Sachs, believes that the combination of 8% to 10% unemployment in 2009 and the extent of the economy's under-utilized resources are beginning to reduce pricing power. This is confirmed by the price declines in such key industries as real estate, auto and energy. Further, another economist, Alan Nasser[7] points out that no direct assistance will be given to home owners, who will still have negative equity for many years to come and some may never ever recover the prices they paid.

With a loss of $6 trillion in housing equity and $8 trillion stock and retirement wealth wiped out, Americans are forced more into saving and debt servicing modes, which further fuels the deflationary spiral, forcing companies to cut production and downsize to match slackening demand.

The objective of President Obama's stimulus package is to act as the consumer-of-last resort by undertaking projects to repair infrastructure, improve the health service, develop alternative energy, and heighten skills through education programs. These targets will add another $3.5 trillion to the Federal Reserve's balance sheet, which some observers believe will not be enough, rather seeing a need for $4 to $6 trillion.

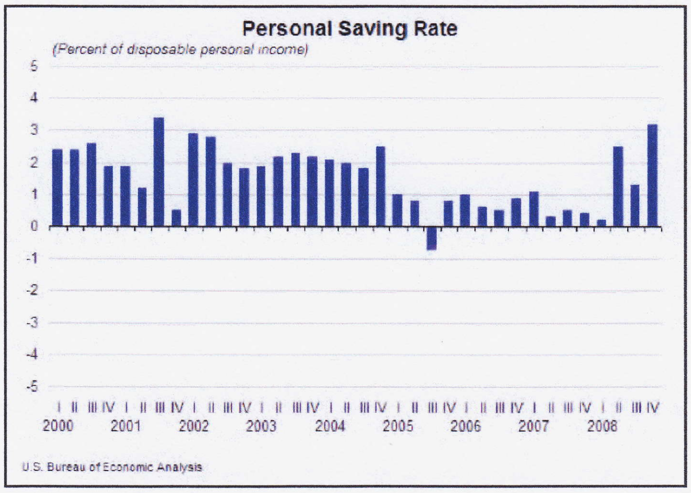
The good news is that vast expenditures will in themselves reverse deflationary trends, but the bad news is that depending on how the stimulus is funded it could later produce anything from a mild to very serious inflation.

Priority 2 - Reduce leveraging

Economic progress, particularly in the U.S. has been pocked-marked by booms and busts; the most notable were the Wall Street Crash of 1929 and the Dot.com bubble of the late 1990s. Bubbles are typically characterized by unsustainable prices and the over-leveraging of credit. The mix of subprime mortgages with those of higher quality in opaque securitization packages that had the blessing of the credit agencies triggered a massive over-leveraging opportunity that never showed up on bank balances sheets.

On the consumer side of the equation, Reuters[8] reported a consumer credit burden of $2.6 trillion, of which $790 billion is credit card debt and rising because the credit squeeze is forcing more consumers to turn to their credit cards. It is thought that the average household owes about $10,000 of this kind of debt with 35% of cardholders paying late.

The U.S. administration is determined to tackle this deep-rooted problem. As all economies need the leveraging of dormant balances to generate earnings and growth the key focus hopefully with be at the very least the reduction of non-transparent leveraging and stronger capital adequacy rules as well has improved screening practices for the vetting of credit applications.



Priority 3 - The return of trust in the financial markets

In view of the ravages wrought by the financial markets on the livelihoods of ordinary people, the regaining of trust will be a steep and difficult path to climb. The measures of the TALF and the PPP programs are designed to rekindle this confidence on both the supply and demand sides of the economy. And from the ashes a new kind of qualified risk taking and innovation will emerge and contribute to stabilization and growth. Whereas the tarnished banks themselves must recapitalize and address their profitability issues in a new dawning of prudent practices. This all means that the fundamental capitalism of Ronald Reagan is being washed out of the system by the controls that will be designed to better manage systemic risks. In turning the page hopefully a new equitable era will deploy resources for the greater benefit of the people as a whole instead of serving the vested interests of influential minorities. However a disadvantage of 'Greater Good' capitalism is likely to be both slower growth and asset price reflation.

Priority 4 - Capital formation and the path to growth

The source of capital formation is the product of savings and wealth, whether generated internally or borrowed from abroad.

As a percentage of disposable personal income, the graph[9] shows the prevalence of a very low personal savings rate in the U.S. The regime of low interest rates enabled Americans to seize the opportunity of owning their homes but created an even greater disincentive to save when from 2005 to 2007 mortgages rates began to rise and the burden of debt servicing grew to bursting point.

A significant contributory factor in the subprime saga was the massive influx of dollars from the saving countries of the East in the years 2002 to 2004, causing the Fed Funds rate to fall to between 1 3/4% and 1%.

In early 2008, however, we can see a jump in savings levels as house prices plummeted from their inflated values and foreclosures increased, thus signaling the onset of the rapidly developing economic slump. The American dream of appreciating house values as a way of storing capital growth had finally burst, just like other assets bubbles before it.

