The Growth Slowdown of the Sick Economies, Part III

Recession, Hyperinflationary Depression or Another Dark Ages?

“The idea of the future being different from the present is so repugnant to our conventional modes of thought and behavior that we, most of us, offer a great resistance to acting on it in practice.”

— Lord Keynes

By James Dale Davidson

It must have been an inside joke. The decision by the U.S. National Intelligence Council to invoke John Maynard Keynes as a prologue to its forecast of what the world will be like in 20 years, Global Trends 2030: Alternative Worlds, must have given rise to lots of giggles among CIA operatives in Langley.

Before I return to considering the ironies entailed in the NIC resting its telescope on the shoulders of Keynes, it might be useful for new readers to recap. In the first two parts of The Growth Slowdown of the Sick Economies, I examined newly fashionable arguments about why the so-called “advanced” economies had more or less stopped growing, even before the collapse of Lehman Brothers triggered the onset of the Great Recession. In my view, the crisis of 2008 did not cause the growth slowdown. Rather, the end of growth caused the crisis.

It is little appreciated that U.S. GDP minus government spending has basically flat-lined in the 21st century. It grew from $9.314 trillion in 2004 to $9.721 trillion in 2010 — a gain of just 0.43%. At that rate, it would take the U.S. private economy 167.4 years to double.

This bleak news was disguised by the officially reported GDP, which grew from $11.371 trillion in 2001 to $13.191 trillion in 2010 — a still sluggish annual growth rate of 1.5%. The much faster growth of GDP than the net private economy reflected a surge of annual government spending from $2.056 trillion in 2001 to $3.47 trillion in 2010.

The unsustainable growth of government spending was financed by increasing the national debt. It soared from $5.807 trillion in 2001 to $13.561 trillion in 2010, a jump of 133%. In other words, the burden of the national debt...
compounded 3,000 times faster than the productive economy grew — without consideration of the multi-trillion dollar annual increase in unfunded liabilities, such as Social Security and Medicare.

As Lord Keynes’ quotation at the beginning of this issue implies, people in general are hardly eager to explore the unpleasant implications of change. However, by tradition, the coming of the New Year opens a brief window, after the popping of the champagne corks and the singing of *Auld Lang Syne*, when predictions are welcomed, if not exactly taken seriously. In most cases, these predictions are relatively short-term and trivial. This month, however, I would like to enlarge the usual prediction model and go beyond stating that I expect a recession in 2013. Taking a cue from National Intelligence Council, I will also venture some ideas about how the world will change over the next 20 years.

**What Happens if the Slowdown Continues?**

The crucial issue on the table for your consideration is what happens if the growth slowdown persists? I think it’s very unlikely that the U.S. system, along with those of many other formerly advanced economies (“the sicks”) could survive the end of growth. As I explore below, the actual budget deficit of the U.S. government, calculated according to Generally Accepted Accounting Principles (GAAP) was $7 trillion, or roughly 50% of GDP in 2012. The U.S. has never grown fast enough to balance a deficit of that magnitude. But a growth stall implies a world of trouble.

I argue that a hyperinflationary depression will likely occur in the U.S. before 2030. The optimist in me would like to think this will not be an installment in a new Dark Age. But that is an issue that involves all sorts of complications better explored at another time.

Meanwhile, let’s return to Keynes’ analysis of why the “idea of the future being different from the present is so repugnant to our conventional modes of thought and behavior.” The piece from which the Keynes quote is taken begins, “The future never resembles the past — as we well know. But generally speaking, our imagination and our knowledge are too weak to tell us what particular changes to expect.” Lacking knowledge and imagination, we assume “for psychological rather than rational reasons,” that “the future will resemble the past.”

This is precisely what the National Intelligence Council has done — given us a linear extrapolation of well-established and well-recognized trends — like China overtaking the U.S. as the world’s leading economic power by 2030. They’ve also extrapolated a trend to predict that half the world’s population will live at a middle-class level of affluence. The seemingly plausible extension of well-established trends among the BRICS and other emerging economies presupposes a tremendous strain on resources and soaring commodity prices.

As all-star investor Jeremy Grantham emphasizes in his argument against expecting a resumption of 20th century growth rates, whole supply infrastructure of commodities, including energy resources, the metals, food and water would have to be hugely expanded to support more billions of people at the lifestyle that the middle-classes of advanced economies have heretofore enjoyed. He doubts, as I do, that these resources could be forthcoming without startling price rises across the board. As the cost of living a middle-class life soars the result to be expected is that tens of millions of people in the once “advanced,” now “sick” economies would be priced into poverty.

Hence, unless it is true that “the future never resembles the past,” we can make a better guess of what lies in store than Buridan’s starving ass playing “Eenie meenie miney mo” over two equally succulent bales of hay. (Another “inside joke,” this time mine, referring to Keynes’ es-
say of 75 years ago, where he compares the dilemma of an investor required to choose among alternative views of the future to the paradox of Buridan’s Ass, a poor creature that hypothetically starved to death unable to choose between alternative meals).

Note for those who only know Keynes for his advocacy of deficit spending, he is interesting for another reason than being “the defunct economist” to whom “madmen in authority” are enslaved. Almost uniquely among famous economists, J. M. Keynes was a spectacularly successful investor, the George Soros of the 1930s.

Keynes is also important in intellectual history for his contributions to understanding the economics of rationality. Before the advent of “neural-economics,” Keynes was one of the foremost authorities on the way investors think about the economy. His 1921 book, A Treatise on Probability, is considered a major contribution to the economic rationality debate, and covers a number of technical aspects of probability, including treatment of problems of non-rankability, non-measurability, and incommensurability, along with what Keynes called “non-numerical probabilities.”

Given his undoubted eminence as an authority on economic rationality, Keynes’ views on forecasting took on a special weight.

