

Mon-ey (mŭn'ē) 1. A commodity as silver or gold, that is legally established as an equivalent of all other commodities and is used as a measure of their comparative values on the market. 2. The official currency, coins, and negotiable paper notes issues by a government.

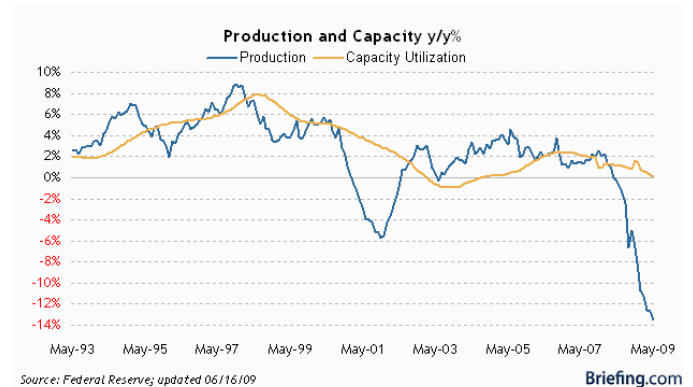
Gold is the money of Monarchs,
Silver is the money of gentlemen,
Barter is the money of peasants,
Debt is the money of slaves.

During the 2nd Quarter of this year markets worldwide rose on the hope that the vast quantities of monetary aid provided by almost every government on earth would bring at least some "green shoots" of growth back to the world's GDP. Over the past five years we have tried to make it clear to you that Cascade views the macro problem as one of massive over-issuance of debt in the US and England, and its subsequent massive mal-investment in unproductive and/or hopelessly unprofitable ventures not only in the US and England's housing market but the manufacturing sector in China.

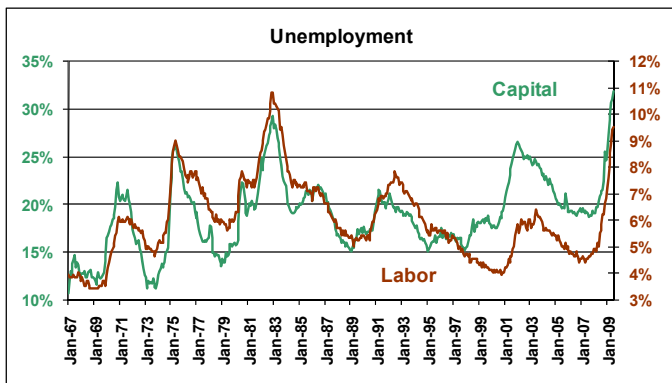
The aforementioned countries are attempting to reflate a hopelessly flawed economic model with the brute force of \$trillions in monetary and fiscal stimulus. During the quarter a serious economic debate started as to the probability of success this program will have and whether or not the major countries in the world actually face future inflation or deflation. The answer will have very consequential implications for your portfolio.

The deflationists are led by Dr. Benjamin Bernanke, currently the head of the Federal Reserve Bank, and proclaimed expert on the Great Depression of the 1930's. He is joined by the bulk of economists who have studied the work of John Maynard Keynes (which has been the almost universal teaching of academia since World War II), and virtually every elected official in the US.

The Keynesian argument (roughly stated) is that government has the obligation to create currency and credit during periods when capacity utilization is low and unemployment is high. During such periods "deficits don't matter". Currently the "output gap" or the distance between what the economy is theoretically capable of producing and what it is actually producing (the spread between the gold and blue lines below) is at its widest since WWII.



Janet Yellon, the President of the San Francisco Federal Reserve last week stated the Keynesian argument eloquently: "Just a short time ago, most economists were casting a wary eye on the risk of deflation- that is that prices might drop, perhaps falling into a downward spiral that would squeeze the life out of the economy. Now, though, all I hear is about the danger of an outbreak of high inflation. I'll put my cards on the table right away. I think the predominant risk is that inflation will be too low, not too high, over the next several years. I take 2 percent as a reasonable benchmark for the rate of inflation that is most compatible with the Fed's dual mandate of price stability and maximum employment....With unemployment already substantial and likely to rise further, the downward pressure on wages and prices should continue and could intensify. For these reasons, I expect core inflation will dip to about 1 percent over the next year and remain below 2 percent for several years...If the economy fails to recover soon, it is conceivable that this very low inflation could turn into outright deflation...But I don't view this as likely. The vigorous policy actions of the Fed and other central banks, combined with sizeable fiscal stimulus here and abroad, have sent a clear message that deflation won't be tolerated." In other words as long as unemployment is high with both capital and labor, prices can't rise.



