

# Qwest for Returns

SEPTEMBER 2009

ISSUE 1

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*The most likely beneficiary of a loss of confidence in the US Dollar is likely to be hard assets, or commodities.*

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## Going south to Argentina

A century ago, both the United States and Argentina were buoyant emerging markets that were full of promise. One went on to boom and dominates the world's economy while the other went on to stagnation.

What happened?

Analysis shows that Argentina created an elitist society, a class structure and a closed economy, which were factors that stifled competitiveness and innovation. By contrast, America was a classless society that embraced open markets.

Unfortunately, America appears to be making the same mistakes that Argentina made a century ago. The US is evolving from a classless to an elitist society. Over time, these changes will serve to erode competitiveness and lead to economic weakness.

## The end of US Dollar hegemony

In effecting these changes, America is facing a long-term decline that is difficult to arrest. This decline will no doubt mark the end of the US Dollar as the world premier reserve currency.

As an example of how a leading currency can collapse, the graph on the left shows the purchasing power of Pound Sterling for the period 1750-2001. The currency began to tumble as Britain lost influence after World War I and Sterling's preeminent position as a reserve currency slipped.

However, it isn't clear what the US Dollar would fall against in the next 5-10 years under such a scenario.

Europe has its own problems. Eastern Europe is a disaster area and threatens the stability of the Eurozone banking system. Japan still faces difficulties as it has barely recovered from its Lost Decade.

The most likely beneficiary of the loss of confidence in the US Dollar is likely to be hard assets. Commodities are the best medium term (5-10 year) insurance against the collapse of the greenback and the American empire.

## A story of two countries

The Financial Times recently had a fascinating article comparing and contrasting the United States and Argentina [emphasis mine] (see <http://www.ft.com:80/cms/s/2/778193e4-44d8-11de-82d6-00144feabdc0.html>):

A short century ago the US and Argentina were rivals. Both were riding the first wave of globalization at the turn of the 20th century. Both were young, dynamic nations with fertile farmlands and confident exporters.

### Is the USD on the same path?



Source: House of Commons Library Research Paper 02/44

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*The US and Argentina were both buoyant and promising emerging markets a century ago. Why did one succeed and the other stagnate?*

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Both brought the beef of the New World to the tables of their European colonial forebears. Before the Great Depression of the 1930s, Argentina was among the 10 richest economies in the world...

There was no individual event at which Argentina's path was set on a permanent divergence from that of the United States of America. ***But there was a series of mistakes and missteps that fit a general pattern. The countries were dealt quite similar hands but played them very differently.***

## Landed gentry vs. Land of Opportunity

The big difference was the United States put the structures in place that made it the mythical Land of Opportunity, whereas Argentina was dominated by its elites and a closed economy:

European emigrants to Argentina had escaped a landowning aristocracy, only to -recreate it in the New World. The similarities were more than superficial. ***In the 1860s and 1870s, the landowners regarded rural life and the actual practice of agriculture with disdain. Many lived refined, deracinated lives in the cities, spending their time immersed in European literature and music.*** The closest they came to celebrating country life was elevating polo, an aristocratized version of a rural pursuit, to a symbol of Argentine athletic elegance. Even then it took an elite form: the famous Jockey Club of Buenos Aires. By the end of the 19th century some were sending their sons to Eton.

America's move westwards was more democratic. The government encouraged a system of smaller family holdings. Even when it did sell off large tracts of land, the potential for a powerful landowning class to emerge was limited. Squatters who seized family-sized patches of soil had their claims acknowledged. US cattle ranchers did not spend much time boning up on the entrance requirements of elite English schools. And as well as raising cattle, the western settlers grew wheat and corn...

By its very elitist and closed structure, Argentina had squandered a golden opportunity for greatness:

By the end of the 19th century Argentina's economy, per head of population, was higher than that of France and a third higher than Italy's. The export boom could have kept Argentina up in the pack, but much of the money was captured by landowners who generally either spent it on imported consumer goods or bought more land with it...

