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Monthly Letter to Our Clients and Friends Red River Valley - Will inflation reemerge as a dominate force? Is China a bubble waiting to burst? - Planned Obsolescence

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Complimentary Copy

*From this valley they say you are going.
We will miss your bright eyes and sweet smile,
For they say you are taking the sunshine
That has brightened our pathway a while.*

*So come sit by my side if you love me.
Do not hasten to bid me adieu.
Just remember the Red River Valley,
And the one that has loved you so true*

Chorus from “Red River Valley”

Red River Valley

The Red River meanders its way northward from southern North Dakota through Fargo-Moorhead, Grand Forks and Winnipeg Canada before endings its journey at Lake Winnipeg. The river flows through an ancient lake bed formed 9,500 years ago at the end of the Wisconsin glaciations creating a valley, or maybe I should say a small depression in the flat lands of the northern great planes. If you get a chance, take a trip to the Red River Valley in late summer. Get off the interstate and make your way to the county roads that place you close to the river. Once there use a little imagination, remove the images of civilization and view the river valley as if you were alive a hundred or so years ago. The beauty of the river as it runs through the wheat fields is a site to see. And yes, for those of you with a little romance in your hearts, shut your eyes and you will see a young girl saying goodbye to her love as he climbs on his horse and makes his way to the north out of the “Red River Valley”.

The Red River and its valley is idyllic for the majority of the year, yet in the spring it changes as it collects the water from the winter snows and spring showers, quickly turning into an angry flow to recreate that ancient lake. The citizens of Fargo-Moorhead, Grand Forks and Winnipeg see the anger first hand every spring and for the most part are fully prepared for the annual rise in the river. The river periodically grows so rapidly that simple preparation is

not enough to stop the flood waters. One of the benefits of living in modern times is that enough knowledge is available to warn us of an impending flood, giving us a little time to prepare for the inevitable. This year the warning began with marginal concern, but quickly turned into a full blown alert. The citizens of Fargo and Moorhead worked together to place over 1 million sandbags to shore up the river bank. They moved in heavy equipment to build temporary levees, shut down traffic on some of the rural roads, and even received help from the U.S. Coast Guard in aiding evacuees as the river continued to rise. All non-essential city employees were freed from their normal duties to do whatever else was needed, from filling sandbags to helping build levees around individual homes and buildings. The extra effort paid off this year; only limited damage was caused to a few low lying areas directly along the Red River

Modern science has given the citizens of Fargo-Moorhead the tools necessary to protect themselves against the devastation these floods could cause them. What of the science of portfolio management and economics? Has that field of study been as valuable to us investors? Has it given us enough warning for us to take precautions? Have the thousands and thousands of hours dedicated to investment and economic research provided us with the tools necessary to see pending danger and take preventive action? Just as important, will we as investors heed these warnings, or will we sit back and watch the flood waters rise until it's too late? **This month we will explore two areas of concern and propose some defensive actions.**

Will inflation reemerge as a dominate force?

Thirty years ago the Chairman of the U.S. Federal Reserve, Paul Volker, took it upon himself to break the back of inflation that had devastated the economy in the 70's. His actions unleashed the power of free market capitalism. Interest rates, the markets' measure of long term inflation, have been declining for three decades. Productivity, led by technology, free trade, and a lower cost of borrowing, has been growing at a rate that rivals the industrial revolution. Asia, led by the forced adoption of a capitalistic principal by the Chinese Government, has kept wage and price inflation in check because their cost of production is substantially below the developed world. The fall of the U.S.S.R. opened up new consumer markets to the world after their economy was converted to adopt the principals of capitalism. India's large and intelligent work force has added to the world's source for low-cost labor, at least when compared to the developed nations. Brazil has used its natural resources and labor force to keep a check on the world's cost of production. New technologies, for finding and delivering low cost energy, have kept prices in check. The size of the consumer market has increased dramatically because of advancements in medical care that extend our lives and decrease rates of infant mortality.

