

Let me simplify and sum up the deflation arguments of the leading bears on Wall Street. Paul Krugman, Nouriel Roubini, Ken Rogoff and David Wiedemer's collective thesis is that governments around the world have borrowed too much money and the economies of those countries will not grow enough to service that debt. If you believe that thesis to be true, then you should buy gold, hard assets and high quality debt that won't default when the economies of the world roll over like they did in the Great Depression. They come to this conclusion based on what happened in 1929-1933 and they think there is going to be a replay of that event in this decade. As you know we disagree with their conclusion. The hole in their logic as we see it is they take ONE data point and compare it to another SINGULAR data point and ASSUME that everything is going to be the same as it was in 1929-1933. They assume no one will do anything different this time than last time. So they take the data point of debt and relate it to GDP in 1929, then take the data point of debt in 2010 and related it to today's GDP and make an assumption that the response by our political leaders and monetary officials will stay the same as it did in 1929. That logic reminds me of a joke where an economist, a scientist and an engineer are trying to open a can of food on a desert island. The scientist said "We should use the rays of the sun magnified by my reading glasses to burn a hole in the can to open it", the engineer said "We should hook the can up to this pulley tied to this tree to open it" while the economist says "Let's just assume we have a can opener and open it". To take one data point and do a regression analysis to another data point and ASSUME that the Federal Reserves of the world won't react differently to those data points is a mistake. As the computer programmers like to say "garbage in, garbage out". We have tried to prove that logic is a mistake by telling you in 1929 the Federal Reserve restricted credit as the economy declined due to a theory in finance called the "real bill" doctrine. The real bill doctrine was a disaster that kept the Fed from printing money to stop deflation and it helped lead to the Great Depression. This time the Federal Reserve has printed so much money we are shocked that anybody would trust the Government enough to buy a 10 year bond at 2.96% or a 30 year bond at 3.92% when inflation has averaged OVER 3.5% for the last 80 years. That said, the deflation guys are winning and my view point on this subject since May has been under siege. To sum this thought of debt deflation up, let me give you a ridiculous example but a relevant one on what the Federal Reserve could and would do if they were worried about paying our debt. If the USA owed 20 trillion dollars and we have 1 trillion dollars of money in circulation is that enough money to service the debt? Let's say it is not. If we have 20 trillion dollars in debt and we NOW have 10 trillion dollars of money in circulation can we service our debt? How about if we print 20 trillion dollars of money to service 20 trillion dollars in debt? Would that do the trick? The answer is yes and that's the power the Fed has to print money and stop deflation.

We have been trying to put a REAL number on our inflation work to help you and us plan for the future. Kelly, Brandon and our summer intern Matt Libel have been working on trying to quantify how bad inflation would be if we are right on our inflation view point. The answers are not good if you hate inflation. Based on their work (a hearty thanks to Matt's Notre Dame statistics training), the consumer price index that measures inflation should be at 250 right now instead of around 200 today. Should the Federal Reserve not take the money out of the system the consumer price index will go above 400 this decade based on past history. That means that we are staring at 25% to 100% inflation in this decade based on the relationship between money in circulation and inflation. I think it's fair to criticize us for not owning government bonds when they went up this quarter but the risk reward in that area is as

good as owning sub prime real estate was in 2007. If a government bond pays you 3% a year for ten years before you compound that money you are looking at a return of 36% on your money while staring at a 25% depreciation of your purchasing power for a net gain in 10 years of 11%. As we have mentioned in the past we think one of the variables to inflation coming back is China raising their exchange rate and that started this month. China has a huge problem ahead of them and they will be a key contributor to OUR inflation rates this decade. We view the situation in China as THE biggest mess on the planet and it won't end well over there. As they implode we think it will help our manufacturing jobs while raising inflation in this country. Nobody believes manufacturing is coming back in this country so it will be interesting to see how that plays out over the next 10 years. I will sum up our bond thoughts before we discuss Greece and Europe. We are EXTREMELY bearish on government bonds. Own them at your own risk.