Keynes thought that “we have before us a large number of alternatives, none of which is demonstrably more “rational than the others….,” Ironically, while Keynes believed that we generally lack the knowledge and imagination to forecast the future conditions that should inform investment valuations, he did believe that “a small minority of the participants in stock markets” are shrewd enough to successfully estimate, not what a security is intrinsically worth, but what prospective buyers are likely to think it is worth. This is a consequence of the fact that while the future may not actually be like the past, people will dependably expect it to be.

So the quote at the top of this article suggests that while we may be unable to forecast how the world will actually change, we won’t go far wrong in guessing that conventional people under the sway of “habit, instinct, preference, desire, will, etc.” will project that it won’t change much and act accordingly.

Keynes’ view that the innate conservatism of the human mind prejudices most people against entertaining the possibility of an alternative future explains a lot. For one thing, it helps make sense of the sometimes huge, schizophrenic gap between underlying economic reality and consensus views of such. Hence, the otherwise puzzling fact that politicians of all factions and parties seem to devote great effort to the collection and dissemination of bogus economic statistics.
Peddling Bogus Recovery as the Genuine Article

For example, as reported in previous issues, I have been amazed by the success with which the Obama administration peddled a patently bogus “recovery” as the genuine article. Investors have dutifully bought stocks “priced for perfection” in the assurance that a recovery was progressing. We reported early in Obama’s first term that his policies seemed geared not so much toward “stimulating recovery” as “simulating recovery.” Quite to my amazement, this seems to have succeeded in hoaxing a majority of Americans — at least in so far as it conditioned public expectations of the future and got him reelected.

On the other hand, a hint that the Obama-simulated “recovery” was not altogether convincing is encapsulated in the common term used to describe this allegedly short and shallow downturn, “The Great Recession.” That term, so obviously at odds with official statistics, found currency because it fits the underlying reality of a deep downturn — one from which no recovery has occurred, and none is forthcoming.

Funny thing is, the credibility of the government’s incredible statistics is far more limited than the powers-that-be would like. As CNBC reported in its All-America Economic Survey 2012, released on September 25, “Americans, by overwhelming margins, believe the economy is worse now than it was four years ago when Obama’s term began.” In pure logic, that implies no recovery at all. But of course, public opinion is not necessarily synonymous with pure logic.

Part of the reason it is difficult to parse public opinion for its logical implications, much less make sense of politics, is that The Great Deception that disguises economic reality is a multi-layered deceit which begins, as Keynes suggested, with the “habit, instinct, preference, desire, will, etc.” of people to fool themselves. Most conventional thinkers cannot abide the deeply gloomy thoughts expressed by Jeremy Grantham:

“The U.S. GDP growth rate that we have become accustomed to for over 100 years — in excess of 3% a year — is not just hiding behind temporary setbacks. It is gone forever. Yet most business people (and the Fed) assume that economic growth will recover to its old rates…

“The bottom line for U.S. real growth, according to our forecasts, is 0.9% year through 2030, decreasing to 0.4% from 2032 to 2050. This is all done presuming no unexpected disasters, but also no heroics, just normal ‘muddling through.’”

Even with the considerable qualifiers stated above, Grantham, whose GMO firm manages $104 billion and who predicted the bursting of the Japanese stock bubble in 1989, the end of the Dot.com bubble in U.S. stocks in 2000, and the collapse of the subprime boom, suggests there will be no recovery in the U.S. until 2016.

That implies a far worse budget picture than the honorable members of Congress entertained in their deliberations over the Fiscal Cliff.

Both major parties have connived at the misreporting of economic statistics. In particular, they have joined in a mutual sleight of hand in dealing with inflation that has caused untold confusion about the true state of the U.S. economy. Even many fiscal conservatives have winked at a succession of statistical gimmicks introduced over the years that have altered the way inflation is measured and reported.

Witness, for example, the suggestion forwarded by House Speaker John Boehner (and accepted by Obama), as part of the Fiscal Cliff negotiations that the government resort to even more heavily gamed “Chained CPI” inflation reporting to reduce Social Security COLA (cost of living adjustments) by another $250 billion over 10 years.
So-called “Hedonic” adjustments lower the cost of living index, supposedly to reflect the higher quality of goods. But these quality adjustments are only taken in one direction. When Häagen-Dazs reduces the size of its standard tub of ice cream by two ounces, this is not treated as a 12.5% increase in the cost of ice cream.

**Statistical Sleight of Hand**

Quality adjustments for government statisticians are strictly a one-way street. They are applied only to lowball inflation, not to bring it properly into view. With unfunded liabilities for entitlements like Social Security and federal pensions that are indexed to inflation stretching as far as the eye can see, many lawmakers in both parties winked at the statistical sleight of hand that understated inflation, thereby saving trillions in cost-of-living adjustments.

Equally, Homeowner’s Equivalent Rent was a convenient device for disguising the impact of the greatest housing bubble in world history on the CPI. Housing accounts for a major portion of monthly outlays by most consumers. Indeed, housing costs notionally comprise about a third of the CPI. But note — by 2006, the peak of the housing boom, only 40% of homes were affordable for families earning the median income. You might think this would have been reflected in a surge in the cost-of-living index. Wrong.

The house price-rent ratio, usually synonymous with the “owner’s equivalent rent” data published by the BLS, is often viewed by economists as an indicator of a housing bubble. When housing prices rise much faster than rents this is seen as an indicator that housing prices are overly inflated. Naturally, a government that is intent upon disguising inflation prefers to measure housing costs according to the generally lagging rental value. As John Krainer and Christien Wei wrote in an October, 2004 analysis for the Federal Reserve Bank of San Francisco, “current prices are high relative to rents. More precisely, house prices have been growing faster than implied rental values for quite some time: currently, the value of the U.S. price-rent ratio is 18% higher than its long-run average.”

