

## The New Biggest Risk of All – DEFLATION

September 29, 2008 Newsletter

*Welcome back, my friends, to the show that never ends.*

*We're so glad you could attend.*

*Come inside! Come inside!*

*There, behind a glass, is a real blade of grass be careful as you pass.*

*Move along! Move along!*

*Cold and misty morning, I heard a warning borne in the air*

*About an age of power where no one had an hour to spare,*

*Where the seeds have withered, silent children shivered, in the cold*

*Now their faces captured in the lenses of the jackals for gold.*

Karn Evil 9—Emerson, Lake and Palmer—from the album Brain Salad Surgery.

### **My Biggest Fear**

Without question, my biggest fear since the Credit Crisis began, even while watching the events that led up to it—the absurd levels of debt on every front, the creation of esoteric instruments based on bad debt—has been what would happen once the Credit Crisis unfolded. That fear was deflation; something that I sense is now upon us.

You may not be familiar with deflation since it hasn't been seen in this country since the 1930's. So in case you are not familiar, I have provided a definition below. I believe the deflation situation that we are facing today in our nation is clearly defined by Investopedia:

**Deflation: A general decline in prices, often caused by a reduction in the supply of money or credit. Deflation can be caused**

**also by a decrease in government, personal or investment spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression.**

So how do we deal with deflation?

From the Federal Reserve's website, their four main goals are outlined below:

- Conducting the nation's monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices.
- Supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers. .
- Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.
- Providing certain financial services to the U.S. government, to the public, to financial institutions, and to foreign official institutions, including playing a major role in operating the nation's payments systems.

From the European Central Banks website, their primary goal is outlined below:

- The primary objective of the ECB's monetary policy is to maintain price stability. The ECB aims at inflation rates of below, but close to, 2% over the medium term.

So there we have it. The Fed and ECB's goal is to ensure a safe system with price stability. Nowhere in either of the Central Bank statements does it say that a goal should be to avoid price and asset erosion.

This is my greatest fear of all and one that is playing out in real time. In sum, I believe that deflation is either already upon us or is right around the corner. And from my perch, deflation is a far worse outcome than inflation in that inflation can be contained while deflation is not easily contained. Just ask the Japanese.

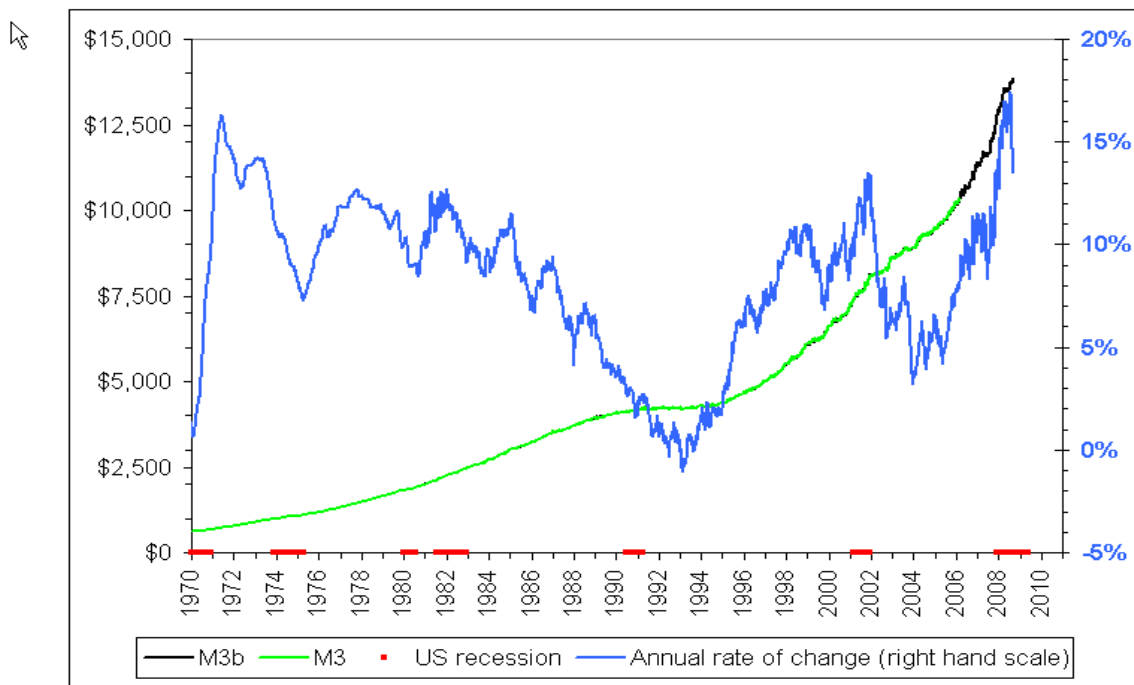
### Where is Deflation rearing its Ugly Head?

