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The Immor(t)ality Of Capitalism?

**"The limitation of riots, moral questions aside,
is that they cannot win and their participants know it.
Hence, rioting is not revolutionary but reactionary because
it invites defeat. It involves an emotional catharsis,
but it must be followed by a sense of futility."
-Martin Luther King, Jr.**

**"All political revolutions, not affected by foreign conquest,
originate in moral revolutions. The subversion of
established institutions is merely one consequence of the
previous subversion of established opinions."
-John Stuart Mill**

**"We are completely dependent on the commercial banks. Someone has to
borrow every dollar we have in circulation, cash or credit. If the banks create
ample synthetic money we are prosperous; if not, we starve. We are
absolutely without a permanent money system.... It is the most important subject
intelligent persons can investigate and reflect upon. It is so important that
our present civilization may collapse unless it becomes widely
understood and the defects remedied very soon."
-Robert H. Hamphill, Atlanta Federal Reserve Bank**

Introduction

It seems that the fundamental law of nature is that all systems collapse from time to time. Throughout the history one can observe that societies arise and subside. We financial people also recognize that all markets rise and fall (at least in relative, if not in absolute terms). On a larger scale, all economies and economic systems rise and fall.

This report discusses two main topics as an introduction. The first one covers the immorality claims of market economy. The second discusses an intellectual gridlock created by systemic problems and silo thinking. We will then progress to observe some emerging trends and, as always, present some potentially lucrative investment considerations.

We are not going to go into the details of cycle theories. Instead, it is sufficient to observe on a general level that these cycles exist. It is considerable that recent decades have had a tendency to start with a disaster. We do not mean that it is any indicator to the future. Just that we find this considerable.

The 2010's is still plagued by what began as a subprime crisis and relatively quickly evolved into a sovereign debt crisis. On October 9, 2007, the Dow closed at 14,164.43, an all-time high. On March 5, 2009 the Dow screeched down to 6,594.44. The 2000's started with the burst of the Nasdaq bubble. Then of course there was the 9/11 incident. The Dow peaked on January 14, 2000, closing at 11,722.98. On March 11, 2003 it closed at 7,524.06.

The early 1990's saw a recession, which in Europe was to a large part because of the collapse of the Soviet Union. In July 1990 Iraq invaded Kuwait, which contributed to the global mess. We investors always mention the 1987 stock market crash and the subsequent Savings and Loan Crisis in 1989.

From 1980 to 1982 there was a recession and distinctively high inflation.

The recession of 1970 was relatively mild, although the Dow dropped 30% between December 31, 1968, when it hit its high of 908.92, and May 26, 1970, when it reached its bottom of 631.6.

In 1962 the Cuban Missile Crisis triggered the Dow to drop 26.5% from 728.8 on December 1, 1961 to its June 26, 1962 low of 535.76. The 1960 recession lasted 10 months, the Dow dropping 13.9% from its high.

Then there was the 1953 recession and the natural down cycle in the late 1940's, which created the 1949 recession.

The history goes further and further with even more fantastic examples of manias, panics and crashes. **We wish to stress that (evidently) cycles do not only appear in the stock market, but in all asset classes. Even more importantly, history overwhelmingly demonstrates that whole societies also follow the cycles of rise and fall.**

We will not focus on smaller cycles within big cycles. What is important to recognize are the very big cycles, which may mark the end of a system, such as the crash of the Communist Soviet Union. The world may be closer to a systemic economic collapse and the subsequent new world order than many would like to admit.