Obviously, the real cost of living was skyrocketing. But not as officially reported in the CPI. The Homeowner’s Equivalent Rent gimmick helped disguise the impact of soaring housing costs on consumer pocketbooks by including only the gain in rental value, which was known to dramatically lag the real costs of owning a home as real estate prices skyrocketed.

Understated inflation is a crucial feature of the Great Deception in the age of Obama. As I pointed out previously, if U.S. consumer-inflation data were collected and reported on the same basis as they were during the Carter administration, year-over-year inflation in September, 2012 would have been 9.6%. For simple reasons of arithmetic, unrealistically low, official inflation not only means lower cost-of-living adjustments for beneficiaries of entitlements, it also means overstated real economic growth.

So don’t get too excited about reports that real growth was revised upward in the third quarter to 3.1%. Most of this is statistical fudge. In particular, a lot of the gains above previous estimates were attributable to a 4.1% surge in the government’s projection of healthcare costs. Also note: the statistical twin of GDP, Gross Domestic Income, or GDI, was revised lower to 1.36% from 1.7%. The discrepancy between the GDP and GDI indicates that there is a lot of statistical sleight of hand going on.

The official, September 2012 Consumer Price Index for all urban consumers (CPI-U) showed that the annual inflation rate grew from 1.7% to 2% — just 20% of the “real” inflation rate as it would have been measured before politicians connived to disguise the greater part of soaring living costs. Obviously, if inflation were still measured in the more exacting way that it was during the Carter
administration, the difference between inflation of 9.6% and 2% — 7.6 percentage points of statistical fudge — would not be overstating real GDP growth, real retail sales, and real household income.

By changing the way inflation is compiled and reported, the government saved trillions that otherwise would have been paid in cost-of-living adjustments for Social Security recipients and other pensioners. Indeed, if inflation had continued to be reported as it was in the Carter administration, current Social Security outlays would be twice as high as they are. Understated inflation also painted a rosier picture of real economic growth than is justified by the underlying reality.

A closer look at the composition of the U.S. economy shows that the perception that we have recovered from The Great Recession might be attributed to a general repugnance among the public to accept that the present should be unlike the past.

**The Great Deception**

When you look closely, a major part of the U.S. private sector — almost 14% — disappeared between 2007, the start of the officially measured recession, and 2009, when a recovery allegedly began. Private economic activity plunged by $1.3 trillion while total GDP remained deceptively stable because of a $1 trillion surge in government spending. Hence, the deceptive impression that the economy shrank by only $300 billion — or only about 2%.

Of course, you might make the mistake of supposing that consideration of the economy is less deceptive and more realistic where runaway deficits are concerned. Wrong. The presentation of the deficit itself is another installment in the Great Deception — a way that perception of reality is twisted in keeping with “habit, instinct, preference, desire, will, etc.” in ways that are remote from the facts.

For one thing, the noisy Fiscal Cliff debate over deficit reduction in Washington focuses only on the headline “cash deficit” of the U.S. government. If you listened to politicians speak and read the newspapers that give credibility to their lies, you could come away with the false impression that the financial picture of the U.S. government was improving. Witness the October 12, 2012 article from the *New York Times*, “Federal Deficit for 2012 Fiscal Year Falls to $1.1 Trillion.”

A narrowing deficit sounds like good news. But it is merely more deception. Executives of a public company who pretended that their financial picture had improved by reporting a decline in their “cash deficit” equivalent to that in Washington would be subject to prosecution and imprisonment for criminal fraud. The SEC requires that the accounts of public companies be kept according to Generally Accepted Accounting Principles (or GAAP standards).

Examine federal finances from that perspective, and you see not a falling deficit, but an exploding, runaway deficit enlarged from an average of $5 trillion for every year since 2004 to a staggering $7 trillion for fiscal year 2012 — roughly half of GDP. Meanwhile, what passes for economic growth added $165.13 billion to federal receipts. Revenues grew at a smidgen more than 2% of the growth rate of the net present value of liabilities, which now stand at approximately $90 trillion, according to John Williams of Shadow Government Statistics. (Prof. Laurance Kotlikoff says that the current sum of explicit debts and unfunded promises comes in at $211 trillion). But who’s counting? Either amount is greater than the total GDP of the world.

And more to the point — if you are an American — the $90 trillion tally for the net present value of U.S. government liabilities is 50% greater than the total wealth of Americans. Think about that. Obama’s Wizard of “Middle Class recovery,” former Treasury Secretary Larry Summers, pegs the total wealth of Americans
at $60 trillion. This means that implicitly, you are broke. And so is every American. The U.S. government could confiscate and tax away every penny of wealth owned by you and other Americans, and it would still be $30 trillion short of balancing its accrual deficit.

When you cut through the fog of deception, the true state of federal finances is so grim that it is preposterous to expect that solvency could be restored by tax increases, much less by economic growth. It is certainly a deception to propose that tax increases on the top 1% or 2% of earners could conceivably bring the annual U.S. budget deficit into balance. Not even confiscatory taxation of all earnings by all Americans could do that.

The unhappy fact is that the U.S. economy has been on unsound footing for years, with government and consumers living beyond their means. As real growth has slowed to a crawl, living standards have been preserved by excessive and unsustainable growth in debt, including stimulus, bailouts and runaway entitlement spending, borrowing economic growth from the future. Now the future is no longer what it used to be. The big-picture forecast, at its rosiest, is that the long-run is right around the corner.

And this brings me to another implication of Lord Keynes’ recognition that “we, most of us offer great resistance to acting” on the idea “of the future being different from the present.”

