

The logo for Crescat, featuring the word "Crescat" in a white serif font centered within a dark red rectangular background.

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Crescat Capital
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Crescat (Latin): To grow, increase, expand/spring forth, arise

Important Legal Disclosures

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Long-Term (Secular) Economic and Financial Market Paradigm Shift

We continue to believe that profound secular macroeconomic paradigm shifts are driving today's increasingly turbulent financial markets. We also recognize the simultaneous powerful cyclical countertrends. We outline these shifts along three key dimensions in the grid below: Private Capital Markets, Public Policy & Public Capital Markets, and Natural Resource Markets. The first two columns show key elements of the transition from the old to the new paradigm. While many of our themes overlap across dimensions, the last column highlights our active cyclical and secular investment themes most closely associated with each dimension. We highlight in maroon italics two important new cyclical themes that we intend to both capitalize on and protect against in the near and intermediate term.

	Old Secular Paradigm (20-30 Years)	New Secular Paradigm (? Years)	Crescat Investment Themes (Secular and Cyclical)
Private Capital Markets	<p>From Debt-Fueled Global Economic Boom</p> <ul style="list-style-type: none"> Leveraged financial sector boom Booming economy both in the US and globally Declining US savings vs. consumption: never-ending strength of the US consumer Off-balance-sheet derivatives boom Private sector accounting shenanigans Win-Win global economic balance Stock and bond bull markets 	<p>To Global Economic Slowdown under Debt-Excess</p> <ul style="list-style-type: none"> Financial sector bust under unsustainable leverage & self-reinforcing meltdown in credit-related assets Ongoing US-led economic stagnation with recurrent recessions Demise of the US consumer Derivatives bust Mark to model accounting crack up Lose-Lose global economic destabilization Stock and bond bear markets 	<ul style="list-style-type: none"> <i>Sharp BRIC Intermediate Term Economic Correction: (cyclical)</i> Real Estate Bust (cyclical and declining emphasis) Financial Sector Bust/Credit Crisis (cyclical and declining emphasis) Low US Economic Growth with Recurrent Recessions (secular) Emerging Market Relative Growth (secular)
Public Policy & Public Capital Markets	<p>From Persistently Easy Monetary & Fiscal Policy Works</p> <ul style="list-style-type: none"> Fed to the rescue with increasing faith in the Fed Growing US fiscal deficits US\$ as world reserve currency Flight to quality = flight to US Treasuries (UST) Strong global demand for UST Declining interest rates Public sector accounting shenanigans believed by markets Declining risk premiums Declining monetary inflation Deregulation and lack of oversight in financial sector 	<p>To Train Wreck from Persistent Easy Monetary & Fiscal Policy</p> <ul style="list-style-type: none"> Fed to the rescue with declining faith in the Fed Unsustainable US deficits Flight from the US\$ & UST Flight to quality = flight to precious metals Massive oversupply of UST Rising interest rates Global financial market discipline for US policy indiscretions Rising risk premiums and increased financial volatility Global monetary inflation spiral Increased regulation and oversight 	<ul style="list-style-type: none"> Upward Shift in the US Treasury Yield Curve (secular) Global Fiat Currency Crisis/ Prisoner's Dilemma (secular) US Political Shift of Power (cyclical)
Natural Resource Markets	<p>From Bear Market in Commodities</p> <ul style="list-style-type: none"> Persistently low CPI Declining raw material inflation Ample, cheap oil supplies No concern about potential impacts of oil economy on climate New money and credit flow to financial assets and real estate under goldilocks paradigm 	<p>To Scarce Natural Resources Bull</p> <ul style="list-style-type: none"> Recognition of distorted inflation accounting Rising raw material inflation Increasingly limited and expensive oil supplies (peak oil) Mandate to address climate issues New money and credit to stimulate financial and Real Estate bust diverted to fan commodity bull 	<ul style="list-style-type: none"> <i>Sharp Intermediate Term Industrial & Energy Commodity Correction (cyclical)</i> Scarce Energy Resources (secular) Commodity Supercycle (secular) Climate Management (secular)

We will discuss each key secular paradigm shift in turn.

Private Capital Markets: From Debt-Fueled Global Economic Boom to Global Economic Slowdown under Unsustainable Debt

Real Estate Bust: We didn't have much company when we warned of the imminent reversal in the Housing Bubble and coming bust in late 2005. We positioned accordingly and capitalized on that theme. Today, no one disputes the Housing Bust. The level of home sales is down sharply from its peak (Figure 1). Home prices are down 16% in the last year and 19% from a peak in July 2006 (Figure 2).

There is far from consensus, however, on whether the Housing Bust has fully played out and—if not—when the worst will be behind us. Though existing home sales rose 3.1% in July (to 5.0M annualized), the National

Figure 1: Construction Activity

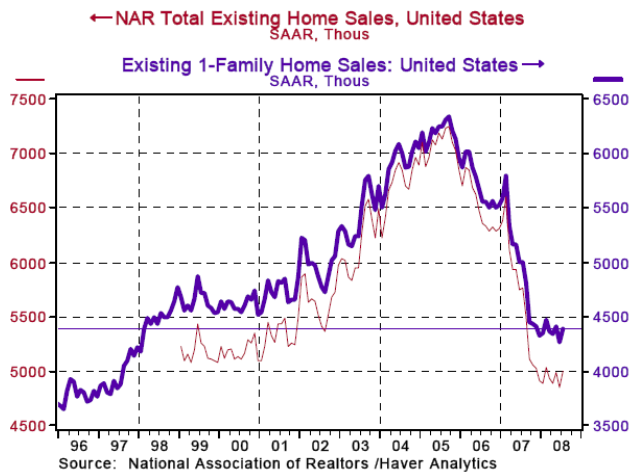
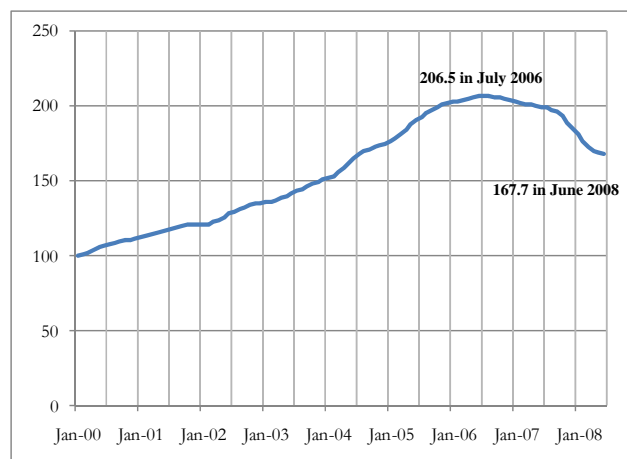
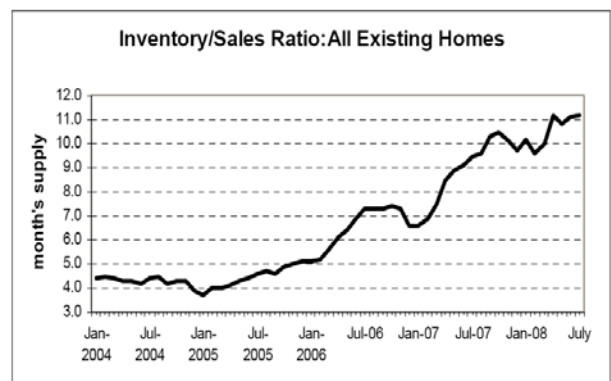


Figure 2: Case-Shiller Home Resale Price Index



Association of Realtors indicates that 33 to 40% of those sales were foreclosed properties. Price declines are decelerating though they are still declining; the July price decline relative to a year ago was 15.6%. With a record inventory of unsold homes of 4.67 million or 11.2 month's supply at the end of July (Figure 3) and total housing sales close to its lowest level in nine years (5.44 million annualized rate in July according to a survey of economists conducted by Bloomberg News), we believe that home prices will need to drop farther before home sales will revive. The inventory of unsold homes is 60% higher than its 25-year mean and is at its highest point

Figure 3: Unsold Homes

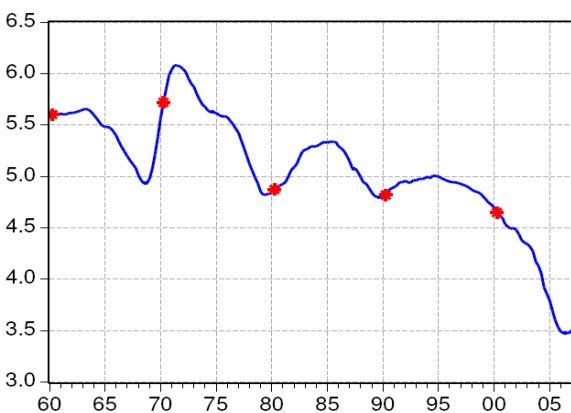


Source: National Association of Realtors

since 1985. Furthermore, in absolute terms, the home pricing correction – while significant – is still only half of prior economic corrections, according to Oppenheimer analyst Meredith Whitney.

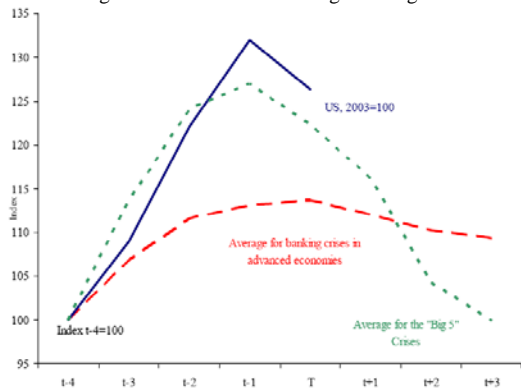
Looking at it from another perspective, home ownership is still expensive relative to renting (Figure 4), suggesting that home prices will see more downside.

Figure 4: Ratio of Rents to Home Prices (percent)



Source: Northern Trust Global Economic Research

Figure 5: Home Prices During Banking Crises



Source: Carmen M. Reinhart, University of Maryland, Kenneth S. Rogoff, Harvard University and the NBER

In the first six months of 2008, the Case-Shiller home prices index fell by 9.4%. An additional home price decline of 13.6% would be required to bring the Rent Price ratio to its long-term 4.8% average

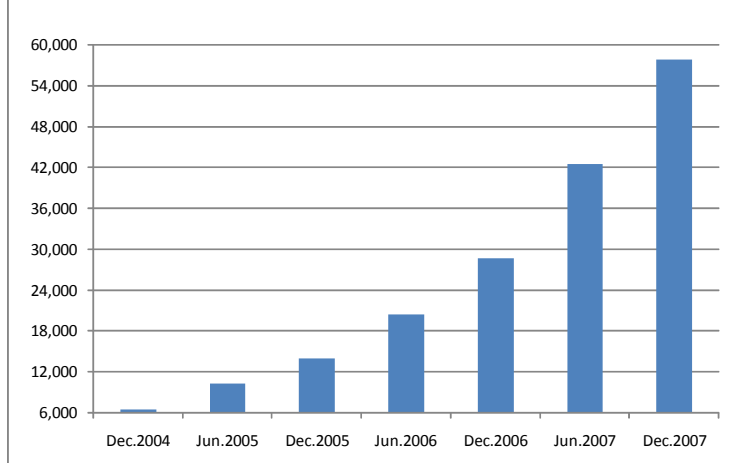
Finally, home prices may face up to 20% further and even more importantly, lingering, price declines that persist for at least three years from their peak in 2006, based on comparisons with other worldwide housing led financial sector crises (Figure 5). Many seem to be predicting an imminent V-bottom of sorts in housing while the data portend a more gradual rounded bottom that doesn't happen for three years from the peak at the soonest. This indicates that we are probably at least a full year away from a bottom in housing.

