REDSTONE ADVISORS INC.

MARKET REVIEW

Quarterly Review and Outlook

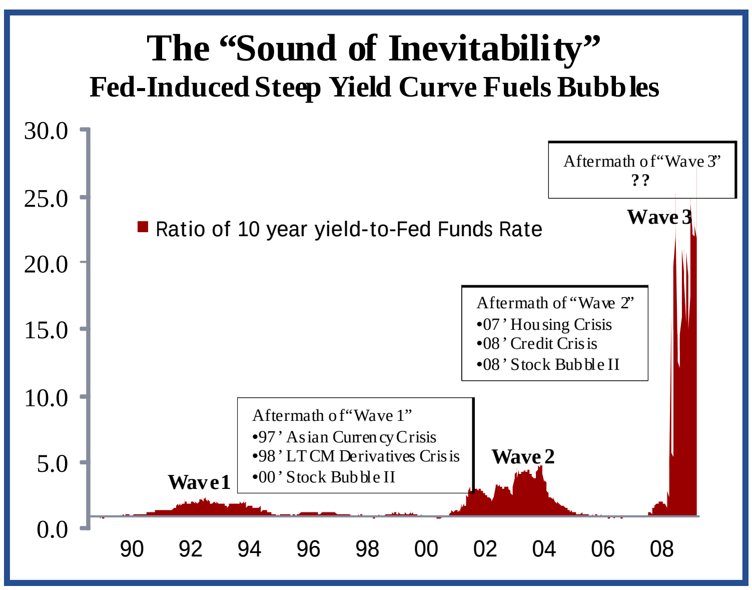
Third Quarter 2009 Report

"There's something happin'in here
What it is ain't exactly clear
It's time we stop, hey, what's that sound
Everybody look what's goin down"
Lyrics from 'Stop, Hey What's That Sound' by Buffalo Springfield

There is *"something happin'in here"* alright, and despite multiple requests for a full disclosure of their activities both within the courts (Bloomberg lawsuit) and Congress (Rep. Ron Paul), the stabilizers at the Fed have thus far not been very forthcoming. However, it is imperative that everyone understands exactly *"what's goin down"* because the *"sound"* we are hearing is the *"sound of inevitability"* as the stabilizers are again ***"blowing bubbles"***, bubbles which will inevitably collapse . . . . . again.

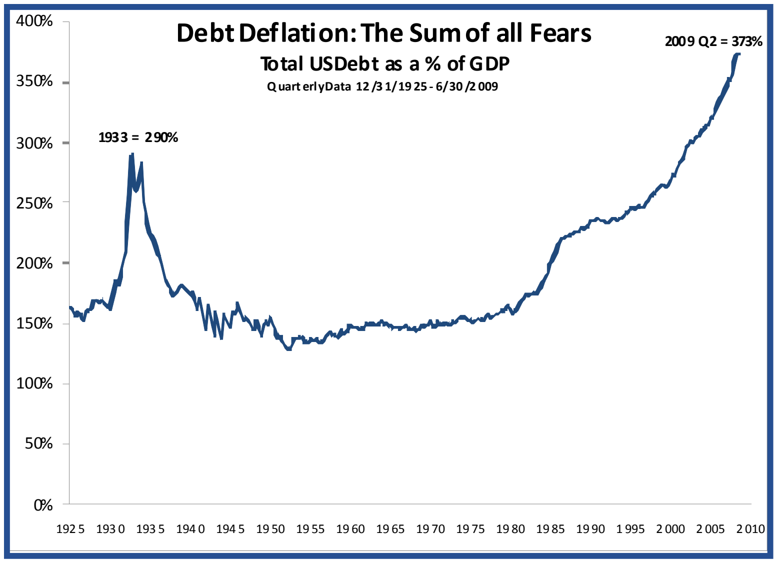
Referring to **Figure 1** we can see that by intentionally pursuing a zero-interest rate policy (ZIRP), the Fed has again engineered an **extremely steep** and **unstable** yield curve. Labeled as **wave 3** on the chart, we can see that the relative steepness of the current yield curve, at five-times that of wave 2 and ten-times that of wave 1, makes wave 3 a veritable **tsunami** by comparison. We have also indentified a representative sampling of the various financial crises which have followed in the wake of the previous liquidity waves initiated by the Fed. And while we are uncertain as to the timing of the next collapse, of its occurrence, we are certain. As Einstein once observed, *"the only reason for time is so that everything does not happen at once."*

