DAAT
Asset Management

Q3- 2008

INFLEXION POINT

We are at an important inflexion point in world economics. The repercussions of international free trade with developing countries, coupled with years of easy monetary policy, are upon us, and the near term prognosis is not good. Upward momentum of inflation has taken hold - a trend which is very difficult to reverse. This is particularly true because the pressure is coming from finite supplies of natural resources. It has been said by many economists that the recent rise in inflation is not as serious as past cycles because we have not seen much carry through in wages. However, this cycle of natural resource shortages, and increasingly higher prices, could prove to be even more damaging than traditional wage spiral inflation.

Food and energy are being consumed by a greater part of the world's population than ever before, both in nominal and proportional terms. This fundamental demographic shift was facilitated by the monetary policy of developed economies over the past 10 to 15 years. Developed economies have benefited from cheaper goods vis-à-vis low wages in the developing economies, while we have supplied capital to these emerging markets, thus giving them the means to improve their standard of living. In the past 5 years this trend received its last shot of adrenaline by virtue of unprecedented easy monetary policy, particularly by the central banks of the US and Japan, and until recently the European Union. The repercussion of this aggressive (read: reckless) policy was felt profoundly over the past year in the banking system where hundreds of billions of dollars of bad loans have been written off. Unfortunately, this was only the first shoe to drop.

The next phase of this unwinding process appears to be stagflation: a simultaneous combination of inflation and recession. This economic term, first coined in the 1965 to describe conditions in England, was last seen in the US in the mid 1970's. Conventional wisdom has been that stagflation won't occur again in the US as we have the technology and wisdom of experience to avoid this type of problem. That is, central banks and economists, in their hubris, believe they can engineer monetary policy via sophisticated models and technology designed to avoid the conditions that cause stagflation. Over the past few years we have heard from economists that 'core' inflation is under control and any recession, if we are going to have one, will be short and shallow. At this point, both views seem to be mistaken. Both inflation and a recession are taking hold.

NO MAGIC BULLET

What can be done to reverse these trends? Every time Mr. Bernanke or Mr., Paulson give a speech, people hang on every word hoping they will reveal the magic bullet. Unfortunately, a policy move by the Fed or the Treasury (or Congress) cannot fix this problem. It's too big and too far entrenched. The result of over a decade of easy monetary policy is embedded in the system. Mr. Greenspan's legacy will turn out to be that he was the 'maestro' of a disastrous monetary policy.

The issue most overlooked in the financial media is the sociological causes of this problem. Developed nations have provided many trillions of dollars of capital to developing nations over the past decade or so. This has enabled a huge portion of the world's population to emerge out of poverty, and into some variation of modern age, middle class, materialism. We laud the achievement as we watch this huge segment of humanity experience the benefits of better food, shelter and a general higher standard of living. At the same time, we in the developed world enjoy the benefit of cheaper goods produced through the developing world's lower cost labor force. However, the strain of the world's natural resources and how it factors into the balance is often overlooked in this discussion. Economics dictates that as the prices of natural resources go higher, there will be a slowdown in consumption and price normalization will occur though equilibrium. But, what is missing from this analysis is that human nature is not as cooperative as supply/demand curves imply.

		Price Direction
S&P 500	1317	8
PHLX GOLD & SILVER INDEX	178.60	4
GOLD (August)	908/oz	3
SILVER (August)	17.47/oz	3
CRUDE OIL - WTI (July)	134.77/brl	5

3-6 month Price Direction
Most Bullish - 1 Most Bearish - 10
As of close 6-22-08

Louis Robin, June 22, 2008

Consumers in the US have only recently slowed their consumption, while many find themselves deep in debt, with the lowest savings rate in decades, and the worst housing market since the Great Depression. Similarly, the recently formed middle classes of developing economies are going to be reticent to change their desire to drive their newly bought cars or forego their new and better eating habits as quickly at the economists and central bankers predict. Thus, we have the ingredients for stagflation. Consumers in developing economies are tapped out, running out of credit, while the developing nations are utilizing the capital we have transferred to them to entrench themselves in their middle class lifestyles.

As our economy slows, worldwide food and energy demand will most likely continue to stay strong, or least not fall sharply, as many are predicting. Some commodity resources such as copper, nickel and iron ore, may not be as strong as they have been in recent years, falling temporarily, but inflationary pressures have a tendency to be persistent, just as consumption habits are difficult to reverse. Over the long run, the world's growing middle class will support a steady upward bias on the price of natural resources.

MONETARY POLICY

The Fed and the ECB policies are becoming confrontational. The ECB, having a better long term perspective on the circumstances, is posturing to raise their base rate from 4%. The Fed is really in a corner, having a political and social agenda, as opposed to the ECB's inflationary fighting mandate. A rate increase by the Fed at this juncture, or anytime soon, will put the fragile housing and automobile industries into another downward spiral. At the same time, the current 2% Fed funds rate continues to fuel the world's inflationary cycle. The most likely scenario is that the Fed will opt to try to keep the US economy out of a full scale recession by leaving rates low, for at least the next 3 to 6 months. However, this effort will likely be futile, and the Fed will ultimately have to join the ECB in its effort to fight inflation. This will come after much more damage is done and they finally realize that they can't engineer monetary policy to eliminate the 'business cycle'. Human nature of the desire for a better standard of living in developing economies is more powerful than the Fed.

If the scenario above is correct, stocks will perform poorly over the coming months. As this is written, the major averages are flirting with the January and March lows. There may be more bear market rallies, but the lows will likely be broken and new leg down of 10-20% is becoming more and more probable. Short term Treasuries may be the best asset class while the next shake out occurs. Technology stocks are most vulnerable here as they have had a long run up and many of these stocks have very high multiples. Agriculture commodity stocks should continue to have good relative performance in the near and medium term.

THE COMMON DENOMINATOR

Commodities will continue to outperform stocks over the coming months. There may be some strong crosscurrents while common stock prices adjust to a new reality, bringing all asset classes down with them. Food commodities, fertilizer and seed companies, in particular, should stay in high demand for the reasons given above, but the great debate on gold and other precious metals continues. Gold has no significant industrial use and it is not a consumable commodity. However, gold continues to be the ultimate store house of wealth; it has been for the millennium. Cultures across the world view gold as a safe place to store their money. In a world of instability and with monetary policies gone awry, people, as well as sovereign wealth funds, will seek alternate places to save, other than intangible monetary assets and fiat currencies. Gold, silver and platinum will be beneficiaries of this. They are the common denominators of wealth across cultures and currencies. It is likely that we will see new highs in gold by the end of 2008.

–Louis Robin
June 22, 2008

What's Missing From Your Portfolio?

DAAT Asset Management has a strategy that fits
Call us toll-free at 800-991-5408

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DAAT Asset Management is a registered investment advisor. Mr. Robin employs his analysis in DAAT Dynamic Assets (DDA), a proprietary trading program. For more information please refer to www.daat.net or call 800-991-5408.