We have pared back our residential housing shorts to a select few, reflecting our sense that this aspect of our theme has already mostly played out. We are, however, maintaining some short positions in commercial REITs. Most importantly, we believe that the protracted housing weakness will continue to impact the US and global economy negatively (to be discussed later in this letter).

Financial Sector Bust: Nouriel Roubini, an economics professor at New York University, has argued that the true cost of the financial sector crisis will not be a mere \$300 billion, the amount allowed for by the housing legislation now before Congress, but something approaching \$2 trillion. "Reckless people have deluded themselves that this was a subprime crisis," he told the *New York Times* recently. "But we have problems with credit-card debt, student-loan debt, auto loans, commercial real estate loans, home-equity loans, corporate debt and loans that financed leveraged buyouts." As reported by the NYT, Roubini argues that "all of these forms of debt suffer from some or all of the same traits that first surfaced in the housing market: shoddy underwriting, securitization, negligence on the part of the credit-rating agencies and lax government oversight." "We have a subprime financial system," Roubini argues, "not a subprime mortgage market."

We share Roubini's opinion on the broader nature of the financial crisis. We have long argued that we are in the midst of the unwinding of the most severely leveraged and economically significant debt bubble in world history.

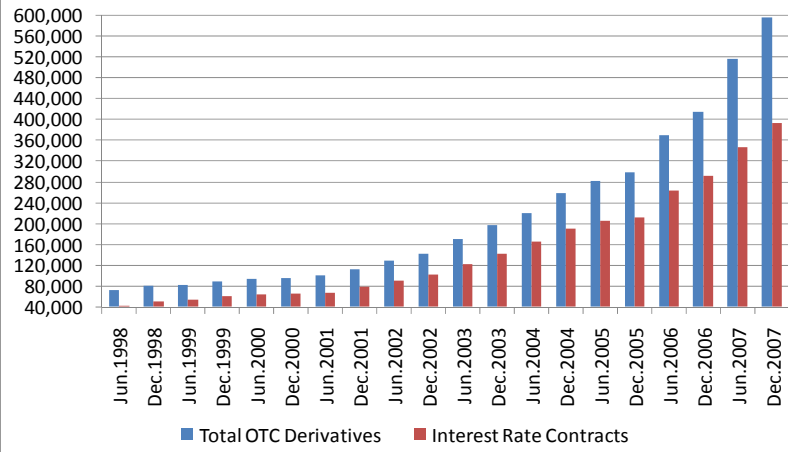
Figure 6: Notional Amounts Outstanding of Credit Default Swaps (\$US billions)



Source: Bank for International Settlements (BIS)

We initiated our Financial Sector Bubble theme in very early 2006 ahead of the peak in financials when very few saw it coming. We went on to warn a year ago of the imminent bust in the sector and warned of an imminent re-pricing of risk across the entire spectrum: credit risk, economic-cycle risk, inflation risk, liquidity risk, volatility risk, duration risk, and counterparty risk. We believe that the excessive leverage and asset problems in the financial sector are even worse than Roubini acknowledged, however, as he failed to mention the notional exposure of off-balance-sheet/over-the-counter (OBS/OTC) derivatives in the financial sector (Figures 6 and 7) which have literally

Figure 7: Notional Amounts Outstanding of OTC Derivatives (\$US billions)



Source: Bank for International Settlements

grown out of control (without regulation) over the past several years.

The financial sector levered up to record levels of both on-balance-sheet and OBS exposure in the last decade under a false paradigm of low inflation, low financial asset volatility, and new prosperity trumpeted by global central bankers themselves, who believed their policies had conquered the business/economic cycle—see the Bank of International Settlements study published in August of 2006 entitled *The Recent Behavior of Financial Market Volatility*. As we predicted a year ago — now clearly evident — such policies have only reinforced, not conquered,

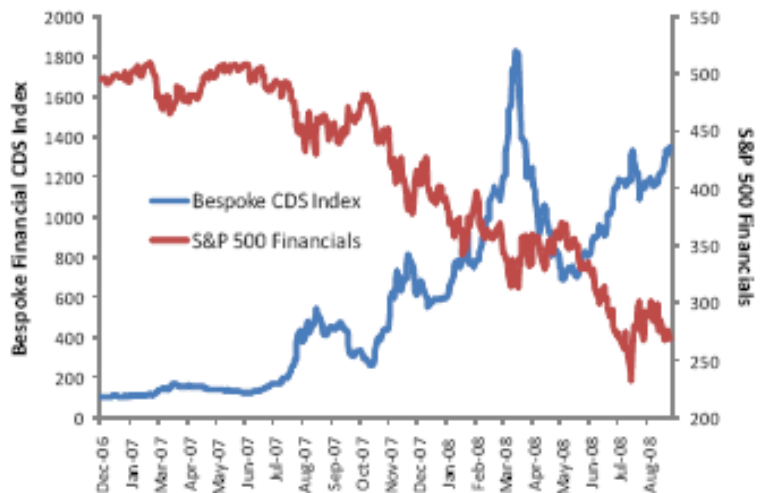
the business cycle, and now public policy has turned to massive central bank and fiscal bailouts, the response that we also believed was inevitable, a key to our longstanding Dollar Crisis thesis that we will discuss later.

With the credit crisis now in full swing, the financial sector remains grossly undercapitalized relative to its assets which are over-exposed to all of these same risks which are now feeding on themselves. All major industry components of the financial sector are caught up in the financial crisis: banks, thrifts, broker-dealers, REITs, insurance companies, and the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.

The on-balance leverage alone is excessive and unsustainable. We have already seen over \$500 billion in financial sector write-downs, primarily related to sub-prime CDO assets led by Citigroup (\$55.1B) and Merrill Lynch (\$51.8B). We share Whitney’s view that hundreds of billions in additional mortgage write-downs await us from likely further housing price declines alone. The Citigroup and Merrill write-downs are likely not the last at those firms, but they have now set valuation levels — 22 cents on the dollar — for sub-prime assets that augur further imminent write-downs at many other firms faced with the need to catch up to these mark-to-market levels.

The excessive leverage has contributed to high bank default risk (Figure 8). Several of the largest and ironically most prestigious broker dealers for instance are operating at 3-5% Common Equity to Total Assets (not even considering OBS exposure). These are alarmingly thin margins of capital at a time when assets are imploding. The Value-at-Risk models and stress tests that banks and broker-dealers use to manage their risk have recently proven to have grossly overestimated the amount of leverage that can be supported. The financial sector may indeed be facing the extreme *Black Swan* risk event recently warned of by *New York Times* best selling author Nassim Taleb. The risk to the

Figure 8: Bank and Broker CDS Index vs. S&P 500 Financial Sector



Source: Bespoke

banking sector of Off Balance Sheet (OBS) derivative exposure alone, is shown in the table below (Figure 9). Among the top three banks, it would take just anywhere between a 15 and 43 basis point loss on the gross derivatives exposure to wipe out their entire common equity. We think it is impossible to maintain such amounts of leverage without large scale accounting shenanigans and that this has been going on for a long time already to get to these extreme leverage amounts.

Figure 9: Off Balance Sheet Derivatives Exposure of Top 10 Banks

Name	Common Equity (\$B)	Total Gross Derivatives Exposure - IRS, CDS, etc (\$B)	Total Net Exposure According to Bank's Valuation Model (\$ B)	Total Leverage Applied to Derivatives	% Loss on Gross Exposure to Wipe out Common Equity
JPMorgan Chase & Co	133	89,997	480.5	187 x	0.15%
Bank of America Corp	163	37,940	222.3	171 x	0.43%
Citigroup Inc	136	37,691	338.3	111 x	0.36%
Wachovia Corp	78	4,885	48.8	100 x	1.60%
HSBC Bank USA	251	4,280	116.6	37 x	5.86%
Wells Fargo & Co	48	1,440	26.1	55 x	3.33%
Bank of New York Mellon	29	1,059	11.7	90 x	2.74%
State Street Corp	14	905	16.1	56 x	1.55%
PNC Financial Services	18	249	5.6	44 x	7.23%
SunTrust Banks Inc	18	241	6.8	35 x	7.47%

Source: Comptroller of Currency; Crescat Capital analysis

We can not help but recall Warren Buffett's past warnings from his shareholder letters that derivatives are both "ticking time bombs" and "financial weapons of mass destruction." Buffett as usual is ahead of the times and learned the ultimate fate of the recent derivatives parabolic growth curve from personal, painful experience in trying to unwind the derivative portfolio of GenRe that he acquired more than half a decade ago now. Buffett reminded us that those who trade derivatives are paid based on earnings calculated by "mark-to-market accounting in securities for which there is no market so mark to model is used instead" leading to "large scale mischief".

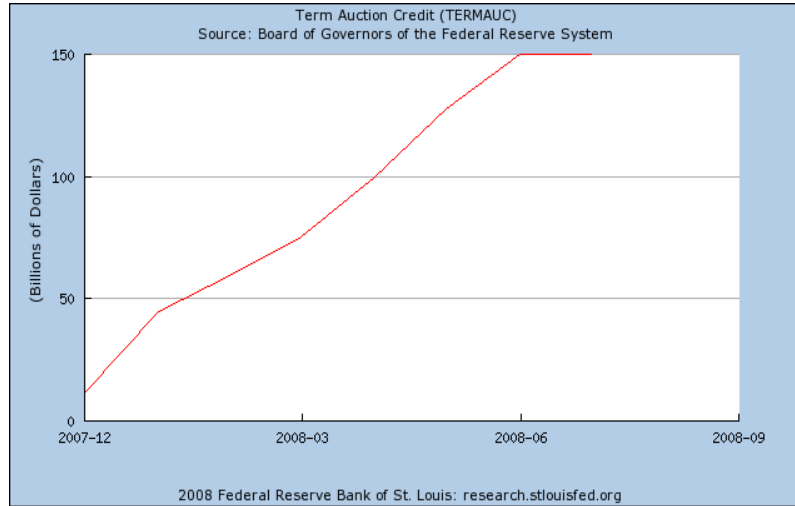
We believe that "large scale mischief" has indeed been at work for some time with strong financial sector profits for years being recorded while operating cash flows have been substantially negative, just one indication of mis-marking of assets, i.e. generally recognizing gains but not losses (on the hopes that the losing positions will come back eventually). We have been warning of the mark-to-model covering up of losses for some time and believe the problem only continues to grow, now likely being aided and abetted by our policy makers who know that they can't reveal the true extent of these losses, much like the savings and loan crisis in the 1980s.

In his annual Jackson Hole address last week, Bernanke acknowledged for the first time the very significant OBS/OTC derivatives systemic risk to the financial system. He raised the potential for a financial clearinghouse to facilitate a market mechanism for valuing derivatives assets. We think a clearinghouse would be a great idea but the establishment of such an entity would probably reveal more major problems than it would solve in the short run. Anyone opting into the clearinghouse would likely be required to submit to a true mark to market. Losses that have been swept under the rug based on mark-to-model accounting, therefore, would be exposed. We think it was this problem that led Bernanke to point out that there was much opposition and disagreement about how to establish a clearing market.