Figure 1



The steep yield curve is both an artifact of the Fed's ZIRP and a centerpiece of their **"Policy of Postponement."** As we have explained previously, the stabilizers are engaged in an all-out effort to forestall a debilitating **debt deflation (Figure 2)**, the prospects for which, have ironically been greatly increased by the Fed's long-term strategy of postponing the day of reckoning by providing massive waves of liquidity. This policy of postponement has prevented the necessary liquidation of the **accumulated malinvestments** of past booms and redeployment of capital and labor, leaving the markets and the economy both **enfeebled** and inherently **unstable**. If the necessary redeployment of resources is prevented by bailouts and stimulus programs, past mistakes will survive and impede recovery in the future.

Figure 2



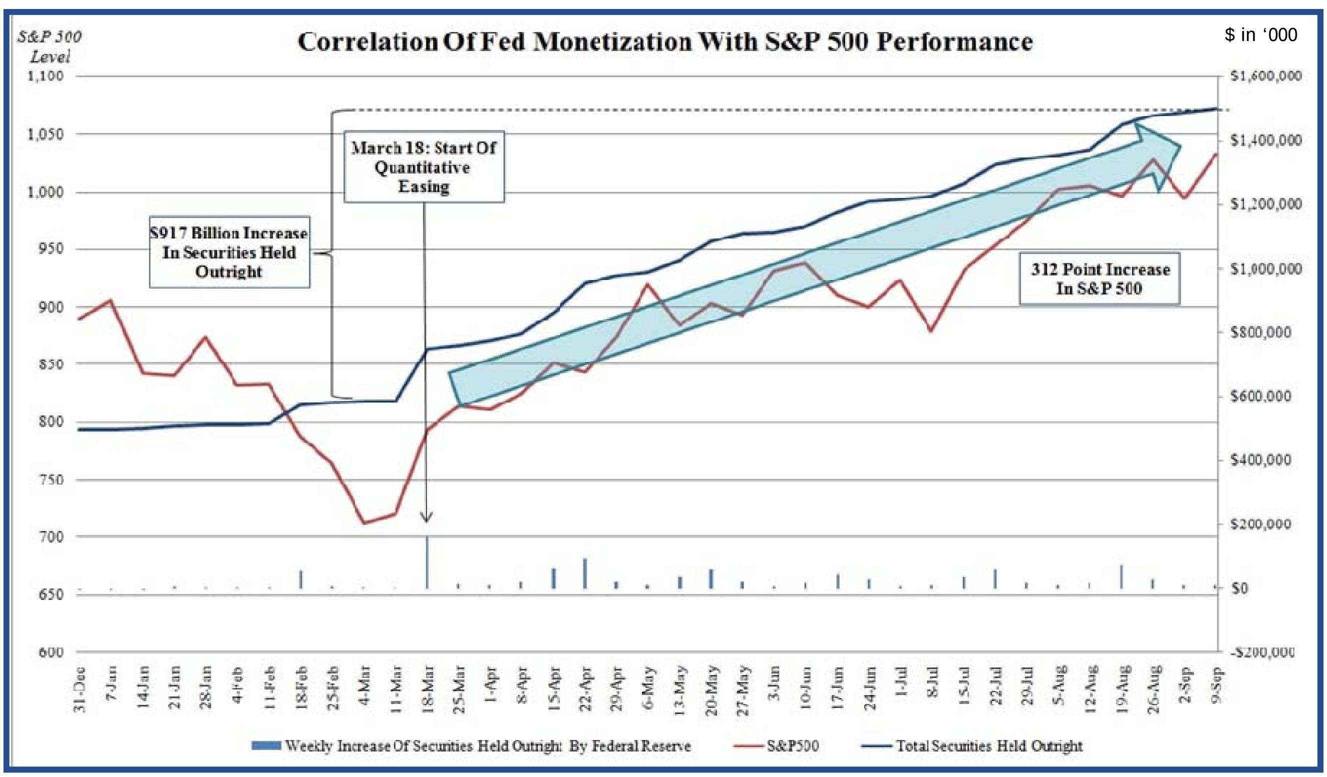
Importantly, it has been the stabilizers' aggressive use of this policy of postponement in the aftermath of the 2000 recession and stock bubble collapse that has both encouraged and enabled all forms of leveraged speculation, facilitating the transition of the US economy and financial markets to an inherently **unstable** and in our opinion, **unsustainable credit structure**. (**Figure 2**) Hyman Minsky, the father of the Financial Instability Hypothesis (FIH), referred to this unstable credit structure as **"ponzi finance"** whereby the lender expects neither the principal nor interest to be repaid, and "solvency" by the borrower can only be maintained by **perpetually rising assets prices** and the opportunity to refinance the debt at **perpetually lower interest rates**. And while as Bernie Maddof has so infamously demonstrated, even ponzi finance works as long as asset prices are rising, once the bubble is ruptured, the true condition of the debtor, like the ***emperor with no clothes***, is exposed. Writing prior to Minsky in 1933, Irving Fisher, the American economist noted for his debt-deflation theory of the Great Depression, anticipated Minskys' hypothesis by observing that "*a credit inflation that creates claims that masquerade as money is prone to deflation since the wealth needed to liquidate the credit is in short supply relative to outstanding claims."*

