



CRESCAT GLOBAL MACRO FUND LP

Crescat Partners LLC
Crescat Portfolio Management LLC
1184 Snowberry Dr.
Golden, CO 80401

15 August 2007

Dear Investors,

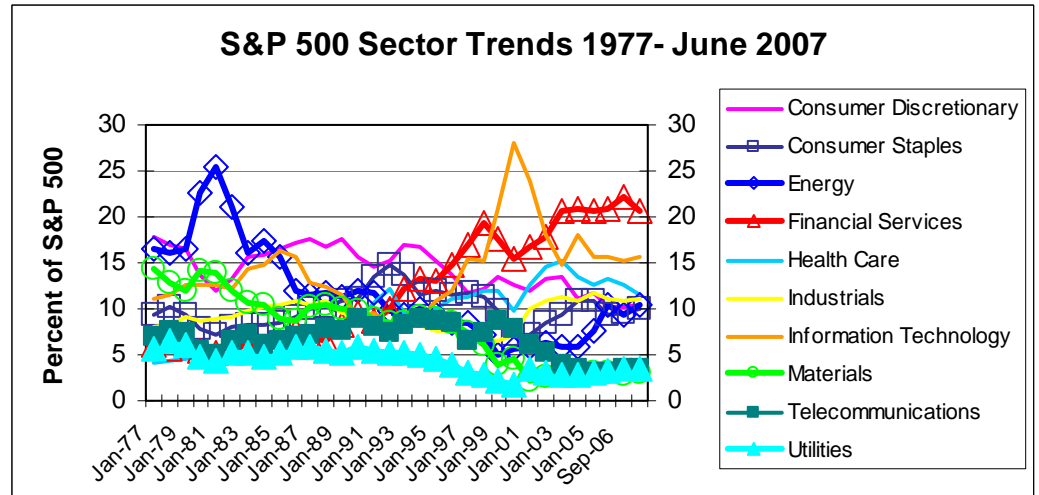
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed
.....private investment fund content removed

Recent Performance

You may recall that we have written about our **debt bubble** and **financial sector bubble** themes at length in past letters and as a result we have been ahead of the curve in positioning for the current financial sector meltdown . In our October 2006 Investment Letter, we wrote: “The sector that jumps out as being the most over-extended when you look at [the S&P sector trend chart] is the financial sector. Financials have risen from 5% of the S&P 500 to 23% over the last thirty years. Notice how the sector percentage chart registered “bubble” peaks for the energy sector in 1981 when that sector reached 25% of the S&P 500 and for the technology sector in 2000 when that sector reached 28%. If the housing bust continues to gain momentum, it will likely be the catalyst for a significant downturn in the credit cycle and hence the financial sector. It seems that very few Wall Street prognosticators are talking about a potential bubble in financials, but given their share of the market compared with other bona-fide sector bubbles, we believe this will be a very important sector to follow closely... We are being very selective in the group in terms of our shorts at the moment. The housing bust logically should be the catalyst for a decline in the financial sector but this translation has yet to be made in the market. When the financial sector clearly starts to turn down, we plan to get much more aggressive with these shorts.”

The chart we referred to is shown to the right, Chart 1, but has now been updated through June 2007. We did in fact get more aggressive with these shorts and have been short a healthy weighting of financial sector stocks for the past several months, ahead of the stampede out of them in July and August. These shorts included a variety of broker-dealers, banks, mortgage, and insurance companies and have been a major source of the fund's outperformance in the

Chart 1: S&P 500 Sector Breakdown Chart
Source: Standard and Poors



last several weeks. Chart 2 shows the sharp drop from the recent all-time high hit in June in the broker-dealer index. In this industry alone, we profited from being short all the major US broker dealers including Bear Stearns, Morgan Stanley, Goldman Sachs, Merrill Lynch, and Lehman Brothers.

Chart 2: Broker Dealer Index
Source: TradeStation



We have been short many other stocks as well including consumer cyclical stocks, homebuilders, and REITs that have helped our performance. You will recall that we were ahead of the curve in our **housing bust** theme and have profited from shorting housing and sub-prime mortgage stocks and sticking with this theme for the past two years. See Chart 3 below. We have been short a select basket of these stocks for virtually the entire ride down despite many assurances by Wall Street talking heads that the market had hit bottom. Now that virtually everyone has given up on predicting a bottom, the homebuilders may finally getting close to one, but as we have been saying all along, we don't think the final homebuilder bottom will be reached until at least one of the majors files for bankruptcy. We have already

Chart 3: Homebuilder Index
Source: TradeStation



booked a lot of profits in our homebuilder shorts, and prefer to add them only after counter rallies. We will try to hang onto a remaining core short position in this group until at least one files bankruptcy, at which point we plan to cover the remaining stake.

Our long Japanese Yen position (unwinding of the Yen carry trade sub-theme) has further helped the fund to outperform during the turmoil (see Chart 4 below). We believe this trade has a long way to play out still and is a way to capitalize on our debt bubble, hidden inflation, and dollar crisis themes. Our energy spread trades, which we put on to hedge our long energy exposure, have also helped our performance.

Our long energy and precious metals positions (both equity and futures positions under our **peak oil** and **dollar crisis themes**) have been swept up in the general market sell off in the last month and have hurt our performance, but our winners highlighted above more than offset these losses to drive the strong performance in what has been a very challenging market.

