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WALL STREET WISH LIST

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In This Issue

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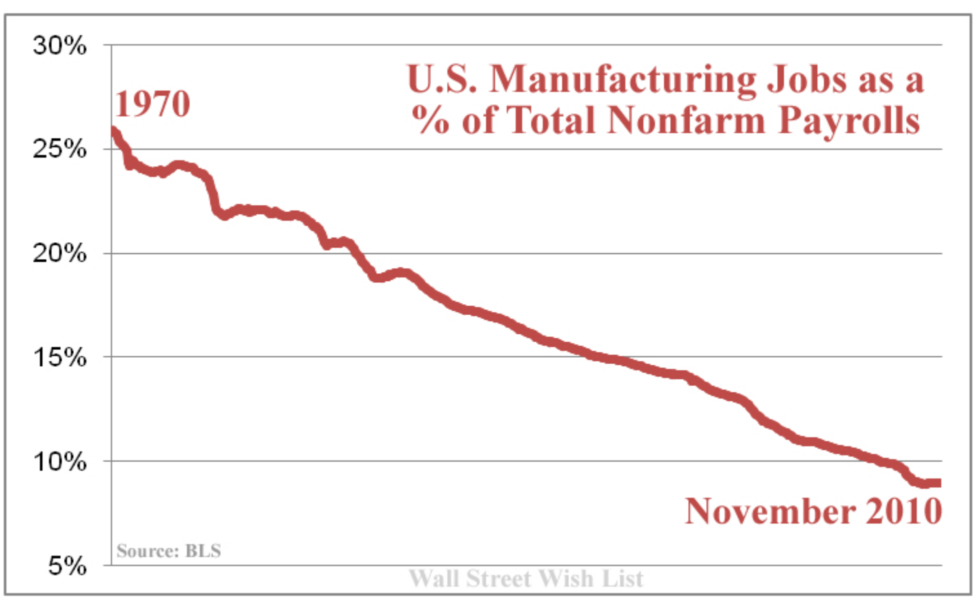
Introduction

How We Got Here

Looking up in the sky it is sometimes impossible to know exactly where a large cloud formation begins and ends. But set against the horizon a more detailed perspective is readily acquired. It is with this thought that we begin thinking about 2011 and beyond - by first stepping back and looking at the historical horizon…

Mega-Trend #1 – Labor Pains

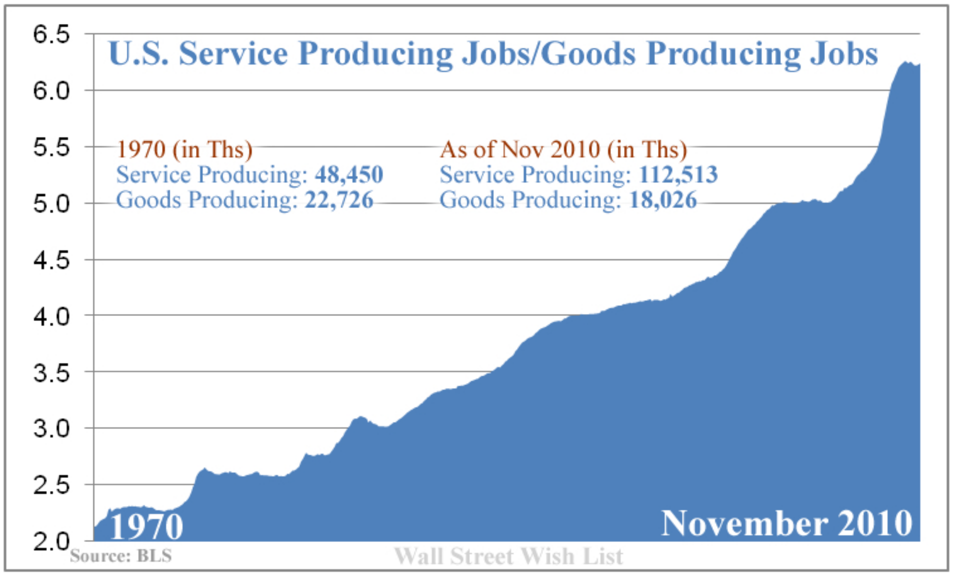
If we had to choose one chart that best illustrates the dys-functional state of the American economy, the following would win hands down.

