

## Overview

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### The New Paradigm

Access to money remained very easy. This resulted in a fascinating phenomenon because rising real estate prices created added demand that mopped up this easy supply of cash. The rising real estate prices made everyone look richer. Yet all they really did was make everything more expensive. The flow of money that goes to the U.S. market and to some extent to the European market is impressive. Real wealth comes from increased productivity or increased capital. In this case the higher numbers only meant added cost of owning property. This resulted in inflation. The increased wealth did not increase purchasing power nor standards of living, but increased borrowing in the U.S. and other places such as the U.K. and Australia. Now since we are awash in liquidity we think that life is beautiful and we are living in a "new paradigm." It is a dejavu all over again. I remember at the beginning of the year 2000 there was this "new paradigm" discussion among many economist and the folks of Wall Street. Then happened the dot com crash, and everyone seems to have forgotten the lesson.

Of course the new paradigm is here and who knows what will bring to the world. Let's analyze how it has developed. Life of everyday layman and the economy are strictly related. If there is cash around and the prevailing philosophy is to spend it, this is what will happen. On the contrary if the philosophy is to save money, this is what people will do. In the 1970's the three countries with

more savings per person than anyone in the planet were Japan, Germany and Italy. Now the countries are Japan, China, and to minor extent the rest of Asia. The two philosophies are now practiced in the U.S. and E.U. on the spending side of the equation, and Asia on the saving side. In addition, we have a technology revolution underway in the past 20 years, and speeding up in the past 10 years. There are breakthrough inventions in biotechnology and high tech that are changing the way we live. But this has not changed yet the economic equation. When you go shopping either you got the cash or else. Since the Roman Empire we have inflation. In history inflation has been low, moderate, or high, depending on many factors. Today we have governments of all sorts, and with few exceptions, that are bashing the currency. This is the main reason of this liquidity. In addition, we have financial institutions and investors borrowing billions in one side of the currencies spectrum and then investing on the other side. This flow is determining today the increase or decrease of currency value, more than any import/export trade. So we live in a "new paradigm" where the exchange of goods and services is much less relevant that in the past to influence currencies exchange rates. In this situation it is everyone guess where we are headed. Since small businesses are most relevant for the economy, we hope that in this madness of borrowing and speculating in currencies one day it will not crash the baby. That madness is in the detail. In the 1970 it was simpler to speculate in currencies. You looked at

the statistics and then you bought Swiss Francs, German Marks bonds, and some R.E. properties in the U.S. and retire. Now the game has changed. Who pays more or less in the currencies arena? Then bingo, we borrow in Yen and Swiss Francs and invest in Euros, US dollars, Australian Dollars, and other currencies that pays more. Who cares about the trade deficit, the inflation, the deflation, the war in Iraq, etc. This is the attitude today prevailing worldwide in the financial arena. I think the greatest challenge facing America's largest investment banks is how to control the credit-derivatives market, now home to a massive \$26 trillion (with a "T") dollars - which more than doubled in size over the last 12 months.

I've written and warned about credit derivatives many times over the last several years and I remain committed to keeping you informed of the massive risks inherent to the global financial system. Is a market often viewed with deep suspicion because of its complexity and lack of transparency, has raised concerns that investors may not understand the inherent risks associated with these products. It's truly amazing that many of the banks and hedge funds which use derivatives don't always understand these securities. Sometimes, these trades are placed without identifying the other counterpart to the trade. Credit default swaps trade away from exchanges in the over-the-counter market, and tend to be negotiated privately and over the phone between traders. That's what makes them very risky because nobody is policing these trades, which start at \$5 million dollars. Remember Orange County in 1994 and Long Term Capital Management in 1998? At this point I would seriously recommend holding solid investment insurance such as gold bullion, or gold stocks. Let's not forget that over 20% of all credit

derivatives trades have yet to be matched. That's a formidable \$5.3 trillion dollars - approximately half the size of the American economy. Wall Street might ultimately fix the derivatives time-bomb before it explodes. I do not know and I do not wait that this is happening.

#### China

China long has had a pressing need to address its Non Performing Loans problem -- and limited means of doing so. With lending practices that differ sharply from those common in the West. For Western lenders, money is viewed as a scarce commodity, and loans are allocated with rates of return and profits in mind. In the Chinese system, capital has been viewed as a political asset, allocated to achieve social aims. Controls over what kinds of collateral could be used, credit histories and sources of income have not been critical considerations.

#### **The Stock Market**

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The U.S. market in my opinion is near an overdue correction. The correction should be between 7% and 10% from current levels. Probably it will not happen soon because of the massive liquidity floating around the world. Many companies today does not need to go public to raise funds. There is plenty cash in private equity funds, chasing few good deals in the market. The correction might happen in the second quarter, or most likely in the second semester of this year. In this scenario trading stocks with options become imperative.

#### **The Currency Market**

With the scenario above I remain with the following model portfolio:  
About 50% in U.S. dollars - about 10% in Euro - about 8% in GBP - about 14% in Danish Kronen, about 9% in AUS\$ and about 9% in CAN\$.  
Yen to be borrowed until the second semester of this year. You might

consider to close the position early.

Global portfolio asset allocation model.

About 50% in stock, about 43% in bonds and short-term bank deposits, and as an insurance invest about 7% in gold and gold mining stocks.

### **A word about life style.**

In the financial world professionals are obsessed by money and success. It is the adrenaline rush. I believe sometimes we should stop, look around, do yoga, exercise and meditate. Moreover, we should consider those less fortunate. Eat healthy foods, drink green tea, and listen to good music.

### **Preferred stock list**

**Life Sciences:** ABC\*, ABT\*, ARQL, ASTM, Bioxell (Swiss BXLN), BCR\*, BEC\*, BDY\*, BIO\* BMET\*, BRL\*, CEPH\*, CRL\*, DGX\*, FLML\*, HAE\*, KG\*, KND\*, MAXY\*, MCK\*, MIL\*, NTY\*, NicOX (Nuveau Marche' France), NUTR\*, NVO, NVS\* OCR\*, PPDJ\*, RMD\*, SHPGY\* SONO\* SYT\*, STKL\*, SUPG\*, USNA\* WPI\* ZMH\*.

**REIT & Construction :** EQR\*, HCP\*, HCN, IGR, HMT\*, HR, HRP, KIM\*, PCL\*, TCO\*, TRC, SNH, PHM\*, PSA.

**Gold:** BVN\* GFI\*, GLG\*, GOLD\*, NEM\*, FOR (listed TSE).

#### **Energy & Others**

ATG\*, BHI\*, CHK\*, CMI\*, COP\*, HBC\*, LFC\*, NVIC.OB, MOT\*, MMM\*, MKC\* QCOM\*, SU\*, TXN\*, UNFI\* USU\*, VE.

#### **Our preferred list of ETF, open and closed funds:**

BGRFX, EMF, EWJ\*, GLD, IGR, PBW\*, PHO\*, RYSEX, TAREX, VGENX, VHGX, VSEQX, XLE\*, XLU\*.

\* Shares with options.

**Indexes: DJI 12,621.69 - NASDAQ 2,463.93- S&P500 1,438.24- Amex BTK 771.55- Russell2000 800.34- 10-Year Treasury Bond 48.26- U.K. FTSE100 6,203.10- Nikkei 225 17,383.42- PHLX Gold and Silver 139.89**

\$-Euro 1.303 - \$-Yen 120.80- \$-CAN 85.06- \$ - AUD 77.69 \$- BP 1.96

### **Have a Great day**

*Dario A. Bianchi*

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