THE CASEY REPORT
Investing Ahead of the Crowd

Volume V, Issue 10 / October 2012

Real Estate and the Economic Cycle

Dear Reader,

Well, Bernanke did it. He pulled the trigger on QE3/QE-infinity/QEternity. Whatever you want to call it, the Fed is about to start creating a lot more money.

Specifically, it will buy $40 billion in mortgage-backed securities per month until the labor market improves. In other words, indefinitely.

The previous iterations of QE had a dubious track record of improving labor markets, and it's not hard to see why. The freshly created money went straight to the banks, which then deposited it at the Fed to earn a little bit of interest. Most of that money still sits there today. Real, productive businesses barely saw a dime.

The Fed has not yet said how it will fund round three, but I'd bet that the scheme will be similar to rounds one and two. Banks will benefit, and jobless people won't. Which suggests that QE3 could run for a long, long time.

There is one thing, however, that monetary easing is more than capable of: inflating asset prices. Take a look at what the previous QEs did to stocks, oil and gold (next page):

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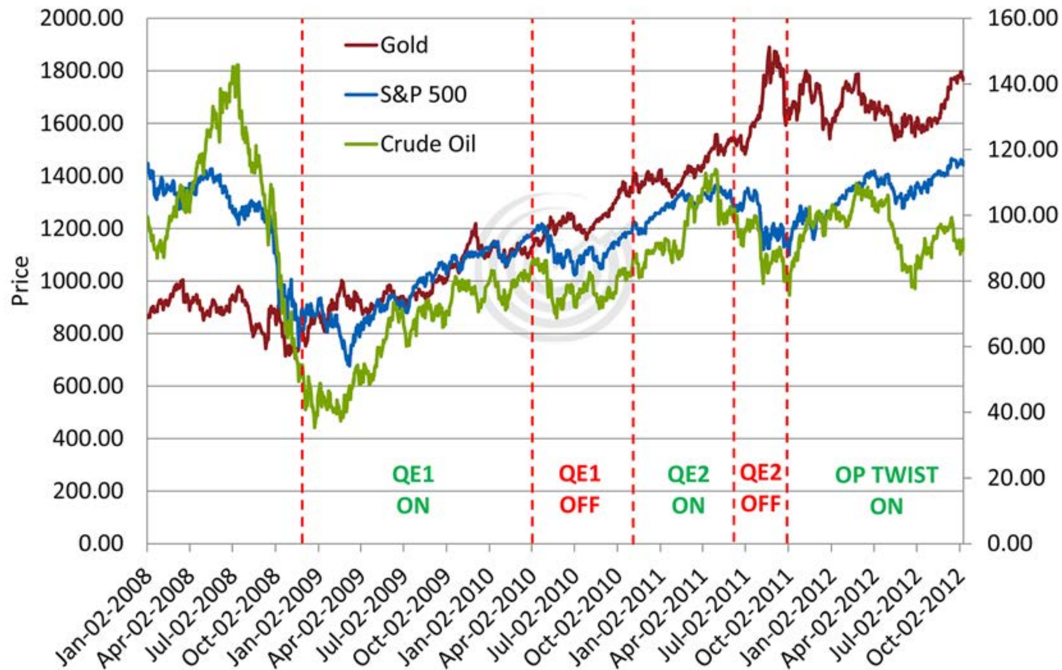

Or if you prefer figures:

	Gold	S&P 500	Crude Oil
QE1 on	+36%	+36%	+65%
QE1 off	+20%	+2%	+1%
QE2 on	+12%	+10%	+13%
QE2 off	+18%	-12%	-10%
Op Twist on	-2%	+25%	+4%

It takes only a cursory glance at the data to understand what's going on. The Fed eases, assets go up. The Fed stops easing, assets stagnate or decline – except for gold, which seems to rise no matter what, at least before its recent consolidation phase.

The investment implications are clear. The Fed is about to embark upon another round of money creation. Given the historical patterns, owning real assets is an absolute necessity. As we've been saying for years, gold is the number-one choice, but other commodities, and companies that produce things people need, are worthy investments as well.

There is one other asset class that does well in inflationary environments: real estate, which has of course been mired in the aftermath of a disastrous bubble. But we're now five years removed from the popping of that bubble, and so this month, **Casey Research Chief Economist Bud Conrad** asks: is it safe to go back in? In his article **Real Estate and the Economic Cycle**, Bud connects the dots between Fed policy and the housing market, and follows that up with an incredibly thorough analysis of real estate in general. His well-reasoned conclusions might surprise you.

As a **special feature** this month, we interviewed **Swedish hedge fund manager David Webb**. David was on the faculty at our recent summit in Carlsbad, and he spoke about the degrading legal protections for US investors. The quality of David's analysis along with the critical importance of the topic prompted us to interview him and share his staggering insights with all of our readers.

Rounding out the issue, **Casey Research Washington Correspondent Don Grove** describes a meeting he attended at the White House in which the merits (or lack thereof) of proposed fracking rules were discussed. And, as always, you'll find the **Data Farm**, along with a very exciting (and unique) new investment recommendation in our **How to Invest** section.

With that, I hope this issue arms you with the knowledge needed to thrive in our highly manipulated economy. Thanks for subscribing!

Dan Steinhart
Managing Editor

Questions or comments? Send them to dan@caseyresearch.com

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Real Estate and the Economic Cycle

By Bud Conrad

This article is the most important analysis I have done in years, because it represents an important change in my position. In 2005, I predicted the collapse in the overleveraged mortgage marketplace, and I said that it would extend far beyond the initial subprime mortgages. To me, it was easy to see that our whole economy would be vulnerable because housing is so important.

But upon learning that QE3 would consist of buying an *unlimited amount* of mortgage-backed securities (MBS), I decided it was time to dive back into the housing data, to see what has changed in the five years since the bubble burst.

In what follows, I begin with an analysis of the housing market since the crisis, focusing on the government's response. The Fed has already intervened in the housing market to an unprecedented degree, and it is now revving up the printing presses again to print more money for housing. Any analysis of real estate is incomplete without first considering the government's actions.

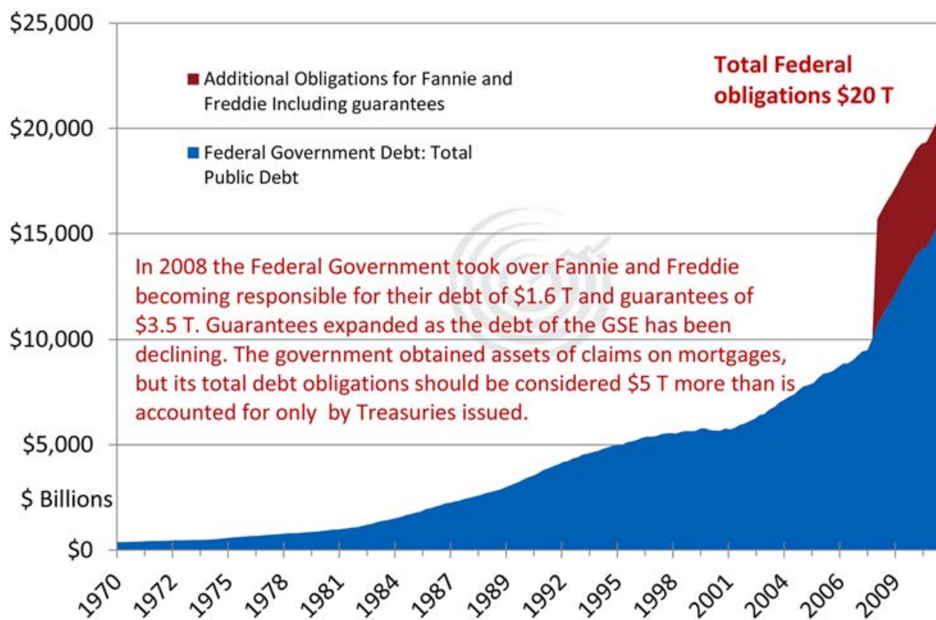
I follow that up with a comprehensive overview of real estate. I dug through all the data I could find and have assembled an array of charts that I think best illustrate where housing is today.

The Last Five Years

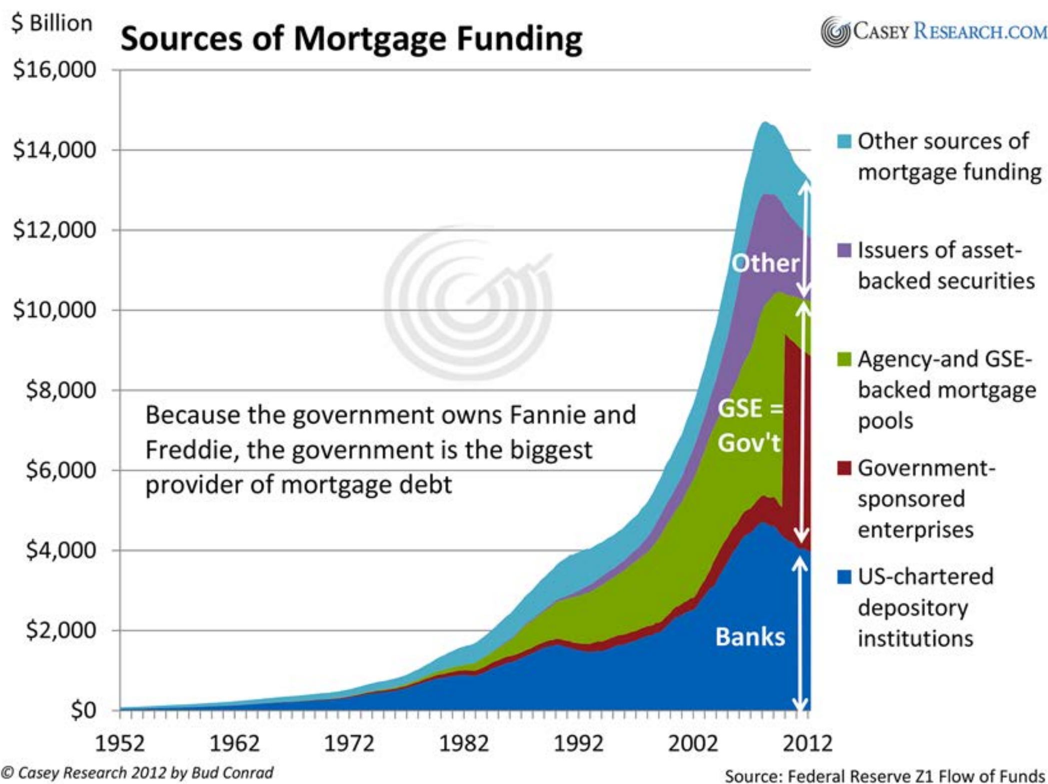
The story begins with Fannie Mae and Freddie Mac, two government-sponsored entities (GSEs) that were designed to facilitate homeownership in the US. Fannie and Freddie are part of what's known as the "Shadow Banking System." Unlike normal banks that take deposits and make loans, Fannie and Freddie loaned money to finance mortgages, but did not take any deposits. They borrowed money by issuing their own agency debt. They also guaranteed several times the amount of mortgages that they funded. They were able to do this, despite inadequate capital, because of their close ties to government.

Eventually (and predictably), Fannie and Freddie lent to extremes, creating the 2006 housing bubble. When their huge losses from bad mortgages came to bear, they did not go bankrupt but instead were bailed out via government takeover. As a result, the government now holds all of those bad loans and guarantees.

So far, direct losses have been almost $200 billion, and the government has assumed an amazing $5 trillion in additional obligations from taking over Fannie and Freddie.



Facilitated by Fannie and Freddie, overall mortgage lending exploded to over $14 trillion before collapsing. Traditional commercial banks account for part of this growth, but the lion's share was from government-sponsored mortgage lending. As a result, the government is now the biggest and most important mortgage lender by far. Almost all new mortgages find their way back to a guarantee by some arm of the federal government – whether it be Fannie, Freddie, Ginnie, or one the government housing bureaus like FHA or FHLB. **Essentially, the government owns the mortgage business.**

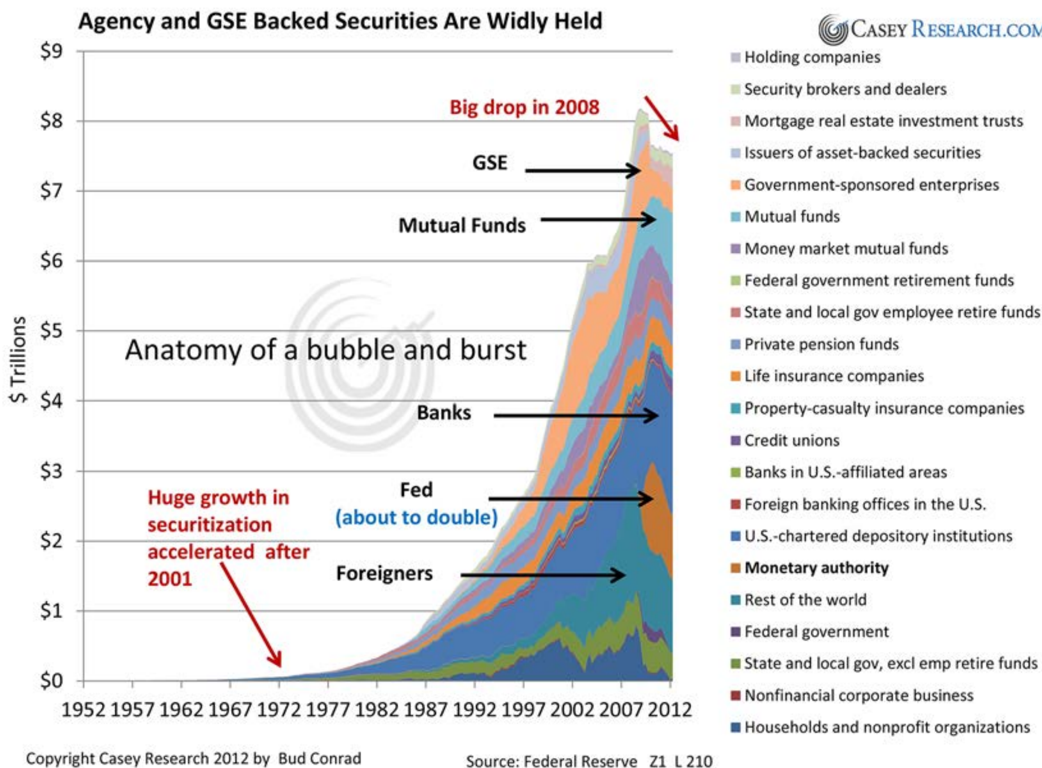


The Treasury recently restructured these GSE conservatorships. The previous arrangement was that the Treasury would be paid 10% on the funds loaned to the GSEs. Now, the Treasury will collect all profits. Also, Fannie and Freddie have been directed to accelerate their wind-down of mortgage holdings to 15% per year, an increase over the previous goal of 10% per year. Since the government owns 80% of these entities and provides 100% of their funds, it can tell them what to do.

These two huge organizations are a sinkhole of guarantees of bad debt that could fester and become major problems if the housing market were to continue its collapse.

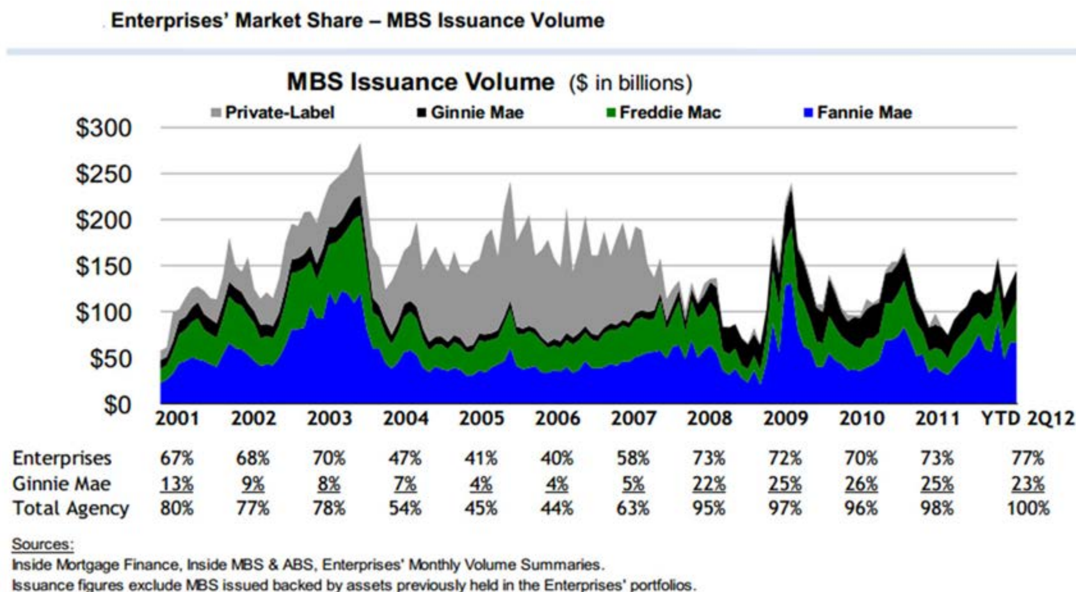
Anatomy of a Bubble

Fannie and Freddie greatly expanded both mortgages and mortgage-backed securities (MBS) far beyond what they would have otherwise been. From almost nothing in 1971, the financing of mortgages through MBS grew to $8 trillion by 2008. This $8 trillion is a very large component of the $13.5 trillion in total mortgages, shown above.

