

## Good News on Electric Cars

OK, for a while now my letters have been pretty downbeat on the state of things economic. There is more of that later. How about some better, lighter news?

As some of you know, when I was in Denver recently I dropped by a Tesla Motors showroom at the Park Meadows Mall. You might know Tesla as a maker of expensive, high performance, all-electric roadsters.

I was shocked to learn that Tesla is taking orders for a very nice looking *all-electric sedan* for delivery in 2012. It seats 5 adults plus 2 kids, gets *300 miles to the charge* and costs \$78,000, with the 300 mile battery pack, \$58,000 with the 150 mile battery pack. With a fast charger, it can be recharged in 45 minutes. The sedan has terrific acceleration, going from 0 to 60 in 5.6 seconds.



*Tesla hopes to have an all-electric sedan priced at \$30,000 in 2014.* If they can pull that off, and most people will believe that when they see it, it would be a mass market electric car that would blow away the Chevy Volt and Nissan Leaf with their max 100 mile range and so-so styling.

In the store I looked at the all-electric roadster, the only car on display and one Tesla will no longer sell when the sedan

comes out. When I lifted the hood, the only thing I saw was the motor for the windshield wiper – no engine, no transmission, no exhaust system, no cooling system! The Tesla car has none of them. The batteries are very low in the chassis. The car is built of high-strength carbon fiber, except for the plastic bumpers but the body looks like any other new car.

Maintenance is interesting. They come to you, charging \$1/mile to come out, with a \$100 minimum. Or, you can download the diagnostic information from the car onto a memory stick and mail it to them! Since there is no oil to change, no engine, transmission, cooling or exhaust systems to keep up, etc, there ought not to be much routine maintenance.

Tesla is publicly traded, symbol TSLA. I do not own it because the stock is high risk and very expensive. The company is not yet earning money and will need to keep raising money. Still, I am rooting for them.

## Another Interesting Green Engine



Harry Schoell, a Florida inventor, just can't seem to get a big break. After years of demonstrations at trade shows, especially for the auto industry, he can't seem to get much interest in his product, the *cyclone engine*. Like the electric car, no transmission, oil or cooling system is needed.

That's too bad, because according to his website, "in combustion tests we have used *fuels derived from orange peels, palm oil, cottonseed oil, algae, used motor oil and fryer grease, as well as traditional fossil fuels ... none of which required any modification to our engine.* We have also burned propane, butane, natural gas and even powdered coal."

The reason the cyclone engine runs on any fuel is that the fuel is only used to heat water to steam. It is the steam that drives the engine. The cyclone engine is thus actually a modern, highly efficient steam engine. This is not the old steam engine for train locomotives that was replaced with diesel engines. Schoell claims this engine is actually *50% more efficient than internal combustion engines.*

Raytheon recently ordered some Cyclone Power engines for testing. Since Raytheon is a big supplier to government, especially the military, that may be where it gets a start, though some marine engine makers and companies who need smaller or backup power generation are also looking at this.



The military consumes unbelievable amounts of oil, gas and diesel that all must be supplied to the troops. Think about being in the middle of Afghanistan and getting power generation from a machine that literally runs on garbage. It reminds me of the car from the future in *Back to the Future*. It's one of those things that to quote an old catch-phrase, makes me go Hmmm.

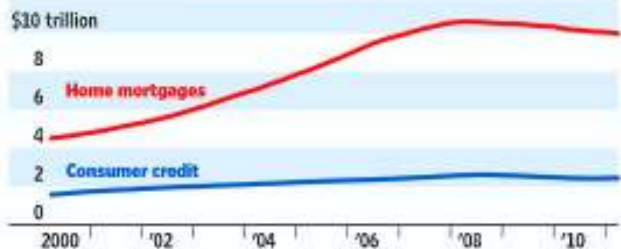
## Are Americans Getting Out of Debt?

**Quick question** – with all the financial turmoil & people losing their homes with their high mortgages how are Americans doing getting out of debt? This is likely the key to future economic growth. I have talked to a number of people who have paid off credit cards, and lowered debt. Is this the norm?

### Maxed Out

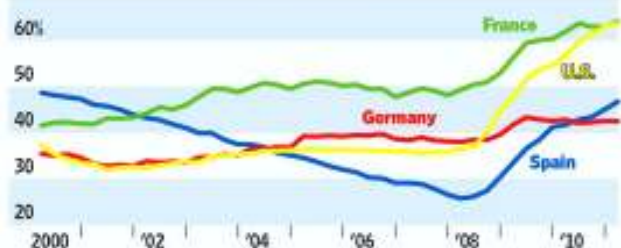
Consumer and government debt has remained high since the financial crisis

Debt outstanding



Note: Seasonally adjusted

Government debt as percentage of GDP



Sources: Sbrabagas Research Partners, Federal Reserve, BEA, Banco de Espana; Agence France Trésor; Deutsche Bundesbank

According to the *Wall St. Journal*, the answer is that mortgage debt has declined only slightly since 2008 and is still more than *double* what it was in 2000. See chart at left. According to the Fed, **consumer credit is down just 6%** three years after 2008 and remains 37% higher than 10 years ago.