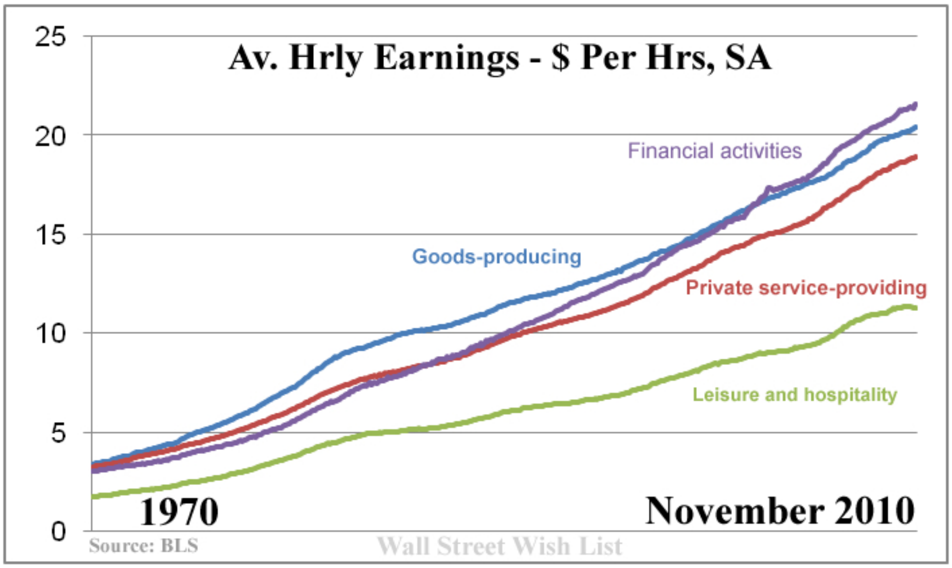


The above chart highlights the cold reality that the U.S. no longer makes things. Instead, and to use another chart, they simply import them. And while there is nothing necessarily amiss with a prolonged trend of rising imports, the disconnect between imported goods and every other indicator conceivable is stunning. For example, for the quarter ending 3Q08 U.S. imported goods had climbed nearly **60-fold** since 1970, versus only a 14-times rise in GDP. As for the unsustainable debt trends often venerated by market bears, the increase in imported goods nearly *triples* the comparative increase in surging consumer credit since 1970.

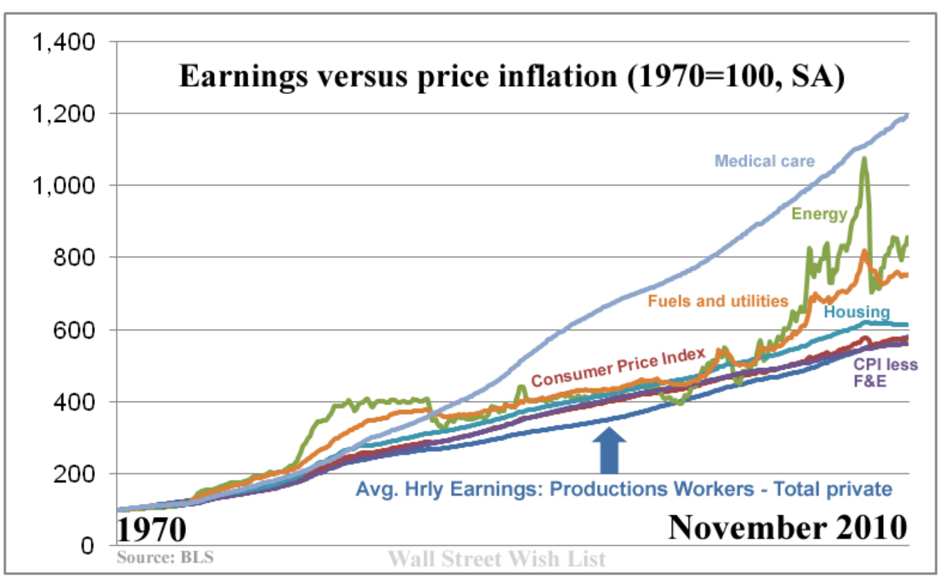
Suffice to say, even as 6.7 million manufacturing jobs have vanished since 1970, the imported goods have kept rolling in (to the tune of approximately $29,000 per manufacturing job lost). This surge has been so profound that before 4Q08 the cumulative sum of imported goods (not *total* imports mind you, just the 'goods') was $7.4 trillion more than *total* exports since 1970.

To explain this phenomenon some herald productivity advancements, which enable the U.S. to produce more with fewer workers. Others eulogize that the U.S. has evolved from that of hapless producer to the world's most sophisticated service economy. Focusing on the latter, service-related industries have indeed more than compensated for the job losses seen in 'goods' producing industries since 1970. And it is also noteworthy that jobs in the 'financial activities' arena have increased by 4-million jobs during the same time (we know how this worked out). Yet even these statistics lose their veracity when considering that most service industry jobs do not pay nearly as well as lost manufacturing jobs, and financial activities are a relatively small and volatile part of the labor market.





Along with the weakening composition/earnings of the U.S. workforce, corresponding trends since 1970 include more part-time jobs, less benefits, and more discouraged workers. In other words, it is clear that fault lines were emerging long before the most recent financial conflagrations erupted.