***Economies rarely get rich on agriculture alone and Britain had shown the world the next stage, industrialization.*** America grasped that building a manufacturing industry would allow it to benefit from better technologies, while trying to squeeze a little more grain out of the same fields would not. It was not as if Argentina consciously rejected the same course. It could scarcely avoid growing its own manufacturing industry. But when industrialization did come, prevailing prejudices ensured it was limited and late. ***Argentina's elites saw no reason to risk their status and livelihoods in the fickle new sphere and anyway there were not enough new workers to fill the factories.*** Argentina brought the same tendencies that it had to the ossified agricultural sector, preferring cozy, safe monopolies to the brutal riskiness of competition.

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*Argentina created a class system, which stifled competitiveness and innovation.*

*America was a classless society that embraced open markets.*

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*By its very elitist and closed structure, Argentina had squandered a golden opportunity for greatness.*

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## Is America still the Land of Opportunity?

The principal competitive advantage of the United States as a country to live, work and do business has been its open economy combined with its strong framework of property rights. America, for many, has been the shining city on the hill, the mythical Land of Opportunity.

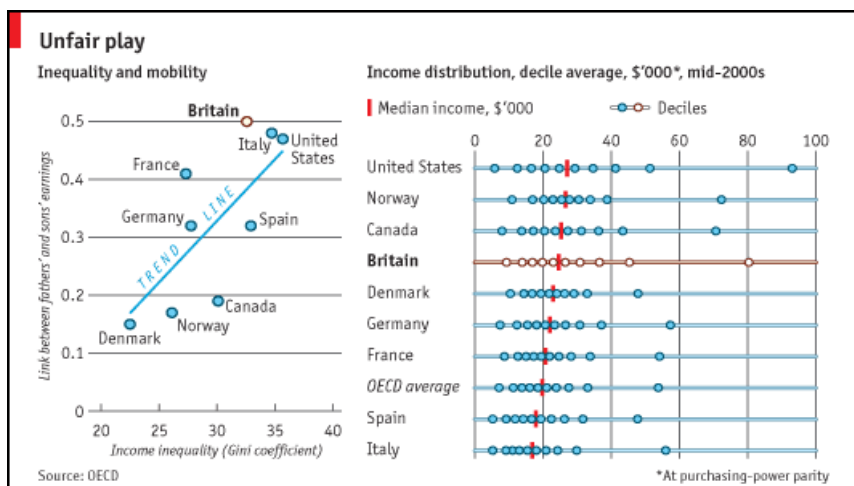
## From a classless to an elitist society

An article in The Economist highlights an OECD study that seems to indicate that the American Dream is only that, a dream.

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*The US is starting to create a class system. Elitism and class systems stifle competitiveness and innovation.*

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Source: The Economist & OECD (see [http://www.economist.com/world/britain/displaystory.cfm?story\\_id=12480828](http://www.economist.com/world/britain/displaystory.cfm?story_id=12480828))

The classic measure of income inequality is the Gini coefficient. High Gini coefficients indicating high income inequality in the US has been well documented for years. In of itself, this is not necessarily a bad thing as high gaps between rich and poor could serve as a strong incentive for wealth creation, if the opportunity presents itself. However, the OECD study also showed low social mobility in the US, as defined by the correlation of the Gini coefficient of parent and offspring, compared to more "egalitarian" countries like Denmark, Norway and, surprisingly, Canada.

High Gini coefficients combined with low social mobility indicates that elites are getting entrenched. America may be in the process of evolving from a classless society to one where class matters. As we saw with Argentina, classed societies close itself to risk taking, competition, innovation and ultimately wealth creation.

## Elitism = Decline

When we combine the history of Argentina with the results of the OECD study, the implications are highly disturbing. These two threads echo the analysis of Simon Johnson, former chief economist of the IMF, when he wrote about the current economic crisis [emphasis mine] (see <http://www.theatlantic.com/doc/200905/imf-advice>):

To IMF officials, all of these crises looked depressingly similar. Each country, of course, needed a loan, but more than that, each needed to make big changes so that the loan could really work. Almost always, countries in crisis need to learn to live within their means after a period of excess—exports must be increased, and imports cut—and the goal is to do this without the most horrible of recessions. Naturally, the fund's economists spend time figuring out the policies—budget, money supply, and the like—that make sense in this context. Yet the economic solution is seldom very hard to work out...

