REDSTONE ADVISORS INC.

MARKET REVIEW

Overview of Credit Markets

Second Quarter 2009 Report

"To rob the public, it is necessary to deceive them. To deceive them, it is necessary to persuade them that they are robbed for their own advantage."
Frédéric Bastiat

"The US should consider drafting a second stimulus package focusing on infrastructure projects because the $787 billion approved in February was a bit too small."
Laura Tyson, Member of President Obama's Economic Recovery Advisory Board

Now comes ***"Son of Stimulus."*** Why must there be a second stimulus program, you ask? Well, according to Laura Tyson, it is because the first stimulus package was just a ***"bit too small."*** Not to be outquipped, Warren Buffet recently echoed the call for a second stimulus package after referring to the first stimulus bill as ***"sort of like taking half a tablet of viagra."***So then, we are to understand that the economic justification for a second stimulus plan is impotence? But how can this be true? Hearken back to January and February of this year and recall what we were told when the first stimulus bill was being crafted. The financial and economic crisis we are now facing was then described by President Obama as ***"deep and dire as any since the days of the Great Depression."*** In fact, the candidate who had run on **"hope"** spoke in near **apocalyptic terms** when describing what might befall us if vigorous government intervention were not pursued. Mr. Obama warned the American people in no uncertain terms that failure to pass the first stimulus bill ***"could turn a crisis into a catastrophe."***Yet, set against this backdrop of impending doom and despair, Mr. Obama characterized the first stimulus bill as being "***big enough and bold enough to meet the size of the economic challenge we face right now."***I certainly detect no lack of **"virility"** in that description. Vodoo economics notwithstanding, government stimulus, that is to say, draining resources from the productive sector and squandering them on arbitrary projects, cannot improve either the economy or the financial markets. In this case, it is not **stimulus** that is called for, but **abstinence**. Or hadn't you heard that ***"abstinence makes the heart grow fonder."***

As we discussed last quarter, to date, the stabilizers have spent, lent or committed nearly **$13 trillion** in an all out effort to combat what Mr. Bernanke recently referred to as "**Depression 2.0."** As we documented, this is by far, the largest outlay in American history. We also explained in detail, our contention that, contrary to the siren song of the government sycophants, the current crisis in the financial markets is not due to a **lack of liquidity**, but is, rather, a **solvency** problem. The markets suffer from a **shortage of capital** resulting from the **overproduction of claims on wealth** brought about by the **evergreen expansion of credit** orchestrated by the Fed. By misdiagnosing the ***"effect"*** for the ***"cause"***, the stabilizers have been pursuing the wrong policy, prescribing the economic equivalent of **viagra** when a **placebo** is clearly called for. We also stated that regarding the condition of the financial markets, the credit markets will be a leading indicator of any impending recovery. So what are the credit markets saying?

To date, the government has been **propping up** a substantial portion of the financial market. And in this effort, the Federal Reserve has been preeminent. A cursory review of **Figure 1** provided by Arbor Research, reveals the unprecedented nature of the bailout operation being directed by the stabilizers at the Fed. Prior to September of 2008, total assets of the Fed were running around **$900 billion**. However, subsequent to the implementation of the myriad of new liquidity and lending facilities, including the TAF, TALF, TSLF and the MMIFF, just to name a few, the Federal Reserve balance sheet more than doubled to a level of nearly **$2.3 trillion.** As of June 24th, total Federal Reserve assets were holding at just under $2 trillion. Much has been made recently of the fact the Fed is currently not increasing its' balance sheet, suggesting this is a sign of improvement. We strongly disagree. Even if we assume that the Fed will not be required to provide any additional liquidity (GM, Chrysler, AIG, CIT?), they still have a $2 trillion balance sheet awash in excess reserves. But in today's backwards "bizarro world", the slow down of a slowdown is positive, right? We can also see that since peaking in December of 2008, the level of **liquidity facilities** (**green line**) has been declining while at the same time the level of **lending facilities** (**red line**) has been rising. The importance of this change in composition will become apparent, if and when the Fed attempts to remove some of this stimulus and shrink their balance sheet. As such, it is a topic for a future report. Suffice it to say for now that removing that portion of the monetary accommodation which exists in the form of **lending facilities** (read, *security purchases*), will be far more difficult than the removal of "liquidity" in the form of **excess reserves**. That is because the Fed will be required to sell their growing securities holdings in order to remove liquidity. As someone recently observed, ***"the day the Fed sells will be a big market event."***

Despite the change in composition, excess reserves or **high powered money** provided by the Federal Reserve to the banking system has remained at **record levels**.

