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Crescat Macroeconomic Update

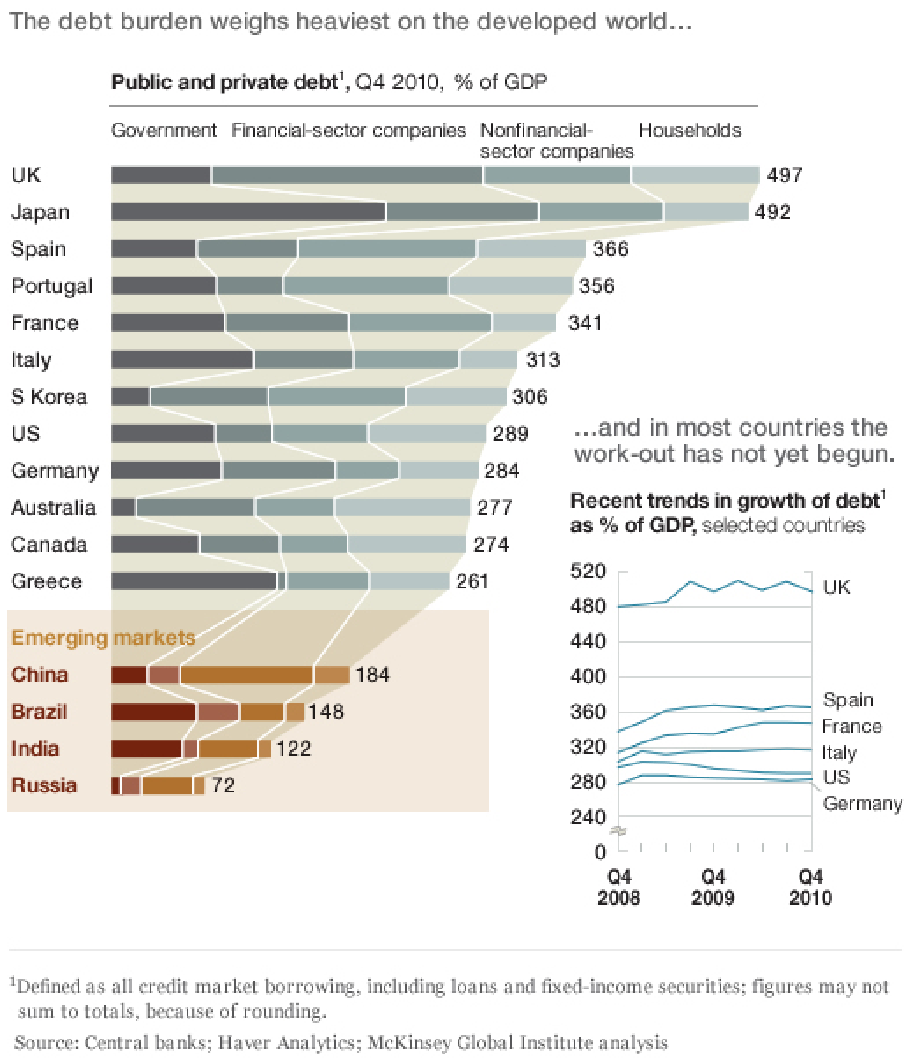
The major developed economies of the world have continued to struggle since the financial crisis that began in 2007. Europe is in the midst of a full blown banking and sovereign debt crisis that threatens to further destabilize the global financial system, including the U.S. banks. The European crisis may be the most acute economic stress in the world today, foremost in the news, if only to distract from the unsustainable government deficits, high unemployment, domestic banking problems, and growing civil unrest here in the U.S. Meanwhile, China's economy, the most heralded success of our time, increasingly looks to be in a massive real estate and fixed asset credit bubble that even now is threatening to unravel.

These economic problems are the result of interplay between loose fiat money and credit that has spawned an upward spiraling series of bubbles, busts, and bailouts. All of this has been made possible by a perverse faith in the ability of fiat money central banks and their sovereigns to sustain excessive debt levels; bail out risk taking governments, banks, other companies and individuals; and create prosperity while maintaining the value of a strong currency. Central banks - the Fed, ECB, and BOE in particular - have been performing this difficult juggling act for too long, attempting to contain inflation expectations, control interest rates, macro manage economy, and serve the special interests of their sovereign political and private banking constituents at the same time. In so doing, they have created an historic debt, derivative, and fiat money bubble. The bursting of this bubble portends additional banking and financial crises, money printing, fiat currency devaluation, inflation, and quite possibly even hyperinflation.

Because of the unique nature of these problems, the traditional safe havens of cash and Treasury bonds have become booby traps for the masses. Perceived to be the "risk-off" hiding places, these false havens offer already negative real interest rates, little if any nominal appreciation, and the potential for substantial real capital loss. The U.S. dollar might perform well versus other fiat currencies, but it will likely suffer relative to real assets. To protect and grow real wealth in today's global macro climate, we are compelled to invest in assets that provide for significant nominal as well as real appreciation, including hard money, scarce resources, and innovative and competitive businesses that offer protection from ongoing fiat currency and debt devaluation.

