

Today's Notes:

1. This Time It is Different

1. Why Its Different this Time

Chris and I have been very busy collecting data, interviewing company management and presenting to audiences over the past two weeks in Chicago, Denver and Spokane. It is good to be home this week. We are in the midst of a traditional northeastern fall. It is a time when jackets and blazers appear in New York and baseball and football scores cross. Day time temperatures are in the mid 60s. Sleeping is a dream. It's another fall season, like many others in my travels.

In presentations in Chicago and Spokane I tried to make a point. The economic situation we are now experiencing is "different this time." There are two perspectives that dictate my view. First, the longer term horizon is all about Convergence. This is the Great Convergence of lifestyles. It will be a global shift of understanding, learning and quality of life as the world's population expands and connects or so over the next few decades.

We have written on this trend for the past decade and we were first to name it a significant structural uptrend in the world's Quality of Life cycle. The great Convergence will dwarf the Great Depression in its positive impact on a vastly larger population. I am optimistic. The West has lived well above its means primarily through debt issuance (borrowing) but the developing world's balances sheets are relatively clean.

Today we see a great conundrum in both Europe and America on how to handle the excess leverage from the past half century party here in North America. US supremacy, particularly in its ownership of the reserve currency dollar, has had much to do with this. Friday we will hear Lewis Lehrman present here in New York on this issue of the reserve currency dollar. The fiat dollar supremacy, as we have known it, is fading. Long live the dollar!

European leaders are finally coming to grips with the fact that debt in ALL the countries will require a significant "haircut." Greece debt is already in line for 50% plus write-down. And if Greece gets a 50% principal reduction you can bet that Italy, Spain, Portugal and others will be lined up.

This will have enormous impact on European and American bank balance sheets as assets must be written down. This will impact the French banks, though all in Europe will feel the pain. The existence of the single currency European Union is at stake.

Europe's leaders finally seem to be coming to grips with the massive issue of sovereign debt reduction. Here in the United States our Congress still has not dealt effectively with excessive leverage in the economy as eventually they must. Neither the Administration nor Republicans

and Democrats in Congress have seen the light. “All debts must be settled.” They cannot be pushed down the road anymore.

Nevertheless the era of the Great Convergence of Lifestyles will follow on this debt induced economic issues and ultimately a new era of demand will result and it will dwarf recent economic boom. In the interim we must incur the pain of debt reduction and the follow on of Minsky’s Ponzi units.

Minsky argued that debts acquired at the top of the market cannot be repaid in total. They are Ponzi units. Are we ever going to realize this deleveraging?

Today it is very different. The following table shows the most recent recessions and household debt issued during recovery. Beginning with household debt accumulation of 31.61% with the recession and recovery of 1954 there have been 9 “recessions.”

Table 1: Household Debt Increases During Recoveries Following Recessions

Year of Recovery	3 Months	6 Months	9 Months	12 Months	15 Months	18 Months	21 Months	24 Months
2009	-0.056%	-1.010%	-1.510%	-2.040%	-2.540%	-2.740%	-3.220%	-3.330%
2001	2.550%	5.040%	7.690%	10.770%	13.870%	17.520%	20.960%	24.180%
1991	1.550%	2.320%	3.770%	5.240%	6.120%	7.540%	9.300%	10.350%
1982	0.800%	3.270%	6.280%	9.820%	13.250%	16.630%	19.680%	23.500%
1975	0.940%	3.160%	6.190%	9.330%	11.840%	14.770%	18.440%	22.890%
1970	2.300%	3.960%	6.400%	9.190%	12.230%	14.900%	17.870%	21.430%
1961	1.570%	3.450%	5.860%	8.180%	10.600%	13.260%	15.870%	18.810%
1958	1.840%	4.450%	7.530%	10.670%	14.180%	17.460%	21.140%	22.960%
1954	2.290%	5.780%	10.500%	15.530%	20.380%	24.280%	28.220%	31.610%

Source: Wall Street Journal October 23, 2011

As you can see, every recovery, except the most recent, was accompanied by significantly increased household debt. In other words, the US economy has recovered from each of these recessions through issuance of household debt. Mom and pop have enjoyed a great lifestyle thanks, in part, to U.S. dollar reserve supremacy. For example in 1954 debt increased 31.61% after two years into the economic recovery. In 1975 household debt increased 22.89 % over the following 24 months. Increased household debt has been the key to recovery.

Debt accumulation by households has increased monotonically following every recession prior to 2007.

Not this time, though. In the cyclical economic recovery of 2001 when Fed Chairman Greenspan lowered rates and Congress made debt available, we had the largest household debt accumulation since 1954. So the recovery from the recession of March 2001 was replete