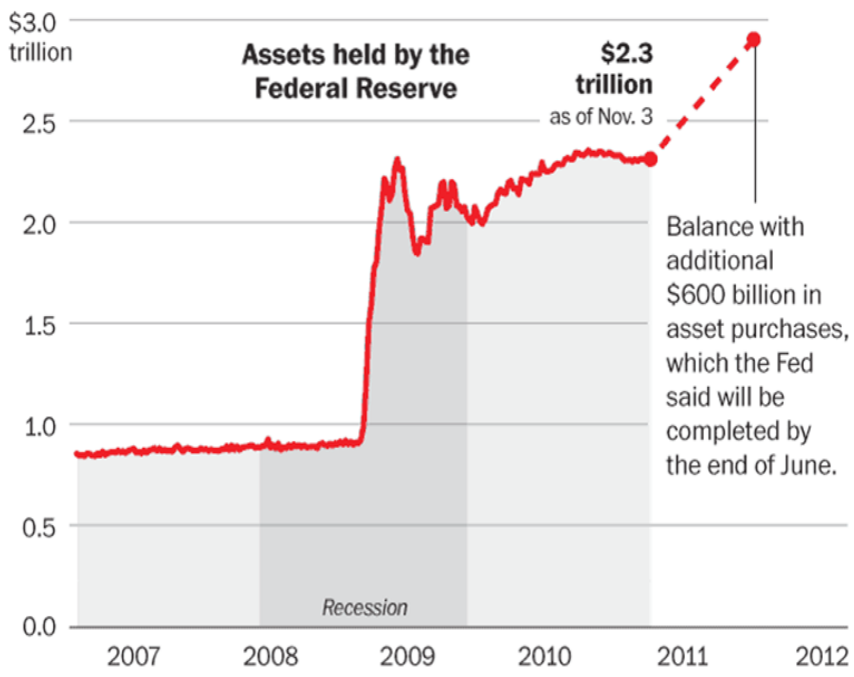
In recent years, the media has frequently published endless debates about whether the free market failed. It also seems that whenever a recession or outright depression occurs, the so-called immorality of capitalism is brought to light. Some pundits then use it as an argument to contend that private ownership *per se* leads to immorality. The more socialistic people also contend that profit is taken from somebody else's pocket, in other words it is robbery. It then follows that only the immoral survive in a market economy. Therefore, they argue, private ownership should be banned.

Profits and victory are loaded words. Victory outside of sports is mistakenly considered somewhat immoral or unethical. People talk about fierce competition at the expense of others. Only the immoral will survive, they say. This is a tempting illusion, but is it really true?

As investors and business people it is our observation that unethical people rarely succeed in business or life. Stealing ideas, ruining other's reputation and misuse of power is quickly going out of fashion. That kind of reputation is dangerous to the whole organization or society. As the recent crisis has shown, ever more moral strength is needed these days. Those who lack it, perish. Immorality is most often found in monopolies and with entities with large amounts of numb capital. This includes high-ranking officers and executive government employees. In the light of history, communist societies have vastly more often produced poverty, considerable misallocation of capital and wealth, large gap between the have's and the have-not's, large scale ecological disasters and overconsumption of raw materials. Whenever we travel in current or ex-communist countries, this is overwhelmingly evident.

We are well aware what our frequent readers must be thinking now. The West is not clean either. We agree. As much as we would like to think that we are morally superb, it is healthy to do a sanity check in our own society. **The Western media wrongly dismisses Russia almost altogether as an investment opportunity and a significant rising power** (we have a special opportunity to watch that as Russia is Finland's neighbor country with some 1250 km [approximately 777 miles] of common border line). In fact, Mr. Putin has highlighted some valid points of the moral of the West, mostly about geopolitical provocations.

We financial people know that there are large amounts of numb capital in certain financial houses. Whenever the tax payer rescues financial companies, that money becomes numb. It has no real roots in the business. And especially when a central bank prints money to the government, it is numb money. This kind of capital quickly causes immorality in the government (i.e. look at exclusively expensive, yet unproductive, private contractors in Iraq and Afghanistan, two pointless wars that cannot be won) and corporations. Remember Enron?



They were unarguably the smartest guys in the room.

It should be clear that the Western economic system is not a completely free market. Although especially the US considers its system to be free, we have certain questions in mind. If it is a free economy, why aren't businesses allowed to go bankrupt? If it's a free economy, why does the Federal Reserve set key interest rates at will? Moreover, why is the central bank allowed to purchase government bonds – in other words, how is it possible that a government can fund itself by printing money? Moreover, why do tax payers have to clean up the mess in the form of taxes and higher inflation? Just about what part of the free market was free when the collapse occurred? We have to say that socialism took a big step, when the bail-outs were introduced.