There is an alternate school of economic thought called the Austrian School with a much different take than Maynard-Keynes.

"This first stage of the inflationary process may last for years. While it lasts, the prices of many goods and services are not yet adjusted to the altered money relation. There are still people in the country who have not yet become aware of the fact that they are confronted with a price revolution which will finally result in a considerable rise in all prices, although the extent of this rise will not be the same in the various commodities and services. These people still believe that prices one day will drop. Waiting for this day, they restrict their purchases and concomitantly increase their cash holdings. As long as such ideas are still held by public opinion, it is not too late for the government to abandon its inflationary policy...But then, finally the masses wake up. They become suddenly aware of the fact that inflation is a deliberate policy and will go on endlessly. A breakdown occurs. The crack-up boom appears. Everybody is anxious to swap his money against 'real' goods, no matter whether he needs them or not, no matter how much money he has to pay for them. Within a very short time, within a few weeks or even days, the things which were used as money are no longer used as a media of exchange. They become scrap paper. Nobody wants to give away anything against them...It was this that happened with the Continental currency in America in 1781, with the French *mandats territoriaux* in 1796, and with the German mark in 1923. It will happen again whenever the same conditions appear. If a thing is to be used as a medium of exchange, public opinion must not believe that the quantity of this thing will increase beyond all bounds. Inflation is a policy that cannot last." Ludwig von Mises.

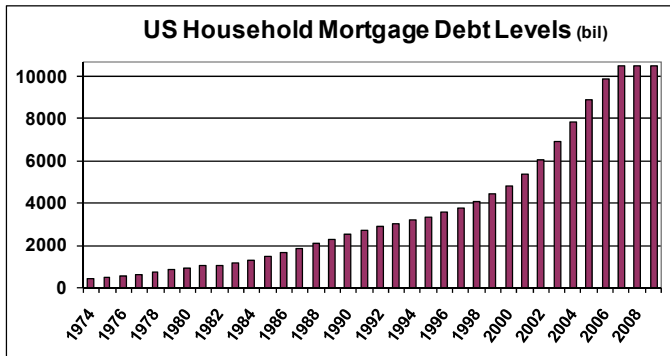
We all learned "not worth a Continental" studying American history, and with the Inflation alarmists drawing grim warnings about America suffering a Weimar style hyperinflation we would like to make a few brief comments about the French inflation of 1790-1796, as we see a few similarities with the current American situation.

In 1789 the French nation was a fiscal mess; it was heavily in debt and faced mounting government expenses and falling revenues. Few people were willing to make loans, and business confidence was very low. The "financial experts" decided that what was needed was to increase the availability of funds to the average person so that they could spend and consume. The country had suffered a ruinous inflation with paper money 75 years earlier under a debt reduction scheme by John Law so there was considerable and heated debate over the idea.

In the end the Assembly was swayed by slogans such as "the people demand a new circulating medium"; that "it will bind the interest of the citizens to the public good", and "we must save the country". It voted to confiscate the lands of the Catholic Church and hold them as collateral for new paper money. The denominations of money were to be both large and small so as to not overwhelm the system all at once. [The assets of Fannie, Freddie, FHA and the now swollen balance sheet of the Federal Reserve compare nicely in scope i.e. about 25% of the national wealth]. In April 1790 came the decree to issue 400 million *livres* [the probable equivalent of the stimulus checks sent in 2009 to Americans]. This money was distributed as *assignats*, notes secured by (formerly church owned) productive property and bearing interest of 3%.