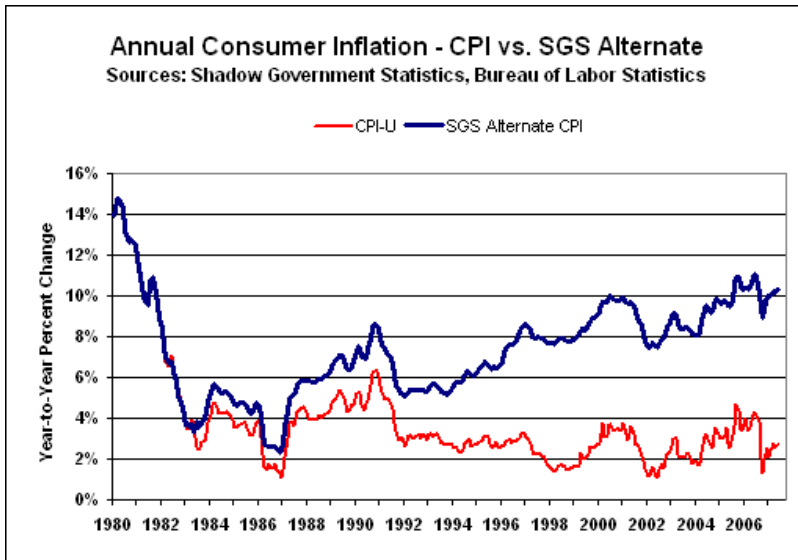
Hidden and Rising Inflation: Value In Precious Metals

We think ultimately gold and silver will be major beneficiaries of the meltdown in the financial sector due to what we perceive as an inevitable Fed bailout. The bailout already began last Friday with a \$38 billion liquidity injection, but we think that is only the tip of the iceberg. Collectively, the world's central banks cranked up the printing presses to the tune of \$130 billion on Friday and liquidity injections worldwide have continued this week. We not only have been forecasting the financial sector meltdown but also the liquidity response, which very simply has been our reason for owning precious metals. We believe precious metals represent one of the best values in the market today, and that further central bank intervention will be the catalyst to spark a major move higher. The combination of value and timing we think could hardly be better for gold over the next several years.

Chart 4: Japanese Yen Futures
Source: TradeStation



Chart 5: CPI Under New v. Old Methods
Source: Shadow Government Statistics



many ways the BLS manipulates CPI in our “**CPI Legerdemain**” piece and also have called into serious question the Fed’s **abolishment of M3** in past letters. We think there is far too much faith in our fiscal and monetary authorities as measured by low inflation expectations in the financial markets. Chart 5 shows the CPI today if it were calculated based on the same method employed in 1980 prior to hedonic adjustments, substitution and other gimmicks legislated by Congress. The gimmicks have had the effect of reducing CPI by the pen rather than by the sword. You can see inflation under the old method of accounting has been rising at 8 to 10% per year, which is more in line with price increases in items like food, energy, healthcare, education, and for awhile at least, real estate. To us, the authorities seem much more interested in manipulating statistics than they are in combating true inflation. Indeed, Bernanke’s self-proclaimed main weapon in fighting inflation is to contain inflation expectations. We would have preferred both he and Greenspan to have been containing inflation’s monetary roots instead, the more important tool under their control. **We believe that the Fed has had the investment community fooled into believing inflation is much lower than reality for too long. The imbalance between true and perceived inflation we think is one of the most important investment themes to navigate in the months and years ahead in terms of risk and return in the global financial markets.**

There is nothing like a deflationary scare in the financial markets to help contain expectations and give Bernanke the license to come to the rescue. We think too many still fear monetary deflation. The Fed has been injecting massive liquidity already for years and been getting away with it in terms of little perceived inflationary impact in the financial markets. Let us refer again to M3 money supply growth by looking at Chart 6. It has been growing in excess of 10% already for the past year. Such injections now are only likely to get more serious. Liquidity injections are indeed inflationary. Last Friday’s was apparently the biggest in a single day since September 2001. The Fed’s open market operations on Friday were conducted in the repurchase agreement (repo) market. Repos are part of M3, which - as we noted - the Fed abolished, arguing that M3 was no longer a useful indicator of inflation. The Fed also said that M3 was too costly to track and publish. Therefore the recent liquidity will not even be counted in the official money supply (M1 and

We have been surprised, however, that precious metals have not been performing better as the crisis has been unfolding. **It seems it may take the market some time to figure out the inflationary implications of the almost inevitable global central bank liquidity response to the financial sector crisis.** We think most major market players have been taken by surprise by the problems in the credit markets, and are still trying to come to grips with it, so they are not likely thinking much further ahead yet. As a result, the baby has been thrown out with the bathwater when it comes to precious metals.

To get a major rally in precious metals will require a shift in inflation expectations. Such expectations we think are far from reality given the monkey business at the Bureau of Labor Statistics and the Federal Reserve regarding the inflation statistics and indicators. We wrote about the

