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UNTYING THE GORDIAN KNOT – 2009 AD versus 333 BC

Greek mythology held that the person who untied the Gordian Knot would rule all of Asia. The person who unties today's Gordian Knot will rule the World – not just Asia - as did Alexander the Great, who defying topological logic, decided to “Cut to the Chase” despite the fact that no one had claimed the puzzle was unsolvable. He solved the problem his way, and we will have to solve it our way.

Well, even Warren Buffett had a rough 2008 as Berkshire Hathaway's stock was down about 30% for the year, and its book value per share was down 9.6%. It proved to be his worst year ever. An admirable characteristic of Mr. Buffett's is that he will own up to it. Even the “Sage of Omaha” is human.

It has been said that Mr. Buffett was held hostage by his strong belief that stocks should be bought and held. Although we believe that the 2008 markets' experience largely discredits that theory, the Sage has always maintained he is unconcerned by short-term market movements because of his long-term outlook. This is a luxury that is not practical for everyone as indisputably proven in the last year and a half. We are also a bit curious as to what “long-term” really means for someone who is 78-years old.

These comments are not meant as a criticism of Mr. Buffett; they are simply a reminder that he also has human frailties and that there is no such thing as a perfect formula for investing.

Exxon, IBM and Johnson & Johnson, to name only a very few, have been excellent long-term investments whereas General Motors, Chrysler, Citigroup, American

International Group, Lehman Brothers*, Fannie Mae, Freddie Mac, Pan American World Airways and one of the most widely held common stocks ever - Pennsylvania Railroad - have not. Investments, like orchids and children, require constant supervision.

*Note that bankruptcies are not necessarily “bad” for everyone. “Weil, Gotshal & Manges LLP earlier this week asked a federal bankruptcy judge in New York to sign off on a \$55.1 million payment for its work representing Lehman”. And that is just for the quarter. “Mr. LoPucki estimates that Weil stands to bring in more than \$200 million in fees by the end of the case. That would exceed the next-highest debtor counsel fee, the \$159 million that Weil earned during the Enron bankruptcy. A Weil spokesman did not respond to a request for comment.” Wall Street Journal, April 16, 2009.

Any guesses as to Chrysler and possible General Motors bankruptcy fees?

With regard to today's stock markets, we believe they should be approached with a great deal of caution because despite several recent and most welcome rallies, the fundamentals necessary to support a sustainable bull market are not yet visible.

Furthermore, as pointed out in our last letter, percentage gains while numerically correct can be misleading. Citigroup, for example, traded as high as 54.77 in January 2007 and as low as 1.03 in March 2009. Citigroup's shares closed on May 1st at 2.97 -- an increase of 1.94 or 188% above its low. It is reported that the bank may still need an additional \$10 billion or more to meet the government's Stress Tests.

The traders and investors who have cash yielding next to nothing have been "trying out the waters" in these extremely volatile markets because the economy has not been falling as fast as it had been.

The reality is that over a period of many years the US consumer has been the engine of economic growth in the United States and the rest of the world. At this time it is very difficult for the consumer to borrow money and virtually impossible for him to take more equity out of his home. In other words, he can no longer use his home as an ATM machine. His credit card is maxed out; and, people on unemployment ordinarily do not have much discretionary income. These are a few of the reasons why the American consumer is not spending, and why he is no longer the engine of US and world growth.

Until the economy and the credit markets are reversed these conditions will continue. That is the reason the US economy has contracted violently - declining 6.1% in the first-quarter --- nearly matching the 6.3% decline in fourth-quarter of 2008. These two quarters' contraction was the worst in more than 60 years.

This chicken and the egg problem accounts in large part for the complexity of the economic problems. We are reminded of the Knot.

President Obama and his administration are attempting to spend America's way out of these problems thus producing the largest deficits in this country's

history. The questions now are not only whether this strategy will be successful but at what price the rest of the world will be willing to buy the US dollar.

Issuance of exorbitant amounts of dollars and dollar equivalents will ultimately produce not only a weaker dollar -- "Monopoly money" -- but also the likelihood of severe inflation. It's only a matter of time.

On April 24, 2009 the *Financial Times* reported: "China reveals big rise in gold reserves. China has quietly almost doubled its gold reserves to become the world's fifth-biggest holder of the precious metal, it emerged on Friday, in a move that signals the revival going on after years of fading importance." The *FT* continued: "...the head of the secretive administration of foreign exchange, which manages the country's \$1,954bn (\$1.954 trillion in American English) in foreign exchange reserves, revealed China had 1,054 tonnes of gold, up from 600 tonnes in 2003."

"Paul Atherly, Beijing-based managing director of Leyshon Resources, said that even after the latest purchases China had a very small percentage of its reserves in gold, far below the US or other developed countries.

"Those [gold] holdings are still too low in terms of the size of its economy and the growing significance of its currency."

Since the US is a financial hostage as a result of its debt held by China, we wonder if they know something that we do not. We think not.

There is no question as to the direction the Chinese are taking. It's not a tough call, and it is the strongest signal we think we can ever recall. Do you know where your currency is or the direction it is headed? The issuance of more paper money will only hasten the outcome.

Buying property is one alternative to owning currency and on that front there is good news for prospective buyers. On April 21st the price of the Helmsley estate in Greenwich, CT was reduced by \$50 million in one fell swoop. This reduction, probably the largest ever for any U.S. house, lowered the offering price to \$75 million from the original \$125 million when the 40-acre property was first put on the market a little over a year ago.

Some observations regarding China's relevance today from an address "The Dragon Rising" given at the Virginia Military Institute in April 2009:

"England doubled its Gross Domestic Product in 48 years, starting in 1780. The US took 47 years to double starting in 1839; Japan 34 years from 1885, South Korea in 11 years from 1966 with America's help, but China doubled its GDP in 9 years from 1978, and then doubled it again by 1996 in 9 more years. From a third world country to the world's 4th largest economy in 28 years. This is unprecedented in world economic growth."

"It's assumed that within 10 to 15 years China's global metal consumption will be 50% larger than the US. A change of this magnitude in finite global commodity demand and trade will have vast political consequences. China is developing intimate partnerships with countries worldwide and is creating ownership interests in critical commodity production and exploration. The US has not developed any long-term strategy for managing the overwhelming consequences of China's new and ever growing ownership positions"

"China's promises to move toward democracy are solely for the benefit of business relations with the US. Neither the majority of the Chinese people nor the Chinese government has as any intention or desire for creating a democracy."

"China is developing a foreign-policy and military strategy to protect its access to and the transport of their vital raw materials. China is producing a very large Navy to protect shipments of oil from the Middle East, iron ore from Latin America, and liquefied natural gas from Australia.

"The Chinese advisors to China's President Hu Jintao say that today China needs the US economically more than the US needs China. But by 2015, only five years from now, China will have economic parity with the US. We will then need China economically as much as China needs the US."

The author concludes: "That will be the prime mover for the tectonic shift in the world balance of power which will take place in the next 20 to 30 years."

We recall that it is an ill wind that bloweth no man good and will continue our efforts to unravel today's Gordian Knots in these most challenging times. This time we will need a really sharp sword!

John W. Hamilton

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