

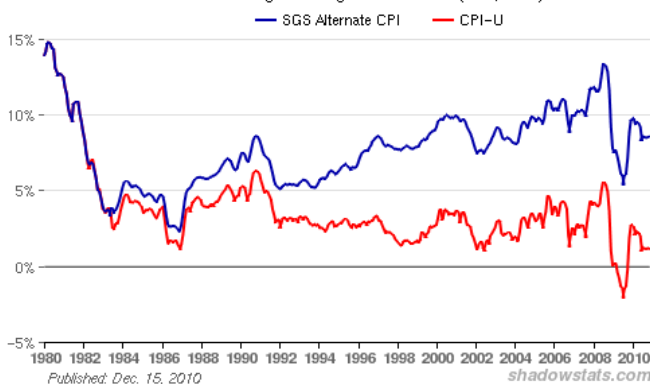
"It is not the certainties that make life interesting; it's the uncertainties. There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things we know that we don't know. But there are also unknown unknowns – the things we don't know we don't know."

Donald Rumsfeld, NATO Conference 2002

In our last Commentary we began a discussion about the collapse of complex societies, outlining possible implications for your portfolio. We started with our view of how the world is becoming more brittle and that with "just in time" inventory management small unforeseen events can become greatly magnified. In this Commentary we will update our thoughts on this theme.

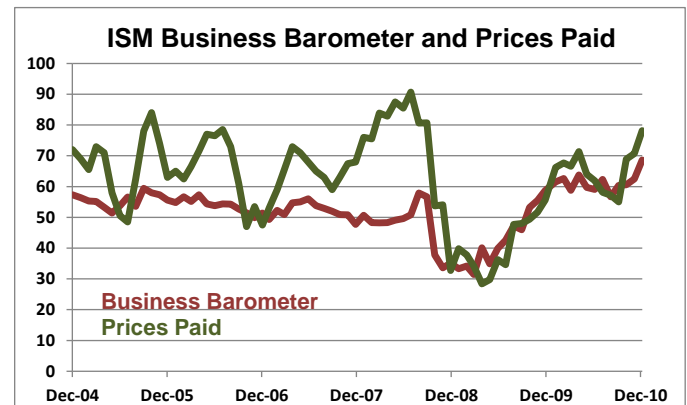
We should start with the Federal Reserve and monetary policy for they are the "things we know that we know". For example we know that the stated rate of inflation as expressed in the Consumer Price Index (CPI) is officially 1.1% (y/y ending November) and that the Chairman of the Fed has stated that this level is "too low". Why is this "too low"?

Annual Consumer Inflation - CPI vs SGS Alternate
Year to Year Change. Through Nov. 2010. (BLS, SGS)



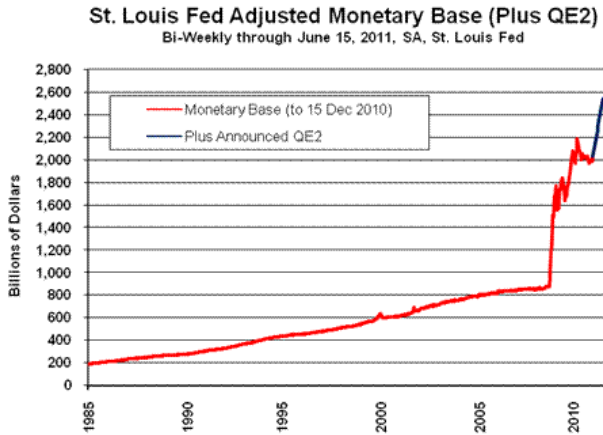
Our recollection of the Humphrey-Hawkins Full Employment and Balanced Growth Act Of 1978 explicitly requires (a) full employment (b) growth in production (c) price stability and (d) a balanced trade and fiscal budget.