With a paycheck that doesn't match even the government's highly suspect computation of consumer prices, the average U.S. worker has had to find alternatives to try and maintain their standard of living. Specifically, in recent decades U.S. workers have acquired a greater tolerance for debt, funneled traditional savings into riskier pursuits, and (up until 3-years ago) increasingly turned their home equity into an ATM machine. With this in mind, the incredible rise in imported goods can be seen as a running corollary to the tremendous increases in debt and asset prices, primarily from the mid-1980s-2008. In order to test this theory, consider what happened after the third quarter of 2008, or as asset prices plunged and the credit markets tightened:

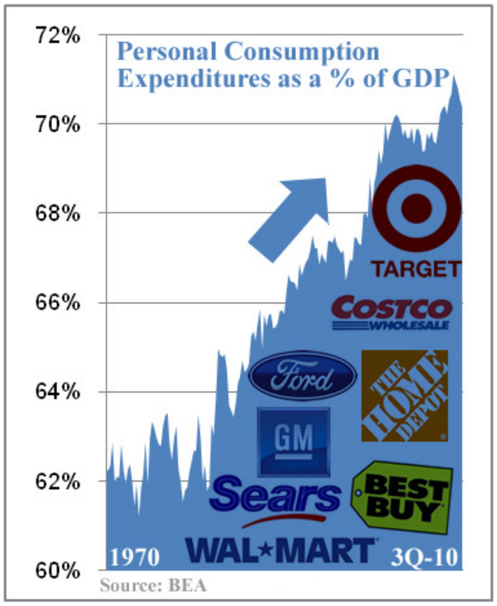
Imported goods took a $393 billion hit in 4Q-2008, and an additional $363 billion drubbing in the first quarter of 2009. These massive figures were 73% larger than the *total* hit to GDP during the same time.

As the financial crisis shifted into overdrive, many claimed that the financial system was at threat of imploding if policy makers did not print money, bailout failed institutions, and enact novel borrowing/stimulus schemes (or more of the same things that caused the crisis in the first place). However, the association that is rarely made is that 3Q08 was a major shock to the global economy because the U.S. stopped their multi-decade, highly unsustainable imported goods binge.

Whether you conclude that the meltdown in 4Q08-1Q09 was a temporary malfunction or the rupturing of a structural defect that foreshadows years/decades of economic distress, the view of the horizon is much the same: **for the better part of nearly 3-decades the U.S. economic system was based upon people living beyond their paychecks to increasingly consume imported goods.** The full ramifications of this conspicuous consumption cannot be known until the horizon broadens even further, although the moniker 'deleveraging' provides the best forecast:

"Deleveraging episodes are painful, lasting six to seven years on average…" McKinsey Global Institute
"History shows that deleveraging cycles typically last as long as seven years…" Rosenberg
"Private sector deleveraging has barely begun." Roubini (July 21, 2010)
"The Age of Deleveraging" Title of Gary Shilling book released on November 9, 2010.

Megatrend #2 – The Birth of Consequences



The most obvious concern following decades of excessive consumption (that is, consumption beyond what the level of real wages would suggest is possible), is that any economic downturn or financial market correction will be amplified given the increased linkage between consumption and rising asset prices/debt. We, and others, began noting this linkage in the late 1990s - during one of the most extreme stock market booms in history. And while the great stock market bust (2000-2002) was indeed spectacular, it did not permanently puncture the precarious investment, borrowing, and spending culture that had become pervasive in America. Rather, it would take another leg up in the housing/credit boom before consequences would emerge.

At risk of repetition, the latest downturn was, and is, profound because more jobs had become focused on catering to unsustainable advances in consumption. A popular mantra highlighting this being, 'the consumer represents more than 70% of the U.S. economy' (see left chart). Not too long ago this mantra was in the 'more than 60%' territory.

With its labor market gone bust, the consequences of a spendthrift age quickly mushroomed. Today the U.S. consumer is seen as being too indebted to increase spending, the financial market is too bruised and battered to attract another speculative herd, and the economy remains too reliant on the consumption of imports to allow for the effective multiplication of government deficit spending. This sorry state of affairs, encapsulated by a mid-recovery unemployment rate of 9.8% (or 17% when looking at U6), shows little relent, and in some respects is threatening to get even worse.

From Labor Pains To Competitive Retreat

When the latest crisis/recession hit, the U.S borrowed/printed trillions to dollars to keep its dysfunctional consumption-focused economy afloat. By contrast, a country like China enacted a $586 billion (U.S.) stimulus package dedicated to roads, railroads, airports, reconstruction efforts (in regions hit by the Sichuan earthquake), rural development, and technology advancement. The contrast is that the U.S. was dedicating resources trying to engineer a turnaround in consumption and asset prices while China was building *things*. Flash forward 25-months later (or since China announced Stimulus #1) and the U.S. is still trying to get its consumption horse to trot, while China's *overly successful* stimulus efforts have already prompted the country into tightening mode.

Incidentally, while many of the 'things' China is building may, arguably, be in response to unsustainable booms (i.e. real estate), the argument that China is building a more competitive economy in the process is palpable. For example, in 2010 China produced the world's fastest super-computer, broke a record for world's fastest commuter train, and won its first order for 100 Chinese-made jetliners. Unlike when we researched Husky Injection Moldings and Deswell Industries, or back when punching low tolerance components was en vogue, China is clearly taking the next step, with sophistication, innovation, and 'value-added' now the orders of the day.

