# December 2010 Investor Letter

***Fourth Quarter Market Conditions***

The stock market confounded much of the consensus by experiencing a number of "counter-trend" price moves during the third quarter. But by the end of December almost all markets were higher except the bonds/mortgages markets.

October was generally a continuation of September's rally, with a strong start to the month and only a mid-month swoon to interrupt a 3.8% total return for the Standard & Poor's 500 index. The Federal Reserve continued to galvanize an easier monetary policy with more hints toward an expected post-election 'Quantitative Easing 2' (QE2) announcement. Weekly claims for unemployment steadied and showed some improvement over late summer numbers. Finally, the midterm election situation continued to point toward the Democrat's control of Congress moving to Republican control of the US House of Representatives, possible control of the US Senate and a large leap in number of governorships, promising tighter financial management and a more conservative political agenda going forward. Stocks generally rose during the month. Gold and silver both set new highs mid-month but closed the month barely higher. Energy gyrated during the month, with oil higher mid-month and natural gas lower; however, but month's end, both generally closed flat. Long-dated US Treasury bonds hit new recent highs during early October, but as QE2 became more of a reality, bonds came off their highs and closed lower.

November was reminiscent of third quarter action – huge volatility in all markets left market participants scratching their heads on many market price moves. Of course, the election and the announcement the following afternoon of $900 billion of QE2 pushed the stock and commodity markets to new 2010 highs, but this early November spike proved to be the peak for the month, with the stock market backing off over much of the rest of the month, and commodity markets also weakened as concerns about Chinese growth hit prices when China tightened monetary policy to fight mounting inflation. Mid-November saw the re-emergence of Eurozone worries that led to the late November bailout of Ireland and its banks; this caused Euro weakness/US dollar strength, which kept equity and commodity markets under pressure through the end of the month. Interestingly, both gold and US Treasuries strengthened on this news, but neither could climb back to early November levels. Energy prices did improve over the month (both



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crude and natgas prices), and energy equities did better than most other sectors of the stock market.

December started out and ended with big moves upward. The equity markets had their best December in decades with the Dow and S&P rising just under 6% each, as market momentum augmented by the fiscal stimulus of better-than-expected tax cuts (passed mid-month after a compromise between President Obama and congressional Republicans) powered US stocks across the board. The bond market continued to drop (with yields rising) for longer-term maturities. Commodities swooned at the beginning of the month as the US dollar strengthened, but commodity prices turned around and strengthened into year-end, led by energy, metals and agricultural prices.

*Precious Metals*

Silver gained in price during October, while gold was volatile and slightly higher for the month, waiting to see how much money the Fed would inject into the US economy. The precious metals reacted to the QE2 announcement with an anticipated jump to new highs, with gold reaching $1,420/oz and silver topping $29/oz. However, the factors that buffeted the equity markets in November: concerns of China growth due to tighter credit and flight to the US dollar due to Eurozone concerns over Ireland, led to a sharp drop in prices from the highs, allowing both metals to show only small gains for November. After a sharp drop at the beginning of December, both gold and silver advanced in price over the middle of the month, ending the year near highs with gold over $1,420/oz and silver over $30.90/oz. One more note: copper prices also rose strongly during the quarter ending over $4.40/lb, which is an all-time high. Many gold mining companies produce copper as they mine gold, so high copper prices should augment gold miners' financial results when they are announced in February.

*Energy*

Energy has been an underperformer during the late summer/fall rally of the stock and commodity markets, but energy prices improved during both October and November as world energy demand continued to grow and inventory levels of energy products dropped. Crude oil prices, after vacillating between low $70s and mid $80s per barrel during 2010, stayed above $80/bbl as supplies dropped and demand grew slightly, drawing US inventory levels down from multi-year highs. Natural gas, after showing horrid price action during the summer and early fall, bottomed in late October and climbed above $4.00/mcf for much of November. December brought cold weather around the world and crude oil prices finished over $91/barrel while natgas prices stayed above $4.40/mcf.

*General Stock Market*

As mentioned above, October showed steady gains in the US stock markets, while November exhibited major volatility, starting out strongly through the US election and the Fed's announcement of QE2 but then falling back to unchanged through the rest of the month. December saw more spectacular gains (many indices gain 6%+), led by speculative stocks such as Chinese internet IPOs [Youku (the "YouTube" of China) and Dangdang (the Chinese "Amazon.com")], technology darlings [Netflix, F5 Networks (cloud computing), Salesforce.com (sales productivity)] and exotic materials companies like rare earth mining company Molycorp. Many of these stock price moves were reminiscent of the 1990s tech mania, culminating in a number of these stocks being added to major indices, further driving price appreciation [example: mid-December, F5 Networks (FFIV), Micron Technology (MU), Netflix (NFLX), and Whole Foods Market (WFMI) were added to the Nasdaq-100 Index]. In spite of these, the best performing stock sector in 2010 was Consumer Discretionary (up almost 26%, led by "beaten-down" retailers) and Industrials (up ~24%). Energy (~18%) and Materials (~20%) stocks also had substantial gains for the year. Technology, Consumer Staples, Telecommunications and Financials all advanced approximately 10% for the year, while Health Care and Utilities were the laggards with only small gains. Energy and Materials led the gains for the fourth quarter, with Energy stocks gaining almost 21% during the quarter and materials gaining 18.5%. As one would expect during a strong advance, the 4$^{th}$ quarter's laggards were the less volatile sectors: Consumer Staples, Utilities, Telecoms and Health Care, all with modest gains at best.

*Other Markets*

As mentioned above, longer-term bonds continued their advance from the third quarter until the formal announcement of "round two" of Quantitative Easing in early November but then proceeded to fall in price (and rise in yield) for most of November and December, pushing up mortgage rates more than 1% from their autumn low point. The US dollar, after weakening during the fall strengthened during the middle of the fourth quarter, peaking in early December. For the rest of the quarter, the dollar bounced around but ended the year on a weak note, further pushing up commodity prices, as referenced above.

***Investing Going Forward***

While we understand the strong finish to the year in the stock market, we are increasingly concerned that the stock market gains have far outpaced the recovery as represented by the underlying US economy. Large numbers of unemployed (and "underemployed") workers, coupled with rising interest rates and a falling dollar point to a correction some time in the near future. A very high percentage of bullishness among stock market

participants is another telltale danger sign of a potential correction in the making. Finally, the outperformance of blatantly speculative companies like the Chinese internet stocks and rare earth elements stocks point to a euphoria seen mostly near peaks in stock market valuations. The continued strength of developing world economies in Asia and Latin America, coupled with strong recovery evidence out of Northern Europe (Germany in particular) and highly accommodative monetary policy in the US, temper our thoughts of a market crash happening this spring, but the outbreak of "speculative fever" will still most probably cause some painful corrections during 2011, even if by year-end stock and commodity prices are ultimately higher for the year. We can see evidence of this in the precious metals markets and equity prices in January 2011 – a strong correction has taken prices down from 2010 highs, but fundamentals and long-term market momentum are still firmly in place to push metals prices higher later in the year. But we still believe that inflation will end up occurring strongly in the near future [as explored further in the Quarterly Commentary below], and coupled with the ongoing fragility of the economic recovery, we think that most equity sectors are overpriced and vulnerable for pullbacks and revaluations. So we have not expanded our investments too far from those we feel will best protect us from the Federal Reserve's money printing.

