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We live and work in real time. Things happen quickly and often without warning. Decision making cannot always be reserved for the calm of a laboratory.

On September 29, the Dow crashed 778 points after the House of Representatives voted down a proposed Federal rescue package for troubled financial institutions. Globally, it was one of the bloodiest days ever in the stock market.

There were no guarantees how the markets would fare in the immediate aftermath of this extreme meltdown. On September 29 and 30, we fielded more than a few client phone calls and even had the following e-mail exchange with a client, which we hope will illuminate where the future might be taking us.

As always, we invite your response.

LIVE FROM THE FRONT LINE

September 30, 2008 (i.e., the Morning After)

Dear *DocOnomics*,

Today I was watching the reaction stocks were having to the latest news and watching the reaction of gold. When the market goes up, gold seems to go down. When the market goes down, gold seems to go up.

If you believe the market is going to rise after things settle down, do we get out of gold and ride stocks?

Or do you believe the market will go down further and therefore we stay with gold?

We have to be near a tipping point for stocks. You would assume that when the Government gets settled with its work-out strategy, things will settle back to normal and stocks will begin to regain what they have lost.

Your Client

Dear Client,

We have been tracking gold vs the Dow every day for the last 5 years and have all of the data points in our system. What we can tell you is that gold is much more inversely correlated to the US Dollar than to the stock market. During the past 2 months, the Dollar has come off its bottom and rallied approx 11%. The fury of this rally is suspect but possibly is attributable to a concern that the European Union is starting to crack and that the Euro may be in jeopardy as a viable currency unit. This possibly is causing some big money to shift into the Dollar from the Euro although the Dollar still is a fundamentally weak currency.

Gold should be viewed as a currency in its own right. Gold gets almost no recognition from Washington and Wall Street because it is an alternative to paper assets. Both Washington and Wall

Street sustain themselves via the creation of paper assets and we are now beginning to see the extraordinary corruption within the paper asset system. For this reason, gold is starting to break through the clouds.

If we adhere to fundamentals and recognize that gold is recognized by over half the world as genuine money and is in relatively fixed or scarce supply, it is something that needs to be held as an alternative to paper assets. I think we all can agree that US paper increasingly will be shunned by the rest of the world and will lose its near-monopoly as the global trading currency and international store of value. Eventually, there will come a point where the US Dollar will not be accepted in international trade by many countries and the US will be cut off by many of its creditors. We don't like to think about this but that is what happens to countries that over an entire generation (or two) incur deficits and print money with reckless abandon .

We do not think we are at a positive tipping point for US stocks. The domestic employment situation looks about as grim as we can remember. Disposable income will continue to shrink and credit will remain tight due to tougher underwriting standards. Without a major job stimulus and/or some type of debt relief for the American consumer, the economy will continue its slide. Perhaps these remedies will come onto the front burner after the elections but at what cost? At this point, it is pure conjecture.

To be honest, we think the Federal Government has revealed its hand that it will increasingly nationalize the economy. The financial sector is the model. By now, it should be clear that 6 financial institutions are being propped up by the Government so that failed banks can be absorbed. This ensures that the financial system will continue to function and not collapse into chaos. These 6 financials will come to resemble the old Fannie Mae and Freddie Mac as quasi-governmental companies that are traded on the Big Board but have rigged balance sheets and earnings.

If we are correct, then socialism is about to become a dominant ideological theme and the US will come to resemble Western Europe where many industries are owned or controlled by the public sector because they collapsed and had to be bailed out with taxpayer money. What types of industries? Besides banking and housing (including the possible absorption of homebuilders), we would bet on airlines, automobiles, casualty insurance, health insurance, railways and possibly energy/utilities. The latter will come about if the Government takes equity positions in drilling ventures on Federal lands and in Federal waters.

Last night on Larry King, we heard Paul Krugman say that this election is very similar to 1932 when Roosevelt ran against Hoover and defeated him by a wide margin. Roosevelt then entered office with the economy and markets in shambles. Out of desperation, he made a series of highly unprecedented and controversial moves to salvage the economy. The central theme was putting millions of people on the Government payroll but there were strict controls and rationing throughout the economy.

If this time around really is different from prior economic declines, it would be premature to make investment decisions according to conventional wisdom. The question we need to be asking ourselves is "Can the meltdown that began in 2006-07 be stopped in its tracks by the collective wills of central bankers and politicians (i.e., more money printing) or is it simply too powerful, in which case it will run its course and leave much more destruction in its wake?"

This discussion can go a lot deeper but we are convinced that the people who created the problems are incapable of fixing them. There are too many conflicts of interest (e.g., Secretary of the Treasury Paulson and his ex-employer Goldman Sachs.) There needs to be a housecleaning. That takes us back to the early 1930s and we know how that turned out. It was a good time to be patient and allow the markets to wring out the excesses. If we had to guess, the corrective process will not reach its terminal point for several more years but there will be surprise rallies along the way that will mask the primary trend.

Kind regards,

DocOnomics