We are well aware that Europe is even more socialistic than USA. As to the ECB, their chosen path has been to talk hard and act soft. Even more impressive is the European mentality on entitlement benefits from the government. Herein is the great danger of democracy. Once people can vote, they will vote for free money. As much as it has it has been good, it is also a very expensive trait. **Especially in Scandinavia, governments are not talking about how expensive a social network the country can afford before it goes bankrupt. Instead, they invent ever new and creative (insidious) ways to tax their citizens.** It is like a private household which on good years bought 10 different automobiles (on credit). When it is time to tighten belt, they will do anything but let go of the autos. In other words, they are approaching the problem from a wrong perspective. The irony is, of course, that the higher taxes are raised, the worse the economy does. The worse the economy, the more left-behind people will vote for free money. Some say the cycle never ends, but as all hilarious farces, this one will end as well. The worst moment in a societies' life cycle is the moment the people start to think about getting something for nothing. We think that no further examples of that need be delivered here.

In our travels to foreign countries it also makes us wonder whether printing money (see The Washington Post's chart: "*Assets held by the Federal Reserve*"), which then has to go somewhere, is moral. As we have continuously pointed out in previous reports, **a central bank can print money in the lunatic hope that it will save their economy, but what they cannot control is where that money goes**. Once it finds its way into agricultural commodities, lifting their prices, millions of people fall back to poverty simply because they cannot afford to buy food. We suggest that in your future travels to the islands of Thailand take a quick tour to Laos or Myanmar. If you plan to visit Argentina, be sure to quickly look at Bolivia and Ecuador. Even better is to learn some Spanish and talk to local people there. **We have always been amazed that people from the most bizarre backgrounds have more in common with us than we would like to admit**. You see, they too like to eat food and drink water. In this sense, inflation in food prices matter, even though the Fed is not counting food prices in their core inflation. The only real explanation to this must be that the employees of the Federal Reserve do not ever dine. Perhaps they just print food bills and eat them.

The point we want to make is this. It is not the system, whether market economy or highly socialistic, that determines most of the moral problems. It is the unlimited access to numb capital that most often provides a platform for moral hazard. **Freshly created capital avalanches (known as QE1 and QE2, parts 3, 4, 5, and so on**

to certainly come) quickly find their way to different markets. Money-printing has unintended consequences - financial, economical and moral. In general, an investor benefits from taking a larger view on the world. In addition to economic and financial issues, **geopolitical tensions play an even more important role.**

As always, we recommend our readers travel frequently to the countries they invest in (or intend to invest in) to see the world in their own eyes. It is not sufficient to look in the eyes of the news reporters, who are in the business of selecting selling headlines anyway. In addition, we recommend our readers to read news papers from different continents. All investors should also introduce themselves to the Muslim world, since it is expanding at a rapid rate, creating ever more tensions in the West.

As the West is plagued by gross budget-deficits, high taxes and ever-increasing debt for decades to come, savvy investors will look ever more to the emerging economies. In relative terms, their living standards are exploding. It is also our view that the West has lost and keeps on losing its competitiveness to emerging economies. In the West, it is not out of question to expect populist politics to emerge in power. People in Greece are already on the streets with their molotov cocktails because of the country's poor economic condition. The situation turns considerably worse, if some countries are forced to leave the Euro. The more the USA and European countries follow the route of suffering lower middle class, and the more Muslims immigrate to the West, the more we should expect racial tensions both domestically and internationally. In short, the war cycle seems to be on an up-swing everywhere (not least in the Korean peninsula).

We are pessimistic about the future of the current economic system. It seems that without an explosion in productivity, the West is going bankrupt or entering a zombie state similar to Japan. This could provide solid ground for war mongering. **As investors, we need to re-consider what a safe asset class really is. Moreover, we need to be concerned not only about the return of our investment but preserving our capital in the first place. To do this, we must be aware of the economic, financial and also geopolitical trends as inflation and wars could shift wealth quickly through rapidly inflating and deflating sectors, making life to us investors rather difficult.**

The reason yours truly is observing the world is not to educate the public with moral opinions, though. It would even be fool hearted to say that we could bring about a meaningful change to the big masses. But it is reasonable to expect that individuals are able to make better investment decisions. We are first and foremost interested in the world, because it provides a window to understand financial markets better. As investors, we are primarily concerned about financial markets.