That these claims have been **"unmasked"** and we are again witnessing the collapse of asset prices that have been systematically inflated by years of credit expansion and speculation, we have previously established. And that the response to this event has been one of unprecedented intervention in an effort to perpetually forestall a deflation of credit, *a la* 1930s (**Figure 2**), we have also discussed at length. Throughout our discussion, we have at times characterized the **programme of the stabilizers'** as being eerily reminiscent to that of Japan, replete with "zombie bank" bailouts, massive deficit spending, a zero interest rate policy and the latest rendition of failed Japanese policy, **"quantitative easing"**, a euphemism for the indiscriminant and heretofore unlimited buying of any impaired asset with **"printing press money"**. To date, the sole visible result of this policy of postponement, i.e., the unprecedented level of intervention and liquidity creation, has been the achievement of a **"New Normal"** consisting primarily of **medicated markets** and a **statistical recovery**.

Currently, all financial markets, are, to one degree or another, either managed or medicated, resulting in liquidity-driven rallies and an abnormally high degree of correlation across all markets. This medicated condition in the markets is the direct result of the unprecedented level of government intervention by way of various liquidity facilities, discounting operations, asset purchases and debt guarantees, oftentimes with the Fed as the primary participant on the bid side. By way of illustration, during the second quarter of 2009, the Federal Reserve purchased **$164 billion** in US Treasury securities, a level of intermediation equal to **50 percent** of net Treasury issuance for the quarter. With respect to the Federal Reserves' purchase of mortgage securities, year-to-date the Fed's net purchases of mortgage-backed securities totals nearly **$800 billion**, a level equal to more than **80 percent** of the securities issued this year by Fannie Mae and Freddie Mac. And when combined with the Federal Reserve's purchase of **$130 billion** in agency debt issued by Fannie and Freddie, the percentage **exceeds 100 percent** of all mortgages issued thus far in 2009! As a result, of the $1.8 trillion originally earmarked for asset purchases under the **quantitative easing program**, the Fed has **"officially"** purchased nearly **$1.1 trillion** in Treasury, mortgage and agency securities thus far. And while Herbert Stein once correctly observed that *"anything that can't go on forever will stop"*, at the current level of intervention, any serious discussion regarding the impending withdrawal of stimulus from the markets should be framed in the context of St. Augustine's prayer: *"Lord give me chastity, but not just yet."*

