Fourth Quarter 2009

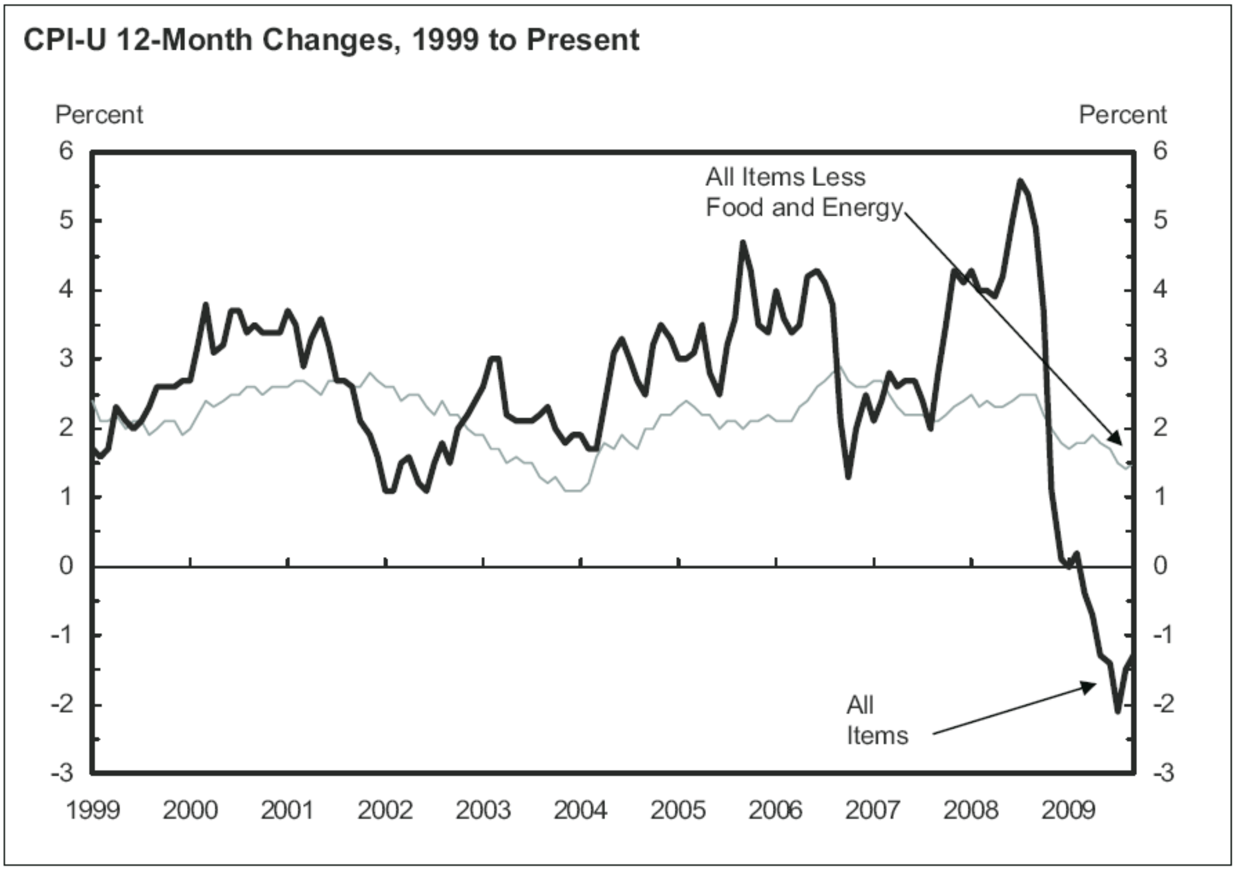
"*Inflation is bringing us true democracy. For the first time in history, luxuries and necessities are selling at the same price.*" – Robert Orben, US magician and comedy writer

The Federal Government has continued the massive fiscal stimulus they began in the latter part of 2008. They have directed hundreds of billions of dollars in numerous programs ostensibly to support the banking, housing, and automotive industries. Naturally, these actions have contributed to a commensurate increase in budget deficits. In addition to the fiscal stimulus, the Federal Reserve has provided large scale monetary stimulus via very low Fed Funds and Discount interest rates along with so-called Quantitative Easing (QE) whereby the Fed injects money into the system by purchasing bonds issued by government agencies.