Ultimately, counterparty risk could cause major structural losses in the highly leveraged credit derivative markets. In his recent speech, Bernanke reminded us that counterparty risk was the reason the Fed could not allow

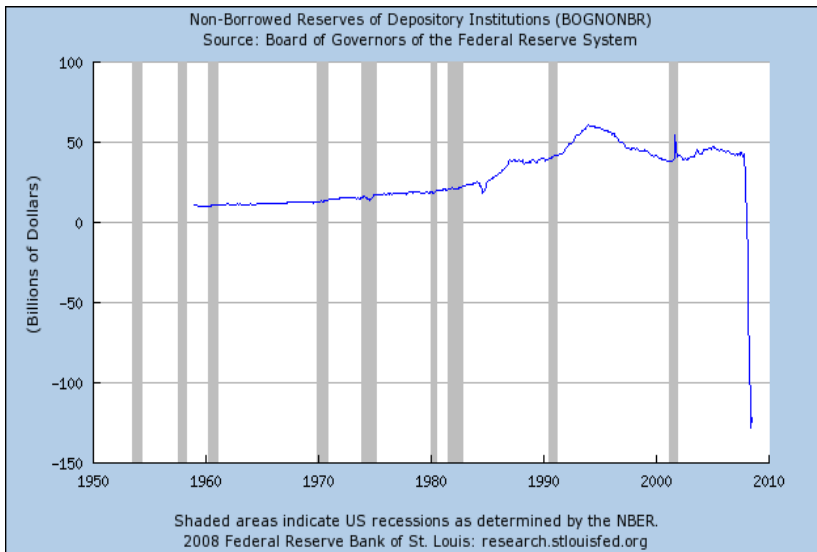
Bear Stearns to fail: “Bear Stearns was deeply involved in a number of critical markets, including markets for short-term secured funding (repurchase agreements) as well as those for OTC derivatives. One of our concerns was that the infrastructures of those markets and the risk-and liquidity-management practices of market participants would not be adequate to deal in an orderly way with the collapse of a major counterparty.” Bernanke goes on to explain how it could have led to a “vicious circle of forced selling, increased volatility, and higher haircuts and margin calls that was already well advanced at the time and would likely have intensified. The broader economy could hardly have remained immune from such severe financial disruptions.” We couldn’t agree more that the risk and consequences of a major counterparty failure is substantial.

Figure 10: Term Auction Credit



The Fed has strived to prevent such failures including many near death encounters with firms such as Countrywide, Bear Stearns, Lehman, AMBAC, MBIA, Fannie Mae, and Freddie Mac by both aggressively reducing the

Figure 11: Non-Borrowed Reserves of Depository Institutions



Federal Funds Rate and by implementing new funding mechanisms — the Term Auction Facility (TAF) and the Primary Dealer Credit Facility (PDCF) — to provide a lifeline directly to banks and large broker dealers. The amounts borrowed under these new facilities have been significant, but we expect them to accelerate further. \$150 billion has been taken down already this year under the TAF (Figure 10).

As a result of the TAF, Non-Borrowed Reserves as of July 1 totaled a negative \$122 billion. (Figure 11). Non-borrowed reserves are historically a positive number. In other words,

banks are required to keep reserves (i.e., un-encumbered or non-borrowed reserves) on deposit with Fed. But due to TAF such un-encumbered reserves are now completely negative and more than twice as much to the negative as they ever were to the positive side. This is just one sign that points to the current effective insolvency of the banking sector and massive Fed bailout to deal with it.

Many banks and securities firms (Merrill Lynch and Wachovia posing particular concern) have a record combined \$871 billion in bonds maturing this year and next, according to JPMorgan Chase & Company, just as bank bond spreads (relative to Treasuries) have risen by 3.38% points in the last eighteen months, another indication of liquidity problems.

It was a failure of regulatory authorities not to recognize the moral hazard problem in the derivatives markets and therefore the need to regulate them. Our government, the taxpayers, and our foreign creditors will almost certainly pay the price.

We have been short financials since their peak and believe that there will be significant further losses. However, financials have been beaten down significantly, so we are very selective in our short positions, focusing on those with the best combination of low common equity to assets (high leverage), high market value to net tangible equity (overvalued), and those with largest OBS derivatives exposures (hidden liabilities).

Economic Slowdown: With the bursting of the debt bubble comes the demise of the US consumer. Inflation is up (reported more extensively later in this letter), GDP growth is down (Figure 12), unemployment is up (Figure 13), and consumer savings are down. Not surprisingly, Consumer Confidence has plummeted from a high of 90% last December to roughly 50% in July, its lowest level since the 1980 recession — and we aren't even in an official recession yet (Figure 14).

Figure 12:

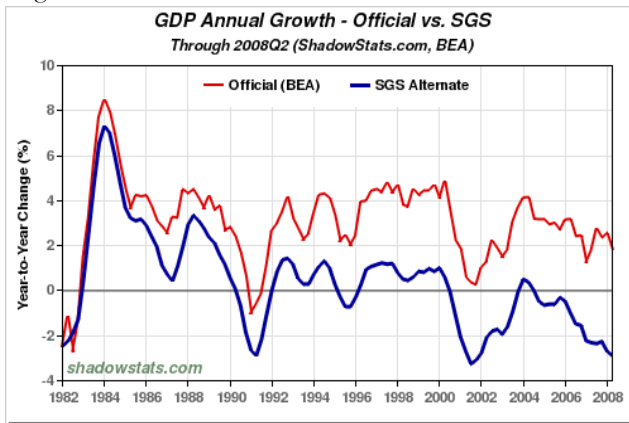
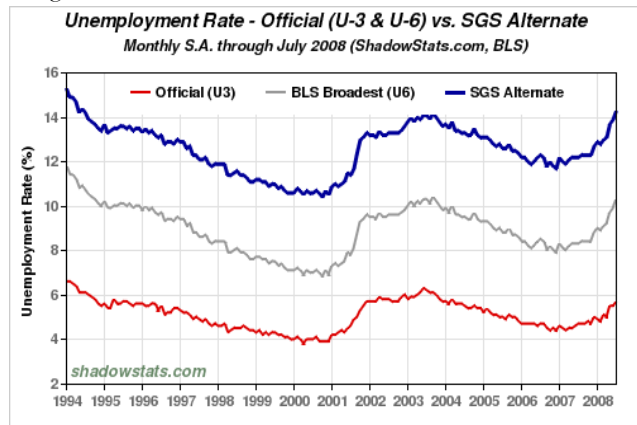
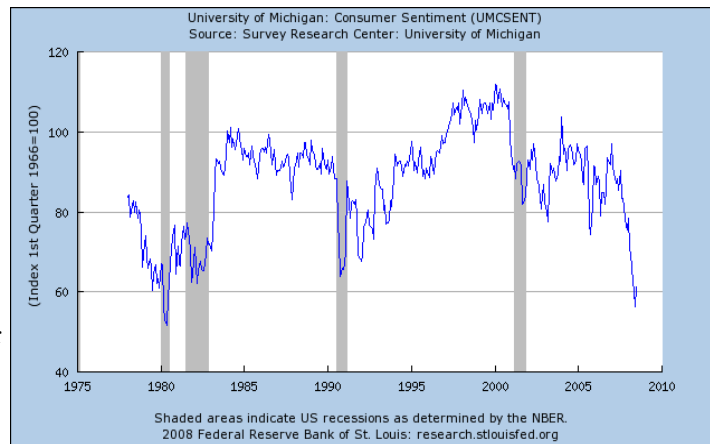


Figure 13:



The Fed has clearly made economic stimulus a priority. As George Soros commented in his recently released work, *The New Paradigm for Financial Markets* (2008), however, “the Fed is constrained in its ability to protect the economy by the fact that it has done it too often.” Despite the Fed’s best efforts, we believe that we are in midst of a substantial US recession and global economic slowdown. Most recessions are not acknowledged until well after they are started, typically resulting in a restatement of activity for prior periods. We believe the officially reported 2Q 2008 GDP is misleading. John Williams — in his *ShadowStats* analysis — highlights the overstatement of GDP growth by distorted inflation reporting. We support his conclusions that GDP growth is already negative (Figure 12) and that unemployment rates are above 14% and are at their highest rate since 1994 (Figure 13). Consumer Confidence is down sharply (Figure 14).

Figure 14: 2008 Consumer Confidence Index
Source: Conference Board

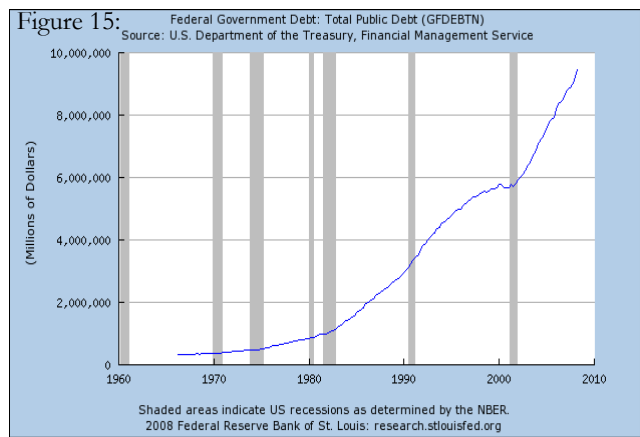


We expect recession-resistant sectors (Consumer Staples particularly) to do well in this environment, while discretionary and cyclical sectors (e.g., Consumer Cyclical) to do poorly. Utilities typically perform relatively well

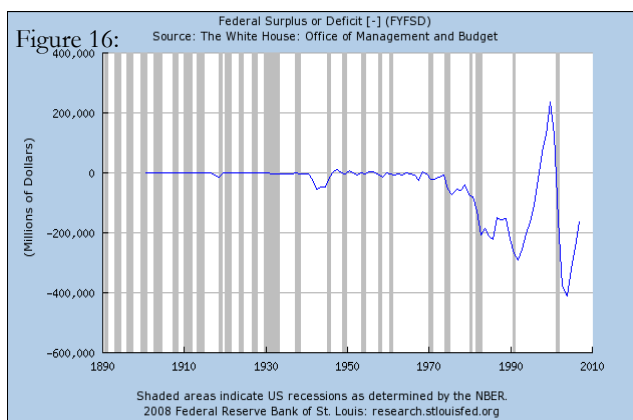
in economic slowdowns, though they face rising costs, growing resistance to increased revenues, and growing concern about their global warming impact. Therefore, we prefer utilities with nuclear and wind exposure.

Public Policy and Public Capital Markets: Persistent Easy Monetary & Fiscal Policy goes from Success to Train Wreck

Upward Shift in the Treasury Yield Curve: Fiscal policy has been key to the period of relatively sustained economic growth in the last few decades. Remarkably, the Treasury has been able to persistently increase debt and government deficit spending without any significant inflationary consequences over most of this period (Figure



15). On-balance sheet federal government debt (predominantly US Treasuries of various maturities outstanding) now approaches \$10 trillion.



The US federal budget went into surplus for several years during the Clinton Administration but has been cumulatively negative for most of the last three decades (Figure 16). In the 1970s such deficits were viewed as highly inflationary, but in the last few decades, it seems the world has learned to adapt to them without causing any serious inflation concerns to be reflected in the market for US Treasury securities. As we discuss in this letter, however, the projected increase in federal debt

from the imminent financial sector bailout and the massive entitlement imbalances portend substantial problems ahead for perceived inflation, perceived US credit quality, and the market for US Treasuries and the dollar.