We would like to address one recurring theme that we have heard a lot lately – the perception that there might be a "gold bubble" and that gold prices are "too high". There have been a lot of articles, especially in mainstream financial publications like the *Financial Times* and the *Wall Street Journal*, which address this notion. A number of financial analysts and fund managers have expressed their frustration with considering gold investments insisting that they don't know how to value gold because it does not generate a return, like a bond or a business.

We don't believe gold is in a bubble for a number of reasons, the main ones being: 1) in bubbles, the euphoria of a "skyrocketing" price overwhelms fear of possible losses; the gold market still shows large amounts of (healthy) skepticism about recent gains in gold's price, 2) gold and gold mining equities holders recently have shown a lot of concern about possible drops in the price of gold and mining shares, which is uncharacteristic of a bubble, 3) most of the professional investing world has little or no investment in gold or mining shares, very different from Wall Street's 5+ year embrace of business-less technology IPOs in the late 1990s and Wall Street banks' bulked up mortgage-backed securities from the housing bubble of the mid-2000s, and 4) "price action" for the precious metals, while having strong gains at times, have never "gone parabolic", where the price gains dwarf past gains by doubling and tripling in value in a very short time. Precious metals and associated equities may form into a bubble in the future (that is what George Soros implied would happen in his quote which has been misunderstood by most of the financial press: "gold will be the ultimate bubble), but it will be after breathtaking gains that make it seem like no one owns enough. We anticipate that when precious metals reach this type of "euphoria" stage, we will be able to find a number of bargains into which we will redeploy most of our capital.

In addition, there are fundamental factors that underpin a higher value than in the past for gold: 1) negative real interest rates (short-term) – with a positive CPI and 0% nominal interest rates, tangibles (especially gold and silver) are good investments that will hold their value while currency/cash is eroding from inflation (and money earns almost nothing due to ultra-low short-term interest rates), 2) quantitative easing – the Fed's monetary policy to buy bonds and introduce more money into the system makes all dollars worth less and less as more new money is introduced into the economy, 3) competitive devaluations – QE2 has led export-oriented economies (in East Asia especially, as well as Brazil) to competitively devalue their currencies to try to keep more competitive with the US dollar, which fell in value substantially during 2010; depreciating currencies should make gold prices appreciate, since gold supplies are increasing at a very slow rate (mine production [no growth year-over-year for the past few years] minus gold losses) and much of the gold trade is denominated in US dollars, and 4) central bank gold buying – with the US dollar falling in value, the Euro being questioned about its very existence and the Japanese Yen becoming less and less relevant for trade and bank reserves, a number of large central banks have returned after decades to buying gold for their countries currency reserves [most notably Russia, India, China (which buys all of her in-country production plus outside purchases) but also some smaller Asian countries]. This leads to a certain underlying bid in the gold market over time.

Finally, the theme that gold prices are "too high" is merely a trap that many investors, including veteran successful professionals, fall into where they are anchored by past prices and think that "things cannot change that substantially". The better way of thinking about whether gold prices are too high is measuring them against the amount of money in the world. In very rough numbers, there were approximately $9.05 trillion of worldwide monetary reserve assets at the end of 2010 (according to Bloomberg), 5.32 billion ounces of gold ever mined (estimate by the World Gold Council) of which central banks around the world own approximately 950 million ounces (also from the WGC). Math would say that $9.05 trillion in monetary assets / 950 million ounces of gold held by central banks = $9,520/oz for money to be 100% backed by gold. When such a method is employed, one can quickly see that $1,300-1,400/oz is most probably nowhere near the top of the price of gold. As the Fed continues to increase monetary stimulus through continued use of quantitative easing and rock bottom short-term interest rates, one can understand that if enough people around the world believe they need the security of owning their own gold to protect them against a depreciating home-country currency, gold prices will rise very substantially even from current price levels.

***Kanos Quarterly Commentary***

# "What 'The Fed' Says"

This quarter we thought it would be interesting to examine closely a number of statements which have been issued this winter by leading officials of the Federal Reserve (and others commenting on recent Fed policy). The Fed announced its latest 'large scale asset purchases' on November 4th (which has popularly become known as "Quantitative Easing 2" or "QE2"), and it immediately spawned a number of critics. This criticism led to the most concentrated amount of communication by the Fed Chairman and Head of the New York Federal Reserve that we can remember in our careers. We have excerpted what we consider the most important parts of these articles so that we can better gauge what these important Fed officials are thinking: 1) Fed Chief Ben Bernanke's article from The Washington Post, 2) NY Fed President Bill Dudley's interview with CNBC, 3) Warren Buffett's New York Times editorial and a rebuttal by Barry Ritholtz from his The Big Picture blog, 4) Ben Bernanke's interview on "60 Minutes" and 5) Market experts roundtable discussion from Barron's Magazine.

In these articles, we have tried to highlight that the Fed's own leaders and most of the financial world that follow the Fed are engaged in a series of policies to "prop up" the status quo but which have diminishing marginal returns and which cannot work ad infinitum. However, as long as the Fed keeps pursuing these policies, we will try to counteract the damage they might cause to financial assets by configuring our portfolios to de-emphasize fixed income, keep smaller balances of cash, try to find yield and pricing power in companies for investment and protect our wealth by owning tangibles, led by metals, energy commodities and to a lesser extent agricultural and industrial commodities.

***1) From The Washington Post, November 4, 2010, Op-Ed article by Ben Bernanke***

## *What the Fed did and why: supporting the recovery and sustaining price stability*

*By Ben S. Bernanke*
*Thursday, November 4, 2010;*

*Two years have passed since the worst financial crisis since the 1930s dealt a body blow to the world economy. Working with policymakers at home and abroad, the Federal Reserve responded with strong and creative measures to help stabilize the financial system and the economy. Among the Fed's responses was a dramatic easing of monetary policy - reducing short-term interest rates nearly to zero. The Fed also purchased more than a trillion dollars' worth of Treasury securities and U.S.-backed mortgage-related securities, which helped reduce longer-term interest rates, such as*

*those for mortgages and corporate bonds. These steps helped end the economic free fall and set the stage for a resumption of economic growth in mid-2009.*

*Notwithstanding the progress that has been made, when the Fed's monetary policymaking committee - the Federal Open Market Committee (FOMC) - met this week to review the economic situation, we could hardly be satisfied. The Federal Reserve's objectives - its dual mandate, set by Congress - are to promote a high level of employment and low, stable inflation. Unfortunately, the job market remains quite weak; the national unemployment rate is nearly 10 percent, a large number of people can find only part-time work, and a substantial fraction of the unemployed have been out of work six months or longer. The heavy costs of unemployment include intense strains on family finances, more foreclosures and the loss of job skills.*

*Today, most measures of underlying inflation are running somewhat below 2 percent, or a bit lower than the rate most Fed policymakers see as being most consistent with healthy economic growth in the long run.* ***[Emphasis mine – KS]****. Although low inflation is generally good, inflation that is too low can pose risks to the economy - especially when the economy is struggling. In the most extreme case, very low inflation can morph into deflation (falling prices and wages), which can contribute to long periods of economic stagnation.*

