Investment Outlook

$4 Gasoline Dampens Outlook

Nothing affects the economy so directly and immediately as rising gasoline prices, now up 34% versus a year ago. The pain falls most heavily on long distance commuters. These are the same folks in the bedroom communities around Phoenix, Las Vegas and San Bernadino who have already suffered the largest home price declines. These communities are being kicked while they're down and this is no help to them or the mortgage industry.

Will gasoline prices stay high long enough to do real damage to the economy? We have to consider four factors: Crude oil prices, consumption, refinery margins and exchange rates. With respect to crude prices, the recent price spike is clearly driven by speculators rather than supply/demand fundamentals. Speculators are buying oil futures as insurance against a civil war in Saudi Arabia. As it becomes apparent that Saudi Arabia will remain stable this year, crude prices should retreat. Oil storage is now at capacity, which means that buyers of oil futures cannot accept delivery, setting up a potential crash in prices.

U.S. gasoline consumption increased 2% during 2010. Most analysts expected a decline. Consequently, refinery margins are at all time highs. In fact, much of the increase in gasoline prices is going to refiners rather than crude oil producers. That is why gasoline is up 34% whereas crude is up "only" 19% versus one year ago.The refinery picture is not helped by 29% of Japan's refineries being offline, and Libya's light sweet crude being replaced by sour crude from Saudi Arabia. Seasonal factors will also goose consumption as we approach the summer driving season.

The last factor is exchange rates. The U.S. competes with China, Japan, Europe and India for oil imports. The U.S. has a more expansionary monetary policy than any of these other countries. Based on this factor alone, I expect exchange rates to increase the U.S. dollar price of crude.

Even if crude goes back to $89, where it was in December, it looks like gasoline will stay in the high $3 range for many months, given limited refinery capacity, steady consumption and a falling dollar. At that level, it can certainly be a brake on U.S. growth rates.

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In the January issue of Investment Outlook we mentioned our more cautious outlook, so during the first quarter we increased the fixed income allocation by a moderate amount in most client accounts. We took our profit in Corning Corp. after the Japanese earthquake. We don't want to be in the stock when Corning announces the damage, as it has some very high tech operations in Japan.

Inflation continues to be a concern and is finally showing up in the CPI figures, with monthly increases of 0.4% in December and January, followed by monthly increases of 0.5% in February and March. If the current rate of inflation continues, we are looking at a 6% annual inflation rate. With T-Bills and CD's paying way below the rate of inflation it's no wonder investors are flocking to gold.

We have a substantial investment in two gold and silver mining stocks, SVL.TO and AUY. We favor these profit making businesses, as opposed to just speculating on holding gold itself. These two companies planned to be profitable at a gold price of $800, so they are looking very exciting with gold at $1,500.

Our biggest fixed income investments are Treasury Inflation Protected Securities (TIPS) and a TIPS funds (WIW). These are inflation protected because the principal amount is adjusted for any change in the Consumer Price Index. We also hold an emerging market sovereign debt fund, which should get a boost if the dollar continues to fall.

Despite the economic headwinds, we feel more secure in stocks than fixed income because of our grave concern over the value of the dollar. At least a stock is backed by some tangible assets and an ongoing business, whereas the value of fixed income all rests on the value of the currency. Standard & Poors just gave a negative outlook to the credit rating of the U.S. Government. Dollar bashing is moving from the fringe to the mainstream, and don't forget a dollar is just a piece of paper unless people have confidence in its value.

Our client portfolios are dominated by stocks whose price is well supported by earnings. ASFI, AYR, CCCL, CVVT, ENTG, GASS sport PE ratios below 12, based on the most recent quarterly earnings. LSE, TPG, TEVA and WPC are also in this valuation range when earnings are adjusted for noncash expenses. We believe these stocks will fare better in a downturn than growth stocks with lofty PE ratios.

We had a few bumps in the road last quarter. In January a short seller put out a report attacking China Valves (CVVT), questioning the accuracy of their financial

reports and highlighting some self dealing by top management. The stock plummeted from 10 to 4. We were greatly relieved when the annual report came out and their financial statements received an unqualified opinion from a U.S. audit firm. However, Wall Street was not impressed, and CVVT is now seeking a more prestigious audit firm to convince investors that their very impressive numbers are real.

We also had a real go round with Silvercrest Mines. Silvercrest is based in Vancouver, Canada, and trades on the Toronto and Frankfurt exchanges. In January the SEC decided that Silvercrest needed to file with the SEC and ordered U.S. brokers to stop trading the stock. Silvercrest immediately undertook registering with the SEC, but meanwhile Charles Schwab starting blocking the daily price feed from the Toronto Exchange and showing Silvercrest at zero market value. When my protests to Schwab went nowhere, I finally contacted the head of Schwab Institutional, Jim McCool, and within 24 hours Schwab went back to showing the correct market value, to the relief of all our clients. I even got a thank you call from Silvercrest Investor Relations. So three cheers for Charles Schwab. P.S.: Silvercrest is still working on their SEC registration. Once the stock resumes freely trading in the U.S. we hope to see a nice bump in the stock price.

As always, I am grateful to our clients for tolerating these ups and downs. These underlying businesses are far more stable than their stock price movement would suggest. Ben Graham said “in the short run the stock market is a voting machine, in the long run it’s a weighing machine”. As long as our underlying companies accumulate profits, it will eventually show up in the stock prices, regardless of investor sentiment.

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