Figure 1

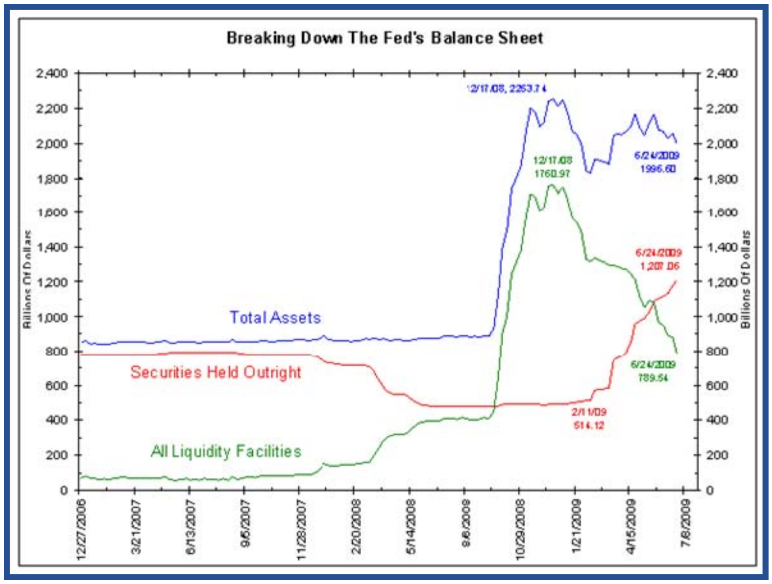
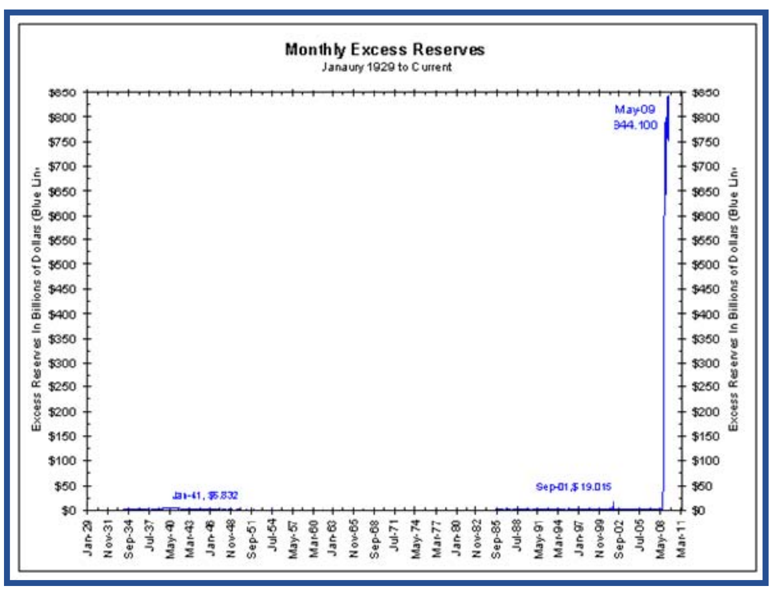


Figure 2



But just how extraordinary are the current levels? Referring to **Figure 2**, we can see that they are literally off the charts. **Figure 2**, again courtesy of Arbor Research, tracks **monthly excess reserves** at the Federal Reserve all the way back to **1929**. Excess reserves are equal to total reserves less required reserves. Required reserves are the level of **non-lendable reserves** banks are required to hold at the Federal Reserve against their deposit base. As of May 2009, **required reserves** were equal to around **$55 billion**, while **excess or lendable reserves** totaled nearly **$850 billion!** By way of comparison, the high water mark for excess reserves during the **Great Depression** was only **$6.8 billion**. Expressed as a **percentage of required reserves**, the level of excess reserves during the Great Depression totaled around **120 percent** of required reserves. When we compare this with the current level of excess reserves at **960 percent**, it becomes clear that the level of stimulus and intervention being introduced into the financial markets today simply has **no historical precedent**. We can only assume that this kind of massive injection of high-powered liquidity into the banking system is what the Nobel-Prize-winning Keynesian quack, Paul Krugman had in mind in 1998 when he advised Japan that ***"the way to make monetary policy effective is for the central bank to credibly promise to be irresponsible."***

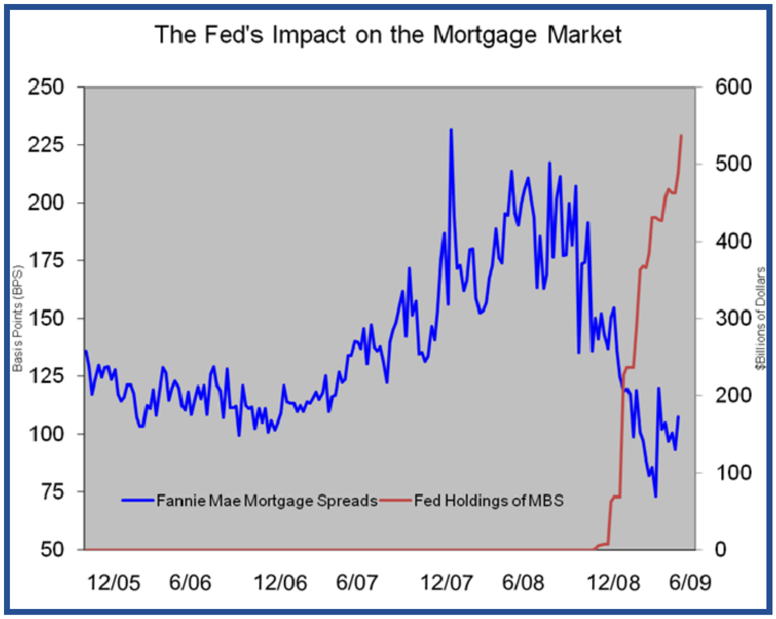
In a world of government intervention and Federal Reserve money-printing, it is nearly impossible to discern market movement. As we discuss later in this report, the non-linear implications of increasing intervention and manipulation find their corollary in the marginalization of market prices. We have been braying about the ***"loss of the feed-back loop"*** regarding market prices, having adopted the label of ***"medicated markets"*** when referring to the condition of the credit markets. Jim Bianco of Bianco Research put together a partial list of the stabilizers involvement in the markets which we here insert:

- The Federal Reserve, through its' Quantitative Easing program, is printing money to buy Treasuries, mortgages and agencies ($2 trillion committed and over $600 billion spent at last count).
- The FDIC is guaranteeing the issuance of certain corporate debt issues via the TLGP (almost $350 billion at last count).
- The Federal Reserve is the single largest buyer of Commercial Paper via the CPFF (about $250 billion at last count).
- The Treasury is now guaranteeing municipal debt via "Build America" bonds.
- The Federal Reserve is providing financing for the purchase of securitization and has committed up to $1 trillion.
- The Department of Education if the largest buyer of securitized student loans, more than the private sector.
- Combined, Fannie and Freddie are buying over 60% of new securitized mortgages, more than the private sector.
- The Federal Reserve's Term Auction facility or TAF, has pumped $500 billion in the LIBOR market. This market has been so overwhelmed by "Federal Reserve money" that it has effectively ceased to be the reference rate for new short-term loans.
- 49.9% of the capital raised by banks has come from various governments (including Sovereign Wealth Funds), and only 51.1% from the private sector.