That is not exactly a prediction from a master of investment psychology that the U.S. public is unlikely to “be realistic” and accept lower welfare state entitlements. But that is an unavoidable implication of Lord Keynes’ insight. We struggle to understand what the future will be like and we find it repugnant that it will be different. Obviously, the fact that the net present value of U.S. government liabilities exceeds the total wealth of Americans by 50% proves that there is very little public appetite for facing reality.

As Jim Rogers put it in a recent interview: “In 1918, right at the end of the First World War, the U.K. was the richest, most powerful country in the world… Within three generations, the U.K. was bankrupt. They couldn’t sell government bonds. The IMF had to bail them out. So I suspect this will be the ultimate end for the U.S. The French went through it, the Italians went through it, the Spanish went through it — a lot of people have been in this situation before. They refused to accept reality, they go into a steady decline, and eventually the whole thing falls apart.”

As John Williams suggests, the “long run” that “eventually” leads to things falling apart may no longer be as far in the future as most of us tend to suppose. Williams suggests that by 2016, before the end of Obama’s current term, the U.S. government “would have no practical choice but to meet its obligations by printing the money it needed. Under such conditions, the U.S. dollar would suffer rapid debasement and inflation — undergoing an actual hyperinflation — so as to become worthless.”

If you think about it, Keynes views on “the continuity and stability of conventional behavior,” (to use economist Bill Gerrard’s phrase), help explain the advent and course of hyperinflation. If you were to spend even an hour studying the history of hyperinflations, you could not miss the fact that their success arises from the “continuity and stability of conventional behavior” as it finds expression in the “money illusion.”

So long as the paper money emitted out of thin air looks identical and shows the same denominations as the older, familiar bank notes, gullible people who expect the future to be no different from the past readily accept the rapidly inflating currency at old values. That is why the path to hyperinflation seems to be undertaken in slow motion, with people apparently unable to notice that they are actually racing down the road to ruin. Yet the sluggishness of perception works
both ways. Once a currency is finally discredited, it is all but impossible to restore to credit.

**Where Zimbabwe Leads the Way**

Consider the example of the Zimbabwe dollar. It shows why there is no neat arithmetic link between the size of deficits (as a percentage of GDP or a percentage of revenues) that governments monetize and the price levels. Yes, there are rough similarities between episodes of profligate spending and runaway inflation from country-to-country. But just because deficits in Brazil of a similar magnitude to Obama’s deficits led to a trillion-fold increase in the price level between 1980 and 1997, doesn’t mean that we are in store for the same result. It could be better. And as Zimbabwe shows, it could be far worse.

Zimbabwe began running large, chronic deficits and financing them with printing press money immediately after Robert Mugabe’s forces overthrew Ian Smith and assumed power in the former Rhodesia in 1980.

Even though they ran large deficits in a chronic fashion, merrily printing money as they went along, measured inflation in Zimbabwe never rose above 15% — at least not for the first two decades. For a long time, they seemed to be getting away with it. Even a government run by an increasingly despotic Robert Mugabe could indulge in two decades of profligacy before anyone seemed to notice.

But notice, they eventually did. As perhaps the 21st century’s shining example of “Quantitative Easing” taken to an extreme, Zimbabwe is interesting both because it shows how slowly hyperinflation may develop in response to the monetization of runaway deficits, and then how drastically and rapidly the currency can collapse. Inflation rates remained relatively tame for two decades after the deficits began. But by November 2001, the monthly inflation rate had jumped to 200%. By April 2006 the monthly rate surged upward, as reported by Albert Makkochekanwa in *Impact of Budget Deficit on Inflation in Zimbabwe*, “with the monthly trend reaching 164,900.3% in February 2008.”

A few months later, by July 2008, the inflation rate was 231.2 million percent. By the end of the summer, the IMF estimated a hyperinflation rate at 489,000,000,000% in September 2008. The record year of quantitative easing drew to a close with an inflation rate at 6.5 quintillion novemdecillion percent. (65 followed by 107 zeros). Try pronouncing that astronomical number in a hurry. It is out of this world, but according to Johns Hopkins economics Prof. Steve Hanke, that was the cumulative inflation rate in Zimbabwe as of December 2008.

By all accounts, inflation was ludicrously high and ruinous. The Zimbabwe dollar, at long last, was so thoroughly discredited that it became a logistical nightmare to keep the denominations of currency rising fast enough to keep pace with the collapse in value of the money supply. There were not enough forests in the world to provide sufficient paper to have bought a dozen Happy Meals at McDonald’s with $1 Zimbabwe notes. Denominations had to soar, not merely to save the forests, but to permit the public to physically carry enough cash to buy anything. As a reminder of what runaway deficits can do, I keep a Zimbabwean currency note for $100 billion in my wallet.

Luckily, Zimbabwe enjoyed its hyperinflation before the U.S. took to imitating Zimbabwe’s fiscal policy. When hyper budget deficits led to hyperinflation of the Zimbabwe dollar, Zimbabwe adopted the U.S. dollar.

Now that you have survived the 13th baktun of the Mayan Long Count calendar, I doubt you will wish to flirt with financial doomsday. I don’t anticipate that you will have, or want the choice of adopting the Zimbabwe dollar when the U.S. dollar goes to ruin.
Fasten your seatbelt, you are in store for a wild ride.

Happy New Year,

James Davidson

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**Taking Stock of a Global Dynamo**

By Charles Del Valle

In 1961, the average Chinese adult drank half a bottle of beer per year.

That’s not much. But, at the time, most people in China could barely afford to feed their family, much less splurge on a bottle of brew. So they drank moonshine — because it was cheap and they could make it themselves.

Eventually, the Chinese started to become more prosperous. As they made more money, they drank more beer. By 1991, the average Chinese adult drank more than 27 bottles of beer per year. By 2007, that number grew to more than 103 bottles.

