Iran, Israel, China & The Fed

-J. Kevin Meaders, J.D, CFP®, ChFC, CLU

January, 2010 - You know I always warn against judging the state of the economy based on information from the general media. These days, it is very difficult to discern the intricacies of our global political and economic environment. Do not be confused, they have now become essentially one and the same. The intermingling of these two facets of society has led to a new level of international economic uncertainty. Sure, economics has always influenced politics, and certainly international conflict has economic ramifications. But never in human history has each domestic economy been so highly dependent and interdependent on the global marketplace. That can be good and that can be bad

Most people realize that China is still a communist country. Most people also realize that China has experienced an explosive amount of growth and development over recent years. What many Americans might not know is that China is now the world's largest holder of United States treasuries. In the year 2000, China owned less than $100 billion in United States treasuries.[1] By the end of 2010, China will own well over $1 trillion in U. S. treasuries. Oh and by the way, owning treasuries is just another way of saying "owning debt." What does this mean and why is this important?

A geopolitical situation that we've been watching carefully over the last two years has been Iran's stubborn insistence on developing nuclear weapons and a deployment system that would be capable of striking Israel. On Al Jazeera and Iranian state television, president Ahmadinejad has said repeatedly that Iran's long-term national goal is to see the utter destruction of Israel. All the while at the United Nations, Iran proclaims a peaceful intention. No one with any reasonable intellect believes them; certainly Israel does not.

For the last two years Israel and the United States have lobbied the other members of the United Nations Security Council, particularly China and Russia, for passing stricter sanctions against Iran. It is clear that China and Russia have taken a stronger stance against Iran, but still do not support a military strike. Enter the Fed.

In the wake of the financial crisis in the United States, the Fed has nearly doubled the money supply. It is important to recognize that <u>no new goods or services are created</u> when the Fed adds money to the economy. All that changes is that there are twice as many dollars chasing those same goods and services. This inevitably leads to the devaluation of the currency. So if the number of goods and services remains stagnant, and the number of dollars in circulation doubles, the only result can be that the value of the dollar drops by half.

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[1] Stansberry Research, *Daily Wealth*, January 6, 2010

Suddenly[2], the $1 trillion in US treasuries that China owns is really only worth $500 billion. How's that for economic leverage to a political situation? The only problem is, of course, that as China's dollars devalue so do yours. This is no secret—I am convinced the Fed's Board of Governors "sees" the problem, and I do not believe they would not take measures to reverse the liquidity before the dollar actually devalues by 50%.

In fact, the Fed is already testing a new financial device, called a "term deposit," which Ben Bernanke has described as "roughly analogous to the certificates of deposit that banks offer to their customers."[3] These Mega Fed CDs are available to banks directly from the Fed and "would encourage banks to park reserves at the Fed rather than lending them out, taking money out of the lending stream."

Thus, I have a tendency to believe that the current liquidity in the economy is serving two purposes, and all indications are that the situation in Iran will come to a head sometime this year, as Israel has indicated that they have no option but to take action against Iran. This will inevitably draw the United States into the conflict since it is likely that Iran will retaliate against the U.S. destroyers in the Persian Gulf.

However the conflict is resolved, it will probably end with an almost total degradation in Iran's air defense system and naval forces, the use of new U.S. technology in the form of bunker buster bombs, and perhaps internal rioting. In the interim, oil prices will surely spike again along with other commodities, if only for a short period. I would not expect any type of confrontation to last very long, as surely neither we nor Israel would want to deploy ground forces. A high-tech naval and air assault is most likely. Should this occur, it will create an opportunity for us to sell our oil and natural resources satellite positions and migrate to domestic and international equities, as well as other satellite opportunities.

Perhaps after just two to three weeks the international markets will recover from the conflict and life will go on as before, as it always does. China and Russia will cooperate with the Western powers in exchange for a strong dollar policy. Ironically, because the Chinese Yuan is artificially pegged to a basket of currencies, primarily consisting of the U.S. dollar, as the dollar devalues, so does the Chinese currency, which is already artificially much lower than it would be in a free-floating market system, such as the rest of the world maintains. The Chinese simply do not play fair.

This is something that really should not be underestimated. The Chinese currency policy is designed to keep the communist party in power. How does the communist party stay in power? By providing jobs. How do you provide jobs? By having lots of exports. Have you get lots of exports? By maintaining cheap labor and cheap production costs. How do you do that? By forcing your currency to be cheaper than your buyer's currency.

But understand that the currency devaluation is only real in terms of other currencies. Because the Chinese Yuan is artificially pegged to the dollar there is very little fluctuation between these two currencies, if any. Essentially this makes both U.S. and Chinese goods more competitive on the international market since foreign currencies can buy more dollars or yuan. Needless to say it does not make our other trading partners very happy.

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[2] It actually doesn't happen immediately, but is a gradual devaluation as the population adjusts. The lag time is what governments depend on as they spend the money before it devalues in the public mind.
[3] Wall Street Journal, *Fed Proposes Tool to Drain Extra Cash*, December 29, 2009

Back on the domestic front, it would certainly appear that despite a 10% unemployment rate, the stock market level seems to be a better indicator as to shoppers' spending habits. Much more money was spent in December of 2009 than in December of 2008 despite the fact that millions of more people were unemployed. The only improvement from these two periods, really, was the value of the stock market. Oh, and yes of course, the bond market.