US government debt as a percentage of the economy is shown as the yellow line in the lower graph at left. That 62% figure is if you count what is privately owned. If you add what Social Security, the Fed and other government agencies own, (see pg. 4) federal debt is now 100% the size of the economy and climbing.

Here's another question. **How much of the current U.S. deficit is due to lower tax revenue?** The answer, according to [www.usgovernmentrevenue.com](http://www.usgovernmentrevenue.com) \$662 billion is from increased spending vs. \$509 billion from lower revenue. Unfortunately, according to CNS News the actual FY2011 deficit is now on track to reach \$1.40 trillion, rather than the originally projected \$1.16 billion.

## Why Didn't All That Fed Stimulus Boost Our Economy More?

Finally, there is confirmation of what I have been writing about the Fed's stimulus doing little to boost our economy other than keeping interest rates low.

According to Jason Mason at SeekingAlpha.com, in the latest stimulus known as QE II, \$584 billion went from the Fed to our banks. During the same period the banks' deposits of foreign reserves increased by \$500 billion. In essence, **banks gave \$500 billion of the \$584 billion they got from the Federal Reserve to their foreign branches rather than loan it out here.** Lesson: when it comes to stimulus, things don't always go according to plan.

## Outlook for Stocks & Commodities

The US dollar is strengthening as European troubles continue. As you can see below, when the dollar bottomed and started to rally early in May (top chart) commodities topped out (bottom chart). The larger lesson between the two charts is how **commodities have been moving opposite the dollar for the last three years**. Stocks also do best when the dollar is declining.



Much of the decline in the dollar has been due to the Federal Reserve's quantitative easing programs, the second of which is just now ending. We'll see how stocks do if the dollar continues to improve.

Long-term, I don't see how the dollar can keep from declining as the U.S. sinks deeper into debt, a slide that shows little sign of abatement. Really, the two-month improvement in the dollar is mainly against the Euro because the problems Europe has been having with Greece have been in the news lately, especially the fear that a Greek default would harm banks, especially in France, which has the largest exposure there.

**I think a further drop of 5%-10% in commodities is possible** over the next month or so is possible. In fact, if China and Europe keep slowing and the U.S. continues sluggish commodities may drop more, including oil. We will have to see if this recent spate of poor economic growth around the world continues or turns out to be temporary, as it was last spring. The answer holds the key for stocks and commodities.

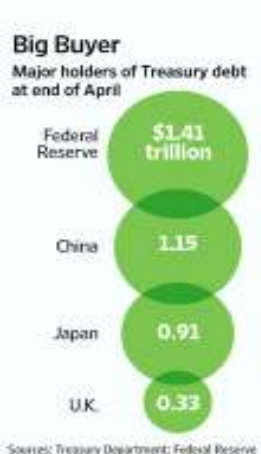
## Outlook for Bonds and Interest Rates

There are lots of bond markets. While treasury bonds, foreign bonds, municipal bonds, corporate bonds, high yield bonds, floating rate bond, convertible bonds and such often move together, there are times when they diverge markedly.

For the past four years U.S. Treasury bonds have been extremely popular because they are viewed as a safe haven and there have been plenty of reasons for investors to worry about safety. So, prices on

treasury bonds have gone to silly high prices, especially on the shortest maturities. Demand has been so high the government has been able to issue debt at nearly zero interest. Money market funds are also effectively at 0% because they own so many short-term treasury bills.

**Who has been buying all this government debt?** For the answer, take a look at this chart showing the biggest owners of US government bonds. You thought the biggest buyer was China, right?



QE II is over, but man, did the Federal Reserve buy a lot while it lasted! Meanwhile, China has slowed its purchases of US bonds and has stepped up purchases of European bonds, gold and other assets. They need to diversify.