- Government spending for fiscal 2009 is projected to be 28% of GDP. Only 1944 and 1945 were higher in the last 150 years.

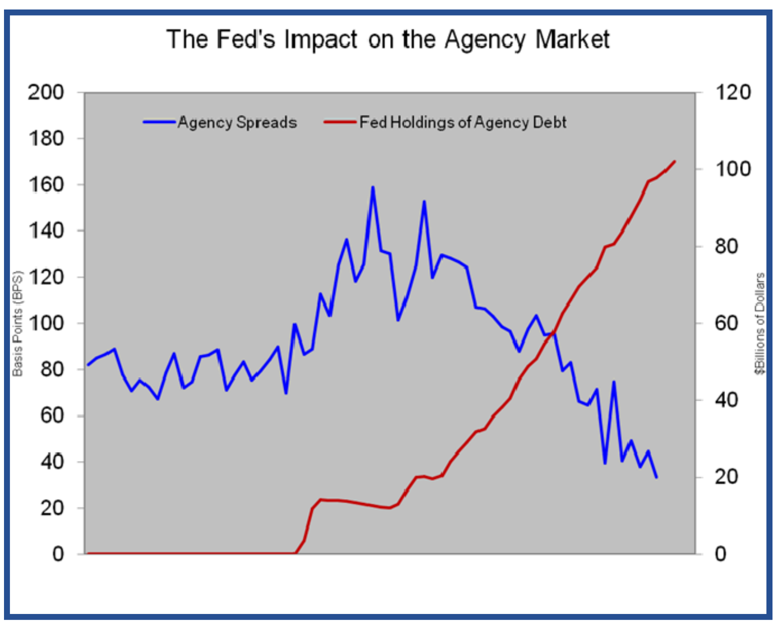
Referring to **Figure 3**, we can see that mortgage spreads on Fannie Mae mortgage-backed securities (**blue line**) were rising sharply in the aftermath of the sub-prime crisis which began in June of 2007. However, we can see that mortgage risk spreads began to **tighten markedly** in the aftermath of the Fed's intervention in the mortgage market via their formal ***"quantitative easing"*** program, whereby they have committed to purchase up to **$1.3 trillion** in agency mortgage-backed securities. As reflected by the **red line** in **Figure 3,** the Fed currently holds just under **$550 billion** in MBS, an amount equaling just over **20 percent** of all agency MBS outstanding. As such, the Fed is directly **one-fifth** of the mortgage market. It remains our contention that the dramatic spread tightening in the MBS market is not signaling a marked improvement in the functioning of the market, but is rather, reflective of the massive level of intervention by the Federal Reserve.

Figure 3



An eerily similar picture develops when we look at the agency market. Referring to **Figure 4**, we can see the same pattern as in the MBS market. Rising agency spreads prior to the massive level of intervention by the Federal Reserve. Currently, the Fed has purchased and holds just over $100 billion in Agency securities. While the ***"dead hand"*** of statist intervention is clearly all over the financial markets, making it nearly impossible to correctly interpret information contained in market movements, it also underscores the subtle pressure on investment managers to generate investment alpha via the ***"patronage trade"*** whereby managers attempt to *anticipate* those markets or companies the stabilizers will intervene in and get in

Figure 4

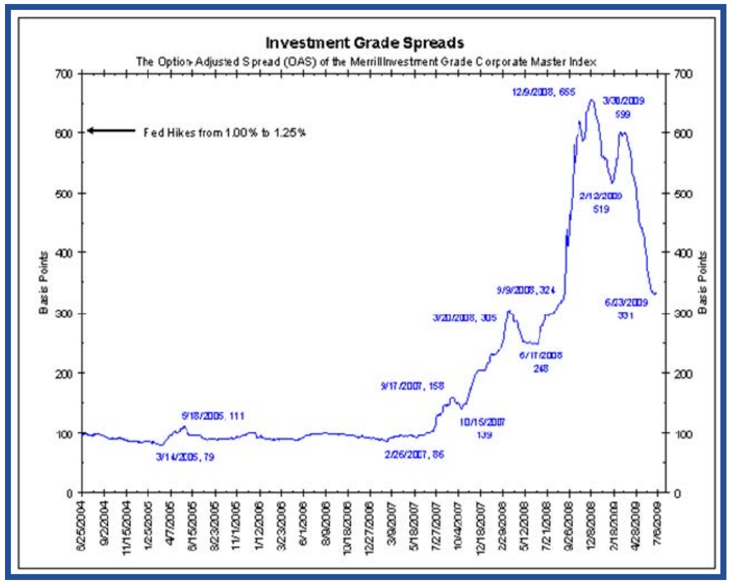


ahead of them. This, in our opinion, is a strategy fraught with peril and can only be pursued successfully by those select few who have access to the inner sanctum.

Clearly the one sector where the patronage trade has been successful thus far in 2009, has been the corporate sector.

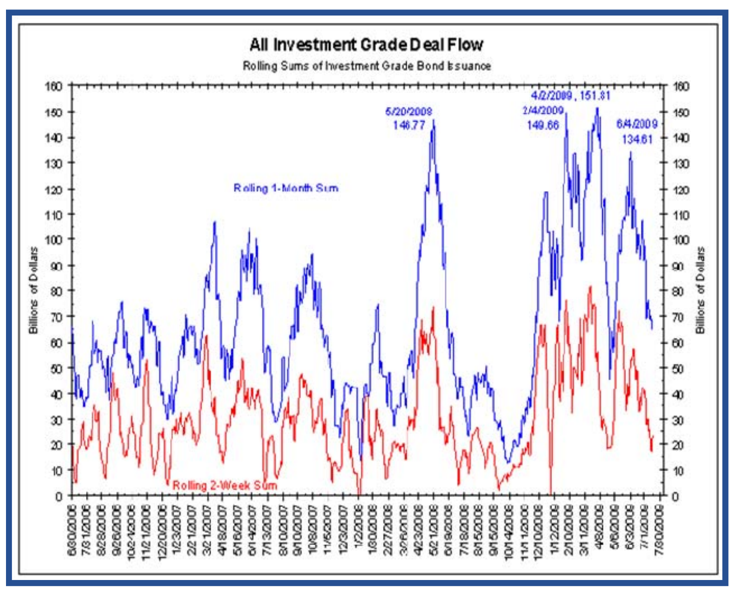
Referring to **Figure 5** provided by Arbor Research, we can see that investment grade spreads have tightened dramatically from their all-time highs reached in December of 2008. After peaking at around **655 basis points**, investment grade credit spreads have tightened by over **300 basis points**, driving the highest quarterly return in the corporate sector (8.81%) since the early 1980's. Again many point to the collapse in risk spreads as an indication that the credit markets are returning to normal and again we disagree. And although we would agree that the corporate market is the least ***"medicated"*** of the credit markets, the impact of the stabilizers can still be seen.