And if these accomplishments are not notable enough, China continues to level the playing field in research and development (R&D): By some estimates it has already topped Japan in R&D spending. Moreover, according to Ernst and Young, China has already bumped the U.S. from its leadership position in the area of alternative energy – "*almost one in two wind turbines installed this year will have been installed in China*". With *manufacturing* accounting for the bulk of R&D spending in the U.S. (70% last year, according to Battelle), it does not take a giant leap to correlate the historic decline in U.S. manufacturing jobs to a less robust R&D future.

R&D Spending ($ US - Purchasing Power Parity)

Year	2008	2009	2010	2011
U.S.	397.6	383.6	395.8	405.3
China	102.3	123.7	141.4	153.7
Japan	147.8	139.6	142.0	144.1
India	26.7	28.1	33.3	36.1
As a % of GDP				
U.S.	2.79%	2.70%	2.70%	2.70%
China	1.28%	1.40%	1.40%	1.40%
Japan	3.41%	3.40%	3.30%	3.30%
India	0.80%	0.80%	0.90%	0.90%

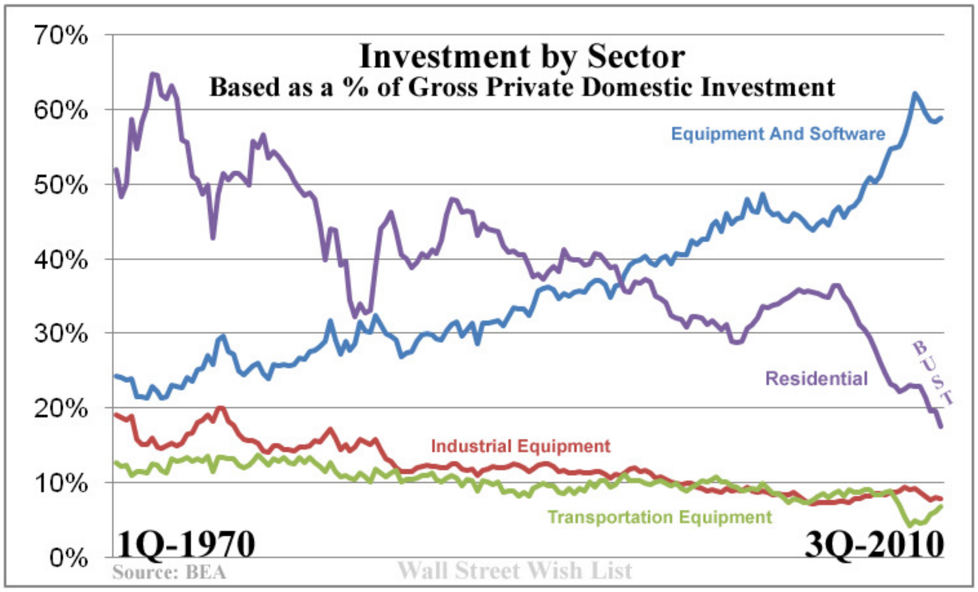
Source: Battelle, R&D Magazine

Granted, the U.S. is still *the* force when it comes to R&D. However, you can make the argument that investment (R&D's kindred spirit) is being funneled into areas that are not necessarily geared towards making the U.S. more competitive. For example, we know that American companies are very efficient when it comes to increasing profits, say by outsourcing workers or by using technology upgrades and laying off workers, but there is considerable doubt as to how advantageous these profit pursuits are to the U.S. economy as a whole. To use a quick example, Battelle and corporate filings peg R&D spending by Microsoft and Merck at approximately $8.5 billion and $6.5 billion each for 2009, and 2010 respectively, but these enormous sums did not stop either company from laying-off employees in each of the last two years.

On this point - that labor force rationalization and profit seeking ingenuity may be at odds with the concept of R&D benefiting the broader economy - consider the Life Sciences Industry where U.S. companies like Pfizer, Amgen, Monsanto, etc. are estimated to have spent a combined $60 billion in 2010 (or 15% of total U.S. R&D). While there is no doubt that the U.S. is the ultimate leader when it comes to devising pills or chemicals for every conceivable ailment or would be infestation imaginable, the contrast between the U.S. patenting science versus say producing *things* is striking. A company like Merck employs thousands to produce millions of dollars per employee in revenue while a company like GM employs hundreds of thousands to produce thousands per employee in revenues.

Don't get us wrong, there is nothing wrong with any company delegating R&D dollars to try and produce attractive returns, and the R&D pie is not fixed insofar as a dollar spent by Merck takes a dollar away from a U.S. manufacturing concern. Nevertheless, we cannot help but question if large corporate interests have become so powerful as to corrupt the decisions of policy makers, and that *this* is the reason that investment and R&D dollars are being geared in an unproductive manner (at risk of straying, we will pick up on this idea in the conclusion).

We mention these points because you cannot help but wonder how much of the U.S.'s $404 billion R&D spending in 2010 was directed at fixing the broken labor market and/or positioning the American growth engine for a brighter tomorrow.