Where is deflation rearing its ugly head? Well, pretty much everywhere. Every place I turn, whether it be money supply, real estate prices, equity prices, debt prices, loan creation, commodity prices (except gold), consumer confidence, I see deflation.

When you think about it, it is not terribly difficult to understand how we got into this mess. Too much debt, notably low quality debt, was created at every level; Government, consumer, corporate, etc. Then, this debt was levered up at the suggestion of the SEC and then carved up into esoteric investments that were scattered about the globe in a nearly insidious manner. We are simply now living through the painful unwind of debt creation, that is to say we are living through debt destruction, which is just a nasty version of deflation.

Note that on the chart below no matter how hard the Fed and ECB try to pump money into our fragile financial system, the rate of growth of 'reconstituted M3' (courtesy of [www.nowandfutures.com](http://www.nowandfutures.com)) is decelerating sharply. This is at a time when the system is starving for liquidity. Banks, brokers and consumers are in dire need of liquidity to solve their levered mess. But just as you can 'lead a horse to water but can't make him drink', you can try to force liquidity into the banking system, but you cannot force banks to lend.

M3, longer term chart



In order for banks to lend, they must first have solid balance sheets and be able to finance their operations at a rate low enough that they can then lend at a profit. When we consider why lending has come to a near stand-still, we must realize why this is so. In my opinion, the majority of financial institutions have been virtually shut out of the financial markets as confidence levels have shrunken to near zero. When I wrote my piece entitled [Dead Men Walking](#), I wrote that there was a 'recipe' for bank failures. This is not an exercise in chest-beating, but many of the names I mentioned are now gone (Fannie, Freddie, Washington Mutual, AIG, LEH) and surely there are many more to follow.

Sadly, If I had to re-write that piece today I could likely come up with north of 25 public companies in the financial space alone that have the recipe for failure. The recipe, as I see it, is that your balance sheet is impaired from poor loans and ownership of esoteric securities that are constantly re-priced lower which results in write-downs/write-offs. This places you in a position that you either need an equity infusion or need to raise capital in the public or private markets, which in theory, sounds great—all the way until you find out that the current cost of capital is so high that it is un-economic to do so.

For instance, Wachovia, a behemoth with nearly \$1/2 trillion of deposits finds itself in a rather precarious situation. Their 2 year debt trades in the 45% yield to maturity area, their 'hybrid' preferred securities that were issued in February 2008 at 100 (fixed-to-floating rate perpetual preferred stock) trades at 22 cents on the dollar or 38% yield and their 8% preferred shares that were issued just last December at \$25 per share trade at \$6 or a 28% yield. Their common shares change hands at \$9, down from \$60 last year. Wachovia is the largest issuer of option ARM's, or adjustable rate securities that had low 'teaser rates' that will 'explode' to much higher

rates, resulting in high delinquency/default rates. Due to their poor lending habits, lousy balance sheet and lack of leadership, Wachovia likely needs upwards of \$20 billion of capital just to remain solvent, but how does one raise \$20 billion at 25-45% and expect to make money? Clearly a rhetorical question if there ever was one.

The problem, of course, is that Wachovia isn't alone in this sinking boat. National City, KeyCorp, Firth Third, Regions, Morgan Stanley, Sovereign, and many others are in the same boat. So if you are one of these unfortunate institutions, what do you do if you cannot get access to capital? You either

- a) Fail or are forced into the hands of a stronger institution (like WaMu was given to JP Morgan on Friday),
- b) shrink your balance sheet,
- c) sell common equity to a vulture investor, forever diluting your existing shareholders or
- d) declare bankruptcy.

**No matter which you choose, all options are deflationary in nature.**

Think about just how deflationary all of this has become. Just looking at Wachovia for a moment, we can see that there are many deflationary signs:

- Their equity is deflating.
- Their debt is deflating.
- Their balance sheet must shrink.
- If they are forced into the arms of a suitor, we will experience the concept of '1+1=1 ½' (if Wachovia and the suitor both have extended lines of credit to the same institution, some of that exposure must shrink in size).

- Layoffs will ensue, raising the unemployment rate.
- Laid off employees will have less ability to consume and service debt.

All of this is highly deflationary. Even more problematic is that it is not just present at Wachovia and is not confined to the US. It is a global problem and one that won't go away very easily. No matter how much money the Treasury, Fed, ECB and Congress throw at the Crisis, the Crisis ends up winning. Simply put, the Crisis is bigger than the system itself.