Unsustainable Global Debt

The collective value of debt in the world's major developed countries relative to income has never been higher. The chart below shows both public and private sector debt relative to GDP levels for the world's major economies.



Source: McKinsey Global Institute

But these record debt levels are even worse than they appear since the above analysis does not account for the liabilities associated with fulfilling the promises of unfunded entitlement programs, nor the liabilities associated with off-balance-sheet derivates that will be discussed further below. In general, the problem with high and rising debt to GDP is that total income of an economy, the denominator of the debt-to-GDP ratio, simply becomes insufficient to service the numerator, total debt. What happens traditionally when debtors can't service their debt from their sustainable income is that they default. This phenomenon causes the total value of debt and hence debt-to-GDP to decline in a self-correcting fashion. Private sector defaults are traditionally resolved through bankruptcies, while sovereign defaults are more frequently resolved through inflation. Highly indebted sovereigns whose debt is denominated in something other than their own fiat currency are typically forced to default outright, however, because they can't (legally) print another country's currency. Such were the defaults driving the Asian Financial Crisis in the late 1990s and the Latin American Debt Crisis of the early 1980s.

Sovereign central banks who can devalue debt through inflation do so through negative real interest rate policies and outright money printing. Inflation reconciles unsustainably high debt to GDP because it boosts nominal GDP at the same time that it devalues debt. The problem with inflation is that it creates real losses for the masses of fixed income savers and investors who are the unwitting owners of the unsustainable debt. Fixed income investors thus face two major risks during times of high and unsustainable debt to GDP: outright default and inflation.

European Debt Crisis

Given the unusual multi-sovereign structure of the euro, Greece and other PIIGS sovereigns cannot directly print money to inflate their way out of their debt problems and thus risk outright default. The market currently assigns a 99.9% probability to a Greek default and a high probability to broader credit contagion. European authorities including the EU, IMF and ECB have already rallied with bailout packages for Greece as well as Ireland and Portugal. Greece in particular is still in crisis. Spain and Italy, the continent's third and second largest economies respectively, may also soon require support. The EU has banded together to throw more debt at the problem through the establishment of the European Financial Stability Facility, a special purpose financing vehicle guaranteed by the collective eurozone sovereigns to provide yet more debt to the troubled sovereigns. The EFSF in turn is planning to issue its own bonds and other debt instruments i.e. to solve the debt problem with even more debt. The EFSF has essentially been funded with €440 billion to date but there are plans to lever it up to as much as €2 trillion.

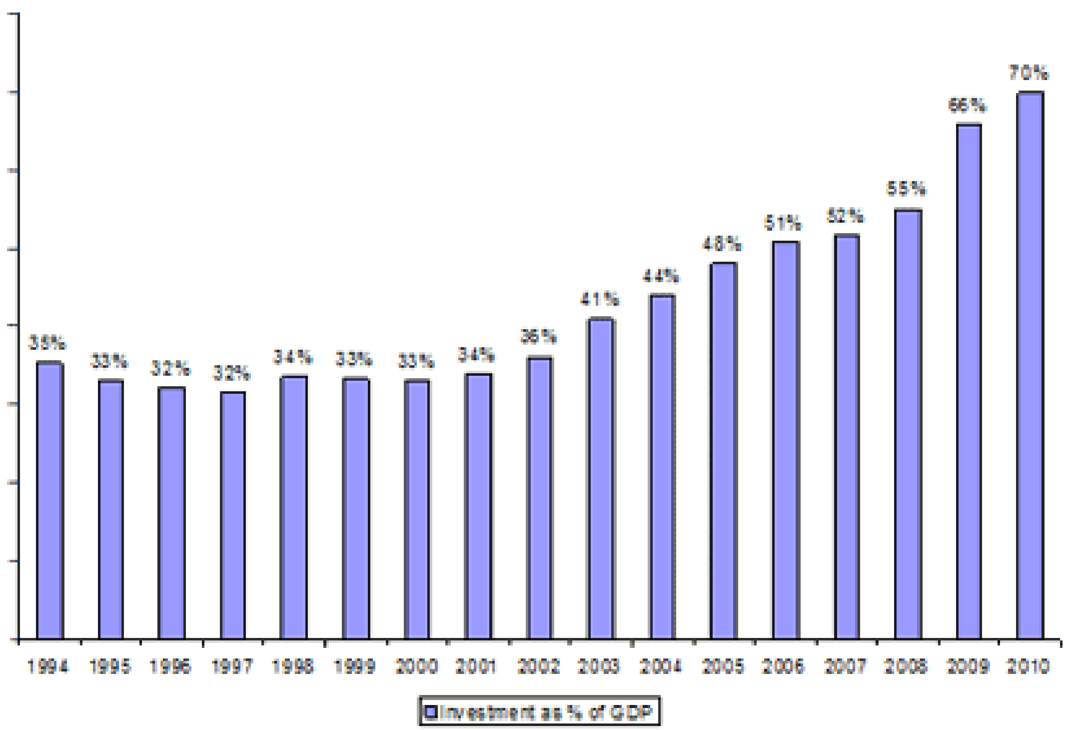
The ECB has also been printing euros to forestall a Greek default and the effects of its contagion to eurozone banks, so inflation is a threat too. The ECB could ultimately buy EFSF bonds to monetize this debt rather than directly monetize the debt of troubled sovereigns. George Soros has been promoting the idea that EFSF bonds could ultimately lead the path to a united European treasury and Eurobond. Like U.S. Treasury bonds are to the Fed, EFSF bonds would become debt monetization vehicles for the ECB.