Systemic Problems

The evolution of species and societies seems to drive them towards more complex structures. We *homo sapiens* are more complex than our ancestor cells in the seas. Without a doubt, our societies are more complex today than a hundred years ago. Indeed, the complexity of our problems increases all the time. Everything creates a problem. Electricity creates pollution. High social benefits create financially weak and needy people. The Internet has spam.

On the other hand, our ability to respond to our problems is determined by our thinking ability. To a large extent, we can automate calculations to computers. But once problems become systemic, there are simply too many variables. The models don't work anymore. They have, if you like, blind spots.

A system is a composed of parts. Every part relates to another, and every relationship between parts relate to other relationships. In short, everything affects everything. The more systems grow the more complex and less manageable they become. For example, many financial houses use algorithms in trading. The problem is that almost all of them use the exact same algorithms. When there is systemic crisis, they all react the same way, creating massive sell-offs in the markets. Every system also has a bottle neck. The bottle neck is the limiting factor. No matter how well other parts of the system work, the weakest link determines the effectiveness of the whole system. Once a bottle neck is removed, it emerges in somewhere else. Some part of the system is always the weakest.

There are three challenges with systemic problems like global warming, global economic crises, wars, over-consumption of raw material and hunger. Firstly, they are interrelated. In other words, hunger and wars are linked to

each other. In fact, they all relate to each other. Not only does a single part in one system affect the whole system, different systems affect other systems. Second, they increase in complexity as small improvements are made. Third, the ability of human beings to manage systems becomes relatively less dependent on computer calculations but relatively more on the ability to see the big picture – brainpower.

However, the human brain does not evolve that fast. It took millions of years to develop a big neo-cortex ("the intelligent brain"). Once problems become too large, too systemic, we lose our ability to see the forest from the woods. This intellectual grid-lock presents itself in many ways. One of them is the tendency to focus on mitigations instead of solving the root cause. For example, to reduce water shortages California limits the amount of bathrooms in households (we have yet to find out how this helps, since our bladders to not get filled any more often when more bathrooms are present). The tendency is to make a minor improvement to the situation or at least delay the problem. Another example of this is to impose another financial bubble on top of a burst one. The root cause for problems are artificially low interest rates over decades, excessive credit growth, and extensive bail-outs. Yet it is remarkable that these issues rarely come up in any so called serious financial discussion!

One way to make mitigations work better is this. **We must not only choose the best one. We must apply them all at the same time.** Instead of picking the most effective shotgun, we should choose the biggest bazooka. Applying all competitive solutions to a sovereign debt problem would be more effective than arguing about, which one should be chosen. Then it might work. Maybe.

Another way the intellectual grid-lock presents itself is silo thinking. Silo thinking is a metaphor drawn from the large grain silos that one sees throughout the US Midwest. The term suggests that each department on an organization (or system) is a silo and that it stands alone, not interacting with any of the other departmental silos. In other words, economists focus on economic problems, politics on geopolitical problems and environmentalists on environmental problems. However, this is not sufficient, because as mentioned above, big systemic problems are interrelated. They affect each other, and must be solved together rather than independently. Silo thinking is rampant, but this is not for investors. We investors need to see the broader picture. We need to follow not only economic and financial trends but observe geopolitical trends and keep an open mind by traveling a lot. Not surprisingly, this is what Vagabond Investors is about and what this whole report is all about. We have repeatedly contended that what modern economics needs is not better financial models but more common sense!

Systemic problems take time to develop. They are cumulative. They tend to build up slowly enough for us not to recognize the change. We adapt to a slowly changing situation, even if it is for the worse. For example, many people do not complain about inflation numbers. Yet everybody knows that when you watch an old film and see price tags in it, you find yourself thinking: "*I wonder what year this movie was filmed on? You can't get such and such for that price anymore*." We only recognize the problems when they become so big and evident that we're in an acute danger. *Global warming is picking up!* Yes, it has been for decades. *The baby boomers begin to retire and we don't have any money*! Yes, demographics can be followed on a calendar. And yes, that retirement money was blown out a long time ago in Vietnam, Iraq and Afghanistan. *Food prices are soaring!* Yes, a symptom of excessive liquidity. *Gold is hitting all-time high!* Really? We have to wonder why… As an old Finnish saying goes, it's too late to hold it when the crap is already in the pants.

