

Dear Investors,

We have recently completed our Quarterly Forum at Armored Wolf where the firm's Investment Professionals reviewed key issues in the global marketplace and identified broad strategic investment themes for the coming months.

### **I. Broad Market/Financial Sector Overview**

Over the past several months, most securities markets (e.g., equities, spread product and commodities) have established a strong counter trend rally. Other barometers of risk such as swap spreads, CDS and the VIX index have also significantly retraced toward their mean. More recently, this resurgence of animal spirits has also spilled over into the financial sector. While bank lending is recovering, most new credit growth amounts to mortgage refinancing ultimately bound for the balance sheets of the GSEs and the Federal Reserve, both of which recently have grown their mortgage holdings more than the traditional banking sector. There are also "qualified" signs of life in certain investment bank services: global M&A registered over \$400 billion in early 2009, now off only 14% year-on-year. Investment grade bond issuance achieved a record \$298 billion in Q1, 2009 whilst issuance in emerging markets, almost exclusively sovereign, also began to return to normal with \$6 billion issuance in the past month.

Most PMs felt current securities markets were ripe for a correction. Nevertheless, it was also felt that any pullback would represent a buying opportunity in selective sectors given that the "Reflation trade" is alive and well. It is strongly held amongst PMs that the US government and the Federal Reserve have shown their colors and strongly prefer inflation to deflation, hence US dollar printing en masse will continue in an attempt to revive the deflated liquidity from the fatally flawed shadow banking system. It is felt that record fiscal deficits, quantitative easing and partially unfunded US Treasury issuance will ultimately begin to debase the US dollar. Such reflation will lead to a weaker US dollar and a steepening US Treasury yield curve. It will also push USD-denominated commodity prices higher, particularly metals and other commodities whose storage costs are low. Such price action would also benefit the commodity exporting countries and their currencies, in particular. Generally, it is perceived there will be a renewed bid for risk assets which, after the likely imminent correction, could advance another 30-40% from current levels.

### **II. Global Macroeconomic Outlook**

Armored Wolf investment professionals briefly reviewed the consensus outlook amongst market investors for the global real economy. This consensus market view, which foresees a recovery in 2010, was critically assessed, contemplating the risks and biases embedded in this forecast. This critical review then served as a backdrop for AW to develop its own, partially non-consensus views on monetary policy formulation in key countries, as well as the outlook for emerging markets and commodities.

Armored Wolf expects an extended downturn, followed by a slow, muted global recovery in which foreign trade and investment flows are slow to recover recent peaks. Within the US, we expect the recession will last a minimum of two years and once recovery appears it will be below trend,

constrained by slowing demographics, lower productivity growth and a persistent, negative feedback loop impeding the real sector due to the impaired credit channel. While fiscal stimulus is historic in its magnitude, it is neither sufficiently front-loaded nor adequately directed to either infrastructure spending or to the household to ensure much near term help.

The Euro-zone and Japan were considered in even worse shape. With a sustainable Developed Countries' recovery some ways off and expected to be tepid, owing to their vastly impaired banking (and shadow banking) systems, it was felt that recovery would first germinate within emerging markets, particularly the BRIC countries. Despite rising NPLs from their slowing economies, the BRIC banking systems remain in better shape, having avoided many of the mistakes made over the past decade in other economies. Despite incipient recovery in these countries, it was felt that their ability to act as a global growth locomotive is limited to a regional network, at best.

Whilst a synchronized global recovery is some years out, once it arrives, it is expected to reveal more balanced growth across the developed and emerging regions. Bretton Woods II is largely impaired so we anticipate seeing slower growth in the OECD and relatively faster growth within emerging markets. This theme fits perfectly into Armored Wolf's investment thesis that incremental demand for energy, commodities and other goods emanates from emerging markets. Trade imbalances should also be less pronounced due to the retrenching OECD consumer. A renewed, larger role for the IMF and other multilateral lending agencies will bolster the weaker regions such as Eastern Europe, the Baltics and FSU. Given our view of a slow recovery in global growth, rising protectionism remains a threat which if implemented would add to inflationary pressures in those countries erecting barriers.

With this macroeconomic backdrop, the AW investment professionals have identified winners and losers: BRICS vs. OECD; commodity exporters vs. importers; domestic-demand vs. foreign-demand driven growth; current-account surplus vs. deficit countries; healthy vs. weak banking systems; countries with adequate access to domestic or external financial resources vs. credit-constrained countries.

### **III. Government Intervention in financial markets**

The US government has initiated widespread and unprecedented intervention in the US capital markets which in large measure has been mirrored in a number of other key economies in Europe and elsewhere. The socialization of private risk has involved guarantees, recapitalization, re-regulation, de-facto nationalization and in some cases outright nationalization. Moreover, this invasive public sector role in private sector business has also in some cases altered long-standing contractual rights, generally accepted accounting practices and security regulations.

Going forward, how will such aggressive government intervention, re-regulation and the erosion of contractual law affect credit intermediation, tolerance for risk taking, the efficient allocation of resources, productivity, relative prices, the sectoral distribution of profits and security valuations?