Warren Buffett recently put it this way: "I don't know what [Europe is] going to do... when politics enter in you get all kinds of things... but if you ask me the most likely thing, in the end they will decide to print money. Which they've got a lot of problems doing, because they do have this common currency. But when politicians face an insuperable problem, and it looks like they can solve it by printing money, I think they will do it."

China Bubble

While Europe is already knee deep in its debt crisis, China may be headed for one of its own. Conventional wisdom is that China has been a great economic success by becoming the low cost manufacturing exporter to the world through a shrewd balance of capitalism and central planning. But today, net exports are only 5% of the China economy. Virtually all of China's growth in the last five years has come from its own domestic fixed asset investment spending, predominantly real estate. Have China's central planners really been allocating resources efficiently?

China Fixed Asset Investment as Percent of GDP



Source: National Bureau of Statistics of China, Kynikos Associates

As part of this binge, China has been an insatiable importer of construction equipment, copper, cement, iron ore, metallurgical coal, etc. as shown in the table below. There remain short opportunities in these companies and commodities as markets force China to dramatically cut back it unsustainable capital investment machine. Such shorts provide a hedge against general more inflationary themes.

China is the World's Largest Buyer

Commodity	China % of World
Cement	53.2%
Iron Ore	47.7%
Coal	46.9%
Pigs	46.4%
Steel	45.4%
Lead	44.6%
Zinc	41.3%
Aluminum	40.6%
Copper	38.9%
Eggs	37.2%
Nickel	36.3%
Rice	28.1%
Soybeans	24.6%
Wheat	16.6%
Chickens	15.6%
Oil	10.3%
Cattle	9.5%

Source: Barclays Capital (2010), Credit Suisse (2010), Goldman Sachs, United States Geological Survey (2009), BP Statistical Review of World Energy (2009), Food and Agriculture Organization of the United Nations (2008), International Monetary Fund (2010)

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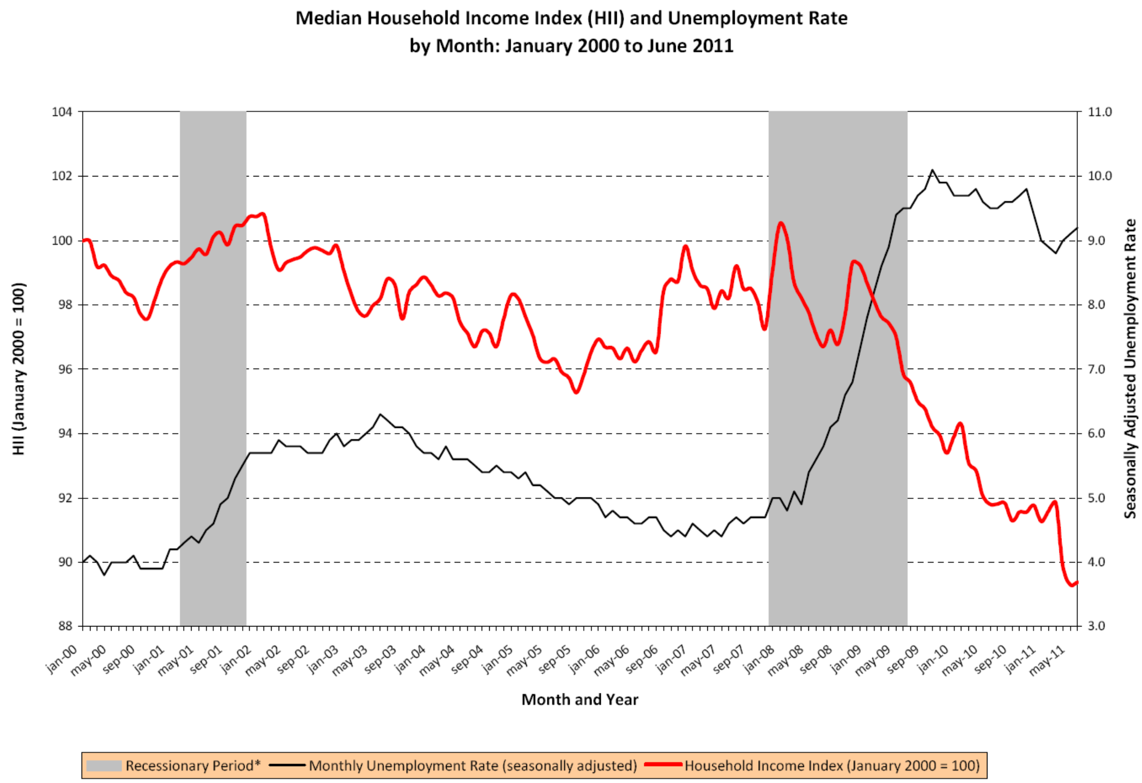
According to renowned short-selling investor, Jim Chanos and his analysts, debt of state owned enterprises, local governments, and other vehicles implicitly backed by the Chinese government has gone from 100% to 200% of GDP, worse than European public debt levels. Shadow banking, including off-balance-sheet trusts set up by the banks to skirt official capital requirements and other loan shark schemes, have grown in leaps and bounds to finance much of the fixed asset build-out. Apartment buildings, office buildings, shopping malls, and even entire cities, remain largely unoccupied. But now China's growth is sputtering, and condo sales are down 50-60% versus a year ago in tier one and tier two cities. Chinese central bank tightening over the past several months likely has been the trigger. With the fall off in copper prices recently, it could be another signal that China's real estate bubble is headed for bust. Now there is talk of central banks having to step in to bail out the banks.