In its annual report for R&D magazine, Battelle helped highlight not only the competitive threats to America's R&D dominance, but also speculated when China would become the 'perceived' leader in 'technical strength'. While the math says China could overtake the U.S. in *total* R&D by 2028, the report in question concluded that China would rule the R&D world from a 'technical strength' perspective by as early as 2015. Whatever the future may hold, it is clear that the U.S.'s dominance in R&D is in doubt going forward.

"The continued expansion of R&D in China is both inspiring in magnitude and worrisome from a U.S. competitive perspective. The Chinese are doing everything in their power to grow and develop through an increasing understanding and emphasis on research and technology. Even most of their highest ranking political leaders are engineers" Marty Grueber, Battelle Research Leader and co-author of 2011 Global R&D Forecast

The blowback from years of allowing its manufacturing base to be eroded has been slow coming, but is now threatening to quicken its pace. Be it the U.S. workforce, which was grossly unprepared for the lethal salvos of the financial crisis, or the R&D environment that allowed non-U.S. competitors to use the crisis to gain ground, U.S. competitiveness is on the wane.

Mega-Trend #3 - The Immovable Objects

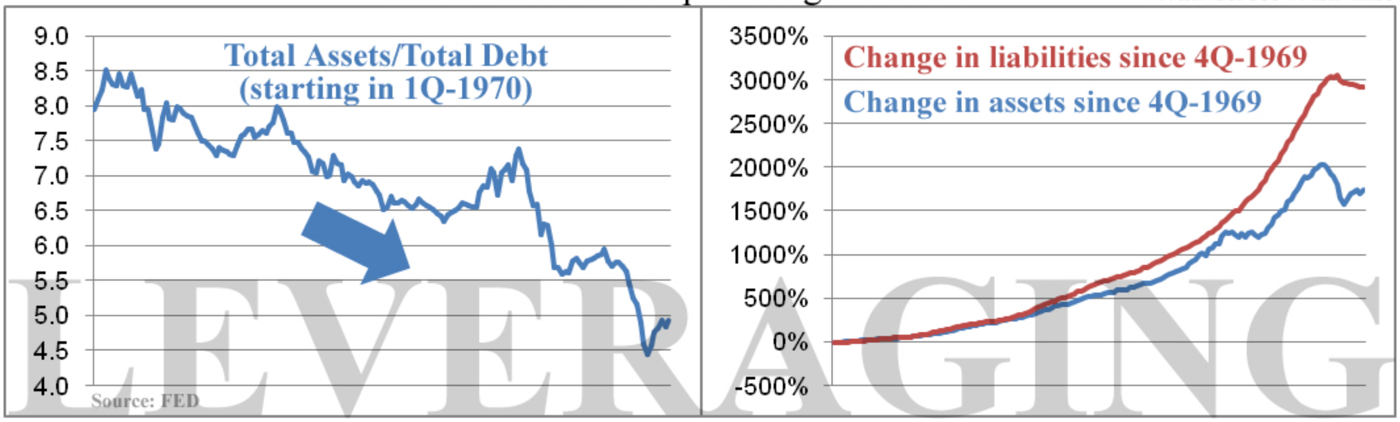
The U.S. dollar and debt. Having discussed these interrelated and seemingly unwavering dominoes for some time, we will be brief in our overview of this third 'mega-trend'.

In the early 1970s Nixon closed the gold window, U.S. policy makers helped craft international arrangements to embed the U.S. dollar as the global reserve currency, and Volcker, eventually, provided the brawn to keep traditional inflationary forces at bay. Shortly thereafter, as alluded to, traditional manufacturing came to be regarded as a fungible commodity in America, financial innovation/technology/marketing helped transplant conventional savings to riskier pursuits, and the Federal Reserve elicited moral hazard via repetitive economic/financial market bailouts while at the same time turning a blind eye to its regulatory responsibilities. Finally, more than two decades of apparent calm started to unravel with the implosion of the equity markets in 2000, the subsequent housing bubble/bust from 2000-2006, and the lingering effects of the credit bubble which are still seen today. The constant through-out these enthralling times was the escalation of debt - first in the private sector and now an exposed albatross in all forms of government - and the ability of U.S. dollar hegemony to delay any would-be consequences of debt.

