

An Investor's Diary

JUNE 2010

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Will the real Barack Obama please stand up, please stand up, please stand up

This diary is not a political Op-ed column. As a matter of fact, I was raised in the belief that a gentleman should keep his political and religious beliefs to himself. This month, however, I will not bore you with my opinions, but I would like to take a brief but close look at the current US Administration. Why? Because Mr. Obama's unique approach to the issues faced by his Administration is having – and will continue to have – a profound impact on national and international life. We need to look at what this means for us as investors.

Also, as the second quarter ended, we update the results of our Quarterly Investment Committee, held on June 17th.

“I repeat, will the real Slim Shady please stand up? We're gonna have a problem here...”

(Eminem, The Marshall Mathers LP (2000.))

When Barack H. Obama was elected as the 44th President of the United States, we all knew the challenges awaiting him were daunting: the largest financial crisis in 50 years, two wars, a deeply divided country and deeply strained foreign relations, even with America's closest allies. In fact, I vividly remember asking myself why anyone would want that job, but “The One” certainly did want it. Since winning the 2008 election, the “Yes We Can” President has been running into a bit of difficulty as the world conspires to throw “curve balls” at him. Soldiers, allies, taxpayers, investors, bankers and voters have been on a roller coaster ride as the US President struggles with issues, many of which were apparent two years ago. Yet, his response and his approach have surprised many who had believed in the pre-election hype that this mere mortal was somehow different.

My concern is that Mr. Obama has simply reverted to his Chicago Democrat type. To understand how Mr. Obama's unique approach is impacting investors worldwide, I will look at three issues – among the many facing the Administration: the war in Afghanistan, the BP oil spill and Wall Street reform.

First, the war in Afghanistan: This war began 105 months ago, on October 7th, 2001. It is now the longest war in American history, having just surpassed the Vietnam War, which lasted 103 months. This is a record only for America, of course: as Rudyard Kipling readers know, Afghanistan has been at war on and off since Alexander the Great and Genghis Khan. History teaches us that there can be no winner in the Great Game (ask the British or the Russians) and that Afghans are a rather resilient people. Indeed, such a war is worthy of the most careful attention, because it is being fought by a US-dominated international coalition and because very few are convinced that this war can be won. Yes, I know President Obama inherited a conflict initiated by George W. Bush, who launched a kneejerk military action in Afghanistan after 9/11 and then switched his attention to Iraq before the war in Afghanistan was resolved. Yet today's war in Afghanistan is very much President Obama's. On August 17th, 2009, Mr. Obama declared: *“This is a war of necessity. Those who attacked America on 9/11 are plotting to do so again. If left unchecked, the Taliban insurgency will mean an even larger safe haven from which al Qaeda would plot to kill more Americans. So this is not only a war worth fighting. This is fundamental to the defense of our people.”* Last December, Mr. Obama decided to change the nature of the Afghanistan war and announced the U.S would send 30,000 more troops to Afghanistan, trebling US forces.

In this vital context, Mr. Obama has just sacked General Stanley McChrystal, Commander of the ISAF (*International Security Assistance Force in Afghanistan*). Mr. Obama's anger was caused by General McChrystal's foolish – or possibly deliberate – decision to let an embedded Rolling Stone magazine journalist privy to all the senior military staff's gossip, bitchy comments and less than flattering opinions of all politicians from the Commander in Chief downwards. (By the way, “the Runaway General”, the Rolling Stone article by Michael Hastings, is an interesting read. If you missed it, please click [here](#).) This is the first time a serving wartime commander of such seniority has been fired by a President since Douglas MacArthur was relieved by President Truman during the Korean War in 1951. MacArthur was fired for insubordination and obtaining – against Harry Truman's orders – the Joint Chiefs of Staff's approval to attack Chinese airbases with nuclear weapons. Mr. Truman's decision was most

justified and Stanley McChrystal's "crime" is petty indeed in comparison. Anyway, the President summoned the General to the White House on June 23rd and obtained his resignation, which Mr. Obama accepted "with considerable regret, but also with certainty that it is the right thing for our mission in Afghanistan, for our military and for our country." The episode has sent deep shock waves through both the US and Allied military establishment currently serving in a deeply unpopular and unwinnable war. We can all agree that having a journalist from Rolling Stone magazine in the heart of it all was stupid, even in the name of transparency. The entire episode has been traumatic for the US Armed Forces which, despite the deeply unpopular wars in Iraq and Afghanistan, remain one of the few areas of US public service held in high collective esteem. And Mr. Obama's sudden and unilateral decision has – once again – left America's allies in Afghanistan feeling shortchanged, ignored and angry.