U.S. Stagflation

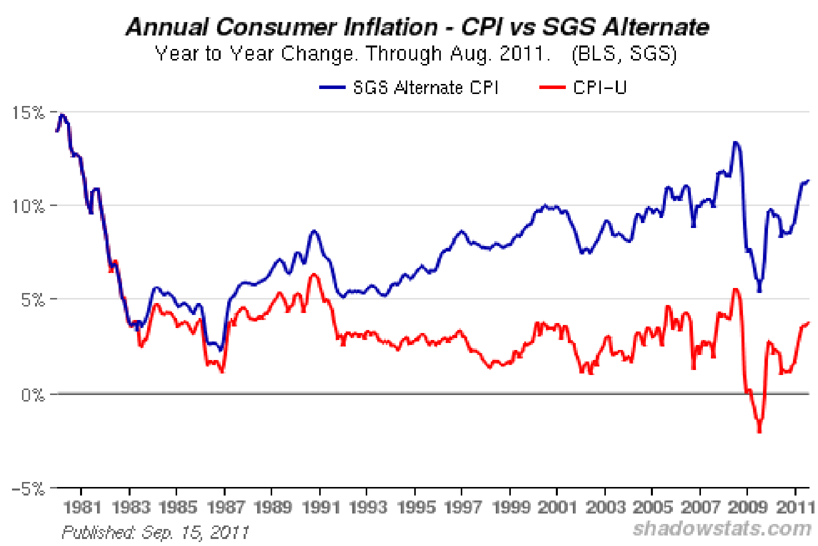
The U.S. faces its own daunting economic challenges including continued decline in U.S. household income, persistently high unemployment, and now growing civil unrest. U.S. real median family income has been trending down since the bursting of the tech bubble in 2000. Based on U.S. Census Bureau data, real median household income is down 11% since January 2000, a time when real GDP is reported to have grown 20%. More troubling is that more than half of that decline has occurred since the end of the official recession in the middle of 2009.



Source: Sentier Research

In other words, the average American family has already endured more than a decade-long depression that has recently gotten worse. Perhaps most troubling is that the cost of living has risen 34% over this time period, according to the CPI reported by the Bureau of Labor Statistics, causing a serious squeeze of the wealth and well-being of a large swath of Americans. Thus, inflation has already been a problem during the last decade despite deflation in housing prices and much press about deflation in general given low Treasury bond yields. Inflation has been a key component of declining real household income. Ultra-low Treasury bond yields, which have been getting even lower now with Operation Twist, are a result of the Fed's interest rate intervention policies, not proof of deflation. These policies have been creating negative real interest rates and inflation for some time. The average American may indeed have been enduring a depression. However, it's been stagflation, not deflation. Such has been the overwhelming macro environment for years already, and it is only continuing, an environment where real growth suffers at the hands of largely surreptitious inflationary driven nominal growth. Such a condition is likely to only continue and to escalate, fooling the average economic participant as more and more money printing stimulates greater and greater levels of nominal, but not real, economic growth. True economic growth suffers relative to reported real GDP levels because inflation continues to get understated. Throughout history, secret inflation has been the political path of least resistance to devalue debts, and there are still record unsustainable debt levels around the globe.