The Federal Reserve was given a mandate by that Act to establish a monetary policy that maintains long term growth, maintains price stability and minimizes inflation. So why is 1.1% inflation not price stability? Looking at the Annual Consumer Inflation data, one could hardly give the Fed a passing grade for achieving price stability. Shadowstats' John Williams has followed the corruption of the official CPI and GDP data for years and refers to them "as little more than political propaganda". We have seen a major rise in the cost of energy, food and clothing this year, and the Institute for Supply Management data indicates that prices paid for manufactured goods is rising.

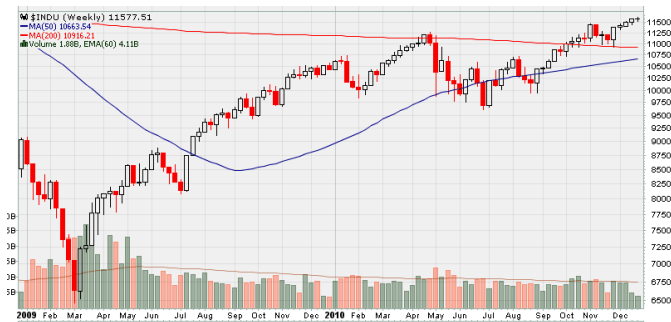


The Bureau of Labor Statistics (BLS) reports that year over year wages grew 2.8% in total private employment and 3.2% in financial activities employment. With so many costs rising how then do we get an official inflation rate of 1.1%? In February 2010, the Bureau of Economic Analysis (BEA) increased the housing component of the CPI to include the "unsampled owners' equivalent rent of secondary residences, raising the total OER component from 23.8 % in 2006 to 25.2% now, and that component fell to -5.1% in November. We suspect that Mr. Bernanke's opinion about inflation relates directly to the drop in value in the housing market and the safety of the mortgages overlaid on these values. We must all remember that the Fed is privately owned by its member banks.

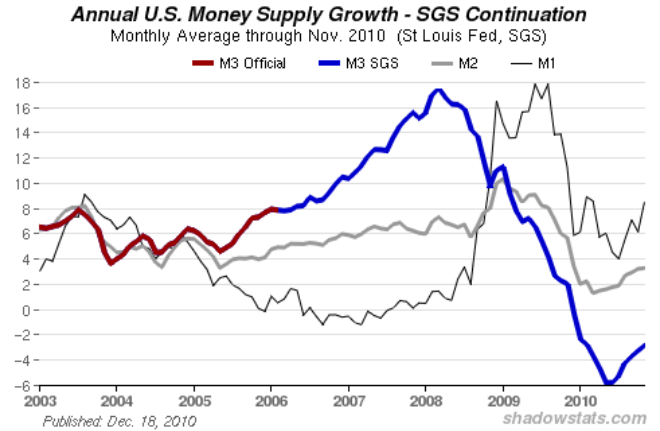
In an act of financial desperation, the franchise holder of the U.S. Congress's responsibility to regulate the supply of money and the value thereof has expanded its balance sheet yet again in a vain effort to get money into circulation. In a quaint conversation on 60 minutes, Mr. Bernanke assured the nation that Quantitative Easing (the outright purchase of assets in the open market) was not inflationary notwithstanding his famous testimony in front of Congress about the "technology" of the printing press.



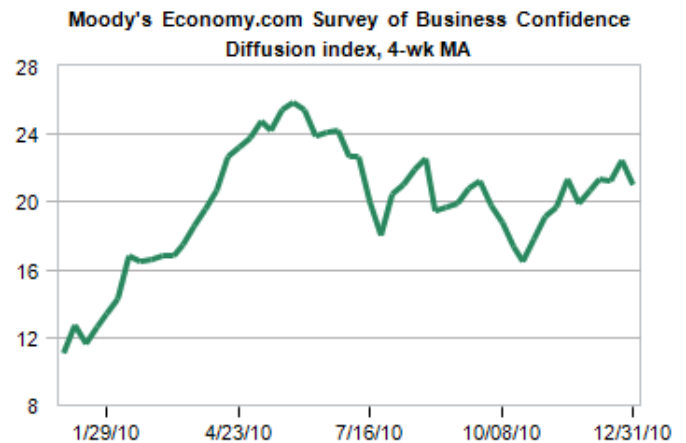
It is a "known known" that the tripling of the monetary base has caused no apparent inflation at the official level, nor has it caused any meaningful job creation. In addition, we know that while the Fed creates money via commercial banks offering loans, they have real trouble controlling how the money is lent. We can divine from the BLS data above that the \$2 trillion of new debt on the Fed's balance sheet has not gone into housing. Where did it go? Clearly some of it went into the stock market despite the public's continuing liquidation of equity mutual funds.