While the Bush Administration was tightly linked to the military – and indeed George W. Bush was a very present Commander-in-Chief – Mr. Obama has steadily distanced himself from the whole Afghanistan issue. For Mr. Obama, Afghanistan is nothing but a political problem, with the nagging fear that he too could be a one-term Democrat like the hapless Jimmy Carter, held hostage (literally) by foreign affairs and shown to be impotent, weak and very human. It is no wonder the President gave his chief opponent, Hilary Clinton, the poisoned chalice of Foreign Policy. And just in case, Vice President Joseph Biden is also on the foreign affairs front.

I suspect that the two real causes of Mr. Obama's temper tantrum are A) this is how things are done in Chicago, and B) his image advisors told him that it would make him look tough. By firing a serving wartime Commander in such a way, Barack Obama's may have tried to aggrandize himself with the American public. He certainly did not succeed with his allies. The consequence is that any country will now think twice before aligning with the Obama Administration.

Second, the BP Oil Spill: History will determine the exact causes and responsibilities of the April 20th, 2010 explosion of the Deepwater Horizon drilling rig, which has led to the largest offshore spill in history and the resulting environmental disaster in the Gulf of Mexico. There is simply no other word: with 11 dead men, a seemingly unstoppable 5,000 feet deep leak, millions of barrels of oil polluting a pristine coastline and thousand of lost jobs, the event can only be described as a catastrophe.

This horrific incident has also been a godsend to Mr. Obama. It offered him, on a silver but oily platter, a unique opportunity to be both the best friend of the environment and the little guy, and the archenemy of polluting, ruthless and foreign cosmopolitan capitalists. It even gave him a political trump card against his Republican adversaries, portrayed as "Big Oil" supporters. For a politician, this is as good as it gets... The President jumped in the oil pan with both feet and decided to intervene personally, telling the nation and the rest of the world that the buck stops with him. One can assume that underlings will be sacrificed if things don't go quite right. The fact BP is a foreign firm has been an additional bonanza for Mr. Obama: his BP bashing is proving popular with his constituency, even if the United Kingdom has taken affront to the oil giant being referred to as "British Petroleum" rather than BP, time and time again.

President Barack Obama has pressed BP to set up an escrow account to pay damage claims by individuals and businesses hurt by the oil spill. The amount: USD 20 billion into an independently managed account. With the support of 54 Democratic Senators, the President is also demanding the company not pay its shareholders dividends. In addition, BP may be facing in excess of USD 10 billion in civil penalties and untold billions in damages and other liabilities. Every American lawyer is loading his guns to go BP hunting, the new Gold Rush. It is my belief that, no matter how poorly BP has communicated on the spill, the company is desperately and earnestly seeking all possible avenues to plug the leak and contain the damages to the fragile US Gulf Coast. BP has faced its responsibilities and, as I write these words, has already spent well over USD 2.5 billion to face its immediate obligations. I have to wonder... Had the spill occurred in Russia, BP's Russian assets might have been seized by the state and then sold off to a state owned or operated entity. From the company's perspective, its losses would be massive, but finite. Yet, because liabilities are limitless in America, BP's foreseeable US scenario is made of infinite legal penalties and endless logjam of lawsuits, followed by sanctimonious politicking from a President keen to reduce the power and reach of Big Oil, regardless of the impact on US jobs or oil prices... Bottom line, if I were BP, I would be looking closely at the political and legal cost of severing all ties with the US, including Alaska. No matter what happens, it will be a nightmare to manage going forward. Just give the company keys (assets) to the US Federal Government and tell them they can do what they want.

