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"*Confidence games played by confidence men*

Government tells us that households have purchased $700Bn of new treasury debt, up 10-fold since 2008. Other confidence hawks adhere to the belief that unemployment is "only" 10% of the population and that the Great Recession is over. The COMEX wants us to believe that it has enough gold on hand to satisfy demands for delivery. Never have we been so thankful to be outside the establishment.

As independent managers, we can ascertain our own vision of reality and attempt to profit from our view of the world. So far, sticking to our knitting has generally served investors well. As times become more complex, we see no reason to disembark from that philosophy. We also continue to listen to other independent thinkers who consistently unearth the truth about the economy and the investing environment.

Everything is fine until it isn't

If the confidence men have their way, you will believe that managed markets are more in the public interest than the chaotic, less obedient ones of years past. If the markets are currently artificially *orderly*, can free markets ever really be restored? We think they can and will regain their former stature, despite the tremendous concentration of credits on computer screens. We know it seems naive to think that investors would resort to eating the rich rather than eating cake, but we think the periods ahead will brim with reasons for the central planning oligarchs to break rank. For example, in the old days, catalysts such as war, oil shocks, food shortages or terrorism would serve as the backdrop to withdraw honor among thieves. However what was formerly a low-stakes prisoner's dilemma has morphed into a global war against a 10-year US treasury yield above 4.5%.

They can jawbone the level of prices and interest rates….for now

If we do not have to worry about things becoming unglued, we must, therefore, accept what Jim Sinclair calls Authoritarian Free Enterprise. This is the phenomenon whereby bourses of all shapes, sizes and stripes, from Oxnard to Tibet, are managed by one entity or another. Never mind that the minefields have become increasingly concentrated and six sigma financial mishaps are regularly occurring. The sentiment that "there are no accidents" remains apropos even if the printing presses are firing on all cylinders and willing lenders are seemingly plentiful.

In this period of the free-money give away (now hosted by us as well as Japan), The Fed, as well as other central banks, are monetizing treasury debt. The Japanese are consistently intervening in their currency markets. All western central banks are playing a dangerous game of "where's the gold." In fact, we cannot think of a market, in a macro sense, that is left merely to the "invisible hand". As a result, the challenge for the investor therefore becomes one of a chess match. He or she must constantly answer the query "what does my opponent want to do next?" The big picture investment analysis has less to do with understanding supply and demand dynamics for a stock, bond or commodity than it does understanding policy initiatives for statist ends. The toughest question, then, to answer now is the following; **Is the price level they *want* the same as the price level I expect**? Their course of action is clear. The genie is out of the bottle. Can anything put her back in?

Once you start, you can't stop

With policies such as a "weaker dollar" and "quantitative easing," the world is being treated to the same remedy that caused its ailments – cheap credit. The free flow ensures happy days, while any attempt to remove the punch bowl results in a nasty hangover. Since inflation is more fun than deflation, and deficits are directly proportionate to corporate earnings, the policy imperative belies new and creative manners and means to spend money created out of thin air. Unfortunately or otherwise, intermediaries such as AIG, Fannie Mae and Freddie Mac are no longer available to spread the risks associated with *leverage gone wild* to other parties, but they still serve as useful "conduits" for taxpayers (you) to make whole the other side of the trade. While this is great for the grabbers, what does it do for the rest of us?

Inasmuch as the world can't live with a constant flow of ever increasing fresh funds, it currently can't live without them, either. That the Fed is reticent to raise rates even in the face of "recovery" may allow us to collectively live beyond our means in the short run, and further concentrate wealth in the long run. Conveniently, the hosts of the free money give-away have the argument of Japan's lost decade(s) to guide them. Their retort – if Japan had only been more accommodative at the outset of its decline, they would not have experienced the prolonged malaise which still plagues the country and the globe. In a binomial world this may be true. From our perspective however, we believe that factors such as demography, the ability of world financiers to "carry" Yen in favor of higher yielding currencies and a consciously pursued export structure, have contributed far more to the lost decades than did restrictive monetary policy. Minus the exports, the United States in 2010 is eerily similar to Japan circa 1990. What makes us think we can print our way out of a deflation? And what if we stop too soon?

Will there continue to be another zero?

While the 2008-2009 experience is fresh in our minds, it is by no means unique. Since Nixon removed the US from the gold standard in 1971, policy has been derived from credit expansion. The balance sheets of government, businesses, and households have continually ballooned for almost 40 years, save for a couple minor interruptions. One hundred became a thousand became a million, became a billion, became a trillion. The conversation, while challenging to one's computational capabilities has maintained a constant relativism made possible by the ability to assume another zero (or two or three). How has this been possible?

It's because the taxpayer never really pays

If the taxpayer were to pay only the accumulated bill of the United States Treasury, the amount for remittance would be roughly $40,000 for every man woman and child. While the government is not espousing that we reach into our wallets for this amount (yet), they can incrementally change the code and the games to where they can Print, Push, Tax and Spend (PPTS) and get somebody else to pay (GSETP). Since we have already hollowed out the middle-American core (the process we have referred to as "inside out") and ensured that nothing too detrimental occurs in my backyard (NIMBY) – thank you China - our focus in this update is on the former two phenomena.