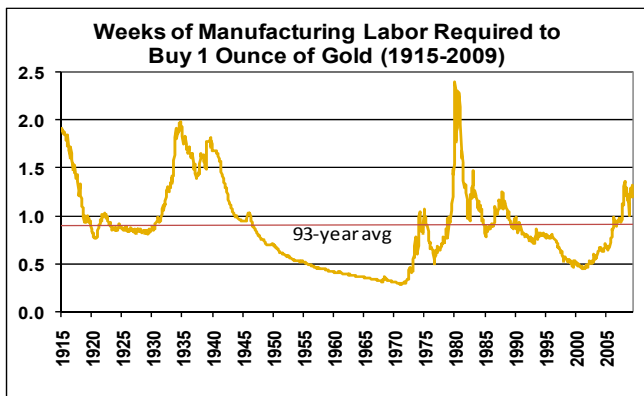
At first all went well. The government paid employees, the money was spent and business revived. But by September 1790, all of the money was spent and business began to slump again. There began a cry for a second stimulus, this time secured by the national lands. This morphed into a scheme to issue enough paper to pay off the national debt (again); let people purchase land and thus retire the currency involved. The debate became exceedingly heated [unlike our present time], and finally 800 million *assignats* were issued, bearing no interest with the plan to burn them as soon as they were used to purchase (newly acquired from the church) land.

Gold and silver virtually disappeared, and once again the economy started to slump. The paper money began to fall in value and with the uncertainty of future value investment dried up and unemployment rose. A large number of people borrowed this new money and purchased shares and property, being encouraged to do the "patriotic" duty [like Fannie and Freddie starting in 2000 offering 125% financing for people who could not afford their homes].



In France [like America 220 years later] this became a huge class of people who depended upon the devaluation of the money to repay their debts in real estate and stock markets.

In December 1791 more *assignats* were issued bringing the total to twenty-one hundred million. They promptly fell from 80 % of face to 68%, and in March 1792 were worth 53%. Thereafter there was a monthly issue of money. The price of everything soared except the price of labor. With the manufacturing sector devastated and unemployment so high, the price of labor remained unchanged [we see gold rising against labor costs now just as then].



Naturally a political backlash ensued. Women in particular joined the Jacobin Club demanding that paper money and specie be made equal. In February 1793 angry mobs attacked and looted stores in Paris and to keep peace the government agreed to impose three ultimately ruinous measures: a Forced Loan upon the wealthy, a progressive tax on income and The Law of the Maximum [wage and price controls ala Richard Nixon] which established the legal price of necessities at one-third the price prevailing three years earlier. All of the lands of Frenchmen who had fled were confiscated. Society remained very violent. The Radicals who had overturned the Royals, next turned on the Republicans then all of the other factions and finally the Robespierrists. In October 1795 an even more radical new government took over called the Directory.

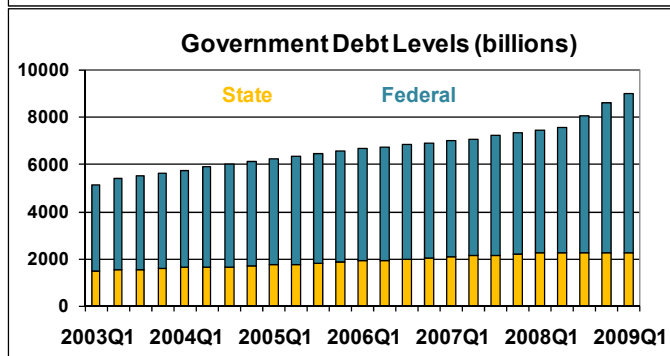
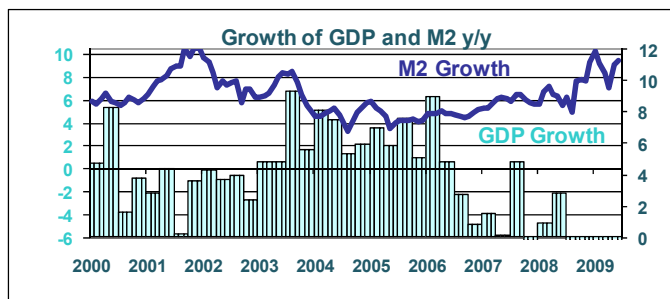
By summer 1796 the inflation had gone hyperbolic just like Zimbabwe in 2006. A new "fully secured" currency was tried called the *mandat* and decreed to be as good as gold. Almost every means imaginable was used to collect taxes and enforce the laws [California legislators should spend this summer reading of their efforts]. This of course failed miserably and quickly. France was financially and morally bankrupt. Those who saw the government's predicament borrowed heavily at the beginning only to repay loans with worthless currency. Almost all of the paper money fell into the hands of the laboring poor who did not have the capacity to buy a business and protect themselves.