Of course, Mr. Obama's real issue is toughness: On NBC's Today Show, he explained that he had met with experts and declared: "We talk to these folks because they potentially have the best answers, so I know whose ass to kick." After firing the CEOs of private companies left and right (General Motors, Bank of America, to name a few), I'm afraid Mr. Obama is now calling the shots for corporate America. True, pelicans covered in oil make for bad PR, but again, Mr. Obama's stance is also due to A) this is how things are done in Chicago, and B) his image advisors told him that it would make him look tough.

From an investor's point of view, what I find significant about the whole affair is that, with Mr. Obama at the helm ordering crippling costs and fines to private corporations, the United States may have become a dangerous place in which to do business. The clear implication for any foreign company operating in the United States is that it now has to think very carefully about the legal nature of its American operating entity. It will become necessary to "ring fence" any US operation from the rest of the world. Another implication of the BP episode is that the price of gasoline at the pumps will rise, not just in America, but worldwide. The US will have significantly increased its dependence on imported oil, which will require some pretty joined up thinking on foreign policy relations.

Finally, Wall Street reform: In late June, Mr. Obama flew to the damp squib G20 meeting in Toronto. The event, with a CAD 1 billion price tag and 600 arrests, as the lunatic fringe was having a field day, was to provide the US President with a hero's welcome after a conference of the US Senate and House of Representatives had approved the game-changing law that will eradicate bad bankers, once and for all. Its name: The Dodd-Frank Wall Street Reform and Consumer Protection Act. It will be no surprise to most of you that the new 2,319-page Dodd-Frank Act does not have the clarity of the

34-page Depression-era Glass-Steagall Act it intends to replace and which was repealed as obsolete 11 years ago. Well, if both laws have the same intent, the Glass-Steagall Act was more radical and – we will soon find out – more efficient than the new bill. Why? Because there is nothing in this new legislation that will prevent financial bubbles or soothe their consequences. Even if the legislation had teeth, banks will have 12 years (yes, that's right, twelve years, or three presidential terms) to comply. The Glass-Steagall Act gave banks less than two years to separate their commercial and investment banking operations! In short, nothing has really changed and I expect nothing will.

If no real change in the rules governing the financial sector was ever contemplated, why create such a legislative and regulatory nightmare? Because the Dodd-Frank Act is yet another iteration of the Obama mantra of enabling the US Government to intervene domestically and overseas in a way never experienced in peacetime. US Regulators will have the power to force institutions to sell assets, to impose capital requirements and to restrict their operations, all in the name of better safer banking. The plain truth is that this policy was enacted looking in the rearview mirror, rather than as a new regulatory framework for the financial services sector. True, banks should pay for the cost of their bailout by the state, but there is little obvious Consumer Protection going on, more like banker kicking! Mr. Obama's operative word is, once again, "tough". Given the public outrage about the financial crisis, the Obama Administration had to make a show of doing something. And Mr. Obama has to look tough. *"We are poised to pass the toughest financial reforms since the ones we passed in the aftermath of the Great Depression"* the president said on June 25th. He added the bill *"represents 90 percent of what I proposed when I took up this fight."* Could Mr. Obama's sudden determination be the result of A) this is how things are done in Chicago, and B) his image advisors told him that it would make him look tough? Is there a pattern here?

So why should investors care about Mr. Obama?

Domestically, in the background to all of this "toughness" are the next midterm elections, with low approval ratings for the President, a growing Tea Party movement that is finding increased resonance across the political spectrum, and massive voter disillusionment with politics. The irony is that, despite pledges to spend the way out of recession, more and more Americans are discovering that the fabric of their daily life is coming undone, as local governments (Cities, Counties and States) are unable to maintain services and are actually getting out of the governmental business entirely, as they outsource schooling, policing, fire services and the rest to the private sector. Who knows how America will vote in November... for the man who sounds and looks tough, or for someone who IS tough?