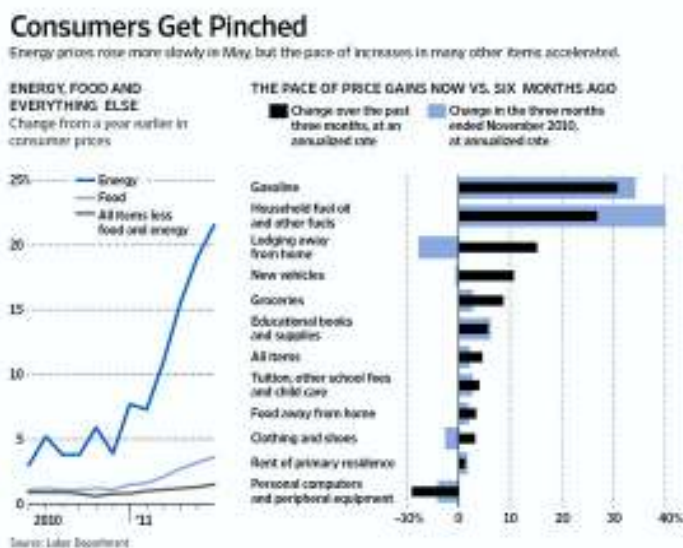
Now that the Fed is basically done buying bonds other buyers have to step in to buy the absolutely enormous quantities of new debt Uncle Sam is selling. Will they? If they don't step up aggressively, rates on treasury bonds are going to go up. PIMCO's Bill Gross thinks those rates will go up and I agree.

**There is a downside to interest rates on treasuries going higher.** The federal government pays an average 2.5% interest rate on its debts, historically a very low rate. At that rate on the current amount of debt interest payments make up roughly 6% of the federal budget. What happens if rates go to 5%, closer to the long term average? By simple math, debt would jump to 12% of the budget. That is without the extra debt from continuing deficits.

Will other rates on other types of bonds go up along with treasuries? If inflation stays low and growth stays low then maybe not, at least for a while. But, if either picks up, rates will rise. Rates may also rise if investors turn from low interest bonds to the stock market, selling bonds to buy stocks. **I am becoming wary of bonds and looking hard at other sources of stable income.**

### Inflation News

So what's the outlook for inflation? This chart is a breakdown of the latest inflation figures as shown by the Consumer Price Index (CPI).



Energy costs, up 22% in the last 18 months of course, steal the show as shown in the **left chart**. Overall inflation came in at a 2.4% annualized pace, slightly above the 2% pace for which the Federal Reserve is aiming.

The **right-hand chart** is more interesting. The blue bars show inflation for the three month period ended November 2010, or six months ago. The black bars are for the last three months. The obvious increases are in gas and fuel oil.

*Notice how in all the other items inflation is higher the last three months. Notice also that new vehicle prices were up by 11% and groceries were up*

9%! Clothing and shoes went from a minus number to about 3%, a swing upward of about 6%. Those are big numbers. Many of these are imports and **as the dollar drops imports become more expensive, fueling inflation.**

**Grocery costs** should continue to go up for a long time due to demand from the rising middle class in many emerging markets. Clothing and shoes are going up and will continue to go up for two reasons – 1) the vast majority are imported and the falling dollar makes them more costly to people buying foreign goods in dollars, which is what we do, and 2) wages and other costs of business are rapidly rising in China and those costs must be passed along to consumers here.

**Now, look at the last item on the chart** – personal computers and peripheral equipment show prices 10% lower. Did computer prices really drop 10% last quarter? Probably not.

This shows the **adjustment the Feds makes to prices** based on their opinion that an item is better. In their eyes a new computer that sells for the same price as the old one but is somehow 10% better is a price *decline* of 10%.

This is a big reason why inflation as measured by the CPI is lower than actual inflation. This adjustment not only applies to computers but to everything we buy, whether phones or cars or appliances or whatever. So when the CPI is up 3% and you get a 3% raise you are actually falling behind.

### **A New Reason for Companies to Expand Overseas**

Recently Boeing decided to add a new production facility for its new *Dreamliner* commercial plane. Most of its current operations are near Seattle, WA and are heavily unionized. Boeing has had four strikes



there since 1989. So, Boeing built its new plant in SC and hired workers there. The cost of living is much lower in SC and it is a right-to-work state so wages are lower, constrictive union work rules are absent and strikes nonexistent.

However, an administrative judge with the National Labor Relations Board (NLRB) sued Boeing, charging that Boeing built the SC plant as retaliation for labor unrest in WA.

It is illegal to retaliate against union workers so **the legal question is whether this represents retaliation or just good business sense**. According to Boeing, the SC plant represents additional jobs, and jobs have also been added in WA. The union says the WA jobs are likely to be cut as the SC plant becomes fully functional.

The case will be heard by the National Labor Relations Board (NLRB), a politically appointed board of three Democrats and two Republicans. These cases often take a long time to hear. Apparently, two years is common. Then there will likely be appeals in the courts which will take years more, perhaps going to the U.S. Supreme Court.

Regardless of how this turns out, **if you were a CEO** whose company had operations in a unionized state like Washington **would you build your next plant in your unionized home state in a right to work state like SC or overseas? Most CEOs are choosing Door #3 – overseas**, avoiding a lot of legal costs, bad publicity, time and hassle.

**Stocks are higher lately and portfolio values are up for the year.** We'll see how the next three months go before heading into the seasonally best time of year. **It's never dull, lately!** If you have any questions or comments on the newsletter and especially on your accounts, please let me know. – Dave