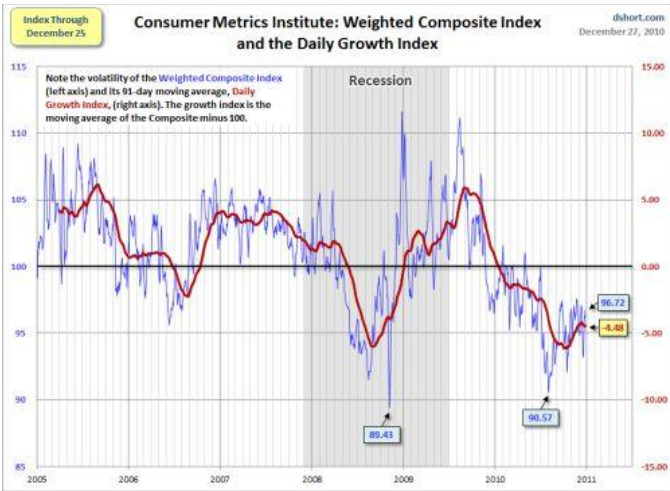
Proof that the ballooning of the monetary base is not expanding lending or borrowing can be seen in the growth of M2 (the sum of cash, checking accounts, savings accounts and retail money market funds). Falling through all of 2009 and into 2010, it has picked up only slightly.



We will follow this closely in the coming months as the ISM data and consumer confidence are rising slightly and if this turns into job creation and bank lending there could be a meaningful upturn turn in the economy and household solvency. Business confidence is the key to job creation, and while businesses are reporting less inventory liquidation and less price discounting, their hiring plans are not rising.

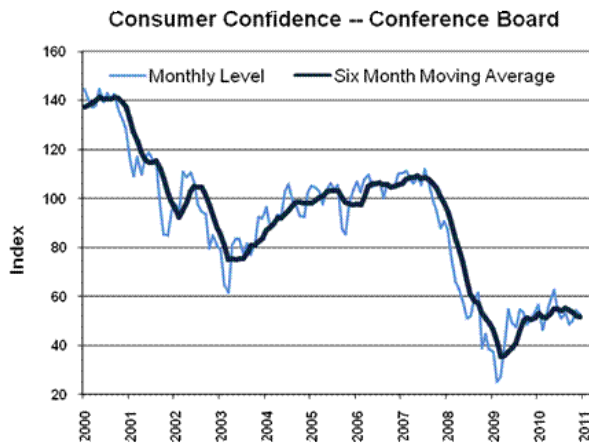


Consumer sentiment is off the low of early 2009 but is still in the area of recessions rather than what we would expect after 18 months of "recovery". We prefer daily private data over monthly private data but both series are telling the same story.