As much as we would like to take an adult diaper company public or invest in Mr. Bernanke's money printers (they are in high demand), we will look at some other investment opportunities.

Investment Observations

Most stock market indexes are up from year to year date. That is not surprising. The path the indexes travelled throughout the year is more than amazing. To be more specific, the actual realization in the markets and the forecast for the markets for year 2010 ends up being unbelievably close to each other. That is rarer than simply rare.

At the beginning of the year many forecasted that we will see the markets continue climbing until somewhere around April and May. It was believed that we would then see a correction and the indexes would close the year near the level where the year started. That seems to be a very

neat coincidence, because there is no certain way to know what is going to happen. However, past is past and we shall look into the future.

It has been long since we have felt this kind of uncertainty of upcoming market performance. There are several things that make us hesitate more than we normally do. A survey of asset managers shows a great confidence on stock markets to outperform other asset classes during the next 6-12 months. This kind of strong confidence in the market environment – where the recovery and earnings growth has been driven by artificial stimulus and massive cost cuts in the companies – make us lean back and wonder what's wrong with the picture. The real recovery in the economy happens when employment starts to recover and the middle class strengthens. That is when the small businesses are picking up the confidence on the economy and expand their operations. That's where the Promised Land is. Right now the social mood is grim. We doubt it is supporting the small businesses' desire to expand and hire new workforce.

It is obvious that QE2 and easy money has floated the stock markets all over the world – as well as most commodity prices, precious metals and property markets in some areas of the world. This shows us how unpredictable the consequences of money printing really are. One unintentional outcome has been a significant rise in long-term US Treasury bond yields. To see more on this subject we recommend you to review July and September issues of the MMM Report earlier this year.

We wouldn't be surprised to see increasing volatility in the markets and different asset classes in 2011. Money flows from one asset class to another, making life as an investor rather painful. From which asset class and where? We have to be honest. We have no idea. There is a real danger of new and severe bubbles. Emerging markets, commodities and precious metals are the leading candidates for this. How long will the bubble continue to grow and, more importantly, when will it burst? Those are the questions we have no answer to.

We'd like to point out that there is a huge misunderstanding about the nature of the bubbles. Many see them as bullish events, but they are not. All bubbles lead to pain and suffering. First of all, they leave most individual investors standing on the station when the train leaves. The big masses tend to hop in at the state of the rampant speculation, which leads them to buy near or at the top, and ride the way back to the bottom only to destroy their wealth. Also the rise in commodity prices make everyday living unsustainable expensive. The bubble in emerging markets lead to a situation, where the rise of foreign investments force currencies to strengthen. At the peak of the

Source: Stock Finder 5.0 iShares MSCI Emerging Markets ETF 2003-2010

demand of the country's export products there is a huge demand of employees. Once the currency appreciates, demand shrinks. And once hot employment market cools down, it leads people wandering on the streets without a job. These people mostly did not benefit from the overall sharp rise in the local equity prices or rise in property prices.

Even though precious metals have increased a lot in price, and it is obvious that they will end up into the bubble state, we are not selling our gold, silver or mining holdings at this point. There will likely be meaningful pullbacks along the way before we will see the top of this speculation. There is a meaningful support at $1200 and $1150 for gold. We still see gold hitting $1500-1600 zone and wouldn't be anyhow surprised to see this yellow metal continue its run a lot higher. We are highly confident that silver continues to outperform gold.

In an environment where money printing is a popular sport, inflation is likely to pick up. We have not seen anything yet. Gold and silver are hedges against these dark forces. Make no mistake, those won't be easy rides. It will be like riding the bucking bronco.

There has been increasing speculation around the huge silver short position JP Morgan is holding. It is at least partly a legacy of the Bear Sterns. It is part of an effort to influence silver price performance to hide the footmarks of real inflation. National Inflation Association said in its December 11th article, "***It's not a coincidence that the day silver reached its multi-decade high of over $21 per ounce in March of 2008, was the same day Bear Stearns failed. Bear Stearns was a holder of a massive short position in silver.***" Our readers can bet that there will be time when JP Morgan is forced to cover the short position, and that time may be near. That could easily lead to a short squeeze of the lifetime. This is one of the reasons we refuse to play precious metals from the short side even as a short term trades.