**Typically, these countries are in a desperate economic situation for one simple reason—the powerful elites within them overreached in good times and took too many risks.** Emerging-market governments and their private-sector allies commonly form a tight-knit—and, most of the time, genteel—oligarchy, running the country rather like a profit-seeking company in which they are the controlling shareholders...

**Squeezing the oligarchs, though, is seldom the strategy of choice among emerging-market governments. Quite the contrary: at the outset of the crisis, the oligarchs are usually among the first to get extra help from the government,** such as preferential access to foreign currency, or maybe a nice tax break, or—here's a classic Kremlin bailout technique—the assumption of private debt obligations by the government. Under duress, generosity toward old friends takes many innovative forms. **Meanwhile, needing to squeeze someone, most emerging-market governments look first to ordinary working folk—at least until the riots grow too large.**

Does this sound familiar? Washington initiating immense Wall Street bailouts? TARP, TALF and a whole host of alphabet soup acronyms for bailout programs? And for whose benefit?

The New York Magazine printed a quote from a Citibank executive that is evocative of the current zeitgeist:

No offense to Middle America, but if someone went to Columbia or Wharton, [even if] their company is a fumbling, mismanaged bank, why should they all of a sudden be paid the same as the guy down the block who delivers restaurant supplies for Sysco out of a huge, shiny truck? (<http://nymag.com/news/businessfinance/56151/>)

Does the disdainful tone of this banker sound like one of the “gentlemen farmers” on the Argentinean pampas? Now that the economy seems to be undergoing a nascent recovery, the mega-bonuses at investment banks are back. The business as usual attitude is alive and well again on Wall Street.

Has Wharton become the new Eton? Top private schools cost \$40-50K a year at the undergraduate level, an amount that is roughly equivalent to the median US household income. Even with financial aid, it becomes a big burden even for the typical American family. If attending a top school is the ticket to the top tier in America, the costs of such an education creates a huge barrier to social mobility.

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*Who suffered the most in the Great Recession?*

*How did the elites react?*

*How did policymakers react?*

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*Has Wharton become the new Eton?*

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*People respond to incentives:*

*The typical Congressman spends about \$3,000 a day just to keep the lights on.*

*Under those circumstances, fundraising becomes job 1.*

*What would you respond to someone bearing gifts?*

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*America is facing a long-term decline that is difficult to arrest.*

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## The economics of political life

The obvious scapegoat for this state of affairs is the politician in Washington. Try as we might, we should not blame the politicians for this mess.

Consider the economics of being a politician in America. The typical US politician needs to spend an immense amount to get his office and keep his office. The Center for Responsive Politics estimates that \$5.3 billion was spent on the 2008 campaign by all sides (see <http://www.politico.com/news/stories/1108/15283.html>). The typical Congressman spends about \$3,000 a day just to keep the lights on in the office, which amounts to about \$1 million a year.

Under those circumstances, fundraising becomes job 1.

People respond to incentives. What would you do under such a regime? How are the incentives set up for a politician when someone comes bearing gifts? Who do you think has the money to buy access? Who benefits under such a structure and who gets shut out?

Under such circumstances, people can easily be put into positions that may be ethically compromising. Observers have pointed to Hillary Clinton's outsized commodity trading gains in the late 1970s as an example. Just to give equal opportunity to the other side of the aisle, Colin Powell disclosed about \$16 million in assets when he became the Secretary of State in 2000. How does a former career military officer accumulate that much wealth?

Is it any wonder why bills don't get through Congress without a zillion riders? More importantly, how governable is a country operating under those kinds of economics?

When political life is saddled with this kind of incentive structure, does it matter very much which party is in the majority? Or has the presidency?