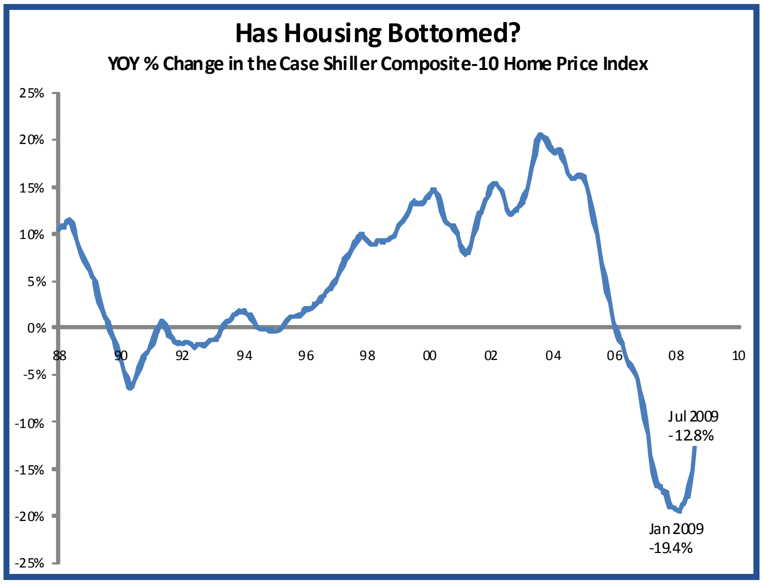
Now we said **"officially"** because of the recent discovery of certain **"shadow monetization operations"** being employed by the Federal Reserve. In one such operation, new Treasury and agency securities issued at auction have subsequently been quietly monetized by the Fed, usually within days, but in some cases, within just hours of their issuance, utilizing primary dealers as intermediaries in order to obscure their actions. In yet another more covert version of this operation, the Federal Reserve has printed money to purchase US agency debt from the custody accounts of foreign central banks (FCBs) who subsequently used those sales proceeds to buy US Treasury bonds at auction. These operations have the obvious effect of keeping the all-important Treasury auction **bid-to-cover ratio** artificially high, thereby promoting the appearance of a **limit-less appetite** for US Treasury bonds by FCBs. And given the current CBO estimates of the required Treasury issuance over the next three years to fund burgeoning fiscal deficits, the importance of avoiding a **"failed Treasury auction"** cannot be overemphasized. And finally what is perhaps less obvious is that by executing monetization operations covertly via the Treasury auction, additional **undisclosed liquidity** is injected into the coffers of the primary dealers – liquidity which can then be used in their own proprietary trading operations to **"influence"** markets. (**Figure 3**)

Figure 3



In addition to medicated markets, the policy of postponement has given rise to the much-heralded and oft-repeated end of the Great Recession by producing what in our opinion is simply a **"statistical recovery"**. In support of this assertion, numerous sightings of **"green-shoots"** have been reported, the most notable of which has been in the housing market. According to many economists, the objective proof of a bottoming of the housing market can be seen in the recent rebound in the **Cash Shiller housing indices**. Referring to **Figure 4**, we can see that in fact, the YOY percentage decline in the Case Shiller Composite-10 Home Price Index is now falling at a slower rate, a negative 12.8 percent in July versus a negative 19.4 percent in January. This liberal definition of a recovery is what has been labeled by some as a **"second derivative recovery."** Mathematically, the second derivative is the *rate of change* in the *rate of change*. Translation: Things are getting worse at a slower pace. Clearly then, the collapse of home prices has been arrested signaling a bottom in housing and we are now well on our way to recovery. Or are we?

Figure 4



Recall that over the past 18 months, the stabilizers have intervened heavily at virtually every stage of the home-buying process. As a result, according to the trade publication Inside Mortgage Finance, "*more than 80 percent of all new residential mortgage loans made this year (2009) have benefited from some form of government support."* (**Figure 5**) Beginning in September of 2008 with the government's bail out of Fannie Mae and Freddie Mac by effectively nationalizing their $5.4 trillion loan portfolios to keep funds flowing to the housing market, to multi-billion dollar programs for new loan subsidies and rate modification programs, virtually no aspect of the mortgage process has been overlooked. And as noted earlier, the Fed has purchased more than 100 percent of the mortgages issued in 2009 ($800 billion) along with $300 billion in Treasury bonds. (Treasury yields serve as the all-important benchmark interest rate for establishing home mortgage rates) And to top it off, the government is also offering $8,000 in tax credits to first-time home buyers.

Figure 5

Mortgage Originations by Type

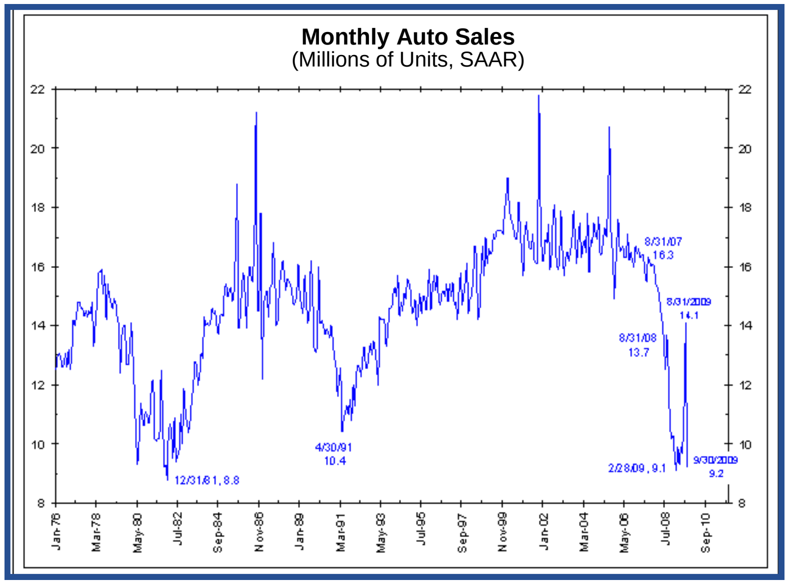
(Dollars in Billions)