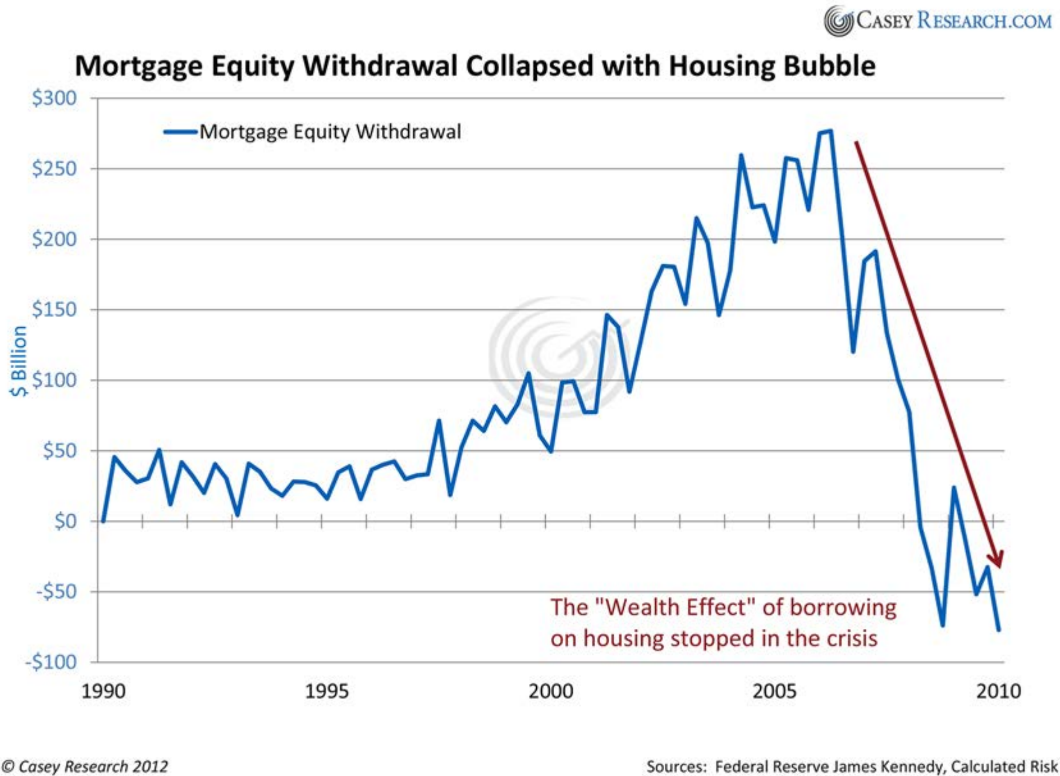


You can see that foreigners were an important source of mortgage money. But as the crisis of confidence spread, foreigners and households sold off their holdings. If the Fed (labeled "Monetary Authority" in the chart) hadn't stepped in, the write-downs of illiquid debt would have been much larger and more damaging. **By buying this paper, the Fed bailed out and continues to bail out banks and other institutions whose toxic holdings would have forced them to recognize huge losses.**

Further, we can clearly see the shift away from private funding of mortgages, shown in gray in the following chart. Private-label MBS declined so much after 2007 that you can barely see them.



The popping mortgage bubble also produced a stunning decline in the wealth effect, which is when people feel richer because their home is worth more. The wealth effect can manifest itself in the actual borrowing of funds when homeowners withdraw mortgage equity, as they did up through 2007. But people stopped using their houses as ATMs when the bubble popped.

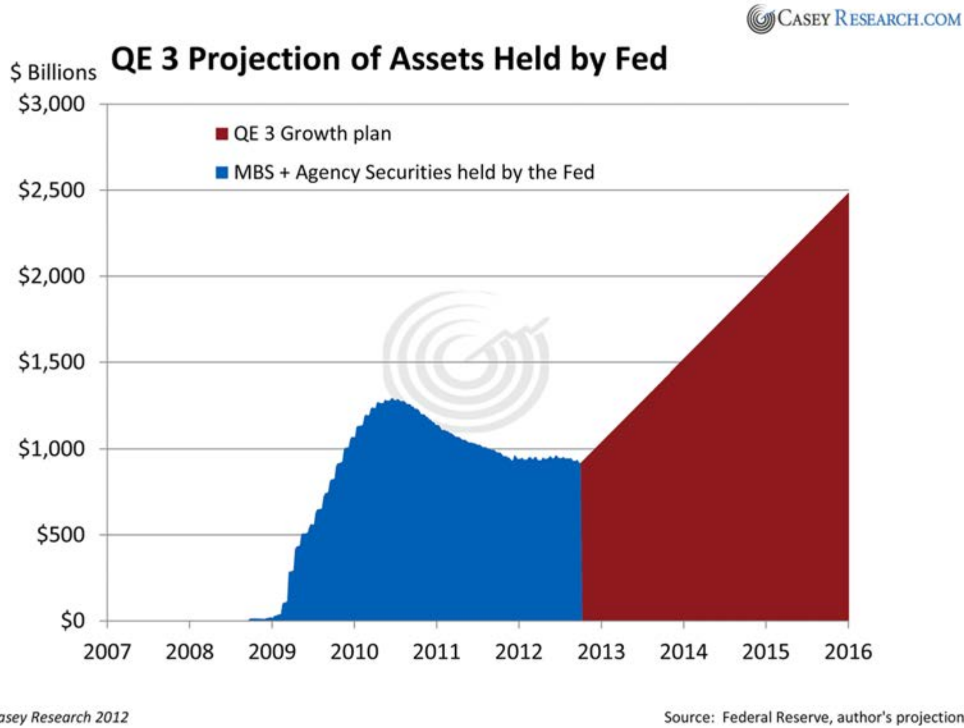


Where Will the Fed's QE3 Announcement Take Us?

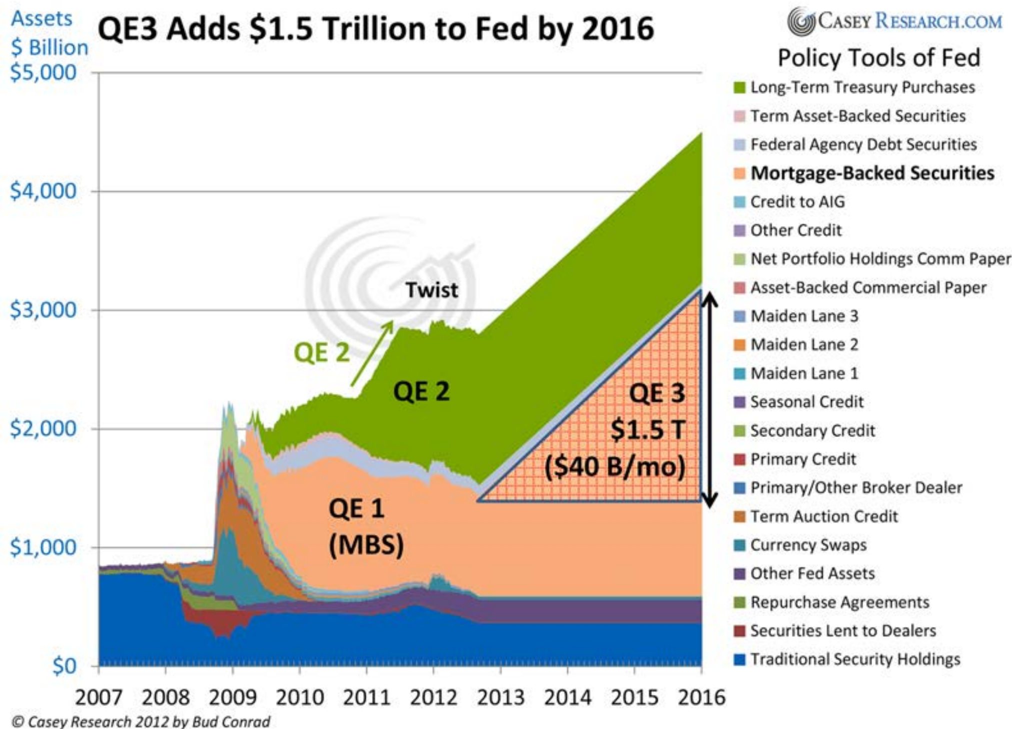
As indicated in last month's article, the Fed is printing again. It announced a new Quantitative Easing on September 13, 2012, in which it will purchase $40 billion of agency and mortgage-backed securities per month. This amounts to a substantial $480 billion a year, with no specific time limit. The Fed says it will continue the program until employment improves, but printing has only indirect effects on employment, so it could continue for quite a while.

Notice that the Fed is directly targeting real estate by buying MBS. This is very important. I think the Fed is trying to bail out the government, which now owns Fannie and Freddie, as well as other holders of their paper.

The Fed already holds a lot of MBS and agency debt, and it's going to hold a lot more as QE3 advances:



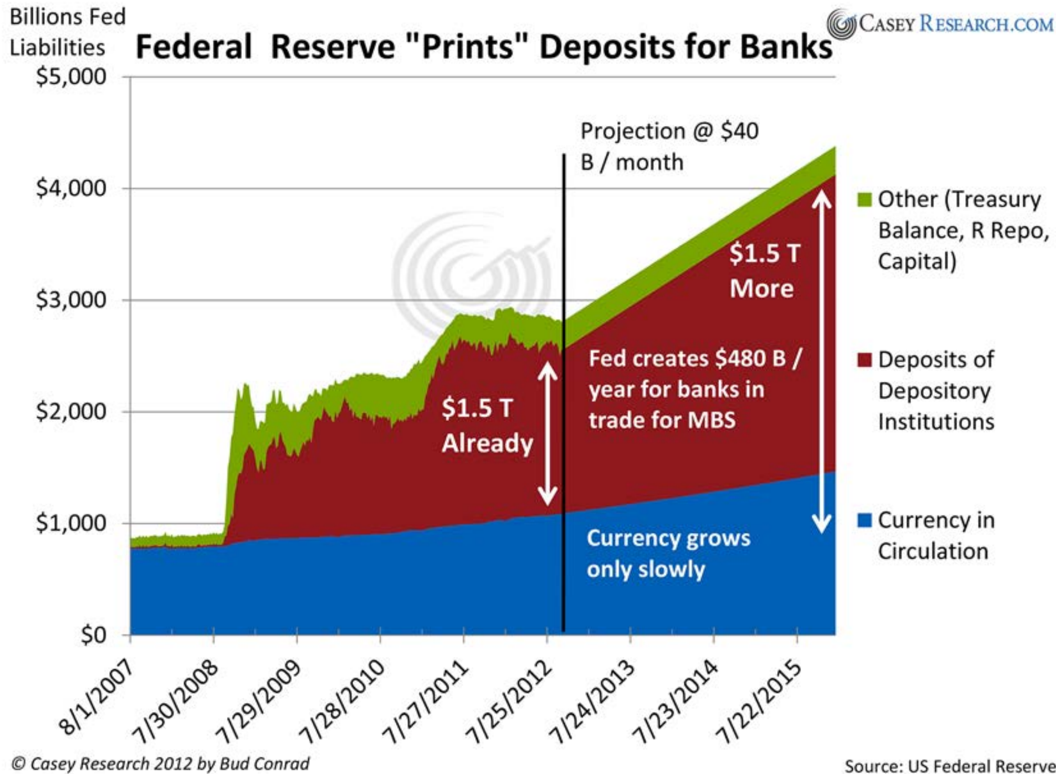
Readers of any duration will recognize the next chart. It is the asset side of the Fed's balance sheet, and I've added in QE3 to project it out to 2016. The crosshatched triangle shows the accumulated growth of the MBS. By 2016, the Fed balance sheet would grow to $4.5 trillion from under $3 trillion today.



This is a huge jump, and the market reacted accordingly. The dollar weakened, gold shot up $40, the Dow was up 200 points, and crude was up $1… all just on the day of the announcement.

How will the Fed pay for the new MBS purchases? My best guess is that they will use the same method they did for QE1 and QE2, which was to create new money and give it to the banks from whom they buy the securities. If that money is kept on deposit at the Fed, as it likely will be if the Fed continues to pay above-market rates on those deposits, it will only be modestly inflationary in the short run. But in the long run, it's a ticking time bomb of inflation.

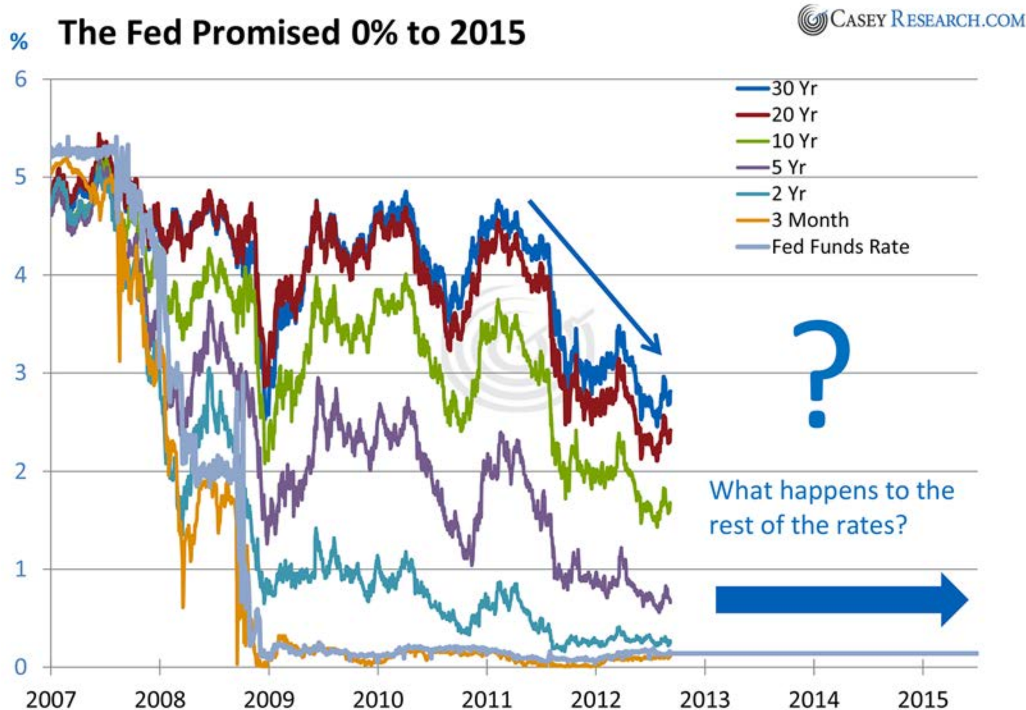
Below, I project what Fed deposits will look like as QE3 grows.



In the same announcement as QE3, the Fed also promised to keep its overnight rate at close to zero for an additional year, through mid-2015. This makes sense; the Fed will need to keep adding liquidity to force rates to this low level, and it is doing just that with QE3.

Some were surprised by the Fed's move, and some even suggested that it panicked. I say it as business as usual. The Fed must keep rates low so the government can service its debt. The Fed has essentially promised to destroy the dollar to keep supporting the US government and banks. It is following through on that promise.

But given the length and size of the promise, it will not be easy to keep.



The most important part of this story is that QE3 is focused on Housing. The Fed explicitly said that it will promote higher housing prices. In the spirit of the time-tested aphorism "Don't fight the Fed," I think that we should join the party.

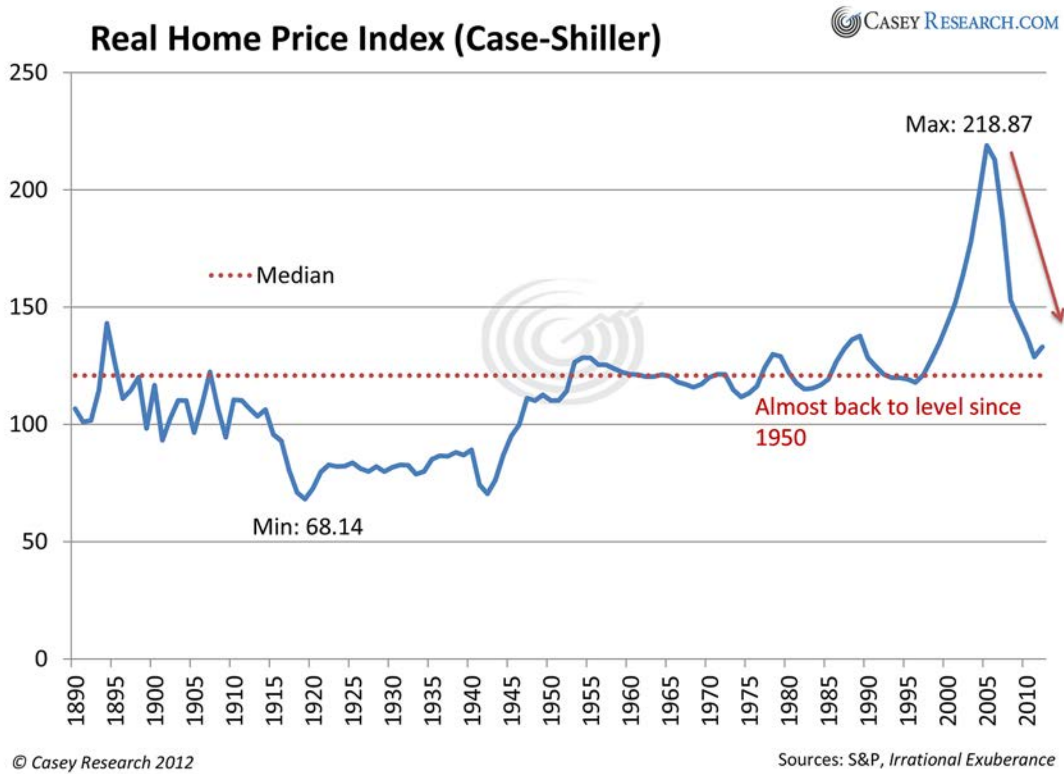
Real Estate Has Hit Bottom

To protect your wealth in this fiat-money era, you need to hold physical assets. My recommendations to hold precious metals and energy commodities have made us a lot of money over the past few years. I left real estate, also a physical asset, out of that recommendation because it was overvalued and the problems facing it were unprecedented. But these issues have abated, as I'll demonstrate.

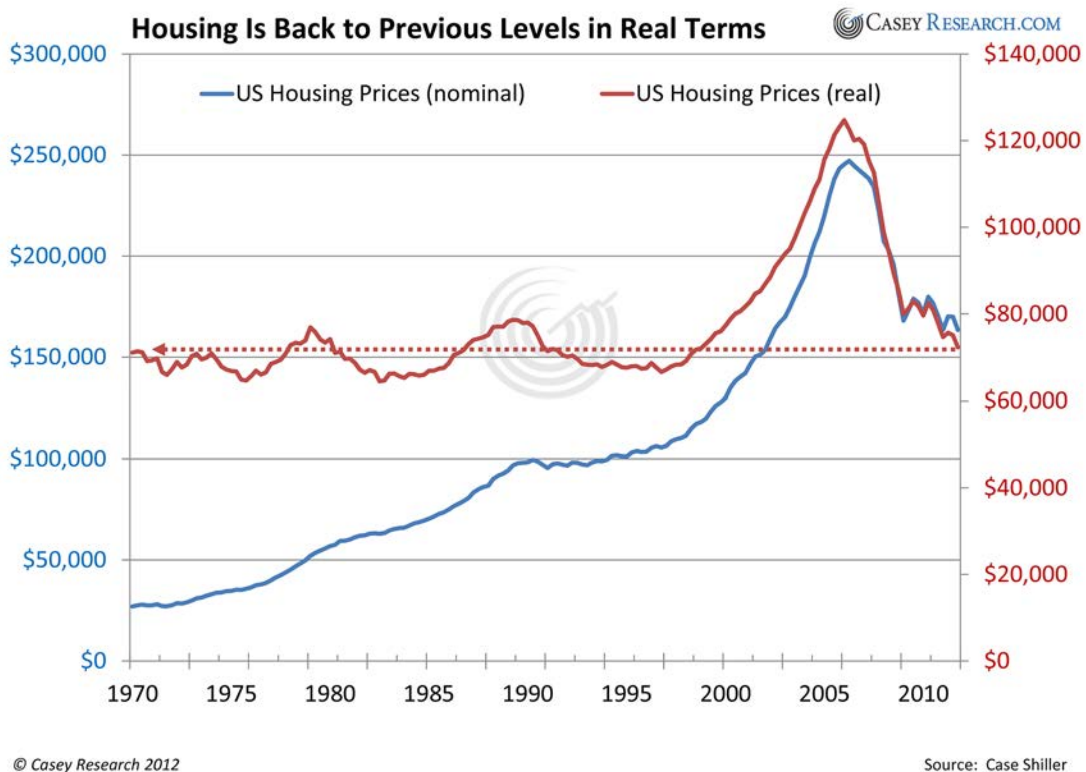
Timing Trumps Location

It's said that there are three things to know about real estate: "Location, Location and Location." In normal times, that saying is unquestionably true. But we are facing the aftermath of an unprecedented market dislocation. **Any developer or real estate investor who has lived through a big downturn knows that location makes no difference when leveraged assets are crashing**. As a result, timing the big picture of real estate cycles is more important than location. With that in mind, where are real estate prices today?

