INVESTMENT PARTNERS ASSET MANAGEMENT
One Highland Avenue, Metuchen NJ 08840 Tel: 732-205-0391 Fax: 732-205-0395

Excerpts from Quarterly Report written by Investment Partners Asset Management – Q1 2010

"Imagine for a second that we lived in a world where budgets of all sorts were balanced. In such systems, money *in* would equal money *out*, prices would be relatively stable, growth (if any) would be largely organic, and economic ideas would only be funded if the cash flows were sufficient to satisfy the terms of the investment. This boring, predictable, Edenesque situation would provide its own checks and balances as well as immeasurable benefits to humanity.

However, as Adam and Eve succumbed to the serpent, somewhere along the way (possibly around August 15, 1971) we decided to embark upon the slippery slope of ***supplementing or replacing cash flows with newly printed dollars – the question of earning versus financing***. This concept is extremely important and its implications vast. An entire book could, and should, be written about nothing more than the causes and effects of ***pulled forward*** demand. Possibly the title could be: The Price of Progress – How Faust and the Book of Genesis Foretold the Current Economic Quagmire.'

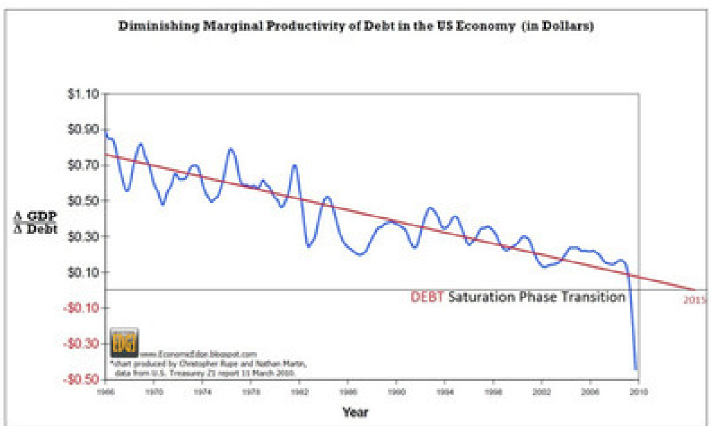
Rather than debate the issue of who (other than us) will earn or finance human advancement in the 21st century, we will attempt to make the complexities associated with the 'debt deal with the devil' understandable. First, we should remark that debts and deficits are, and remain, social choices within a representative republic like ours. However, given the choice of getting something for nothing or austerity, our 'only human' electorate decided in the 1960's and 1970's that a blank check and ever declining interest rates trumped thrift. Not surprisingly, equally human leadership reflected the desires of the masses and chose the free lunch as well. The seduction of 'buy now pay later' was in full swing.
Perversely (and much to our chagrin), this behavior has been not only rewarded but fortified, magnified and levered, with seemingly unlimited financial market assistance. The allure of riches without effort manifest in the stock market in the 1980's and 1990's, the bond market to present, the housing bubble, and the commodities markets for the last decade. Cash flow problems? No worries, just invest, speculate, flip, or drill your way to prosperity. Brains and bull markets were seemingly fused in an unholy matrimony.

With this blank check to the *smart* people came the additional public sector temptation associated with making investment mistakes without immediate political consequences in the unlikely event that the government was fallible after all. Even though there were speed bumps along the way, we funded medical research, explored space, regulated industry responsibly, and enhanced public safety without having to worry about prior considerations like payback periods and dividend yields.

However, what began as lofty progress measures quickly morphed into budget escalators, unfunded mandates, the subsidization of dubious pet programs, and that damned section of Interstate 95 in Georgia they have been working on for 30 years. The result was that government became larger and more intrusive, the numbers added more zeroes, and the bureaucratic skim required higher interest payments. Projects with stable and predictable cash flows were crowded out by malinvestment at every turn (and we mean *every* turn). Since inefficient public initiatives rarely produce positive cash flows the demands on the dwindling ranks of the productive required greater and greater cash flow supplements from the public (and larger deficits, and more leverage, and increased periodic volatility etc.). What a vicious cycle.