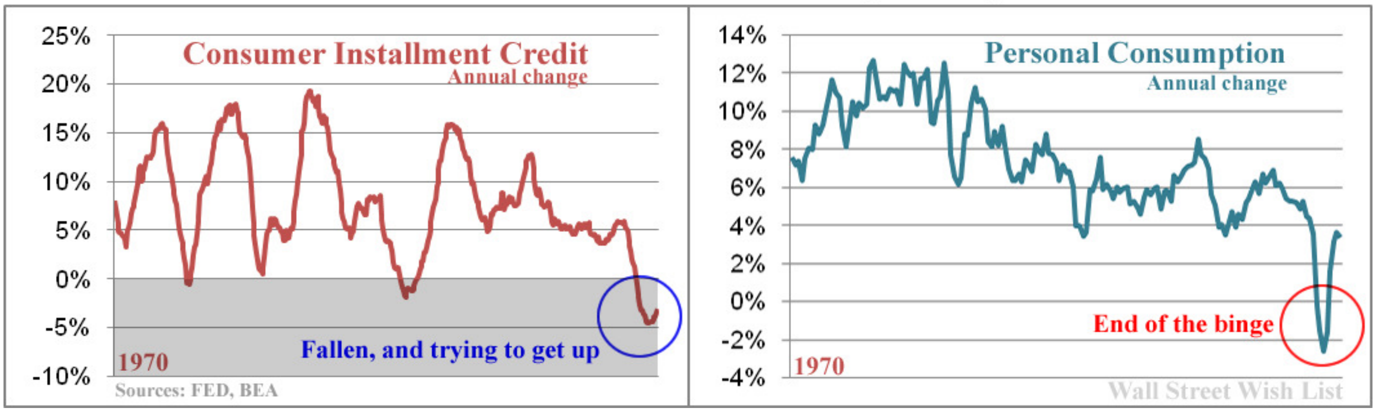
Ironically, while U.S. dollar hegemony has served America's interests well for some time, the unspoken policy today is for a controlled devaluation of the dollar. The idea here is that with its labor market gone bust and competitiveness in decline, a weakening dollar can give the U.S. the edge it requires to boast exports. History is quite clear in that no great debtor nation has been able to debase their currency smoothly enough so as to acquire a lasting competitive advantage. Moreover, there is the question of exactly which currencies the U.S. dollar can weaken against, especially with the world's new growth engine, China, strictly controlling its currency (not to mention the countless nations also adopting policies to stop their currencies from appreciating in 2010). As for the Euro, which was once thought to be next in line as the global reserve currency, it continues to face the prospect of sovereign defaults/restructurings. Then there is a relatively small commodity-centric leader like Canada, whose currency is near par with the dollar, where there are already calls for the central bank to step in and do whatever it takes to stop the Loonies' rise.

Added to the currency conundrum is the U.S.'s reliance on debt. Remembering that asset prices were a key mooring of conspicuous consumption, it is noteworthy that the amount of assets that support the consumer's current debt load has shown no sign of deleveraging. In the context of declining debt servicing costs and rising savings – two recent and positive trends – the worsening asset/debt ratio often gets overlooked by those with a proclivity for undue optimism. What these individuals may be missing is that the numerical limitations to actually reducing net debt are daunting, save a phenomenal upswing in asset prices. The situation here is analogous to that of a company with a busted balance sheet successfully refinancing and trying to waste less money, but that never really producing enough extra to significantly reduce its debt-load. Lower interest payments and reduced spending can indeed make debt more manageable – assuming interest payments remain low - but this does not comment on the balance sheet per se.