*Even absent such risks, low and falling inflation indicate that the economy has considerable spare capacity, implying that there is scope for monetary policy to support further gains in employment without risking economic overheating. The FOMC decided this week that, with unemployment high and inflation very low, further support to the economy is needed. With short-term interest rates already about as low as they can go, the FOMC agreed to deliver that support by purchasing additional longer-term securities, as it did in 2008 and 2009. The FOMC intends to buy an additional $600 billion of longer-term Treasury securities by mid-2011 and will continue to reinvest repayments of principal on its holdings of securities, as it has been doing since August.*

*This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.* ***[Emphasis mine – KS]***

*……….Although asset purchases are relatively unfamiliar as a tool of monetary policy, some concerns about this approach are overstated. Critics have, for example,*

*worried that it will lead to excessive increases in the money supply and ultimately to significant increases in inflation*. ***[Emphasis mine – KS]***

*Our earlier use of this policy approach had little effect on the amount of currency in circulation or on other broad measures of the money supply, such as bank deposits. Nor did it result in higher inflation. We have made all necessary preparations, and we are confident that we have the tools to unwind these policies at the appropriate time. The Fed is committed to both parts of its dual mandate and will take all measures necessary to keep inflation low and stable......* ***[Emphasis mine – KS]***

Bernanke makes his case for why QE2 was implemented; however, some of his points are questionable. First, the Fed for the last few years has stated that its goal was 1-2% inflation – in this article, Bernanke acknowledges that **inflation is somewhat under 2%** but claims that is **too low**! The Fed is also claiming that their "leaking" of the eventual implementation of QE2 led to higher stock prices and lower bond (thus, mortgage) interest rates, stimulating the economy. He fails to realize that much of the increase in asset prices occurred in order to **sell these assets to the Fed**. Since QE2 was implemented, long-term bond and mortgage interest rates have **gone up, not down.** Stock prices have continued to go up, but they have been accompanied by commodity prices, especially food and energy (except natural gas) prices, causing prices to go up for many everyday items, which most of us consider inflation (the Fed mainly considers wage inflation when looking for inflation). He also says that since quantitative easing worked in early 2009 (when plunging mortgage bond prices caused a massive need for more liquidity), then it must be a reasonable policy tool to be used whenever needed in the future. He also "splits hairs" by using the strict approach to the mechanics: the Fed is not "raising the currency in circulation", instead it is raising the cash reserves that banks have deposited at the Federal Reserve – for all intents and purposes, money is money and it is available to cause price inflation. Thus, while Bernanke claims that QE2 is "safe and effective" as it is being implemented [on November 4th], it hasn't exactly worked out the way he claimed it would.

***2) Excerpts from CNBC Interview with William Dudley, President of the Federal Reserve Bank of New York, November 16, 2010, interviewed by CNBC [Steve Liesman]***

**CNBC [Steve Liesman]**: Were you surprised by the criticism of the fed from the G20 meeting…

**Bill Dudley**: Not surprised that they're unhappy because-- their currencies are appreciating -- rapidly. There's large capital inflows coming to the emerging markets. And obviously, that makes their job harder, so it's not surprising that they'd be unhappy about it. I think that we have to, as a central bank, explain very clearly why we're doing what we're doing. And that in fact, that what we're doing is actually in their long-term interests. The sooner the U.S. gets out of this period of malaise that

it's been in, the sooner that we have more rapid employment growth-- stronger economy-- the quicker we can exit from these-- extraordinary-- monetary policy steps. And that'll be good for everybody. ***[Emphasis mine – Dudley is acknowledging that the US is causing foreign currencies to appreciate – although he doesn't think it's the Fed's "fault".]***

**CNBC [Steve Liesman]**: And just … one more criticism from abroad, the German finance minister says it's hypocritical of the United States to accuse China of currency manipulation, and then use its printing presses to, quote, artificially lower the value of the dollar.

**Bill Dudley**: I think that's very off base because I think that the goal of our policy is a very simple one, to ease financial conditions. We're not trying to push the dollar to any particular level. What we're trying to do through our large scale asset purchase programs is to remove treasuries from the market, and force private investors into other assets. ***[Emphasis mine – KS. They are targeting higher asset prices – any assets, including food and energy commodities]***

**CNBC [Steve Liesman]**: You've talked publicly about an equivalent between purchase of assets and a federal reserve basis point interest rate cut. The rest of the world doesn't see it that way. Are they not listening, or can you understand why they would see it as a slightly different sort of aim-- or goal here?

**Bill Dudley**: Well, I think the problem we have is really the fact that we don't have an international financial system that allows currencies to adjust smoothly around the world in sort of equivalent-- amounts in different countries. In some countries, their currencies are very flexible.

In other countries, the currencies are not flexible at all. And so the pressure builds up on those countries with the very flexible currencies. And so that increases their problem. So the problem isn't the Fed's monetary policy, the problem is the fact that we don't have-- international currency system that allows equivalent flexibility-- of currencies across the different countries. ***[Emphasis mine – KS. Dudley argues here that everyone should have flexible currencies, but he is counting on the US Dollar as everyone's reserve currency to make QE2 effective. If the US Dollar wasn't the world's reserve currency, Dudley would have a much harder job conducting monetary policy.]***

**CNBC [Steve Liesman]**: Has the Fed effectively communicated its policy? Why, except for a single op-ed (see above) in the Washington Post, didn't the Federal Reserve come out and talk about what it was trying to do, and what impact it would have?

**Bill Dudley**: Well, I think that we certainly explained-- in the run-up to the policy decision why we were contemplating the possibility of doing large scale asset purchases. I think probably we haven't communicated it as effectively as we'd like to in terms of why we're doing this, and why we can do this safely.

You know, I think there's sort of two sort of critiques of the large scale asset purchase program. One, it won't be effective. It doesn't do that much. And we agree with that, that we don't think that this large scale asset purchase program's going to have a huge, powerful effect on the U.S. economy.

And two, I think there's a lot of concern about exit. Once-- when the time comes and the U.S. economy finally does pick up speed and inflation starts to rise, will we-- will we be-- will-- will-- will we be able to exit from this program smoothly without a long term inflation problem? And I think the answer to that second question is really critical. And our answer to that question is very much yes. We have the ability to exit smoothly because we have the ability to pay interest on excess reserves. We have the ability to drain excess banking res-- reserves from the system. So we are very confident of our ability to exit when the time comes, in terms of the tools.

We also are very confident of our will to exit. So the second thing I think that's-- that worries people is will the Fed do the right thing when the time comes. And I think everybody on the FOMC-- I think everybody on the Federal open market committee is completely committed to keeping inflation-- low over the long term. ***[Emphasis mine – KS. Unfortunately, the Greenspan/Bernanke Fed has always been slow to exit any stimulus: 1) extra liquidity after Asian/Russian crisis of 1997/98 fed the tech bubble and 2) their keeping rates at 1% for too long in 2003 led to the housing bubble.]***

**CNBC [Steve Liesman]**: Just today (Nov. 16th) 600 economists published an open letter saying that the Fed's plan to do large asset purchases risk currency debasement and inflation. Does it make you think twice that maybe you have the economics wrong here if 600 economists, many of them fairly renowned in their own right are on the other side here?