Inflation can result from an increase in demand relative to supply or a decrease in supply relative to demand. These classic definitions of Demand-Pull and Cost-Push causes of inflation have both been muted for thirty years. **The world-wide financial crisis has added additional firepower to these forces as it has destroyed consumer demand, especially that of U.S. Consumers who have been living beyond their means for years.** We do not see this changing

for at least a couple of years. With lower demand, the probability of a supply shock having an impact as large as the oil embargo of the seventies is remote. **However, this consumer demand destruction of the financial crisis is sowing the seeds for the next round of inflation.**

The thirty years of financial freedom encouraged by government policy has taken a major change. In the U.S. we have seen the winds of change in the form of new financial regulations, tax policies that will increase taxes of both consumers and corporations, government mandates forced on individuals, states, and corporations and new social programs, all costing a substantial sum. These actions are not inflationary by themselves. **However, if we combine an easy monetary policy with a reinvigorated consumer and increased demand by government, the seeds of inflation could sprout into a full blown inflationary spiral.** The current monetary policy of developed nations has been an attempt to reinvigorate consumer demand through massive monetary stimulus. There is no doubt, at least in my mind, that this policy will have its intended effect and revitalize the private sector. Increasing demand from the private sector, along with the fiscal demands of new government obligations (for example the bill on health care), could easily create a round of inflation where the aggregate demand of government and the private sector will exceed available supply.

All of this is warning us that there is a real possibility that inflation will be higher in the next ten years relative to the past. It would not surprise me at all if the average inflation rate in the coming ten years is closer to 4% than the 2% assumed by many of us. Of course that would mean the current rate of inflation will have to accelerate to an annual rate of 6% or more at some point in the next decade. Remember, we are looking at warning signs. Just as heavy winter snows may indicate a higher than average flooding of the Red River, it doesn't always happen. Yet it would be prudent to look at the signs and take some precautions. **A simple step you can take as a conservative investor is reducing the average maturities of your fixed income holdings.** After all, at the current level of interest rates with the possibility that inflation will accelerate, you have very little to lose by keeping maturities short. If rates do go up, then the natural process of re-investing at the new "current rate" should benefit you.

As to common stocks, less diversification and more selectivity could be the solution. If inflation returns then the broad markets may have another decade of difficulty. It would be wise to include in your portfolio ownership interest in companies with the power to pass on price increases. These companies, as Warren Buffet states, "have a wide moat". Utility companies, consumer staples, health care providers, and certain consumer discretionary companies that have a high level of inventory turn-over would work well.

Winning your personal fight against rising prices requires you to have a rising income. Investments that can increase cash payments in the future work to your advantage. Rents, dividends and of course your own income have had a history of rising in line with inflation.

Is China a bubble waiting to burst?

It is important for us to remember that a bubble refers to a price so high that it takes on a life of its own, independent of the underlying fundamentals. Price bubbles have a similar underlying life span, yet they all begin with a growth story and an expectation that the growth will not only continue but accelerate into the future. Here is one version of the China story.

The reforms China pushed in the late 70's to embrace a form of free market capitalism has worked continuously. For thirty years China's GDP has multiplied sixteen times. The last two great bubbles, technology and housing, barely phased the country. The ability to embrace modernization and world trade has propelled the Chinese economy to the world's second largest, surpassing Japan in the last decade. China has replaced Germany as the world's largest exporter, and is the world's biggest steel producer. China is also the world's largest market for autos, one of the world's largest holders of foreign currencies of all origins, and an owner of \$1 trillion of U.S. Treasury debt. With more than 1.3 billion people, most living on an average annual income of just \$3,200, China's consumer market potential is huge. With an estimated 300 million farmers moving to the cities over the next ten years, it is virtually guaranteed that GDP and average income will continue to grow rapidly.

China's growth story is now accepted as one that will continue far into the future. In fact, I haven't seen many economists or portfolio strategists, if any, predicting less than an 8% annual growth rate for China over the next decade. This belief is so universal that these same economists and portfolio strategists have pushed, shoved and browbeaten each of us into making sure our portfolios include a heaping helping of emerging market stocks.