In real (inflation-adjusted) terms, the Case-Shiller annual housing index is off more than 40% since the 2005 peak.

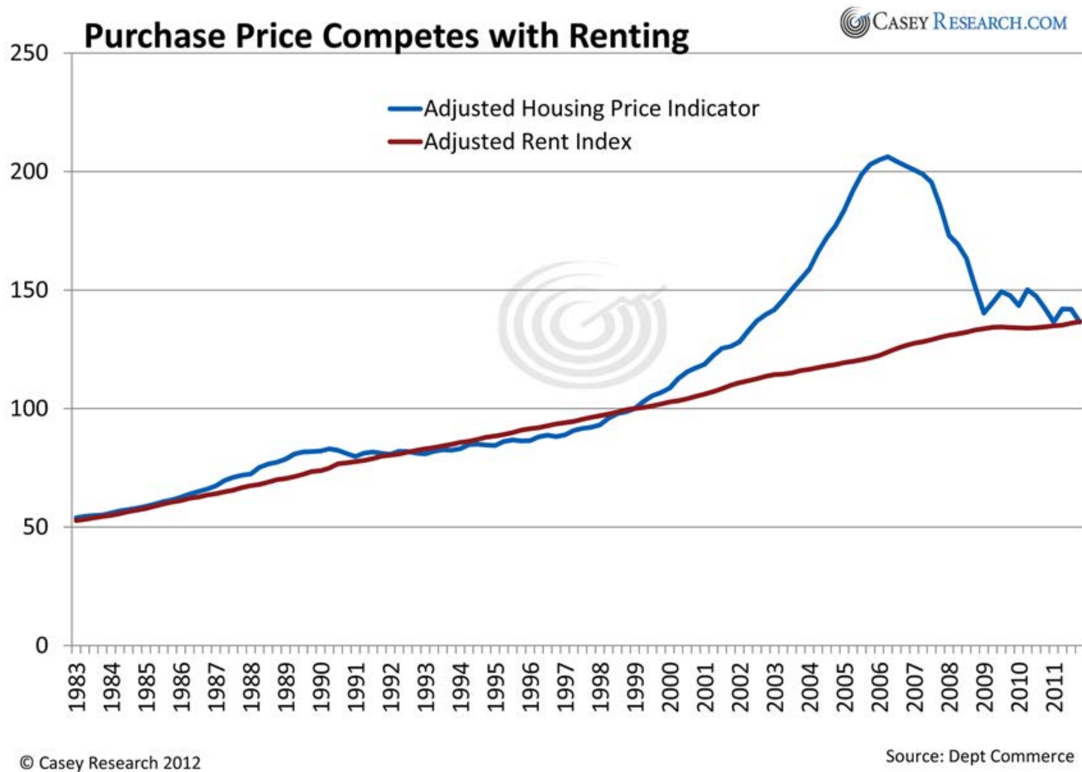


A comparison with nominal real estate prices reveals the same conclusions. **Prices are back to pre-bubble levels**.



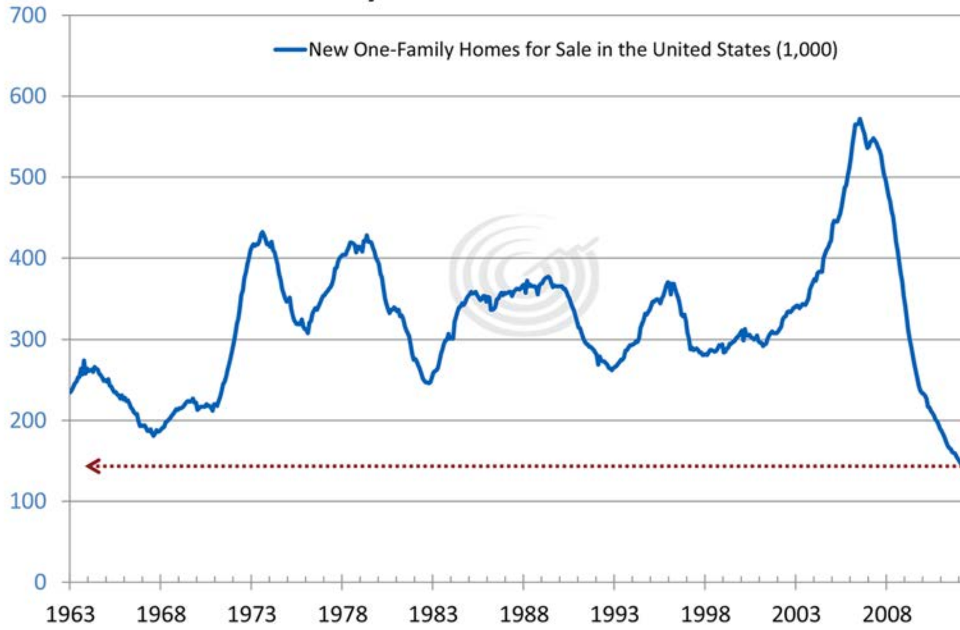
Rental Rates Rose Even as Prices Plummeted

The choice to rent or own is crucial to the real estate equation. We know that prices have fallen dramatically since 2006. But during that time, rental rates continued higher. As a result, buying is more attractive than renting today. Add in the longer-term benefits of appreciation in a money-printing environment, and owning looks much better than renting.

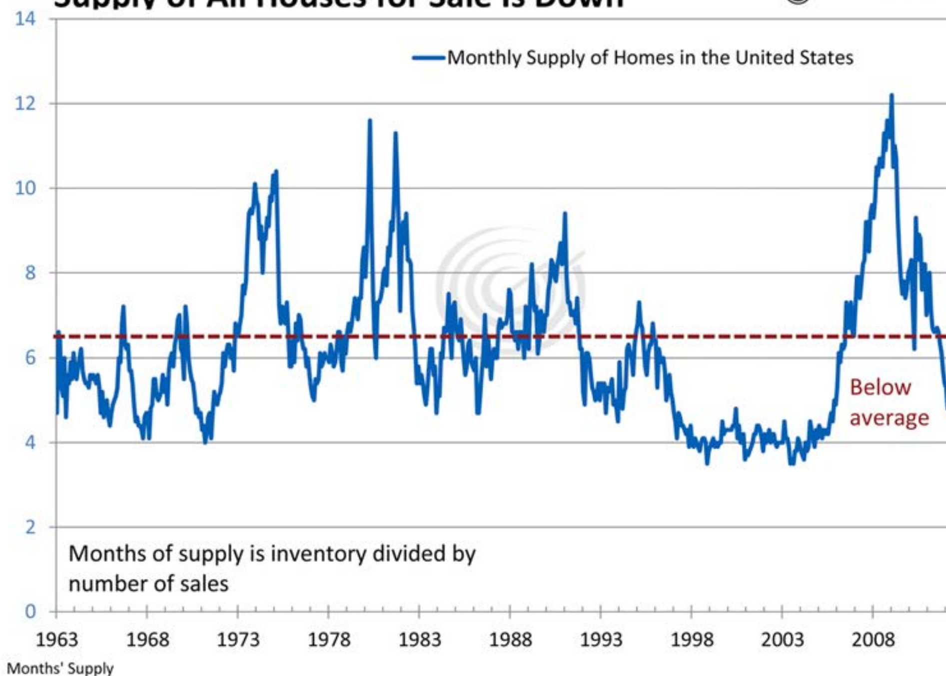


The Supply of Houses for Sale is Low

There are a couple of good measures to judge the supply of housing. One is the number of new homes in inventory for sale, which is at its lowest on record. Lower supply leads to higher prices:



Realtors use the ratio of homes for sale to the sales rate to calculate how many months it would take to sell off the inventory. Today, it would take less than five months to sell off the entire home inventory. That's well below the long-term average of about 6.25 months.



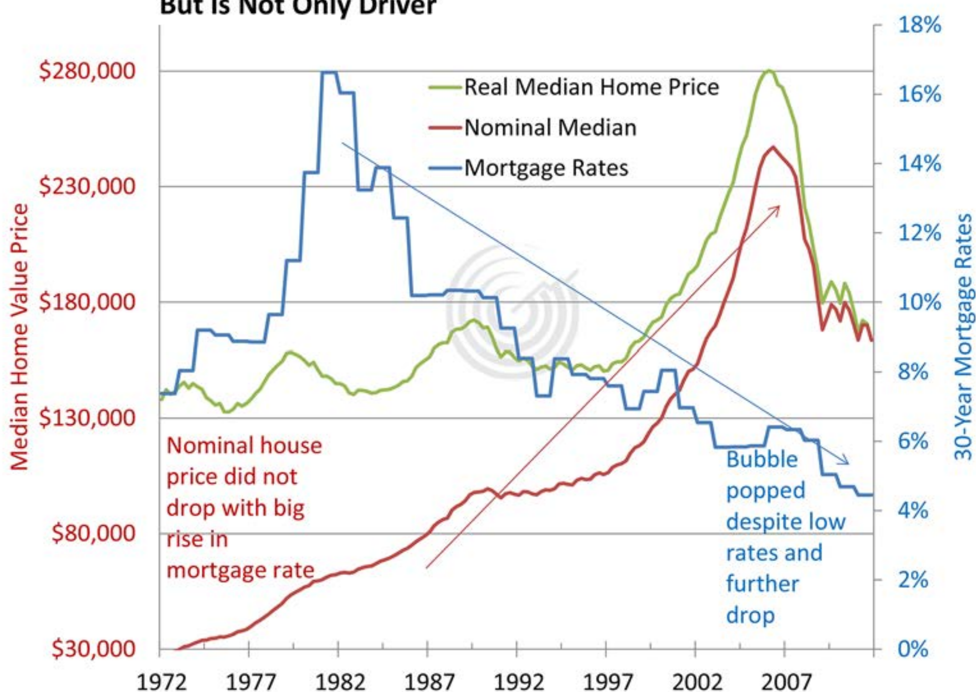
I could go on with more supply charts, but you get the picture: the housing supply situation is favorable.

I will note, however, that there are houses that are in default but have not yet been foreclosed on and put up for sale. This "shadow inventory" is unaccounted for in official supply numbers, so supply may be understated.

Record-Low Interest Rates Are a Key Driver

Low rates make housing affordable, and mortgage rates are at record lows.

Surprisingly, history shows that high interest rates need not have a big negative effect on housing prices. Intuitively, higher rates should suppress home prices, because they make it more expensive to borrow money to buy a house. But in the run-up in mortgage rates from 1972-1981, housing did not decline. Real home prices remained relatively stable, and nominal prices rose.

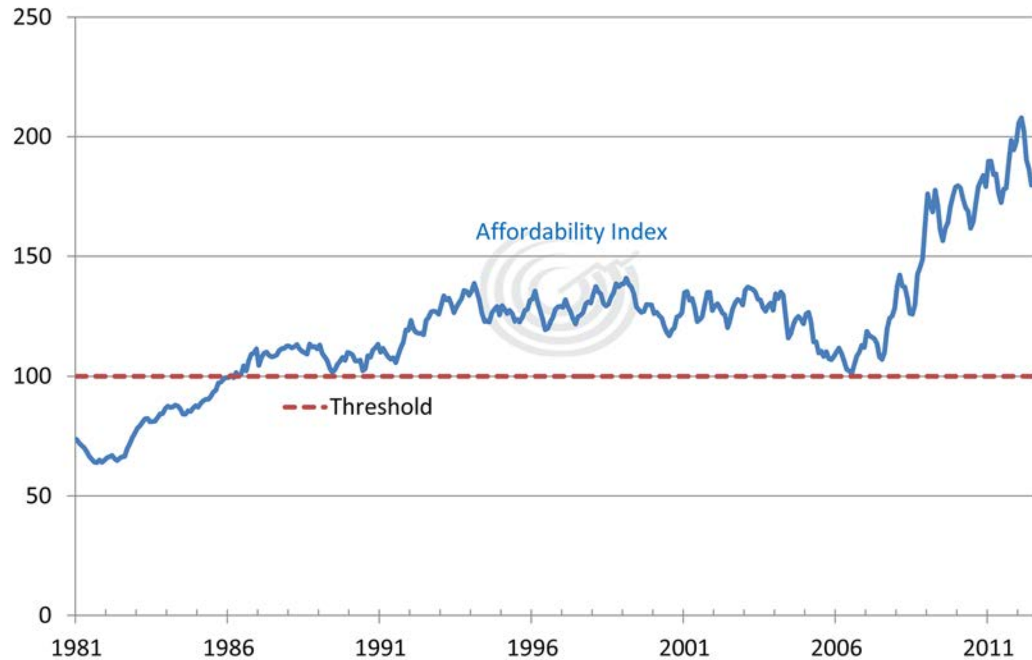


That's not to say that low rates don't help home prices – they most certainly do, as 1981 through 2005 proved. But rising rates need not be disastrous for home prices.

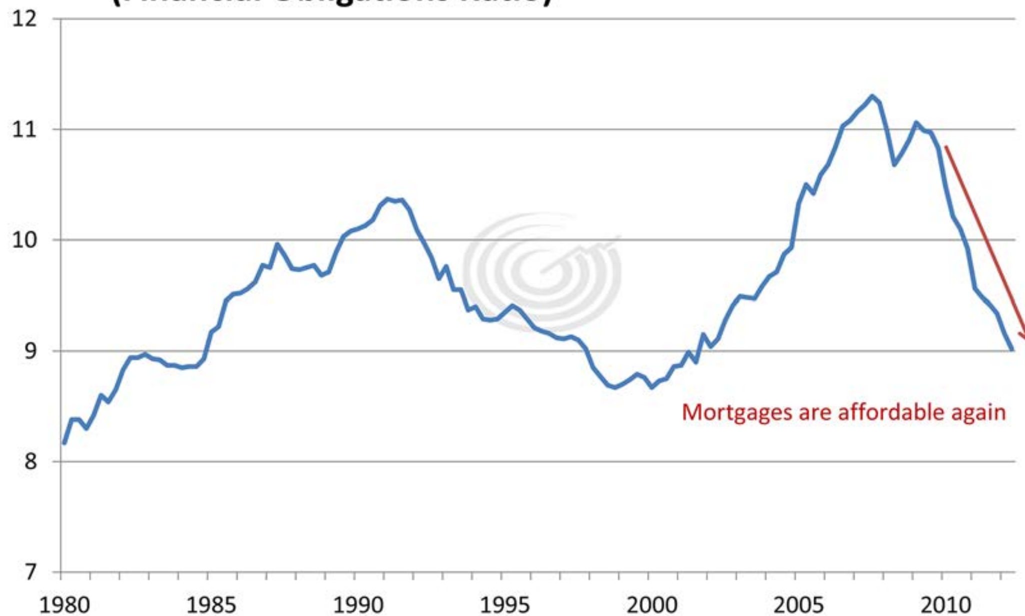
A Combination of Indicators Support Housing

Below, I've collected a number of indices that I think are worthwhile indicators of the housing market. I dug into dozens of indicators in my research, and these are a few of my favorites. I'm presenting them with little comment, because they are self-explanatory. The common thread is that **real estate prices are back down to affordable levels, and real estate is once again a good investment.**

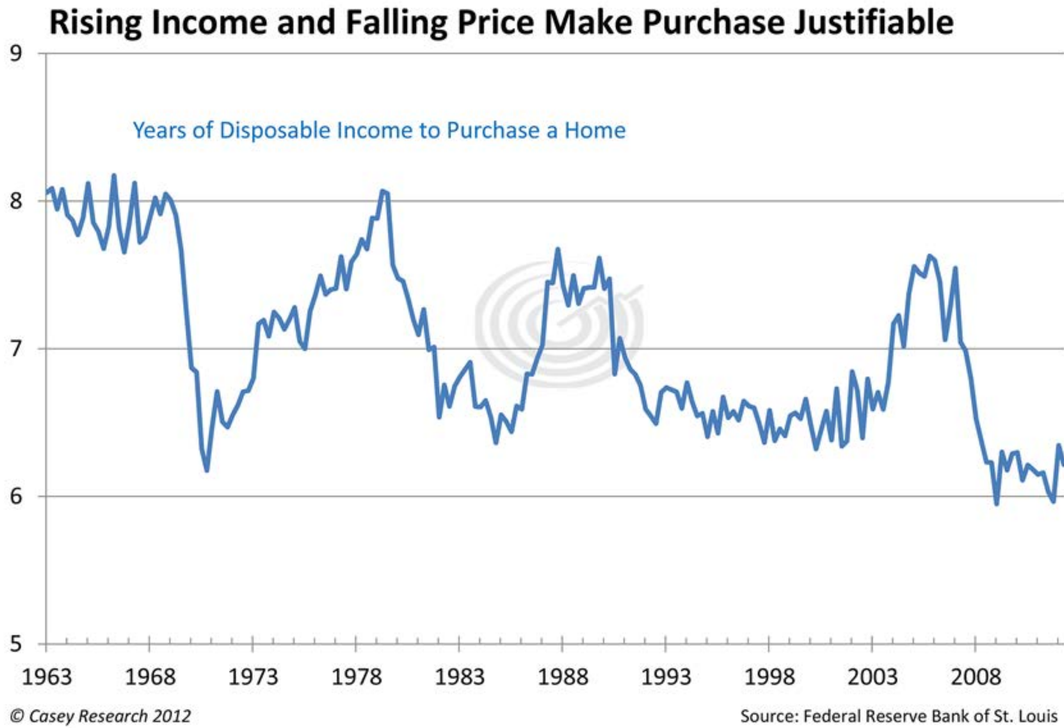
The National Association of Realtors calculates an affordability index based on payments required for purchase and the level of household income. With both low rates and low housing prices, affordability is higher than it has been in a very long time.