There is much evidence that government reported inflation in the U.S. has been understated for years already. The Bureau of Labor Statistics' ("BLS") revised statistical methodologies since 1980 have led to systematic understatement of inflation and hence overstatement of real GDP growth. Government statistics analyst John Williams convincingly shows that such changes have caused reported CPI to effectively go from a measure of the cost to maintain a constant standard of living to one that now measures the cost of a declining standard of living in the U.S. One of the most impactful changes was the BLS adoption of "geometric weighting" as a scheme to give less to weight in the CPI basket to goods and services that rise in price and more weight to ones that fall. The rationale is the concept of "substitution", the idea that consumers would buy less of goods rising in price and substitute other lower cost goods. Of course, consumers will do that, but it doesn't mean that one is enjoying a constant standard of living by substituting hamburger for steak. Williams calculates SGS Alternative CPI, his own version of CPI (see the chart below) that backs out geometric weighing adjustments and other methodology changes adopted by the BLS since 1980. He calculates that inflation is currently running at an 11.4% annualized clip.

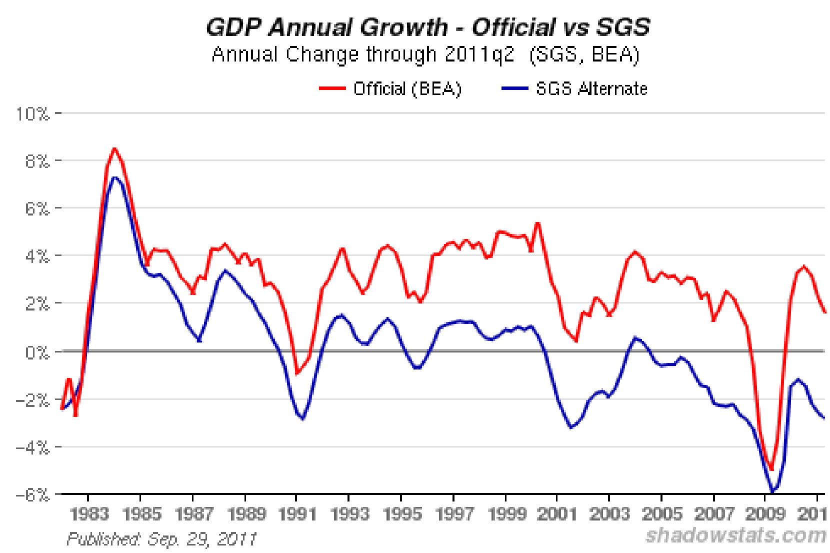


Source: www.shadowstats.com

Williams calculates that the actual cost to maintain a constant standard of living has risen 83% since January 2000. Such seems more consistent with the average American experience, particularly when one considers the rising costs of food, energy, healthcare, and education.

Reported CPI is also reduced by "hedonic adjustments" that Williams describes as "another BLS gimmick." He explains, "If gasoline rises 10 cents per gallon because of a federally mandated gasoline additive, the increased gasoline cost does not contribute to inflation. Instead, the 10 cents is eliminated from the CPI because of the offsetting hedonic thrills the consumer gets from breathing cleaner air." However, conservatively, Williams doesn't add back the effects of the BLS's hedonic adjustments in his inflation estimates even though the BLS uses them to reduce reported CPI.

The political motivations for our government to understate CPI are many. CPI is the basis for inflation indexed government entitlement benefits as well as interest payments on inflation indexed government bonds (TIPS) and other federal spending. Moreover, faith in low and contained inflation as reflected in a low CPI is the underpinning for the strength of the U.S. dollar itself, the global reserve currency. A new gimmick is on the drawing board right now with congressional consideration of using "chained" CPI rather than the standard CPI. "Chained" CPI was heretofore an experimental BLS series that is fully "substitution" based rather than approximating these changes with a mathematical formula. According to Williams, moving to chained CPI will have had the historical effect of reducing CPI another 0.4% per year. The CPI has already been a bogus inflation index for years. What good is a measure of the rising cost of a declining standard of living? The problem is that the vast number of economists and investment analysts still accept this number at face value.



Source: www.shadowstats.com

If this higher level of inflation were backed out of reported nominal GDP growth, Williams shows that real GDP growth (SGS Alternative shown above) would highlight a stagflationary depression that began with the tech bubble crash of 2000. A similar adjustment to reported household income would highlight an even steeper decline since 2000 than the 11% reported in the Household Income Index above.

Some indicators suggest that the U.S. economy is improving: growing private sector payrolls, rising industrial production, increased bank lending, and solid corporate earnings. These nominal measures are encouraging and welcome. Regrettably, however, the prospects for real growth remain weak given the under-reporting of inflation and the threat of substantial growth in inflation going forward. Stagflation remains the dominant trend and it risks escalating into a more severe form.

Gargantuan Level of Off-Balance-Sheet Derivatives

Some of the most dangerous gimmicks of our policy makers may lurk even further behind the scenes in the unregulated, off-balance-sheet derivative markets. As shown in the table below, the notional value exposure of off-balance-sheet derivatives is now up to $333 trillion - predominantly interest rate swaps - among the top U.S. bank holding companies. That's right: $333 trillion! Banks claim these derivates serve the useful purpose of hedging and reducing risk in the economy, yet one is hard pressed to justify why even a small fraction of $333 trillion is necessary.