Once a growth story is in place and accepted, the tools of modern finance and the free markets are unleashed, allowing for the next two requirements of a bubble: capital investment and credit. China's industrialization has required massive capital investments for the construction of factories, roads, rail, housing and commercial buildings. This capital has been provided by outside sources, including individual and institutional investors. Combined with the new world of credit creation through fractional reserve banking, as adopted by the Chinese themselves, the amount of investment and credit creation is staggering. Last year alone, bank loans increased by close to \$1.5 Trillion. These loans help expand infrastructure, housing and state owned industries.

The problems created by easy money and unlimited sources of capital are that they can lead to massive misallocation. These are lessons we quickly learned, during both the tech bubble and more recent housing bubble. China has spent large amounts of capital to build unneeded projects. So many highways have been constructed that traffic levels are just 12% of the developed markets average. A new high-speed railway is being built that, based on the current income levels of its citizens, will be underused and forever operated at a loss. The cost of residential housing has exceeded the ability of people to pay rents, yet building continues.

China Realty Research reported in February that one in five new residential properties are intentionally being held vacant by their owners; it seems that due to Chinese standards, once a property is rented, it loses value. This is completely irrational. Commercial property is also a major recipient of capital, even though the vacancy rate is high. One example is the Pudong district, where commercial property vacancy stands at 50% while new construction runs unabated. Another example, and the high point of misallocation, involves the city of Ordos in Inner Mongolia. Ordos was built from scratch beginning in 2001, and is now a city of new shiny buildings. It has everything a new modern city requires except one; Ordos has no people. The million or so people that were to move to the new city live thirty miles away in old Ordos City. The problem being that no one can afford to live in new Ordos, at least as told by citizens of the Old City interviewed by Al-Jazeera and broadcasted on YouTube.

The Capital needed for these projects could only happen with undying belief in the Chinese growth story. Of course the building projects themselves continue to fuel the story, as each one increases GDP. As GDP continues to grow prices continue to appreciate. Last summer the Shanghai stock exchange traded at 38 times trailing earnings, without a doubt, bubble territory. What's worse is the fact that you can't trust reported earnings when the majority of these earnings are the result of a mandate put forth by the Chinese authorities.

The warning signs of a bubble are here. The growth story may be real, but a conservative investor should at least recognize the signs and take some preventive steps. One thing is sure, a breakdown of the China miracle will be a flood that is very difficult to protect against. It will affect first those in the developed and emerging countries that supplied the capital in a very big way. Next to be affected will be those industries that supplied the resources necessary to build the infrastructure projects. The last ones to suffer will be the countries, industries and individual companies whose market for goods and services are dependent on the Chinese government and consumers.

Preventive steps you can take include scrutinizing any holding that has emerging markets or Asia in its title. Review your stock holdings for the amount of revenue the company earns from business in China, paying particular attention to companies with capital investments in infrastructure projects. Most importantly, make sure that any holding that has an investment in China is paying for itself through actual revenues, not hoped for revenues based on potential growth.

Planned Obsolescence

Two years ago we orchestrated a business plan to return our company to the Anderson family. This was a big step that required us to buy back shares held by non-family members at a considerable cost, transfer accounts and convert our operations from one of a product manufacturer to an investment advisor. Personally I have enjoyed every step of the process. For a few years it seemed like just going to work was a chore, now it's a joy.

The second step of our long term plan is to incorporate the concept of “planned obsolescence.” I am proud to say that this process will begin in earnest by the time you receive our next monthly letter. This year Justin will acquire 10% of the company’s shares. For the next nine years he will acquire an additional 5% so that on the tenth year he will have acquired control of the company’s business. Being true to this process, in addition to his duties today, he will have to assume 5% more responsibility a year.

This will mean that I will have to work diligently to become the best “obsolete” member of our family. To remind Justin of the cost of obsolescence our agreement requires that I will always have a place in the company’s offices for as long as I desire. He will learn that an obsolete employee, even the best of the obsolete, can be expensive.

Until next time,

Kendall J. Anderson, CFA

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