The US government released its financial statements for 2007 recently. In the report, the Government Accountability Office (GAO) goes out of its way to warn the world, its citizens, policy makers, and investors of the disastrous fiscal course that the country is on. The GAO points to protracted deficit spending and massive new Treasury supply coming to market to fund our country’s current off-balance-sheet liabilities that dwarf the level of debt created to date. Importantly, the government accountants would not issue a clean opinion on the US government’s accrual financial statements, but shockingly, they did issue a clean opinion on the valuation of the off-balance-sheet liabilities not accrued for on the official statements. In their own words, here is what the GAO reported in the recently released 2007 financial statements for the US federal government:

“For the 11th consecutive year, three major impediments prevented GAO from rendering an opinion on the federal government’s accrual basis consolidated financial statements: (1) serious financial management problems at the Department of Defense, (2) the federal government’s inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government’s ineffective process for preparing the consolidated financial statements...the GAO was able to render an unqualified opinion on the 2007 Statement of Social Insurance...Information included in the Financial Report, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting, can help increase understanding of the nation’s long-term fiscal outlook. The nation’s long-term fiscal challenge is a matter of utmost concern. The federal government faces large and growing structural deficits due primarily to rising health care costs and known demographic trends. Simply put, the federal government is on an imprudent and unsustainable long-term fiscal path.”

Figure 17: Simplified Statement of Social Insurance as of January 1, 2007

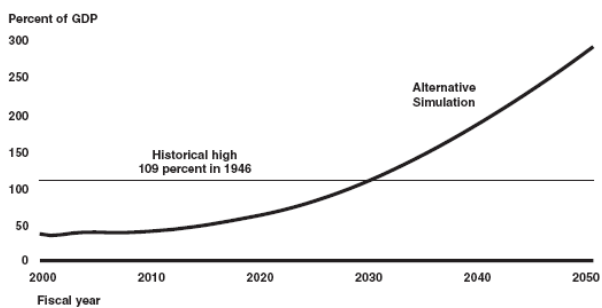
Dollars in trillions					
	Social Security	Medicare Hospital Insurance (Part A)	Medicare Supplementary Medical Insurance (Part B)	Medicare Supplementary Medical Insurance (Part D)	Total
Present value of future revenue (earmarked contributions, taxes, and premiums)	\$34	\$11	\$5	\$2	\$52
Present value of expenditures for scheduled future benefits ^a	41	23	18	11	93
Present value of future expenditures in excess of future revenue ^b	(\$7)	(\$12)	(\$13)	(\$8)	(\$41)

Source: The Department of the Treasury.

The GAO quantified the net present value of U.S. off-balance-sheet, accrued liabilities — primarily liabilities for Social Security and Medicare in excess of projected revenues (Figure 17). The current entitlement deficit is an ever-growing debilitating chunk of future GDP (Figure 18). A sharp increasing supply of new Treasury debt must be issued (Figure 19) over the next several decades to address those liabilities. This impending massive supply of new Treasuries at the same time as we face diminishing global demand growth for them under a déjà vu reconciliation of the Bretton Woods II (discussed later) monetary system points to a secular bubble peak and impending collapse in the prices for US Treasury securities.

James Grant, in his 25 July 2008 *Grant's Interest Rate Observer*, calculated the present value of GAAP liabilities for the federal government by adding in GSE-guaranteed debts to account for the current implosion and promised bailout of Fannie Mae and Freddie Mac, as well as FDIC insured deposits to capture the poten-

Figure 19: Debt Held by the Public under GAO's Alternative Simulation

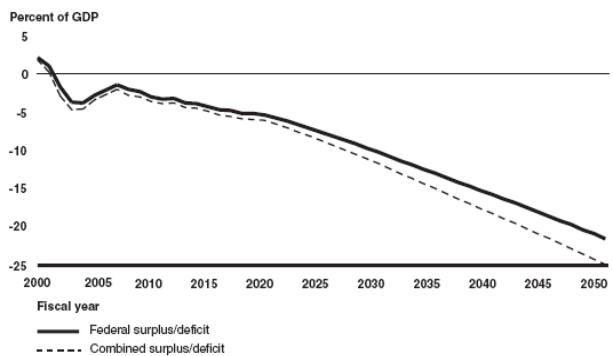


Source: GAO's April 2008 analysis.

Note: Assumes currently scheduled Social Security and Medicare Part A benefits are paid in full throughout the simulation period.

tial debt impact of the financial sector bailout. The punch line: \$67.3 trillion. In other words, the present value of public sector liabilities alone are 488% of total 2007 US GDP of \$13.8 trillion. We believe this to be a record amount of leverage-to-income for any major government throughout history. Adding the private sector debt, which is currently 286% of GDP in the US economy, including the record leveraged financial sector, we calculate the combined leverage-to-GDP ratio to be more than 750%!

Figure 18: Federal and Combined Fed, State & Local Imbalance



Source: GAO's April 2008 analysis.

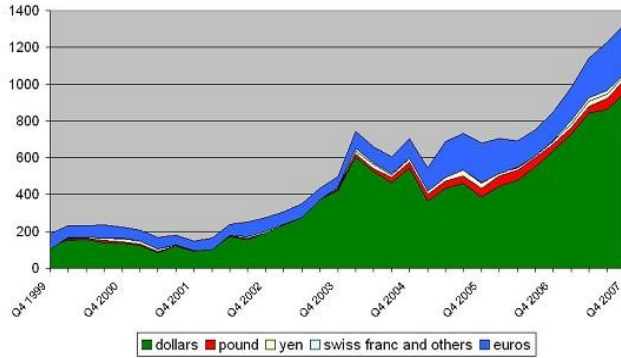
Note: Federal surpluses and deficits are from GAO's alternative simulation.

This staggering leverage figure does not include the hundreds of trillions of notional OBS/OTC deriva-

Given already stretched levels of on-balance-sheet leverage in the country and GAO unqualified levels of public exposure, we fear that we face a massive US public and private market debt crisis that has yet to be appreciated

in the market. With our trading partners still appear to be naively gobbling up depreciating US dollars, (Figure 20), we see US policy makers continuing to cram them down their throats until they scream Uncle Sam. As our debt burden grows, devaluation of that debt is the natural course as there are very simply few other politically acceptable domestic policy alternatives to get us out from under our debt burden.

Figure 20 Reserve growth, by currency (\$ billion, rolling four quarter sums)



Already, the Chinese central bank has accumulated over \$1.5 trillion in foreign exchange reserves — primarily US Treasuries (Figure 21). We are confident that we are on a crash course, getting nearer and nearer to the tipping point, where China and other creditors wake up to

Figure 21 China's Staggering Foreign Exchange Reserve Growth

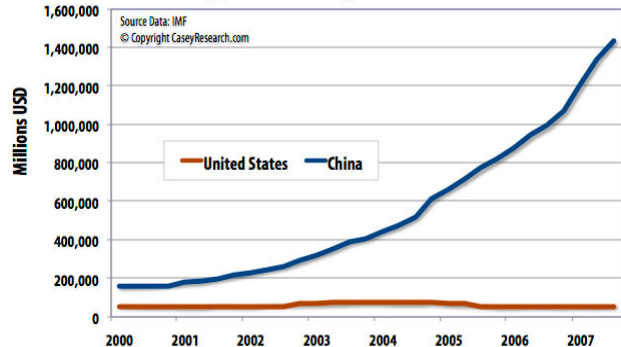
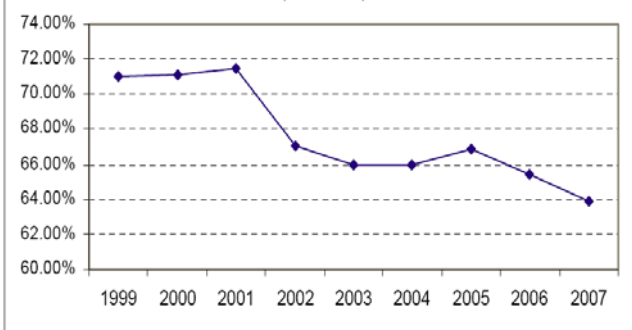


Figure 22 Share of U.S. Dollar in Official Holdings of Foreign Exchange (After Euro)



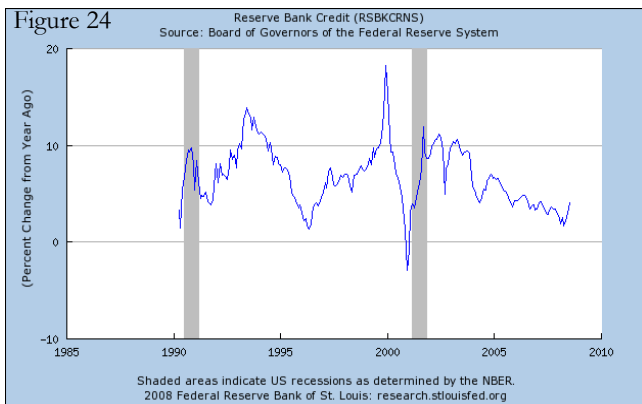
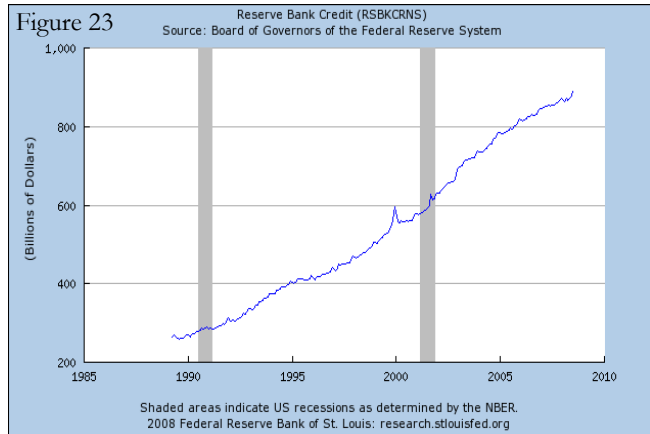
Source – IMF Annual Reports and COFER database

the idea that they stand to lose much more than they gain by continuing to finance unsustainably growing US public and private deficits. As we will discuss later, the breakdown of the current world monetary order and subsequent instability that it stands to cause bears striking resemblance to the prior global monetary breakdowns of 1933 and 1971. Since the advent of the Euro, while reserves overall at central banks have been growing under global central bank money printing, the share of US dollar reserves has been declining (Figure 22). While the world has felt this trend in the form of a declining dollar, it has yet to be translated into declining Treasury prices in the US, because foreign central banks have still been accommodative acquirers of US Treasuries (in spite of their negative real returns in the foreigners' currency after currency translation and local inflation). Now, with even greater glut of US Treasury supply coming to market over the next several years, we see the foreigners finally saying enough is enough. We see the negative returns from US Treasuries soon becoming not just a foreign problem but also a major US problem.

Accordingly, we are currently short the long end of the US Treasury yield curve. It is further important to keep in mind that a breakdown in the yield curve should extend yet another leg of the US Financial Sector Bust, since the asset side of the US financial sector is not structurally prepared for a sharp move up in interest rates. Further financial sector losses in turn can only lead to bigger bailouts and money printing at home that will further feed foreign distaste for US Treasuries. In this way, the self-feeding forces that created the record 27-year

US Treasury bubble become self-unwinding forces in its destruction.