The broad objective of these policies is to stem the economic decline and eventually spur recovery. To date there is some evidence that the American economy has stopped declining but it is too early to be certain that expansion is underway, in spite of what policymakers and various pundits are claiming. "Less bad", though a normal precursor to recovery, is not a synonym for growth. Certainly the unemployment figures give no comfort, though we remind readers that increases in employment might occur only well after expansion has begun.

Regardless of when recovery occurs, many people are legitimately concerned about a major side effect of the huge scale of fiscal and monetary stimulus: ***inflation***. Some are predicting a significant amount, perhaps on the order of high single digits to double digits for at least a few years. Some are using the word hyperinflation, although for Americans that may simply be high teens like we had in the late 1970's but not the horror of daily price increases experienced in Weimar Germany in the 1920's or more recently in Zimbabwe. Regardless of the ultimate level of inflation, those worried about imminent inflation point to this year's substantial increases in gold, oil, many foreign currencies versus the dollar, and even the stock market as early evidence.

We believe inflation will become a concern for Americans at some point in the next few years, but not presently. Instead, investors must be aware of the continued possibility of ***deflation***, a phenomena not seen in this country for extended periods since the 1930's. Present fiscal and monetary policy is an attempt to forestall deflation, which is a natural byproduct of a credit collapse such as the one that recently occurred. Indeed, the latest release of CPI data from the Bureau of Labor Statistics (http://www.bls.gov/cpi/cpid0909.pdf) contains the chart below that demonstrates the current case of mild deflation. The bond market is also reflecting the possibility of deflation or at least the absence of inflation (its mortal enemy) given low rates across the yield curve.



The economy can withstand a minor bout of falling prices. After all, what consumer does not enjoy prices of things they buy being lower? But too much deflation can lead to a death spiral where discretionary consumer spending not just pulls back but shuts down, debts are repudiated, unemployment skyrockets, and many businesses fail. All of these occurred during the Great Depression.

We fear no such scenario, in large part because much of what occurred in the 1930's was a result of poor policy choices to combat the reality that existed then. (This does not mean we are thrilled with present policy – we are not – but we fully acknowledge the difficult choices and appreciate that many have learned from the mistakes of the past.)

It is possible that Americans may continue to experience slight deflation or mild inflation, at least as measured by the official figures, for some time in the near future. Given the flaws and inherent difficulties in measuring the levels of overall prices, the reality for many may be that some prices will fall a bit at the same time others rise.

We doubt that any amount of reasonably strong economic growth will occur without being quickly accompanied if not preceded by inflation. But we also believe economic growth, whether it has already started or not, will be tepid (and therefore questioned by many) for a prolonged period of time because of the deep injury to the economy, which is one reason why inflation may not be imminent. Regardless of how growth and inflation plays out, we suspect it is anyone's guess as to when broad-based inflation will finally kick in.

> At some point, the existence of slow but definite growth coinciding with noticeable inflation could very well lead to the need to make extremely difficult policy decisions that must choose between growth and inflation on a razor's edge. For now, though, the Federal Open Market Committee "expects that inflation will remain subdued for some time" and therefore current conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period" (http://www.federalreserve.gov/newsevents/press/monetary/20091104a.htm).

In conclusion, we believe inflation will be a concern for investors sooner or later. We are inclined to believe later, but will continue to maintain our vigilance on this and other areas of the present situation, manage risks appropriately, and invest accordingly.

We thank you for your business and take this opportunity to extend to you and your families early Good Wishes for the Holidays!

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