January 4, 2010

REALITY VS. PERCEPTION

It is very important that we help you attain an understanding of what is taking place in the economy and financial markets. As we all know, reality and perception of that reality can be poles apart. This is exactly what has taken place in 2009, just as it did in 1999. Our discipline kept us from abandoning our position then, and if you recall, we recouped all of our 1999 loss in the first three months of 2000. As it always has in the past, economic fundamentals (see the list at the end of the commentary) will prevail and our investment strategy will deliver the returns that coincide with reality as opposed to the prevailing perception.

Reality

We appear to have emerged from the most severe recession since the 1930s. What we have not done is corrected in any fashion the underlying economic dislocations that will allow this economy to grow as strongly as in the past. You cannot correct economic over-indebtedness with additional debt, i.e. stimulus packages. It has never worked in the past and won't this time either. Yes, it is quite likely that the 4Q09 real GDP will be in the neighborhood of 4.5%; however, the old axiom that the shape of the recovery is determined by the severity of the recession will not happen this time - in other words, according to said axiom, a sharp and deep recession should be followed by an acute and large rebound. Again, it won't happen! Inventory rebuilding, the narrowing of our trade deficit, and government stimulus will provide a *temporary* GDP boost, but will not propel this economy in any sustainable measure.

With the above in mind, it is clear that stock prices are terribly overvalued and fixed income securities (other than direct U.S. government obligations) are also overvalued.

Perceptions

The consensus since the spring of 2009 has been that the recession would come to an end during the second half of the year and that a strong economic recovery and expansion would thus

ensue. Supposedly, this strong growth would reignite inflation with the real possibility of hyper-inflation, driving the dollar to zero and interest rates to the sky. The gold bugs, who have been preaching this scenario since the 1970s have finally attracted a main stream following. It's back to obtaining inflation hedges – stocks and commodities, plus precious metals. We are frank to admit that this scenario is plausible, but only well into the future. Before we get to that distant event, a long, long period of debt deleveraging must take place, first in the private sector, then later in the public sector. Debt reduction is deflationary and we will only reach inflation once these deflationary measures have been corrected. It is also possible that a real political leader may emerge from somewhere and address the inept monetary and fiscal policy that has prevailed in Washington since the days of Hoover and Roosevelt and seems to be coming to a head as this is being written.

A Final Comment

2009 was not a good year for us. The month of December was particularly bad as tax-loss selling took place. We expect this to be reversed and then some in 2010.

We take our responsibility seriously and encourage you to call with any questions and/or concerns, day or night. No call will go unanswered.

We encourage you to add to your present positions, as we have in the past when the markets have temporarily gone against us. Act proactively when and if you can - we have done so during last year for our personal accounts. Recent surveys have shown government bonds to be the least desired securities in the market place. It is best to buy an asset before other investors recognize its true value. Once government bonds become a desired asset, it will be too late to gain maximum returns.

The Economic Fundamentals

1. **We are experiencing a balance sheet recession. The last one was in the 1930s.**
2. **High debt levels along with high unemployment place a damper on personal consumption.**
3. **Current public policy (government taxing and spending) is anti-growth.**
4. **There is no shortage of anything except brains.**
5. **A slide back into recession will probably take place toward the middle of 2010.**

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