Figure 5



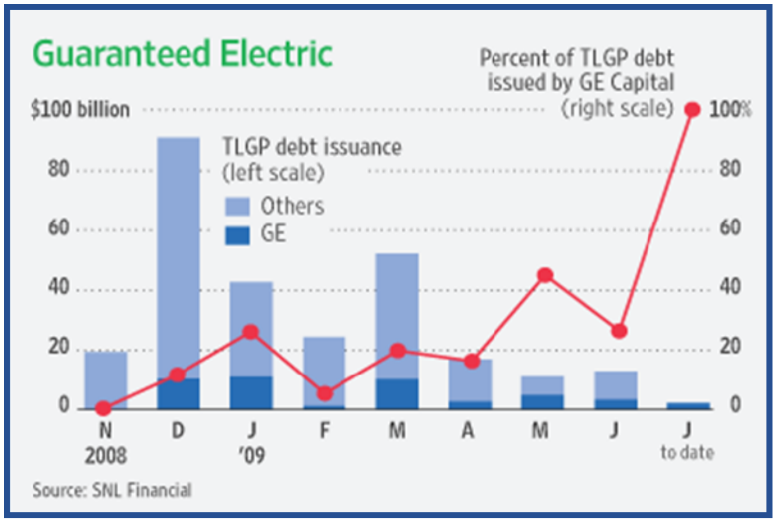
Referring to another of Arbor's charts in **Figure 6**, we can see that **new issuance** of investment grade debt has slowed recently from their first and second quarter highs. It was in fact, the return of new issuance to their previously high levels of 2008 that was heralded as indicative of a return to normalcy. However, aside from the recent **bearish collapse in issuance**, we would also point out that during the **rush to issue debt** during the first half of 2009, **over 50 percent** of all new issuance was issued under the **FDIC's TLGP guarantee program** and was therefore effectively **"new Treasury" issuance** as the debt was guaranteed by the FDIC which is in turn guaranteed by a **$500 billion credit line** from the Treasury. The impact of this program on GE debt issuance can be seen in **Figure 7**. We would also be quick to point out, that while investment grade corporate spreads have indeed tightened markedly, at a level of **300 basis points**, they are still **substantially higher** than their previous record high reached in 2002. Also, we would note that despite all the rhetoric surrounding the appearance of

Figure 6



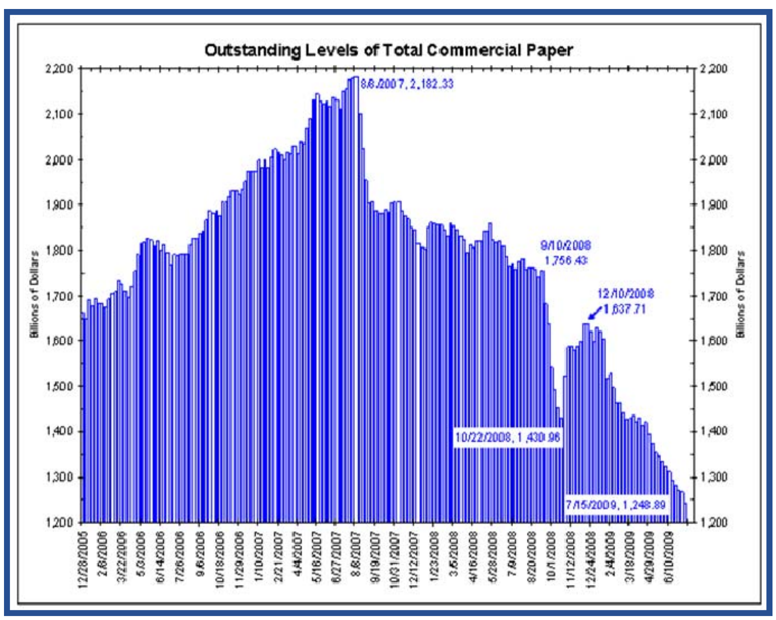
"green shoots" in the economy, we are not convinced that the bottom has been put in regarding corporate profits. The headlines as of late, heralding profits above analysts' estimates, are in our opinion, a **straw man**. To date, the lions' share of those exceeding their ***"guided" estimates***", have posted higher per share earnings exclusively on reduced costs (employee layoffs and plant closings) as opposed to higher sales. Top line earnings continue to fall relative to prior periods. In time we fear those "green shoots" will turn out to be weeds, since both grass and weeds respond to the same stimulus.