Chart 6: M3 Money Supply Reconstructed
Source: Shadow Government Statistics

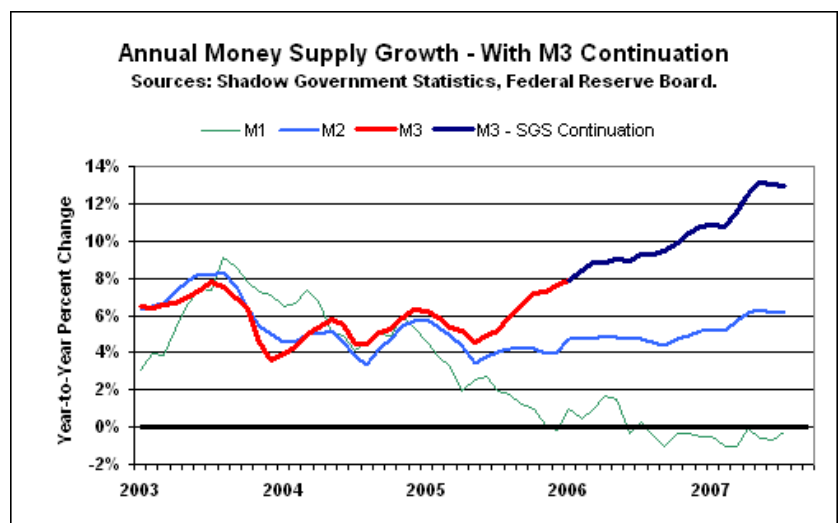
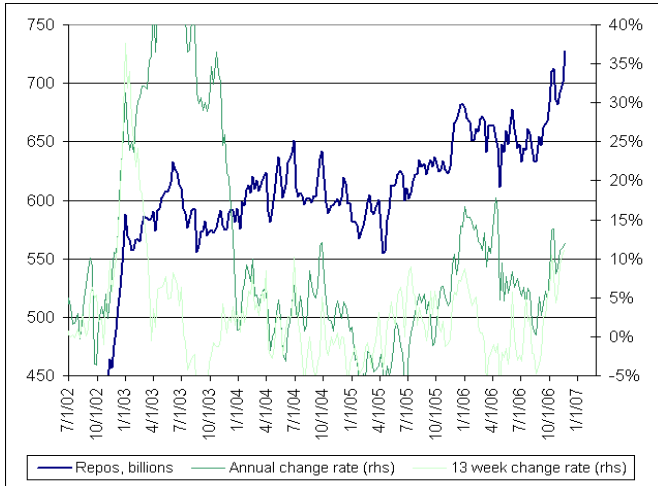


Chart 7: Growth in Repurchase Agreements (Repos)
Source: Federal Reserve



M2).

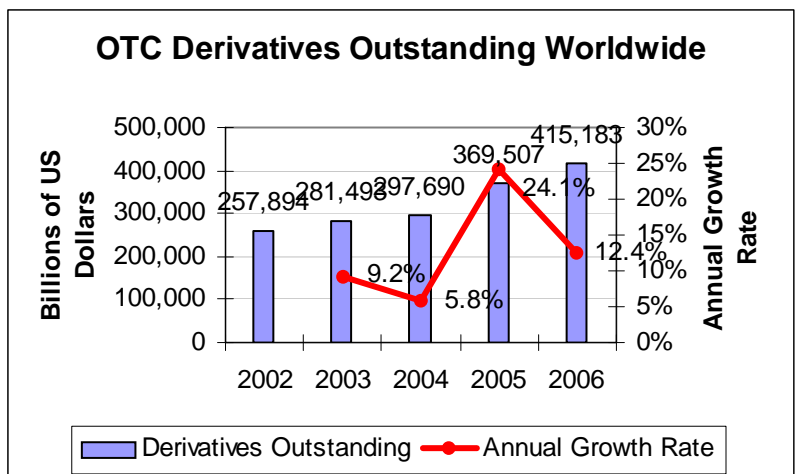
We believe that it is ludicrous to think that broad measures of money supply, which include widely embraced and rapidly growing forms of short-term credit, such as repos, are not useful indicators of the money supply. Repos have actually been a key component of the leverage behind the boom in the structured credit market in the past several years. Chart 7 shows the explosive growth in the repo market. If M3 was abolished because it was so costly to produce, then why does the Fed still track and publish all of its components so that, with a little bit of work, we can still chart it? We can think of no other real reason why Bernanke abolished M3 than to take it out of the public view to provide a hidden channel to stimulate the economy without the raising inflationary red flags.

Bernanke Between a Rock and a Hard Place: But the Choice Seems Inevitable

The Fed has been walking a tightrope that represents the perfect balance between economic growth and monetary inflation. The market believes the Fed has largely succeeded in walking the tightrope over the past many years, but we think it has erred miserably on the side of inflation and has succeeded only in covering up that fact. This cover-up is largely responsible for the now-unfolding financial bubble. We expect more of the same behavior from the Fed, pretending to walk the tightrope but continuing to err on the side of pumping excess liquidity to ward off recession, particularly now that it is facing a major credit crisis. When the rest of the world starts to discover the truth of the Fed's inflationary ways, however, we believe there will be further dramatic re-pricing of financial assets, an inflationary dollar crisis, and substantially higher market interest rates. **We think a cyclical recession is inevitable but that it will be of the stag-flationary variety as opposed to a dis-inflationary recession for the first time in over quarter century. We think that few market players are ready for both economic stagnation and inflation at the same time, making it all the more likely to emerge.**

Bernanke is between a rock and a hard place. If he doesn't ease, the credit market and banking implosion will likely continue to spiral out of control, creating one of the worst recessions in history. If he eases, he will likely stabilize the financial markets, but he risks unleashing serious inflation. Either way he loses, but the choice, we think, is inevitable. The only logical decision is to continue to err on the side of inflation. The best he can do is to time the first ease when deflationary fears are rampant but prior to a true breakdown in the banking and financial system. Unless the financial markets stage a miraculous comeback of their own, we think we are very close to that point already. The Fed is trying to show some muscle in holding off on the ease, to combat the inflation-fearing minority. Bernanke is holding out as long as possible and providing largely hidden liquidity instead. Given the current banking crisis now unfolding, we think he will very soon have no choice but to ease, most likely by lowering the Fed Funds rate. **An emergency Fed ease, of one form or another, or the lack thereof, we think is the biggest risk and opportunity in the market right now. Despite deflationary concerns now becoming widespread, we think it is important not to get caught up in the indiscriminant panic selling of everything. Selling or getting heavily short at the wrong time could be a major mistake. Counterpunching after big moves and sticking with our themes, we believe will be a much better strategy for this market.** In that respect, we think investing long in gold and silver into the recent sell-off could be a great move in the

Chart 8: Size and Growth of OTC Global Financial Derivatives
Source: Bank of International Settlements



short term as well as the medium term. It certainly should be if the Fed goes ahead with an emergency interest rate ease. If we don't get the ease, we believe the implosion in the financial sector will get much worse, and we will be in for a particularly nasty and sudden recession. We really find it hard to believe that the Fed would so easily allow that to happen.