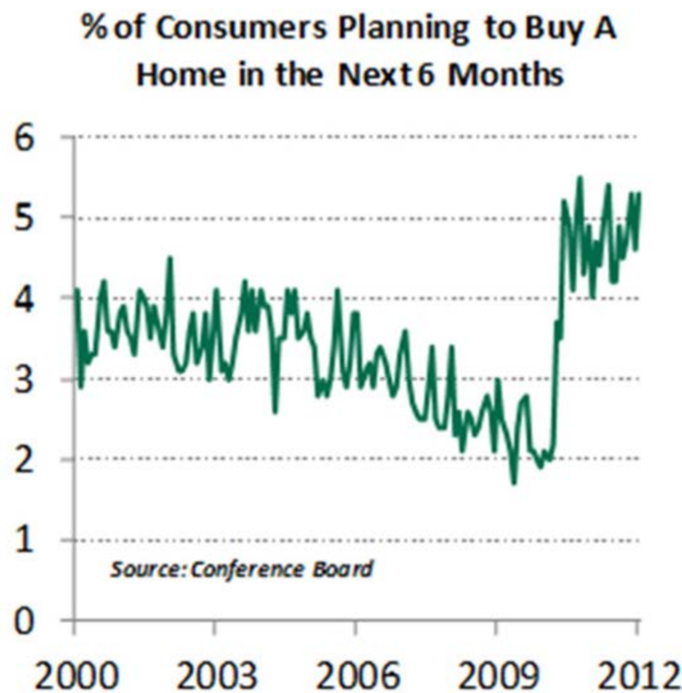
The mortgage financial obligations ratio is calculated by the Federal Reserve. It is the ratio of mortgage cost to personal income. With rates down, the index shows that housing purchases are affordable.



It takes the average person a little over six years' worth of disposable income to buy a house, which is well below the long-term average.

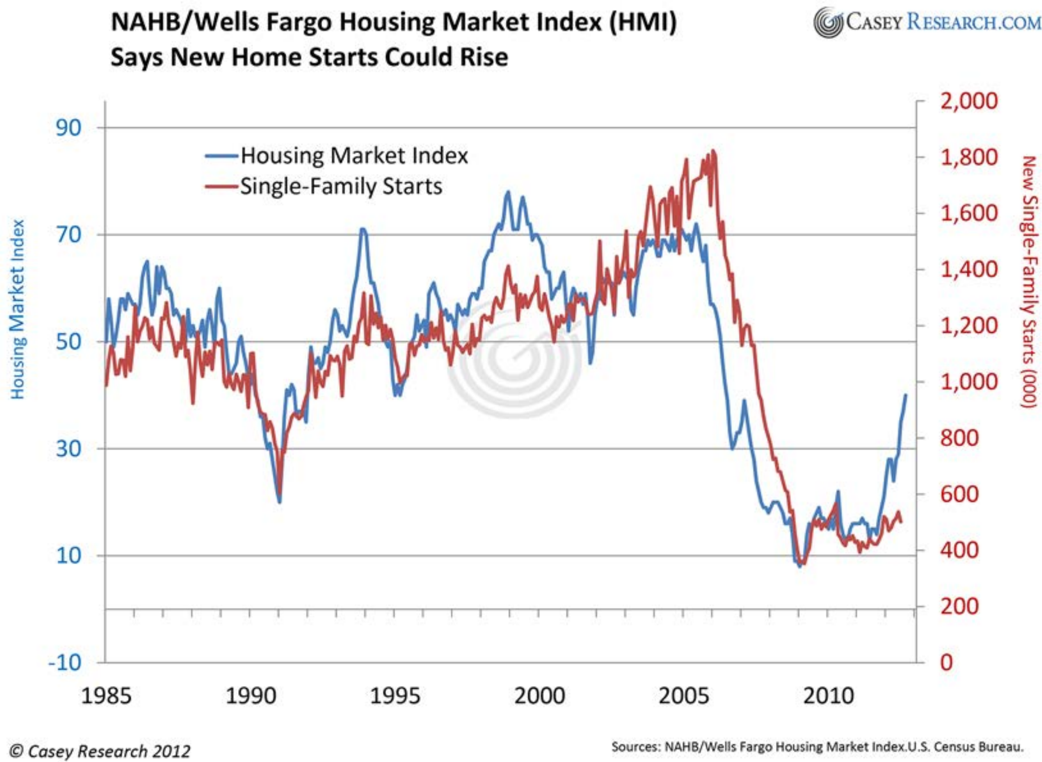


The Conference Board reports the percentage of people planning to buy a home in the next six months. This indicator is bullish as well.

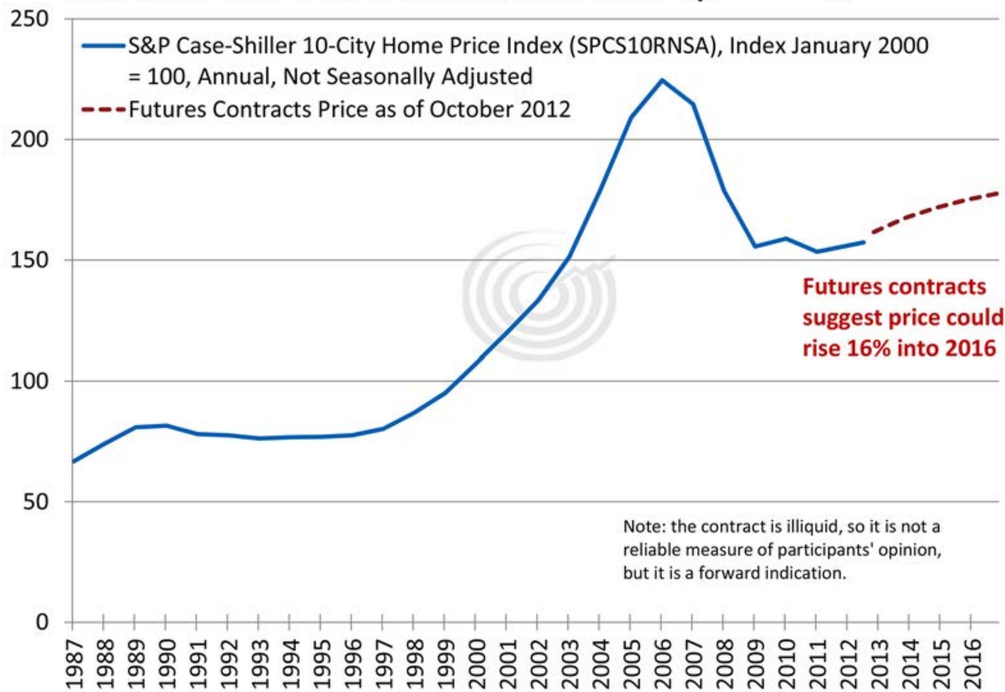


The National Association of Home Builders and Wells Fargo have developed an index that slightly leads housing starts. It is based on traffic at home sites and expectations for purchases. As you can see below, it has turned up sharply, indicating that home starts should soon rise.

Furthermore, while housing starts are recovering, they are still at a very low level overall, which suggests that inventory will not increase meaningfully in the near future.



Finally, Yale professor Dr. Robert Shiller developed a measure of housing prices across 20 cities in the US. The index is traded on the Chicago Mercantile Exchange as a futures contract. The very low trading volume makes it unsuitable as a speculation on housing prices, but it is a useful indicator. The futures prices suggest that housing prices could increase by about 16% in the next couple of years.

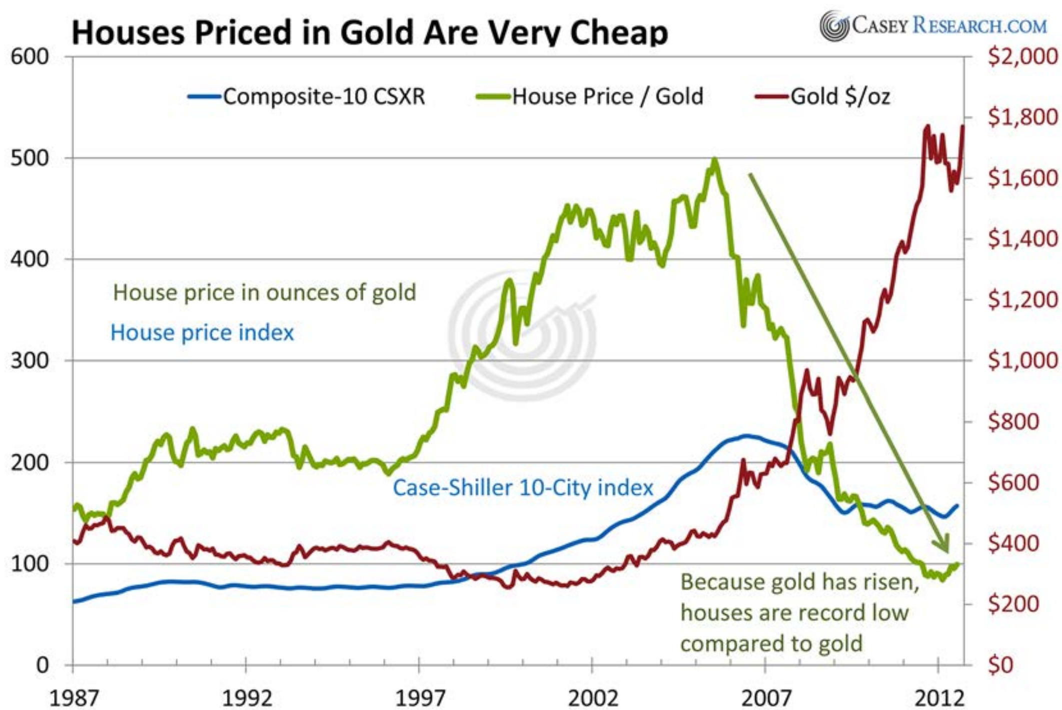


After poring over all of the indicators shown above (and many more), I believe that real estate prices could increase 10% per year for the next few years.

Houses Are Lagging Gold

As a check on reality, I often make ratios of important assets in relation to gold. This is useful because measuring anything in terms of a depreciating paper currency is imperfect at best.

The chart below shows that gold has handily outpaced real estate. In fact, real estate is at a record low in terms of gold. This tells me that real estate has strong potential to rise.



Housing is similar to gold in many ways. Both are real, tangible assets with real value, both can be held outside the financial system, and both serve as inflation protection. Housing even has some advantages over gold: it can produce rental income and has major tax benefits, including the ability to deduct yearly depreciation. It is even possible to have positive yearly cash flow from rental property without having any taxable income.

The bottom line is that you should have real estate in your portfolio.

But Housing Does Have Unique Risks

Interest rates: The interest rate is key to affordability. If rates spike as they did in 1980, houses would become much less affordable. My analysis earlier indicated that housing prices don't always suffer amidst rising rates, but that doesn't mean rising rates are good for housing.

The Fed has promised to keep rates low into at least 2015. While I think it may have problems keeping its promise, it will certainly try to, and it may very well be successful. With the focus on MBS purchases as described in the first section, the risk of rising mortgage rates is as contained as it has ever been.

Finally, locking in long-term financing at a low rate is a no-brainer.

Economic catastrophe: I have long criticized government deficits and trade deficits, expecting them to cause dollar debasement and economic slowing. Economic slowing hurts real estate. The Great Depression brought massive deflation, especially in housing, and people were forced to sell while there were no buyers.

It is conceivable that this could happen again today, but I doubt it. The government and the Fed have already taken unprecedented steps to ensure that deflation doesn't take hold, and I believe they will err on the side of too much money printing rather than too little. For that reason, I think inflation is much more likely than deflation.

If we were to get hyperinflation, the economy would slow dramatically, but housing would be a safe haven.

Demographics: It is no secret that retiring baby boomers will be looking to sell off their biggest asset and downsize now that the kids are out of the house. I cannot provide the size of this long-term downward pressure, nor do I have the data to compare it to the upward pressure from immigration and echo boomers. But it is a net negative.

Taxes: There is risk that the mortgage interest deduction will be cut, perhaps for second homes or for very expensive homes with big monthly payments. But tax uncertainty is a risk with any investment, so I'm not too worried about this one.

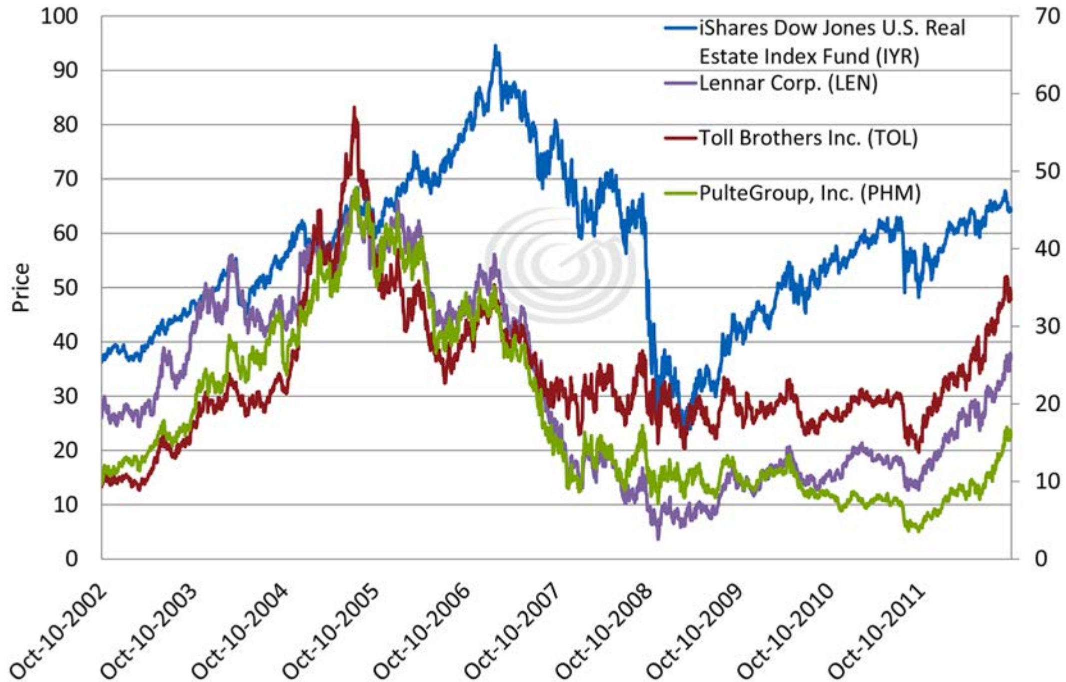
Recommendations

Real estate investing is much more involved than simply buying a stock. If you're buying a house, you have to consider the location, the time period, the property taxes, your credit rating and any number of other things that affect the investment.

I cannot make a recommendation on any specific piece of real estate. What I can tell you is that the balance has swung back in favor of real estate investors. The Fed is actively juicing the real estate market. It has explicitly said that it wants to increase real estate prices, and it is following through on the promise via QE3. <u>You should follow the Fed's lead and invest where they are</u>.

If you can find a great property with strong cash flows in a good location, you should consider buying. If you'd rather not get involved in real estate management, here are some other, indirect ways to invest:

- Buy your own house if you don't yet own one.
- Get INTO debt and lock in your low rate for as long as possible. You can borrow money to buy a house and pay it back in depreciated dollars.
- Flippers who buy distressed houses, perhaps in foreclosure, can do well in the short term.
- **The iShares Dow Jones US Real Estate Index Fund (IYR)** is a good proxy for US real estate. It is up 300% since its 2009 lows, and there could be more gains ahead. Homebuilders like **Toll Brothers (TOL), PulteGroup (PHM), and Lennar Corp. (LEN)** are also decent proxies. They have already had a big run-up but could still offer opportunities if the economy continues to recover. They are still below their peaks of 2005, but the bargains of last year are behind us (see chart below). If you go this route, be sure you conduct your own due diligence before investing in any company.



- REITs may hold some opportunity, particularly REITs focused on a growing need like retirement homes or medical facilities. Be aware, though, that REITs typically employ a lot of leverage, so they are risky.
- The suppliers of building materials could also do well.

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Special Feature:
You Don't Own What You Think You Own

An Interview with Hedge Fund Manager David Webb

David Webb is a Sweden-based hedge fund manager with an exceptional track record. Between September 1, 1998 and November 9, 2002 – the period leading up to and including the dot-com crash – he used his neutral long/short equity strategy to produce a cumulative return of 258%.

David spoke at our Navigating the Politicized Economy *Summit in September, and he was quite a hit. In particular, when he spoke about the erosion of investor protections in the US – a topic few people understand – it was as if an electric shock had hit the room. David's presentation was so popular that the audience vocally demanded an encore when his stage time expired.*

Given the vital importance of this topic, we decided that David's knowledge is far too valuable to keep among the 300 or so attendees of our summit. So we called up David in Sweden, and an edited transcript of our interview is below.

Dan Steinhart
Managing Editor

The Casey Report: Hello David, thanks for talking with us today. Do you want to start by telling us a bit about your background?

David: Sure. I grew up in Cleveland. My grandfather, father and uncle were engineers, in the business of overhead materials handling – cranes, hoists, etc. I grew up in the sixties and seventies, when Cleveland really felt the brunt of the beginning of the industrial decline of the United States. My family certainly felt the impact.

In my formative years, I had an intense desire to understand what was happening in the world, what forces were at work. My dad wanted me to get an engineering degree, but instead I got a business degree and struck out for Wall Street in 1982. I arrived in August 1982, which was the beginning of the bull market.

I began working at CompuServe, one of the early computer services companies, in their Wall Street office. My clients were investment banks. After a year, I realized I was on the wrong side of the desk, so I managed to talk my way into a position as an analyst in the mergers and acquisitions group at Oppenheimer and Company.

I had a very intense experience in the M&A world for five years and then moved to the venture side of E.M. Warburg Pincus in 1987. At a young age, I ended up having complete responsibility for managing the acquisition of a regional telephone company called LCI Communications. This came about because the partner on the deal developed a bad back and stayed in bed for six months. So I handled everything: the sub-debt financing, the bank financing, the due-diligence work. It was very, very intense for the better part of a year.

That was a great experience, but it created a lot of stress for my family. I was sleeping on the floor in the office, getting maybe an hour of sleep a night, sometimes for days on end. When you're managing a complex deal like that, you can never escape from it. I would wake up to phone calls on early Saturday morning, work until three in the morning and then repeat that every day of the week.

The deal turned out to be very successful – the largest capital gain in the history of Warburg Pincus – and I could have had a good future there. But it nearly destroyed my marriage. My wife told me that if she'd known our life was going to be like this, she wouldn't have signed up for it.

So we decided to leave that kind of life and move back to Cleveland, and I eventually started as a partner in Shaker Investments. When I started, the company had three million dollars, which isn't enough to pay for much of anything in that business. We grew that to about a two-billion-dollar business in less than ten years.

My heyday really began during the Asian financial crisis. I took responsibility for managing a hedge fund that had not been well managed up to that point. On the last day of August 1998, the market absolutely plunged, and I averted disaster by fully hedging the portfolio in the opening minutes of the day.