But here’s the thing…

Even though the Chinese now consume more beer than ever before, the rate is still far below those in more developed countries. In the U.S., for example, the average adult drinks 365 beers per year.

By this measure, the Chinese per-person beer consumption rate could triple … and still not approach that of the average American. This tells us that there is tremendous room for growth in the Chinese beer market.

But it’s not just beer they’re drinking.

According to Datamonitor, alcoholic beverage sales in China are expected to grow from 47 billion liters in 2009 to 61 billion liters in 2014. That’s a robust increase of 29%.

This strong growth is happening for a number of reasons.

Economic growth in China is so strong that people have more discretionary income to spend. But it’s not just the cheap stuff that’s moving off the shelves. Upscale brands are also popular, with many buyers viewing them as investments.

At a Beijing auction last year, a bottle of 1958 Maotai liquor received a bid of $230,000!

Rising incomes are just one reason why alcohol sales are booming in China. Another is the advance of women in Chinese society.

Saritha Pingali, a market analyst at Datamonitor, said: “The fast-growing female consumer segment may create demand for pre-mixed drinks and fruit-based alcoholic beverages like wines in the Chinese alcoholic beverages market as Chinese women are financially more independent but also believe that wine consumption is good for health and promotes beautiful skin.”

Because of that, wine consumption in China is on pace to grow three times faster than other alcoholic drinks.

**A Billion New Emerging-Market Consumers**

But that’s just part of the story. Increased alcohol consumption is occurring in every emerging market in the world. And since the emerging markets contain 75% of the world’s population, there is no doubt that alcohol consumption will continue to rise worldwide over the next few decades.

One forecast has a billion new emerging-market...
consumers with over $20,000 in yearly income leading to $150 billion in alcohol sales over the next 10 years.

If that prediction proves true, alcohol sales in Brazil will grow from 14.48 billion liters in 2010 to 17.58 billion liters in 2015.

In Mexico, wine sales will jump from 6.81 billion liters in 2010 to 7.74 billion by 2015.

In Vietnam, alcohol consumption has grown at a 7% annual clip for the last decade.

Some naysayers believe that the strong growth we see today will slow over the next few years.

But I would refer them to a quote from The Economist: “Each Nigerian sips only a third of a shot each year, on average. A typical Frenchman downs 40, even though it goes badly with wine.”

In other words, there’s a lot of untapped demand in emerging markets. And as these countries develop and their citizens enter the middle class, they will inevitably drink more expensive alcohol.

Seizing the Opportunities

One company already taking advantage of this trend is London-based Diageo (DEO).

Diageo sells products in 180 different countries. And it owns some of the best-selling brands in the world, such as Johnnie Walker scotch, Smirnoff vodka and Jose Cuervo tequila.

If there’s a beverage that has alcohol in it, Diageo likely sells it. And it does a damn good job of it.

The company is the #1 spirits producer in North America (which makes up 34% of its net sales). It’s also top spirits company in Asia (which makes up 12% of its sales), the top scotch seller in South America, and the leading beer company in Africa.

When all is said and done, Diageo derives about 40% of its net sales from emerging markets. And it has plans to grow that even more. Diageo wants the China market alone to make up over 20% of its net sales by 2015.

Extended Reach

In China, most consumers drink domestic alcohol because it’s cheaper. Plus, the government prevents large companies from gobbling up too much market share. So, in order for Diageo to grow sales, it has to partner up with local alcohol producers. And that’s precisely what it is doing.

In June of 2011, the company spent $22 million to grab a stake of Sichuan Chengdu Quanxing Group. This acquisition provided Diageo with a controlling interest in ShuiJingFang, maker of the popular drink Baiju, which accounts for more than 30% of China’s spirits market. This is a big deal.

Diageo has paved the way to become one of the first foreign companies to acquire a large Chinese-listed company. Even Coca-Cola has not accomplished such a feat.

However, acquiring local Chinese companies is but one piece of Diageo’s Asian growth strategy.

Buying expensive spirits provides cultural cache for affluent and striving Asians looking to impress friends and business partners. To meet this demand for expensive drinks, Diageo has created new premium products.

One example is Johnny Walker XR, a 21-year-old scotch based on a recipe from Sir Alexander Walker, the grandson of Johnnie Walker. Retailing for $105 per bottle, it’s flying off the shelves in Asia.

However, Diageo’s growth strategy extends far beyond Asia.

Global Footprint

In late 2011, the company bought Turkish distiller Mey Icki, invested in the Serengeti Breweries in Tanzania, and increased its investment in Vietnam’s largest spirits company, Halico. Diageo plans to create premium-branded drinks for all of these companies.
And in east Africa, Diageo saw sales of its scotch whiskey grow by 34% over last year. Most of this growth came from the Johnnie Walker brand, which saw sales double. Sales look even stronger this year.

Having identified the biggest drivers of Diageo’s growth, it must be noted that approximately 60% of Diageo’s sales are supported by the fragile economies of Europe and North America.

Fortunately for Diageo, alcohol sales tend to be recession-proof. Back in 2009, Diageo’s alcohol sales in the US managed to climb 1%. For 2012, alcohol sales in the U.S. grew by 6%.

Even Europe, which is facing a multiple economic crises, Diageo managed to keep sales declines to just 1% over the last 12 months.

Running the Numbers

So, now that we’ve covered Diageo’s largest growth opportunities, let’s dig into the nuts and bolts a bit more.

Diageo is a massive company — with a $75 billion market cap. Such size provides it with significant economies of scale. This has allowed it to keep its operating margins — the cash it makes after paying the bills — at around 29%.

Better yet, thanks to its strategy of introducing premium brands in the emerging markets, Diageo’s margins actually grew three percent over the last 12 months.