### **Who are the Losers in this Mess?**

The sad answer to the question of who loses in a deflationary mess is pretty much everyone. We have prepared ourselves and our investors for this for many years and have avoided credit risk and been void of equities for quite a while, but we may still feel the pain. As the credit market implodes (and I am serious when I say implodes—the credit market is now taking on that surreal '1-800-get-me-out' feeling), think of who owns all of this debt. Retail investors around the country have been force-fed preferred shares that now trade at a mere fraction of their issue price. Fannie and Freddie preferred shares trade near \$0, so one can only imagine how folks will feel when they open their brokerage statements in early October only to find their preferred shares they bought last year at \$25 are at \$1... Or if they owned a closed end bond fund that consists of leveraged municipal bonds (municipals are getting destroyed as well lately), preferred stocks or equities. These prices also have been annihilated and I can only imagine how little these folks will want to run out and buy a new car, plasma TV or Blackberry. One can see how this will now affect retailers, airlines, restaurant chains and anyone else that provides all but the necessities.

Other losers include fixed income investors that thought they were prudently investing funds in 'high grade corporates' like all of those that are now either in default or trading as if

they are in default. Many of these investors are large insurance companies that buy long-term bonds to match up their assets and liabilities. As the bonds collapse in price or become insolvent, the bonds become impaired assets and begin to affect their claims paying ability. This is why I believe the next area of concern will fall squarely in the asset management firms and insurance companies.

And let's not forget hedge funds that, despite being hedged, are getting hammered as well. As markets begin to freeze up and nearly everyone is forced to de-lever simultaneously, we find asset prices falling yet further. **Again, all of this is highly deflationary and is global in nature.**

This is specifically why we avoid leverage for the most part as it is no fun to have a margin clerk tap you on the shoulder and tell you to sell something you would rather not sell. **This is now occurring and it will not stop until the Fed, Treasury, ECB and other entities stop intruding and intervening in our markets.** I, for one, am tired of the constant intrusion into what used to be a free market. I am tired of having Sunday's become a work day while we wait to see who will be merged into whom. Making it illegal for me to express my views about a bank or insurance company via a short sale is Socialistic and will simply make the pain last longer. Handing \$700 billion of our money over to a bunch of fiscally irresponsible financial institutions is sickening. I have spent the better part of the last 10 years trying to steer clear of the most complicated financial mess ever created and what happens? I end up the proud owner of all of the garbage I stayed clear of, namely Fannie/Freddie/AIG and \$700 billion of nuclear waste. And then I get to watch the long list of executives at these institutions reward themselves with tens of millions of dollars! What a country!

Who else is a seller of our paper? Foreigners. Each month, we are told how many assets are being purchased or sold by foreign institutions,

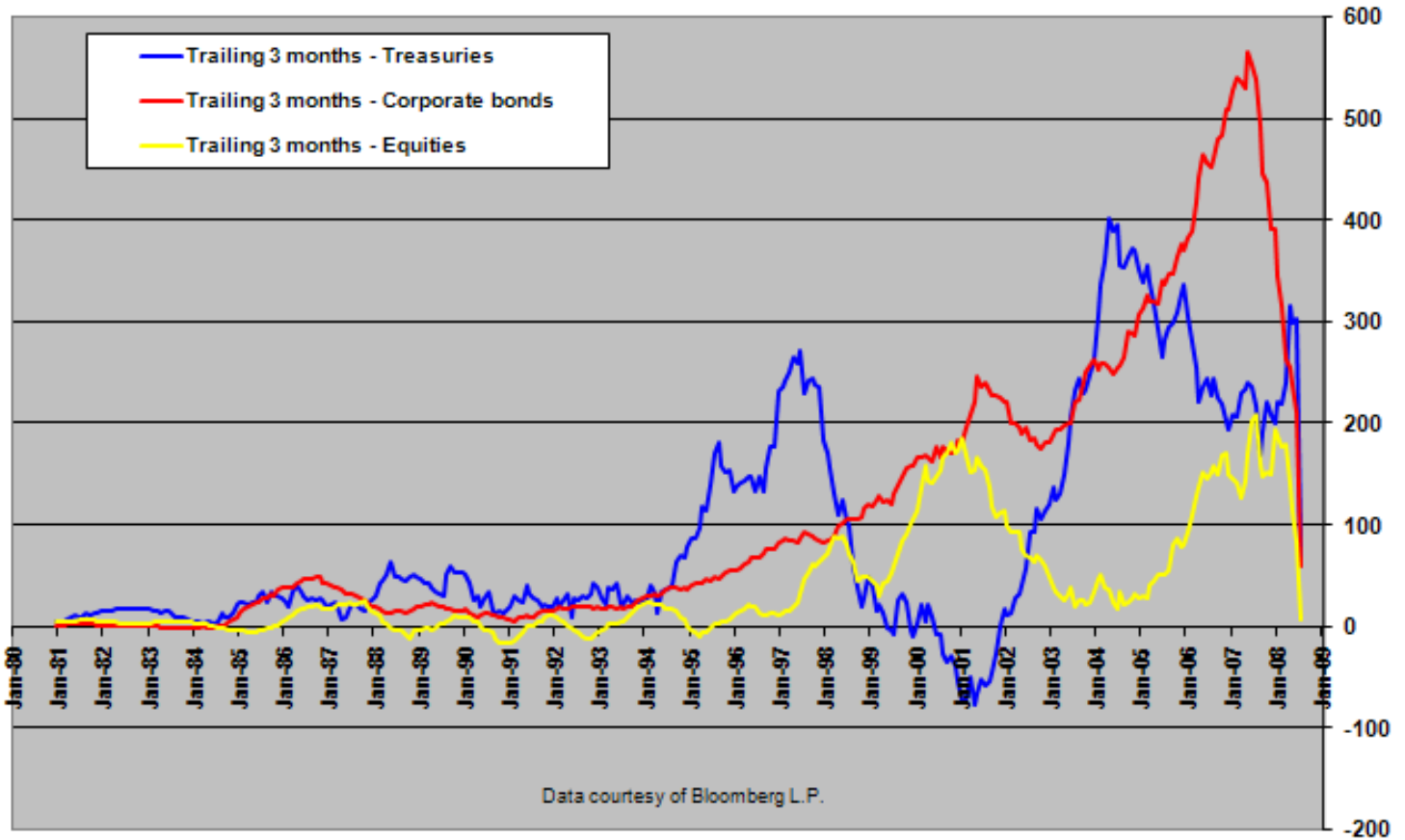
mainly Foreign Central Banks. As I stated earlier, this is not just a problem in the US, it is global in nature, so the foreign investors need to sell as well. Below you will find three charts that show the 3, 6, and 12 month trailing cumulative totals of foreigners in Equities,

