



Global Financial Landscape April/May 2007

"Wikinomics" vs. "Eupeptinomics"

A thrilling adventure is taking place in economics. The small battles between "Wikinomics" and "Eupeptinomics" taking place now will no doubt lead to larger confrontations and the demise of one or the other.

"Wikinomics" is reshaping the world destroying old industries but at the same time creating new ones according to Don Tapscott's book. In "Wikinomics", profits and productivity increases using "mass collaboration." Structural changes brought about by computing and the internet is re-creating the world and thus economics, according to Don Tapscott. "Eupeptinomics" on the other hand is the stodgy style of economic theory that produces a euphoric state of prosperity for all. A paradigm built upon the management of fiat money and the removal of fear, a vital component in the psychology of markets. It is the state of affairs where government agencies and quasi-government agencies control and manage market behavior through interest rate changes, money supply, and availability of credit. Managing the psychology is more subtle. Jawboning and speeches and press releases that attempt to control expectations are the favored weapons. Another weapon is revising regulations to relax credit standards, changing bankruptcy laws, bailouts, and limiting the downside moves in the stock market have all served to create this euphoric atmosphere by eliminating fear for both buyers and sellers. The removal of fear has also led to complacency, as well as an increased appetite for risk. And, it has also led to predatory lending practices and allowed the creation of LCFIs (Large Complex Financial Institutions) that now threaten financial stability worldwide. The Central Bank of England now places risks from LCFI's in second place behind trade imbalances in their top two risks to global financial stability. So we now add it to our fast growing list of new threats to the economy.

Continuing with our story we give a few examples of the battles already scored. The first is the Gold Corp story in Don's book. Gold Corp and its mutual fund manager turned CEO gave all proprietary geological data to internet users around the world offering a reward for those who could correctly analyze their properties and identify where to drill for gold. Gold Corp and the world were startled when they succeeded beyond their wildest dreams. Sharing proprietary data is just not done they said. But it saved Gold Corp from extinction and made them a highly profitable company.

The next battle we share took place in Europe between central bankers. Heated words were exchanged over the removal of M3 money supply figures from the United States Federal Reserves publicly available data releases. It even brings to question their new claim to transparency. The third battle already won took place with the advance of the Linux open source operating system competing with Microsoft. Even Bill Gates had heated words to say about methods that destroy abilities to make a profit. Expect the battle between Wikinomics and Eupentinomics to escalate as we transition into the new economy. An abundance of talent and instantaneous information available over the internet will lay waste to slow institutions and companies doing business in the old traditional ways.

Meanwhile, our old economy here in America continues to be in a transition stage from past Federal Reserve interest rates hikes. These market changes seem to come much slower these days which add to complacency and the feeling of continued prosperity. We suspect the tiny quarter point moves in interest rates introduced by Greenspan may have something to do with delayed consequences of Federal Reserve actions.

Speaking of events and the current economic environment Paul Volcker recently commented that "the situation is intractable."

Dr Marc Faber in his monthly Gloom, Boom & Doom Report of April 2, 2007, has a good handle on how we should view all investments. Marc says "I mention this because it will become increasingly important for investors not only to decide which asset class train they want to board, but also, and even more importantly, whether they want to board any of the asset trains." The subtitle on this report is rather interesting. It is a headline quote from Business Week on April 27, 2000, "**Relax, the Over-all Market Probably Won't Tank.**"

Now for the breakdown:

Capital flows to emerging and foreign markets are increasing as institutional investors seek higher yields in countries where fundamentals do not support higher equity prices. And it's your retirement money they are investing. According to the IMF, mutual funds, pension funds and institutional funds are investing your retirement money, your pensions, and you're IRAs. The IMF has cautioned that this hot money flow threatens financial stability in the emerging economies of Europe. The countries most at risk are the newer entries to the European Union, Estonia, Latvia and Lithuania, Bulgaria, and Romania. Romania and Ukraine have been revised downward this week. Investors would be wise to stay away.