What has allowed this dynamic to persist until today is the principle which states – the taxpayer never *really* pays. This is essentially the economic theory behind the so-called ***Ricardian Equivalence***. This theory (which was written about 200 years ago) is ironically attributed to British Economist David Ricardo (who, it turns out, didn't actually believe it). Anyway, it goes a little something like this: money raised today by government debt can potentially support fiscal deficits and be earned by tax revenue in the future, as long as the debt produces a sufficient wealth effect for businesses and households, and the government can afford to continually meet the debt's interest payments. Under that scenario, the theory asserts that increasing debt levels have no negative effect on GDP. Good theory, right? Apparently Robert Barro from Harvard thought so too, and in the 1970's he picked up on this theme, applied it to our modern economy, and popularized it among our country's thought leaders. (Barro's name, though, doesn't appear on the theory for some reason. Ricardo's name does. I guess it's a lot easier to blame an economist who's been dead since 1823 if, for some reason, the modern adaption of the theory turns out to be a total disaster… But what are the chances of that?) Anyhow, our politicians have been more than happy to embrace Barro's adaptation of the Ricardian Equivalence and have been busily spending our money and our children's money and children's childrens' money with the debt spigot on full blast for the past 4 decades. Long story short: the US taxpayer now owes $44,000 (and growing) per person as his share of the largesse. Look at the bright side, though. We get to participate in a fun and exciting Economics experiment. We are dying to see how it turns out.

Ok. Macro-Economic Theory class is now over. Unfortunately it's time for our next course: Math. The law of large numbers and compounding have powerfully combined to make debt service at all levels more and more difficult as the amount of money needed to maintain economic output also expands geometrically – the aforementioned taxpayer and his $44,000 tab, is no longer producing sufficient flows to continue the game. Pictorially, what we are describing looks like this:



We have been discussing the conundrum demonstrated by this chart with many of our clients since November 2008 (before the large tail at the end of the graph was added). This picture, which is easily worth more than a thousand words, depicts the productivity of additional debts layered into a fiat monetary system. What is implied is that there is no mathematical way that coordinated interventions by governments around the world can quantitatively ease to the extent necessary to combat the recessionary forces facing them. Japan tried it…..for 20 years, with little effect. The economies of the PIIGS nations, not to mention Iceland and Argentina (the US, Great Britain, Brazil, Germany, Russia……) also encompass similar characteristics.

To our astonishment, even after all the printing and waste, the world is *begging* for inflation. People are rioting in the streets of Greece and Iceland (the perfect petri dishes), clamoring for a return to slow and steady, state-sponsored, multi generational, incremental, hidden-tax, wealth redistribution associated with the cash flow supplement paradigm. In China, workers are unsatisfied with the current wage structure. And here in the US, we are concocting any mechanism by which we can spend more money on *something* in future periods than we do now. Is it because we too need inflation? Or have we erroneously confused inflation with cash flow supplementation?

We squarely believe the latter. Our assertion is rooted in one simple fact; <u>deficits equal corporate and individual earnings</u>. The present level of cash surrogacy is enough to produce the current level of output – as well as continually declining housing prices, persistent double digit employment, consistently high real interest rates, consumer and small municipality credit crunch be damned. Try to imagine what we would resemble with anything less?

In fact, when viewed through the lens of both inflation *and demography*, one can easily argue that the reason Washington DC has been hell-bent on its current path has less to do with the feigned two party paradigm **and much more to do with the aging faces of the population and the potential for deflation.** The demand of the baby boomers has been pulled through in the form of asset securitization and debt service of all shapes and sizes, described above. The moment (we surmise 2007) which these folks turned from asset **in**vestors to asset **di**vestors, things have been liquidated, securitization assumptions have been ratcheted down or nullified, and the cash flow associated with debt service has evaporated. Is it any wonder we are attempting to give amnesty to illegal aliens (so we can tax them and keep their money here), spending trillions more than we collect, commanding that the rest of the world destroy their currencies at the same rate we are, commandeering 14% of GDP through the ponzification of health care, and trying to implement carbon emission (i.e., breathing) tax? The government needs money, and is extracting it any way it can. With the aging demography, it is trying to create as much cushion against a future deflationary spiral as can be undertaken prospectively."

FORWARD LOOKING STATEMENTS

This discussion and analysis contains certain forward-looking statements and projections that involve a number of risks and uncertainties. Actual events or results may differ materially from the expectations and projections. Past performance does not guarantee future results. Market and other risks may affect the actual results achieved by accounts or investment vehicles managed by IPAM and/or its affiliates.