BILL DUDLEY: I think the issue is that people do not understand clearly, and that is partly on us to communicate clearly our ability to manage this when we actually assess that we can have an enlarged balance sheet and not have a long term inflation problem.

And the reason for that is we have the ability to pay interest on excess reserves, which allows us to raise the cost of credit in a way to moderate credit demand when the time comes. That tool we did not have prior to the fall of 2008. So if you're reading the old money and banking textbooks, yes, you would be very concerned that the increase in

the size of the Fed's balance sheet is going to ultimately lead to a long term inflation problem.

Except the world today is different than the world prior to 2008 because we have new tools in place. If we didn't have that tool, we wouldn't-- we'd be doing what we're doing. That tool gives us the ability to exit smoothly when the time comes. ***[Emphasis mine – KS Dudley actually believes that they can raise interest rates to pay interest on reserves held at the bank and the markets will react instantaneously. The problem is that it has never been done, so no one know how the markets will react. This is a very important point – this is still a big experiment!]***

**CNBC [Steve Liesman]**: What's happening to this money you put out there? Does it create money? I mean, people say the Fed is just printing money. Is that an accurate description of what you guys are doing?

**Bill Dudley**: Well, I wouldn't say we're quite printing money. What we're doing is when we buy treasury securities, we are increasing the amount of reserves in the banking system. For those reserves to actually create money, the banks actually have to lend those reserves out.

The problem we have in the U.S. economy today is not that there's too much lending. No, the problem we have in the economy today is there's insufficient lending. Up until very, very recently, total loans, outstanding were declined, they'd been declining for the last several years.

So there's plenty of reserves in the banking system right now. If we increase the amount of reserves in the banking system, it's not going to have any big consequence for lending. How the large scale asset purchase program works is not through its effects on bank reserves, but its effects on financial asset prices.

By easing financial market conditions, it makes housing more affordable. It reduces the costs for businesses to invest. This higher stock market increases household wealth. But even a little bit of nudge to the economy today I think is very, very important because if the economy can grow a little bit faster, that gives you a much better prospect about being in a virtuous (?) circle, little bit stronger growth leads to a little bit more demand. Little bit more demand leads to more employment growth, higher income, rising confidence, a virtuous circle. ***[Emphasis mine –KS Dudley here is wrong; in the 21st century, the banks he is transacting with are "primary dealer" banks which are large combination commercial banks/investment banks/trading houses – thus, they don't have to lend, they can fund investments in stocks, bonds, commodities etc. with "easy" cheap Fed money.***

***[KS - This is the most important exchange:]***

**CNBC [Steve Liesman]**: One of the concerns that people have is that the-- the recent run in with deflation we had in 2003, they argue the Fed had it wrong, that while the Fed was busy fighting deflation at an output gap, in fact, there was inflation brewing, and the Fed was forced to reverse course fairly rapidly. What assurances do you have, can you give us now that this is not a repeat of '03, given also that the economy looks like they'd been at a little better footing in the last month or two.

Bill Dudley: Well, if you remember back to 2003, we didn't have an inflation problem in 2004, or 2005, or 2006. In fact, you know, the problem in the 2003 expansion was not what was happening to price inflation, but what was happening to housing prices. So I think what that cycle tells us is that we have to watch other things than just prices of goods and services, but financial asset prices. So—

CNBC [Steve Liesman]: But inflation did rise into the sort of four percent level.

Bill Dudley: It was pretty moderate. I mean, at the end of the day, I think it's not fair to say that we had an inflation problem during the last cycle. Look, obviously, we're going to have to look at all the panoply of economic indicators very carefully to know when the time is right to exit.

Now, you know, I think-- you know, it's-- I think it's remarkable though that we're spending so much time talking about exit when you think about the fact that we have a 9.6 percent unemployment rate, and an economy that's growing only about two and two-- two to two and a half percent at an annual rate. We're not even generating sufficient jobs yet to-- actually bring the unemployment rate down. So you know, this exit could be several years away. ***[Emphasis mine –KS Dudley here goes against everything he just said earlier. He calls 4% moderate inflation; he doesn't think that the Fed exited too slowly. And he doesn't seem to understand that housing prices were the public's only way to play the asset price boom caused by ultra-low interest rates in the mid-2000s – exactly what they are promoting in 2010-2011! I think this shows the Fed is pretty smug about what they think they can do, even when it has been disproven in the very recent past.]***

**CNBC [Steve Liesman]**: How much of a concern are higher commodity prices?

**Bill Dudley**: I mean, I think that higher commodity prices, you know, are not a big concern, but certainly, they're a small concern. Obviously, to the extent that commodity prices go up a lot that would be a hit to real incomes in the U.S., and therefore, would be a negative in terms of the economic outlook.

I think the important thing though is we don't know, to the extent that commodity prices are going up, it's hard to know what's really driving it. Is it the large scale asset purchase program, or is it the fact that emerging growth in the emerging world is very, very strong? Or is it the fact that in certain parts of the world, the growing

season hasn't been very good, and so there's been increase in agricultural commodity prices?

CNBC [Steve Liesman]: --but does it also mean that people don't believe in the dollar anymore, and they're looking for safe have assets like-- assets like gold or oil?

Bill Dudley: Well, I think the important thing here-- you know, when you're talking about commodity prices is that the share of commodity prices in the U.S. consumer basket is pretty low. So commodity prices have to go up a lot to have a really-- significant effect on-- on real income growth in the United States. ***[Emphasis mine – KS Dudley doesn't seem to care that higher food and energy costs will have a growing negative effect on US public spending, and that easy Fed policy is one of the biggest causes. He completely ignores the Fed's part in this.]***

**CNBC [Steve Liesman]**: When you look at gold, and you see it over $1,400 an ounce, does it give you again, concern over the credibility of Fed policy?

**Bill Dudley**: …And over the last three months [August to October - KS], as we've gone from a very low probability of a large scale asset purchase program to a much higher probability, inflation expectations have come back to where they were earlier in the year. So we certainly monitor that. Now, gold prices is a tricky one because you know, when real rates are really low like they are today, like five year tips [Treasury inflation protected bonds – KS] yields [are] negative, the carrying cost of holding gold is really, really low. And so gold prices are going to go up in part because the carry cost is extraordinarily low in an environment where monetary policy is easy like it is today. ***[So Dudley thinks gold prices are going to go up while the policy is in effect! - KS]***

**CNBC [Steve Liesman]**: You talked about the idea of being able to put the genie back in the bottle when it comes to exit strategy. What about the idea of Fed credibility on inflation fighting? Do you feel like you can promote inflation for a while, or higher levels of inflation, and then turn it on a dime, and say, no, no, no, now we don't want to do it that way, we want to promote stable prices or lower inflation?

**Bill Dudley**: Look, I don't think there is any support at all within the federal open market committee to allow higher inflation than what's consistent with price stability. If you look at the federal open market committee-- almost all the members think that-- price stability is somewhere in the range of one in three-quarters to two percent.