During that time, I learned that the S&P 500 is basically the world's worst hedge. In a crisis, the Fed provides liquidity, and it goes straight into the S&P. So long/short managers who use the index to hedge get destroyed.

It's the stuff *outside* the index that falls in a crisis, because it's not receiving that liquidity. So I got the idea of developing an index to short based on the Russell 2000. I talked to Goldman and other firms about it, but the cost would have been more than five percent to have them hold the index for me.

So I decided to do it myself. I constructed my own index using hundreds of companies that I called "the cream of the crap." Through the dot-com buildup, I ended up having a very unusual and powerful position of being short hundreds of tech stocks in the opening months of 2000.

Of course, first I had to get through the fourth quarter of 1999, when tech stocks were still rising, which was a living hell. But overall, I did very well through that whole process, from the Asian financial crisis through 2002.

Without going into the reasons why, I left Shaker and started something called Verus Investments at the beginning of 2003 to do exactly the same thing. At that time, I was monitoring the rate of growth of the M3 money supply in order to navigate when the Fed was pushing harder. They are always growing the money supply, but some times faster than others.

TCR: So you used movements in M3 to help position your fund?

David: Yes, watching M3 gave me some lead time because the money would first show up in bank deposits. This is before the Fed started directly injecting money into the financial markets, when they were still operating through loaning to the banking system. So it would show up in deposits first and make its way to the financial markets with some latency, and I used it as a signal to cut back on shorts.

This is when I started to realize that the amount of money that the Fed was creating was very large relative to the GDP of the US. In fact, we were getting to the point where the amount of money being created was perhaps larger than the GDP growth of the US.

Most people don't realize that quantitative easing really started in 2003. I know that because beginning in 2003, the stimulus no longer showed up in M3, which was actually decelerating through the first half of 2003. That is when the Fed, in desperation, went to direct injection into the financial markets, and they did it secretly.

The market is normally a closed system, or at least it used to be. You could see day by day that if tech stocks were up, the old-line industrial stocks were down. If equities were up, bond prices were down. If you imagine looking at an equalizer for a sound system, where you see the frequency ranges bouncing up and down, that's what the market was like. If money was going to flow into one area, it had to come out of another area.

But during that first half of 2003, bond prices rose because interest rates were driven down to one percent, and every segment of the equity market went straight up as well. So where was that money coming from? It was being created and injected, probably into the Treasury market at that point.

This was a challenging time for me because I knew that, under the surface, this was a crisis situation. But the public thought it was wonderful, because the market was going straight up.

So I anticipated a collapse and remained short for two years. But when George Bush was reelected in 2004, I realized things weren't going to change. I decided that even if I were very well positioned for the collapse, the prime brokers themselves could fail.

And so I felt that it was not possible to run an entity to protect people in the US because we were looking at a monolithic collapse when it finally happened. We got that failure in 2008. Massive and escalating government intervention has provided stabilization for a period of time, but the problems were never resolved. The widespread insolvency is still being masked.

I apologize for this long-winded introduction – I have been watching and thinking about these things for a long time.

TCR: Not a problem – you have an impressive and diverse financial background. There was one thing in particular that you spoke about in Carlsbad that really got the audience's attention. It was your study of investor rights and protections in the US. You shared your findings, and they were not good. Can you tell us about that?

David: Sure. I was looking for signs of the beginning of the financial collapse well before 2008. In the first half of 2008, I noticed mention of the failure of a little securities firm in Florida called North American Clearing. What got my attention was that all client assets were swept to the receiver.

I thought, how could client assets become involved in the bankruptcy of the broker? But they were. The way I explain it to my friends is, it's as if you bought a car, you paid for it with cash, and when the auto dealer goes bankrupt, your car is repossessed.

TCR: So let's say the average Joe buys Microsoft through his broker. You're saying that that stock is not really his property if push comes to shove?

David: It's not even when push comes to shove. Those stocks are legally no longer defined as property.

TCR: Can you expand on that?

David: It took me some years to uncover the basis for how this has changed. It all arises from a revision of the Uniform Commercial Code, Article 8, in 1994. This article governs securities "ownership."

When they did this revision in 1994, they created a completely new legal concept called a "security entitlement," which means that a security is now a contractual claim rather than property. That's the key, and it's hugely important because a contractual claim in a bankruptcy proceeding has very little standing.

So even though there are records that a particular security is your property, it's really not. If your broker goes bankrupt, those securities, by law, become part of the bankruptcy estate. As a client, you cannot revindicate those securities in a bankruptcy.

Of course, secured creditors have a higher priority to the assets of the bankruptcy estate than you do. So you're left with an inferior claim to what you thought was your own property.

TCR: Aren't brokers required to segregate client assets?

David: That's a separate issue, and it varies by country. In Britain, for instance, there is some legal requirement to segregate assets.

But in the US, I like to cite an article and presentation about the MF Global bankruptcy by two securities law experts, one of which is a former commissioner of the FCC. They say point blank that there is no legal requirement to segregate client assets.

TCR: Which means firms probably don't do it.

David: Exactly. So realistically, the assets are rarely segregated.

But it gets worse. All of the securities are pooled – there is no specific identification of who owns what. By law, in a bankruptcy, the losses must be shared pro rata across the client pool. So even if a client somehow manages to get a legal assurance that their securities are not being hypothecated, they are still in a pool where other clients have margin accounts and their securities are being hypothecated.

TCR: Can you explain hypothecation?

David: Hypothecation is when a firm pledges a clients' assets as collateral to another party. The securities firm is allowed to use the client assets as collateral for its own proprietary trading. In my book, that's fraud. But it is perfectly legal.

So the securities firm borrows the security on the assumption that it will return like securities to the pool. But, of course, when an insolvency occurs, the music stops and those securities are not returned.

The firm that received those securities as collateral is a secured creditor, and if there is a bankruptcy, they take those assets – the assets you thought you owned – and immediately sell them. They are gone. And you're left as an unsecured creditor, which means you get what's left over at the end, if anything.

Further, in 2005, the Bush administration rewrote the bankruptcy law.

There used to be a concept of "fraudulent conveyance," which meant that if a firm transferred assets to a secured creditor within six months before its bankruptcy filing, the receiver was required by law to give those assets back. It's called a clawback.

But this revision of the bankruptcy law changed that. The law now specifically says that the receiver is not to claw back the assets. So what was considered a fraudulent conveyance prior to 2005 is now legal.

This is very similar to what happened with MF Global and their transfer of client assets to JPMorgan. But it was not considered fraud. Everything was done according to the law.

TCR: Knowing this, it's amazing that the financial system still functions at all.

David: Yes, it is a very precarious situation. Now here's how it ties into the macro-picture.

One set of assets can be used as collateral multiple times, which is called rehypothecation. So a securities firm gives client assets to a secured creditor as collateral for proprietary trading. The secured creditor can then turn around and use those same assets as collateral for their own proprietary trading. So those assets are passed on to another firm as collateral, and so on. This is the chain of hypothecation and rehypothecation; the same assets are used as collateral over and over again.

I can't stress this next part enough – it's very, very important. There are about $700 trillion of derivatives worldwide in a $70 trillion economy. It's pretty easy to see that there cannot possibly be enough collateral backing. The entire financial asset base of the public is being used as collateral.

This is a huge risk that everyone bears, whether they know it or not. If we have a major failure anywhere in that collateral chain, the collateral is pulled out and cannot be returned to the pool.

People often ask me when this crisis going to hit, and I have two answers. The first is, it's not going to be one event. It's going to be a series of events over many years. And the second answer is that it's already happened. We've been in the collapse for fifteen years. Since the Asian financial crisis, we've seen many failures.

TCR: And a number of those failures were not bailed out.

David: True. People tend to think that the government will bail out everyone and stabilize everything if a serious problem arises. To that, I reply: what about MF Global? MF Global was headed by John Corzine, who was a co-chief executive of Goldman Sachs, a governor and a senator. Who could be more connected than John Corzine?

Yet he wasn't bailed out. It's clear to me that if a firm run by someone like that is allowed to fail, we shouldn't count on the government being able to bail everyone out and prop everyone up.

TCR: Because it can't.

David: Exactly.

TCR: Is there any way to keep your assets safe, or at least safer? How about taking physical possession of paper securities certificates? Or getting the securities registered directly under your name using the Direct Registration System?

David: First of all, I think that there is a drive to eliminate all paper certificates. Not many companies will issue paper certificates anymore. They're almost impossible to get in the fixed-income world. But if you are able to get a paper certificate, do it and keep it in a fireproof safe.

As for the Direct Registration System: as the financial crisis was heating up in 2008, the Depository Trust Company mentioned that they would publish on their website a list of securities eligible for DRS. Interestingly, nothing has been published on the topic since April of 2009. It's a completely cold trail.

Now, I'm not saying it's impossible to get direct registration on some things. If you can do it, great. But the industry is not making it easy. I suspect that the reason there's been no discussion of it since April of 2009 is that the securities industry realized that it would take a lot of the collateral out of the system, and they can't have that. So now it's being downplayed, because the securities industry does not want to let go of that collateral.

TCR: So if by some miracle you could get a couple of your stocks directly registered, would that provide an extra layer of protection?

David: Yes, you should do it if you can. It takes the securities out of the collateral chain.

I suspect that as more disasters occur and outrage escalates, the authorities will say, well, we created this system, but you people weren't using it.

TCR: So it's just to cover their behinds.

David: Perhaps. Or maybe they made the system preemptively, because they realize that when a catastrophic collapse does come, it will be necessary in order to restore any kind of confidence.

TCR: What about cash held at brokers? Is that in as much danger as securities?

David: Absolutely. There is no legal requirement to segregate cash, either. Although some brokers offer cash accounts that are covered by FDIC insurance, which adds a layer of protection.

TCR: Good to know. So here's the million-dollar question: if someone wants to invest in the US, how do they ensure they're as protected as possible?

David: For one, it's imperative not to have everything in one place.

Diversifying between types of assets and sectors is no longer adequate. Having all of those diversified assets with one broker could be disastrous. There are such epic risks today that investors need to diversify in ways that they have never considered. Use multiple brokers.

It's also smart to own some physical gold, which is outside the financial system. It makes sense to own land as well, as long as you have no debt against it. The advantage of land is that you can have real title to it, and if you own it debt free, you are at no great risk during a catastrophe.

That's one thing that got my family through the recession during the early '70s in Cleveland, which felt a lot like a depression to us. My dad built our house for cash. He saved until he could build it without a mortgage. At one point in the early '70s, revenues of my dad's business went to zero; we survived because we had no debt.

To me, it doesn't make sense to have debt against things, including your home, so that you can have money invested in the stock market. Paying down debt is the lowest-risk adjusted return you can get.

Finally, effective international diversification is very important. Americans are not used to thinking about this. It is possible to diversify currency, custody and systemic risk by opening accounts in other countries. Consider Canada, which has one of the soundest financial systems in the world.

But there is a considerable burden associated with that. You must report foreign financial accounts annually on FBAR forms to the Treasury and possibly also with your tax return on the new form 8938. You have to be careful with this because there are severe penalties for not meeting the reporting requirements.

TCR: To summarize, your advice is no debt, physical assets like land and gold, securities held in a variety of places and international diversification with the appropriate compliance. Any other investment tips?

David: Individuals should use insured time deposits with banks in various places. You might not think that yields on time deposits are attractive, but they are much higher than a government bond of comparable maturity, with essentially the same risk. That is one advantage individuals have over institutions, and it's an important way to protect your assets from insolvencies.

TCR: Great. Thank you very much for talking with us today.

David: Thanks for listening. This is important stuff. Few people know anything about it, and even fewer have put the pieces together.

David Webb is the founder of Origin Investments AB, which has applied to the Swedish Financial Supervisory Authority (Finansinspektionen) for permission to manage a market neutral long/short equity strategy designed to serve as a core holding for institutional investors. Mr. Webb was the founder of Verus Investments, where he managed long/short equity hedge funds with AUM in excess of $600 million. Previously, Mr. Webb was a senior managing member of Shaker Investments where he was the sole manager of long/short equity hedge funds with AUM in excess of $1.3 billion. Mr. Webb has served as an associate with the venture investment arm of E.M. Warburg, Pincus & Co., Inc., and as an associate with the Mergers and Acquisitions Department of Oppenheimer & Co., Inc. While with E.M. Warburg, Pincus, David managed the acquisition of Litel Communications, Inc., and served as a director and officer of LCI Communications Holdings Co.

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How to Invest

Our monthly look at ideas to keep your portfolio aligned with the bigger trends.

We have an exciting investment recommendation for you this month – a unique company in an emerging industry, with one of the most compelling competitive advantages we've ever seen. Let's get right to it.

New Investment Recommendation

PetroLogistics LP (PDH)

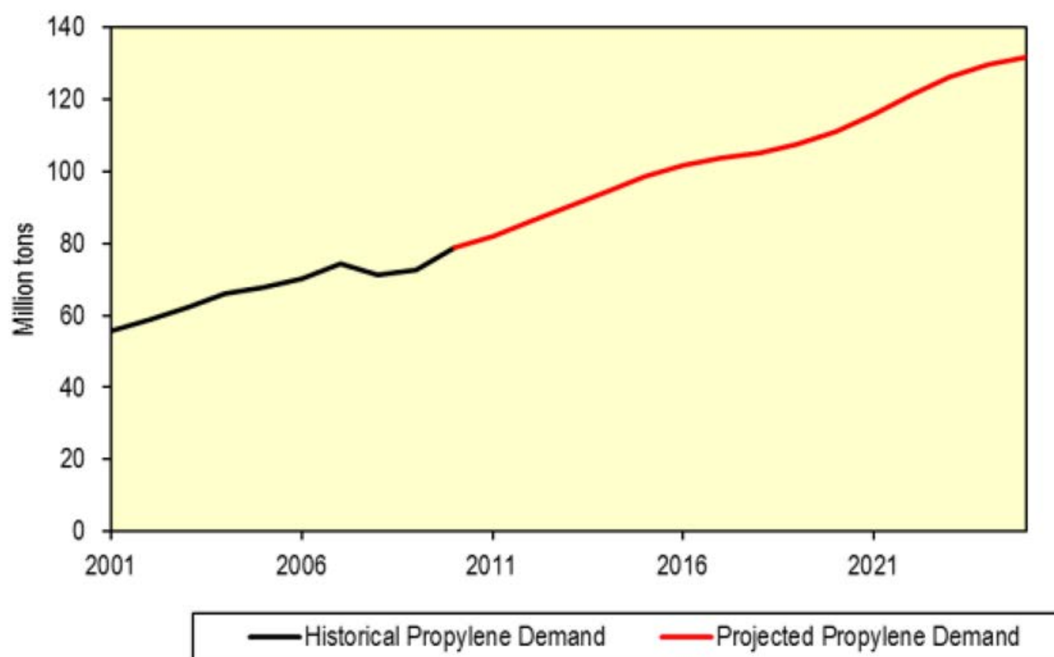
Executive Summary: PetroLogistics is the only on-purpose propylene producer in North America, and will be for the next few years. As other propylene sources continue to decline, PetroLogistics has an opportunity to profit handsomely. **High Risk**.

The Trade: Wait for guidance on when to buy PDH.

Current Price	$13.28	52-Week Range	$10.00 - $17.06
Market Cap	$1.8 billion	LT Debt to Equity	117.6%
Revenue (TTM)	$741.1 million	Projected Dividend Yield	8.02%
TTM EPS (Diluted)	($0.68)	Interest Coverage	2.83
Forward P/E Ratio	8.3	TTM EBITDA Margin	17.0%
Price-To-Book Value	6.2	TTM Return on Assets	7.4%

Most people have probably never heard of propylene, even though it's the second most used chemical commodity in the world. That's because it's a "behind-the-scenes" chemical, primarily consumed as an intermediate in other chemical manufacturing processes. But it's a component in *a lot* of stuff: paints, building materials, automotive parts, packaging and a wide range of plastic products, just to name a few.

Global demand for propylene is about 80 million tons per year, and the US accounts for about 25 million of those tons. Demand typically increases at about the same rate of GDP, projected to be about 2% per year:



Source: ChemSystems

But while propylene demand steadily rises, the supply of propylene is decreasing, especially in the US. **Since 2006, total US propylene production has decreased by 3 billion pounds – or 9%**.

To understand this odd disconnect, we first need to learn a bit about how propylene is made.

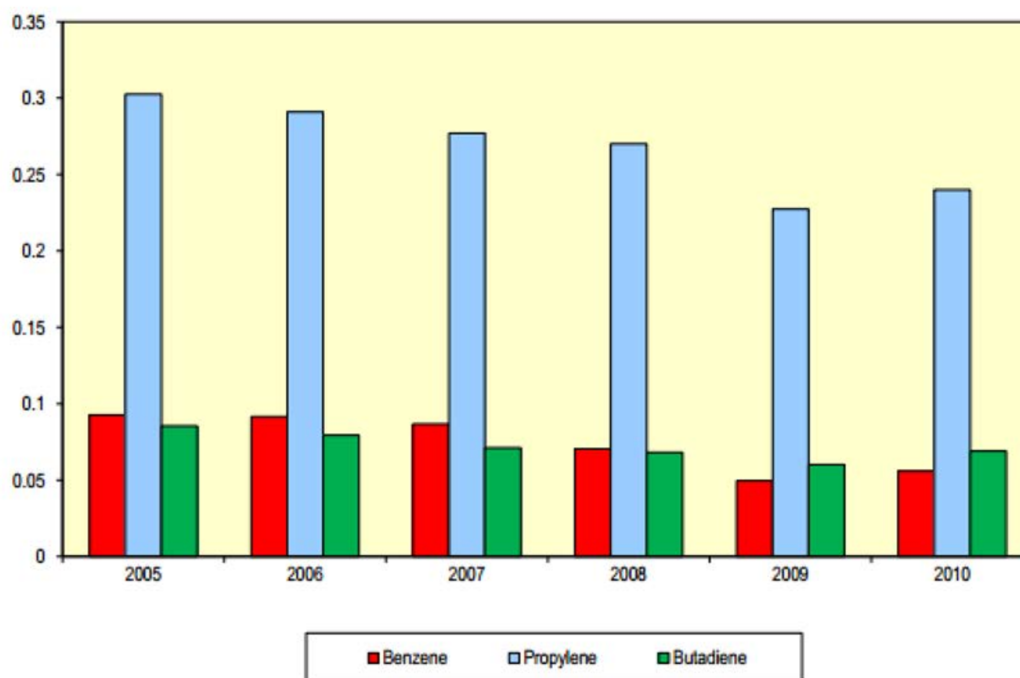
A Byproduct

Propylene comes from two processes – ethylene cracking and gasoline refining. Both of those processes produce propylene as a *byproduct*, meaning neither is done specifically for the purpose of producing propylene. As a result, the supply of propylene is highly dependent on external factors.

Let's start with ethylene crackers, which are a type of petrochemical plant designed to produce ethylene. These crackers place a hydrocarbon "feedstock" under enormous amounts of pressure to "crack" the molecules into smaller ones. Ethylene is the main output, and propylene is a byproduct.