Treasuries and Corporates. The trends are rather obvious. The risk aversion trade is on, so now not only do we have forced domestic sellers, we have company in foreign institutions.

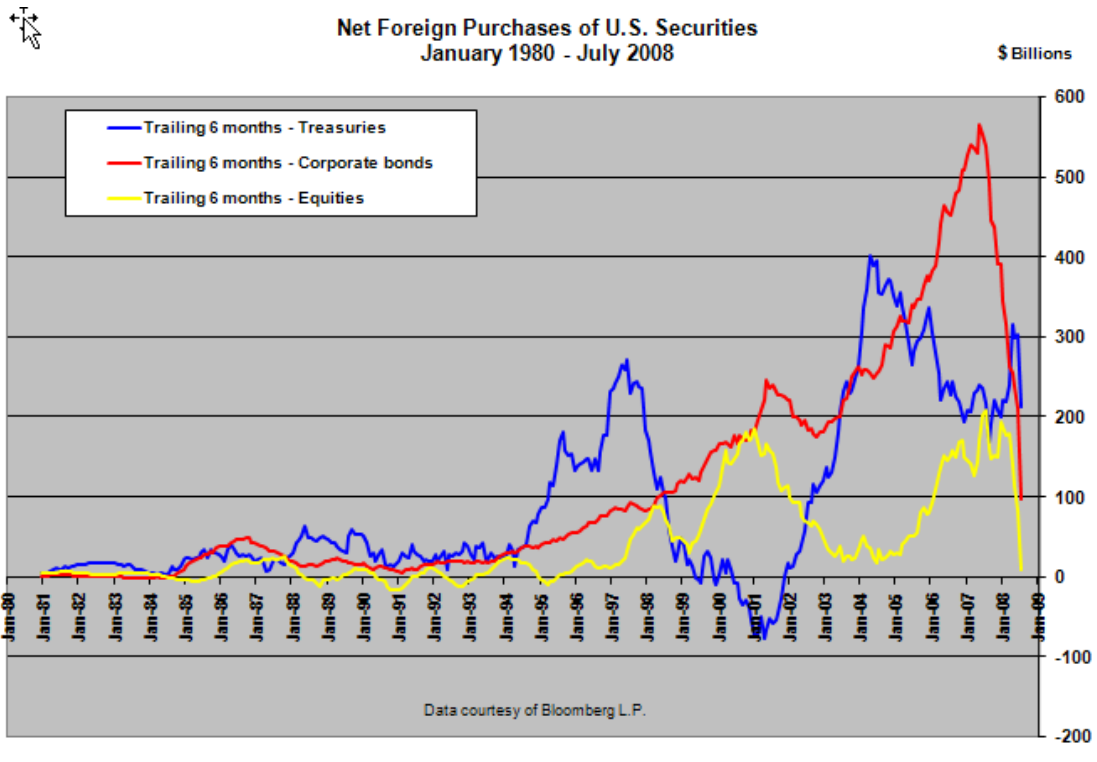
### 3 Month Trailing Cumulative Foreign Purchases