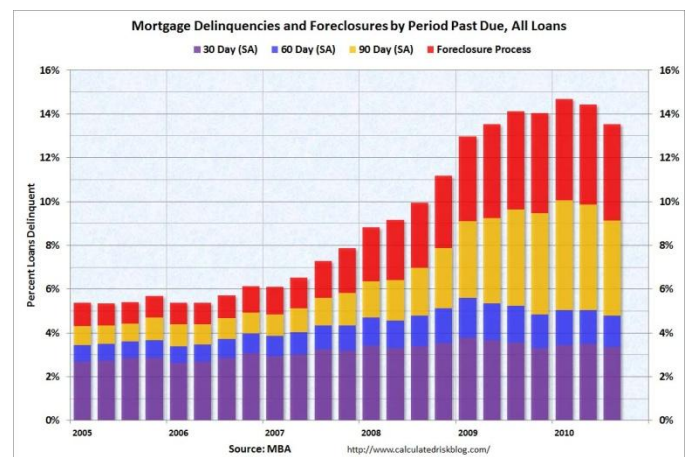
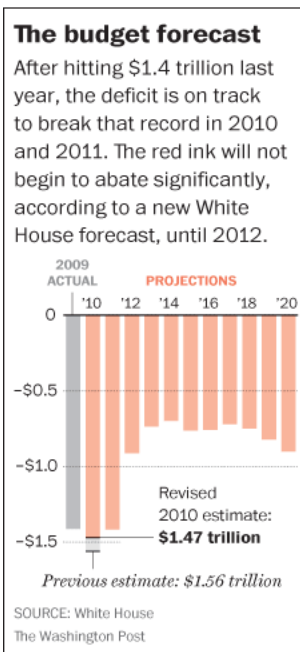
Third, interest rates are being held artificially low to allow banks to recapitalize by borrowing near zero and lend to the government to finance the growing deficit. Last, the fiscal situation at the State and Local government level is deteriorating as home prices continue to fall and real estate based revenue falls with it.

All of this spending only created about \$1 trillion of new GDP, reinforcing the notion that we are at debt saturation, and adding more debt to the US balance sheets does more harm than good. Adding more debt does not solve the existing debt problem. The recent fall in the price of the ten year US Treasury may signal a turn in the appetite for fixed income investors to take long dated risk.

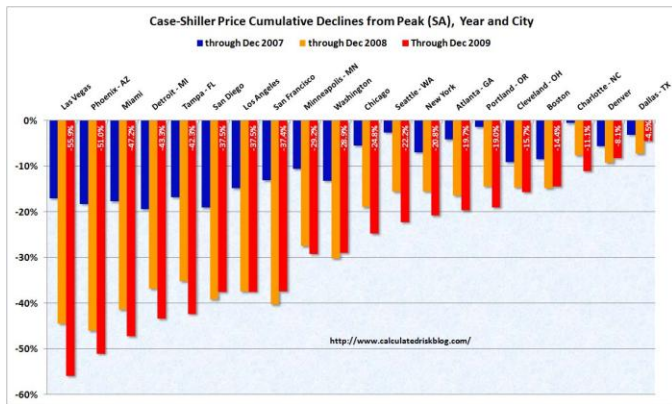


To summarize the “known knowns”: First, the Fed created about \$2 trillion of new debt swapping it for bad bank debt. Second, the Federal budget deficit was \$1.47 trillion.

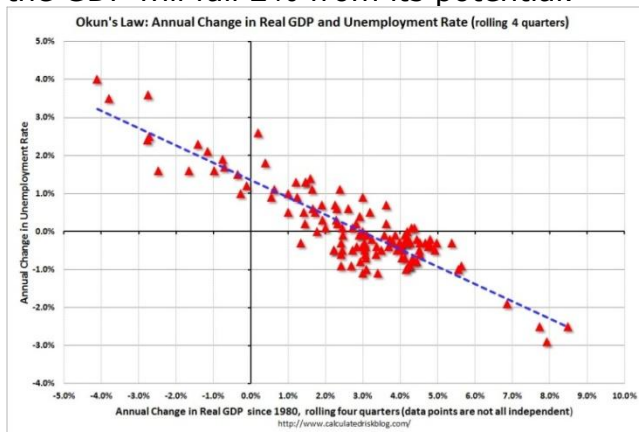
There are three “known unknowns” that we are particularly concerned about: How long will it take for real estate to stabilize, how long will it take for employment to stabilize and how long it will take for public deficits to stabilize. The Comptroller of the Currency reported that the number of homes in some stage of foreclosure is 1.2 million, up 10% from last year.



The S&P/Case-Shiller Home Price Indices show a deceleration in annual growth rates in 18 of the 20 cities covered. The 20 city index is -29.6% from July 2006 and up 4.4% from the April 2009 trough.