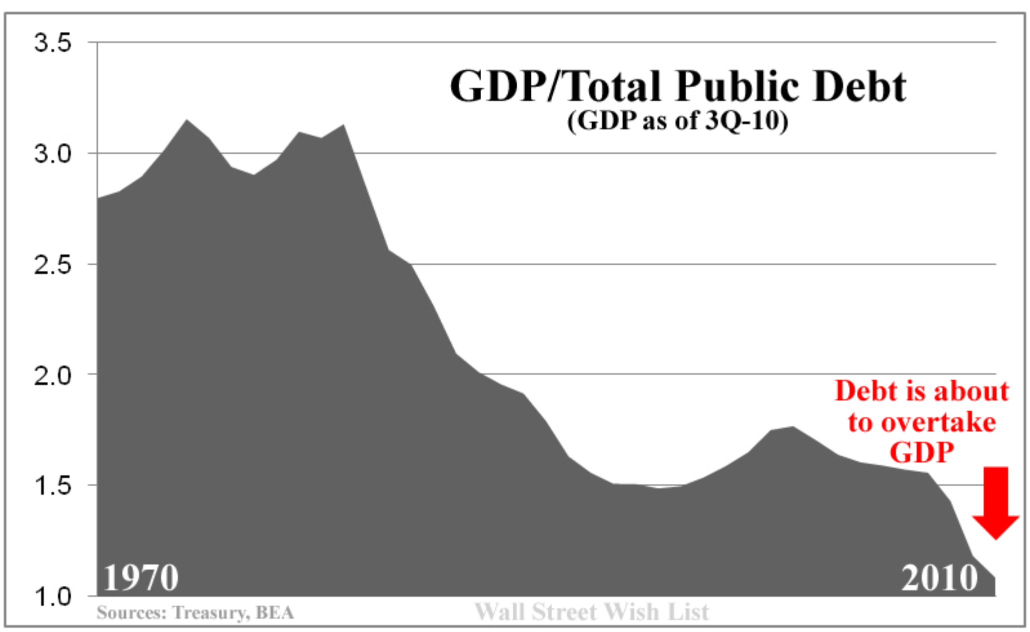
Households and nonprofit organizations

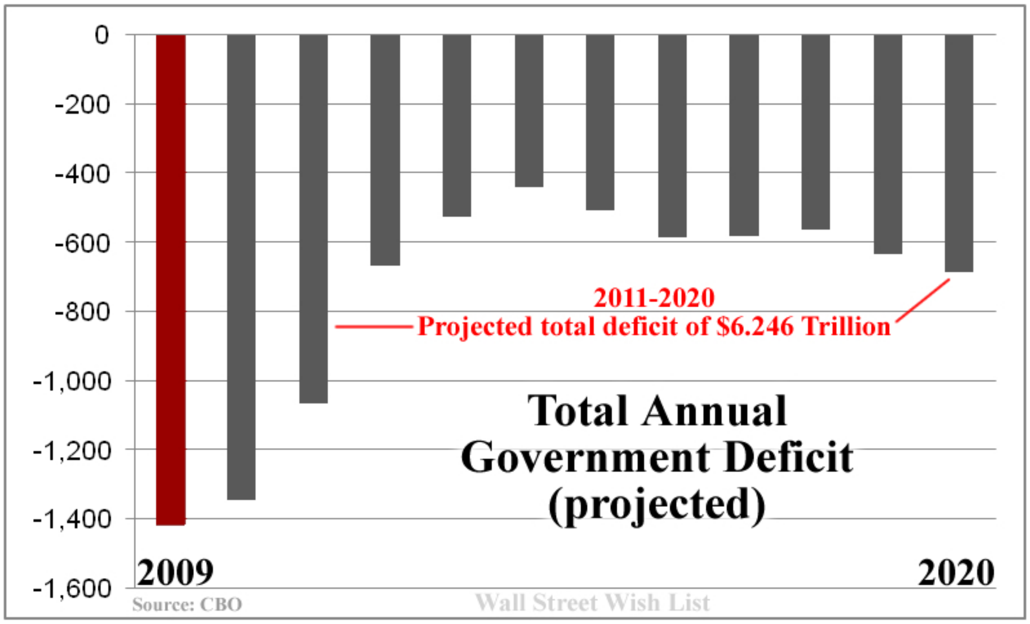


Consumer Credit *versus* Personal Consumption Expenditures

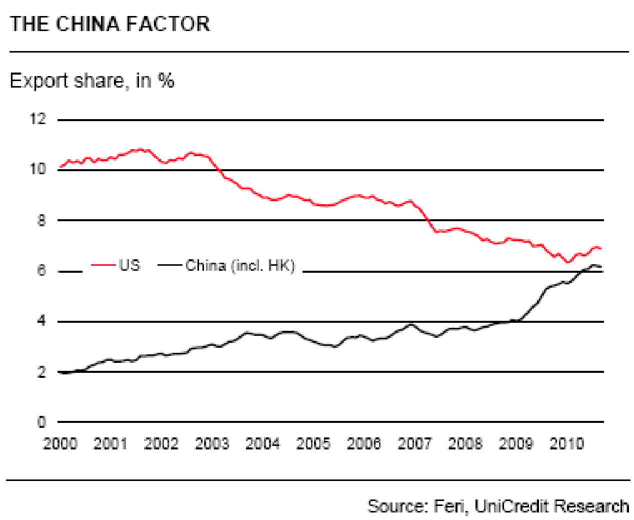


In the case of the U.S. government, which has been called on to answer the consumer's deleveraging challenges, it is has already embarked upon a mammoth deficit spending program that has the potential to see the U.S. surpass many of the debt extremes seen in highly stressed Euro-nations. Up until now the negative effects of this U.S. government debt binge have not presented themselves. But that is not to say they will not in the future. On this front it is noteworthy that long-term U.S. interest rates have increased sharply in recent weeks even after the Fed adopted QE2, and that the rating agencies continue to warn of downgrades at some point in the future.





Suffice to say, the relationship between debt, the dollar, and the U.S. consumer is one that provides an endless degree of fascination. Not prone to extremism such as 'hyperinflation starts now!', what can be said is that so long as the dollar remains the reserve currency of the world and/or the U.S. consumer remains the largest consumptive force in the world, there appears to be no limit to the amount of debt the U.S. can acquire at very low interest rates. The bedeviling caveats to add to this are that with the global economy steadily breaking its linkages to America, and increasing global debt refinancing demands in constant competition for capital, common sense says that there are limits to U.S. debt accumulation.



Conclusions

From The Historical Horizon To The Crystal Ball

As our synopsis of how we got here no doubt conveys, we have a negative outlook on the U.S., and hence, the global economy. Save the advent of miraculous innovations not yet apparent, we do not envision a smooth transition to a sustainable period of economic advancement. To recap:

Top 3 Major Mega-Themes

1) The U.S. labor market is vast storm cloud that has taken many years to come into view, and will continue to rain challenges upon the U.S. economy for many years to come. The theme of deleveraging is the major impediment to focusing resources on a more healthy labor market.