Interest rates are in a rising trend worldwide, and this is a negative for all asset classes, including art, equities, bonds, property, commodities and gold. Interest rates are rising in Asia and Europe to slow overheating economies and to squelch inflation, and even though the last interest rate change was nearly a year ago here in the U.S., we still have to consider it trending upward. All asset classes are subject to decline in this environment.

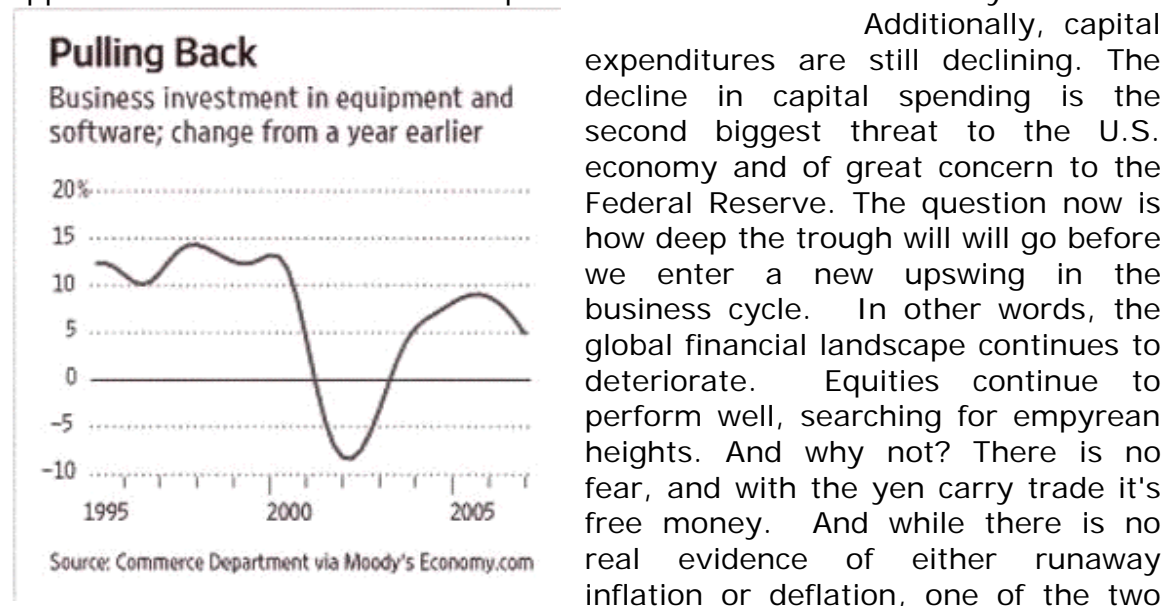
Nothing about the current environment squares with historical evidence. Equity markets and property markets are at most risk during rising interest rates. Historically, commodities are negatively correlated to equities, but not last year or this year. All things paper and tangible continue to climb in testimony of the liquidity powers of central bankers.

The yield curve is still inverted well into the tenth month, a historical indicator of an economy heading for recession.

Not only does the dollar remain at risk from the trade imbalances, but all currencies as well and therefore worldwide financial stability. All financial crises over the last two decades have been currency related; this, we presume, is the nature of the Bretton Woods floating exchange rate system.

Closer to home, the biggest problem for the Federal Reserve is first, the deteriorating housing market, second is the decline in capital expenditures, and third is the threat of inflation from excess liquidity. Expect the Federal Reserve to lay blame for inflation on increased wage prices and perhaps oil prices, but never expect them to admit to inflation from their own actions in the creation of money. In a "Wikinomic" world, accepting responsibility for such actions would be the first step in advancing to a better system. For the Federal Reserve to move into the new economy and still remain an effective source for financial stability they must open up and collaborate with their millions of clients like you and me. Transparency, a search for truth and reality based outcomes as practiced by Mikail Gorbachev is what is needed.

