2009 MID YEAR REVIEW OF MARKETS: THE GRAND EXPERIMENT

"*I believe that banking institutions are more dangerous to our liberties than standing armies. If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around [the banks] will deprive the people of all property until their children wake-up homeless on the continent their fathers conquered. The issuing power should be taken from the banks and restored to the people, to whom it properly belongs.*"

Thomas Jefferson, (Attributed), 3rd President of the United States of America

The global financial crisis seems to have gotten better by many accounts, especially with stock markets steadily rising this quarter from their lows of March 2009. "Green shoots" are apparently everywhere. Returns at June 30, 2009 are summarized below:

	2009 YTD	Last 3 Years	Last 5 Years	Last 10 Years
S&P 500	3.16%	-22.70%	-10.74%	-20.16%
Value Line Composite	8.37%	-42.14%	-35.04%	-47.44%
MSCI EAFE	8.42%	-20.88%	14.73%	17.06%
MSCI Emerging Markets	36.22%	10.12%	101.88%	137.15%
Citigroup 5 Year T-Note	-2.78%	27.12%	29.08%	77.04%
Barclays Five Year Muni	2.96%	18.20%	23.81%	61.18%
DJ AIG Commodity Index	5.30%	-22.38%	-.49%	101.95%
Gold-London PM Fix	7.45%	52.32%	136.10%	248.76%
CPI	1.69%	5.36%	12.69%	28.62%

All returns are cumulative, not annualized

Despite the run-up recently, major US based stock indices remain well off their highs, and have recorded dismal longer term performances versus their foreign cousins. Gold and commodities have provided the best long term returns, albeit with greater volatility, and bonds have produced solid if unspectacular contributions.

Given the large divergences seen above, an argument could be made that "it's time for mean reversion", with US stocks ready to lead the charge back to the top of the performance tables. We suspect, however, that the pattern of the last ten years may not so willingly change. Investors could come to appreciate again the value of "long cycle" thinking, as economic recovery in the US is delayed, and pronounced deflation or inflation becomes the operative framework for strategic planning. Whatever the direction, a quick return to normalcy is a low probability outcome, and investors would be well advised to brush up on their history and study how assets have behaved in other transformational eras.

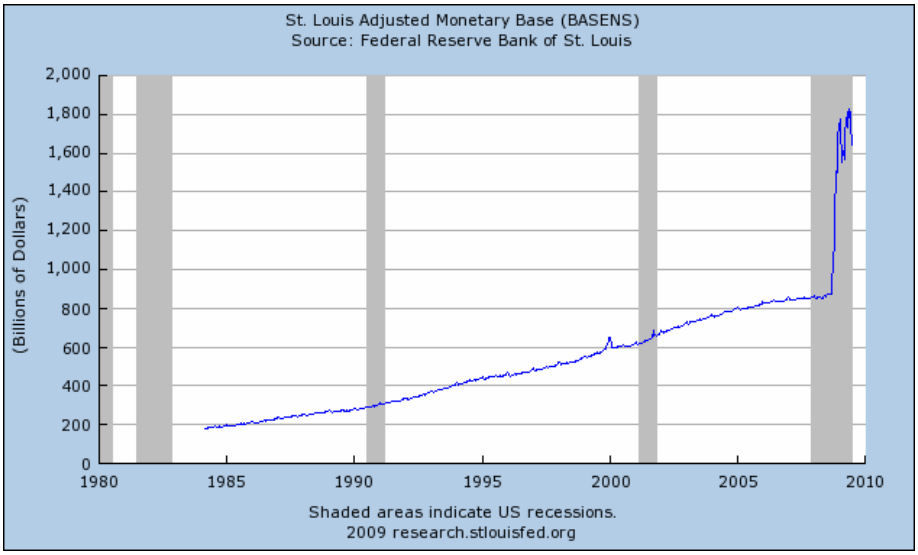
Central Bank Conundrum

To revive an ailing global economy, central banks like the US Federal Reserve have lowered interest rates to zero or near zero. The theory is that by lowering the "cost" of money, more borrowing will occur, and thus more investment in jobs, businesses etc.

However, this time monetary policy has proven to be impotent, with century long lows in interest rates producing nothing but pink slips and growing unemployment.

So central banks around the world are in full on "reflation" mode, furiously printing money to stave off deflation (i.e. adding new money to the system trying to create demand, and thus higher prices, for everything from houses to stocks, and, most importantly, bad loans).