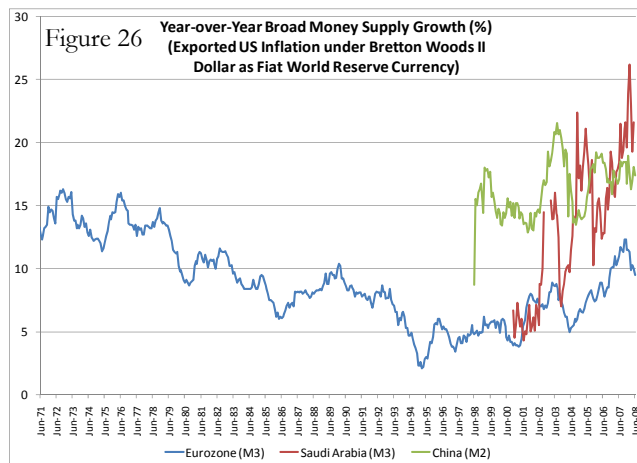
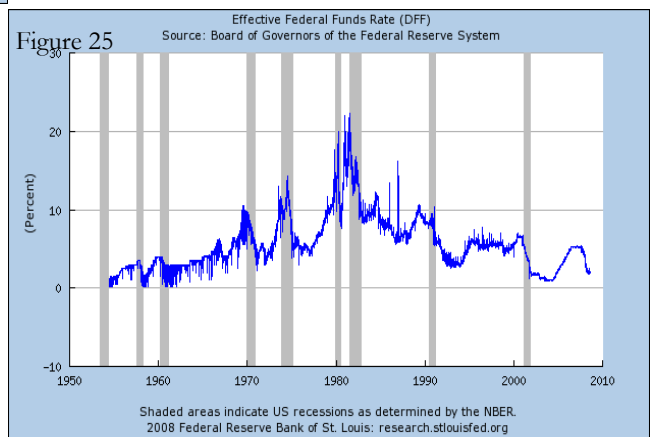
Monetary Expansion: The Fed is authorized to print money, a power that comes with a dual mandate to use it wisely to promote both sustained economic growth and low inflation. But traditionally, the Fed has tended to over and undershoot in its use of this power, and on balance it has tended to err on the side of inflation, tending to fend off recessions more vigorously than it fights inflation. This remains the fundamental problem



today of global fiat currency regimes. The economy has generally benefitted from the Fed's navigation over the past few decades, but the persistent swings in policy have led to a series of rotating bubbles. When one bubble is pricked, a recession is threatened or triggered. In the attempt to re-stimulate the economy a new bubble develops somewhere else. Furthermore, the increasing sensitivity to swings in Fed policy is exacerbated by the increased level of overall leverage in

the economy as we discussed earlier.

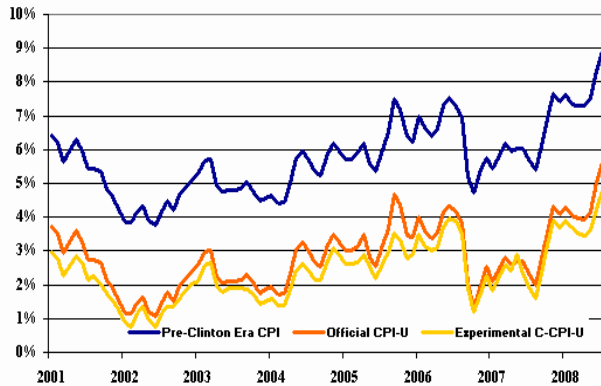
The Fed's balance sheet (Reserve Bank Credit) (Figure 23) shows that the printing presses have been cranking away at a moderate but steady pace for the past few decades, with Reserve Bank Credit having grown from \$250 billion to over \$900 billion in less than twenty years. The percent change chart of the same, however, shows that such annual rates of money printing have actually fluctuated from -2% to 18% over this time and in the 2000s and it is the swings in the rate of this



monetary expansion that has led to the popping of bubbles and new bubbles. This chart shows that the Fed stoked the economy heavily with new money in 1999 (Figure 24) in fears of Y2K. When the Fed sharply reversed its course, it triggered one of the worst bear markets in history and ultimately the 2001 recession. Clearly, the Fed gets poor marks in following its dual mandate in 1999 and 2000. The subsequent jump up again in Reserve Bank Credit growth in 2001 through 2003 later proved to help start the Housing and Financial Sector bubbles that we correctly noted

and capitalized on. The sharp rise in rates in 2005 (Figure 25) and coincident decline in Reserve Bank Credit drove the pricking of the Housing Bubble in 2006 and 2007 and ultimately the Financial Sector Bust. Generally the Reserve Bank Credit chart shows the rate of money printing trending down in recent years, an encouraging trend one would think with respect to inflation. Conversely, it failed to prevent a strong bull market in energy and industrial commodities. We were able to correctly forecast and capitalize on the commodity bull market in part because we noted inflation building up at the broader M3 level (taking into account the fractional reserve

Figure 27
ALTERNATE CPI MEASURES
 YEAR-TO-YEAR CHANGE, NOT SEASONALLY ADJUSTED. To July 2008
 Sources: Shadow Government Statistics, BLS



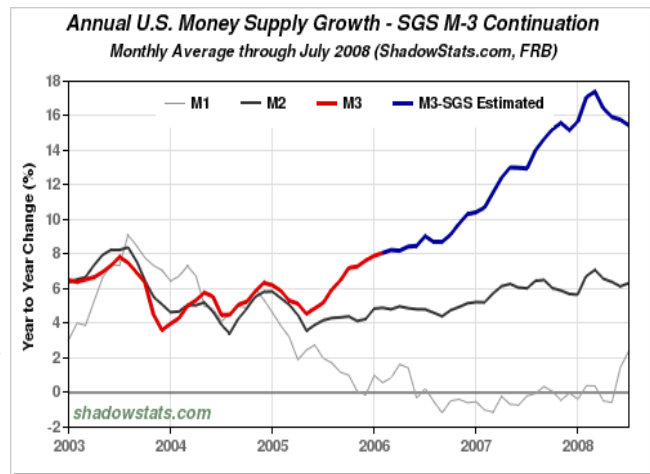
money multiplier effect) and by foreign broad money supply growth level in the economy (Figure 26). James Grant also recently noted that broad money (M3 or M2 when M3 not available) was growing at close to 20% annualized across the world's 20 largest economies — the fastest rate since 1999. We also started to see bigger longer term secular forces beginning to surface for commodities relative to financial assets which we discuss later in this letter.

We are starting to see Reserve Bank Credit actually break out to the upside again. James Grant noted that in July, Reserve Bank credit shot up to an annualized growth rate of 9% (not reflected in the chart) due to the increasing pace of the financial sector bailout. The

Fed is now in the midst of a battle with the financial sector. If we indeed get a sustained new pick up in Fed money printed to fend off the credit crisis, the question is where will the next bubble develop. Money intended to bail out an old bubble train wreck almost always goes to a new bubble. We think one of the clear winners in the next big bubble to develop will be precious metals and that they still have a long way to run.

Inflation versus Deflation: We have written before about how Bureau of Labor Statistics (BLS) uses calculation methods—such as hedonics, substitution, seasonal adjustments, geometric weighting, the core rate, etc. — that collectively systematically understate CPI, we believe. We have also noted how the Fed's elimination of the M3 money supply number results in masking the ballooning money supply problem. We prefer the approach of John Williams of Shadowstatistics.com, who calculates alternative valuations of GDP, unemployment, CPI (based on its pre-adjustment formula), M3, and other measures (Figures 12, 13, 27, and 28). According to ShadowStats, pre-adjustment CPI is roughly 9% and M3 money supply growth has accelerated since 2005 and is currently growing at 16% per year (Figures 27 and 28).

Figure 28



In any macroeconomic environment there are both inflationary and deflationary forces. Even before launching our global macro strategy, we have acknowledged the battle between these forces. Our housing bubble/bust theme has been on track throughout and we subsequently predicted the significant deflationary forces unleashed as a result of the leveraged unwinding in this asset class. We have also keyed off of deflationary forces by shorting many financial stocks and consumer cyclical stocks. We are further short the Treasury mar-

ket, again playing off what we believe will be a deflation in those assets. At the same time our commodity related theme counterbalanced our strategy by working to take advantage of some inflationary characteristics. Our Dollar Crisis theme has been an inflationary theme, capturing appreciation in precious metals as well as inflationary devaluations of the dollar relative to foreign currencies.

The fact remains, however, that inflation and even hyperinflation — not deflation — have been the overwhelming path of least resistance to deal with excessive indebtedness throughout world history. In those cases, governments resorted to devaluing their debt by issuing even more, and by using their powers to print money to purchase their own debt, creating inflation and diluting existing debt holders.

Global Fiat Currency Crisis (a Prisoner's Dilemma)

We have contended that our long-standing secular Dollar Crisis theme is not limited to the US dollar. Ultimately, we have said, it is a global fiat currency crisis led by the dollar. We have accordingly transformed the name of our overriding currency theme from Dollar Crisis to Global Fiat Currency Crisis. A fiat currency is one created by government decree rather than a hard asset, typically gold. We have been operating under a global fiat currency regime since Nixon left the gold standard in 1971. We think the problem of dollar strength or weakness relative to other currencies is secondary to the much greater escalating problems caused by the prisoner's dilemma (PD) or mal-incentives of the current global fiat monetary regime. Our Dollar Crisis theme gave too narrow an impression of our views and also recently became too crowded of a trade. It is interesting to note that the recently popular trade and rhetoric is to be a dollar bull on the hopes of a European rate cut. To be sure, we are bearish on the dollar, but we are also bearish on fiat currencies of many flavors, particularly those of free-floating developed countries. We are most particularly bearish on those currencies with respect to precious metals: gold, silver, and platinum — most predominantly gold.

The current global fiat currency system became dubbed Bretton Woods II (BWII) in the early 2000s due to its similarities to the Bretton Woods (BW) monetary regime adopted near the end of World War II by the allied powers during a meeting in Bretton Woods, New Hampshire. The original BW regime called for participants to limit the movements of their currencies relative to the USD, while the USD was fixed (convertible) to gold at \$35 per ounce as the “world reserve currency”. Ultimately, the BW regime collapsed in 1971 under a crisis of confidence in the USD due to persistent US trade deficits and rising global monetary inflation effectively exported by the US. Other nations began to seek, as the gold standard allowed them to, the conversion of their dollars into gold, forcing the US to abandon the convertibility of the dollar into gold, referred to as Nixon's closing of the gold window. Currencies thereafter became freely floating and none convertible to gold. Similar problems led FDR to confiscate gold from US citizens and revalue the dollar relative to gold in 1933.

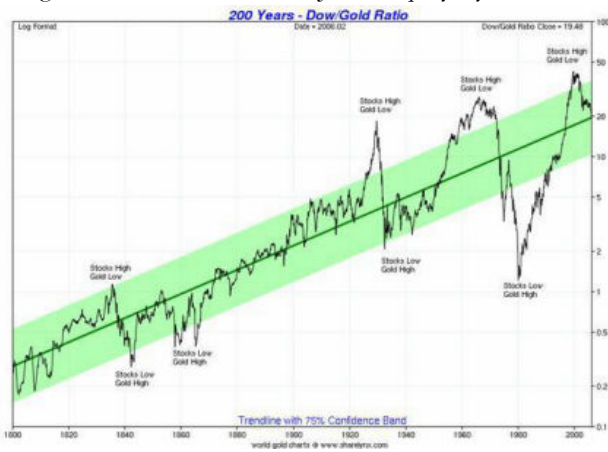
We face a very similar situation today. Like both prior monetary system breakdowns, the breakdown happens when foreign central banks ultimately turn away from the dollar and turn towards gold. This is why BW broke down and it seems to be exactly where BWII is headed today. In the last decade plus, central banks have been net sellers of gold and net accumulators of foreign reserves. This has only fed the global inflationary monetary spiral.