Figure 7



The same observations regarding the impact of federal intervention and stimulus could be made with respect to most credit markets. The headlines abound with stories proclaiming that **LIBOR** no longer paints a true picture and that the extraordinary level of government intervention in this market has distorted the rate to the point that banks no longer use LIBOR as the reference rate for unsecured lending. And under the Fed's **commercial paper program**, the Federal Reserve will buy and rollover your commercial paper. This has become known as the ***"GE Bailout Program"*** as GE is the largest commercial paper issuer in the world. And while it is true that commercial paper spreads have tightened, it is also true that the commercial paper market is a mere shadow of its' former self. (see **Figure 8**) The bottom line is that almost all credit markets are either ***"managed"*** or ***"medicated"*** by way of federal intervention. There is no unfettered market mechanism by which to steer. For this reason, we do not believe the ***"all clear"*** has been given and now is the time to re-enter the pool. To quote Jim Bianco, ***"Investing in a market with government involvement is like the world of the magician David Copperfield … welcome to my reality where nothing is as it appears."***

Figure 8



Overview of Economy

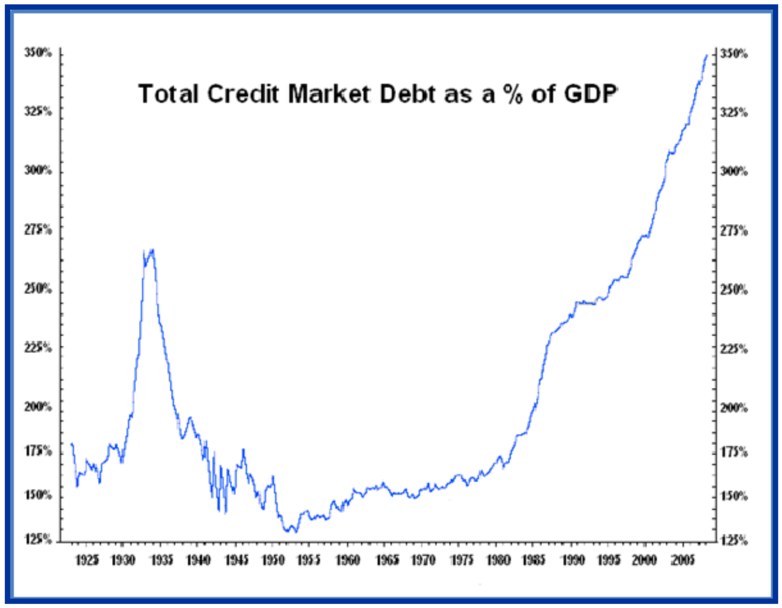
"Inflation or deflation, Tell me if you can.
Will we become Zimbabwe, or will we be Japan."
Country music spoof performed by
"Merle Hazard and Bretton Wood"

Someone wrote a book entitled, ***"Don't Sweat the Small Stuff – and it's all small stuff."*** And while we would generally agree with the sentiment expressed by the title, there are, nevertheless, times when it is critical to get the big picture right. In our opinion, that time is now, particularly as it relates to investors and their stance on the incessant debate surrounding inflation versus deflation. The question to be decided is simply this: ***Are we, in fact, facing a debilitating deflationary spiral, or will the unprecedented level of monetary and fiscal stimulus create (hyper) inflation?*** To this question of inestimable importance, we offer an unequivocal, *"yes"*.

Before you accuse us of duplicity, consider first, a brief review of our written record. For many years before it was either fashionable or generally accepted, we wrote extensively about the existence of an **unprecedented bubble in credit**. We said the effects of this Fed engineered credit inflation were **unsustainable economic distortions** and **malinvestments**, and as such, the greatest risk arising from their inevitable correction would be a debilitating **debt deflation** *a la* Japan or circa 1930s America. In January of 2003, we published an economic newsletter devoted entirely to the topic of deflation entitled **'The Sum of All Fears'** and in this piece, we outlined the process by which ***credit inflation*** leads to ***credit deflation***. To accomplish this, we first had to disabuse our readers of the misguided notion that deflation is simply a ***decline in prices***. This definition is favored by **Keynesians** of all stripes who usually attribute the fall in prices to a collapse in aggregate demand, undoubtedly triggered by what all Keynesians consider to be that most insidious of economic activities – **saving**. By reasoning from effect (falling price level) to cause (evergreen credit expansion), the stabilizers fraudulently arrogate to themselves the moral ground from which to fight the pernicious foe of falling prices by imagining the most discredited theory in political economy, **dissaving**. *If people will not do what is in their best interests*, namely borrowing to spend themselves into prosperity, *then the government must needs do it for them*. To embrace *this* view of deflation, is to ***"strain at gnats, and swallow camels."***

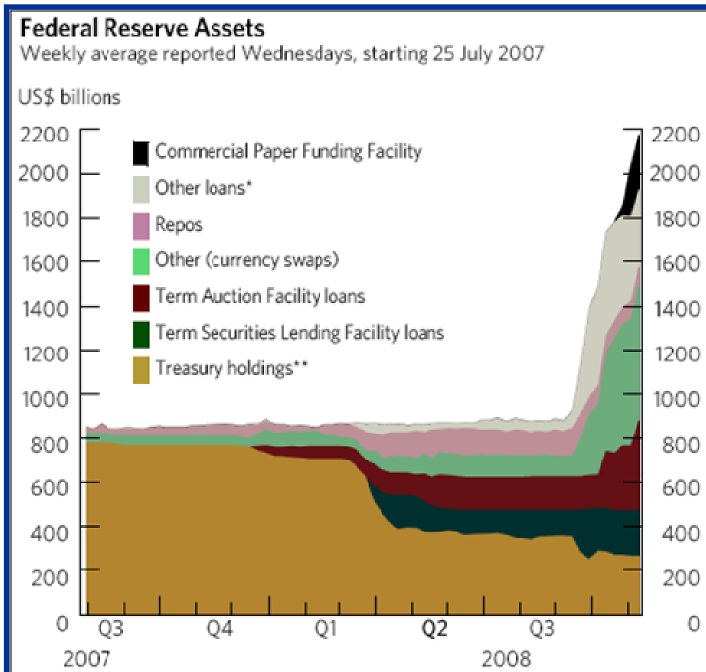
Properly defined, deflation is any decease in the quantity of money and credit in circulation, just as inflation, properly defined, is any increase in the quantity of money and credit in circulation. This decrease (increase) in the quantity of money may be caused by either a decrease (increase) in the money supply or a rise (fall) in the demand for money, or some combination of the two. Changes in the general price level *per se*, are merely the potential *effects* of the deflation or inflation, they are not the cause. Another closely related misconception regarding the *effects* of both deflation and inflation is the idea that any change in **price levels** resulting from an increase or decrease in the volume of money, must, by definition, be restricted to the **goods market**. Surely this canard has been fully and finally debunked, as over the past decade, we have witnessed first-hand the effects of unbridled credit inflation on the **price of marketable assets**, with the creation of multiple bubbles in both stocks (twice) and housing, all of which ultimately collapsed under their own deflationary weight. It is sheer sophistry by the Fed to point to a tame or falling price index (the effect) as ***"objective proof"*** that inflation (credit expansion) is non-existent. In so doing, the stabilizers have, wittingly or unwittingly, underwritten the largest inflation of money and credit in the last century. (**See Figure 9**) The ultimate effects of which have been reflected in both the price of assets (stocks and homes), as well as in economic distortions, such as the collapse in private savings and a burgeoning trade deficit. All the while, a complicit Fed has pointed to a low and stable price level as justification for a policy of reckless monetary accommodation. Ironically, Benjamin Strong's Fed of the 1920's used the very same ***"happy circumstance"***, i.e., a falling price level, as the basis to open the money spigots and *"give a little coup de whiskey to the stock market"*, and so ensure our permanent prosperity. In both instances, the results have been the same, unprecedented malinvestments and economic distortions resulting from an unsustainable expansion of credit. It was for this reason that we concluded our newsletter by stating ***"the sole precondition for deflation*** – namely a massive increase in debt – ***has already been met"*** and as such, ***"the deflation bomb is now in play."***