Net Foreign Purchases of U.S. Securities  
January 1980 - July 2008

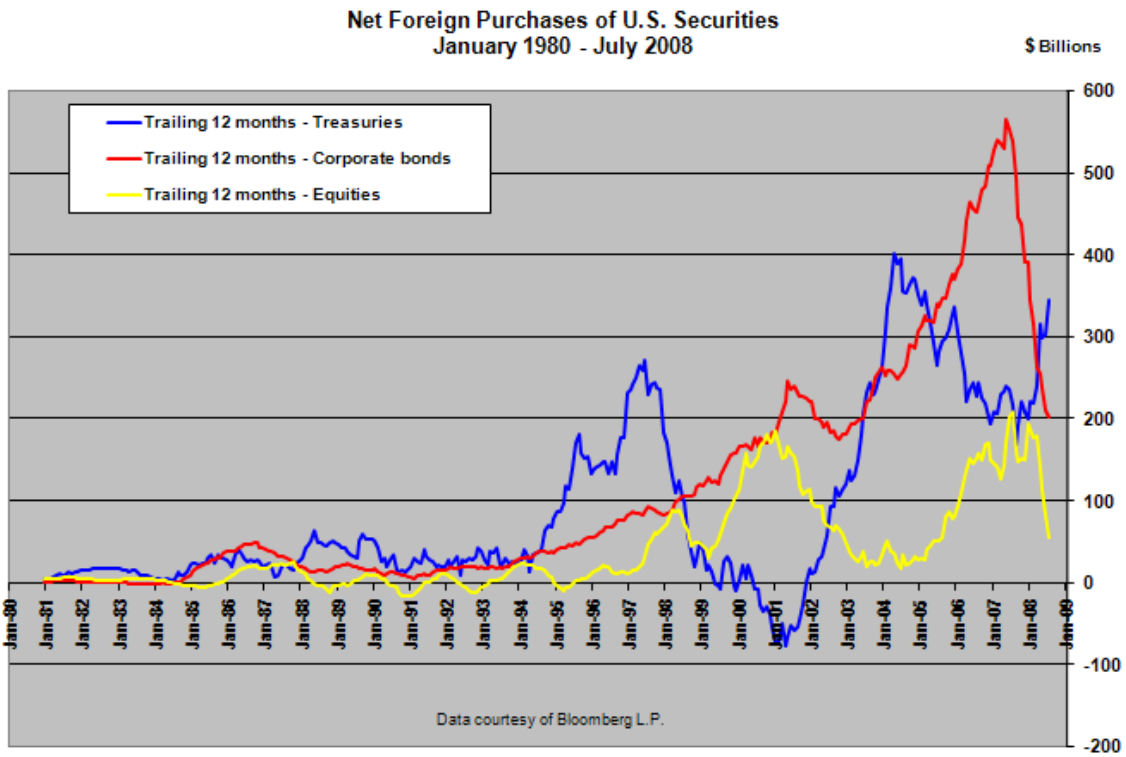
\$ Billions



## 6 Month Trailing Cumulative Foreign Purchases



## 12 Month Trailing Cumulative Foreign Purchases



How else do we know that deflation is upon us? There is considerable shrinkage in the commercial paper markets as demand for short

term credit dries up. And it is drying up in a hurry. **This is also highly deflationary.**



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Yet another sign of stress and deflation is the nearly non-functioning Treasury Bill market. Since we are seeing money market funds 'break the buck' and liquidated, the money has to make its way somewhere. And in this instance, it is finding its way into the Treasury

Bill market, where yields are approaching 0. In one extreme transaction last week, Treasury Bills trades above par, or in other words, a negative yield. Yep, more deflation. I saved a picture of the Treasury Bill screen from that day for 'posterity' and will share it below.