Unsustainable Leverage in a \$415 Trillion OTC Derivatives Bubble

The real problems in the financial sector, we are convinced, are much bigger than a credit crisis in sub-prime mortgages. Similarly, the housing bubble was only one piece of the problem. **The overriding bigger problem is the more than \$415 trillion highly leveraged notional amount of over-the-counter financial derivative assets outstanding**

in global financial system. This was the amount reported outstanding at the end of 2006 by the Bank of International Settlements and is supported by a mere \$48 trillion in global GDP. This derivative exposure alone represents 9:1 predominantly off-balance sheet leverage in the global financial system..

In the US, on-balance-sheet total credit market debt is \$46 trillion. Add to that U.S. Social Security and Medicare off-balance-sheet debt of approximately \$36 trillion and roughly \$138 trillion of off-balance-sheet derivative exposure, and the US has \$220 trillion of total financial exposure supported by GDP of merely \$13 trillion. That is a total debt to GDP of 17:1 in the US, which is nothing short of insanity. With this amount of leverage in the US financial system, there is absolutely no margin for error. The problems with the credit crisis now unfolding, however, represent a major error. As a result, we think there are a lot more shoes to drop in the financial markets. **While it may take some time to play out, we believe there is no way to avert a significant recession in the end, even after the almost inevitable Fed easing, which will be stagflationary.**

Chart 9: Sharply Widening Credit Spreads in High Yield
Source: Bill Gross, PIMCO

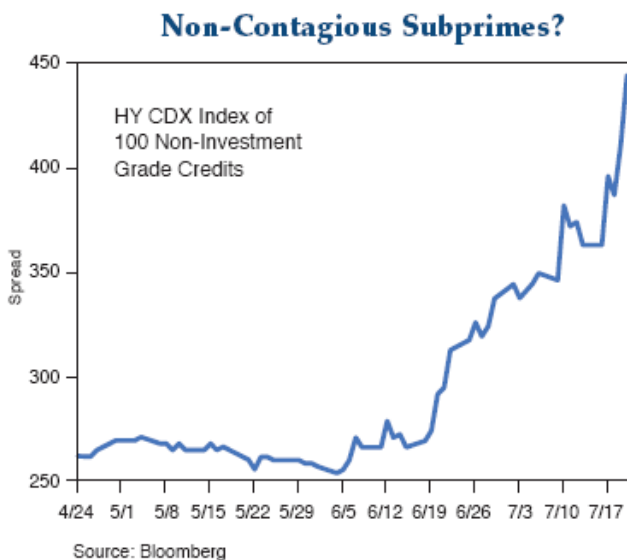


Chart 2

Table 1: Guide to Credit Derivative Jargon
Source: The Economist

Derivative language	
A guide to the jargon	
Term	Meaning
ABX	Index of subprime mortgage loans (see below)
CDX	Index of US credit-default swaps
Credit Default Swap (CDS)	Agreement whereby one party makes a series of payments to another in return for compensation in the event of a bond default
Collateralised Debt Obligation (CDO)	Portfolio of bonds, divided into tranches, giving investors different rights
Collateralised Loan Obligation (CLO)	Equivalent of CDO using loans, not bonds
Continuous Proportion Debt Obligation (CPDO)	Specialist vehicle that uses borrowed money to insure a broad portfolio of bonds or loans
Credit Derivative Product Company (CDPC)	Specialist vehicle in the CDS market
Equity	Riskiest part of a CDO
iTRAXX	Index of European credit-default swaps
Mezzanine	Tranches of a CDO that lie between the equity and the senior tranches
Residential Mortgage Backed Security (RMBS)	Bond backed by home loans
Subprime mortgages	Housing loans made to borrowers with poor credit ratings
Synthetic CDO	Equivalent of a CDO, except the underlying portfolio is based on credit-default swaps

Source: The Economist

Breaking Down the Risks and Exposures

The leveraged growth in asset backed securities (ABS) and credit derivatives, such as CDOs, CLOs, and CDSs (see Table 1 above) get a lot of press and have been a fast growing part of the market. The vast majority of the \$415 trillion OTC derivatives are traditional ones, such as interest rate contracts, which make up 70% of the market at \$292 trillion. Most of these are “interest rate swaps”, hedges and bets on the direction of interest rates. Foreign exchange contracts further make up 10% of the market at \$38 trillion. CDOs get a lot of press because of their link to the \$1.3 trillion dollar US sub-prime mortgage market now in distress, but interestingly CDOs only make up only \$900 billion or 0.2% of the OTC derivatives market. The CLO market, a market for securitized bank loans, is a less than \$1 trillion slice of the overall derivatives market. CDSs represent \$29 trillion and are perhaps the biggest risk in the overall credit derivatives sector, which we will discuss further below.