That's what we're committed to, as the chairman had said, two percent or a bit less. There's no desire to fool around with going above that. It's too dangerous. We-- we saw what happened in the '60s and '70s when-- once the central bank tolerates a little bit more inflation. At the end, it gets you nothing because at the end, you're going to

have to put that genie back in the bottle. ***[Emphasis mine – KS However, Dudley has just said that 4% inflation in the 2000s wasn't too bad; the Fed sees rising employment as the main driver of inflation, so they will err with rates too low until employment increases strongly, which could lead to some high prices like the Fed helped create in 2008 ($147/barrel oil, etc.)]***

**CNBC [Steve Liesman]**: The economy of late looks like it's on a little bit better footing. Are you at all more optimistic than you had been?

**Bill Dudley**: Well, I think the most recent set of economic numbers have been a little bit better. We saw a somewhat better private sector employment report [in November]. We saw a pretty good jump in hours worked in October; retail sales [were] a little bit firmer.

But you know, the economies have a lot of volatility in them. So I would be a little bit hesitant to throw out too big a signal from one month's worth of data. Also it's important to recognize that we have lots of slack in this economy. So we need many, many months of 200,000, 300,000 pings in payroll employment. We haven't even got to that level once yet. ***[Emphasis mine – KS This signals that the Fed will not stop stimulation until employment picks up strongly and for many months.]***

**CNBC [Steve Liesman]**: But people say the Fed is playing a dangerous game by targeting the stock market.

**Bill Dudley**: I don't think we're targeting the stock market, what we're doing is we're removing treasury securities from the private sector's hand, and letting the private sector choose what assets they want to replace those treasury securities with.

So it's really the private sector making the choice, okay, so I'm-- no longer can hold these treasuries, because I have now sold them to the Fed. So the private sector's deciding, you know, do they want to bid up the stock market, do they want to buy corporate bonds. So it's really the private sector that's making the decision what asset to own at that point. ***[Emphasis mine – KS I think he answered the question thinking that the markets will put money toward stocks (raising "wealth") and bonds (lowering costs of borrowing for mortgages and businesses), but he is also acknowledging (without meaning to) that liquidity could flow to commodities, something the Fed would rather not happen.]***

I think New York Fed Chief Dudley actually showed more distinctly that the Fed has not thought out their policies and is still conducting a large monetary experiment that they understand has some serious side effects (rising currencies in developing countries, higher commodity prices) that the Fed would rather ignore. Dudley (and Bernanke, his boss) are convinced that they can target the monetary effects they want and moderate the undesirable ones at the same time – probably an impossible feat.

***3) From The New York Times, November 16, 2010, Op-Ed article by Warren Buffett [not a Fed official, but he sounds like one in this article – KS] I wanted to include this piece because it is the epitome of "Establishment" thinking. I have also included a rebuttal article from Wall Street research analyst Barry Ritholtz, which "translates" Buffett's letter for "the rest of us".***

# *Pretty Good for Government Work*

By WARREN E. BUFFETT

DEAR Uncle Sam,

My mother told me to send thank-you notes promptly. I've been remiss.

Let me remind you why I'm writing. Just over two years ago, in September 2008, our country faced an economic meltdown. Fannie Mae and Freddie Mac, the pillars that supported our mortgage system, had been forced into conservatorship. Several of our largest commercial banks were teetering. One of Wall Street's giant investment banks had gone bankrupt, and the remaining three were poised to follow. A.I.G., the world's most famous insurer, was at death's door.

Many of our largest industrial companies, dependent on commercial paper financing that had disappeared, were weeks away from exhausting their cash resources. Indeed, all of corporate America's dominoes were lined up, ready to topple at lightning speed. My own company, Berkshire Hathaway, might have been the last to fall, but that distinction provided little solace.

Nor was it just business that was in peril: 300 million Americans were in the domino line as well. Just days before, the jobs, income, 401(k)'s and money-market funds of these citizens had seemed secure. Then, virtually overnight, everything began to turn into pumpkins and mice. There was no hiding place. A destructive economic force unlike any seen for generations had been unleashed.

Only one counterforce was available, and that was you, Uncle Sam. Yes, you are often clumsy, even inept. But when businesses and people worldwide race to get liquid, you are the only party with the resources to take the other side of the transaction. And when our citizens are losing trust by the hour in institutions they once revered, only you can restore calm.

When the crisis struck, I felt you would understand the role you had to play. But you've never been known for speed, and in a meltdown minutes matter. I worried whether the barrage of shattering surprises would disorient you. You would have to improvise solutions on the run, stretch legal boundaries and avoid slowdowns, like Congressional hearings and studies. You would also need to get turf-conscious departments to work together in mounting your counterattack. The challenge was huge, and many people thought you were not up to it.

Well, Uncle Sam, you delivered. People will second-guess your specific decisions; you can always count on that. But just as there is a fog of war, there is a fog of panic — and, overall, your actions were remarkably effective.

I don't know precisely how you orchestrated these. But I did have a pretty good seat as events unfolded, and I would like to commend a few of your troops. In the darkest of days, Ben Bernanke, Hank Paulson, Tim Geithner and Sheila Bair grasped the gravity of the situation and acted with courage and dispatch. And though I never voted for George W. Bush, I give him great credit for leading, even as Congress postured and squabbled.

You have been criticized, Uncle Sam, for some of the earlier decisions that got us in this mess — most prominently, for not battling the rot building up in the housing market. But then few of your critics saw matters clearly either. In truth, almost all of the country became possessed by the idea that home prices could never fall significantly.

That was a mass delusion, reinforced by rapidly rising prices that discredited the few skeptics who warned of trouble. Delusions, whether about tulips or Internet stocks, produce bubbles. And when bubbles pop, they can generate waves of trouble that hit shores far from their origin. This bubble was a doozy and its pop was felt around the world.

So, again, Uncle Sam, thanks to you and your aides. Often you are wasteful, and sometimes you are bullying. On occasion, you are downright maddening. But in this extraordinary emergency, you came through — and the world would look far different now if you had not.

Your grateful nephew,

Warren

*Warren E. Buffett is the chief executive of Berkshire Hathaway, a diversified holding company.*

**From "The Big Picture" blog, www.ritholtz.com, November 17, 2010**

# *Dear Uncle Sucker*

**By Barry Ritholtz - November 17th, 2010, 11:38AM**

*For many years, I've been a fan of Warren Buffett's long term approach to value investing. Understanding the value of a company, regardless of its momentary stock price, is a great long term investing strategy.*

*But it pains me whenever I read commentary from Buffett that glosses over reality or is somehow self-serving. His Op-Ed in the NYT today – Pretty Good for Government Work – paints an artificially rosy picture of the Bailout, ignores the negatives, and omits his own financial interest in government actions.*

*What might he have written if Sir Warren was dosed with some sodium pentothal before he sat down to pen that "Thank you" letter? It might have gone something like this:*

DEAR Uncle ~~Sam~~ Sucker,

I was about to send you a thank you note for bailing out the economy . . . but then some nice men dressed in Ninja outfits came in and shot me full of truth serum. That led me to make one more set of edits to my letter thanking you for saving the economy.