The amount of propylene produced varies depending on the feedstock used. Ethylene crackers can use almost any hydrocarbon as a feed. When oil-derived or "heavy" feeds are used, the propylene yield is higher. When "light" feeds, such as natural gas liquids, are used, the propylene yield is lower.

Here's the key: the shale gas boom and high oil prices have pushed ethylene makers to use more light feeds than heavy feeds. The result is that **propylene production from ethylene crackers has declined by 29% since 2006.**



Source: ChemSystems

The second source of propylene – gasoline refiners – has been unable to pick up much of the slack. Gasoline refiners use fluid catalytic cracking (FCC) to convert crude oil into gasoline, and propylene is a byproduct of this process as well. Since 2006, propylene production from refiners has increased by 2% – not even close to filling the 29% gap left by ethylene crackers.

US Propylene Production - Excluding PetroLogistics	2006	2011	% chg
Steam Crackers	16.1	11.4	-29%
Refineries	17.5	17.9	2%
	33.6	29.3	-13%

The bottom line: US propylene supply has shrunk and continues to shrink in the face of growing demand.

Filling the Production Gap

There is a third method of propylene production, called **propane dehydrogenation,** whereby propane is converted directly to propylene. The actual process of propane dehydrogenation is complex and replete with technical language, but the idea is the plant refines the propane by removing two atoms of hydrogen, thus converting one molecule of propane (C3H8) into one molecule of propylene (C3H6).

Our recommendation, **PetroLogistics (PDH)**, operates the world's largest propane dehydrogenation facility. But more importantly, it's the *only* propane dehydrogenation plant in all of North America.

As such, PDH enjoys enormous advantages. Since other propylene producers only produce it as a byproduct, they often cannot or will not react to high propylene prices by increasing production. As a result, PDH doesn't have to worry about any other producers filling the gap. It has a built-in, guaranteed market.

Furthermore, PDH has the ultimate first-mover advantage. Though a few companies have built their own propane dehydrogenation facilities, none will come online for at least two years. Dow Chemical Company's plant is furthest along, but will not be finished until 2015 at the earliest.

So we have an industry with a looming supply shortage, a single company equipped to provide that sorely needed supply, and virtually no competition. In other words, PDH has immense potential.

Company Basics

PetroLogistics IPO'd in May of this year. It is a Master Limited Partnership (MLP), which means it must distribute substantially all of its net income each quarter to shareholders. As a result, we project PDH will have a juicy dividend yield – somewhere near 8% to begin, with the potential to rise north of 10%.

PDH only owns one plant, which has the capacity to convert 1.68 billion pounds of propane into 1.4 billion pounds of propylene annually. It is strategically located near the Houston Ship Channel, which contains the heaviest concentration of petrochemical and refining complexes in the world. Roughly half of all US propylene consumption is located within 50 miles of PDH's facility, so PDH has unmatched access to its customers.

PDH sells substantially all of its propylene to five big customers. Dow Chemical is PDH's largest customer and accounts for about 47% of PDH's sales. That is the same Dow Chemical that we mentioned above, which is building its own propane dehydrogenation plant scheduled to come online in 2015.

While this may sound like cause for concern, Dow has signed a contract with PDH to purchase a minimum 510 million pounds of propylene per year through 2018. That accounts for 35% of PDH's maximum capacity. So it's clear that Dow expects to need much more propylene than it can produce for itself, even after its own facility comes online.

Furthermore, PDH still has the next two years to operate virtually competition-free. Yes, there are some risks on the horizon, but we have plenty of time to reevaluate them as 2015 draws closer. Wall Street has a "what have you done for me this quarter" attitude, and rarely looks 6 months into the future, let alone a year. We can reevaluate the competitive landscape in mid-2014, with plenty of time to sell if we don't like what we find.

Finally, PDH has announced that is exploring the possibility of doubling its output. But discussions are still in the very early stages.

MLP Tax Implications:

MLPs are partnerships, which are taxed as passthrough entities. This is both bad and good for investors.

First the bad: All income and expenses earned and incurred by PDH will flow through directly to the investors in the proportion of shares they own. To account for this, PDH will send its investors a form K-1 at the end of each year and will also provide the IRS with a copy of that K-1. K-1s are complex, and the tax implications vary based on what types of income and deductions are reported. For that reason, it's best to consult your CPA if you receive K-1s.

Now the good: MLPs can offer their investors a "depreciation" shield, which is a fancy way of saying that your entire distribution may not be currently taxable. Instead, your distribution will reduce the basis of your shares, increasing your capital gain when you do sell the investment. The net effect is some of your taxes will be deferred until you sell, rather than being due when you receive your distributions, as they are when you own shares in a corporation.

High Risk

Despite all of the advantages unique to PetroLogistics, it's still a high-risk company because its profits are heavily dependent upon the spread between propane and propylene. That spread is very volatile and difficult to predict.

Propane is the simpler half of the equation. The price of propane is highly correlated to that of natural gas, and with the rise of shale gas, we expect propane prices to remain reasonably low for a long time.

But propylene prices are the wild card. Propylene prices are usually correlated to the price of crude oil, and propylene usually trades at a premium to crude. Here's why.

When gasoline refiners produce propylene as a byproduct, they have two choices: they can either sell it on the chemical market or blend it back into their gasoline. As a result, propylene almost always trades at a premium to gasoline – because when propylene is cheaper than gasoline, refiners blend it back into their gasoline, reducing the supply of propylene and increasing its price.

So, since gasoline trades at a premium to crude, and propylene trades at a premium to gasoline, propylene trades at a premium to crude.

Of course, there's an exception to every rule, and the exception to this rule is today. Propylene is currently trading at a discount to crude – a very unusual situation. Logically, these backward conditions should abate quickly, and in reality, they usually do. But this is an example of how unpredictable propylene prices can be.

So while supply and demand suggest that the price of propylene should rise, and we believe it will, that's not a given. **Propylene prices are very unpredictable**. We are willing to take that risk because of the large potential reward, but it is important to understand.

What We'll Be Watching For

PetroLogistics IPO'd in May, just a few months ago. Thus, we want to observe two events before we buy shares, because we suspect that we may be able to get a cheaper entry point.

We are waiting for two key events before buying PDH:

1. ***October 30 – Lock-up period ends –*** Most of PDH's shares are in a "lock-up" period, which means a large portion of shareholders are restricted from selling any stock until October 30, 2012. PDH's stock price could experience some downward pressure after this lock-up period expires, so we're waiting until it passes to buy.
2. ***November 15 (estimated) – Earnings release –*** Certain analysts have pegged PDH's forward dividend yield north of 14%. We think 8% is more realistic at present. For that reason, we suspect that the market may be disappointed at PDH's quarterly dividend, so we're waiting until after the announcement to buy.

Recommendation

PDH is a high-risk, high-reward company. It is both riskier and has more upside than the typical companies we follow in *The Casey Report*. If that risk/reward profile fits your investment goals, PDH is a great opportunity. If you do choose to buy it, do not allocate more than 2% of your capital to it.

We will advise you when to buy PetroLogistics.

The Speculator's Corner

Speculator's Corner Portfolio Review:

PowerShares Deutsche Bank Agricultural Fund (DBA): (Click for Original Recommendation)

DBA shares have stagnated after the summer rally. They have sold off to the lower end of the recent trading range, so we are placing a stop loss: **sell the calls if DBA closes below $28.85.** Otherwise, continue to **hold** these calls for a move higher in agricultural commodities.

iShares Dow Jones Transportation Index ETF (IYT): (Click for Original Recommendation)

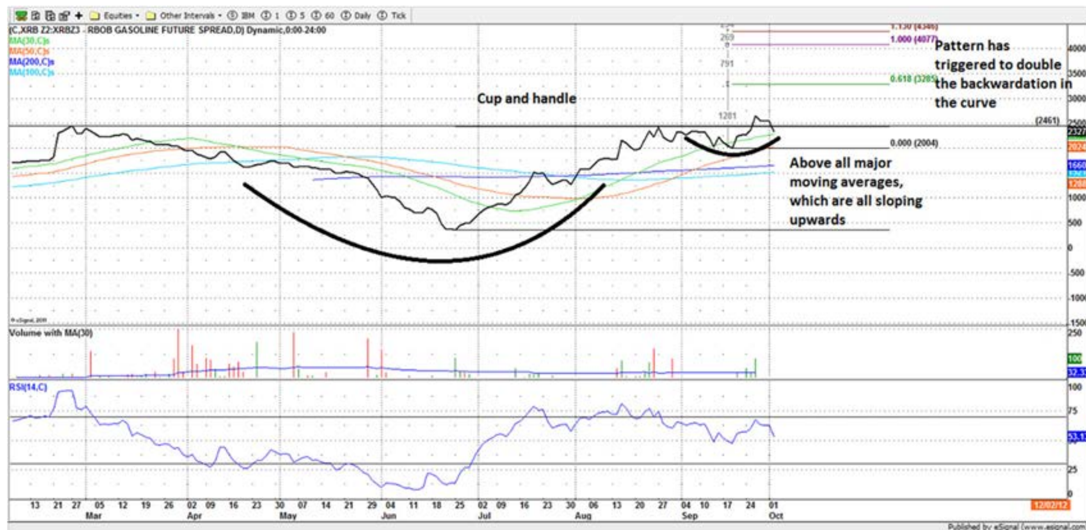
Transports continue as one of the weakest sectors in the stock market. IYT looks technically poised for a move to lower levels; **hold** these puts for a move to our initial target of $86.11.

Hedge Your Price at the Pump
By Aaron Bedrick

> **Executive Summary:** Quantitative easing by the Fed combined with tight supplies in the gasoline market indicate a likely move higher in gasoline prices.
>
> **The Trade:** Purchase UGA when it is trading between $56.19 and $58.31. Sell for a gain if it reaches $67.25. Stop the position out by selling if it closes below $54.65.

The Fed has pulled the trigger on QE-infinity, and the side effects of free money are beginning to show. In the week ended October 5, gasoline prices in California hit their highest levels of all time, surging to $4.668 per gallon.

But QE-infinity isn't the only catalyst for higher gas prices; tensions are high in the Middle East, hyperinflation in Iran is threatening to bring civil unrest, and refinery explosions and shutdowns domestically are keeping gasoline supplies tight. The gasoline futures curve has responded and is indicating that prices are ready to explore higher levels.



Click here to enlarge.

This chart shows the 2012-2013 calendar curve in gasoline. It might appear complicated for those unfamiliar with futures contracts, but it simply represents the premium that market participants will pay to receive their gasoline in 2012 versus 2013. When demand for gasoline rises or supply declines, this premium will rise.

This is a forward-looking indicator, and it has triggered a pattern called a "cup and handle," which tells me that the premium is ready to double from current levels. That, in turn, indicates that gasoline prices should rise.

Unfortunately, these days you can't talk gasoline without talking politics, and that goes doubly with the election so close. High gas prices are often cited as a political stumbling block for incumbents, hence the conspiracy theories circulating that gas prices will be suppressed until the election. Or maybe they're not conspiracy theories: Jerry Brown, governor of California, has already taken "emergency steps" to increase the state gasoline supply, similar to when President Obama tapped the Strategic Petroleum Reserves last year.

But if politicians are trying to suppress gasoline prices, it doesn't appear to be working. The gasoline futures curve has steepened, which tells me that longer-term purchases are happening. That means that regardless of short-term political theatrics, real buyers are stepping in to take delivery of gasoline. In other words, I'm not worried about political manipulation.

Here's how the rest of the technicals look: the gasoline futures market has been consolidating since making new highs in September. I think that the gap that was left in the first week of October between $56.19 and $58.31 will be filled, giving us a chance to buy on that dip. We are far above the 100-day and 200-day moving averages, both of which are now upward sloping. This all paints a very bullish technical picture.

[Click here to enlarge.]

We recommend buying UGA when it is trading below the bottom of the recent gap, $58.31, and above the September low of $56.19. Stop out the trade if UGA closes below the July high of $54.65. If UGA rises to $67.25, sell for a profit of 15 – 20%, depending on your entry point.

This isn't our typical high-risk/high-reward speculation. The upside is only about 20%. But it's the risk/reward ratio that really matters, and for this trade, it's over 1:3. That's very attractive especially, considering that we don't need to use options.

Finally, some food for thought: every person who drives a vehicle is essentially short gasoline. Every time someone fills their car with gas, they are covering their shorts at the current market price. Everyone feels pain at the pump. This trade allows us to hedge our unavoidable exposure to gasoline and potentially earn a small profit as well.

The Casey Report Portfolio

THE CASEY REPORT PORTFOLIO[1]							
INVESTMENT	**Ref. Date[2]**	**Symbol**	**Current Recommendation**	**Price at Issue**	**Price 10/9/12**	**Price Target**	**Gain / (Loss) %[3]**
GOLD & SILVER							
Buy Gold		-	**Buy**	$937.50	$1,763.92	-	88%
Buy Silver		-	**Buy**	$17.56	$33.80	-	92%
Central Fund of Canada	10/5/2009	CEF	**Buy**	$12.98	$23.54	-	82%
		T.CEF.A		$13.90	$22.97	-	65%
Market Vectors Gold Miners ETF	9/8/2011	GDX	**Buy on Weakness**	$57.00	$52.08	-	-8%[4]
Thanks to Mr. Bernanke and his new “QE-infinity” bond buying program, GDX rose nearly 14% in September. What looked like a hopeless situation for gold miners just 2 months ago has completely turned around, and GDX is near 6-month highs. **Continue to buy GDX on weakness.**							
ENERGY PLAYS							
Vanguard Energy ETF	7/6/2010	VDE	**Buy on Weakness**	$97.17	$107.23	-	12%
AGL Resources Inc.	7/20/2011	GAS	**Buy on Weakness**	$41.28	$40.05	$50	5%
No news on GAS this month. The company is expected to report earnings on 10/31/2012. Check our portfolio page for an analysis of the results. **Continue to buy GAS on weakness.**							
Black Diamond Group	7/12/2012	BDI.TO	**Buy**	$22.17	$22.10	$28	0%
No news here. **Continue to buy BDI.**							
Access Midstream Partners, LP	9/13/2012	ACMP	**Buy on Weakness**	$31.28	$34.84	$37	11%
As mentioned in the update on our portfolio page, our newest recommendation had some very positive news earlier this month. Former parent company Chesapeake Energy (CHK) decided to sell nearly all of its midstream assets to Global Infrastructure Partners (GIP) for $2.7 billion. The sale included gathering and processing systems in the liquid-rich Eagle Ford and Utica shale plays, among others. This is very positive for ACMP because it eliminates Chesapeake from the equation. GIP, ACMP’s general partner, now owns an array of attractive assets that it can drop down into ACMP as it sees fit. The market cheered the news, which pushed shares of ACMP up nearly 15% in September alone. The stock price has appreciated rapidly in the last few weeks, so we recommend **buying ACMP on weakness.**							
EMERGING TRENDS							
American Water Works Company Inc.	8/11/2011	AWK	**Hold**	$31.16	$36.75	$38 - $42	21%
No news for AWK this month. The company is slated to report earnings on 10/31/12. **Continue to hold.**							
Brasil Foods SA (ADR)	10/13/2011	BRFS	**Buy on Weakness**	$20.29	$17.91	$24-$28	-11%
BRFS upped its Middle East exposure after agreeing to acquire a 49% equity stake in Federal Foods Limited, which is located in the United Arab Emirates. We like the deal – it gives BRFS yet another growth avenue for its food-processing business. **Continue to buy BRFS on weakness.**							
National Oilwell Varco	5/10/2012	NOV	**Buy**	$68.43	$80.09	$95	17%
Just one indirect piece of news on NOV this month: Brazilian oil giant Petrobras (PBR) disclosed that it is seeking a partner to invest in US offshore deepwater oil fields, which hints that PBR has figured out how to extract this hard-to-access oil. NOV has been acquiring companies that make parts for Floating Production Storage and Offloading (FPSO) vessels, which would be used by PBR to extract deepwater oil. NOV has positioned itself to reap the rewards from the Brazilian deepwater oil extraction, and we’re getting closer to seeing if it pays off. NOV will report earnings on 10/25/2012, and we’ll have analysis on our portfolio page. **Continue to buy NOV on weakness.**							

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Hillenbrand, Inc.	6/14/2012	HI	**Buy**	$17.53	$18.58	$26	7%
The usually quiet Hillenbrand had a busy month. The Funeral Consumer Alliance (FCA), which has been engaged in a lawsuit with Hillenbrand since 2009, closed its case after a US Fifth Circuit Court of Appeals denied the FCA's request for a class-action lawsuit. The FCA alleged that Hillenbrand violated anti-trust laws by limiting casket sales to only licensed funeral homes. Not only does this remove an albatross that's been hanging from HI's neck since 2009, it also terminates certain restrictive covenants and other agreements entered into between Hillenbrand and its former parent, Hill-Rom Holdings. These restrictions and other agreements limited Hillenbrand's ability to increase dividends and engage in certain acquisitions, so this is excellent news. Hillenbrand also acquired privately held HMIS Inc. on September 29 for an undisclosed sum. HMIS is a back-office and operations management technology system provider to funeral homes, cemeteries and crematories in the US, Canada and Central America. We like this acquisition; it complements Hillenbrand's "Batesville Interactive" suite of online applications, which is the number-one provider of funeral home website solutions in the industry. This is good news for Hillenbrand and its shareholders. **Continue to buy Hillenbrand.**							
GLOBAL DIVERSIFICATION							
iShares MSCI Chile Investable Market Index Fund	2/3/2011	ECH	**Buy**	$70.83	$62.31	-	-9%
Global X FTSE Norway 30 ETF	2/3/2011	NORW	**Buy**	$15.93	$15.22	-	-2%
WisdomTree Emerging Markets Equity Income Fund	2/9/2012	DEM	**Buy**	$57.63	$53.28	-	-5%
DIVERSIFY CASH							
Norwegian Krone	6/3/2010	NOK	**Buy**	0.1542	0.1745	-	13%
Canadian Dollar	6/3/2010	CAD	**Hold**	0.9542	1.0225	-	7%
The announcement of QE-infinity reminded us why we diversify into different, stronger currencies. Now more than ever, we reiterate our recommendation that readers diversify cash between Canadian dollars, Norwegian krone and US dollars. EverBank World Currency CDs are the best way to go.							

[1] This sheet represents our current portfolio recommendations and is not a comprehensive track record.
[2] Reference date is the release date of the publication when the recommendation was originally made in The Casey Report.
[3] Includes Dividends
[4] We also hold a free ride position in GDX, which we recommended for purchase on 1/14/2010 and recommended a free ride on 4/14/2011. We netted a 28% gain upon taking the free ride, which is not included in GDX's performance above.

***Portfolio Page Updates:** Get the latest on your companies by regularly visiting the portfolio page on our website, or click here.