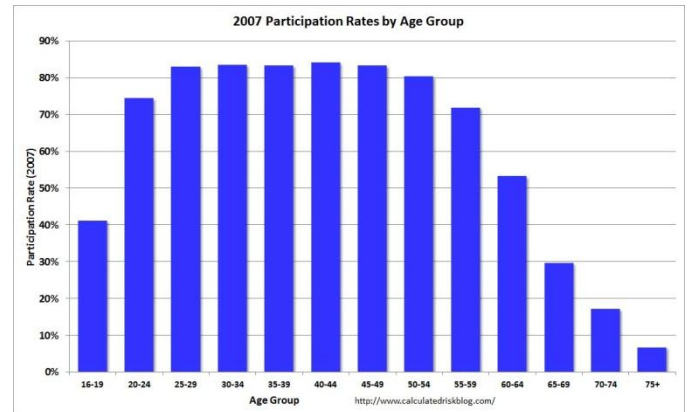


Without substantial growth in the economy, it is very difficult to expect all of the looming foreclosures not to continue to exert price pressure on single dwellings. To get a rough idea of what it might take to stabilize things we look at Okun's Law proposed by economist Arthur Okun in 1962. It states that for every 1% increase in unemployment the GDP will fall 2% from its potential.



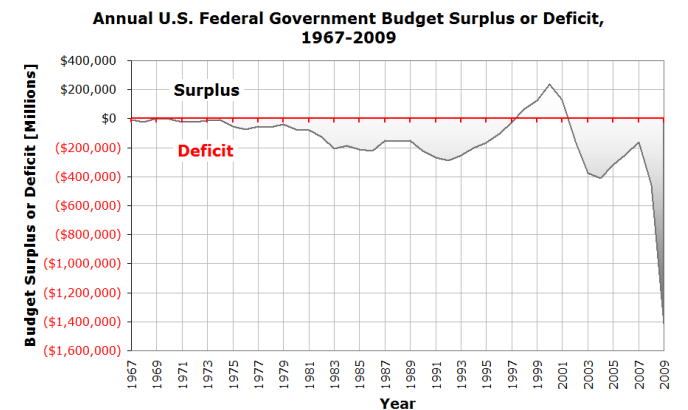
This is sometimes referred to as the "output gap". Historic evidence (see above chart) now suggests that to reduce unemployment by 2% GDP would have to rise by 7%. It is our guess that GDP will rise only modestly in 2011 but that the growing pressure of the declining \$US will cause inflation to rise faster than wages in 2011 and most of the rise in GDP for several years will be inflation.

We are particularly concerned that the U.S. faces a structural unemployment problem that cannot be easily solved. 14.8 million are unemployed and at least as many are discouraged or hopelessly underemployed.



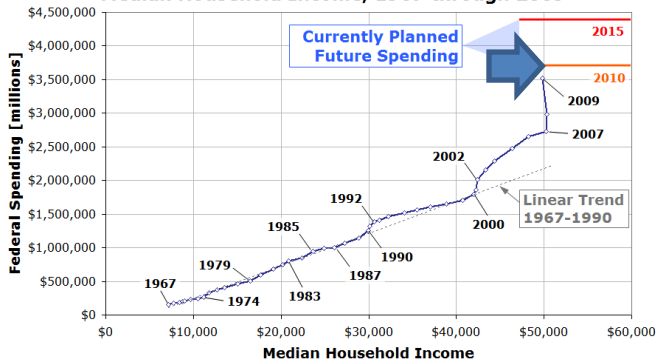
Fewer than half of all Americans have work of any kind, and the biggest unknown is how they will retrain themselves to be self-sufficient in the coming era of rising energy prices and falling government transfer payments. That is a "known unknown".

In our opinion the principal national issue of 2011 is going to be government revenues at all levels, and how they can be stabilized. Current spending is not sustainable.