2) The U.S. is growing increasingly less competitive precisely because it continues to embrace growth objectives that center on short-term consumption. If, and more likely when, China surpasses the U.S. in R&D spending this could take the U.S. versus China debate beyond the largely anecdotal state it is in today.

3) The U.S. dollar remains the most flawed currency in the world, and one day this will change. However, until this happens U.S. government debt can, and likely will, rise above the thresholds that usually trigger sovereign debt worries, and the Federal Reserve will likely continue its policy of printing money when it deems it to be necessary.

Faced with the prospect of terrible sports losses from an opposing children's camp, Bill Murray gave a memorable speech in the movie 'Meat Balls' via the repetitive use of the phrase 'it just doesn't matter'. Looking in our crystal ball a similar sentiment swells within - 'it just doesn't matter' what politicians, investors, and central bankers do going forward, because the unsustainable trends that have been woven into the economic fabric that is America are not even close to being unwound.

It Just Doesn't Matter!

We have, in our opinion, moved past the point when the U.S. can work hard to gets its fiscal house in order. We have entered the waiting game for a historic default/restructuring of U.S. debt. Thankfully, for America (not for everyone else), all of the U.S.'s obligations are denominated in something that can be printed without limits by the Federal Reserve. This fact makes comparisons between Argentina circa 2002 or Greece/Ireland circa 2010 absolutely inappropriate. Will the U.S. ever bow and adopt austerity measures to appease the demands of other central banks and sovereign debt investors? Everything we see says no…

It Just Doesn't Matter!

Should the U.S. be unable to borrow cheaply to fund its economic experiments say 3-years from now, the portfolio changes that are made between now and then could be rendered immediately irrelevant. If the investor makes untold profits trading assets in USD, what does he really gain if he does not sell before USD goes bust?

It Just Doesn't Matter!

We fear monger in this manner because we sincerely believe that U.S. policy makers are taking the wrong path; that while a country like China has top policy makers that are in many cases trained engineers, nearly all U.S. policy makers are versed only in the haphazard art of engineering dangerous asset/credit bubbles. In the case of Ben Bernanke, he had the audacity to state the following after the launch of QE2:

"This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate this additional action…" Bernanke

Doesn't everyone see that there is something severely wrong with the architects of U.S. economic policy seeing the solution to economic crisis in lower interest rates and higher stock prices?

What Does Matter

These longer-term threats highlighted, our crystal ball remains conflicted over the short-term. To be honest, the U.S. looks like it will avoid a double dip, and employment may pick-up next year. Moreover, there is still no immediate threat to U.S. dollar hegemony - with perhaps China being the main threat say 5-10 years from now. This outlook essentially creates a dual mandate to the investor: 1) Try to profit given the current rules of the game and 2) Make sure you are fully prepared **before** the rules change. In this case, the dollar rules…

Our viewpoint is to continue being exposed to precious metals, try to purchase non-cyclical equities at undervalued prices, and to invest in specific stories rather than chase the big macro conclusions everyone is glued to. Added to this is the goal of finding investments that are not completely reliant on the U.S. economy and/or the U.S. dollar and, eventually, focusing capital on higher growth areas.

This conservative tack ensures that we will miss many, if not all, of the largest moves in the markets, but it may help us keep our assets during crisis times.

In summary, as the clouds look to be clearing, the horizon casts a conflicting glow. It just doesn't matter if a period of calm settles over the financial markets today, because the barometric pressures of a weakening labor market, over-consumption, and unsustainable debt will change the forecast tomorrow. Until then, remember that the dollar can still be printed, and this makes all the difference.

Wish List Review & Outlook

Historical Wish List Performance		
Year	Wish List	S&P 500
2001	52.50%	-12.92%
2002	9.96%	-23.02%
2003	24.10%	26.05%
2004	25.27%	9.03%
2005	-3.01%	3.17%
2006	7.76%	13.59%
2007	-13.54%	3.66%
2008	-15.02%	-40.08%
2009	33.13%	32.01%
2010	18.18%	13.55% *
Total Return	**214.96%**	**0.52%**
Av-Annual Return	**21.49%**	**0.05%**
10-year CAGR	**12.15%**	**0.005%**

* *Assumes $22.36 in cash dividends*

Since December 26, 2009 the nine Wish List companies selected – on an evenly weighted basis - have increased by 18.18% when including dividend payments and before taxes and commissions. During the same time (Dec 26, 2009 – Dec 24, 2010) the Dow Jones Industrial Average gained 10.01%, the S&P 500 gained 11.56%, and the Nasdaq gained 16.62% (to end only 47% *below* its all time high set in 2000). Using 2010 as the reference, and whether including dividends or not, the Wish List outperformed the S&P 500 benchmark by a significant margin. This marks the third year in a row that the Wish List has beaten the U.S. benchmark, and the sixth year (out of 10) since inception. Our failings notwithstanding, we are proud of this ongoing record, mainly because when the broader markets have been hit with large declines we have outperformed on every occasion.

To view the complete Wish List Report sign-up for a FallStreet.com membership.