### Treasury Bill Yield Screen Shot

BILL PRICES											
1	9/25/08	↑	.31/30	--		23	2/26/09	↓	1.07/ 6	1.08	-.16
2	10/02/08	↓	.28/16	.16	-.28	24	3/05/09	↓	1.14/13	1.15	-.15
3	10/09/08	↓	.05/ 3	.03	-.61	25	3/12/09	↓	1.13/12	1.14	-.16
4	10/16/08	↓	.07/ 1	.01	-.34	26	3/19/09	↓	1.18/17	1.19	-.13
5	10/23/08	↓	.13/ 9	.09	-.88	27	3/26/09	↓	1.41/40	1.43	-.15
6	10/30/08	↑	.31/29	.29	-.16	28	6/04/09	↑	1.67/66	1.70	-.08
7	11/06/08	↓	.18/12	.12	-.73	29	7/02/09	↓	1.76/75	1.79	-.07
8	11/13/08	↓	.17/16	.16	-.21	30	7/30/09	↑	1.80/79	1.84	-.08
9	11/20/08	↑	.31/29	.29	-.56	31	8/27/09	↑	1.80/79	1.84	-.09
10	11/28/08	↑	.35/26	.26	-.64	32	9/24/09	↑	1.85/84	1.89	-.13
11	12/04/08	↑	.28/26	.26	-.84	33	CMBR10/02/08		NOT PRICED		
12	12/11/08	↑	.13/12	.12	-.22	34	CMBR10/30/08		NOT PRICED		
13	12/18/08	↑	.22/18	.18	-.08	OTHER MARKETS					
14	12/26/08	↓	.46/45	.46	-.25	35	US Long(CBT)	16:59	↑	116-25	- 08+
15	1/02/09	↓	.51/50	.51	-.12	36	10Y Fut(CBT)	17:00	↑	114-29	+ 01+
16	1/08/09	↓	.41/40	.41	-.20	37	EURO\$ (IMM)	16:59	s	96.300	-.310
17	1/15/09	↓	.53/52	.53	-.22	38	S&P 500 Ind	16:59	↑	1185.87	-2.35
18	1/22/09	↓	.41/40	.41	-.24	39	NASDAQ Comp	17:09	↓	2155.68	+2.35
19	1/29/09	↓	.55/54	.55	-.26	40	DowJones Ind	16:30	↓	10825.17	-29.00
20	2/05/09	↓	.83/82	.83	-.13	41	Gold (CMX)	17:09	↓	882.63	--
21	2/12/09	↓	.94/93	.95	-.16	42	NYM WTI Crd	17:09	↑	105.55	-1.06
22	2/19/09	↑	.93/92	.94	-.25	43		17:00	↑	0	--

## Will Deflation Lead to Depression?

Let me just say that I hope not. **What is needed is for the Government to get out of the way and let the market be a market.** The interventions/intrusions that have become so commonplace and sickening need to end. Those of us that manage hedged portfolios need to be allowed to hedge ourselves. It is a stabilizer, not a bad thing.

Note how Wachovia, Nat City and others plunge even though short selling is banned. This shows the market is differentiating between the good, bad and ugly. Let Darwinism back into the markets, let companies fail, let the system work it out. Will this lead us into a very deep Recession? Of course it can. But we can see that no matter how many intrusions we have all been forced to live with, the markets march relentlessly lower. I understand that the Authorities are simply trying to slow down the unwinding process and let there be just a handful of good banks left at the end, this will likely take place anyway as poorly run companies fail. My sense is that the more they intervene/intrude, the greater chance for a Depression, and to be brutally honest, I would rather not see that happen to what used to be a great country. It can be great again... if they just let it alone.

Short selling is an important dynamic in our business. Not only do short sellers provide liquidity to buyers, but it is part of the Democratic process that allows investors and traders to cast their negative vote against companies that they feel spot poor fundamentals. Think of it this way—If Wal-Mart, Pfizer or Johnson&Johnson were under ‘attack’ by short sellers, would their shares buckle? Not likely. Shares of Lehman, etc didn’t fail due to short selling, in my opinion, rather, they failed due to poor management and levered balance sheets. Shorts also serve a purpose in the convertible arbitrage market—after all, if shorts could not sell short their underlying common

shares, the convertible bond deal would likely not get underwritten, potentially starving a company of financing. As we can see this morning, Wachovia shares are not down 60 percent due to short selling—they are lower by 60% because they are insolvent. I have no problem with re-instituting the ‘up-tick rule’ that was instituted in the 1930’s to avoid bear raids, but short selling needs to be allowed in the marketplace, particularly when trillions of dollars are committed to long/short hedge funds.

To tell you just how much they have intruded, let me give you a couple of real-life examples of what has happened as a result of the short selling ban. A friend of mine, that happens to be an exceptionally talented long/short manager called me while I was having dinner at the Ryder Cup and said, ‘I had to shut down my business today, how on Earth can I run a long/short book when I can’t short things?’ Another fellow said, ‘do I change my convertible arbitrage fund documents to say that I can no longer run the fund as designed?’ When I asked an options trader if I could do a particular options trade (a put option strike roll, where you sell one put option you own and simultaneously buy another put with a different strike price), he advised me to call my lawyer, as no one understands the rules well enough yet.