Two things ended this sad story: First was the decree in September 1797 that neither *assignats* nor *mandats* continue as legal tender and debts to the government could be settled for a short while at one percent of face value, and that two thirds of the national debt be paid in bonds redeemable in confiscated real estate, with the final third to be "paid as the government thought best". The second was the rise of Napoleon Bonaparte to the Consultanship, at which time he proclaimed "While I live I will never resort to irredeemable paper, and "I will pay

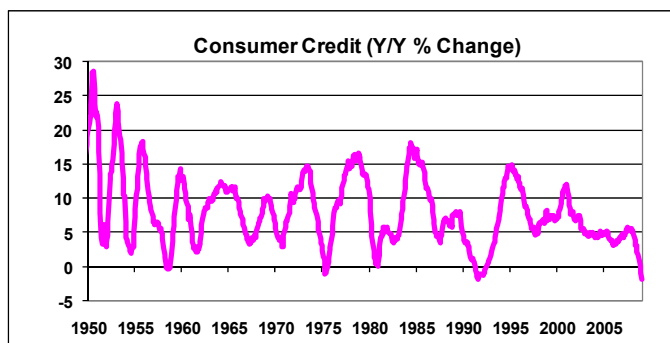
cash or I will pay nothing". He honored both promises ending inflation expectation by immediately returning to the gold standard.

We are not suggesting that America's fate follow the path of 1796 France, nor are we arguing for a return to the gold standard. We are observing, however, that the over-leveraged, over indebted and the under-saved-for-retirement constituency is going to have a growing political interest in maintaining a policy of debasing the currency. The policy of open trade which has hollowed out our manufacturing base is having the same effect on domestic wages as that of 1796 France. Our housing bubble and the enabling lending schemes were premised on the continuing rise in real estate prices, which in turn was premised upon rising household wages. Both assumptions are now proved wrong, and the inability to service household debt will soon be reaching critical mass. Either there will be credit write downs through bankruptcy and/or forgiveness or loan values will be reduced through inflation. Moving bad debts from the private sector onto the public sector via TARP etc. is a temporary measure not a solution. The \$700 billion to bail out the nation's biggest banks and Goldman Sachs in particular has been the most expensive Band-Aid in history, yet the wound is not cleansed or closed. Total debt is still rising.

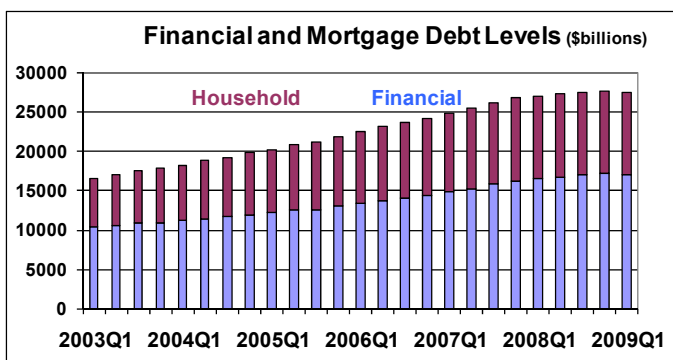
Creating inflation has become national policy. The money supply is growing faster than GDP. Under normal circumstances this would increase the medium of exchange in circulation and commerce would grow.



Transferring toxic assets from commercial and investment banks to the Fed in return for US Treasury notes does not insure that the banks will make loans to insolvent households and businesses leveraged to a now broken American consumption model.



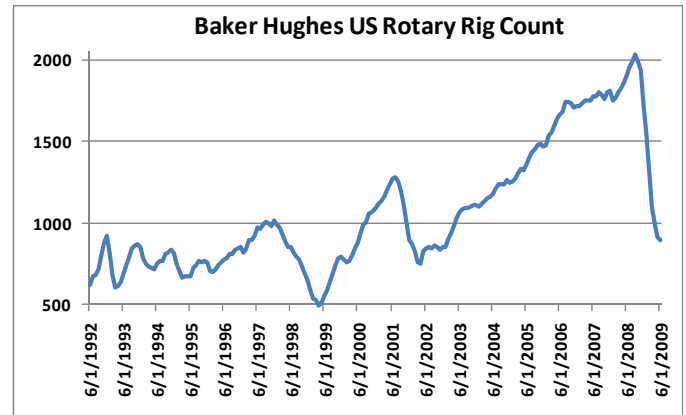
France in 1796 did not have a monopoly on the world's reserve currency, and her financial problems remained within her borders. It is the fate of whoever holds the reserve status that their currency should suffer some inflation. As world commerce increases, so does the need for a transaction currency. The \$US has served the world well as a medium of transaction, and will continue to do so for a long time, but it is becoming suspect as a storehouse of wealth.