Internationally, the relationship that Obama is building up – or tearing down - with America's traditional allies is also a real cause for concern. Foreign Policy is being played fast and furious on a number of fronts at the moment. No one is really sure where they sound on any number of key issues: Iran, Israel (friend or foe these days?), Taiwan, China, North Korea and all of the 'Stans'. What is certain is that world stability has not been enhanced by the "Yes We Can" man.

So, until the real Barack Obama stands up, caveat investor!

James M.M. Edwards

Chief Investment Officer

Quarterly Investment Committee Update

Our meeting took place on June 17th, a few days before the Chinese publicly talked about relaxing their currency peg arrangements and, perhaps not surprisingly, several days before the G20/G8 meeting hosted by Canada.

By the end of the month, most equity markets had broken down through key levels such as 10,000 on DJIA, 5,000 on the FTSE 100 and 6,000 on the DAX. Emerging Market equity indices have not fared much better, with some of them like China now in major bear configurations and off as much as 50 % from their previous highs. Talk recently is now of "double dip", as Central Banks and academics (who have not covered themselves in much glory over the last two years)

Therefore, our Key Themes remain quite similar to the March Quarterly View:

- **Global economy has recovered, but not equally.**
- **Central Bank liquidity provision will remain in place.**
- **Sovereign debt roll overs are key.**
- **Tax and Spending plans will impact the rate of growth for many countries.**

VIEWS

- **Maintain Hedge Fund exposure as equity directional bias proxy.**
- **Do not fight the Central Banks**
- **Maintain exposure to commodities**

PORTFOLIO

- **Composite Index 40 % Bonds, 50 % Equity, 10 % Cash**
- **2Q10 Weighting: 25 % Bonds, 50 % Equity, 5% Cash, 20 % Alternatives**

The major change since Q1 has been to reduce Bonds by 5 % and increase the Equity allocation by 5 %.

are now arguing the merits of taking the QE punch bowl away.

The reality, as highlighted in some of our chart data, is that whilst CB liquidity is still high, this liquidity is not filtering through the system, and credit is hard to obtain. Banks in some Euro countries cannot access the Euro interbank market because no one will lend to them, except the ECB. David Cameron was praised at the G20 for his fiscal conservatism, although the reality remains that liquidity will need to be pumped into all economies for several more years, even as unemployment remains high and growth remains minimal, certainly below long-term averages.

	OVERHEATING	SLOWDOWN	RECESSION	RECOVERY
NORMAL BUSINESS CYCLE				
CENTRAL BANK LIQUIDITY CYCLE	TIGHT	EXPANSIONARY	ABUNDANT	CONTRACTIONARY
YIELD CURVE	FLAT	INVERTED	STEEP	STEEP
MARKET LIQUIDITY	ABUNDANT	CONTRACTING	TIGHT	EXPANDING
MARKET SENTIMENT	RISK SEEKING MOMENTUM DRIVEN	PRUDENT TILT TOWARDS BONDS	RISK AVERSE CASH IS KING	OPTIMISTIC LIQUIDITY DRIVEN
PREFERRED TRADITIONAL ASSET CLASS	STOCKS COMMODITIES REAL ESTATE	CASH BONDS	BONDS	STOCKS COMMODITIES HIGH YIELD FX + EM
PREFERRED HF STYLE	EQUITY HEDGE	RELATIVE VALUE ARBITRAGE	TACTICAL TRADING	EQUITY HEDGE
SUB-STYLE: PERFORMERS	EQUITY MOMENTUM RISK ARBITRAGE	VOLATILITY TRADING CTA CREDIT/VOL ARB	SHORT SELLING MARKET NEUTRAL CONVERTIBLE ARB	DISTRESSED RISK ARBITRAGE CARRY FX / CREDIT EMERGING MARKETS
SUB-STYLE: HEDGERS	VOLATILITY ARB	MARKET NEUTRAL	EQUITY VALUE	CTA

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To find out more about Eurofin Capital, please contact us:

Eurofin Capital S.A.
Avenue Edouard-Dapples 7
Case Postale 567
1001 Lausanne
Switzerland
Tel: +41 21 614 60 90
info@eurofincapital.com

www.eurofincapital.com