Year/ Quarter	Total Gov't Related	Gov't Related Mkt Share	Other	Other Mkt Share	Total Originations
2000	$491.15	46.9%	$556.85	53.1%	$1,048.00
2001	$1,081.60	48.8%	$1,133.40	51.2%	$2,215.00
2002	$1,457.35	50.5%	$1,427.65	49.5%	$2,885.00
2003	$2,143.89	54.3%	$1,801.11	45.7%	$3,945.00
2004	$1,021.27	35.0%	$1,898.73	65.0%	$2,920.00
2005	$961.54	30.8%	$2,158.46	69.2%	$3,120.00
2006	$895.11	30.0%	$2,084.89	70.0%	$2,980.00
2007	$1,166.72	48.0%	$1,263.28	52.0%	$2,430.00
2008	$1,157.80	77.2%	$342.20	22.8%	$1,500.00
2009-6 mos.	$816.51	82.1%	$178.49	17.9%	$995.00

Source: Inside Mortgage Finance

When you add it all up, we are of the opinion that the reason that housing appears to be bottoming is the same reason car sales were advancing in August during the governments' **cash-for-clunkers program** – there was a government subsidy driving them higher. So despite all the talk about ***"green shoots"*** and a ***"light at the end of the tunnel"*** because markets have rallied and housing prices are falling at a slower rate, it is our contention that this **"statistical recovery"** will follow the same trajectory as auto sales did when the stimulus is finally withdrawn. (**Figure 6**) After all, we must never forget that the light at the end of the tunnel can also be an approaching train.

Figure 6



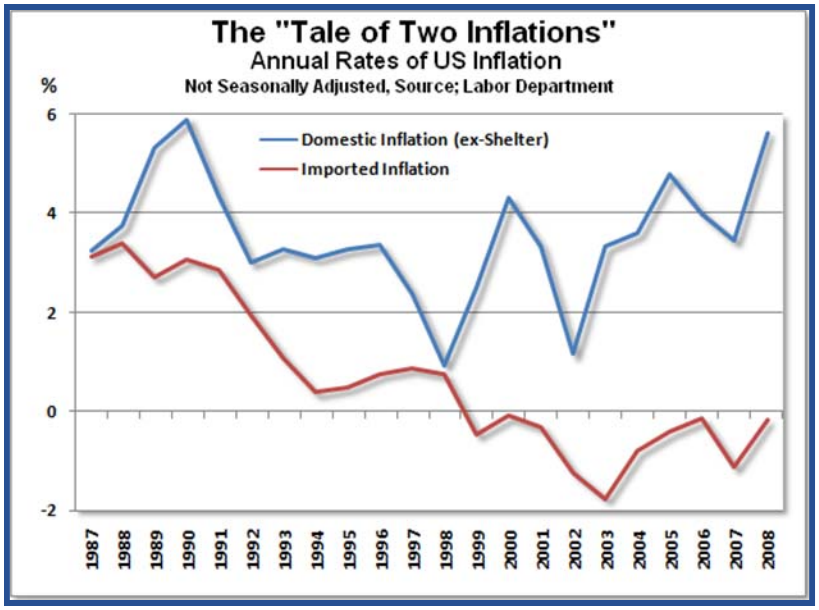
That a train is approaching, we have no doubt. As we have oft repeated, the fundamental economic problem is not the "bust" – rather it is the credit-driven "boom" during which too many claims go masquerading as wealth. The current financial crisis was the result of too much cheap credit, too much indebtedness and too many malinvestments. It is, therefore, more than a little ironic that the stabilizers are attempting to resolve the crisis with . . . even cheaper credit and even more indebtedness in an attempt to subsidize and protect malinvestments and overproduction -- in the banking system, the housing sector, the auto industry, and everywhere in between. Writing about this nearly a century ago, the Austrian economist, Joseph Schumpeter warned that the only sound economic recovery is an **organic recovery**. Government stimulus, he observed, *"adds to an undigested remnant of maladjustment, new maladjustment of its own which has to be liquidated in turn, thus threatening business with another crisis ahead."*

In addition to the problem of undigested malinvestments, there is also the *not so insignificant* issue of the stabilizers' **exit strategy**. At some point, the Fed will have to exit the markets and withdraw the medication. If they exit too early, it would be tantamount to ***"Atlas shrugging"***, precipitating the very deflationary collapse they have long been struggling against. If they exit too late, they risk at best, rising inflation and higher long-term interest rates, while at worst, they risk the collapse of the dollar and hyperinflation *a la* Weimar and Zimbabwe. And while opinions divide sharply over whether we will have deflation or inflation, what is beyond all doubt is that they *will* get it wrong.