The amount of US dollar creation is unprecedented:

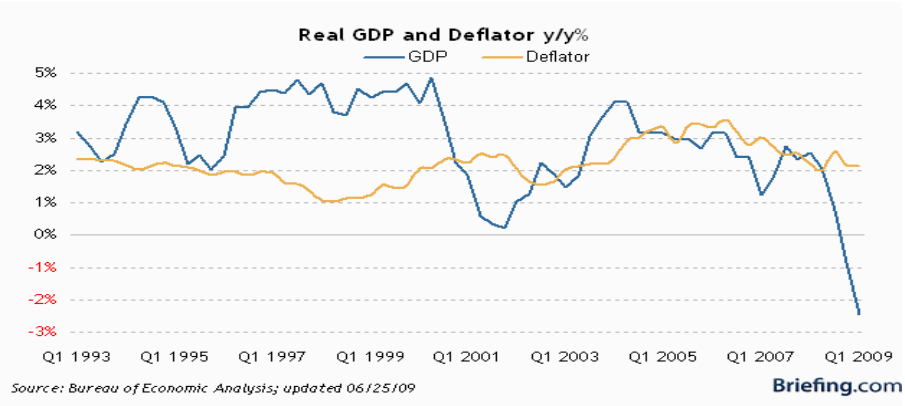


Various terms have been applied to this maneuver, from "quantitative easing" to "credit easing". Either way, the primary goal is the rehabilitation of the banking system, or the creation of a new credit cycle by increasing the supply of money. This all might work.

But this Grand Experiment of creating money to supply credit means that there must be a willing borrower on the other side who is able to service the debt. In short, an entrepreneur, businessperson, or consumer who has confidence in the future. Given the recent historic interventions by governments into the private markets (think GM), it is hard to make the case that reliable assumptions will hold in the event of further stresses. Any prudent scenario analysis will consider both a resumption of normality and the evolution of a different framework for a private market with much more government involvement. A few forward thinking practitioners have already begun this evaluation, with one dubbing it the "new normal".

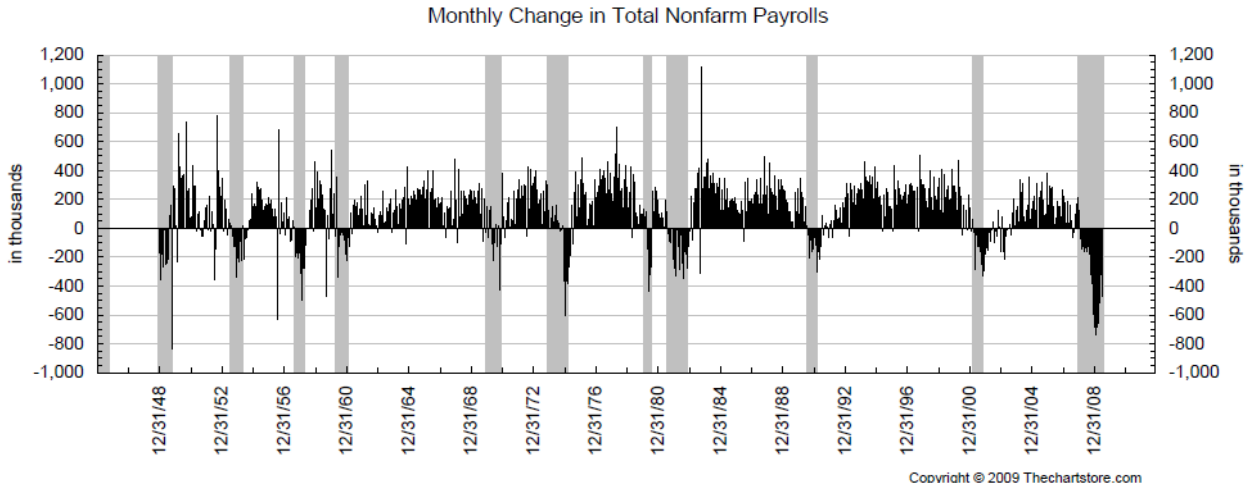
Macroeconomic Outlook

US GDP growth contracted sharply in Q1 2009 at a -5.5% annual rate, following a 6.3% decline in Q4 2008:

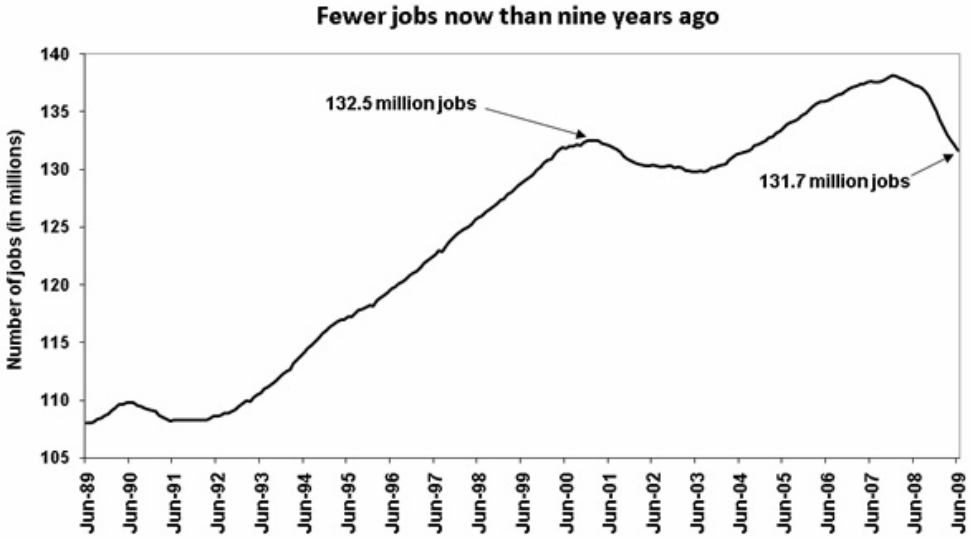


Major economies around the world are exhibiting the same trends, with the large export oriented economies (Germany and Japan) showing significant 30%+ declines in year over year industrial production. Many are pointing to this slowing rate of decline as evidence of a turnaround coming later this year.

Consumer spending, normally 70% or so of the US economy, has plunged as jobs disappear:



The total number of jobs lost since the start of the recession (18 months ago) now stands at 6.5 million. The economy currently has fewer jobs than it had in May 2000; i.e. the entire growth in jobs over the last nine years has now been wiped out:



Source: Economic Policy Institute

The labor force, however, has grown by 12.5 million workers since then. The Economic Policy Institute has estimated that the economy needs to create 127,000 jobs per month just to keep up with population growth, so, just to keep even, 2.3 million jobs needed to be created during this 18-month period. Instead, 6.5 million jobs were lost. The US is thus currently 8.8 million jobs below where it would need to be to maintain pre-recession levels, a very deep hole indeed.

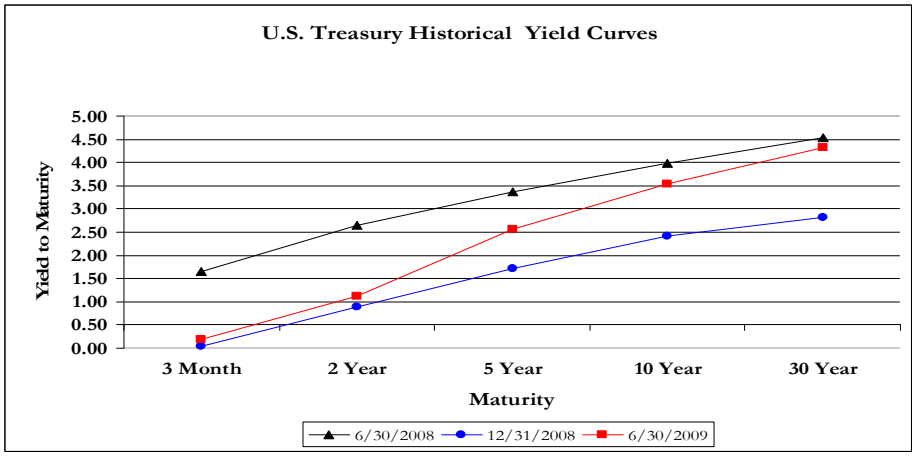
Significant job losses are one of the outcomes of a dangerously overleveraged economy which has now been forced into a de-leveraging posture. Without jobs, the ability to generate income to service debt has fundamentally changed, so we do not expect to see meaningful credit growth until this situation changes. Since credit is the "oil" that greases the economy, we'll be hearing squeaky wheels for a while.