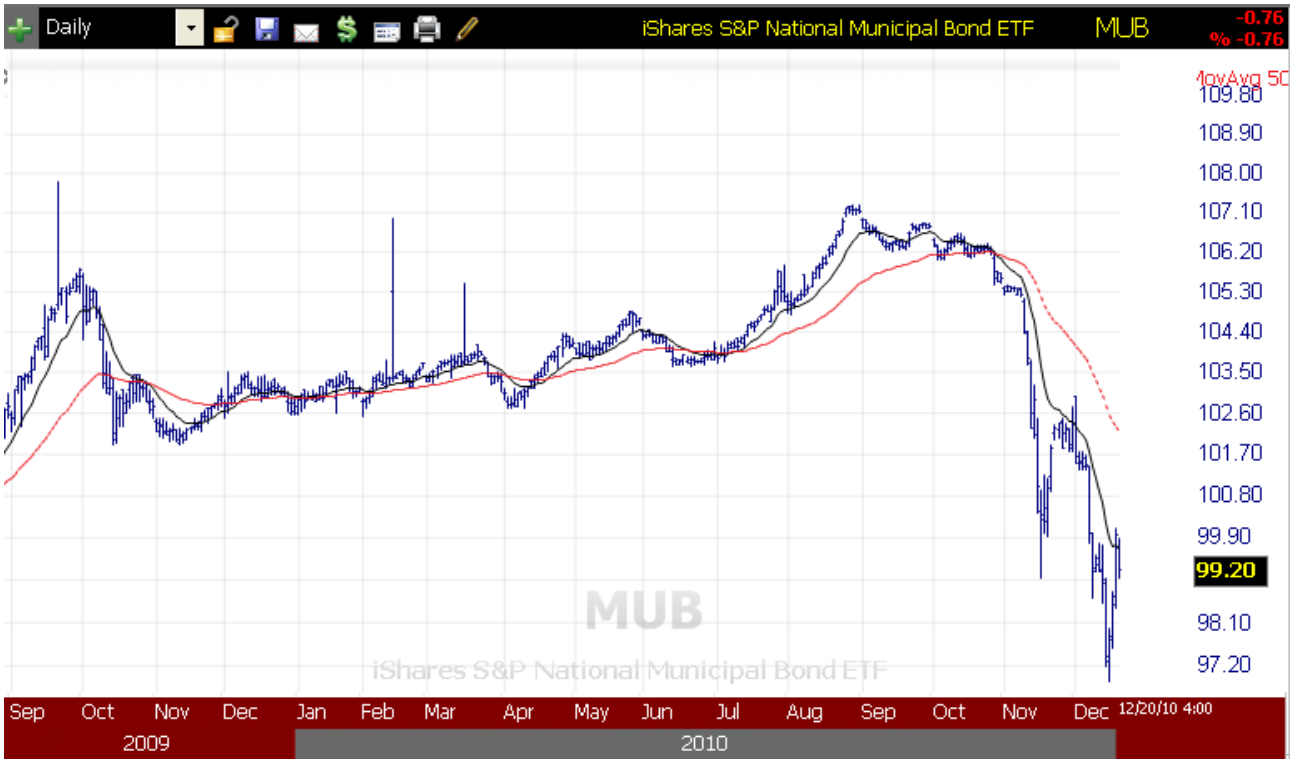
Another commodity we don't short is oil. The reason for this is very simple. Oil is transported in vessels next to politically unstable areas. It doesn't need more than one intentional strike against the oil transportation infrastructure or closing the route the vessels use. Even that can kick the oil price up $50 overnight. We would advise our readers to consider what a severe military conflict would bring. You can imagine that it would be a very painful experience in case you have shorted oil. There are some risks that are not worth taking. In our perspective shorting oil and silver are certainly these.