In our opinion, the Fed has clearly demonstrated its' willingness to do ***"whatever it takes"*** to forestall a debt deflation, and will therefore act as they have in the past and stay too loose for too long. Under this scenario, the consensus opinion would call for rising inflation along with sharply rising long-term interest rates. However, we have reservations regarding such a conventional outcome, due to both the structural bifurcation in goods inflation as well as the stabilizer's resolve to keep interest rates low.

The bifurcation of goods inflation revolves around the **tale of two inflations**, one for domestic goods and services and another for imported goods. Referring to **Figure 7**, we can see that prices for domestic and imported goods have been moving in opposite directions for many years, with prices for import goods experiencing outright deflation since 1998. In contrast, prices of domestic goods have been rising by over 3 percent per year on average, with the current year-over-year rate of inflation in domestic goods running at nearly **6 percent**. Setting aside the sizable issues surrounding the management of **"reported inflation"** such as hedonic adjustments, geometric weighting and substitution of owners' equivalent rent for the cost of homeownership, falling prices for imported goods have been a key factor in the story of **benign inflation** in recent years. And low inflation rates, regardless of their source, have been the **"basis"** for keeping interest rates too low for too long. However, the real story regarding the **trend in future inflation rates** lies in the source of the deflation in imported goods. And while an abundance of cheap labor in emerging Asian economies has certainly played an important role in declining import prices, it has been the **managed exchange rate** of Asian currencies, principally the Chinese Yuan that has had the greatest impact on the trend in imported goods inflation. However, since moving from an artificially low fixed rate of exchange to a **managed appreciation** of the Yuan in 2004, the trend in inflation of imported goods has been **rising steadily over the past five years**, and is currently close to zero. (**Figure 7**) In our opinion, while China's exchange rate policy will clearly play an important role in the reported rate of US inflation in the near future, their policy decisions will be based solely on their own domestic agenda, with their need to sustain the export side of their economy by **resisting a rapid appreciation of the Yuan** taking precedence. Against the background of massive liquidity creation by the US Fed and heightened fears of rising inflation, such action would, paradoxically, serve to keep import inflation under control.

Figure 7



If import inflation remains low, we believe that reported inflation in the US will remain **"contained"** given the aforementioned issues regarding the **management** of domestic inflation rates. As such, reported inflation would not exert undue pressure on long-term interest rates, thereby perpetuating the favorable "benign" inflation environment so necessary for the stabilizers to keep interest rates too low for too long. Under these conditions, the bubble that is currently being created in the financial markets will ultimately implode, with the same result for investors. Referring to **Figure 8**, which graphs the quarterly change in US net worth since 1970, we can see that since the wholesale adoption of the policy of postponement as the preferred means to meet the dual mandate of maintaining both price stability [of assets] and full employment, the **degree of volatility in wealth creation** has exploded. As a result, for the twenty-five year period between 1970 and 1995, the ten-year annualized rate of change in net worth averaged **9.1**

percent with inflation for this period averaging 5.7 percent per year, resulting in a real or inflation-adjusted annualized increase in net worth of **3.4 percent** for this period. In stark contrast, for the fourteen year period between 1995 and 2009, the annual change in net worth fell to just **3 percent**, and using the **"official"** inflation rate of 2.7 percent, the real annualized increase in net worth was just **0.4 percent**. Given the degree of malfeasance in reported inflation, it is clear that the Fed-induced cycle of boom-bust-boom **destroys wealth**, rather than creates wealth. For this reason, we continue to maintain that the appropriate assessment of the ongoing **"great debate"** regarding the likely occurrence of deflation versus inflation, can be best summarized by the statement of Gluskin Sheff economist, David Rosenberg; *"Deflation is the fact, inflation is the fear."* As such, investment decisions made under these conditions should emphasize **"surviving dollars"**.

Figure 8