The "colliding forces" of inflation and deflation that we wrote about last summer are now favoring deflation, with the latest CPI numbers tracking at a negative annual rate of -1.9%. According to the FOMC Statement of June 29: "the prices of energy and other commodities have risen as of late. However, substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time". There is a difference between prices which rise modestly and an ongoing decline in assets and prices which characterize a deflation. Astute investors should consider how

deflation, a long absent phenomena in the US, could impact their holdings, to more fully prepare for the widest range of potential outcomes.

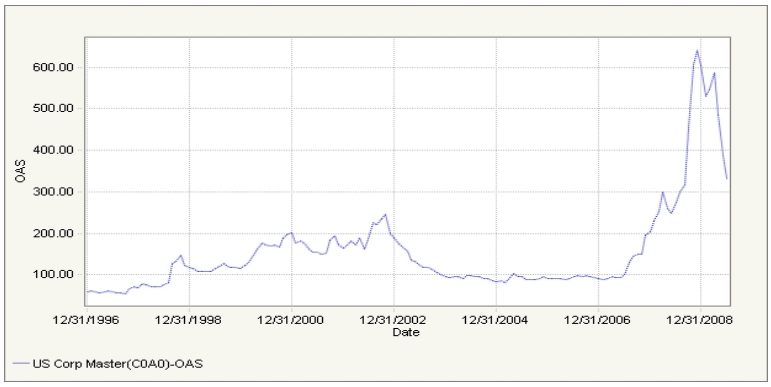
Bonds

The US Fed is keeping short term interest rates near zero, but long rates, which are driven mostly by market forces, have risen since year end:



The rise in longer term yields is problematic, as this increases the "cost" of money obtained through mortgages and other loans. Long yields may be reacting to anticipated inflation down the road with all of the money creation going on, or to the increase in issuance/supply of Treasury bonds to support more government borrowing. The Fed has announced a program to buy up longer term bonds to keep rates down and thus keep credit flowing, but that is some serious wishful thinking in our view. (In the UK, the Bank of England has already purchased almost 20% of outstanding Gilts--the British version of Treasury Notes--and yields are higher now than when they started.) This is called "monetization of debt" and it cannot alter collective market forces. If the world becomes a seller of Treasuries, yields will rise.

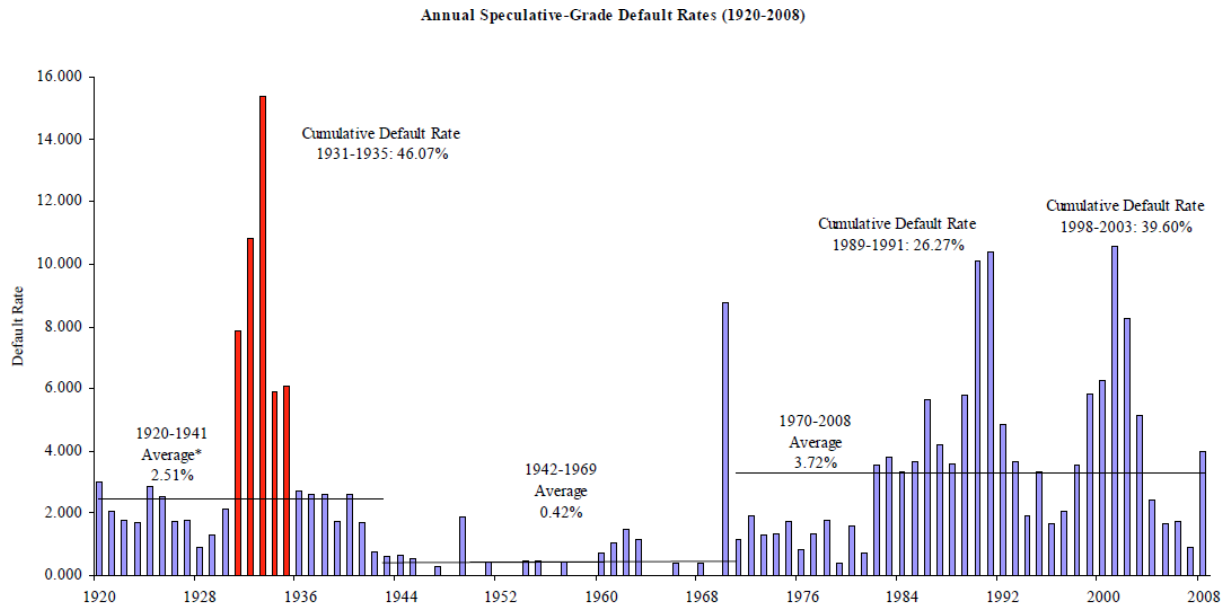
Corporate bond spreads have declined (prices up) since year end, in harmony with the rise in stocks:



Source: Merrill Lynch

This rally in corporate bond prices is premature in our view. New fronts are opening up in the financial crises, with record credit card losses (now over 10%) forcing large banks to rescue formerly AAA rated asset backed securities comprising their loans. Commercial property is under increasing pressure, as tenants go bankrupt or default (General Growth Properties, among the largest of all US mall operators and once the darling of REIT growth investors, filed for bankruptcy in April). Surviving tenants are asking for and receiving significant decreases in rents, leaving landlords to hold the bag. Most importantly, the majority of residential mortgages originated during the go-go years are just now entering their interest rate re-set periods (goodbye "teaser rate"), and we expect another tsunami of bad news for the housing market to hit over the next 6-12 months (look for the terms Prime, Jumbo Prime, Alt A, Option ARM and HEL to move to the front pages).

For all these reasons, we feel default rates are still very early in their ascent, and could peak at much higher levels than today, sending yields up dramatically. A long term view of default rates is instructive:



Source: Morgan Creek Capital Management

Central banks of developed nations around the world continue to make headlines with aggressive monetary actions, but the mainstream media and investors in general seem not to notice (or care) as much. We think it bears watching closely.

On June 25, the European Central Bank engaged in its first ever auction for one year loans, pumping out €422 ($619 billion) to over 1,000 banks at an ultra-low cost of 1%. This record amount of emergency finance, already being dubbed "stimulus by stealth", is meant to unlock credit markets and revive Eurozone economies. However, as has happened in the US, banks could decide to hoard the funds, buying government bonds instead of making loans, and earning a risk-free "spread". In technical terms, when new credit is not created, the multiplier effect is impotent, resulting in very low money velocity and thus economic growth.

Meanwhile, in the most under-reported story of the year so far, the Swedish Riksbank surprised the market and lowered their official interest rate to .25%, but is also now effectively charging interest to banks who hold excess reserves (do not lend). Sweden's banking system is the most heavily exposed to the financial sinkhole of Eastern Europe, and these actions loudly underscore the collapse in demand for credit that is occurring globally. (In Germany, the national export association recently warned of "a dramatic deterioration" in credit conditions in the coming months, predicting a "massive financing squeeze" as banks exert pressure on borrowers and retract new offers of credit.)

Of note also is news that the US Federal Reserve is considering fundamental changes to the giant repurchase – or repo – markets where banks around the world raise overnight dollar loans. In the repo markets, borrowers, such as banks, pledge collateral in return for overnight loans from lenders, such as money market funds. The plans include creating a "utility" to replace the Wall Street banks that handle current transactions. Acting as a "clearing bank", large entities like JP Morgan are thought to exercise too much control over lenders by deciding at what price and how much collateral is pledged against these short term loans (remember Lehman Brothers?). Our view is that the Damocles Sword of off balance sheet liabilities continues to threaten systemic failure of the global banking system, and that this is an effort by the Fed to take *apriori* action by inserting the government directly into the driver's seat of credit allocation. If this change occurs, the government will decide who gets money and on what terms, and is likely to accept any crappy piece of paper offered as collateral if it means holding the system together. No one is talking about this. The current mismatch between assets and liabilities is quite large:

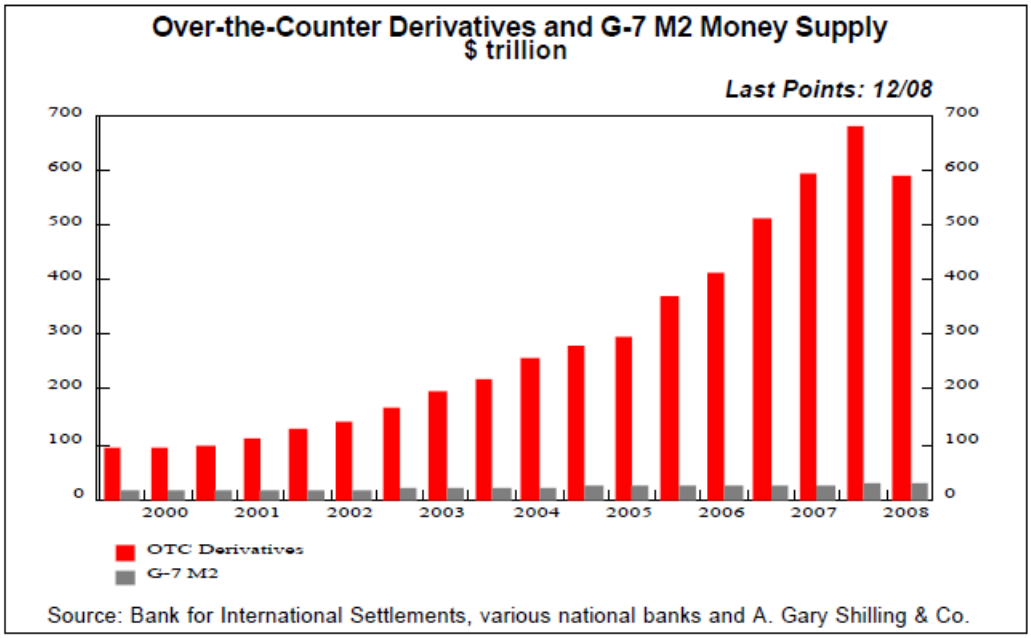


Chart originally appeared in A. Gary Shilling's INSIGHT, July 2009, www.agaryshilling.com

This is another example of how much leverage has gotten into the system. It will have to be reduced one way or another. We'd prefer to see the deliberate, methodical way, but the Fed is apparently not waiting around to be tested again. These repo market changes could take effect as early as October 2009.

Equities

Stocks recovered smartly in the first half of 2009, but sector performance was very uneven:

Technology	24.08%
Materials	12.28%
Consumer Discretionary	7.52%
S&P 500	***3.16%***
Health Care	-0.96%
Energy	-3.21%
Consumer Staples	-3.44%
Utilities	-4.08%
Financials	-4.76%
Telecommunications	-6.73%
Industrials	-7.68%

S&P 500 earnings are estimated to finish up the year around $40 per share, less than half the level of recent peak earnings. "Operating" earnings (without all the accounting shenanigans) may actually post a negative total for 2009. As sectors come in and out of favor, we continue to believe that financials must regain a leadership role in order for the stock market overall to enjoy a sustained rebound, at least in the US. As long as government "bail-outs" continue, this is unlikely to happen. Overseas markets, ex-currency risk, look much more interesting than the US, and their demographic trends of younger populations and increasing consumption patterns could be very rewarding for investors.

More importantly, profit margins are set to contract further as the government crowds out the private sector. This theme is largely unexplored by the mainstream media, but it looms large in our view. A well positioned company in this scenario would have large and growing top line revenues, low debt, relatively fixed costs, and a scaleable business model with "moat-like" barriers to entry. Operating statements, therefore, will not support as robust an earnings environment as in the past.

Balance sheets, however, are a different story. In the energy and natural resource arena, an area we have favored for some time, China continues to leave telltale signs of its large and growing interest in these types of assets. In June, the largest foreign takeover by a Chinese company was announced, with Sinopec's $7.2 billion bid for Addax Petroleum. Talks are underway for China National Petroleum Corp to buy a majority stake in YPF of Argentina. In the steel arena, Australian miner Rio Tinto rejected a $19.5 billion investment by Chinalco in favor of a rights issue, no doubt with heavy pressure from Australian

authorities concerned about foreign investments in strategic national resources. We expect to hear this theme come up much more frequently in the future, and believe that investing in these types of assets can bring much needed protection from potential problems with the US dollar and inflation.

Similarly, gold and precious metals stocks should be a core holding for these uncertain times. China recently reported a rise in its official gold holdings of 15 million Troy ounces, which is more than the combined amount sold by the ECB and UK over the previous six years. They also committed to buying in short order the equivalent of two Fort Knox's worth of new gold ($80 billion). These concrete actions support an emerging view that the world's fastest growing institutional investor class – namely central bank managers, not hedge funds or sovereign wealth funds – are beginning to view gold as a useful counter-cyclical tool and important permanent holding, and not the "barbarous relic" of old.

The Bigger Picture and Outlook

The government is here to help. As US voters are now beginning to realize, when they voted for change they signed up for a whole lot of it, and not necessarily of the beneficial variety. The unprecedented intrusions of government into the private sector are by far the primary issue the markets must grapple with, and the results so far are not in the least encouraging.