## The end of Pax Americana? And the US Dollar?

Let me be clear about this, America is facing a long-term decline that is difficult to arrest. On the other hand, it doesn't happen overnight.

The Soviet Empire reached the apex of its prestige with the launch of Sputnik in 1957. It was evident to the world that it had fallen apart in 1989 with the fall of the Berlin Wall – a space of 32 years.

Britain was at the zenith of its power at the start of World War I in 1914. By the time of the Suez Crisis in 1956, it was evident that the country had been reduced to a mid-sized power – a span of 42 years.

Arguably, Pax Americana reached its height in 2000 with the top of the NASDAQ bubble. The country enjoyed a fiscal surplus. Everyone wanted to get in on the technology boom that was centered in America. If history is any guide, the true realization of the decline should take 30-40 years, which would indicate a 2030-2040 timeframe for irrevocable evidence of American weakness.

Along with the decline of the American Empire, the enormous US debt load is going to threaten the value of the greenback. If the US Dollar begins to lose its status as a reserve currency, then its meltdown is not out of the question.

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*Hard assets are the best medium term insurance against the collapse of the U.S. empire*

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## What would the US Dollar fall against?

If the US Dollar falls, who would win under such a scenario?

I don't have all the answers.

There are three current candidates for major reserve currency status in the world: the US Dollar, the Euro and the Yen. Everything else is too illiquid. (Swiss franc? You've got to be kidding; there isn't enough of it around. Renminbi? It isn't even freely convertible...)

If there is a loss of confidence in the US Dollar over the next few years, then what would it fall against? Europe has its own problems. Eastern Europe is a disaster area and threatens to drag down the Eurozone banking system. Japan still faces difficulties as it has barely recovered from its Lost Decade.

Should such a scenario of Dollar weakness be realized in the next 5-10 years, I believe that the loss of confidence will manifest itself in a rise in commodity prices. Hard assets are the best medium term (5-10 year) insurance against the collapse of the US Dollar and American empire.

For investors, these big picture economic circumstances need to be considered in formulating investment policy and objectives.

# Qwest Investment Management

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*People are our strength.*

*Creating value is our goal.*

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## About the Author

*Cam Hui has been involved in the equity markets since 1980, both on the buy side and the sell side. Most recently, Cam was a Relative Value and Technical Research Analyst with Merrill Lynch in New York. He is currently living in Vancouver, British Columbia with his family. He maintains his interests in the markets through his investment blog:*

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## About Qwest

Qwest Investment Management Corp. ("Qwest") is an investment management firm which specializes in identifying, structuring and managing investment products. Qwest is currently focused on investments in the natural resource sector.

Qwest's executive management team has over 100 years of combined experience in corporate and financial product structuring and investment management which provides the team with the skills required to evaluate and profitably manage the risk and rewards inherent in the capital market industry.

Qwest is the parent company of Qwest Investment Fund Management Ltd., a company which provides investment advisory and portfolio management services and Heritage Bancorp Ltd., a company which provides administrative services.

## Interesting Facts About Qwest

- Specialists in investing capital Canadian the natural resource sector;
- Throughout their careers, members of the Qwest management team have completed hundreds of financings and have raised and/or invested billions of dollars of capital in the natural resource sector;
- Resource company flow-through specialists;
- Recognized for our experience in Canadian oil and gas sector;
- Top quartile oil and gas-weighted flow-through portfolio performance.

## Qwest's Portfolio Management Team

From our Calgary, Alberta office, Qwest's portfolio management team is strategically situated to conduct in-depth research and analysis of Canada's oil and gas companies. Our portfolio management team is led by Ms. Jennifer Stevenson who brings over 20 years of oil and gas industry experience and a strong track record in financing and investments in oil and gas companies.

The portfolio management team's additional strengths include:

- first-hand knowledge and insight into the oil and gas sector (i.e. situated in the heart of the Canada's oil patch)
- years of experience working with management teams to finance their oil and gas companies
- specialization in the research and analysis of Canadian mining companies
- considered to be leading experts in the oil and gas sector by Canada's most reputable media outlets



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