Chart 10: Size and Growth of Credit Default Swaps
Source: Lehman Brothers

Given the size, leverage, and inter-related nature of the derivative market, we believe the credit crunch is necessarily spreading far beyond sub-prime. It is very clear to us that the entire credit market is currently in the process of freezing up and we have only begun to hear of the casualties. By the way, the total size of the US sub-prime mortgage market - which is receiving virtually all of the blame for the credit meltdown - is only \$0.84 trillion. The point is that the risks in sub-prime mortgages pale in comparison to the risks imposed by the much larger credit and OTC derivatives markets. **The fallout from the sub-prime collapse already seems enormous, but the risk of it spreading to the much larger credit and derivatives markets is what is truly enormous, \$500 trillion+. We expect re-pricing of risk across this entire spectrum, a re-pricing of credit risk, economic-cycle risk, inflation risk, liquidity risk, volatility risk, and term premiums, all of which had reached euphorically low levels recently.**

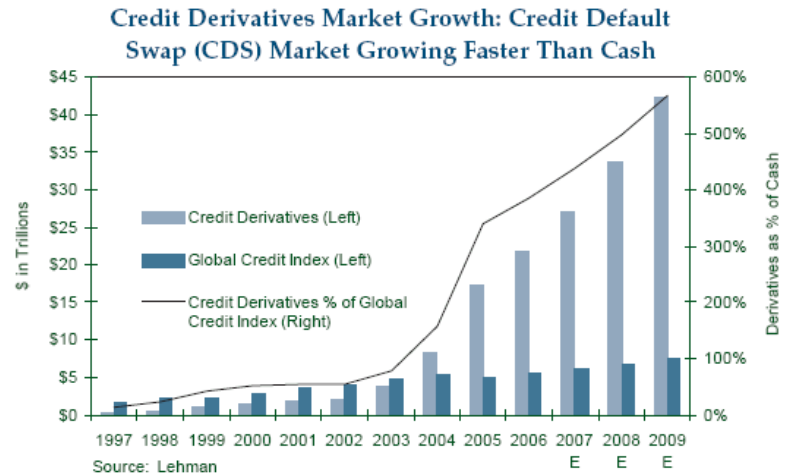


Chart 3

Bill Gross at PIMCO in his latest monthly letter says, "Some wonder what squelched the hunger of potential lenders so abruptly, while in the same breath suggesting that the subprime crisis is "isolated" and not contagious to other markets or even the overall economy. Not so, and the sudden liquidity crisis in the high yield debt market is just the latest sign that there is a connection, a chain that links all markets and ultimately their prices and yields to the fate of the U.S. economy." Gross pointed out that corporate high yield credit spreads have suddenly widened by almost 150 basis points (see Chart 9) and that ultimately the duration effect of a large rise in corporate credit spreads can do even more damage to the economy than a Fed rate increase. We agree with this point in the context of our theme which we have written about: that the last round of Fed rate increases would - with 80% probability - ultimately lead to recession.

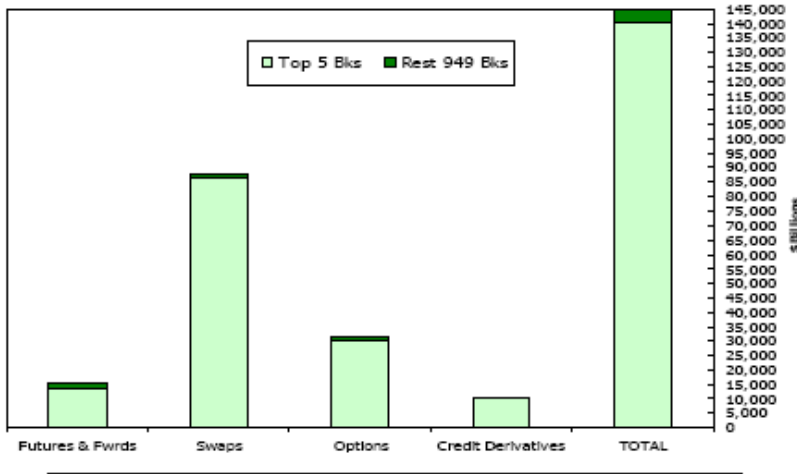
CDS = Could Do Some Damage

The surprisingly largest and fastest growing segment of the credit derivatives markets are "credit default swaps". The CDS market has skyrocketed in the last few years to \$29 trillion, roughly three times the underlying corporate bond market of which they are a derivative (see Chart 10 above). CDSs let investors buy default protection on the underlying bonds but have become much more than that. They have become a highly leveraged way for financial institutions to speculate long or short on corporate bonds. Since only 1/3 of this market is represented by actual underlying cash bonds, it means that somewhere in the financial system is roughly \$19 trillion of uncovered puts options on corporate credit, or in other words, **a \$19 trillion uncollateralized bet that there will not be a material systemic credit crisis.** Even if the risk exposure is only 10% of the \$19 trillion notional amount, it still equates to a potential \$1.9 trillion loss or about 4% of world GDP. And when the average on-balance-sheet (not including derivatives) leverage of the major banks and financial institutions is more than 15:1 (not including derivatives), a loss of that size could wipe out the entire equity base of the US top ten banks and brokerage firms combined. We are not suggesting that such a scenario will occur, but want to point out the magnitude of the exposure. In reality, there are two sides to every trade, and financial institutions also own the other side of this trade. The problem is that it is not a zero sum game. Because most parties are highly leveraged, and every party has the option of bankruptcy, one side can win on this trade but still lose. **The counter-party risk is substantial** and should ultimately lead to wide losses throughout the financial sector.