The outcome from Federal Reserve actions over the last decade is still up for debate, but stagflation, which we saw in the late seventies, is beginning to look more plausible. Not in a long time have so many elements appeared on the financial landscape that threaten financial stability.



Additionally, capital expenditures are still declining. The decline in capital spending is the second biggest threat to the U.S. economy and of great concern to the Federal Reserve. The question now is how deep the trough will go before we enter a new upswing in the business cycle. In other words, the global financial landscape continues to deteriorate. Equities continue to perform well, searching for empyrean heights. And why not? There is no fear, and with the yen carry trade it's free money. And while there is no real evidence of either runaway inflation or deflation, one of the two

will rule the day. Federal Reserve's Mishkin has offered us a tidbit stating that it may take a couple of years to get inflation down to acceptable levels.

In which case, expect higher interest rates, a further impediment to all markets. That said, there is insufficient evidence to support raising or lowering the interest rate. It is "eupeptinomics" and euphoria at its finest. In normal markets, nature demands an exact punishment for errant risk takers. Where there are no consequences or just compensation for actions, all fear is removed from the market, and the bubbles become like a Southern Thunderhead. They begin so innocent and non-threatening. Before long the bubbling gets uncontrollable. First, cloudlets bubble out the top as though they would become an entity of their own, much like an errant child running to escape, which you cannot stop but only redirect. Then the cloudlets bubble out the sides growing ever larger and eventually the whole mass gets so heavy and stressed it drops to earth and bursts in a torrential downpour.

Will the Dollar Take Its Medicine?

The dollar is stumbling at multiyear lows and continues to trouble and Baffle the experts. Expect the dollar to readjust to market reality eventually. It is impossible to predict whether it will be a disorderly adjustment or if the adjustment will take place in a controlled fashion. According to Federal Reserve economists Michele Cavallo and Cedric Tille, the dollar needs to adjust downward by thirty-eight percent. They suggest a controlled drop of twelve to fifteen percent this year, fifteen percent in 2008 and the balance in 2009. The dollar is down about four percent so far this year.

However, nature and "Wikinomics" may overrule institutional slowness, in which case the dollar would just collapse. The dollar adjustment may be reflected in commodities rather than in against other currencies, or possibly both arenas.

Commodities

The commodity cycle is still moving upward with many years left to the upside before supply meets demand. Agricultural commodities and the metals sector are climbing, but the precious metals are finding strong resistance at decade highs reached in May of 2006. Since all the other metals are achieving new highs, I think it is strange that the precious metals are not following through. If the precious metals cannot break through upper resistance levels this spring, then we can expect big moves to the downside in all commodities. In which case, a decrease to lower resistance levels would be the call. Check your charts. Weather highlights in nine of the eleven major grain-growing regions of the world are in good shape this year. According to the USDA, Russia and the Ukraine and Eastern Asia are in the best shape. Expect supplies to be equal to or somewhat better this year than last. However, expect demand to continue to outstrip supply, although at a slower pace if central bankers continue to raise interest rates.

Metals

Most metals are still pushing upward and continue to make new highs.

Angloplat, the world's largest supplier of platinum, refuses to supply physical metal for a new ETF (exchange traded fund) based on platinum issued by ZKB, Zurich Cantonal Bank, because of tight supplies. Last year the LME in Europe revised trading rules in the futures market in nickel for the same reasons, and in fact, supplies purchased did not even exist. The LME let the brokerages off the hook.

Other new metal ETFs are planned this year from major banks on both sides of the Atlantic and will continue as a positive force pushing commodity prices higher.

Additionally, gold is still in a hollow period in which new supply is actually declining. All of this simply illustrates the continued strain on natural resources worldwide which will lead to higher prices in the future, providing of course that all markets do not collapse under the strain of global risks. In fact, the IMF is predicting much lower prices for all commodities in the second half of this year.