This gives the company some breathing room. In an age of rising demand of resources, one would expect the raw materials that Diageo needs to go up in price.

But with fat margins, the company can absorb the higher costs without passing them on to consumers.

In Diageo’s latest earnings report, it actually beat analyst expectations with sales up 9%. Much of this growth came from — you guessed it — emerging markets.

But with diversity comes currency exchange risk. Diageo offsets this by establishing a base in the country it’s operating in. It keeps the profits there until the exchange rates improve. Then it moves the profits back to the U.K. That’s a smart business strategy. And it’s exactly what the company needs to do to ensure that it doesn’t suffer any currency-related losses.

Diageo has also become the first alcohol company to implement Fast Moving Consumer Goods (FMCG) technology into its business. In essence, FMCG is an integrated sales system that allows the company to rapidly plan, execute and evaluate its brand awareness programs with customers and distributors.

If a marketing strategy isn’t working well, the company can quickly change it. If a specific campaign is doing great, the company can rapidly expand it. This ensures that every dollar the company spends is used as efficiently as possible.

But my favorite thing about Diageo is its dividend of 2.9%. It’s been paying a steady dividend twice a year since 1998. Over the last three years, it has increased its dividend at an average of more than 5% a year.

So there’s a lot to like about Diageo. It’s a well-run company that’s quickly expanding its presence and sales in emerging markets. This has allowed its share price to increase in a bear market and keep hiking its dividends over time.

That’s why I suggest you buy shares of Diageo (DEO) today at $116.56. Just don’t chase the stock past $121.

Portfolio Review

Investors can be a fickle bunch.

They often buy at the first sign of good news and then dump everything they own at the first hint
of trouble. That’s why more than 90% of first-time investors lose their shirts in the first year. They simply don’t know how to invest.

James Davidson and I do things differently. We use a measured, top-down approach to investing. We take a detailed look at the big picture first, and then use our research to determine how the future will unfold. Our investment approach does not waver.

With 2013 promising to be an eventful year, it’s an ideal time to review our portfolio to see how our investment selections are positioned to take advantage of the economic landscape in the coming months.

The Taxman Cometh

During the recent “fiscal cliff” negotiations, Senator Lindsey Graham (R-S.C.) expressed his commitment to do whatever he felt was right for the country — even if that meant raising taxes.

It looks like the Republicans are caving in to Obama’s demand for more “revenue.”

What does this mean to investors?

Many people will look to buy tax-advantaged investments as quickly as they can. The highest demand for those investment options will come from states with the highest tax burdens, such as California.

That’s why we recommended that you buy California municipal bond funds such as the Invesco Van Kampen California Value Municipal Income Trust (NYSE:VCV) and the PIMCO California Municipal Income Fund II (NYSE:PCK).

Both funds have already increased more than 15% in 2012.. And we believe the gains will extend into 2013 as more investors pile into them.

That’s why we still recommend buying the Van Kampen CA Muni Income Fund. Just don’t chase shares past $16.

The PIMCO CA Muni Income FD II SBI remains a good pick as long as it’s under $12 a share.

These two funds will help you become more tax-efficient in what promises to be an less-than-friendly environment for taxpayers.

Bracing for ObamaCare

With last year’s U.S. Supreme Court ruling and President Obama’s reelection, it appears that implementation of ObamaCare is a virtual certainty.

One of the most impactful portions of the new measures are the federal government’s elimination of massive subsidies to private insurers and the gradual reduction of the rate of growth of payments to providers. This provision will mean a reduction of over $716 billion of spending in the healthcare sector over the next 10 years.

That’s a huge chunk of change.

In this new environment, the healthcare industry will likely rally on innovation to wring efficiencies out of the existing system. And that’s exactly where our recommendation of TapImmune (OTC BB:TPIV) fits into the picture.

TapImmune has come up with a revolutionary drug to fight cancer … while avoiding the nasty side effects of chemotherapy. It triggers the body’s immune system to kill off cancerous cells and tumors without harming healthy cells.

It’s a cancer-therapy game changer. Not only does it promise to improve the quality of life for cancer patients, it will likely result in more cases of remission — and that means lower healthcare costs, which in turn corresponds to the way hospitals and doctors will have to cope with government spending in the sector.

Right now, TapImmune’s new drug is in Phase 1 clinical testing. If the trials end successfully, we could easily see TapImmune’s shares at more than $1 each. While that’s an amazing gain, our goal is to hold onto TPIV until it completes all three phases of clinical testing.

Today shares are fetching 11 cents. We recommend
buying shares of TapImmune and holding them for the long-term. Just don’t chase shares past 15 cents.

**The Gold (and Silver) Rush Continues…**

For the first time in history, the Federal Reserve has officially targeted a specific unemployment rate. Bernanke has promised to keep the monetary spigots open until we hit a 6.5% unemployment rate.

Furthermore, the Fed is encouraging banks to loosen mortgage requirements to boost the housing market.

This means more money in circulation, which will eventually lead to rising inflation.

Some doubt that inflation will spike. And they use the Consumer Price Index as proof that inflation has stayed tame over the last few years.

But precious metal prices are telling a completely different story.

Since the Fed started its first round of quantitative easing back in November 2008, the price of gold has risen 278%, with silver climbing more than 138%.

We believe that gold and silver will continue to climb as long as the Fed keeps printing money.

That’s why we recommended that you buy into **SPDR Gold Shares (NYSEArca:GLD)**. It’s an easy way to take advantage of the bull market in gold. Of course, if you prefer to buy physical bullion, there’s nothing wrong with that.

At this time, the price of gold has stayed under its 13-month high. We expect it to hit new highs sometime next year. That would give you a 10% gain if you bought gold today.