In the past, the vast majority of structured credit products and OTC derivatives were easy to get into - at a big profit in fees to banks and securities firms creating them - but they carried a large spread to get out. Now, many of these assets are impossible to get out of, and because nobody wants to own them, banks and securities firms stuck with loads of them on the books. But even though the fair market value for these securities has plummeted, few firms are marking them to market on their books. **The vast majority of these OTC derivatives and structured credit products are "marked to model", which means they are ultimately priced based on whatever the institutions think they can away with based on the assumptions in their models.**

Chart 11 Concentration of Dealers
 Source: Office of the Comptroller of Currency

Five Banks Dominate in Derivatives
 All Commercial Banks, First Quarter 2007



To compound the problems, there are only a handful of banks and brokerage firms of size and capability that deal actively in these OTC institutional securities. The lack of listed or electronic markets and the **concentration of dealers** is a major systemic problem that is now being tested in a major way for the first time since the Long Term Capital Management fiasco in 1998. We believe concentration reduces liquidity, widens bid-ask spreads, and increases the likelihood of a complete freeze-up in the market during a time such as now. Chart 11 shows the concentration of derivative dealers among commercial banks. We believe the system is not handling the current crisis very well at all. In the face of excessive leverage, inflated asset prices, increased margin requirements, widening credit spreads, and a limited number of dealers, we believe the liquidity for all structured credit products and OTC derivatives has dried up substantially. We

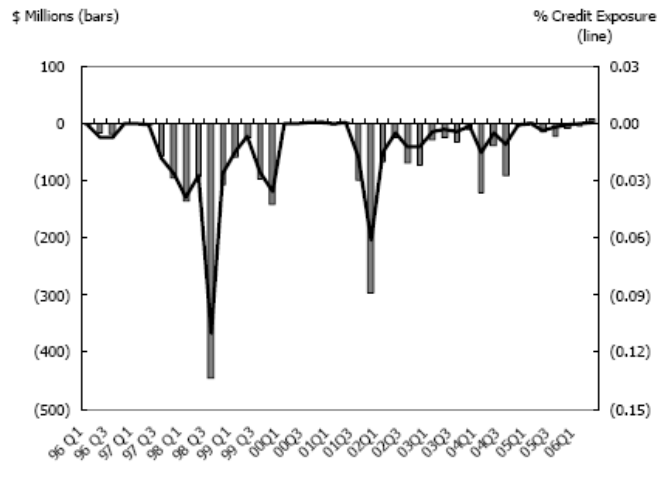
believe there are many forced sellers, under margin calls and other constraints, and many wanna-be sellers, but few buyers. We already know for sure that bids for sub-prime mortgage products have fallen to crisis levels. **Given the collective margin squeeze in the financial sector, how can the liquidity crisis not be spreading to the other highly leveraged, highly inflated derivatives and credit products in the global \$500 trillion + market?** We think there is a major fire beneath the smoke.

The Mark-to-Model Scandal in the Making

The broker dealers, banks, insurance companies, large hedge funds, and their foreign counterparts that own these trillions of levered assets have been playing a giant poker game. These securities had been priced recently as if everyone held aces. The reality is that there are few bidders. With mark-to-model pricing, many are still pretending to hold aces. They are still getting away with it, but it is a scandal that is just starting to unfold. The scandal is due to mark-to-model pricing, which is a new theme of ours. On one level, mark-to-model pricing is preventing the crisis from being recognized to its full extent. As a result, there will be strong push within the financial sector to keep this system in place. But mark-to-model pricing is structurally unsound as it encourages accounting manipulation and excessive risk-taking. It will prove a scandal when enough firms go completely under and the full extent of the past manipulation and fraud becomes disclosed in the form of investor losses. **Under marked-to-model pricing, the only firms that mark the \$415 trillion in OTC securities to market are the ones forced to sell through margin calls or investor redemptions.** For the rest of the market, the accounting remains inflated.

In the end, we think this scandal will dwarf Enron, Worldcom, and Tyco combined. **Chart 12 shows derivatives charge offs in the commercial bank-**

Chart 12
 Source: Office of the Comptroller of Currency
Quarterly (Charge-Offs)/Recoveries From Derivatives
 All Commercial Banks with Derivatives
 1996 - 2006 Quarterly Data



Quarterly (Charge-Offs)/Recoveries From Derivatives (\$ Millions)

ing system. One can see that it has been a long time since we have had a major charge-offs in the derivative space, but they do happen. We believe that there will be a new spate of charge offs to hit the banking and broader financial system, exceeding the LTCM charge offs in 1998 and 1999. We think it would happen today if the securities currently held were simply marked to market.

To date, our funds have never traded any OTC derivatives or structured credit products. As a result, our performance has not been based on any mark-to-model pricing. Deliberately, our performance has come from liquid, highly scalable, listed securities.

There are many reasons why mark-to-model pricing is a major scandal and a crisis in the making. In the quest for a high Sharpe ratio, a risk-adjusted return measure that has been key to attracting investor capital into hedge funds, many hedge fund managers have embraced securities with mark-to-model pricing as a way to both mask volatility and inflate performance and therefore inflate their fund's Sharpe ratio. Hedge funds rushed to these products and Wall Street was only too happy to create them. The entire financial sector - not just hedge funds but also banks, broker dealers, and insurance companies - has also embraced these securities due in no small part to their mark-to-model pricing advantages. **Simply stated, mark-to-model pricing allows the entire financial sector to manipulate its financial statements.** As a result, we have little trust in past earnings of financial companies and expect future write-downs to emerge like cockroaches. You will hear from time to time many bulls claiming that the problems are contained. For a while, it may seem that way. For instance, we think a Fed rate cut would spark a major counter rally in the near term to alleviate fears. But we think more problems will surface over time. We believe that the bubble is just now starting to burst and that its unwinding will be a long process given the enormity and high leverage of this market. We further believe that the Fed - out of necessity - will bail it out over time - also in an enormous way. **Navigating these times presents a tremendous opportunity for the Crescat fund to both capitalize and protect capital on both the long and short side of the financial markets. We have been expecting the financial derivative meltdown for some time. We are not happy about the price we will have to pay in the economy as a whole for its bailout, but we look forward to the opportunities it presents to generate strong returns for our investors.**