We won't review all the gory details of the Chrysler and GM "pre-packed bankruptcies", but it is quite clear that the government eviscerated the rights of senior creditors by denying them compensation for their lawfully obtained collateral, and gave it instead to the UAW. In a normal world, that is called stealing.

Then there is the recently passed Public Law 111-22, the "Helping Families Save Their Home Act of 2009". This one makes the auto bailout look like child's play. This Act allows mortgage servicing companies to ignore private contracts and modify delinquent mortgages without the threat of being sued (as long as they follow Treasury guidelines of course). And anyone who helps them in this process is also covered under the Safe Harbor rules. So the owners of the mortgages (i.e. investors) won't be seeing any defaults. Just forbearance, and lots of it (your ten year Note just became a Perpetual): "this Act…removes certain legal liability for mortgage servicers that conduct loan modifications, even if the modifications may be in violation of contracts between services and mortgage holders."

Along with the death of private contracts, the market will soon have to deal with the ramifications of the government bailing out the government(s). California is broke and so are most of the 49 other states. The Golden State is now issuing scrip, or IOU's, to cover the shortages. Now, voila, the Municipal Securities Rulemaking Board just this week deemed these IOU's to be "municipal bonds", which means the States can hand them over to the Feds as collateral for loans. Anyone see another bailout movie coming?

And the spending is picking up speed. The Treasury Department said on July 13 that the federal budget deficit topped the $1 trillion mark for the first time ever, up sharply from $286 billion in June of 2008. Most forecasters estimate that it could top $2 trillion by calendar year end.

Using the Obama administration's own projections, the non-partisan Congressional Budget Office (CBO) estimates that, including the record 2009 budget deficit of $1.85 trillion and huge annual deficits over 2009-2019, an additional $11.1 trillion will be added to the national debt. It took the United States of America 233 years (1776-2009) to amass a national debt of $11 trillion. It will take our government less than ten years to double that if we continue down the current path.

These estimates assume positive GDP growth and return to trend tax receipts. These are the same kind of bogus assumptions that were run during the bank "stress tests" in April, when the "worst case" scenario for the unemployment rate was pegged at 8.5% (it's currently 9.5% and heading north).

None of the above CBO estimates include even part of the massive expenditure required to a.) implement a national health care plan and b.) bring Medicare and Social Security into the realm of solvency. Estimates vary for the amounts needed, but most economists agree it will take at least $20-$40 trillion.

Warning shots have already been fired. The Chinese are publicly questioning the safety of their investments in US debt, and have repeatedly called for a new global reserve currency. The ultra-cautious Germans have passed a Constitutional Amendment in their version of the US House to ban deficit spending. In an extraordinary rebuke of global central banks, German Chancellor Angela Merkel warned that the massive bailouts undertaken were sowing the seeds for another crisis down the line.

In short, the Grand Experiment is really a test of fiscal sanity. There should be no doubt on the part of serious investors that a doubling of the US national debt in such a short period with such enormous ongoing financing needs will spell disaster for the US dollar, bonds, and stock markets. Unless forceful

countermeasures are taken, the only question is how long the charade can continue, and who will be the first to race for the exits.

Given such an existential threat, we strongly encourage investors to include this type of scenario in their long range planning. It is not inconceivable that there could be an official dollar de-valuation, controls on movement of capital, and a ban on private ownership of gold (these all happened in the US in 1933, not so very long ago). In short, nothing should be inconceivable from an investment viewpoint.

So it turns out that old Tom Jefferson may have been right. Private banks, like the US Federal Reserve, which have been given the power to print unlimited amounts of money, appear to have created a systemic framework that leaves the property rights of the individual trampled in service of the institutions. In the most widely read article of the year in the Atlantic Monthly, "The Quiet Coup", Simon Johnson (former Chief Economist of the IMF) argues that the finance industry has effectively captured the US government. Unless we break the financial oligarchy that is blocking essential reforms, no recovery is possible. And time is running out.

For all these reasons, it is unlikely that capital markets will exhibit the historical relationships and returns that are claimed to be "normal". Of course, markets will rally from time to time and it will be deemed "safe to get back in the water". But history shows clearly markets can undergo long periods of change. Our view is that we have just entered another long transition. US investors would be well advised to adopt a global view, where many more opportunities await. A focus on risk management, not just return maximization, should form the delicate balance required for success in what is truly becoming the brave new world.

Robert E. "Emery" Pike, CFA
Managing Principal and Chief Investment Officer
July 15, 2009