Print, Push, Tax and Spend (PPTS) juxtaposes individuals and businesses, for a potentially dangerous donnybrook with governments. It involves the creation of money, borrowed from a coalition of the willing, its careful allocation, its leverage through what remains of our fractional banking system, and of course its taxation. As such, the more we borrow, the more we can tax. In our opinion, this amazing promotional offer will not last forever and is contingent upon what we have referred to in the past as "everyday low interest rates." If rates rise, we fear that the government, if cut off in the credit markets will set its focus on anyone other than themselves who has even remotely benefitted from playing PPTS – namely the investor class.

Our fears are already becoming actualized. It seems that daily we are being treated to a new game, all of which have either your piece of the national debt pie escalating or you stroking a check directly. It is the latter which is the significant departure to PPTS protocol, and certainly runs counter to our "taxpayer never really pays" motif. It is at this critical juncture that the investment manager must accurately gauge the extent to which PPTS morphs into GSETP. In the realm of the health care debate and "climate change," if their intentions are realized, you are going to know quickly who the "somebody else" is. How long can the government subsidize that which counters the laws of supply and demand? The amount of time, we believe, is directly proportionate to the period between now and when our collective $40,000 (and climbing) tax bill comes due. Until then, a new bubble economy surrounding health care may already be in the incubator.

The more there is, the more its worth – bubble, bubble toil and trouble

Since 1999, we have been treated to a variety of frothy witches' brews. In all instances, something was subsidized or untaxed, economic risks were reduced, and likely outcomes suddenly became insurable. Because paper wealth is destroyed faster than it is created, costs and prices escalated in each case, only to fall even quicker. The Nasdaq stock bubble, the housing bubble, agriculture subsidies and gimmicks, oil programs, and other things military and industrial all demonstrate that bubble economies only serve to mask massive deflationary headwinds. Why is permanent inflation so hard to produce?

The answer is not so simple but can be described by a couple of catch phrases posited by Dow Theorist Richard Russell. The first is "inflate or die." The second is "debt is a synthetic short position against the dollar." Recall our hypothesis that since 1971, the world's monetary policy has been accommodative in the aggregate. Since 1981 in this country and 1991 in Japan, interest rates have trended only one way – lower. This has resulted in the following factors:

1) Credit expansion, along with government subsidies and interventions have produced inflation at every turn, for almost every asset class
2) It takes more dollars at lower rates to produce substantial returns;
3) As such, the demand for leverage has been intense.
4) But, for every dollar printed, between 12 and 100 dollars are created via collateralized leverage within financial intermediaries (and look at how that is turning out).
5) If an ever-expanding access to new funds is not insured, the pyramid collapses on its own weight.
6) Ergo, there is no way to print one's way out of a deflation. Think of trying to bail a boat that has a hole in its bottom that gets larger with every scoop.

That there is a mountain of empirical evidence to support this argument seems to be an inconvenient fact for our leadership. Their constant attempts at re-inflating old bubbles and promoting new ones mocks their stance on price stability. Since the paper bubble process does nothing more than transfer wealth from earners to speculators, why do our policy makers consistently pander to the speculative community?

Feigned growth is more exciting than saving and investing – comping the players at the expense of the bond vigilantes

Time was that a boy would sit on his grandfather's knee to hear tall tales about the old days. One such story that comes to mind is the one about what were formerly known as bond vigilantes. Bond vigilantes were those pesky critters who would sell bonds of a host country whose economic prospects and monetary policy appeared unfavorable. Ultimately these people would hone in the profligacy of its spending authorities, especially if those who were supposed to guard the national coffers were doing their jobs. If the dollar at the time was cratering, and the vigilantes were driving up yields, the dollar normally would cease its decline in some equilibrium. All was right in the markets.

However, over the last 30 years the bond vigilante has become an endangered species.   Every time it appeared as if bonds could be sold and a dollar collapse could be thwarted, a not so invisible hand would reach into the people's deep pocket and stem the decline without a commensurate rise in interest rates. Being a bond vigilante was proving to be very unprofitable, and still is to this day. From the following chart, we wonder if that is changing?

For as we pointed out earlier, the world's policy makers, if they do anything else, will stop at nothing apparently to maintain access to low interest rates. Under that scenario, and the bubble thesis of which we just spoke, the removal of the feedback loop of vigilantes past is now terminally broken. Of bonds, stocks and the dollar, something is going to be sacrificed so that "inflate" prevails over "die." By sacrificed, we mean obliterated. We witnessed Act I, the great stock market collapse of 2008-2009, under which the dollar and bonds became quite attractive. Not to sound too Aristotlean, but there are many iterations of what Act II can look like, but only a couple of forms. If we already know that rates cannot be allowed to rise, is the plan to bludgeon the dollar next? If so, how low does it go? Will our foreign creditors assume the role of bond vigilantes, *redux*? Or will the casino patrons continue to be "comped" until we have borrowed every last dime on earth?

Can the seemingly unmanageable be managed?

We believe that Wall Street's multi-decade transformation from a relationship business to one of transactions has been a main reason why it seems to function for the benefit of speculators. As a result, what has largely been lost, but hopefully not from independent firms like ours, is that clients are not merely customers, but individuals.   To us, we take the responsibility of managing what belongs to you very seriously. We thank you for your continued trust and support and look forward to communicating with you again soon."

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