Then, something completely surreal showed up on my Bloomberg screen yesterday - an index created by Bloomberg that tracks the performance of the ‘do not short list’. On this list are companies like Zale’s, CVS Drugstores, Sears Department Stores, Amerigroup, Atlas Pipelines, Atlas Energy Pipelines, and 10 other non-financial companies, with a total of 964 companies now being in the list. What was originally supposed to be a list of important financial institutions that needed protection turned into a muddled collection of companies with good lobbyists. I thought initially that it was a joke but, alas, it is the real deal... and it

makes me ill that it even exists. It is yet another failed intervention that will just squeeze a few

weak shorts out of the market, only to make it worse later on.

### Bloomberg Do Not Short Index

INDEX DESCRIPTION PAGE				Page 1/ 27	
BUSNSHRT - BBG NO SHORT IDX - US					
The Bloomberg US Restricted Short Sell Stock Index was developed to track the performance of the equities that were placed on the Restricted Short Sales list by the Securities and Exchange Commission on September 19th, 2008. The equity members consist of Banks, Insurance Companies, and Securities Firms with the ban effective through October 2nd, 2008. The index start value is 100 as of 9/19/08					
1)GIP Prices	Value	% Chg	Net Chg	No Industry Groups	
Year_to_Date	N.A.	N.A.	N.A.	MEMB	962 Members ↑412 ↓524 +26
2)TRA 52 Weeks Ago	N.A.	N.A.	N.A.	MOV	Today's Movers by Index Pts
3)GPO 52 Week High	170.46		on 01/02/08	1	JPMORGAN CHASE +.375
52 Week Low	90.47		on 09/17/08	Leading 7	BANK OF AMERICA +.242
Trading Hours	09:30-16:30		Local	Movers 8	WELLS FARGO & CO +.241
Fundamental Information				9	CITIGROUP INC +.092
Price/Earnings	140.38	Ex-Dvd	-.0050	10	WACHOVIA CORP -.182
Dividend Yield	4.56		on 09/29/08	Lagging 11	GENERAL ELECTRIC -.098
Index Information				Movers 12	ING GROEP-ADR -.088
Currency	USD			13	ROYAL BANK-S ADR -.075
Volume	2.46BLN		on 09/26/08	14CN	News on Today's Movers
Market Cap	4.70TRI				No Futures Available
Divisor	43868.97747261				No Options Available
Index value calculated by Bloomberg every 0.5 min.					

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Note how there were 412 stocks up, 524 stocks down and 26 unchanged in this index while the Dow was up 120 points on Friday. And oh by the way, the four worst losers in the index were, you guessed it, financials—Wachovia, GE, ING and RBS.

Another thing that happened at our trading desk that was unusual is that as I was tracking the spread widening in Wachovia and Morgan Stanley, I instinctively picked up the phone to call my prime broker to borrow shares to short, then stopped and yelled out to my partners, 'Oh that's right! I am not allowed to short them!' I then saw Wachovia get carved in half in a few hours time and watched in dismay as the homework I did would have, in a free market, made money for my investors. Instead I had to sit by and just watch.

This will all pass, and I think that the interventions and intrusions will soon come to an end (the only card they have to play, I think,

is to directly hand our cash to the banks to shore up their balance sheets).

What concerns me most is the fact that we find ourselves in a situation where all the major brokers have failed, been merged into depositories or, in the case of Goldman Sachs, converted into banks. On top of this, many banks have now bitten the bullet and many more are likely to follow suit; these will likely be regional banks and community banks. But consider this—not only is the financial system impaired but the Federal Reserve is impaired and the Treasury is likely next in line for impairment. When I think of the AIG bailout by the Fed, it really was an 'end around' where the Treasury bailed them out. Paulsen clearly couldn't make it seem like he was playing

favorites by letting Lehman go under and bail out AIG, so they lent money to the Fed to bail out AIG. Just take a look at who the largest

owner is of AIG equity in the screen below—The United States Government. More Socialism.