Source: Stock Finder 5.0 S&P 500 index

Next we will look at the insights of the US equity markets. That might give us some ideas what might be coming for the short to intermediate term. One thing we should like to underline is the performance of the Municipal bonds. We do not point a finger to the Muni fund managers, but rather highlight the nature of the market and how it has lead the stock market tops and bottoms earlier. **Municipal and corporate bonds topped before the equities in 2007 and bottomed out in March 2009 before the equities.** What concerns us is that municipal bonds have sold off very sharply in November and December 2010. At least this reminds us that we live in the world where substantial gains can be whipped out in a matter of days, regardless of the asset class!

To get an idea of the health of the markets, we like to follow how different industry groups perform and how broad the advance in the markets is. That is, how many stocks are making new highs and how many are making new lows. Looking at the Wilshire 5000 composite, which represents slightly better the overall market than S&P 500, we find out that the index is up 11.49 % from the beginning of the year. The more interesting fact is that 131 of the 239 Morningstar industry groups have outperformed and 108 have underperformed the index, 25 being below their 2009 year end value. We would also like to emphasize that gold has rallied 22.2 percent in dollar terms from the beginning of the year and only 83 industry groups have outperformed gold. It is obvious that the nominal price performance has lagged gold, turning real returns negative for 156 industry groups. Freshly printed money has inflated equity as well as precious metal markets. At the same time some pundits argue that there is no real inflation going on. At least there is hard evidence of asset inflation. We are not saying that there are no deflating sectors in the economy, but the main point is that the inflationary forces are out there, and they are well.

However, this is not the only thing that that concerns us. Many data points are whispering that some kind of a pullback or correction is coming. Regardless of the indicators, the indexes have continued their march higher. What makes us curious is that the indexes make new highs in nominal terms, but the number of stocks making new lows is expanding. At the same time, the new highs are lagging. **That shows us that the advance is being led by a narrower group of stocks and at the same time an increasing number of stocks are scrambling in the mud**. We all know that something very funny is going on and something is not right in the financial system. Still the markets push higher like all the problems were solved. Our concern is that very much of the upcoming good news have al-



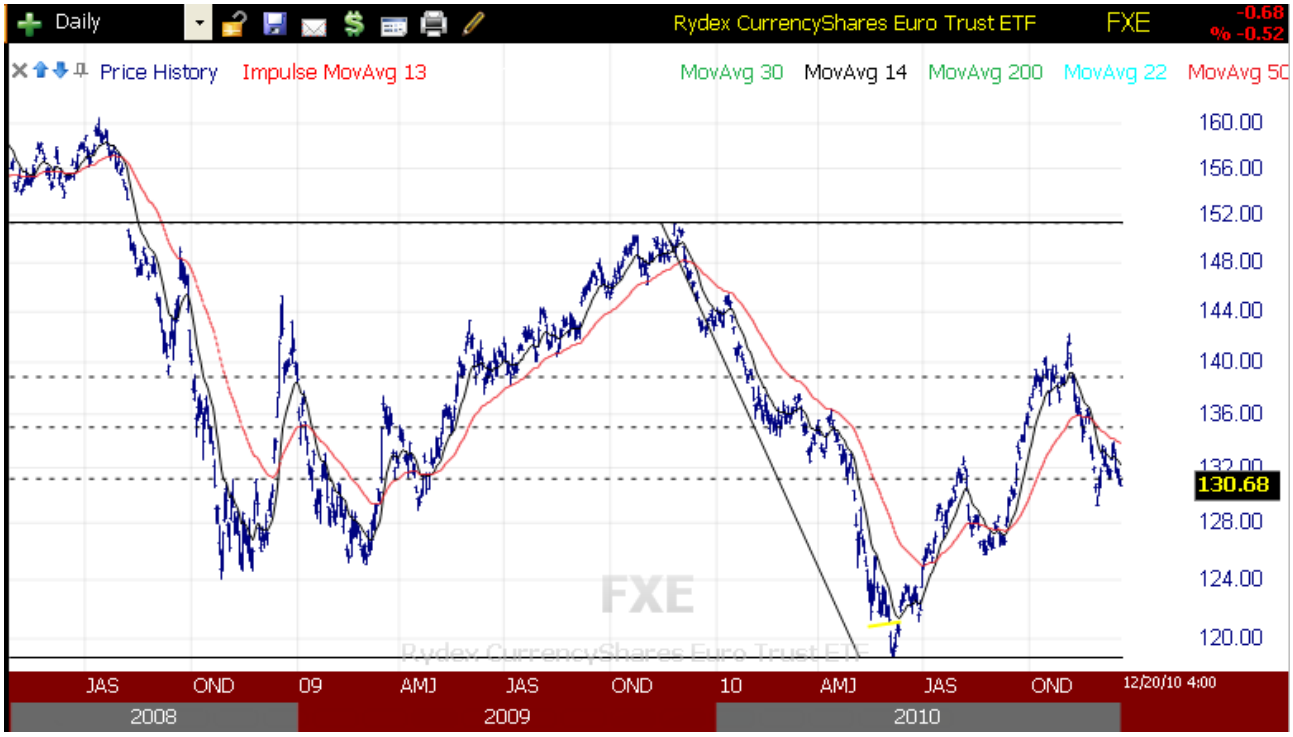
Source: Stock Finder 5.0 iShares S&P National Municipal Bond ETF MUB