End of the 25-Year Secular Bond Bull Market and The Beginning of the End of Faith in Central Banks

As we have mentioned, the gulf between truth and perception is probably as wide as it has ever been when it comes to the true level of inflation. It was the exact opposite when former Fed Chairman Paul Volcker hiked rates all the way

Chart 13: 10-Year Treasury Yield
Source: The Big Picture



to 19% in 1981. Faith in the Fed then was dead. Inflation then was actually dramatically lower than perceived. The pendulum has swung over a quarter century from no confidence to overwhelming reverence in the Fed. Chart 13 illustrates a 25-year period of ever-increasing bond market confidence. Greenspan was able to get away with Fed Funds rate at 1% for almost a full year over concern about deflation. Even today under Bernanke, faith in the Fed remains strong and belief that inflation is low is still widespread. **In the end, we think it has been the overwhelming but undeserving trust in the Fed and global central banking in general, that has led to a major 25-year secular bond bull market bubble top that is only beginning to unwind. We believe we are at the beginning of**

a major secular bond bear market. We think the bond market will prove to have hit its secular peak in 2005.

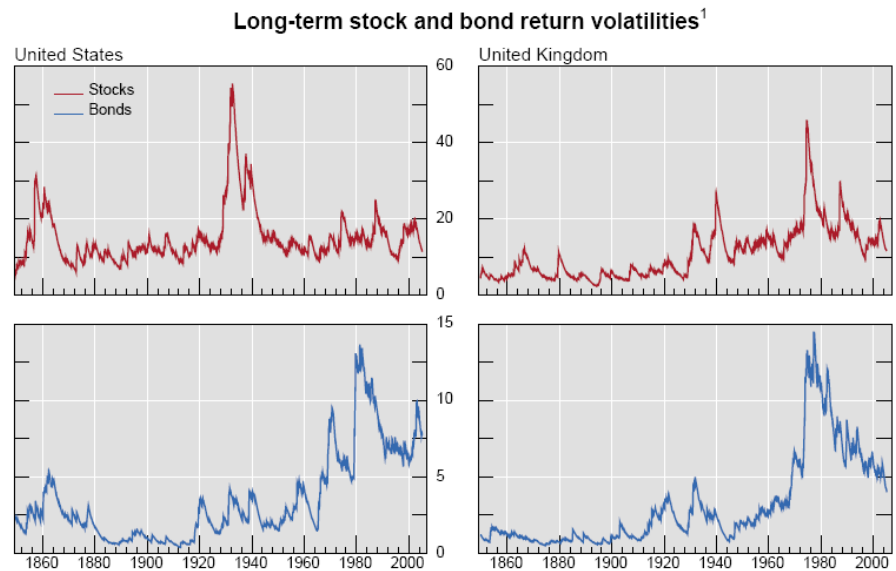
The broader credit market bubble and all the assumptions that have created it are ultimately self-destructive. **The most ridiculous thinking going around last year and early this year was actually promoted by the world's central bankers themselves. It was the idea that the economic cycle has been permanently muted and therefore volatility of financial assets had also been permanently reduced in large part because of their own successes in central banking.** The Bank of International Settlements (BIS) published this theory in August of last year in a paper entitled *The Recent Behavior of Financial Market Volatility*. The BIS is essentially an exclusive club comprised of the world's

central bankers. It is the bank to the word’s combined central banks. In the BIS paper, the central bankers credit “financial innovations”, “improvements in risk management techniques”, “more liquid financial markets”, the “greater role of institutional investors”, and “systematic and transparent monetary policies” as being “important drivers of the volatility reduction” that “seem to be structural, and may therefore have a *permanent effect on volatility*” (their emphasis).

The problem with this type of thinking is that there is nothing “permanent” about a “variable” in the financial markets. It is precisely this type of new-era thinking that again and again leads to manias and bubbles, which ultimately lead to the bursting of those bubbles. Low volatility leads to increased complacency, speculation, and leveraging which leads higher volatility and ultimately leads to dislocations and higher risk premiums. Ultimately, it is a self-reinforcing cycle that gone on since the beginning of financial history.

Chart 14 (below), sourced from BIS’s own paper just mentioned, illustrates very long-term financial market volatility. Volatility of financial assets ebbs and flows. The low levels reached at the time of the paper’s publishing were nothing out of the ordinary over the past few centuries. Spikes from these levels are frequent and extreme. However, there is no evidence whatsoever of lower volatility over time due to advancements in the financial markets. In fact, the opposite is true. The regression line through the long-term volatility charts is upward not downward sloping, which means that if anything, over time, volatility of financial assets has structurally increased, not decreased as the financial markets have evolved.

Chart 14 Financial Market Volatility
Source: Bank of International Settlements



¹ Annualised volatilities calculated using monthly data, in per cent.
 Sources: Global Financial Data; BIS estimates.

Increased volatility would logically be explained by the increased use of leverage over time, particularly among financial institutions.

We believe that the BIS, in its erudite hubris, is no different from the geniuses of Long Term Capital Management. They created their own bubble and now are paying the price in the form of a major structural financial market meltdown. The financial sector at large is now facing increasing losses that cannot be fully absorbed under its excessively leveraged balance sheet. The innovative financial products that the central bankers credited with muting the economic cycle now risk doing exactly the opposite.

We can’t help but think of the financial institutions that wrote the \$19 trillion notional value of uncovered puts in CDS

market based on the BIS’s low volatility thesis. They thought they had been coining free money, but they were in fact taking huge leveraged credit risks and are now experiencing major losses. Due to mark-to-model accounting for these OTC derivatives, however, we think that these losses are still largely being covered up.