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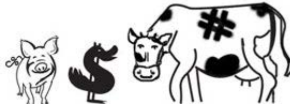
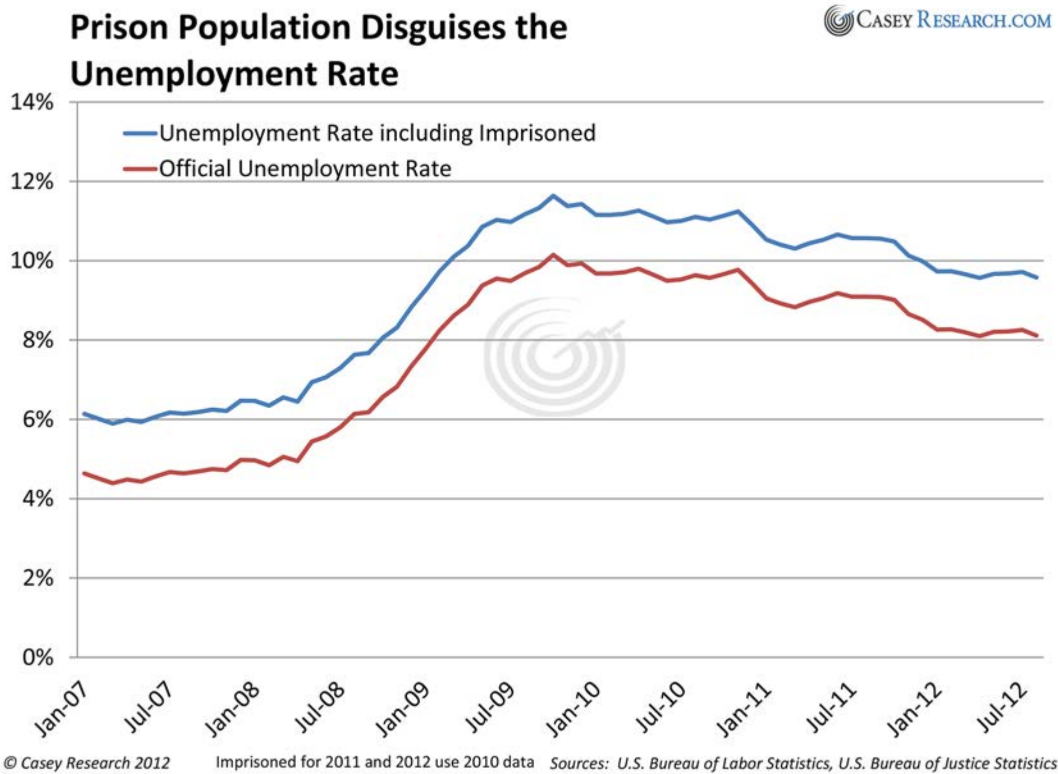
Casey's Data Farm



A monthly recap of data worth paying attention to.

Unemployment Rate Does Not Count Prisoners

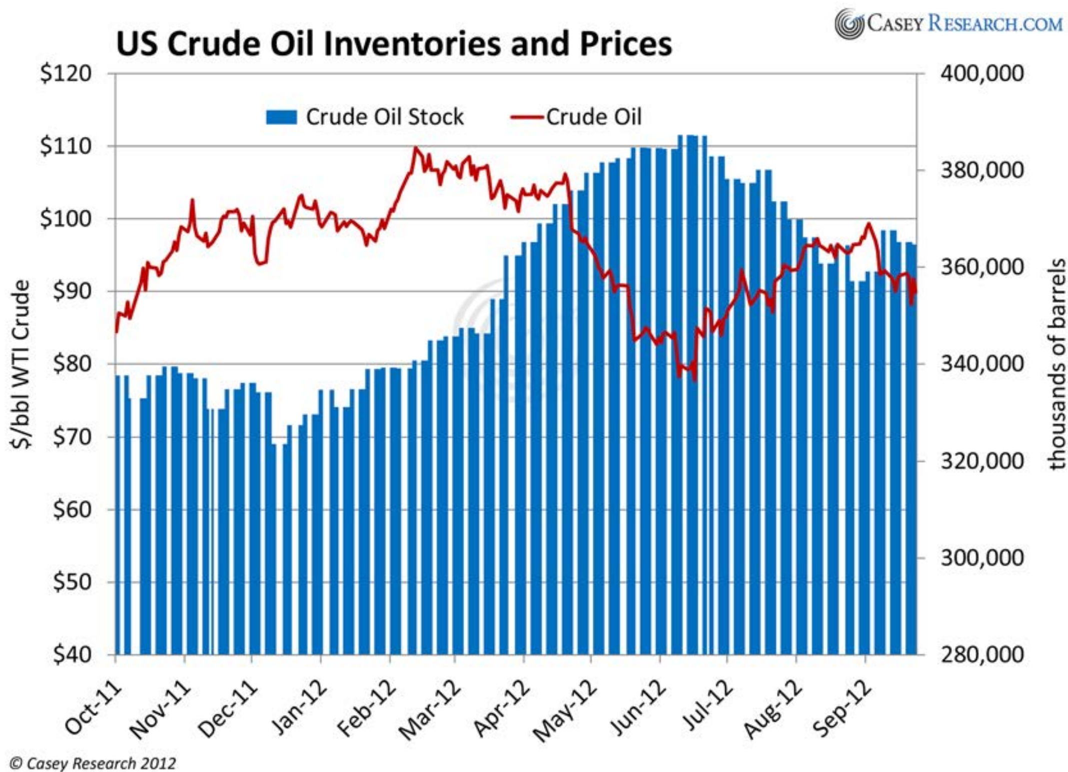


When comparing unemployment rates from country to country, one important factor often left out of the discussion is the rate of incarceration in the United States. At 753 prisoners per 100,000 people, the United States has the highest per-capita incarceration rate in the world. In total, we have almost 2.3 million people in our prisons. If this number were added to our unemployment data, the unemployment rate would be closer to 9.5% than 7.8%.

In some ways, the prison population is more significant to the health of the economy than the average unemployed worker. Sure, the unemployed aren't productive, and in some cases they require benefits, food stamps or other programs. But prisoners are completely unproductive while costing their respective states tens of thousands of dollars to keep them in prison. Furthermore, when these prisoners get out, they're often not model citizens, and their criminal record reduces their chances of getting a job.

If other countries had similar incarceration rates, these numbers wouldn't matter, but considering that we're at the top of the list, it makes a big difference in comparison. If these people weren't in jail, they'd be out on the streets – with probably more than a few looking for a job. Not all of them, but certainly enough to impact the unemployment rate.

Crude Oil Prices Are Listening to the Fundamentals

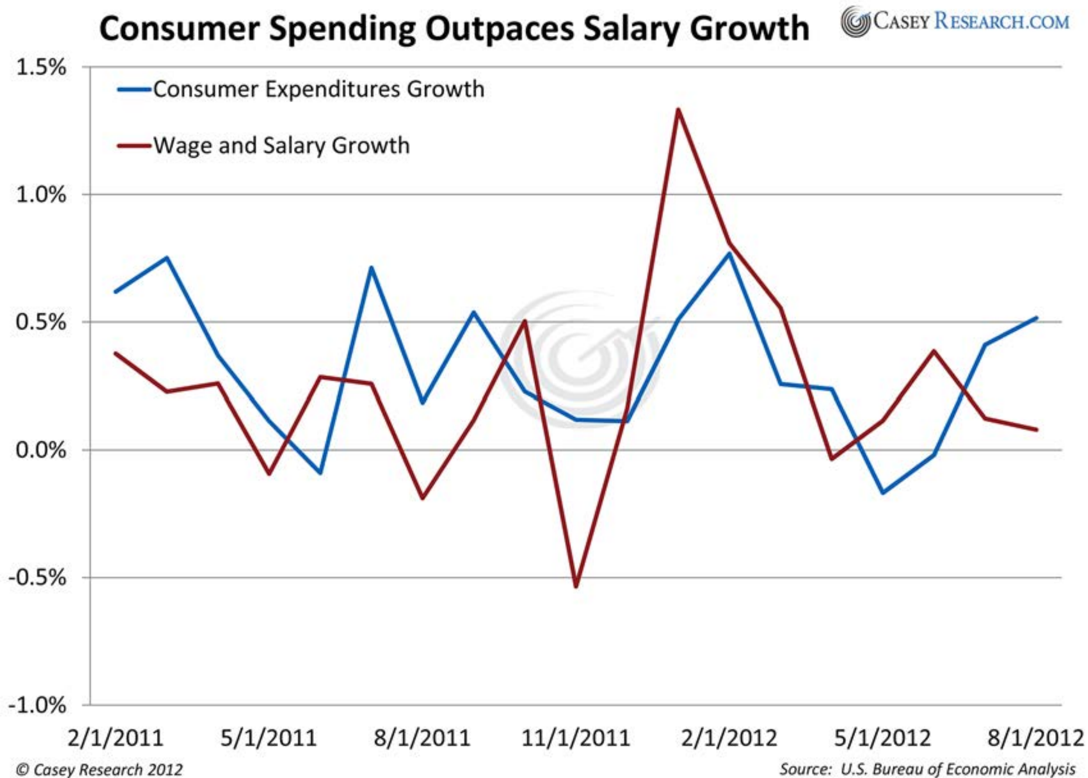


From October 2011 to mid-April 2012, WTI crude prices had a mind of their own and did not heed the fundamentals of supply. As inventories grew from a bottom from late December 2011, oil prices continued to rise anyway.

But in the last six months, the crude oil price has changed its behavior. As inventories rose to a peak in late June 2012, oil prices bottomed out to an eight-month low. Then, as supplies began tapering off, crude prices rose again. Now, with inventories rising again in recent weeks, prices are on the decline.

This is significant because it indicates that oil traders are less concerned about the geopolitical situation than they were before. While problems in the Middle East are still unresolved, the domestic supply situation has been the primary driver of the oil price lately.

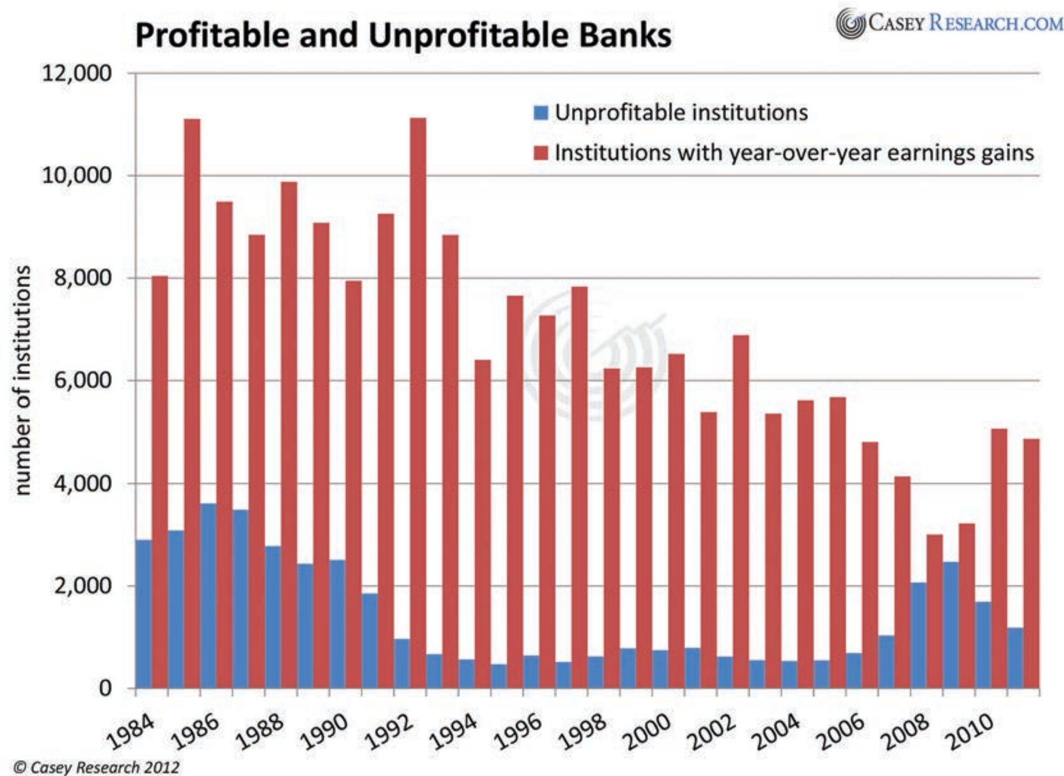
Consumer Spending Is Not Being Driven by Wage Growth



Though consumer spending has recently jumped, the growth isn't organic. As the chart shows, consumer spending is not being matched by higher wage growth. That means consumers are either digging into their savings or are taking on new debt to pay for those expenditures. While such spending can give the economy a temporary boost, it's ultimately not sustainable – particularly if financed by debt.

Unfortunately, over the past year and a half, spending has often exceeded wage growth. This might not be a huge problem for now, but if debt levels start to grow out of control again, the end result will be another crash down the road.

The Banks Recovered Quickly After 2008

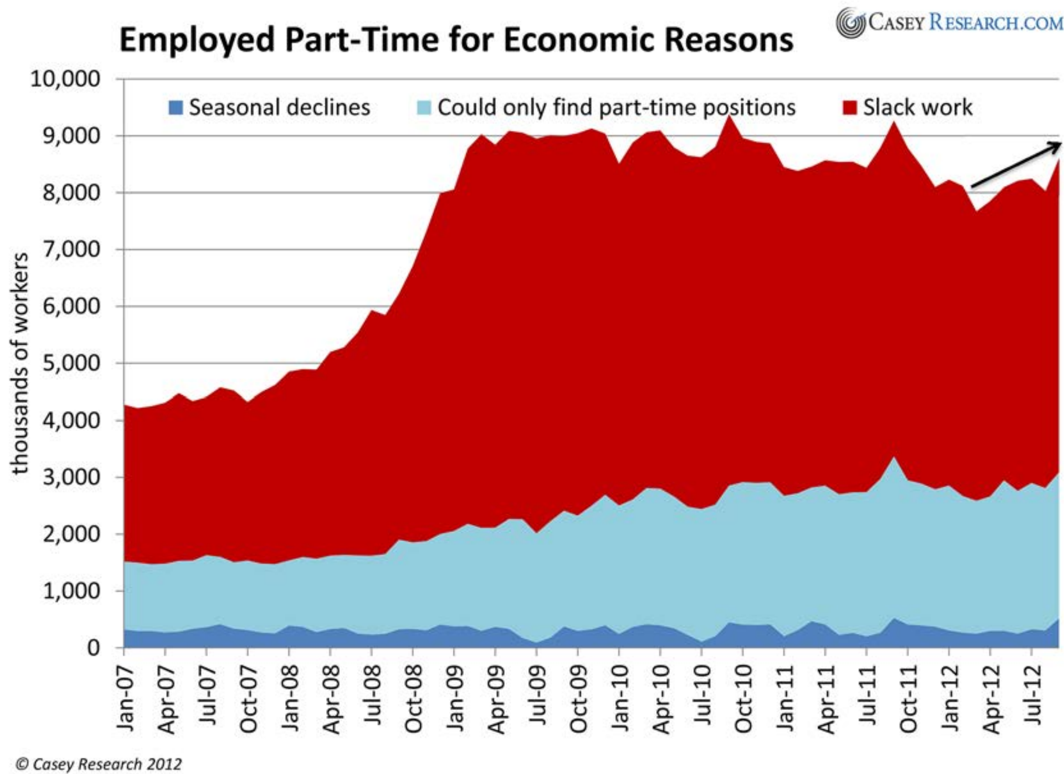


The chart above shows two interesting trends. First, notice the declining number of banking institutions since the 1980s. This is part of the march toward bigger and bigger banks. While the larger deals like Wells Fargo's acquisition of Wachovia dominate the headlines, smaller banks have been making acquisitions as well, further consolidating the industry. Big banks made distressed acquisitions during the crisis, and small banks also used it as an opportunity to snatch up local competitors.

Second, notice the quick return to profitability in the banking sector after the crisis. In 2008 and 2009, there was a quick jump in the number of unprofitable banks, but it's already receded back near pre-crisis levels. The same goes for the number of banks with year-over-year earnings gains.

Through we don't have non-bank data on this chart, it's safe to say other industries haven't recovered nearly as quickly. Chalk this up as one of the many benefits of receiving free money from the Fed and bailouts from the government.

Reasons for Part-time Work Are Changing; Total Numbers Remain High



In the September employment situation report, one of the big changes was a sudden jump in the total number of part-time workers. Since August, the number of part-time workers increased by from 8 million to 8.6 million.

You could look at the rise in part-time workers in two ways. Yes, it's a negative in that part-time work isn't as good as full-time work. Part-time workers make less money, and their jobs are less stable. If the economy stumbles again, part-timers will probably be first on the chopping block. If the situation deteriorates, these job gains can disappear overnight.

But part-time work is much better than no work, and an increase in any category of jobs is a good thing. The bottom line is that a growth in part-time jobs is a slight positive, but we would much prefer to see growth in full-time jobs instead.

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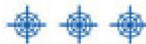


Obama Watch

A Solution in Search of a Problem

By Don Grove, Casey Research Washington Correspondent

On May 11, 2012, the US Bureau of Land Management published proposed regulations governing "Oil and Gas; Well Stimulation, Including Hydraulic Fracturing, on Federal and Indian Lands." BLM is a latecomer to this party. Its belated meddling lacks practical or economic justification. Instead, the proposed BLM rule would drive oil and gas developers off federal and tribal lands. Complying with the rules is too complicated and costly. Producers can realize a much faster and much better return on their capital investment by developing oil and gas reserves on adjoining private lands.

Federal and tribal lands hold large reserves of oil and natural gas. At a time when the United States desperately needs to move toward, not away from, energy independence, it makes no sense to let bureaucratic meddling effectively place these valuable domestic reserves out of reach. The problems with BLM's approach are myriad.

BLM Misses the Mark

First, a central, federal, one-size-fits-all approach does not work. The reserves that the oil and gas industry wants to access using hydraulic fracturing occur in areas with different geographic, topographic, hydrological, population, precipitation and umpteen other characteristics. The oil and gas deposits are found at different depths, the water table is at different depths. The surface and subsurface vary dramatically, ranging from the Marcellus Shale Formation in the Northeast to the San Juan Basin in the Southwest. States and tribes have long ago stepped up to the plate with sensible regulations suitable to their individual conditions. They are way ahead of BLM.

Second, even if states and tribes did not already have this under control, BLM's proposed regulations are inappropriate. The BLM regs are based on inaccurate assumptions, flawed economics and a perceived but actually non-existent need.