It also helped me recall some things I seemed to have forgotten in my other public pronunciations about the bailouts.

I suddenly recalled who it was who allowed the banks to run wild in the first place: *You*. Your behavior before, during and after the crisis was the epitome of a corrupt and irresponsible government. You rewarded incompetency, created moral hazard, punished the prudent, and engaged in the single biggest transfer of wealth from the citizenry of the United States to the Wall Street insiders who created the mess in the first place.

*Kudos*.

Before I get to the bailouts, I have to remind you that in:

• 1999, you passed the Financial Services Modernization Act. This repealed Glass-Steagall, the law that had successfully kept main street banking safely separated from Wall Street for seven decades. Even the 1987 market crash had no impact on Main Street credit availability, thanks to Glass-Steagall.

• 1997-2010, you allowed the Credit Rating Agencies to change their business model, from Investor pays to Underwriter pays — a business structure known as Payola. This change effectively allowed banks to purchase their AAA ratings, and was ignored by the SEC and other regulators.

• 2000, you passed the Commodities Futures Modernization Act. It allowed the shadow banking industry [large banks had large off-balance-sheet subsidiaries where they expanded their loan portfolios but did not include them in bank assets, actually similar to what Enron did – KS] to develop without any oversight by the Commodity Futures Trading Commission, the SEC, or the state insurance regulators. This led to rampant creation of credit-default swaps, CDOs, and other financial weapons of mass destruction — and the demise of AIG.

• 2001-04, the Fed, under Alan Greenspan, irresponsibly dropped fund rates to 1%. This set off an inflationary spiral in housing, commodities, and in most assets priced in dollars or credit.

• 1999-07, the Federal Reserve failed to use its supervisory and regulatory authority over banks, mortgage underwriters and other lenders, who abandoned such standards as employment history, income, down payments, credit rating, assets, property loan-to-value ratio and debt-servicing ability.

• 2004, the SEC waived its leverage rules, allowing the 5 biggest Wall Street firms to go from 12 to 1 to 20, 30 and even 40 to 1. Ironically, this rule was called the Bear Stearns exemption.

These actions and rule changes were requested by the banking industry. Rather than behave as adult supervision, you indulged the reckless kiddies, looking the other way as they acted out. *You were the grand enabler of the finance sector's misbehavior*. Hence, you helped create the mess by allowing the banking sector to run roughshod over decades of successful constraints. (*Kudos* again on that).

There were voices warning about the upcoming crisis, but you managed to turn a deaf ear to them: Warnings about subprime lending, problems with securitization, against the false claim that residential real estate never went down in value, or that the models forecasting VAR were wildly understating risk. An economy driven by growth dependent upon credit fueled consumption was unsustainable, and yet you encouraged that reckless credit consumption. The compensation schemes for Wall Street were hilariously short term (ignored by you); the crony capitalism of Boards of Directors that undercut market discipline was similarly ignored. You encouraged the hollowing out of the US economy, allowing it to become increasingly "Financialized" at the expense of industry and manufacturing. What was once a small but important part of the economy became dominant, yet unproductive, with your blessing.

<u>Bottom line</u>: You were at a loss for understanding the many factors that led to the crisis in the first place.

When the crisis struck, you did not seem to understand the role you should play. Instead of stepping up to halt the financialization, to unwind it, you gave away the shop. You failed to extract concessions from firms on the verge of bankruptcy. Your negotiating skills were embarrassing. In the face of meltdown, you panicked.

You could have undone the decades of radical deregulation at that moment. You could have fired the incompetent management, wiped out the shareholders who invested in insolvent companies, gave the creditors and bond holders a major haircut for their foolish lending. Instead, you rewarded them for their gross incompetence.

The solutions you ran with were *ad hoc*, poorly thought out, improvised. You crossed legal boundaries, putting the Fed in the position of vioolating its charter and exceeding its mandates. You created a Moral Hazard, the impact of which may not be felt until decades in the future.

Very few of your senior elected and appointed officials understood what was going on.

Rather than offer an intelligent response to the crisis, you delivered brute force: Trillions of dollars were thrown at the problem, papering over its symptoms but not its underlying causes.

Well, Uncle Sam, you delivered a motherload of cash. Considering the dollar sums involved, your actions were remarkably ineffective. What was left over afterwards was a wildly over-leveraged consumer whose credit limits had been reached; State and municipal budgets were heavily dependent upon that excess consumer spending, creating huge budget holes because of it. Net net: The resultant economy was in the worst recession since the Great Depression.

As a student of the Great Depression, Ben Bernanke should have had the best grasp – but his bailout of Bear Stearns revealed him to be just another banker, intent on saving the banks – banking system be damned. To give you a clue of exactly how lost Hank Paulson was, he spent his time praying, and creating documents that exempt himself personally for liability. He's from Goldman, so we know that "team first" ain't exactly his style. Tim Geithner, who did such a stupendous job overseeing the banks in the first place, was in way over his head. And while I never voted for George W. Bush, I give him great credit for hiding under the bed and pretty much staying out of everyone else's way. I would call him clueless, but that wouldn't be fair to the legions of clueless around the world.

Sheila Bair grasped the gravity of the situation earliest, and put numerous failed banks through the insolvency process. If we were smart, we would have allowed her to work her way through the entire finance sector, effecting a GM-like prepackaged bankruptcy for Citigroup, Bank of America, Merrill Lynch, Morgan Stanley, AIG, etc. It would have been painful as hell, but we would be much better off had we allowed her to tear the band aid off quickly. Instead, we are suffering through a death of a 1000 cuts, Japanese style.

I would be remiss if I failed to mention my personal positions in this: I made a killing in Goldman Sachs and GE. My investments in Wells Fargo would have been a disaster if not for you. Don't even get me started with me being the largest shareholder in Moody's – that was some clusterf#@k. And considering all of the counter-parties that Berkshire Hathaway has, we risked being just another insolvent investment firm along with everyone else had nothing been done.

So I must say thanks to you, Uncle Sam, and your aides. In this extraordinary emergency, you came through for me — and my world looks far different than if you had not.

Your grateful but wide-eyed nephew,

Warren

***4) Excerpts from the transcript of CBS television show <u>60 Minutes</u>, December 5, 2010, Fed Chairman Ben Bernanke interviewed by Scott Pelley***

Friday's unemployment number was a troubling surprise, up from 9.6 percent to 9.8 percent. The economists who decide such things say the recession ended in 2009.

But this is the worst recovery the nation has ever seen. Ben Bernanke is concerned. As chairman of the Federal Reserve, Bernanke has enormous power over the world economy. And he has used that power in ways that the world has never seen.

During the panic of 2008, he committed trillions of dollars to rescue the financial system. And the Fed dropped interest rates nearly to zero.

Now, in a new move that has become controversial, Bernanke intends to commit another $600 billion to hold down interest rates.

Chairmen of the Fed rarely do interviews. But this week, Bernanke feels he has to speak out because he believes his critics may not understand how much trouble the economy is in. We wanted to know whether we're headed for another recession, whether Congress should extend the Bush tax cuts.

But first we wanted to talk about unemployment which has been at 9.5 percent or more for 16 months.