Sources: White House, Historical Tables, Budget of the U.S. Government, FY2011 © Political Calculations 2010

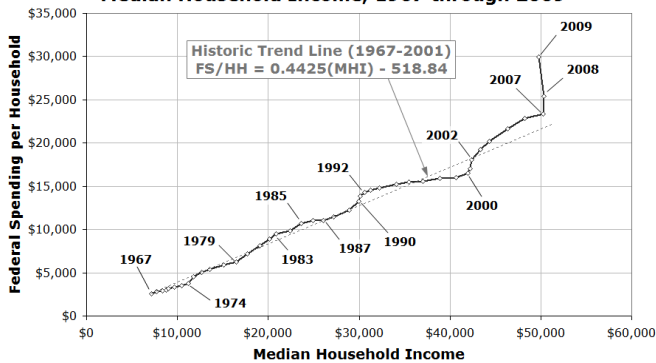
U.S. Total Federal Government Outlays vs Median Household Income, 1967 through 2009



Sources: White House, Historical Tables, Budget of the U.S. Government, FY2011
U.S. Census, Historical Income Data, Households by Median and Mean Income © Political Calculations 2010

The graphic above from Political Calculations demonstrates how far from the long term trend current federal spending has become. The Census Bureau reports that the median annual income of households fell in 34 states in 2009 and rose only in North Dakota. It is likely that income fell in 2010 as well. The large blue arrow shows spending in 2010. The Administration has announced spending plans through 2015 that takes the arrow up to the red line.

U.S. Total Federal Outlays per Household vs Median Household Income, 1967 through 2009



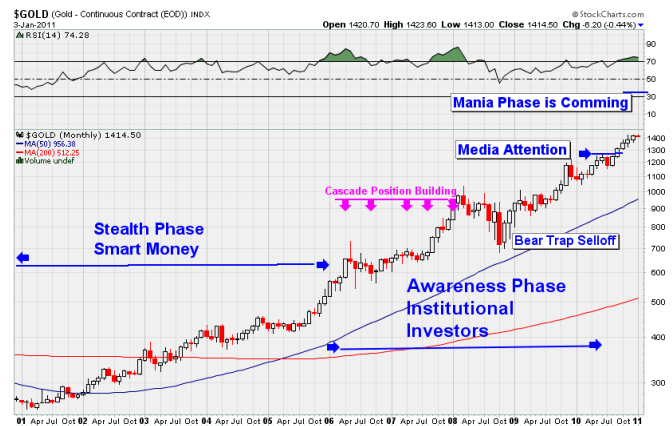
Sources: White House, Historical Tables, Budget of the U.S. Government, FY2011
U.S. Census, Historical Income Data, Households by Median and Mean Income © Political Calculations 2010

Putting this in a different perspective, in 2009 Federal outlays were almost \$30,000 per household versus median income of \$50,000. We estimate that this rose to \$32,600 in 2010, and will rise to \$38,000 in 2015. State and Local spending in 2010 was \$18,180 per household. Do the math. Historically Federal revenue has been between 17% - 20% of GDP and the linear trend in the above chart shows growth at a constant 44.25% of median household income. We are getting further away from what Political Calculations calls the zero deficit line.

Herb Stein (the Chief Economic Advisor to President Nixon) was fond of saying "the unwritten law of economics is if something can't happen, it won't happen". In our opinion, the United States has more government than it can afford, and the spending models presented by the White House Budget Office do not make sense. What part of the model can't happen is unknown. How taxpayers and bond buyers will behave between now and 2015 is an "unknown unknown".

What has been not discussed much in the Mainstream Media until recently is the behavior of gold. In our last Commentary we published a schematic about the course of past manias. In the fourth Quarter of 2010 gold found media attention after rising for ten consecutive years. We cannot think of any other asset that has that record, and our research tells us that the probability of gold reaching a new high in 2011 is strong. Unfortunately, we expect to see the precious and base metals, along with their respective mining companies, experience increased volatility throughout 2011.

If the major "known unknowns" are resolved, and if stability can be found in employment, real estate and government finance, the mania phase may be avoided. For the good of our country, we certainly hope so.



Cascade Investment Counsel, LLC
827 Alder Creek Drive, Medford, OR 97504
541.857.8551 www.cascadeinvestment.com