

MONETARY POLICY AND LEVERAGE

Easy monetary policy and its close cousin, leverage, have been the most important economic trend in the past decade. For at least that long, the Federal Reserve under Alan Greenspan, and now Ben Bernanke, has had historically accommodative monetary policy. Similar policies have been adopted by many major central banks around the world, causing leverage upon leverage. Never in modern history has there been so much liquidity in the international markets. The Fed took this to another level after 9/11, lowering fed funds to 1%, the lowest rate since 1954. As a consequence, inflation in asset values occurred around the world. Real estate values rose dramatically, not just in the US, but in Europe, Latin America and the Far East. Often the term 'bubble,' probably appropriately, has been used to describe the extent of this rise. This bubble is either 'bursting,' 'deflating,' or 'flattening' and this trend will continue over at least the next year. The correct adjective will depend very much on how orderly the de-leveraging of these assets takes place while the subprime mortgage problem unravels.

Equally significant as real-estate inflation is asset inflation of various types: equities, art, commodities, etc. The accommodative monetary policy of central banks has fed this trend and it can be said that many of these assets are also in a 'bubble' phase. Again, how long the absorption of these trends will take is the currently unknowable. Some of these assets may remain inflated for years or even rise to further extremes as the forces of easy monetary policy unwind. Central banks have already begun to see that the 'multiplier' effect of their policies of the past decade needs to be reined in. But it's not so simple; it's sort of like putting toothpaste back in the tube.

So what's wrong with leverage and inflation? Nothing much, in the short term and when it's under control. But from the consumer point of view, over a period of years, it's a killer. Food and energy are up substantially, even while the government reports moderate 'core' inflation. The real estate boom has been great for property owners' balance sheets, while at the same time many have been leveraging these assets, piling on liabilities. The extreme fast pace of the rise in property values has evolved to become a drain on most consumers. On the aggregate, consumer paychecks have not risen as fast as the cost of housing. Add this to their increased food and energy costs and we have the ingredients for a real consumer slowdown. The consumer in the US is finally starting to pull back as we can see from the slowing rate in retail sales (May 2007, down .9%). As a consequence, the potential of a consumer led recession in the next few quarters is real, while a

further consumer slow down seems inevitable. The repercussions of this trend may be far reaching.

S&P 500	1541.57
PHLX GOLD & SILVER INDEX	158.26
GOLD	680/oz
SILVER	13.21/oz
CRUDE OIL - WTI	74.73/brl
10 YEAR U.S. TREASURY YIELD	4.95%
As of 7-23-07	

INTEREST RATES & THE U.S. DOLLAR

The US consumer has been driving the current economic expansion, both here and abroad. Further, the expansion has largely been driven by consumers depleting the 'savings account' of their home equity through refinance and cash outs. Long term interest rates, particularly rates on higher risk debt, have begun their upward move – a long overdue consequence of the excess leverage and risk that is now entrenched in the system. These higher rates will exert additional pressure on the vulnerable housing markets. But alas, the Fed has the magic bullet for this eventuality; lower fed funds rates, injecting easy money into the economy, again. Unfortunately, this re-leverage will not be received well in the already inflation sensitive stock and bond markets. The dollar will likely make new lows if this scenario comes to pass (the dollar is currently flirting with its 20 year support level).

COMMODITY PRICES

The classic remedy for inflationary cycles like the one just described is to overweight tangible assets (commodities), as opposed to intangibles (stocks and bonds). This explains the run in the past few years on gold, silver, oil, copper, nickel, fine art, and the like. Intangible assets (stocks) have been rising, but not as fast tangibles.

While stock markets in the US and abroad have risen, in real dollar terms they have far underperformed commodity prices over the past five years. This trend will continue as long as the weak dollar persists and now is the time to be vigilant in owning tangible assets. Note: real estate, being a tangible asset, could be thought of as an inflation hedge in this scenario, but the problem lies in the leverage. If one can hold on and withstand the initial and maybe prolonged weakness, while the leverage is removed from the system, real estate can hedge the inflationary cycle. However, housing prices are so inflated, as a result of the leverage inherent in the mortgage markets, there is likely to be a deflation of real property (or at least a flattening out period), before it levels out and rides the inflation wave again.

EMERGING MARKETS

The BRICs, (Brazil, Russia, India and China, as the emerging economies have often been referred to) have been a primary support for the developed economies in recent years. We consume their cheap products made with cheap labor, while they park the dollars with which we pay them in our Treasury securities (debt). This debt is in essence our government's subsidy, which enables us to maintain our way of life, consume more, and perpetuate the cycle. To believe that this cycle will continue and somehow fix itself is a fantasy. A recent trend has begun, revealing the inevitable; the BRICs don't want to hold so much US debt. This shift will force higher rates of return (higher interest we pay them to hold US debt securities) as they find alternative currencies to park their money. The obvious example is that the euro is at its all time high versus the dollar. This begs the question, can the BRICs sustain the growth trends they have been enjoying while US consumption is cut back vis-a-vis higher long term interest rates and the US consumer slowdown discussed above. The answer is not clear at this point. Certainly the BRICs will continue to grow and industrialize into the 21st century. But there may be some stumbling blocks along the way. The stock markets of these countries have seen phenomenal returns over the past decade. Caution over the next few quarters is warranted as we see how the de-leveraging of capital markets begins to unfold around the world.

INVESTMENT STRATEGY

In the coming months it seems that the odds of a correction of some of the excesses discussed will ensue. Expect a further weakening in the housing

market, with the wild card of subprime mortgages that may have a long term, cascading effect. But in any case, the softness in this area will cause a continued dampening effect on the US consumer, the driver of the recent economic expansion. Expect the bull market in stocks that we have been experiencing for the past 4 years to correct sometime in 2nd half of 2007. Will we have a 5-10% correction, or will it be worse, it's too soon to tell, but the preponderance of the fundamentals, economic data and market technicals creates a strong case for this trend change.

The yield curve has begun steepening and most likely that new trend will continue. To what extent this will occur, is also too soon to tell. Leverage buyouts, which will soon be converted to corporate debt (approximately \$300 billion on calendar this quarter), and subprime unwinding (estimated to be trillion dollars) brings more and more risk to long term debt obligations, i.e. higher long term interest rates. This, as a consequence, will cause increase pressure on the housing markets.

The weakened consumer and higher long term interest rates will eventually force the hand of the Fed, and lower short term interest rates will return. Remember the Fed controls short term, while the market controls long term rates. To predict whether this will happen in the second half of this year, or in 2008, is not too crucial. But the prospect of this eventuality will push commodities prices higher as the dollar slips to new (historic) lows. Gold, silver and oil, and the companies that control these assets, are the best investment for this scenario. These commodities should act as dollar surrogates, while at the same time inflation hedges. These commodities provide the essential ingredients of liquidity, historic and/or intrinsic value and limited supply.

-Louis Robin
July 23, 2007

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Call us toll-free at 800-991-5408

¹US Census Bureau News, Advance Monthly Sales for Retail and Food Services, June 2007

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