It was the abuse of its status as world reserve currency under BW that ultimately forced the US into one of its worst economic periods in history, a decade plus of economic stagflation including a brutal bear market for stocks and bonds, particularly the nasty 1973-74 bear market and recession. Interest rates and inflation rose persistently throughout the decade peaking out about ten years later with the Federal Funds Rate north of 20%, 30-Year Treasuries yielding more than 15%, gold having a run from \$35 to more than \$800/ounce, and the economy crash landing into the double dip recession of 1980/1982. We think these are the same challenges we have to look forward to today under the breakdown of BWII. After that unwinding, gold went to a peak of \$5000/

ounce on an inflation adjusted basis using 12/31/07 dollars terms according to John Williams CPI series (Figure 29). Silver went to \$365 dollars an ounce in today's dollars (Figure 31). While precious metals have already been in a gradual bull market in the last several years, we think they have much further to run under BWII unwinding, a run that should be not unlike those of the 1970s based on the same fundamental forces. Similarly we expect gold to continue to strongly outperform stocks as is consistent with past secular swings, a trend already in full force (Figure 30).



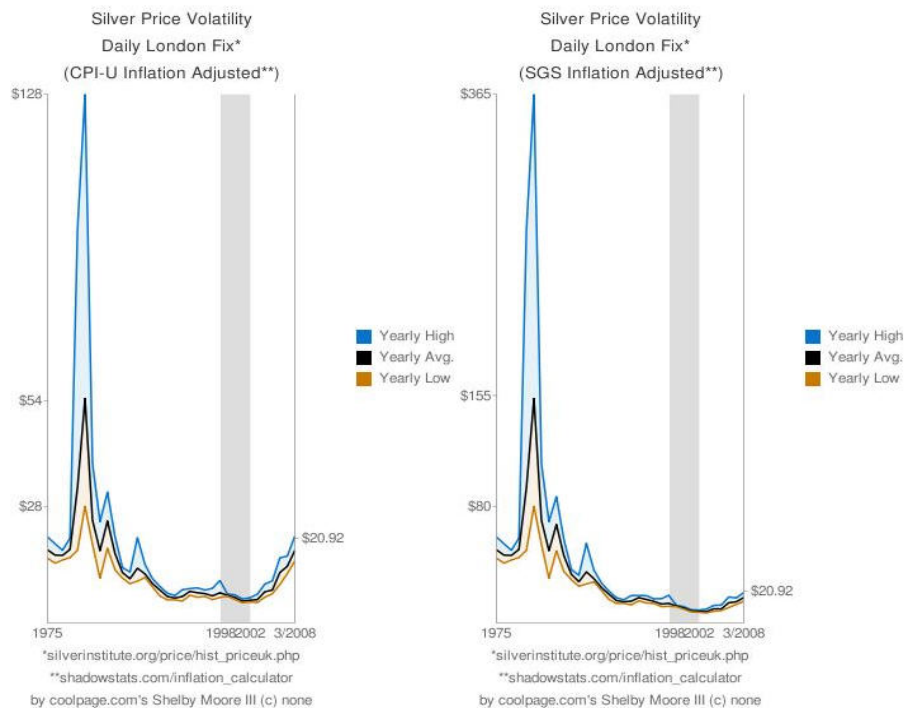
Figure 30: Gold versus Dow Jones Equity Cycles



BWII, even more than BW, presents a classic PD with multiple sovereign country players. A PD exists when the incentives for one party to act in its self-interest wind up forcing a sub-optimal decision relative to acting in a way that benefits the group as a whole. Applied to currency systems, if one country can secretly inflate its currency in circulation, it can acquire relatively more wealth for itself at the expense of the other countries. But *secret inflation* works to the relative advantage of each country only as long as the others do not also cheat, or as long as the others cheat to a lesser extent. Ultimately, however, because each country is cheating,

the incentive perversely morphs into out-cheating everyone else, with the result that the whole system ultimately spirals out of control into a free for all with all countries worse off. With every country's central bank having a printing press, and no country backing its currency by gold, we have been in a balance that appears to be equilibrium with the rest of the world funding increasing US deficits (with their own printed money) but it has really been nothing but an upward global inflationary debt spiral. To date, this spiral has been sustained by the faith-based paradigm of sustainable eco-

Figure 31: Inflation Adjusted Price of Silver



conomic growth and low inflation in the reserve currency country making its debt appear attractive. But as this paradigm of understanding shifts to recognize the US economic crisis caused by unsustainable debt levels and already manifesting in the twin Real Estate and Financial Sector Busts means that we have the foundation for a very poor US economy and rising US monetary inflationary to bail it out. We appear headed towards a massive turn away from US debt and hence the dollar that will only accelerate the US monetary inflation as the US is forced to monetize its own increasing debt.

Figure 32

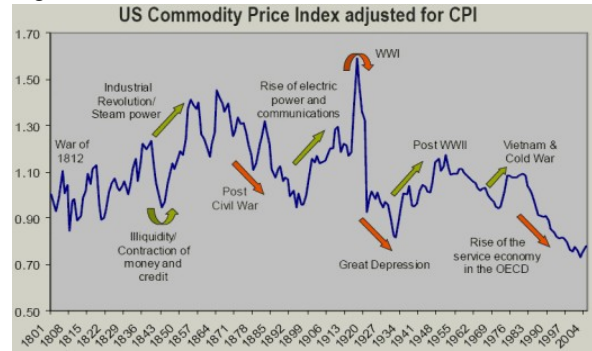


Figure 33: 2007 GDP

Rank	Country	GDP (millions of 2006 USD)
1	United States	13,843,825
2	Japan	4,383,762
3	Germany	3,322,147
4	China	3,250,827
5	United Kingdom	2,772,570
6	France	2,560,255
7	Italy	2,104,666
8	Spain	1,438,959
9	Canada	1,432,140
10	Brazil	1,313,590
11	Russia	1,289,582
12	India	1,098,945
13	South Korea	957,053
14	Australia	908,826
15	Mexico	893,365

Source: Goldman Sachs

Therefore, we believe the risks of a disorderly unwinding of the BWII system is high. Such an unwinding today would take on similar characteristics to the unwinding of BW: a grinding bear market for US stocks, bonds, and the dollar; rising domestic stagflation; flight to gold and other scarce real assets; and shunning of US financial assets, US Treasuries, and the US dollar, a circular process of monetary inflation and debt/dollar devaluation. John Williams of Shadowstatistics.com believes that such an unwinding could lead to hyperinflation. We are in the camp that at the very least it will be high and rising monetary inflation.

Natural Resource Markets: From Bear Market in Commodities to Bull Market in Scarce, Real Assets

Commodity Supercycle: Throughout history, commodity markets have demonstrated sharp swings in both real (inflation-adjusted) and nominal values over both cyclical and secular periods. In real terms, over very long periods, e.g. a few hundred years, commodities tend merely to hold their value, leading some to conclude that financial as-

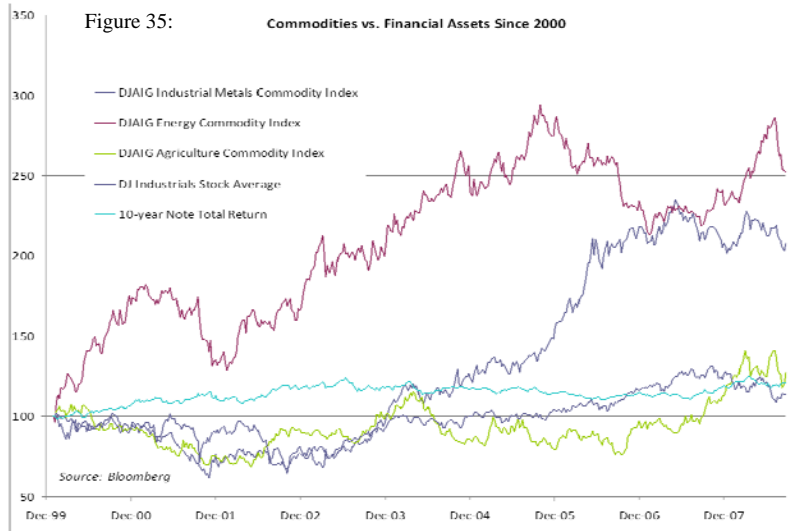
sets offer better returns. The truth is that such advice ignores long secular periods (10 to 30 years) where commodities tend to outperform financial assets on both a nominal and real basis. Commodities shine best over secular periods of rising monetary inflation where they typically outperform financial assets, often substantially. We recently completed a long secular period from roughly from 1980 to 2000 where financial assets substantially outperformed commodities, driving real commodity prices to 200-year lows (Figure 32). We believe we are now in secular period where commodities will outshine financial assets. In this decade, the first seven and a half years have seen commodities blow financial assets away. We believe there is potential for commodities prices in the longer-term as well, even excluding the projected demand growth by emerging economies.

Our Global Growth theme is based on the both the realized and yet-to-be-realized potential of emerging econ-

Figure 34: 2050 Projected GDP

Rank	Country	GDP (millions of 2006 USD)
1	China	70,710,000
2	United States	38,514,000
3	India	37,668,000
4	Brazil	11,366,000
5	Mexico	9,340,000
6	Russia	8,580,000
7	Indonesia	7,010,000
8	Japan	6,677,000
9	United Kingdom	5,133,000
10	Germany	5,024,000
11	Nigeria	4,640,000
12	France	4,592,000
13	South Korea	4,083,000
14	Turkey	3,943,000
15	Vietnam	3,607,000

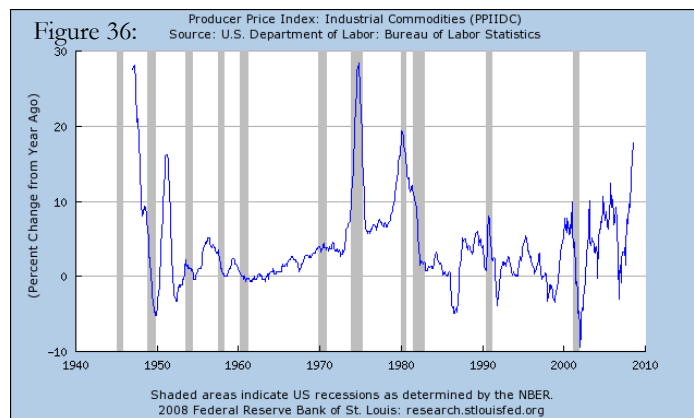
Source: Goldman Sachs



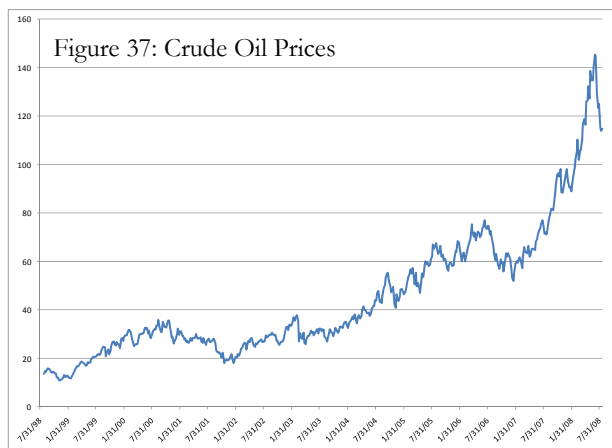
omy growth in not only BRIC countries (Brazil, Russia, India and China), but also the N-11 (Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey and Vietnam). The economies of the BRICs, Mexico and Indonesia are projected to overtake the bulk of the G7 by 2050 (Figures 33 and 34). Those six economies are projected to grow 16x from a collective \$9 trillion in 2007 GDP to \$145 trillion (real) in 2050. By comparison, the G-7's (US, Japan, Germany, UK, France, Italy and Canada) collective real GDP is projected to

grow 2.4x from \$28 trillion in 2007 to \$66 trillion in 2050.