It seems clear that Washington policymakers at the US Treasury and the Federal Reserve have decided not to opt for a strong dose of Schumpeterian creative destruction. Rather, they are feverishly attempting to piece back together the financial system as it existed prior to the onset of this debacle. Whilst we believe this is a mistake of gargantuan proportion, it is not our job to recommend policy to Washington but rather to fathom the investment implications of the policy stance.

We believe their reticence to limit debt defaults and bank failures will damn the United States to a longer downturn, and a shallower and tepid recovery, if not a lost decade, and further undermine the US dollar as a perceived good store of value. Incipient recoveries are likely to be vulnerable and unsustainable, leading to double-dip or even serial recessions. This is not only due to the zombie banks' unwillingness and inability to lend as they embark on the long road to repair their balance sheets, but also to the reticence of the consumer to take on more debt on their already overly-leveraged household ledger.

Increased taxation, regulation, job loss and weak wage growth will also weigh on the US recovery once it begins. The breadth of the safety net extended by the government to the banks, insurance companies, auto industry, GSEs and other sectors coupled with record fiscal deficits dramatically increases the US Treasury issuance in the face of sated demand for these instruments in some quarters. This holds a material risk of steepening the UST yield curve and/or fomenting further weakness in the US dollar and indeed raising the risk of a full-blown US dollar crisis, which we see as a stronger possibility than most.

#### **IV. What is the outlook for US price trends?**

As a hedge fund manager who is focused on real asset strategies, it is critical for Armored Wolf to have an incisive view on the outlook for monetary policy and inflationary trends. Deflation, Inflation, Stagflation or Hyper-inflation: what is the likelihood, timing and magnitude of these alternate price scenarios and what are the implications for monetary policy, financial asset prices, currencies and other market trends?

Currently, we believe deflationary pressures prevail as evidenced in the US housing market, commercial real estate values, trends in headline retail, wholesale and import prices and the total collapse of money velocity given the rise in demand for cash balances. This downward pressure is not surprising given the rising incidence of debt destruction (i.e., defaults), slowing credit growth, the large output gap in the real sector and the results of the Taylor rule suggesting the Fed Funds rate should be negative 5.5% and that current monetary policy is too tight. It's AW's view that Quantitative Easing has helped mitigate the inappropriately high cost of credit and weak credit growth, but has not been sufficient to restore system liquidity. Thus, more QE is expected which we believe will ultimately reveal the deflation fear as a "straw man" and eventually stoke accelerating prices and pro-cyclical inflationary expectations.

Because the Bush and Obama Administrations have chosen to protect the financial oligarchy by bailing out the largest nineteen banks rather than let some go to the wall through the well established (Chapter 7) bankruptcy process, the American public will pay for this with higher inflation, a weaker US dollar and a lower standard of living. Current policy is committed to continue to flood the system with liquidity for a considerable period and to more deeply commit public agencies to intercede in the impaired credit intermediation process. Whether it is low interest rates penalizing savers and holders of cash equivalents or bonds, a paradigm shift in the perceived value of the US dollar, or some other catalyst, it is inevitable that velocity will eventually mean revert. Once triggered, this is likely to occur faster than the Federal Reserve can effectively sterilize or perhaps even garner the willingness to raise rates and, thus, axiomatically stoke inflation. In addition, prospects for multiple years of profound fiscal stimulus through record deficit spending by Federal, State and Local governments is also pro-cyclical for inflationary expectations.

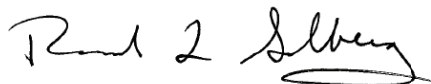
So the US policy bias is to generate inflation and avoid the painful miasma of debt deflation. But will rising inflation or record amounts of new US Treasury issuance in the face of approaching saturation of US dollar assets in key investors' portfolios trigger a significantly weaker US dollar, or even a US dollar crisis? Essentially, we expect the return of powerful inflationary forces over the course of the next twelve months to undermine the US dollar and act as a catalyst for the "Reflation trade". Although the US dollar may benefit from a near-term correction of the risk markets, its longer term trajectory is likely to be driven more by its use as a funding currency for carry trades and also due to a fundamental erosion in the confidence of the Greenback as a store of value than due to a sluggish economy, per se.

We believe the US economy will struggle to achieve a robust recovery which returns it to "trend" growth. This is due to larger-than-usual declines in consumption as the household balance sheet is rebuilt through higher savings, lower leverage and as the negative wealth effect from the stock market decline only slowly dissipates. A steepening yield curve under the weight of record US Treasury issuance and the Alt-A and Option ARM resets scheduled to begin a three-year schedule later this year will also act as headwinds on the economic recovery.

Inflation will return despite a weak economy. Over the next six to twelve months we expect strong inflationary pressures, driven by monetization of a rising portion of US Treasury issuance, a weakening US dollar and the inevitable reversion back to more normal demand levels for cash balances.

A powerful inflationary impulse coupled with a prolonged recession followed by a weak recovery suggests that **stagflation** is the real threat to the US economy on the one-year horizon.

Whilst we believe the current market is very much a trader's market, the palpable risks for incipient inflation and a weaker US dollar mean that we expect another non-USD "melt-up" and thus have a strategic bias to be short the US dollar and US Treasuries, long TIPs , long commodities, commodity-producing countries and their currencies, miners and other resources companies many of which are domiciled in emerging markets.



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