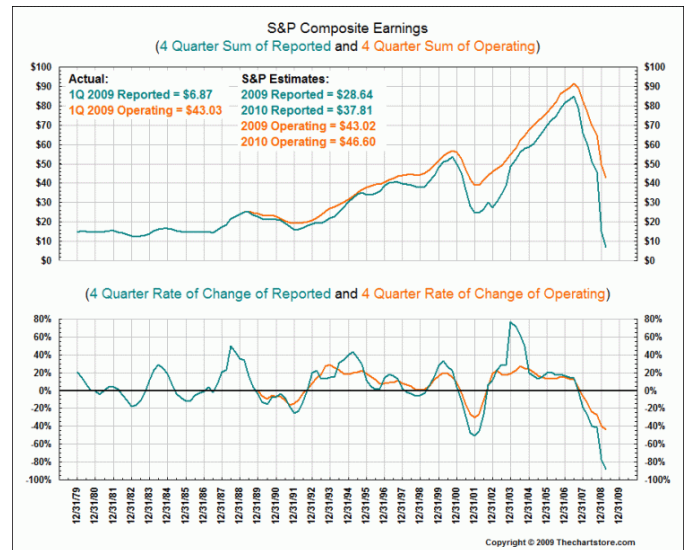
After eight disastrous years of Bush II rule the American public appears to have little intellectual will to debate the extraordinary events of the post Lehman financial structure, and we fear that short term policy failures could lead to the syndrome of the blinded prizefighter flailing his arms like a windmill hoping to hit any object.

If the worldwide slowdown continues there may not be a need for several trillion more transaction dollars, and may in fact be a need for fewer dollars altogether. This poses a dilemma for policy decisions made on the assumption that deficits don't matter. We belabor this to an important end. For the first time since the Chinese revolution in 1949, companies are being allowed to settle debts and transactions with foreigners in domestic currency (yuan), reducing the need for the central bank to continue to hold \$US. And for the first time there are serious voices calling for the end of the sole hegemony of the \$US in world commerce. In a 170 page report by the Peoples Bank of China on June 26, Mr. Zhou Xiaochuan wrote that "When a national currency becomes the global price-setting currency for primary products, the trade settlement currency and the reserve currency, that national currency has great difficulty attending to both domestic monetary policy goals and the reserve currency needs of various countries...and the economic development model of debt-based consumption is most difficult to sustain." In an essay last March, Mr. Zhou suggested that the Special Drawing Right, the IMF's unit of account, could eventually displace the dollar as the principal reserve currency. Not inconsequentially, both China and Russia have reported purchasing large quantities of gold bullion to add to their reserves, and the IMF's Special Drawing Rights are linked to gold. By China asking the IMF to manage part of its members Foreign Exchange reserves, it is clear that a partial gold standard is in the near offing. At the G8 summit last week and India and Russia both reaffirmed their desire to reduce their holdings \$US based assets. Who is going to finance America's debts?

The collapse in energy prices in 2008 brought the easy to predict cancellation of many promising energy projects. This insures that we will have rapidly rising energy costs given any recovery. So far in 2009 the price of oil has gone from the \$30's to the \$60's. Natural gas remains far below the cost of new production, but with average well life only 3 years that will change soon.



The Presidency of Jimmy Carter began to fail when he fell to the political pressure to "immunize" Americans from the rising cost of energy by flooding the system with excess money. The G. William Miller led Fed obliged. Now as then wages are stagnant and average hours worked are declining and unemployment is rising. One in ten Americans is living on food stamps, and a fast rising number need public assistance. How soon will this lead to demands for another stimulus package? And then a third?



In every equity bull market prices rise first, expectations rise second and earnings rise third. Since the March low we have enjoyed the first two. Starting next week it will be "show me" time for corporate earnings and the markets as well. It may get bumpy.

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