Growth in emerging economies has helped to fuel a commodity renaissance in both industrial commodities and industrial equities (Figure 35). We believe that this trend is part of a secular commodity cycle that will continue after a near-term cyclical correction. While we were ahead of the pack for a long time on commodities, commodities got ahead of themselves, with some hedge funds and other investors overweighting them significantly. It resulted in a substantial intermediate term commodity bubble. This intermediate term bubble has clearly been pricked, and we have dramatically reduced our commodity exposure until the fundamentals, valuations, and long term trend are lined up positively once again.

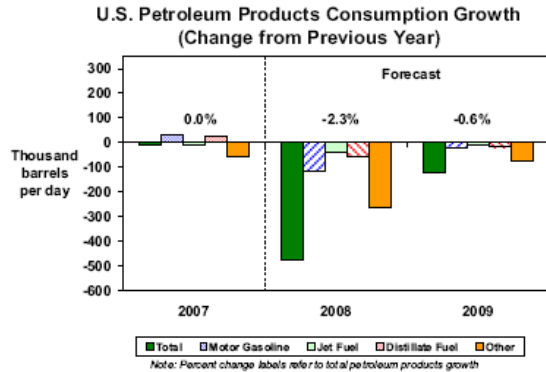


Sharp Intermediate-Term Commodity Correction: Northern Trust economists Paul L. Kasriel and Asha Bangalore recently published an excellent report titled, “When the U.S. ‘Catches a Cold’, So Does the Rest of the World.” Kasriel and Bangalore were among the few Wall Street analysts who accurately forecast the housing bubble and bust in the US back in 2005 and 2006. In this report, they write “We have believed that the global slowdown in economic growth would bring down escalating commodity prices – especially industrial commodity prices, which are cyclically sensitive. Commodity prices now appear to be responding to the global slowing in economic growth. ... In recent weeks there has been a sharp drop in the prices of the three “Cs” – crude oil, corn and copper. We believe the declines in the prices of crude oil and copper are being dominated now by weaker



Source: Bloomberg

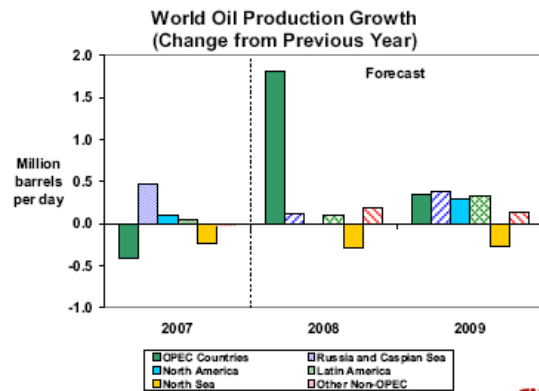
Figure 38: Growth in Petroleum Product Consumption



Short-Term Energy Outlook, August 2008



Figure 39: Growth in World Oil Production



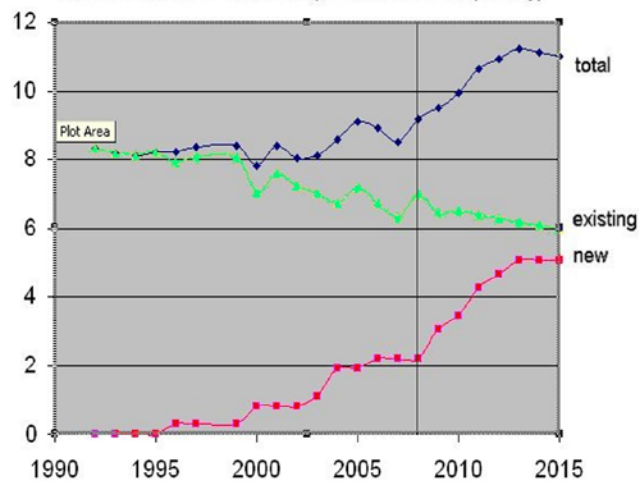
Short-Term Energy Outlook, August 2008



global demand rather than increased supply. Thus, we view these commodity price declines as a symptom of weaker global economic growth, not a cause of stronger future growth.”

These economists are referring to the “Negative Feedback Loop” described by Muhammad El-Erian of PIMCO in his recent writing and speeches, recognized by Bernanke as the “Adverse Feedback Loop” in his Jackson Hole speech last week, and even more profoundly espoused as the “Theory of Reflexivity” by George

Figure 40: Saudi Oil Production (millions of barrels per day)

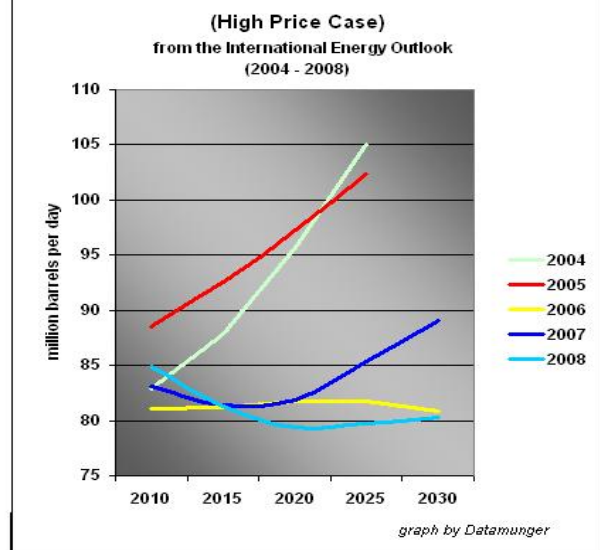


Source: The Oil Drum

Industrial metals climbed by 3x since 2002 and have sold off sharply in recent months (Figure 36). Moreover, industrial commodities are subject to cyclical swings (Figure 36). The energy price boom and recent correction have been even more acute. The question is how much farther the correction can and will go. With demand weakness and a cyclically sensitive tendency, we believe that the risks are weighted toward continued commodity deflation. Accordingly, we are switching course from our long-term bullish stance (which has not changed) to acknowledge a likely further intermediate-

Soros. These various terms refer to how economic and market phenomena can be self-reinforcing and independent. Soros makes the further point that markets do not have self-correcting mechanisms that tend to stabilize them towards equilibrium or “efficient prices” as many academics postulate. They instead tend towards boom and bust extremes as a result of prevailing cyclical and secular perception biases that work to create their own fundamentals, rarely stopping in the middle at an efficient price.

Figure 41: Projected Conventional Oil Production

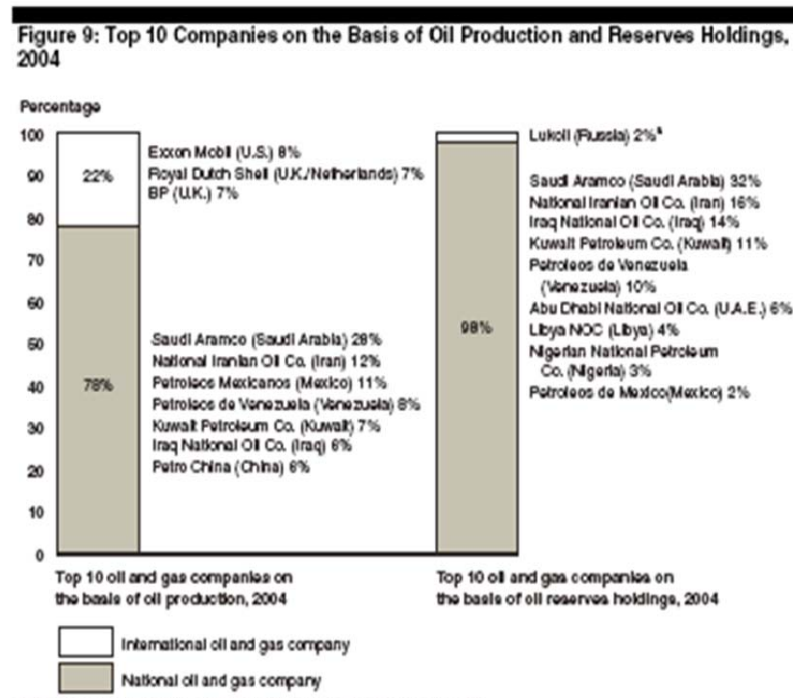


term cyclical correction in industrial and energy commodities. Given how sharp cyclical corrections in commodities can be, even in long term bull markets, we think it prudent to reduce long exposure and even go short.

The recent extreme bullish sentiment is another factor causing us to reach this conclusion. Recent SEC Form 4 filings show energy and basic materials sectors to have been too over-crowded on the long side among hedge funds. Even after the recent correction, energy and industrial commodities and related equities are still the top performing groups in the market over the last five years. Short term rallies will no doubt suck even more investors back into these popular sectors. We plan to use such opportunities to sell short over the intermediate term, as long as our research continues to confirm that our US Economic Recession and Global Growth deceleration trends remain the overwhelming important macro themes in the market.

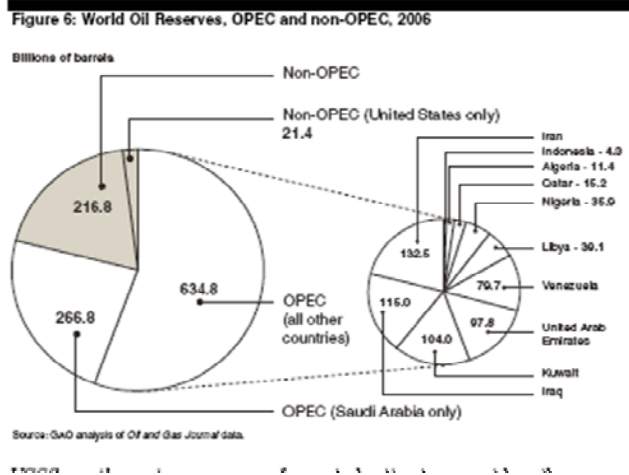
Scarce Energy Resources / Intermediate Term Outlook: After rising to \$147, crude prices have corrected sharply (Figure 37). We see significant risk that the current cyclical correction in energy prices will continue to \$100 or lower. Demand has declined in the US (Figure 38) and has decelerated globally. There appears to be ample supply to meet near-term demand (Figure 39).

Figure 43: Top 10 Oil Companies



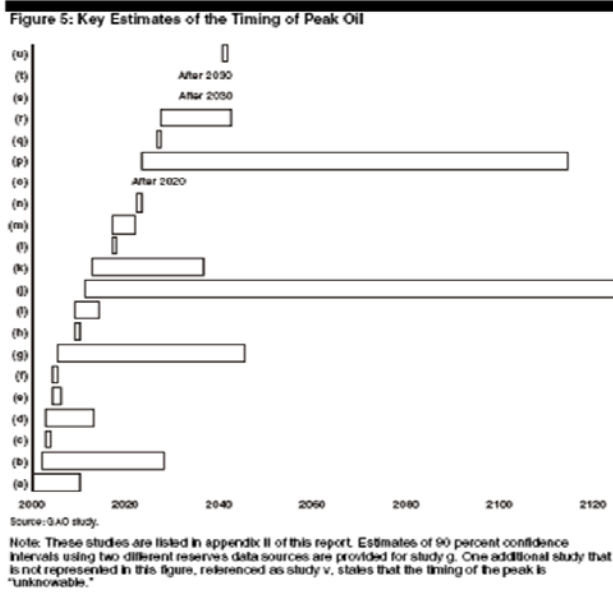
Source: GAO analysis of data from *Petroleum Intelligence Weekly* (Dec. 12, 2005).
 Note: The *Petroleum Intelligence Weekly* data relies on company reports, where possible, as well as other information sources provided by companies. See appendix I of this report for limitations of these data and their effect on our use of these data.
 *Lukoil is the only company in the top 10 based on reserves that is not 100 percent state-sponsored.