Figure 9



That deflation (properly defined), and not inflation (erroneously described), has in fact been the stabilizers ***"sum of all fears",*** driving the unprecedented policy actions of the past 18 months in an effort to forestall its occurrence, is another point we have been ardently making for some time. It has been our long-standing contention that the actions, not the rhetoric of the stabilizers, reveals their tacit understanding that should the US economy follow in the footsteps of Japan and slide into the black hole of a deflationary contraction, they would be powerless to extract it. As economist Robert Prechter has observed, ***"You can't beat deflation in a credit-based system."*** For this reason we documented several ***"white papers"*** written by both Mr. Bernanke and the staff of the Federal Reserve over the past several years on the topic of **preventing deflation**. In their research, the authors concluded that the sole reason for both the Great Depression of the 1930s and Japan's "Lost Decades" of deflation in the 1990s and 00's, was an unwillingness by the respective central banks to do what was required and pursue a sufficiently aggressive monetary expansion. It was out of this ***"deflationary phobia"***, that Weimar Ben gave his *opus magnum* on deflation, 'Deflation: Making Sure It Doesn't Happen Here', publicly vowing that the Fed, "***armed with a technology called a printing press"***, would never again fail to pursue a monetary policy of ***"credible irresponsibility",*** and so established the intellectual foundation for his systematic strategy of ***"whatever it takes"***. At the same time, sycophants of the financial and economic quarters wring their proverbial hands in fear over the ***potentially inflationary consequences*** of the stabilizer's actions, all the while ignoring former Federal Reserve Governor Alan Blinder's admission that *"the last duty of a central banker is to tell the truth."* And while publicly talking about ***"targeting inflation"***, the stabilizers have continued to take unprecedented action to forestall what Mr. Bernanke has referred to as ***"Depression 2.0."*** These actions, including an impromptu expansion of their charter, a dizzying array of new liquidity and emergency lending facilities resulting in a doubling of the Fed's balance sheet (**See Figure 10**), zero interest rates, and a formal policy of quantitative easing, are reflective of the Fed's all-out effort to ***reflate*** both the banking system and the economy by, as Paul McCulley of PIMCO puts it, ***"turning deflationary swamp water into reflationary wine."***

Figure 10



* Other loans include other liquidity programs (e.g., Primary Credit Facility)
** Treasury holdings exclude TSLF loans
Source: Federal Reserve Board of Governors

So, will it be inflation or deflation? Einstein once observed that *"the only reason for time is so that everything does not happen at once."* Armed with this insight, and coupled with the proper definition of both terms, we respectfully qualify our original answer of *"yes"*, with *"in due time."* The credit inflation of the last decade *has become* the debt deflation of today. Writing in our January 2003 newsletter on deflation, we described the current deflationary environment as an involuntary tightening of credit triggered by a **massive repayment of loans** and the **impairment of value** in the banks' (both chartered and shadow) asset side of the balance sheet. Specifically, we said that "*should borrowers begin paying back a volume of debt greater than the amount of new loans issued, or if borrowers default on enough of their loans, or if the economy cannot support the aggregate cost of interest payments, or if enough banks become reluctant to lend, then the multiplier effect will operate in reverse and credit will contract.* ***"This"*** we said, ***"is deflation."***

How does that description of six years ago square with today's conditions? Remarkably well, we think. Consider first the marked trend in **debt repayment**. Referring to the two charts in **Figure 11**, we can see that after a decades-long collapse to a negative rate, the personal savings rate has **rebounded markedly**. However, the methodology employed by the Commerce Departments' NIPA calculation of the personal savings rate is that of a **residual**, whereby the personal savings rate is determined by subtracting personal consumption expenditures (PCE) from disposable personal income (DPI), and then dividing this residual value by DPI. And while consumer interest payments are included in PCE, **principal payments** are not. Looking now at the second chart in **Figure 11**, we can see that coincident with the meteoric rise in personal savings, there has been a **marked downturn** in the **household debt service ratio** (DSR). The DSR is calculated by using an estimate of required payments, **principal and interest**, on outstanding mortgage and consumer debt, divided by DPI. In our opinion, the sharp rise in personal savings and the marked downturn in the debt service ratio are **causally related**, and underscore the **current deflationary environment** whereby consumers are **deleveraging** by **repaying debt**, not increasing savings account balances.