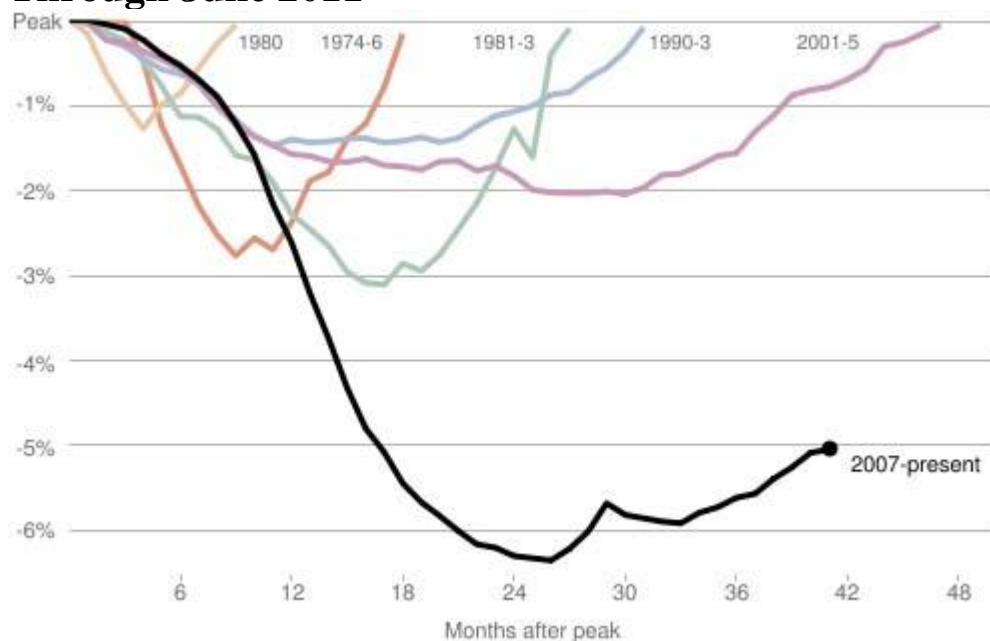
over two years with plenty of household leverage, more leverage than at any time in the previous half century.

That and the inclination for Congress suggest that everyone should own real estate set the fires burning. By September 2001 non-farm employment had recovered as the chart below shows.

But the contraction that began in 2007 is of another class. This is not cyclical in the sense that we believe recessions are part of an ongoing automatic cycle. There are structural issues today that are thorny problems. As Irving Fisher suggested they are based on two central problems debt and the purchasing power of the currency. This is a contraction of economic activity in which has not yet begun to expand.

Table 1, above tells, the real story of our 21st century contraction. Despite the National Bureau of Economic Research announcing the end to the 2007 – 2009 recession in 2009 there has been no household debt expansion in the past two years since NBER's call. Consumers are saving and paying down debt even though their pay down is still minuscule. This is a highly unusual occurrence and strongly suggests that it is different this time. It is defined as the particular economic conditions in which we now live.

Table 2: Non-Farm Employment During US Economic Recoveries Through June 2011

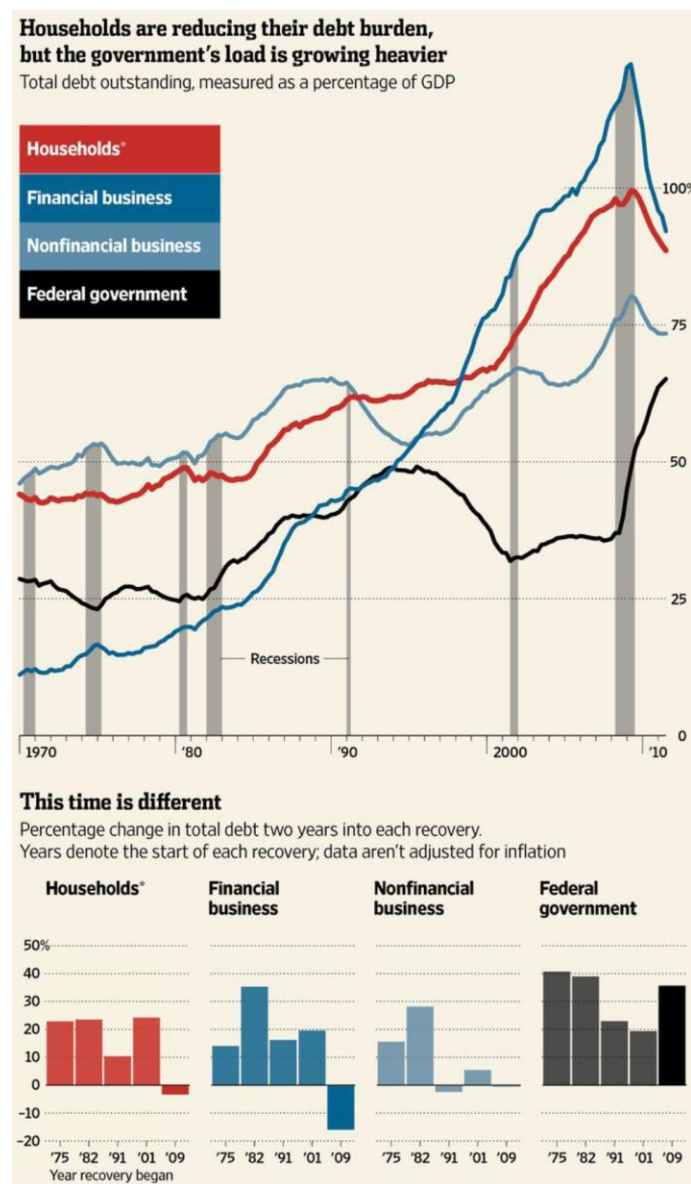


Enter the US government via the taxpayer. The following graph (courtesy of the WSJ) shows the contraction of household debt and the expansion of government debt during the most recent “recovery.” It is dear reader, the Federal Government, not households, financial businesses or nonfinancial businesses that is the lender / borrower of last resort.

We are in a different world today. De leveraging, not re-leveraging, is the key to a new business cycle. That appears to be a difficult realization for our leaders because the de leveraging will be painful and politically anathema – but it must happen. One wonders if

consumer debt can continue to be easily replaced with government debt – particularly with the August downgrade of US sovereign debt.

In any circumstance, we have quite likely reached our overall debt limit and the denouement cannot be far behind.



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