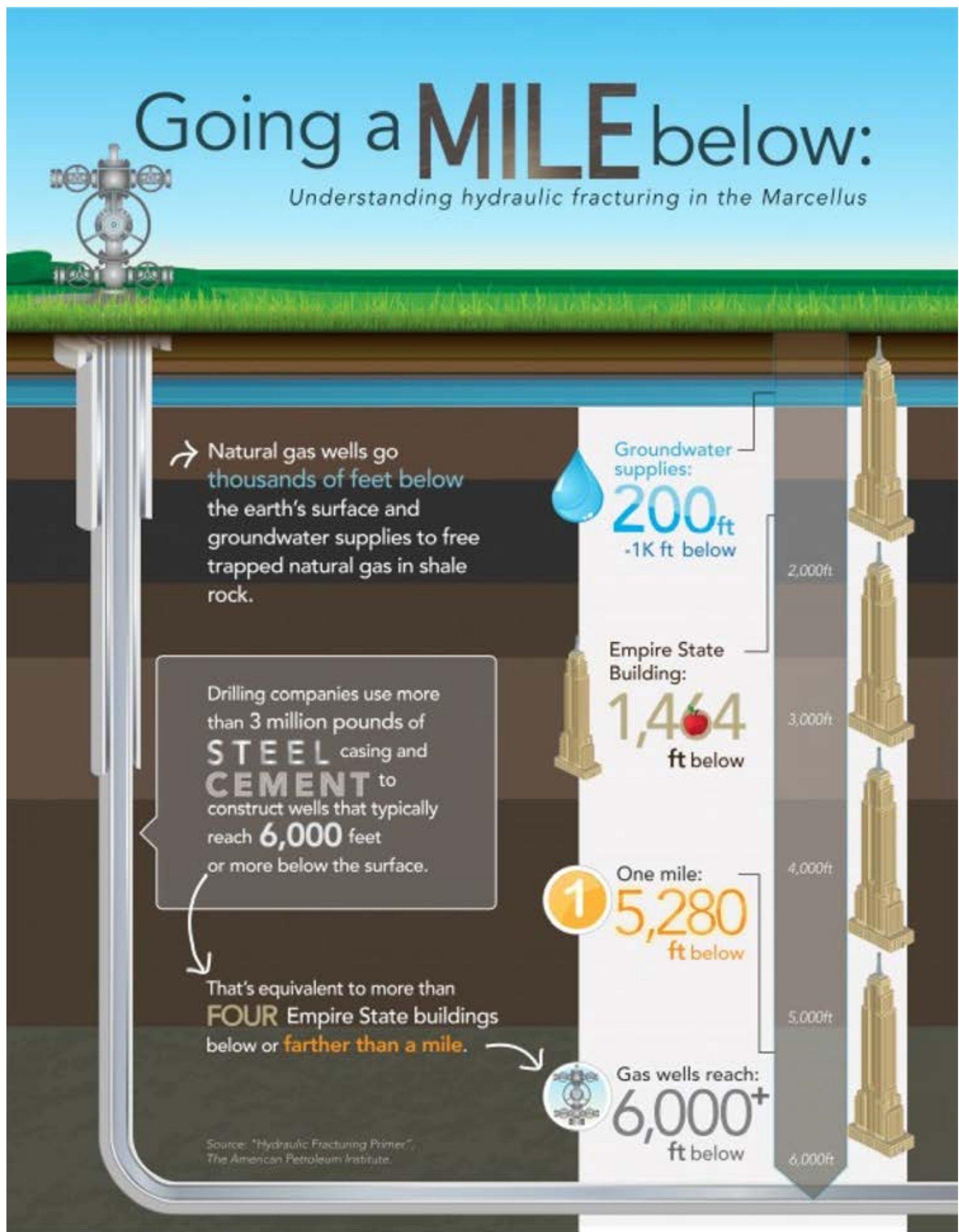
"[I]t is assumed" (by BLM for its base case) "that a certain number of well stimulation events may result in contamination and thus pose a cost to society." This is the foundation of the agency's flawed estimation of "social benefits" ranging from $11.7 million to $50.3 million per year. We are left to guess what those social benefits might be. Despite hysteria about fracking causing earthquakes, contaminating aquifers and about explosive gases coming from kitchen sink faucets, there is actually no evidence that fracking causes such problems. Indeed, the Association of American State Geologists (AASG) "recognizes that the environmental record of hydraulic fracturing activities over the past 60 years has been overwhelmingly positive."

Probably the most frequent indictment of fracturing is its potential contamination of drinking water. But the AASG further notes that "geologic data generally show a significant vertical separation between most oil and natural gas reservoirs targeted for hydraulic fracturing and the shallower freshwater aquifers." (See here.) In other words, fresh water is not typically found anywhere near the fracturing area.

BLM acknowledges that about 3,400 wells, roughly 90% of all wells drilled on federal and Indian lands each year, use hydraulic fracturing. But it offers no evidence of groundwater contamination as a result of that fracking. As noted by Donovan Schafer in his excellent article, *Frack Attack*: "Freshwater sources can, in fact, be contaminated by oil and gas activity. However, the contamination is not a result of the actual fracking process. Instead, it is caused by poor drilling practices and surface spills."

Even Matt Watson, an energypolicy specialist with the Environmental Defense Fund, acknowledged that “the term ‘fracking’ is being used for all the things in the process that can cause problems. Most of those problems have nothing to do with the actual fracking.”

Elizabeth Ames Jones, chairwoman of the Railroad Commission of Texas, testifying before the US House Committee on Science, Space and Technology, said: “For fracturing fluid or the natural gas or oil to affect the water table in Texas, those substances would have to migrate upwards [through] thousands of feet of rock, sometimes even miles. It is simply geologically impossible. The stories of environmental damage or contaminated drinking water from hydraulic fracturing are simply untrue. You have a better chance, frankly, of hitting the moon with a Roman candle than fracturing into fresh water zones by hydraulic fracturing shale rock.”



That comes as no surprise since fracking fissures tend to radiate horizontally, not upward. Even if they did radiate upward, those thousands of feet of multiple layers would blunt their progress long before they got anywhere near fresh water. This illustration shows how far the Underground Source of Drinking Water ("USDW") is from fracking operations.

Prohibitive Costs

BLM badly underestimates the cost of compliance with its proposed rule. Oil and gas developers already face costly delays in obtaining BLM approval of Applications for Permits to Drill (APDs). The cost of gathering, compiling and submitting the additional information BLM now wants is real, substantial and not realistically tied to any benefits. Operators already submit information on well bore integrity, casing and cementing programs to the agency through the existing APD process. The BLM rule adds 10 more categories of information to be supplied.

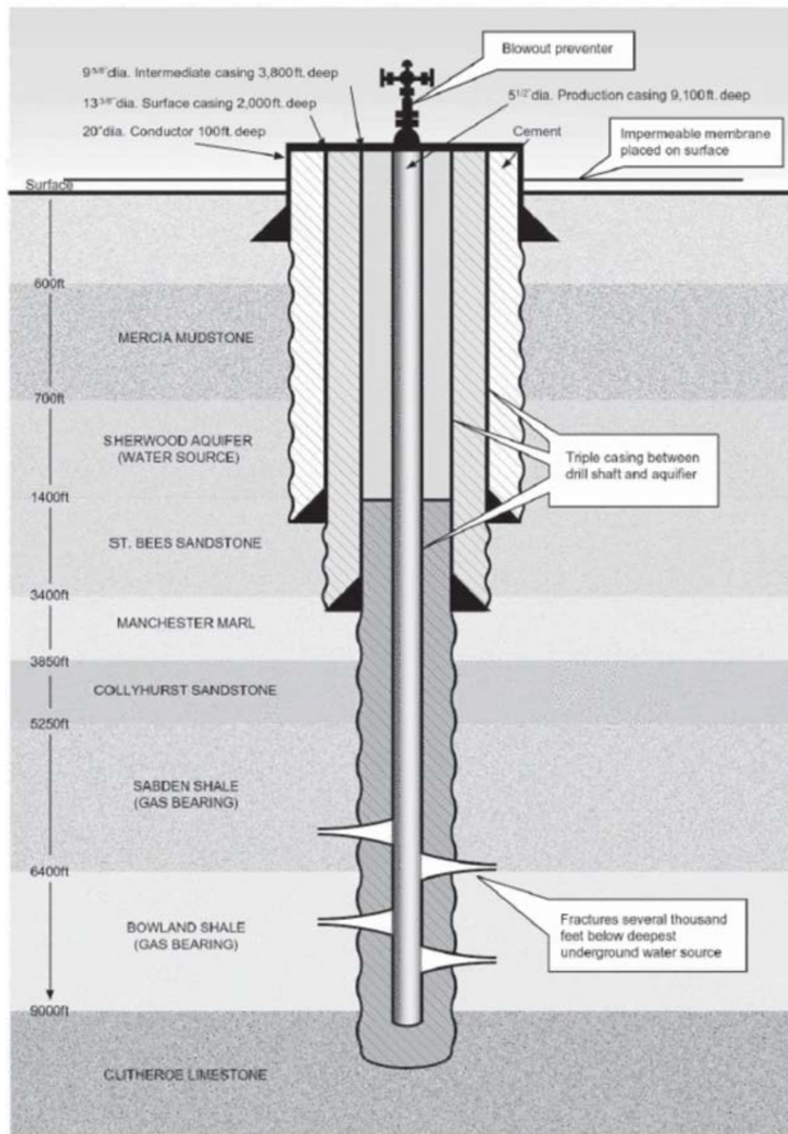
BLM is already limited by a shortage of staff having necessary expertise. The proposed rule would compound delays and the resulting expense as BLM struggles to deal with added responsibilities. I am reminded of the sensible admonition: "Never holler 'Whoa!' at a horse race."

The delays imposed by BLM's unnecessary "cement bond log requirement," (see side bar) for example, complicated by its more stringent requirement to isolate "useable" rather than "fresh" water, will mean that drilling rigs will sit idle at a cost of over $20,000 per day. Let me explain.

The following illustration shows a typical configuration of nested well casings, each cemented within the wellbore, passing through the Sherwood aquifer in the UK. As you can see, the fresh water in the aquifer is thousands of feet above the fractures.

What is a Cement Bond Log?

Developers inject cement to fill the "annulus" – the space between the steel pipe called the well "surface casing" and the wellbore (the hole drilled through earth and rock). Fresh water, in groundwater aquifers, is relatively near the surface. Oil and gas production fluids are isolated from that fresh water by the surface casing and the cement in which it is embedded. Cement is injected through the casing pipe into the bottom of the hole where it pushes back up through the annulus until it completely fills the wellbore surrounding the surface casing all the way to the surface. A bond between that cement and the casing ensures that no contaminants from below find their way into fresh-water zones that the well passes through. A "cement bond log" documents data from a probe of the wellbore that uses sonic technology to detect any gaps or voids in the cement.



[Click here to enlarge.]

BLM has dropped its definition of "fresh water," however, and now proposes that producers also protect "useable water" (found at much greater depths) with cemented surface casings. "Useable water" includes water that is in fact not "useable" at all, water containing up to 10,000 parts per million (ppm) of total dissolved solids (TDS). For comparison, EPA's drinking water standard for humans is only 500 ppm TDS. The cost of extracting and treating supposedly "useable" water (that is actually heavily laden with dissolved solids like salt and sulfate) far exceeds the value of any practical usage.

Furthermore, to protect that "useable" water, drillers would need to extend the surface casings thousands of feet deeper. Then, to comply with the cement bond log requirements, they would need to wait for the cement to fully cure, run the sonic probe, produce the cement bond log, submit it to an inadequately staffed BLM and wait 30 days for approval.

The time costs would be prohibitive. Drilling rigs can't just sit idle waiting for these preliminaries to be finalized. Instead, they will be decommissioned and moved elsewhere at great expense –greater expense than can be justified. These costs are completely overlooked by BLM. Faced with such costs of developing oil and gas on federal and Indian lands, operators will go elsewhere.

Indian Country Speaks Out

BLM is just "occupying the field," making sure it has a hand in this rapidly growing industry, but without regard to the unintended consequences of its actions. BLM's proposed fracking rule would result in reduced domestic oil and gas production generally and a reduction in revenues from federal and Indian lands.

Indian tribes would be particularly hard hit. The United States government has a solemn, long-standing trust duty to American Indian tribes. That includes BLM. These actions by the tribes' federal trustee wreak havoc with the tribes' opportunities to earn badly needed oil and gas revenues from their reservations. The federal government also has a trust duty to American taxpayers as the custodian of our public lands. American taxpayers, the true owners of federal lands and beneficiaries of federal land management, are probably not as acutely aware, as are tribes, of the irresponsible actions of their trustee.

Meanwhile, the predicament of both tribes and taxpayers is worsened as wells drilled on neighboring private lands drain common reservoirs. A similar situation is happening off the Florida Keys where our own domestic oil and gas industry is barred from drilling while foreign operators, as guests of Cuba and with less environmental constraints, are free to suck common reservoirs dry.

I recently attended a meeting at the White House with representatives of oil- and gas-producing Indian tribes at which they urged Obama administration officials to withdraw the proposed BLM fracking rule. Dan Utech, deputy director for Energy and Climate Change on the White House Domestic Policy Council, stated that President Obama's "All of the Above" energy strategy calls for responsible development of oil and gas resources, as stated in his State of the Union address and in later speeches. Dan said it was important to pursue fracking prospects responsibly and acknowledged that BLM may have taken a "crooked path" toward that objective.

The tribal representatives – seasoned veterans of the real world of oil and gas production – explained why BLM's proposed rule failed to advance that objective. They asked what pitfall BLM is seeking to address. They discussed cement bond logs as an example of how the BLM rule imposes a huge economic burden that is not justified by any corresponding benefits, and without correcting any contamination problem.

The tribal representatives took issue with BLM's shift from protecting not just fresh water but all "useable" water from drilling. Operators normally extend surface casing down to a depth of 1,500 to 2,000 feet – way more than enough to protect "fresh water." Running the surface casing to the depth of all "useable water" would mean extending the surface casing thousands of feet deeper. These new requirements push tribal oil and gas, and oil and gas on federal lands, out of the market.

Dan Utech said that the concern about BLM approval delays was at the top of their list and that others from the drilling industry had already brought it to the attention of Obama administration officials. He said, "We want to be damn sure we get this right and take the time to do it right." He did not identify the pitfall the rule was designed to address or explain what the rule was a remedy for, despite requests that he do so. Nor did he consider the possibility that the "right" role for BLM might be doing nothing at all.

During markup of House Bill 3973, the Native American Energy Act, Don Young, chairman of the House Natural Resources Committee's Subcommittee on Indian and Alaska Native Affairs, successfully passed an amendment that would prohibit the BLM rule from applying to Indian lands unless the Indian land owner gives express consent. Young said: "With their new fracking rule, the Obama administration is doing a real disservice to America's tribes. By giving Indian tribes the option to follow this new rule, my amendment simply increases tribal control over their lands and eliminates this new layer of bureaucratic red tape."

Although not discussed at the meeting, Congressman Bill Flores (R-Texas) has separately introduced H.R.6235, "a bill to delay action on the proposed rule regarding well stimulation on federal and Indian lands until such date as the secretary of the Interior submits a report examining certain effects of such rule." H.R.6235 was referred to the House Natural Resources Committee.

Just Say No

I would summarize the message from Indian Country as this: the Obama administration needs to call off its dogs. Tribes are already quite sophisticated with respect to oil and gas development including fracking. Preferably BLM should withdraw its rule and simply leave tribes alone. By inserting itself at this stage, BLM is just delaying tribal energy development to the detriment of tribes without corresponding benefit. Tribal representatives emphasized that the BLM rule is a solution in search of a problem. They said there has not been one incident of groundwater contamination as a result of fracking. They emphasized that Indian lands are not public lands.

Perhaps most important, the proposed BLM rule and the method by which it has been promulgated so far lacks respect for tribal sovereignty and authority. Fortunately, nothing in federal statutes requires subjecting tribal lands to the same standards as federal lands where tribes are capable of managing such matters themselves. In fact, the Indian Mineral Development Act protects the right of energy-producing tribes to develop their mineral resources as they deem appropriate. Moreover, federal Indian mineral leasing regulations may be superseded by tribes. Tribes could simply exempt themselves from these proposed BLM regulations unilaterally.

Tribes may be able to squirm out from under the heavy, dead hand of this federal agency. The American taxpayers, however, still get screwed. There is little question as to whether BLM has jurisdiction over public lands.

So what does all this mean for oil and gas exploration and development enterprises? If BLM does not back off, developing oil and gas resources on public lands may be more trouble than it's worth. Developers may be able to work with Indian tribes, however, to develop oil and gas resources on reservations without having to deal with BLM.

None of the Above

The Obama administration's energy policy is ostensibly "all of the above." That is supposed to mean that, in the interest of energy independence, the administration supports and encourages development of all forms of energy. Of course we know that is simply not true. The administration has engaged in a blatant war on coal, has blocked onshore leases on public lands, has restricted offshore drilling and has blocked the Keystone XL pipeline. The Obama energy policy would more accurately be described as "none of the above," at least with respect to fossil fuels.

This no-fossil-fuels policy makes no sense. It is a disservice to all Americans who rely on readily available, affordable energy. It is a further disservice in that it hogties an entire sector of the economy, resulting in lost jobs and the reduction of otherwise available federal and tribal revenue. Even for an administration unashamedly working in collusion with its favored friends to the detriment of the rest of the nation, this policy does not add up.

It is time for voters and taxpayers to follow the example of energy-producing Indian tribes and just say no.

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End Note

A closing comment by Doug Casey

It's almost election time, and this is the last issue of *The Casey Report* you'll receive before you're confronted with the choice not just of whether to vote for Tweedledee or Tweedledum, but with the much more fundamental choice of whether or not you should engage in the pathological charade in the first place.

I'll go into some of the reasons why you shouldn't in the next *Conversations with Casey*. But in the meantime, consider the thoughts of Albert Jay Nock. Like Lysander Spooner, who was featured here last month, Nock (1870-1945) is one of the leading thinkers in American history, but one who's never noted in school books, if only because his best-known book is titled *Our Enemy the State*. Consider his words below as you decide what to do in the coming election.

> "The State's criminality is nothing new and nothing to be wondered at. It began when the first predatory group of men who clustered together and formed the State, and it will continue as long as the State exists in the world, because the State is fundamentally an anti-social institution, fundamentally criminal. The idea that the State originated to serve any kind of social purpose is completely unhistorical. It originated in conquest and confiscation – that is to say, in crime. It originated for the purpose of maintaining the division of society into an owning-and-exploiting class and a propertyless dependent class – that is, for a criminal purpose.
>
> "No State known to history originated in any other manner, or for any other purpose. Like all predatory or parasitic institutions, its first instinct is that of self-preservation. All its enterprises are directed first towards preserving its own life, and, second, towards increasing its own power and enlarging the scope of its own activity. For the sake of this it will, and regularly does, commit any crime which circumstances make expedient."
>
> Albert Jay Nock, *The Criminality of the State*, American Mercury, March 1939.

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