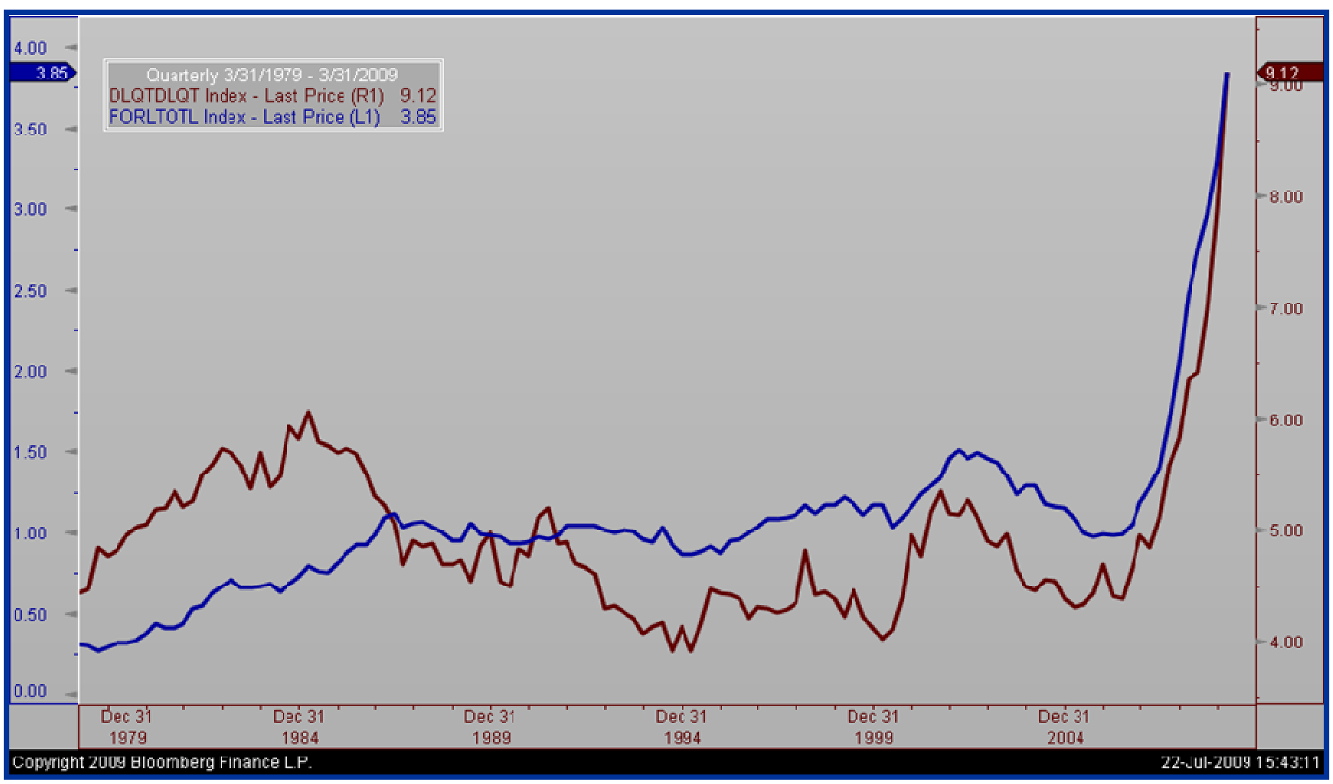
Consider next, the degree of **impairment in bank assets** by looking first at the level of delinquencies and foreclosures on mortgage loans. Referring to **Figure 12**, we can see that mortgage delinquencies (**red line**) as a percentage of mortgage loans outstanding, averaged around **3 percent** from 1979 through 2007. However, since the collapse of the housing bubble, the delinquency rate has skyrocketed to **9.12 percent**, the highest level recorded since the MBA began keeping records in 1972. In addition, we can also see that the percentage of loans in foreclosure (**blue line**), has likewise, recently spiked to an all-time high of **3.85 percent**. The combined rate of loans in foreclosure and at least one payment late is at a record **12.1%.** In addition, delinquencies on **sub-prime loans** has risen to **25%,** while delinquencies on **prime loans** rose to **6.1%** from 5.1% one quarter ago. And despite unprecedented efforts such as the Obama administrations' Home Affordable Refinancing Plan and the Fed's outright commitment to purchase up to **$1.3 trillion** in mortgage securities, home prices continue their inexorable decline while refinancing activity has all but collapsed, pointing to an increase in **deflationary pressure** on bank credit.

And what of the governments' previously announced plan for dealing with the impairment of bank assets by buying toxic assets from troubled banks, the **Public-Private Investment Program**, or PPIP?

Figure 11

When originally announced, the **$1 trillion** PPIP was heralded as the key element of the administration's financial stability plan. The original plan called for two components, one involved the purchase of **toxic loans** and the other the purchase of **toxic securities** from participating banks. The fund was to be run by private investment managers with the goal of purging bank balance sheets of toxic assets and providing ***"indicative bids"*** which would become the basis for valuing those toxic assets which remained on the banks' books. However, since its' announcement, the plan has been **curtailed drastically**, with the half of the program focused on buying toxic loans shelved, and the half focused on buying toxic securities, scaled back markedly. The official explanation from the Treasury and the FDIC is that the improved ability by banks' to raise capital through stock sales has mitigated the need to sell toxic assets. In our opinion, the real reason is far different. Recent decisions by banking regulators and the Financial Accounting Standards Board (FASB) have allowed the banks to ***pretend*** that the toxic assets have not declined in value as long as they **do not sell them**. Specifically, bank regulators conducting so-called ***"stress tests"*** arbitrarily chose not to include a banks' economic loss on any toxic assets that mature after 2010. Separately, FASB watered down accounting rules and reduced the pressure on banks to mark down the value of toxic assets. Taken together, the decisions by banking and accounting authorities amount to the implementation of a ***"Don't Ask, Don't Sell"*** policy which strongly discourages banks from selling any toxic assets that mature after 2010 at prices that would fairly reflect their impaired value. We are reminded of the admonition of political satirist P.J. O'Rourke who warned; ***"When buying and selling are controlled by legislation, the first things to be bought and sold are legislators."***