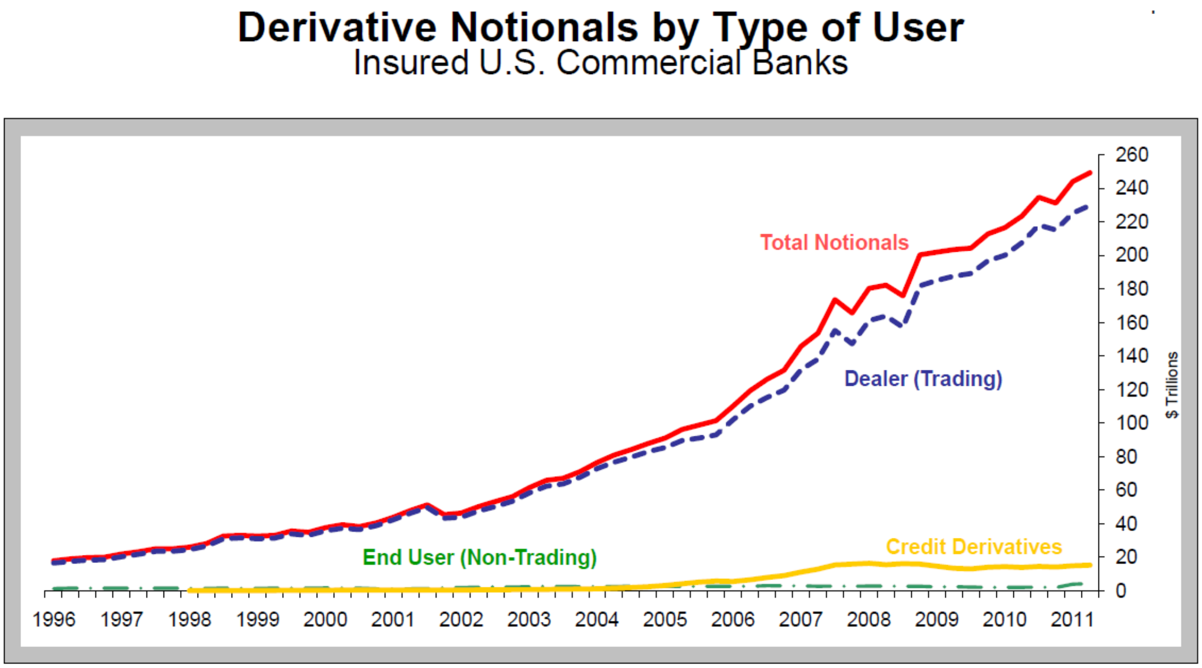
NOTIONAL AMOUNT OF DERIVATIVE CONTRACTS
TOP 25 HOLDING COMPANIES IN DERIVATIVES
JUNE 30, 2011, $ MILLIONS

RANK	HOLDING COMPANY	STATE	TOTAL ASSETS	TOTAL DERIVATIVES	FUTURES (EXCH TR)	OPTIONS (EXCH TR)	FORWARDS (OTC)	SWAPS (OTC)	OPTIONS (OTC)	CREDIT DERIVATIVES (OTC)	SPOT FX
1	JPMORGAN CHASE & CO.	NY	2,246,764	78,977,450	1,693,438	2,164,699	11,569,472	47,598,956	9,845,448	6,105,437	469,152
2	BANK OF AMERICA CORPORATION	NC	2,264,436	74,811,101	3,288,994	1,546,806	12,519,496	46,529,779	6,787,645	4,138,382	413,117
3	MORGAN STANLEY	NY	830,747	56,401,634	158,931	1,038,336	7,918,712	35,162,310	6,365,230	5,758,115	442,532
4	CITIGROUP INC.	NY	1,956,626	55,186,164	877,517	3,342,856	7,974,039	31,250,476	8,916,014	2,825,262	567,407
5	GOLDMAN SACHS GROUP, INC., THE	NY	937,192	53,405,245	1,812,343	3,249,493	4,764,925	29,888,177	9,386,342	4,303,965	359,691
6	HSBC NORTH AMERICA HOLDINGS INC.	NY	366,343	3,904,658	79,794	112,724	686,649	2,185,495	164,022	675,975	86,588
7	WELLS FARGO & COMPANY	CA	1,259,734	3,663,016	198,409	81,713	1,023,091	1,842,420	430,331	87,052	14,594
8	BANK OF NEW YORK MELLON CORPORATION, THE	NY	304,952	1,423,736	24,099	22,494	382,676	679,083	314,773	611	46,845
9	STATE STREET CORPORATION	MA	188,985	1,360,873	129,175	0	862,273	297,447	71,822	155	35,818
10	TAUNUS CORPORATION	NY	412,229	973,614	91,625	140,499	517,563	149,675	35,674	38,578	710
11	ALLY FINANCIAL INC.	MI	178,889	717,528	76,528	112,414	40,315	409,520	78,721	30	0
12	PNC FINANCIAL SERVICES GROUP, INC., THE	PA	263,260	338,581	57,713	6,690	16,968	225,079	28,381	3,749	976
13	SUNTRUST BANKS, INC.	GA	172,237	320,920	39,325	27,584	39,905	167,360	44,124	2,620	395
14	NORTHERN TRUST CORPORATION	IL	97,398	260,764	0	0	252,692	7,868	97	108	12,399
15	METLIFE, INC.	NY	771,483	259,442	19,310	0	34,662	93,602	99,602	12,266	0
16	REGIONS FINANCIAL CORPORATION	AL	130,908	140,169	2,370	0	59,531	73,994	3,592	681	148
17	TD BANK US HOLDING COMPANY	ME	189,724	104,106	0	0	15,726	86,860	1,247	274	8
18	U.S. BANCORP	MN	320,874	89,617	535	6,100	30,455	43,556	6,949	2,022	1,177
19	FIFTH THIRD BANCORP	OH	110,805	84,146	180	385	8,751	49,404	24,444	982	852
20	RBC USA HOLDCO CORPORATION	NY	84,884	69,359	1,314	3,450	58,456	5,133	151	855	0
21	KEYCORP	OH	88,859	68,219	2,054	4,000	5,003	48,553	5,675	2,934	1,676
22	BB&T CORPORATION	NC	159,310	58,102	2,056	0	9,260	36,743	10,044	0	37
23	CAPITAL ONE FINANCIAL CORPORATION	VA	199,753	50,475	348	0	5,978	44,071	78	0	4
24	CITIZENS FINANCIAL GROUP, INC.	RI	131,800	48,280	0	0	6,372	37,962	3,115	831	72
25	UNIONBANCAL CORPORATION	CA	80,094	45,755	4,491	0	2,089	26,944	12,172	60	708
TOP 25 HOLDING COMPANIES WITH DERIVATIVES			13,748,284	332,762,954	8,560,549	11,860,243	48,805,059	196,940,468	42,635,692	23,960,942	2,454,906

