**SPECIAL REPORT**

There are some economic and political trends in the world today which are significant, somewhat frightening, and almost unprecedented.  The purpose of this report is to outline our thinking about the world economic scene and explain the reasons behind our extremely conservative approach to managing your capital at this time.

When you read this report please keep in mind that the interaction and integration among people, companies, and governments of different nations. This process of globalization has transformed the world’s capital markets over the last 25 years.  We are more financially interrelated with other countries, their economies and their capital markets than we’ve ever been. Investment capital now moves very freely between all countries of the world and at record speed.  For example, it is possible for me to quickly convert your dollars to Euros and buy stock in a Brazilian mining company which is controlled by the Chinese government. It would take me about 10 seconds to execute this transaction.

The huge expansion of investment opportunities around the world over the past 25 years has greatly complicated the investment decision making process. It forces us to create a process to greater examine and evaluate the worldwide economic and political developments before making capital allocation decisions for our clients. In short, we’re fishing in a much bigger lake.

This global economic evaluation process eventually results in an investment allocation for our clients based on a) our view of the world economic scene and b) long term trends in world capital markets.  This Special Report outlines the rational for our current investment strategy in this rather interesting environment.

A FINANCIAL TOUR OF THE WORLD

I’ll start with the most critical and complicated area of the investment world.

**WESTERN EUROPE**

The challenges of the immigration facing Western Europe are dominating the headlines. The real challenges facing Europe however are structural economic issues totally unrelated to the immigrant issue.

The Euro is still in trouble and may not survive in its current form for more than five years. The Greece problem has not been solved and the likely next problem country will be Italy. That will be a major problem for the future of the Euro.

 Western European economies are stagnant at best. Unemployment is high and most countries have severe budget problems. Their banking system is seriously undercapitalized.

The most serious problem Europe is facing is deflation – negative inflation. Approximately 25% of high quality short term European government and corporate bonds have negative yields.  If this problem continues, it is only a matter of time before the bank depositors will have to pay for the privilege of depositing their money in the bank.

It is interesting to see how Europeans investors are dealing with this deflation issue. They are basically doing four things:

Hoarding Currency - large denomination Euro bills are disappearing from circulation.  It is quite possible that large denomination Euro bills could actually sell for more than their face value if this trend continues.

Currency Conversion - Many European investors are converting their Euros to other currencies.  Much of it is ending up in the US.

Private Banking- Europeans are investing more of their capital in private banking type investments thus bypassing the regulated banking system. This process is called “chasing yield” and it can cause problems- our sub-prime economic problems in 2007-08 were largely caused by this process.

Investing outside of Europe - European investors are buying investments in more economically stable countries such as Canada, Australia and the US. The biggest problem with deflation is that consumers defer spending in anticipation of lower prices in the future. This can have a severe impact on economic growth.  Japan is a good example of this.

So, Western Europe is continuing to struggle with some serious structural economic issues.  In short, there are some very good fundamental economic reasons for minimizing our investment exposure to European capital markets at this time.

**CHINA**

The second largest economy in the world is facing huge long term economic problems.

Foreign investment has leveled off and the government is subsidizing state owned companies in order to preserve jobs.

Their economy is expanding at a slower rate - if you can believe the Chinese economic statistics.

The “One Child” policy in China for the last 30 years has absolutely guaranteed that China will grow old before it grows rich - too many senior people compared to young workers.

China is experiencing huge capital outflows.  Chinese investors are converting their wealth into other currencies and overseas investments.  If Chinese investors are getting their capital out of China, I can see no reason whatsoever for allocating any of your capital to China.

**JAPAN**

* Deflation,
* Bad Demographics- too many senior people.
* 20 years of economic stagnation,
* An inflexible and outdated economic system,
* Japanese demographics. They have too many old seniors in the pipeline.  One third of the Japanese people are classified as retired. Metaphorically speaking, “Japan is a bug looking for a windshield.”

**RUSSIA**

Russia is basically a huge gasoline station that is losing money like crazy. (For example,) It costs them over $80 per barrel to extract their oil and they are selling it for $40. The only problem is that this gas station is run by not the most honest business minded opportunists and is equipped with huge military and functioning nuclear weapons. There are no investment opportunities here.

**THE RAW MATERIALS EXPORTERS**

Most third world countries are dependent on exporting raw materials to the industrialized world.  A large portion of these exports are to China, and the Chinese are not buying as much of this stuff anymore.  Furthermore, the price of these raw materials has fallen dramatically in the past few years.

These countries include most of Africa, the Middle East, SE Asia, Mexico, Russia and Latin America.  You can also add Australia and Canada to the raw material “exporter list”.

All of these countries have the same problem- their exports are shrinking both in quantity and price.  Oil prices have fallen from $120 to $40 per barrel. This is causing severe budget problems for many of these countries.

We see virtually no investment opportunities in these regions in the near future.

**CONCLUSION**

I believe that most of world is facing severe economic and political problems caused by:

- Economic problems in China,

- Low commodity prices,

- Economic stagnation in the developed countries,

- Serious Euro/EEC problems,

- Deflation,

- A civil war in the Middle East, and

- The largest mass migration of people since WWII.

Here in the US, we are somewhat isolated from these problems because a) our economy is growing, b) we are not experiencing deflation, c) our capital markets and banks are basically healthy, and d) we are not really dependent much upon exports.  This is not to say that we don’t have serious economic problems.  We do- but compared to the rest of the world, we are the least rotten apple in the barrel.

Therefore, in the immediate future we will continue to emphasize US based equities and a large allocation to cash.

We have a large cash position because:

We like to buy “bargains” and after seven years of a bull market, there are very few bargains to be found, and a lot of our investment strategy is based upon the analysis of long term trends in the capital markets.  At present, these trends are erratic at best.

There is an inherent danger/risk with this strategy. The less diversification you have, the higher the risk in the portfolio.  Our large cash position reduces this risk.  We are well aware of the fact that holding this much cash drastically reduces our investment returns and makes it very difficult for us to accomplish your long term investment return benchmarks on a short term basis.

In summary, given the world economic situation, we think it is best for the time being to focus primarily on capital preservation.  We do have some equity exposure in areas such as real estate, utilities and reasonably valued stocks.

We cannot manage investment returns - these are dictated to us by the capital markets.  We can control risk however.  Given our current outlook on the world economic scene and the long term trends in the capital markets, we are basically in a risk aversion mode at this time.

***“Before you devise a plan to make money you must first devise a plan to avoid losing it.”***

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