Just don’t chase shares of SPDR Gold Trust Shares past $175. Alternatively, don’t chase gold bullion past $1,800 per ounce.

**Cornering the Oil Market**

Since the Fed started its money-printing spree in 2008, the price of oil has jumped about 45%. This has led oil producers to spend obscene amounts of cash to boost production. And one of the best ways to do that is by exploiting offshore finds.

Nearly every oil producer is looking offshore. That’s a big reason why we told you to purchase shares of **SeaDrill (NYSE:SDRL)**.

SeaDrill has virtually cornered the offshore rig market. And it has contracts set in stone for years to come. So even if a recession brings down oil prices, oil producers are obligated to keep paying SeaDrill.

There’s no doubt this company will thrive over the coming decade. We remain bullish on SeaDrill. However, don’t chase the price past $43 per share.

**Coping with Low Yields**

The Fed has promised to keep interest rates at 0% until 2015. That’s far below the current rate of inflation, which means if you place your money into a savings account, you’ll lose purchasing power.

That’s what makes dividend-paying companies essential for your portfolio. These companies pay yields well over the rate of inflation … and offer you the potential for capital gains.

One such company is tobacco producer **Altria (NYSE:MO)**.

This is a company that is not only giving us 79.2% in capital gains, but also has a long track-record of steadily increasing dividend payments… no matter the environment.

Lately, it’s been expanding its business into smokeless tobacco products and wine to make up for the slowdown in its cigarette business.

These moves have paid off handsomely for Altria. And the momentum should stay strong for years to come.
Thanks to a recent sell-off, Altria is now trading at attractive prices. So we recommend that you buy shares of Altria. Just don’t chase shares past $34.

**A Struggling Stock Market**

Corporate earnings are down. Dividends are getting cut at weaker companies. Margins are thinning.

These three things paint a picture of a weakening economy. And it won’t be long until that starts to really impact the stock market.

The key to making money in this environment is to look for the weakest companies and short-sell them.

That’s why we advised you to short Education Management (Nasdaq GS: EDMC). This short has worked out beautifully in our favor, giving us gains of 64.18%.

However, we think that most of the money has been made on this play. For now, we’re placing a hold on Education Management.

**The European Implosion**

The European Union (EU) is stuck between a rock and a hard place.

Over the past month, the EU struck a deal to keep funding troubled Greece and keep it in the union. But the terms of the agreement were somewhat vague.

It’s clear that the EU doesn’t want Greece to leave the union. It would set a precedent for Spain and Italy to do the very same thing. And Germany would be left paying the bill, as the euro currency got stronger, making German exports more expensive.

The debt crisis could last years. And the longer it is allowed to fester, the more expensive it will become to solve. Ultimately, the costs may be unbearable. And the EU will dissolve into the annals of history.

That’s not a good sign for the euro currency, which is why we told you to capitalize on a weaker euro by buying into the Market Vectors Double Short Euro ETN (NYSEArca:DRR).

Even though we see the euro falling much further over the long term, the current resolution on Greece has led to a rally in the euro.

So for now, we’re placing a hold on DRR.

**Developing Countries Will Outperform**

There’s a reason why James D. Davidson loves Brazil so much…

There are more moneymaking opportunities there than most places.

Brazil is growing faster than the developed world, which has caused a spike in electricity demand.

That’s why we told you to snatch up shares of Cia Energetica de Minas Gerais (NYSE:CIG). Unfortunately, CIG’s shares have taken a hit since Brazilian authorities announced a new tariff scheme for electricity prices.

We think investors have seriously overreacted to the news by pricing a 40% earnings drop into Cia. There’s no way that’s going to happen.

We recommend buying shares of Cia Energetica. But make sure you don’t chase shares past $15.

Brazil’s growth is the engine that’s driving growth in most of South America. Chile, Columbia, Peru — all of these countries are experiencing robust economic growth.

That’s why we told you to snatch up shares of Chilean pension provider Administradora de Fondos de Pensiones Provida SA (NYSE:PVD).

We like PVD not only because it’s a provider for Chile’s national pension program … but its yield of 7.4% is phenomenal.

Since buying into PVD, we’re up 52%. We recom-
recommend buying more shares. Just don’t chase them past $106.

Corporate Darwinism

Natural selection, a concept made popular by Charles Darwin, is the idea that, in nature, only the strong survive.

Yet Darwinism is not limited to the state of nature. It also applies to the business world. Natural selection in the business world takes many forms. Sometimes it occurs via competition. Other times it’s brought on by unforeseen disruptions.

When these disruptions occur, entire sectors and industries are transformed.

James Davidson and I have identified two disruptive technologies that are already changing the way business is done.

The first is automation. Machines are doing an ever-increasing amount of manual labor. And this transformation is not confined to manufacturing.

Hospitals are replacing pharmacists with machines. Mining companies are opting for driverless trucks. Even writers fear computers that promise to create flawless copy.

Automation is in its infancy. Over the next few decades, we will see it happen to virtually every sector of the economy.

That’s why we told you buy shares of Rockwell Automation (NYSE:ROK).

Since our recommendation, we’re up 16.95%.

As this company grows, so will its profits and its share price.

We still see wisdom in purchasing shares of Rockwell Automation, but don’t chase shares past $80.

The second major disruption comes via 3D printing. That’s why we advised you to purchase shares of 3D Systems (NYSE:DDD) last month. It’s the leader in the 3D printing industry.

In fact, just last month scientists at the Wake Forest Institute for Regenerative Medicine built a 3D printer that can create human cartilage.

Like we told you last month, 3D printing is poised to change the world as we know it. We recommend buying shares of 3D Systems, but don’t chase shares past $48.

Silver Lining

If there is one piece of wisdom that James Davidson and I can impart, it is this: No matter how bleak circumstances appear, opportunities to prosper still exist.