Note: Currently, the Y-9 report does not differentiate credit derivatives by contract type. Credit derivatives have been included in the sum of total derivatives.
Note: Prior to the first quarter of 2005, total derivatives included spot foreign exchange. Beginning in that quarter, spot foreign exchange has been reported separately.
Note: Numbers may not add due to rounding.
Data source: Consolidated Financial Statements for Bank Holding Companies, FR Y- 9, schedule HC-L

Source: Office of the Comptroller of Currency

The chart below shows the growth in notional value of derivatives - now up to $249 trillion - just at the insured bank portion of these holding companies over the last 15 years.



Source: Office of the Comptroller of Currency

The insured U.S. banks and trust companies collectively hold collateral from counterparties of just $258 billion, a mere 0.1% of those banks' notional derivatives exposures. These banks assert that 91% of the risk associated with $3.9 trillion in current receivables associated with these derivatives is offset by liabilities to the same counterparties via bilateral netting agreements. The banks use their own models to determine how much potential future exposure they have due to changes such as interest rate moves. Risk based capital rules allow the banks to then reduce this estimated future exposure using the same current netting ratios. Such methods probably vastly understate the risks of these derivatives contracts. The bottom line is that a default on only a tiny fraction of the notional exposure would be sufficient to trigger the biggest global financial crisis yet. The Bank for International Settlements latest figures (as of December 2010) show total G10 bank notional OTC derivative exposure at $601 trillion.

What is the modified duration on the $200+ trillion in interest rate swaps in the U.S. insured banks alone? In other words, if rates go up just one percent, how many trillions of systemic losses and counterparty defaults will we face? How much money will the Fed need to print to save the too-big-to-fail financial system from that gigantic default? What is the purpose of these swaps in the first place? Why do they dwarf the amount of debt in the economy that would actually need to be hedged against interest rate fluctuation if that is their purpose? If the purpose is interest rate speculation, why is only 0.1% of it collateralized? How many people are paying enough attention to even be asking these questions? The OCC report does not address these questions at all but goes out of its way to obfuscate the risks.

What if the Fed itself is the major driver of the proliferation of the massive notional value of interest rate swaps as part of its interest rate setting policies? Analysis of Fed minutes from a Greenspan era meeting reveals the elaborate details behind a non-conventional monetary policy strategy for keeping interest rates artificially low. The recommended strategy was presented by the head trader at the New York Fed and involves writing naked, out-of-the-money, off-balance-sheet put options in "increasing" amounts using large bank dealer counterparties. This strategy was to be executed through bank dealers' counterparties (who of course would take their trading cut along the way). Traditionally, the Fed - through its open market operations - intervenes in the markets by buying government fixed income securities in order to drive down interest rates. This money printing is revealed as the Fed takes the securities onto its balance sheet.