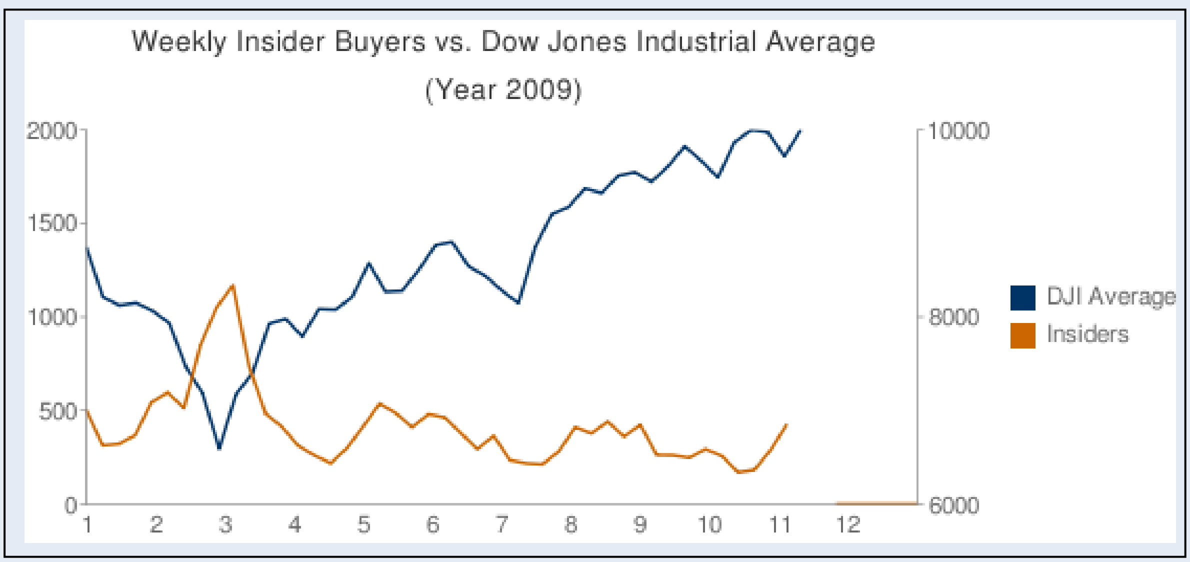
Nevertheless, there have been indications that the economy really cannot stand on its own without government assistance. I cite the cash for clunkers program and the new home purchase credit as examples. Cash for clunkers, albeit a stupid idea, simply transferred some government money back to the automotive industry. The new home purchase credit certainly stimulated the housing market for awhile, but again as goes the stimulus so goes the results. Keep in mind that 'a stimulus' only means taking taxpayer money and throwing it at the problem. It is not a net solution.

Banks are sitting on a ton of cash in order to absorb more losses. Good thing, because their losses keep mounting. "Overall, personal bankruptcy filings hit 1.41 million last year, up 32% from 2008, according to the National Bankruptcy Center. Chapter 7 filings were up 42% as of November 2009, compared with the same period a year earlier."[4]

Nonetheless, with bankruptcy filings and unemployment up since last year (bearish indicators), so also were fourth quarter retail sales and industrial production (bullish indicators). The former bearish indicators are lagging, and the latter bullish indicators are current to leading. In layman's terms this means: "past bad, future good—hopefully."

This is pretty typical of most indicators today except insider trading. Insiders are still selling more than they're buying. The following chart compares the Dow Jones average with the number of insider buys in 2009. Note that in March the trend reversed and has ever since been spreading apart. What does this mean? It means people in the know aren't buying.

Perhaps we can't put too much emphasis in insider trading because you can see that the pullback in July would have been a good time to invest, but the insiders were just not interested.



Source: SCCfilings.com

[4] Wall Street Journal, *Personal Bankruptcy Filings Rising Fast*, January 5, 2010

In the future we can see several probabilities that as of yet have no chance of abating unless circumstances change significantly.

1. We expect the dollar to lose value vis-à-vis other currencies.
2. We expect interest rates to rise globally.
3. We expect tax rates in the US to increase.
4. We expect inflation in the US after 2010.

Our research has indicated that the last four time periods when we experienced a similar economic environment was 2004-2006, 1999-2000, 1994-1995, and 1988-1989.

We are now analyzing how all of our investments fared during the last four periods of rising interest rates and will soon be adjusting our accounts as appropriate. As interest rates rise, which they will certainly have to do, bond prices will fall. Similarly, we are currently researching investments that will thrive in a rising rate, rising tax, rising inflationary environment.

2010 will probably be shaky through the third quarter, depending on when Israel strikes, but we believe that soon after the Israel/Iran conflict the Fed will seriously begin re-absorbing money back out of the global supply. Soon thereafter they will also begin to start raising interest rates. The economy will be set up for another Bull Run and unemployment will drop significantly and quickly.

About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through ING Financial Partners (member SIPC).

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- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

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