**Chairman Ben Bernanke:** The unemployment rate is just not going down. Unemployment is just about the same as it was in mid-2009, when the economy started growing. So, that's a major concern. And it looks that at current rates, that it may take some years before the unemployment rate is back down to more normal levels.

**Scott Pelley:** We lost about eight million jobs from the peak. And I wonder how many years you think it will be before we get all those jobs back?

**Bernanke:** Well, you're absolutely right. Between the peak and the end of last year, we lost eight and a half million jobs. We've only gotten about a million of them back so far. And that doesn't even account the new people coming into the labor force. At the rate we're going, it could be four, five years before we are back to a more normal unemployment rate. Somewhere in the vicinity of say five or six percent.

Four or five years. And Bernanke told "60 Minutes" something else that makes that even more painful.

**Bernanke**: The other aspect of the unemployment rate that really concerns me is that more than 40 percent of the unemployed have been unemployed for six months or more. And that's unusually high. And people who are unemployed for such a long time, their skills erode. Their attachment to the labor force diminishes and it may be a

very, very long time before they find themselves back in a normal working position.

Pelley met Bernanke Tuesday (Nov. 30) in the Thompson Library on the campus of The Ohio State University. He was in Columbus on one of his frequent trips to hear how people are coping with the economy.

**Pelley**: The major banks are racking up profits in the billions. Wall Street bonuses are climbing back up to where they were. And yet, lending to small businesses actually declined in the third quarter. Why is that?

**Bernanke**: A lot of small businesses are not seeking credit, because, you know, because their business is not doing well, because the economy is slow. Others are not qualifying for credit, maybe because the value of their property has gone down. But some also can't meet the terms and conditions that banks are setting.

**Pelley**: Is this a case of banks that were eager to take risks that ruin the economy being now unwilling to take risks to support the recovery?

**Bernanke**: We want them to take risks, but not excessive risks. We want to go for a happy medium. And I think banks are back in the business of lending. But they have not yet come back to the level of confidence that, or overconfidence, that they had prior to the crisis we want to have an appropriate balance.

Last month, Bernanke announced the Fed's intent to buy $600 billion in U.S. Treasury securities, which is supposed to have the effect of lowering rates on long term loans for things like cars and homes.

Bernanke wanted to emphasize that these are the Fed's own reserves. It's not tax money. It does not add to the federal deficit.

Critics of Bernanke's Federal Reserve have the opposite worry [deflation]: they say the $600 billion and holding down interest rates could overheat the recovering economy, causing prices to rise out of control.

**Pelley**: Some people think the $600 billion is a terrible idea.

**Bernanke**: Well, I know some people think that but what they are doing is they're looking at some of the risks and uncertainties with doing this policy action but what I think they're not doing is looking at the risk of not acting.

**Pelley**: Many people believe that could be highly inflationary. That it's a dangerous thing to try.

**Bernanke**: Well, this fear of inflation, I think is way overstated. We've looked at it

very, very carefully. We've analyzed it every which way. One myth that's out there is that what we're doing is printing money. We're not printing money. The amount of currency in circulation is not changing. The money supply is not changing in any significant way. What we're doing is lowering interest rates by buying Treasury securities. And by lowering interest rates, we hope to stimulate the economy to grow faster. So, the trick is to find the appropriate moment when to begin to unwind this policy. And that's what we're going to do. ***[Emphasis mine – KS Bernanke is trying to be coy here – they are not actually "printing money", but they are giving large banks the ability to borrow Fed money at no cost and do anything they want with it. The Fed hopes they lend it out or buy stocks (for the "wealth effect") or bonds (to lower interest rates), but there is no guarantees where this liquidity will end up.]***

**Pelley**: Is keeping inflation in check less of a priority for the Federal Reserve now?

**Bernanke**: No, absolutely not. What we're trying to do is achieve a balance. We've been very, very clear that we will not allow inflation to rise above two percent or less. ***[Emphasis mine – KS This is completely unrealistic; the Fed cannot move fast enough once people are convinced of inflation. And the reason the Fed is doing this in the first place is to promote inflation! So controlling it above 2% is not only unrealistic but impossible.]***

**Pelley**: Can you act quickly enough to prevent inflation from getting out of control?

Bernanke: We could raise interest rates in 15 minutes if we have to. So, there really is no problem with raising rates, tightening monetary policy, slowing the economy, reducing inflation, at the appropriate time. Now, that time is not now. ***[KS comment – Even though the Fed could raise interest rates in 15 minutes, the markets wouldn't necessarily react in an expected way. When Volcker raised short-term interest rates to 22 percent in 1980, gold soared in price and prices went up further for a few months until the market realized rates were finally high enough. Bernanke has not idea how the market will interpret his first rate hikes.]***

**Pelley**: You have what degree of confidence in your ability to control this?

**Bernanke**: One hundred percent. ***[KS comment – A completely arrogant and unrealistic answer; if he is so sure, he is going to make a lot of policy blunders as inflation spirals up and out of control.]***

**Pelley**: Do you anticipate a scenario in which you would commit to more than $600 billion?

**Bernanke**: Oh, it's certainly possible. And again, it depends on the efficacy of the program. It depends on inflation. And finally it depends on how the economy looks. ***[KS comment – This is a virtual certainty. QE2 has not achieved enough (although***

***the stock market is higher), so expect to see QE3 announced in the April-May time frame. NY Fed chief Bill Dudley expressed (in the article above) that they would need "months of 300,000 job additions" to feel like unemployment is truly dropping sustainably.]***

**Pelley**: How would you rate the likelihood of dipping into recession again?

**Bernanke**: It doesn't seem likely that we'll have a double dip recession. And that's because, among other things, some of the most cyclical parts of the economy, like housing, for example, are already very weak. And they can't get much weaker. And so another decline is relatively unlikely. Now, that being said, I think a very high unemployment rate for a protracted period of time, which makes consumers, households less confident, more worried about the future, I think that's the primary source of risk that we might have another slowdown in the economy. ***[KS comment – Unfortunately, housing is getting worse and unemployment is also, because the length of the typical unemployed person is growing. Thus, he is wrong, and the longer the recovery takes, the higher the chance of slipping back into recession.]***

**Pelley**: You seem to be saying that the recovery that we're experiencing now is not self-sustaining.

**Bernanke**: It may not be. It's very close to the border. It takes about two and a half percent growth just to keep unemployment stable. And that's about what we're getting. We're not very far from the level where the economy is not self-sustaining.

**Pelley**: Is there anything that you wish you'd done differently over these last two and a half years or so?

**Bernanke**: Well, I wish I'd been omniscient and seen the crisis coming, the way you asked me about, I didn't. But it was a very, very difficult situation. And the Federal Reserve responded very aggressively, very proactively. ***[KS comment – Plenty of analysts and investor warned of the risks of the crisis years before it happened, but the Fed was too self-assured to pay attention to pundits at the time (or even today).]***

**Pelley**: How did the Fed miss the looming financial crisis?

**Bernanke**: There were large portions of the financial system that were not adequately covered by the regulatory oversight. So, for example, AIG was not overseen by the Fed. ***[KS comment –Classic bureaucratic "cover-your-ass" – blame it on something that was either someone else's fault or was "not on your watch", like AIG.]***

**Pelley**: The insurance company.

**Bernanke**: The insurance company that required the bailout, was not overseen by the

Fed. It didn't really have any real oversight at that time. Neither did Lehman Brothers, the company that failed. Now, I'm not saying the Fed should not have seen some of these things. One of things that I most regret is that we weren't strong enough in putting in consumer protections to try to cut down on the subprime lending problem. That was an area where I think we could have done more.