You just have to know where to look.

By taking a top-down approach to investing, we’re able to identify the major trends that are impacting the economy, and then devise strategies to capitalize on the current environment.

As a subscriber to Strategic Investment, you’ll be the first to know when the next opportunity knocks.

Until next month…

Charles Del Valle
## STRATEGIC INVESTMENT PORTFOLIO

<table>
<thead>
<tr>
<th>Investment</th>
<th>Date Added</th>
<th>Price on 12.26.12</th>
<th>Purchase Price</th>
<th>Dividend Yield</th>
<th>Total Returns</th>
<th>Currency Adjusted Total Returns</th>
<th>Advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>NEW BUY</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Diageo (DEO)</td>
<td>NEW</td>
<td>NEW</td>
<td>NEW</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>Buy - up to $121</td>
</tr>
<tr>
<td>STRATEGIC INVESTMENTS</td>
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<td></td>
</tr>
<tr>
<td>3D Systems Corp. (DDD)</td>
<td>12/4/12</td>
<td>$51.90</td>
<td>$43.93</td>
<td>0.0%</td>
<td>18.14%</td>
<td>18.14%</td>
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<tr>
<td>Administradora de Fondos / Pensiones Provida (PVD)</td>
<td>6/6/12</td>
<td>$48.60</td>
<td>$74.48</td>
<td>7.4%</td>
<td>35.77%</td>
<td>35.77%</td>
<td>Buy - up to $106</td>
</tr>
<tr>
<td>Altria Group Inc. (MO)</td>
<td>6/9/10</td>
<td>$31.66</td>
<td>$20.05</td>
<td>5.6%</td>
<td>79.8%</td>
<td>79.8%</td>
<td>Hold</td>
</tr>
<tr>
<td>Cia Energetica (CIG)</td>
<td>8/23/11</td>
<td>$12.23</td>
<td>$14.21</td>
<td>9.3%</td>
<td>-2.8%</td>
<td>-2.8%</td>
<td>Buy - up to $15</td>
</tr>
<tr>
<td>Education Management (EDMC)</td>
<td>5/2/12</td>
<td>$4.85</td>
<td>$12.31</td>
<td>0.0%</td>
<td>60.6%</td>
<td>60.6%</td>
<td>Hold Short</td>
</tr>
<tr>
<td>iPath S&amp;P 500 VIX Short-Term Future ETN (VXX)</td>
<td>4/5/12</td>
<td>$31.96</td>
<td>$71.44</td>
<td>0.0%</td>
<td>-55.3%</td>
<td>-55.3%</td>
<td>Buy - up to $16</td>
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<tr>
<td>Market Vectors Double Short Euro ETN (DRR)</td>
<td>1/26/11</td>
<td>$42.98</td>
<td>$43.10</td>
<td>0.0%</td>
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<td>-0.3%</td>
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<tr>
<td>Orco Silver (OKV)</td>
<td>8/24/12</td>
<td>C$ 2.42</td>
<td>C$ 1.50</td>
<td>0.0%</td>
<td>61.14%</td>
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<td>Buy - up to $1.50</td>
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<tr>
<td>PIMCO CA Muni Income FD II SBI (PCK)</td>
<td>8/7/09</td>
<td>$10.46</td>
<td>$9.14</td>
<td>7.2%</td>
<td>42.6%</td>
<td>42.6%</td>
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</tr>
<tr>
<td>Rockwell Automation (ROK)</td>
<td>10/29/12</td>
<td>$82.96</td>
<td>$70.25</td>
<td>2.3%</td>
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<td>18.76%</td>
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<tr>
<td>SeaDrill</td>
<td>7/31/12</td>
<td>$37.45</td>
<td>$38.79</td>
<td>9.5%</td>
<td>1.81%</td>
<td>1.81%</td>
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<tr>
<td>SPDR Gold Trust Shares (GLD)</td>
<td>1/20/11</td>
<td>$160.62</td>
<td>$131.57</td>
<td>0.0%</td>
<td>22.1%</td>
<td>22.1%</td>
<td>Buy - up to $175</td>
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<tr>
<td>TapImmune, Inc (TPIV)*</td>
<td>5/2/12</td>
<td>$0.10</td>
<td>$0.17</td>
<td>0.0%</td>
<td>-45.1%</td>
<td>-45.1%</td>
<td>Buy - up to $0.15</td>
</tr>
<tr>
<td>Ultrapar Holdings</td>
<td>9/26/12</td>
<td>C$ 21.70</td>
<td>C$ 22.38</td>
<td>2.3%</td>
<td>-3.04%</td>
<td>-3.04%</td>
<td>Buy - up to $26</td>
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<tr>
<td>Van Kampen CA Muni Income Fund (VCV)</td>
<td>8/7/09</td>
<td>$13.77</td>
<td>$11.88</td>
<td>5.8%</td>
<td>41.2%</td>
<td>41.2%</td>
<td>Buy - up to $15</td>
</tr>
</tbody>
</table>

## NOTES:

The Strategic Investment Portfolio is an equally-weighted strategy and does not include taxes or dealer commissions, if any. “Total return” includes capital gains, dividends, interest payments, and stock splits. “Total Return (currency adjusted)” is equal to the “Total Return” adjusted for any gains or losses due to currency fluctuation on securities listed on non-U.S. exchanges. “The Purchase Price is based on the first closing price after the recommendation’s release. Sources for price data: Yahoo Finance, and websites maintained by securities issuers. Dividend yield is based on trailing 12-month distributions. Stop-losses: The Strategic Investment Portfolio maintains a 25% trailing stop-loss on every stock, ETF and bond recommendation. The 25% stop-loss is waived for any security listed in the portfolio marked with an asterisk.(*)