The twist with this non-conventional strategy is that instead of printing money to control interest rates, the Fed would sell uncovered put options on Treasuries to drive rates down, a transaction in the off-balance-sheet derivative markets. The Fed could even take in some income in the process i.e. in the same way that AIG took in income by writing CDS on subprime debt. The money printing would only come into effect if and when the option expired in the money and the Fed was forced to exercise them, taking the Treasuries onto its balance sheet. To deal with that risk, the Fed trader recommended that the Fed be prepared to sell these naked put options in "increasing amounts" in order to force rates back down and prevent the Treasuries from being put to the Fed. The problem is that the size of risk and ultimate cost of losing control only grows. A force of global bond market vigilantes - potentially including foreign sovereigns and their central banks - could force an exercise that would trigger literally trillions in money printing.

Mum is the word as to whether the Fed has implemented this strategy because there is no disclosure or accountability whatsoever for the Fed's off-balance-sheet derivative activities. The sheer size and opacity in these markets is frightening. If the Fed were doing this, might not the banks also be employing the same strategy for themselves? For example, could the banks be writing off-balance-sheet naked puts in increasing amounts in their own funding markets i.e. to drive LIBOR rates down?

One thing is clear. The Fed is either explicitly or implicitly insuring a potential disaster in the OTC derivatives markets via its too-big-to-fail policies. It has allowed the explosion in OTC derivatives in the banks and all of the moral hazard that goes along with it. We are stuck in the same upward spiraling loop of bubbles, busts, and money printing bailouts. The endgame to such a spiral may well be hyperinflation.

Role of Gold

Gold is valuable not because it is shiny, but because it is rare (0.004 parts per million in the earth's crust), and it is very difficult to find and extract. Thus it has been used as money for thousands of years either as currency itself or to secure sovereign currencies and their creditors. It also happens to have excellent electrical conductive properties, as does silver, so both are widely used in electronics. But even under gold and silver monetary standards, clever sovereigns throughout history - from ancient Greece in 377 B.C. to the United States in 1933 - have found ways to extract seigniorage from gold backed currencies devaluing their currency and debts via inflation. Gold standards have been abandoned many times under the stress of excessive debt or demand for physical bullion, such as in the U.S. in 1971.

No gold standard exists in the world today. We live in a totally global fiat currency world, and the non-gold backed U.S. dollar is the global reserve currency. The value of fiat currency is only supported by the trust that economic participants have in the sovereign not to dilute the value of the currency via money printing. Central banks still own and report that they own gold, but the Gold Anti-Trust Action Committee has produced much evidence that major fiat Western central banks have been secretly dishoarding their gold for years and employing tactics in conjunction with the large bank dealer counterparties to suppress the rising price of both gold and silver. The practice may have started innocently back in the 1980s when gold was truly overvalued relative to fiat money and fiat money was ripe for defense through central bank gold sales. In recent years, GATA alleges that the practice has grown substantially. According to GATA and its many contributors who have studied the evidence, the Western central bank cartel – the Fed, the BOE, the ECB and their large bank counterparties - has been engaged in a gold price suppression scheme involving gold swaps, gold leasing, and other derivate schemes much of which is again off-balance and unaccountable. After all, a gold price that rose too high, too fast, would call into question the safety and soundness of fiat money and facilitate the loss of confidence that would trigger the end game for fiat money. The problem is that such schemes, if they are indeed happening, could make a vicious hyperinflationary endgame all the more inevitable.

So What Does One Do?

Crisis creates opportunity. In this environment the conventional safe havens of cash and U.S Treasury bonds may be the only investments guaranteed to lose. Long and short opportunities abound. First and foremost, investors should continue to acquire and hold a significant stake in precious metals given the extent of the global fiat currency and debt devaluation that has yet to play out. The ultimate rise in the price of precious metals is bounded only by the amount of money that central banks are compelled to print, which is in turn bounded only by the amount of debt that they are compelled to monetize.

Enduring the volatility in gold and silver markets is a challenge for many, but in fiat money terms there is likely to be substantially more medium and long term upside than short term downside. The downside to not owning gold is substantial amidst an upward spiraling cycle of debt devaluation and fiat money printing. Central banks already appear to be breaking from the fiat money cartel by printing money to buy gold, not debt. The Chinese, Arabs, Indians, and Russians are taking the lead. Western central banks may be forced into the race to buy gold themselves at the same time that they are forced to print even more money to fend off banking crises and monetize even more debt.

While precious metals are paramount for protection in the current environment, the investment landscape for stocks is not as gloomy as it seems. There are always opportunities in the stock market, and in particular for ownership in innovative and attractively valued companies with productive assets. Even in the brutal hyperinflation of Weimar Germany, nominal appreciation of the leading industrial stocks generally kept pace with hyperinflation, while investor wealth held in cash and fixed income savings was decimated. While the global economy faces many challenges, new and productive technologies continue to emerge and offer economic and investment promise in areas as diverse as healthcare, energy, agriculture, and computing. Life, business, and markets will go on, even in the midst of war, inflation, deflation (the current risk in China), stagflation, or outright hyperinflation. We remain compelled to seize the opportunity.

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Chief Investment Officer