**Pelley**: The gap between rich and poor in this country has never been greater. In fact, we have the biggest income disparity gap of any industrialized country in the world. And I wonder where you think that's taking America.

**Bernanke**: It's a very bad development. It's creating two societies. And it's based very much, I think, on educational differences. The unemployment rate we've been talking about. If you're a college graduate, unemployment is five percent. If you're a high school graduate, it's ten percent or more. It's a very big difference. It leads to an unequal society and a society which doesn't have the cohesion that we'd like to see. ***[KS comment – The shame of his statements are that the Fed and its "easy money" policies and "too big to fail" bailouts of the past 30 years has led to this gulf between "the two societies". The Fed claims to be apolitical, but it bowed to politicians all too much in recent decades and the results of such policies are just being seen today.]***

***5) Excerpt from Barron's, Barron's Roundtable: "Attention, Stockpickers" article, January 15, 2011***

Financial world analysts and money managers discussing current market conditions include: **Marc Faber**, money manager and editor of the Gloom, Boom and Doom Report; **Bill Gross**, head of Pimco and manager of the largest bond mutual fund in the world; **Felix Zulauf**, Swiss money manager and **Fred Hickey**, market analyst and writer of The High-Tech Strategist. There discussion recounted below shows how large money managers view the recent moves of the Fed:

**Marc Faber**: [Commenting on the Fed's recent moves and US Government tax package] "History has shown that giant countries on the way down are very dangerous because they are desperate. But this year [2011] the U.S. has stabilized and is going to grow modestly.

"…Janet Yellen, vice chair of the Federal Reserve, said about a year ago that if it were possible to push interest rates into negative territory, she would vote for that. This is a very important statement because it implies that the Fed will keep real interest rates negative as far as the eye can see. Negative real rates amount to expropriation and destroy one function of money: to be a store of value and a unit of account ***[Emphasis mine – KS]***. If you measure the stock market not in dollars but gold, it is down 80% since 1999. I no longer regard the U.S. dollar as a valid unit of

account. People shouldn't value their wealth in dollars because one day, in dollars, everyone will be a billionaire."

**Bill Gross**: "I agree with Marc on many things, though not everything. I don't know if the U.S. has reached a desperate point, but it is employing instruments and vehicles and policies that smack of desperation. We are not looking at a default here, but at years of accelerating inflation, which basically robs investors and labor of their real wages and earnings. We are looking at a currency that almost certainly will depreciate relative to other, stronger currencies in developing countries that have lower levels of debt and higher growth potential. And, on the short end of the yield curve, we are looking at creditors receiving negative real interest rates for a long, long time. That, in effect, is a default. Ultimately creditors and investors are at the behest of a central bank and policymakers that will rob them of their money." ***[Emphasis mine – KS Very strong words from a guy who knows most of the Fed's governors and bank presidents personally and runs tens of billions of bond funds.]***

**Marc Faber**: "It is much easier for a government to print money and default in the way Bill just explained than to come out and say "we aren't going to pay half our debts." Also, one of the big debates these days is between the deflationists and the inflationists. The deflationists claim the Dow will drop to 1,000 or less and the economy will contract sharply, and therefore you should be in government bonds, not commodities, equities or real estate. But if China and India continue to grow and car makers do better … commodities will do OK.

"In a deflationary environment, tax revenues go down and fiscal policy remains expansionary. Deficits stay high, and even increase. Interest rates on government debt go up, and the quality of that debt declines. In a disaster scenario, I would rather own equities than government bonds. Since I am ultra-bearish, my preferred assets are equities and hard assets: real estate, commodities, precious metals and collectibles."

**Felix Zulauf**: "In the late 1970s and early 1980s, Paul Volcker [then the chairman of the Federal Reserve] crunched inflation by applying very high real interest rates for several years. Now we are getting the same process, just in reverse. Just as it took several years for the market to see that Volcker's policies would lead to declines in inflation and interest rates, it will take several years for the market to realize the Fed's current policies are highly inflationary. They will lead to a debasing of the currency, which is happening to varying degrees in most of the industrialized countries. ***[Emphasis mine – KS]***

Fred, speak up and give us your view.

**Fred Hickey**: "Last August, things weren't looking so well. Then Ben Bernanke gave a speech in Jackson Hole that implied the Fed would engage in quantitative easing, and from that point forward, the Dow added 1,400 points. Gasoline prices went from

> $2.65 a gallon to well over $3.00—a $50 billion hit to consumers. Food prices rose to record levels. It caused a major imbalance in the economy. If you own financial assets, you're doing quite well. If you don't, you're getting hit by higher food prices, higher insurance costs, higher everything, and you're not getting any interest on your savings. ***[Emphasis mine – KS]*** Target's [TGT] numbers were no good at Christmas. Saks' [SKS] numbers were fantastic. That's a big problem.
>
> "We continue to print money. In 2000 easy money led to gross imbalances. In the mid-2000s, 1% interest rates led to a housing bubble and then a credit crisis, and now rates are at zero. To get a response from the economy, the Fed must print ever more money. It did, and everything looks great right now. But as of June, when the $110 billion they are printing per month ends, things might not look so rosy. A year ago people were talking about an exit strategy. I knew there wasn't going to be one, ever. The economy has structural problems and we aren't dealing with them. Money-printing won't work, yet that's the prescription we continue to give the patient. If the Fed keeps printing after June, we'll have higher gasoline and food prices and more imbalances until this ends. And at some point it will end, because the dollar will fall apart. What we are doing now makes everything appear rosy. But it is a devastatingly terrible policy for the long term." ***[Emphasis mine – KS While Fred Hickey may overstate things, he states that trying to create lots of more money to help our economy is eventually doomed to failure.]***

One Kanos investor has asked us how we would solve the problems of the Fed and our country. We disagree with Bernanke et al. that massive liquidity is constantly needed to stave off deflation and the consequent recession/depression. Short-term rates at 0% allow financial institutions to limit their investments to only the safest of longer-term governmental and quasi-governmental bonds, leading to less credit for the rest of the economy and allowing (or encouraging) investment in riskier assets like stocks and commodities. Were short-term rates allowed to rise, we believe that more rational flow of capital would start to occur. However, we also realize that the most important but unstated aim of the Fed is to repair bank balance sheets by allowing banks to borrow at no real cost and invest at higher rates in longer-term investments. While this is a longstanding Fed policy, the flip-side of this grossly unfair situation is the yield starving that confronts the savers in our economy, who once could survive on dividends and interest from their built-up capital (like retirees) but now must supplement their meager income by working longer or simply lead a lower lifestyle. The Fed looks after its own banks, but the damage of its current policies, both short-term and long-term, will be with us for many years to come.

The Managers of Kanos Capital Management

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