### List of AIG Common Stockholders

As of Sep26 Vol 135053564 Op 2.77 D Hi 3.28 D Lo 2.75 N						
AIG US Equity		95) Saved Searches	96) Default Settings	Page 1/175	Holdings Search	
American International Group Inc						CUSIP 02687410
21) Sources	22) Types	23) Countries	24) Metro Areas	25) Advanced Filters		
Name Filter				Sort By	Amount Held	
Holder Name	Portfolio Name	Source	Amt Held	% Out	Latest Chg	File Dt
1) UNITED STATES GOVERN	n/a	Research	10.688BLN	79.90	0	9/17/08
2) STARR INTERNATIONAL	n/a	Form 4	207,917,035	1.55	-35,000,000	9/25/08
3) FIDELITY MANAGEMENT & FIDELITY MANAGEMEN		13F	155,968,525	1.17	21,267,525	6/30/08
4) AXA	AXA	13F	132,593,871	0.99	38,069,864	6/30/08
5) DODGE & COX	DODGE & COX	13F	114,148,972	0.85	62,084,942	6/30/08
6) STATE STREET CORP	STATE STREET CORP	13F	96,320,952	0.72	4,456,346	6/30/08
7) BARCLAYS GLOBAL INVES	BARCLAYS GLOBAL IN	13F	94,039,496	0.70	5,187,754	6/30/08
8) CAPITAL RESEARCH GLO	CAPITAL RESEARCH G	13F	90,182,600	0.67	11,873,415	6/30/08
9) VANGUARD GROUP INC	VANGUARD GROUP I	13F	78,906,131	0.59	6,891,775	6/30/08
10) DAVIS SELECTED ADVISE	DAVIS SELECTED ADV	13F	73,991,712	0.55	8,564,629	6/30/08
11) AMERICAN LIFE INSURAN	AMERICAN LIFE INSU	Sch-D	63,391,777	0.47	0	6/30/08
12) GREENBERG MAURICE RA	n/a	Form 4	34,264,732	0.26	-5,000,309	9/25/08
13) WELLINGTON MANAGEME	WELLINGTON MANAGE	13F	32,756,840	0.24	7,640,990	6/30/08
14) CAPITAL WORLD INVEST	CAPITAL WORLD INVE	13F	31,132,400	0.23	21,810,400	6/30/08
15) BANK OF NEW YORK MEL	BANK OF NEW YORK	13F	31,000,824	0.23	933,350	6/30/08
16) LEGG MASON CAPITAL M	LEGG MASON CAPITA	13F	29,192,127	0.22	477,670	6/30/08
17) NORTHERN TRUST CORP	NORTHERN TRUST CO	13F	28,499,161	0.21	-473,688	6/30/08

26) Latest Chg 27) Hist Held % Out on Page 89.58

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2008 Bloomberg Finance L.P.  
 6457-768-1 27-Sep-08 16:42:13

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There is a saying about losing your job—‘it is recession when your neighbor loses his job and a depression when you lose yours’. Considering the trend in initial unemployment

claims, continuing unemployment claims and the unemployment rate, it points towards, at best, a deep Recession and possibly worse. I happen to think this will engulf the Euro-Zone as well, as their symptoms are not terribly different from ours.

## Weekly Initial Unemployment



## Continuing Unemployment Claims (those currently receiving benefits)



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## The US Unemployment Rate



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Another place that deflation is rearing its ugly head is in commodities. Oil seems to have peaked but is likely going to be restrained in a trading range from \$75-\$125. I come to this conclusion by knowing that production has peaked and stayed at roughly 85 million barrels per day at a time when emerging markets will soon have an unending demand for oil. On the other side of the coin, demand destruction

seems to come into play as oil spikes into the \$130-140 range. One commodity that may buck the trend is gold, but I have to confess to being anything but a commodities expert. Since gold does not pay a dividend or interest and because I can buy riskless Ginnie Mae pools at 6% yields, I would rather park my money there. But, gun to head, I would most definitely own gold if I had to make the choice.

## The RJ/CRB Commodity Price Index (in logarithmic terms)



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## Summary—Will Hyperinflation Follow Deflation?

It seems like a foregone conclusion that deflationary pressures are now squarely upon us. Prices are falling in asset classes across the board and the economy is beginning to contract as shown in the list below:

- Stock prices around the globe are falling.
- Credit spreads are blowing out around the globe (lower prices).
- Commodity prices are falling.
- The economy is contracting.
- Unemployment is surging and is likely to continue to surge.
- The Federal Reserve's balance sheet is impaired.
- Real estate prices continue to fall.
- Business spending is declining.
- Commercial paper outstanding is dropping.
- Money market funds are 'breaking the buck'.
- Treasury bill rates are near 0.
- The TED spread (LIBOR – T Bill rates) is at sickening levels.
- Counter party risk has never been higher.

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So, welcome to the world of deflation. The bullet points above seem to coincide with the definition of deflation at the beginning of this piece.

Will we see hyper-inflation after deflation, as is the norm? I have not yet made my decision on this subject as we are not alone in this mess. When countries have isolated bouts of deflation, they usually have to inflate their way out of it. Perhaps we will, perhaps we will not. Or perhaps there will be global hyper-inflation.

At any rate, risks remain high. Perhaps the highest in my career. Can the market bounce on some bailout news? Of course it can, but we will continue to use all rallies as selling opportunities. We remain void of credit risk (although Goldman Sachs debt in the +10% area intrigues me) and void of equities from the long side. We continue to look for a rough 2009 and will likely get short again should the Socialistic short selling ban be removed.

Position in FITB, FITB options.

Bennet Sedacca,  
President

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