Figure 42: World Oil Reserves



Particularly important is that the Saudis appear to have increased production capacity. For three years straight in 2005-2007 global oil production was in a flat trend even in the face of rising global demand. Respected geologists such as Kenneth Deffeyes, professor emeritus at Princeton and former head of its geophysics department, were predicting that the world had indeed seen the peak in oil production. We shared the views of Deffeyes and other peak-oil analyst/proponents such as Matthew Simmons (*Twilight in the Desert*) and many contributors to *The Oil Drum*, who argued that Saudi production projections were not possible due to aging fields and lack of big new discoveries. It now appears that the Saudis have increased production above their prior 9.6 MBD peak of 2006 (Figure 40). They also further claim to be gearing up to increase production to 11.3 MBD by 2012 by re-developing the Khurais, Manifa and

Figure 44: Peak Oil Estimates



(Figure 41). New sources are being developed but there are no major new fields on the horizon.

Energy is scarce not only because there is a declining supply under the ground, but also because of above-ground considerations. Oil reserves are controlled increasingly by countries viewed as unstable and potentially adversarial to Western economy interests (Figure 42). The major, global oil companies have the strongest proven capabilities for finding and producing oil, but they control an ever shrinking portion of total oil supply and reserves (Figure 43).

Even abundant-oil proponents such as Dan Yergin, believe peak oil will happen eventually. It is just a question of when. There are a wide range of estimates on the timing of peak oil, from 2005 to 2050 (Figure 44). Christophe de Margerie, the CEO of oil multinational Total, projects that oil supply will not exceed 95 MBD by 2020—far less than demand projections for that time. We believe that the timing now will be in two to ten years.

More importantly, we believe that future oil production will — on average — be increasingly more expensive to find, produce, transport, and convert. That means higher prices after the near-term cyclical correction and ultimately a better time to get long again.

We continue to believe that Energy is proving to be increasingly scarce. Like industrial commodities, however, energy commodity prices (crude oil in particu-

lar) got ahead of themselves and appear due for further significant cyclical correction over the intermediate term.. As with industrial commodities, rallies will almost certainly continue to suck in many new and old buyers on rallies. This could prove a painful mistake until the cyclical energy correction has more fully run its course..

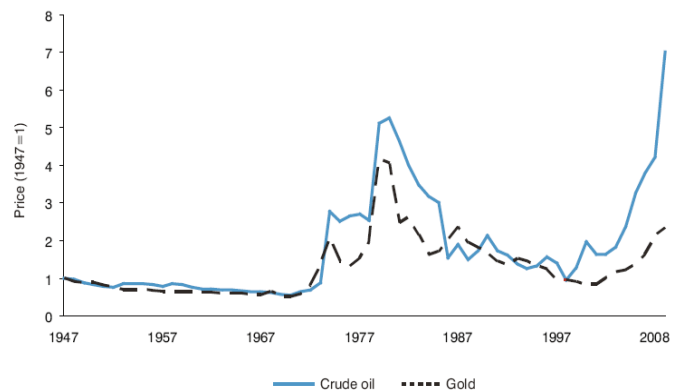
Shaybah II fields.

The Saudi production increase is critically important. Since demand for oil is very inelastic, supply availability can have a significant impact on price of this scarce resource. The flattening supply with growing demand was our reason for remaining long energy for so long and we did very well by that. However, the Saudis have finally proven their ability to increase production (at least in the short run) at the same time that global demand is faltering. This is a huge warning sign to step aside for now, even go short, since energy prices have gotten ahead of themselves based on such conditions.

Scarce Energy Resources / Longer Term Outlook: Energy supplies remain scarce. Many large existing fields in Saudi Arabia, Mexico, the North Sea and elsewhere are already in decline. The EIA has consistently reduced its forecasts for future conventional oil production trends

Figure 45: Crude and Gold Prices

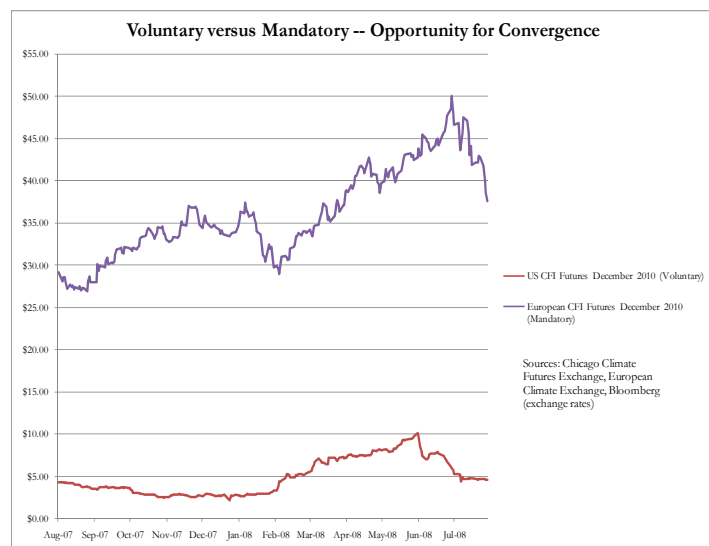
Year-end Crude and Gold Prices from 1947 to 2008 (Price-Deflated)



Sources: BP Statistical Review; Bloomberg; Booz & Company analysis

We will opportunistically short energy futures and energy stocks as we ride out the intermediate term cyclical correction. We want to see global production flatten or decline again before we can believe in the timing to get back long again other than through spread trades where we can take advantage of unusual divergences within energy markets by being both long and short at the same time. We will also selectively hold long stocks in those sectors which have been beaten down excessively and thus represent good values in the current environment. In refining, for example, demand weakness and announced capacity expansions point to declining earnings, that have driven some stocks as low as 1-3 x current cash flow. We are focusing in particular on those refiners with likely the lowest cost structures and thus the most likely to survive the impending rationalization as new capacity is added.

Figure 46: CFI Futures Prices in Europe and US



refiners with likely the lowest cost structures and thus the most likely to survive the impending rationalization as new capacity is added.

One trade we have currently is a short crude position that is hedged with a long gold position. Crude oil and gold prices have historically displayed a high correlation, though crude price increases have outpaced gold price increases by 3:1 since 1998 (Figure 45). For the reasons discussed in this letter, we believe it likely that gold will increase and crude will continue to decline—so we see this as a great hedged way to play both sides. We believe it is a low risk/high reward position for the currently uncertain environment that also fits well with our themes.

Climate Management: We have maintained, but not added to, our long positions in Carbon Financial Instrument (CFI) futures. The overall exposure remains relatively small in the portfolio and we consider them a strategic holding in this new field. An increased supply announced in early June has caused prices to drop from their highs, and during July, the fall in oil prices and its attendant effect on natural gas prices meant that electricity generators were able to reduce coal consumption, leading to reduced demand for CFIs, especially in Europe. We believe lower oil and natural gas prices will continue to mute the CFI market in the near term, but longer-term, the prognosis for carbon futures remains encouraging.

In the US, we are seeing new regional initiatives that will likely serve as the model for a national program. The Regional Greenhouse Gas Initiative, covering much of the northeastern US, will commence operations in early 2009, and California recently passed Assembly Bill 32, which also stipulates a cap-and-trade process. The Chicago Climate Futures Exchange, where the CFIs are traded, has recently been joined by a NYMEX version, The Green Exchange. We welcome the greater choice and liquidity these various efforts provide. We believe the prices for CFIs will converge between the US and the rest of the world. Currently (Figure 46), an unbiased estimate would suggest perhaps a 15% likelihood of such a convergence, judging from the dollar-equivalent pricing of European (mandatory) and US (voluntary) CFIs. We believe the likelihood is much greater, since both platforms of the major US political parties endorse a cap-and-trade mechanism and we believe that the public will to address catastrophic climate change has increased.

In addition, we have supplemented our futures positions with some equity holdings in alternative energy and energy storage companies. While wind and solar are getting most of the news in this area, we believe the prospect of plug-in hybrid vehicles will shift our consumption patterns over time from liquid fuels to electricity. Accordingly, we are following developments in battery technology closely and hold some of what we believe are

the more promising companies. Liquid fuels will not be obsolete, however, and we are keeping a close watch on developments in gas-to-liquid, coal-to-liquid, and biofuels. For the biofuels area, we are seeing research focusing on sustainability and yield, while minimizing the effect on the world's food supply.

Conclusions:

The major secular paradigm shifts now at work are creating increased volatility and multiple cross-currents in today's financial markets. It is imperative to have a robust macroeconomic compass to filter out the noise and ride through the many cross currents. We are confident that our cyclical and secular themes form that compass to capitalize on this historic transition prudently. The opportunities are tremendous but the cross swings can also be tremendous. Given the potential for wide swings, we are operating with less notional exposure than we have in the past.

- ◆ **Private Capital Markets: From Debt-Fueled Global Economic Boom to Global Economic Slowdown under Unsustainable Debt**
 - **Housing Bust:** We see much more downside in home values but the opportunity is largely played out in terms of residential real estate equity values. We continue to short equities in commercial real estate, particularly Retail REITs.
 - **Financial Sector Bust:** We see many more financial institution stresses due to excessive levels of derivatives exposure and further corresponding public bailouts. We are selectively shorting those financial companies most exposed to these risks.
 - **Economic Slowdown:** We expect significant spillover from the Housing Bust and Financial Sector Bust into the broader economy, both domestically and globally. We are long equities in relatively recession resistant sectors and short equities in more cyclical sectors.

- ◆ **Public Policy and Public Capital Markets: From Persistent Easy Monetary & Fiscal Policy Success to Train Wreck**
 - **Upward Shift in Treasury Yield Curve:** US Treasuries will ultimately buckle under the weight of unsustainable social program obligations, extreme deficit spending, prolonged trade deficits, and the current easy monetary policy needed to fight the Financial Sector Bust. We are short US Treasuries.
 - **Global Fiat Currency Crisis:** The world monetary order, with the US\$ as reserve currency, is causing spiraling global inflation and faces a potential breakdown similar to the BW collapse of 1971. We favor long positions in precious metals.
 - **Political Shift of Power (not discussed in this letter):** We expect increased Democratic Party majorities in both house of Congress and a likely Democratic President. We are taking long and short equity positions to capitalize on this expected shift.

- ◆ **Natural Resource Markets: From Bear Market in Commodities to Bull Market in Scarce, Real Assets**
 - **Sharp Intermediate Term Industrial and Energy Commodity Correction:** Industrial and energy commodity prices have appropriately corrected due to fundamental supply / demand trends as well as the recent over-exuberant cyclical upswing. We are shorting selected industrial commodity and energy positions — both futures and equity.

- **Commodity Supercycle:** Industrial commodity demand will continue to grow, after the intermediate term cyclical correction, to fuel the growth of emerging economies in the long run. We hold spread (hedged) trades for the intermediate term, going both long and short, to take advantage of intra-market divergences until we can be more confident to get long again.
- **Scarce Energy Resources:** Energy supply is finite and prices will resume their upward march after the intermediate term cyclical correction plays out. We hold spread (hedged) trades, going both long and short, to take advantage of intra-market divergences until the correction works itself out and we can feel comfortable getting long again.
- **Climate Management:** There is a growing political and grassroots mandate for policy action to address carbon emissions. We believe that a cap and trade regime will be employed and that alternative energy technologies will see favorable incentives for development. We are long carbon futures and long alternative energy equities.