Priority 5 - Find the right balance between consumption and savings

It is inescapable to acknowledge that a right balance must be found between the rate of real national savings and consumption; to live within one's means in a workable and orderly capitalistic society with the reasonable and controlled leveraging of debt. I believe the lessons of this recession/depression have been sorely learnt, even though they were there for all to see; but alas the greed factor dominated! We should give thought to the sentiment that a certain Mr. Micawber[10] wisely expressed when he counseled;

"Annual income twenty pounds, annual expenditure nineteen shillings and six pence, result happiness.
Annual income twenty pounds, annual expenditure twenty pounds and six pence, result misery."

Summary

The bunging up of the good ship Lollipop with stimulus packages in place or yet to come will keep the financial system afloat sufficiently to ride out this storm either through dumping the toxic ballast overboard or at least by reducing their dead weight. However the packages will not address the navigability of the good ship when faced with the headwinds of inflation unless its sailors, from the captain to the cook, learn from their mistakes. What will be gained in refitting the ship with better steering gear will certainly be lost in the speed of recovery.

As of the date of writing, the SP500 lost 48% of its value from its peak. For the Index to recover to its November 9, 2007 high of 1,565.15 from today's value of 815.94 is a move of 92%[11]! This broad index, as a mirror of wealth lost, makes it clear that the recovery will not be plain sailing for a long time to come.

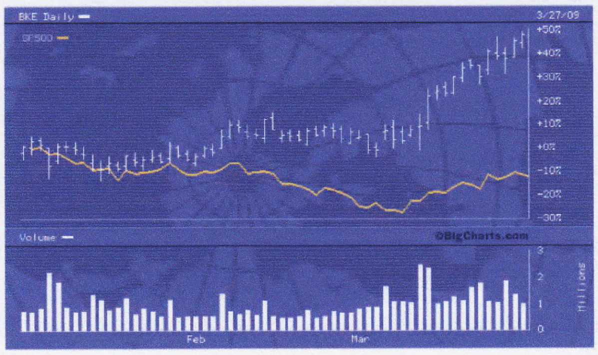
1 Saving Bear Stearns and letting Lehman Brothers go bust
2 Troubled Assets Relief Program - $680 billion
3 Term Asset-Backed Loan Facility - $1 trillion
4 Public-Private Partnership - $1 trillion
5 "On the Good Ship Lollipop" was sung by 6 year old Shirley Temple in the 1934 film "Bright Eyes"
6 In a CNBC interview of March 19, 2009
7 Professor emeritus of Political Economy of Evergreen State College, Washington
8 Reuters dated Mar 6, 2009: U.S. Consumer credit rises $1.75 billion in January: Feb
9 U.S. Bureau of Economic Analysis
10 David Copperfield (1850) ch. 12 by Charles Dickens
11 (1565.15-815.94)/815.94 = 91.82%

Investment Corner

by *IMCZ Treasurer John Henry Smith*

As there are several categories of investment styles, each Grail stock will be analyzed in accordance with a stated style or strategy, i.e. Momentum Investor, Value Investor, etc.

Assessments and Analysis based on March 27, 2009 closing price $29.14	
Analysis of:	The Buckle, Inc.
Industry:	Specialty Retail – Apparel Stores
Strategy:	P/E Growth Investor
YTD Performance:	+51%
SP 500 YTD Performance:	-10%



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COMPANY DESCRIPTION

The Buckle, Inc. is a retailer of medium to better-priced casual apparel, footwear and accessories for fashion conscious young men and women. As of February 2, 2008, the Company operated 368 retail stores in 38 states throughout the continental United States, excluding the northeast, under the names Buckle and The Buckle. The Company markets a selection of mostly brand name casual apparel, including denims, other casual bottoms, tops, sportswear, outerwear, accessories and footwear. The Company provides customer services, such as free hemming, free gift-wrapping, easy layaways, the Buckle private label credit card and a frequent shopper program. Most stores are located in regional shopping malls and lifestyle centers. The Company had 368 stores on February 2, 2008.

CATEGORY	CRITERIA OF A P/E GROWTH INVESTOR	SCORE	REPORT CARD
This methodology considers Buckle, Inc. a "fast grower"!			
P/E Growth Ratio:	The Price/Earnings ratio (P/E) relative to the EPS growth rate based on the average of the 3, 4 and 5 year EPS growth rates.	BKE's P/E ratio of 14.56 and its EPS growth rate of 26.31% over the period produce a favourable P/E/G ratio of 0.56.	PASS
Sales & P/E Ratio:	A P/E ratio below 40 for sales over $ 1 billion.	BKE's sales of only $792.1 million do not satisfy this criterion, but an investor can analyze the P/E ratio relative to the EPS growth rate.	NEUTRAL
EPS Growth Rate:	Earnings growth between 20% and 50% based on the average of the 3, 4 and 5 years EPS growth rates.	BKE's average EPS growth is 26.3% for the period.	PASS
Total Debt/Equity Ratio:	Equity 3 to 10 times debt.	BKE's debt/equity ratio is 0.00%.	PASS