Source: Stock Finder 5.0 DJ Wilshire 5000 Composite

Source: Stock Finder 5.0 SPDR Gold Trust GLD

Source: Stock Finder 5.0 iShares Silver Trust ETF

Source: Stock Finder 5.0 iShares Barcleys 20+ Year Treasury Bond Fund TLT



Source: Stock Finder 5.0 Ryder CurrencyShares Euro Trust ETF FXE (EUR/USD)

ready been discounted into the prices and there is a lot to do to meet those expectations. Companies can't continue the venue of cost cuttings forever. The increase in earnings has to be done in an old fashion way by increasing sales.

In case there is some serious uncertainty in equities markets, the currencies are no better. Dollar has fluctuated against Euro over 20 percent during the 2010. Those are staggeringly violent moves indicating that there is something seriously wrong in the equation. Even though we don't like the long term prospects of US Dollar, the Euro doesn't look any better. Europe is suffering from structural problems that could lead to very

painful situations. We are not suggesting that breakdown of the Euro will happen, but merely that the worst is still ahead. Thus we would expect EUR/USD continue to fluctuate in 2011. These moves may be unpredictable both in direction and magnitude.

Some of our loyal readers have indicated a lot of interest in natural gas pays. We easily understand the fundamental reasons for the rising interest as well as the difficulty to participate. Natural gas is relatively cheap compared to other commodities (or the other commodities are very expensive compared to natural gas). The question is, which one will make the move? Our guess is that the natural gas is poised to run. The undeniable difficulty is how to play this market. Most individual investors are not willing to do it via futures which is understandable. One way to participate is to own Chesapeake Energy (CHK: NYSE) or First Trust ISE Revere Natural Gas Index Fund (FCG) or US Natural Gas ETF (UNG). However, we are not big fans of the natural resource ETFs due to their astronomical rollover costs. If possible, try to satisfy your appetite by trading natural gas futures.

Some of you might want to have a look at Market Vectors Vietnam ETF (VNM). Vietnam stock index has been on a sideways move from summer 2009 and is showing some life. This is not an all-in kind of a play like none of our plays ever are, but continuous accumulation from pullbacks might give us a nice ride.

Our plan to accumulate silver and gold plays from pullbacks is still in tact. We continue to be bearish about long-term US treasury bonds even if they might pop a little up from deeply oversold condition before they take a next leg down.

Overall we are a bit concerned about the health of the equities market and feel a bit hesitant to make any oversized plays right now. We recommend you to keep a close eye on your money and risk management. In case you are feeling heavy on the markets you might want to buy some cheap put options just in case the markets decide to crack down. We are not saying that they will, but now might just be a good time to study options to buy insurance on your portfolio or to make speculative bets. Something doesn't look quite right, so that leaves us looking for negative divergences from the markets to short. Having both longs and shorts a fairly calming way to trade and invest—at least for us.

For additional trading ideas visit www.vagabondinvestors.com

Have a great holiday season! On Christmas there should be more important things than money. Year 2011 will definitely be an interesting year to say the least. We will continue to dig the most interesting trends, investment and trading themes and bring them into the daylight. Thank you for being a loyal reader in 2010.

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