Scarce Natural Resources; the Dollar Crisis; and the Commodity Super-cycle

As we have been saying, our dollar crisis theme is really a global fiat currency crisis in the making, and ultimately favors precious metals and scarce natural resources, such as energy, even more than foreign currencies.

The preference of financial over real assets, combined with manipulation of the inflation indices has kept reported inflation down and led to leveraged financial asset inflation. We now believe we are about to face the opposite: serious financial asset deflation and serious real asset inflation, particularly in the under-leveraged scarce natural resource area. The Fed’s likely upcoming liquidity pump, rather than going to re-flate financial assets, we think will create inflation in hard assets, ex US housing, until the housing bust plays out due to the overbuilding and over-leveraging therein. **We have written extensively about our peak oil theme in the past so will not repeat it in depth here. We remain**

committed to that theme and believe the energy markets have a long way to spike as they come to grips with the realities of limits to the production of conventional oil, and the lack of clean and efficient alternatives of scale. Under our scarce natural resources theme, we are most excited about the potential for precious metals and energy commodities, but we are also interested in scarce industrial and agricultural commodities.

Some have said that we are in the early stages of a “commodity super-cycle” and we agree. The market has disagreed over the past few weeks, but we think this is a major opportunity. Commodities are currently being sold off along with financial assets, but sooner or later, we think there will be a return to the traditionally negatively-correlated relationship between these two asset classes as shown in Chart 15 above.

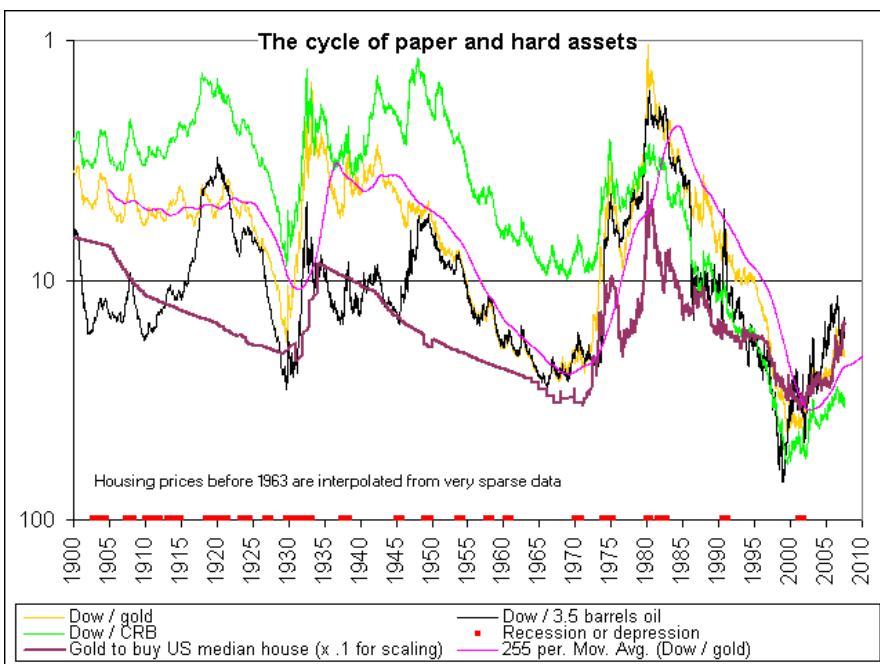
Since the traditional relationship has diverged recently, commodities appear to be providing the major buy opportunity. Fundamentally, it makes sense because the new liquidity coming from the Fed to bail out the financial sector is likely to find its way into scarce natural resources and fiat currency substitutes, rather than credit derivatives and the housing market that comprised the last bubble.

When Greenspan started lowering rates in 2001, the money didn't flow back into inflating tech stocks. It went to new areas and created new bubbles. The liquidity from the coming bailout of the financial sector should prove no different. Indeed, the new secular commodity bull market cycle already started (after a 20-year bear market) with the first financial market meltdown that began in 2000 (again, see Chart 15). The commodity bull market should prove volatile, with sharp corrections along the way, just as we are experiencing now, but we think it still has several years to play out. As the chart shows, the commodities markets had sharp corrections in the 1970s too, but the secular bull lasted almost a full decade and the upside surges well more than compensated for the risk. We believe that commodities (through both the futures and equity markets) still represent one of the best places to capitalize on the imbalances now being reconciled in the global macro economy. They also provide a way to hedge against serious inflationary risks of the meltdown/bailout scenario that we believe is unfolding in the financial sector. Stocks that are beneficiaries of rising commodity prices also should continue to be a great place to invest in the coming years. **Among the different industries and sectors in the stock market, our model has identified commodity-related stocks (in the basic materials and energy sectors) as having the best combination of value and growth characteristics in the market today given the current low trailing and projected multiples of earnings and high recent and projected earnings growth rates.** We think it is a great time to buy them. We also think there will continue to be significant upside from shorting financial sector and consumer cyclical sector stocks over time, but those sectors may well get sharp counter rallies under Fed easing along the way. As always, we sincerely appreciate your continuing confidence in us.

Kindest regards,

Crescat Partners LLC
Crescat Portfolio Management LLC

Chart 15: The Cycle of Paper v. Hard Assets
 Source: Nowandfutures.com



Kevin C. Smith
 Partner/Portfolio Manager
 (303) 271-9997 phone
 (303) 271-9998 fax
ksmith@crescat.net

Claiborne B. Booker
 Partner
 (505) 984-3063 phone
 (505) 984-3073 fax
cbooker@crescat.net

Dan Hoskins
 Partner
 (720) 379-3177 office
 (303) 807-2865 mobile
dhoskins@crescat.net