Current Economic Threats – each of the following items have surfaced on our radar screen from the many articles and journals we follow. We can not say that any of these events will happen. We only suggest that they may happen and investors would be wise to review them and weight them accordingly. It is our opinion that excessive liquidity, trade imbalances, rising interest rates and structural changes are the biggest threats and in that order.

- LCFIs – Large complex Financial Institutions
 - Internationally active banks
 - Hedge Funds
 - Private Equity Groups
- Excessive liquidity – Yen Carry Trade and other Central Banks expanding money supply
 - Inflation
 - Bubbles and other anomalies
- Trade imbalances
- Rising interest rates worldwide
- Structural changes
 - Free flow of information from esoteric to exoteric
 - New financial vehicles with unknown risk (derivatives, etc.)
- Increased capital flows into emerging markets
- Infrastructure Disruption
 - Geopolitical
 - Glitches in payment systems and check clearing houses
- Floating exchange rate system (Bretton Woods)
 - Currency crisis

New Economy

Young and old continue to find ways to increase productivity and cut expenses using the tools of the new economy. Therefore, this is "Wikinomics" where people embrace the newer technologies to make old ideas work and create new business to build wealth. For example, at the local bait and tackle store, a man in his late sixties told me he was selling Catalpa worms on EBay. Since these worms live several weeks, he ships them mixed with leaves via mail, FedEx or UPS. He never leaves his home which cuts the cost of travel and results in much higher profits. Catalpa worms are a delicacy for bream and catfish, and they only appear in the spring. This gentleman tells me he has nearly 1000 Catalpa trees. This is the only tree from which these specialty fishing worms can be obtained. Truly, the E-spirit is alive and well.

Sources:

"Wikinomics" by Don Tapscott and Anthony D. Williams

Current Account Adjustment with High Financial Integration: A Scenario Analysis by Michele Cavello, economist with the Federal Reserve Bank of San Francisco and Cedric Tille, Senior Economist with the Federal Reserve Bank of New York

Fed's Mishkin says business investment posing "noticeable" risks to US economy

<http://www.afxnews.com>

A Second Platinum ETF Drives Prices by Allan Seccombe [miningmx.com]

Trichet warns on "complacent" markets by Richard Beales in Boston

Foreclosures reported up 47% in past year by [Rex Nutting](#), *MarketWatch*

Last Update: 11:34 AM ET Apr 18, 2007

EMERGING MARKETS REPORT

S&P: Emerging Europe is at risk of overheating

By [Polya Lesova](#), *MarketWatch*

Global Financial Stability Report - IMF - April 2007 www.imf.org

Economic Review 2006 - Federal Reserve Bank of San Francisco

The Changing Face of Investors - Finance and Development – IMF March 2007, Volume44, Number 1

Manias, Panics and Crashes by Charles Kindleberger

Emerging Markets Report, Polya Lesova, *MarketWatch*

Financial Stability Paper No. 2 – April 2007, A New Approach to Assessing Risks to Financial Stability–Bank of England <http://www.bankofengland.co.uk>

Global Financial Landscape April/May 2007

By R. Van Hudson

vanhudson@beechislandinvestments.com

[Disclaimer](#)

The copying, republication or redistribution of content, including by framing or similar means, is expressly prohibited without the prior written consent of Beech Island Investments. Financial Landscaping and Beech Island Logo are registered trademarks of Beech Island Investments, LLC. The content on this site, including news, quotes, data and other information is provided by Beech Island Investments and its third party content providers are for your personal information only and neither Beech Island Investments nor its third party content providers shall be liable for any errors, inaccuracies or delays in content, or for any actions taken in reliance thereon. The content on this site is intended for

educational purposes only and the content is not to be construed as investment advice or a solicitation to sell or buy securities. Before using any content on this site consult a professional tax and/or investment adviser.

-