Figure 12

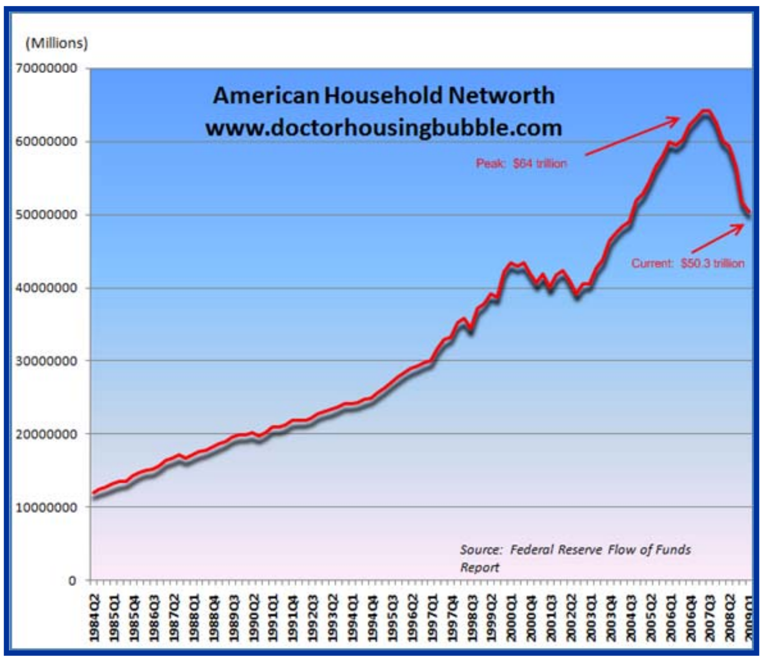


Despite the current deflationary environment, the correction of the malinvestments has not been accomplished since the collapse in asset prices has not been arrested and the destruction of wealth has not abated (see **Figure 13**). Thus far, all of the reflationary efforts by the stabilizers to ***"put humpty back up on the wall"*** have only managed to *forestall* the day of deflationary reckoning by effectively transferring the problem from the balance sheet of the **banking oligarchy** to that of the taxpayers, the US Treasury. However, it is our contention that by preventing the adjustment of prices, they not only forestall the correction, they **forestall the recovery**. Austrian economist Wilhelm Röpke summarized it this way; *"Deflation is the unavoidable reaction to the inflation of the boom and must not be counteracted, otherwise a prolongation and aggravation of the crisis will ensue, as shown by the experience of the US in the 1930s."* To paraphrase the Austrian position, *et sequitur*, **"no bust, no boom."**

However, it would be a mistake to blithely presume that the efforts of the stabilizers have failed and investors should simply resign themselves to an environment dominated by a debilitating debt deflation. We believe it will be important to follow the advice of the 19th century French economist Frédéric Bastiat, and analyze both ***"what is seen, and what is not seen."*** What *is seen* is an unqualified commitment by those in charge of the printing press to do *whatever it takes*, whether ***"by hook or by crook"***, to arrest the nascent deflation and prevent a catastrophic, standard-of-living-reducing, contraction of the money supply. Talking his own book while in London recently, Treasury Secretary Timothy Geithner claimed victory in their war on deflation by stating; "*Policy has been very successful in arresting and mitigating the force of the storm and we're starting to see a better basis for recovery."* Our translation; **Government intervention has succeeded in achieving its' top priority of protecting the banking franchise and postponing the day of reckoning in the hope that a false dawn will somehow alter the outcome as it chews up time.** This, in our opinion, is the sum total of what the stabilizers can hope to accomplish, a ***"successful failure."***

Regarding that ***which is not seen***, we continue to reiterate our long-standing conviction that contrary to conventional wisdom, there will be ***many false dawns*** as this epic struggle plays out between the irresistible force of deflation and the immovable will of the stabilizers to reflate. As such, there will be no **sequential recovery process** as delineated by Mr. Geithner, whereby we transition from deflation to reflation to inflation, with each step and its attendant investment risks clearly delineated. Instead, we remain of the opinion that as the **war of deflation-abatement** plays out, we will experience a rolling series of deflationary-reflationary episodes as the

Figure 13



inevitable process of price rediscovery and the unavoidable correction of malinvestments unfolds against the interventionists' efforts to maintain stability. Taking our cue from Hyman Minsky's Financial Instability Hypothesis, we hold to his conclusion that ***"stability will beget instability."*** And as such, we must now add a new risk measure to our investment lexicon, ***"central planning risk."*** This new form of risk reflects the non-linear risks associated with the stabilizers' great experiment with central planning. These are, in short, the real and unavoidable risks attendant to the **unintended consequences** of intervention by the "Leviathan State". These investing ***"uncertainties"*** represent what Donald Rumsfeld once called ***"unknown unknowns."*** Over time, the investment communities' insatiable desire to turn these ***"unknown unknowns"*** into ***"known unknowns"*** has promoted an over-reliance on **statistical analysis** in risk management, fostering an environment of arrogance and pseudo-science. However, more than eighty years ago, Frank Knight, the "Grand Old Man" of the University of Chicago, established the **"brute facts"** surrounding the **laws of uncertainty**. His work distinguished between **measurable** and **non-measurable** uncertainties and concluded that a measurable uncertainty is not an uncertainty at all, but is rather only **volatility**. He further concluded that what is a **real uncertainty** is both **unknowable** and **non-quantifiable**. It is, in fact, this very ***"real uncertainty"*** that now obscures both the response and the trend in asset prices in markets that are effectively **"managed"** and **"medicated"** by the stabilizers, that is "***not seen."***The investment conclusion we draw from this may be stated as follows: For investment decisions made under conditions of real (non-measurable) uncertainty, the **severity of the consequences**, not the **probability of occurrence**, should drive the decision. For even though we are forecasting a rolling recession as the most probable outcome of the continuing epic struggle between the market forces of deflation and the interventionists' forces of reflation, we must remain vigilant against the things *we don't know, we don't know*. For it is written; ***"Their foot shall slide in due time."*** Deut. 32:35.