**Beacon Rock Research**

**September 15, 2009**

# Market Commentary

**www.beaconrockresearch.com** **Disclosures 1,2,3,4** **5956 N.W. 213th, Portland, Oregon 97229**

Mike Niehuser, 503-307-3188
mike@beaconrockresearch.com

## Inflation is Always and Everywhere a Monetary Phenomenon

Observation following a tumultuous political summer season: the time honored pattern of a summer correction in the gold price has been broken. Over the last seven years, gold has followed the seasonal buying patterns of China and India. Accordingly, gold prices increase from higher demand beginning in late summer continuing through early spring of the following year, and remain flat or decline until the cycle is repeated.

The gold price actually increased during the late spring and summer months, and is now receiving wider attention from the financial media since it crossed the US$1,000 level. This would suggest that something is superseding the customary seasonal pattern of gold prices. This was not altogether unexpected by anyone paying attention to actions by the Federal Reserve to boost liquidity in the wake of the meltdown of the financial markets in the fall of 2008. The Fed has since taken extraordinary measures to increase liquidity in order to offset the collapse in both supply and demand for credit.

### The Role of the Federal Reserve

The Fed has had limited success in averting crises by increasing liquidity in recent history. Liquidity was increased in anticipation of potential disruptions affecting information systems when the millennial clock struck on Y2K and in the wake of the September 11 terrorist attacks on the World Trade Center in New York City. When confidence of the markets resumed, excess liquidity was drained from the economy in time to avert long-term damage from inflation. With ballooning deficits, one can only wonder when too much liquidity may irreparably harm the economy.

Reported inflation and equity markets in the U.S. appear to be at the mercy of the Fed's open market activities increasing or contracting the money supply. The volatility of the Dow and metal prices appear correlated with Fed actions through 2009. Fed Chairman Ben Bernanke wrote his doctoral dissertation on the Great Depression of the 1930s. His thinking is unlikely to stray from the observation that tight money deepened the crisis, and he is unlikely to allow markets to slip into or remain in a "liquidity trap." As the goal of the Fed is to move the economy toward "full employment," with Bernanke's finger on the monetary trigger, the target of both full employment and stable money is becoming harder to hit as it moves further into the distance.

### Dusting Off Irving Fisher's Equation of Exchange

To understand Bernanke's dilemma, Irving Fisher's Equation of Exchange may provide some helpful insights. The Equation of Exchange is M times V equals P times Q (MV=PQ), where M signifies the current supply of money and V signifies velocity, or the rate at which money circulates through the economy. The product of M and V quite simply must equal Q, or output, which is the sum of all goods and services transacted in the economy adjusted for the price of money, signified as P.

This Information is obtained for sources believed to be reliable, but its accuracy and completeness are not guaranteed. Copying, faxing, replicating, or quoting from this report without permission is in direct violation of copyright laws. Beacon Rock Research employees and affiliates may have positions and effect transactions in the securities or options of the issuers reported herein. Please refer to the company index in the back of this issue for additional disclosures.

Early on it was believed that velocity (V) was constant, but recent experience has shown this to be incorrect, as banks as well as consumers have cut back on lending and spending, while both hoard cash due to decreased financial visibility. The two primary schools of thought weighing in on Fisher are the Keynesians and the Monetarists. The Keynesians correctly recognize the volatility of velocity, but believe deficits and monetary stimulus are essential for avoiding the liquidity trap which may have existed in the Great Depression. Milton Friedman, the dean of the Monetarist school, while early on was incorrect in assuming velocity to be constant, quite correctly recognized that "inflation is always and everywhere a monetary phenomenon," and gold is the time honored hedge against inflation.

## Understanding Divergent School's of Thought May Provide Understanding

The two schools of thought seem to agree on this point but have nearly opposite views on the subject as it relates to the role of money and the mission of the Fed. The current administration and managers of the Fed act in alignment with the Keynesians. Quite certain in their own abilities, they act with complete confidence that they can cure all the ills in the economy (eliminate "unfairness") with open market policies. Given the extraordinary events and direction of the administration, this self-assurance appears to border on hubris.

It is generally accepted that, due to the lags in affecting monetary policy, it may take six to eighteen months for the full impact of an action to be recognized. There are simply too many variables and unintended consequences that must be anticipated. In addition, in the current global economy, the U.S. is now a competitor for capital as well as goods and services, the U.S. economy is no longer a closed system, and the Fed is no longer the master of the world economy.

The Monetarists, lacking the current limelight of the financial media, no doubt remain optimistic in the ability of individuals to make their own intelligent financial decisions. While Monetarists would likely have gone along with a short term infusion of liquidity, it is questionable that they would have supported excessive government intrusion into commerce (banks, auto industry, energy, healthcare, etc.).

Certainly, under the Monetarist's optimistic vision of free markets, the cycles would be more intense, but by allowing inefficient operators to retire, the lifted burden from the economy would have allowed the upward advance of wealth for all members of the economy to continue. In any event, Friedman believed that a stable but growing money supply able to meet the long-term demand for liquidity would be critical to support a growing and efficient economy, or "full employment."

## The Equation of Exchange Demands Either an Increase in Production or Inflation

Fisher's Equation of Exchange, while helpful in understanding the events of the last twelve months, may now provide a clue to the next twelve months. The present situation may be summarized as excess growth in the money supply offsetting slower circulation of cash while excess capacity (unemployment) in the economy absorbs inflation. The U.S. Dollar, while weakening, remains reasonably resilient as the U.S. continues as one of the world's most stable economies (for the time being).

As velocity reverts to the mean, liquidity may emerge either in a growing economy or higher prices with potentially rapidly increasing inflation. Depending on how quickly the economy responds, and influenced by the election cycle, Bernanke will be at a crossroads. Having concluded a Faustian bargain by preserving excess liquidity in the economy, Bernanke has assured his own reappointment, career, and desired legacy as having avoided a second Great Depression. How will Bernanke know when to pull liquidity out of the economy and how much is enough? He may be in the unfortunate position of having fewer tools at his disposal to remedy the situation without upsetting a recovery.

From a Supply Side perspective, promoting an environment friendly to expansion of production of goods and services (Q) may increase visibility and allow money to more freely circulate, absorbing both excess money supply and taking the wind out of inflation. This would require a national policy promoting efficient markets through non-intrusive government activity, such as reducing taxes on the most productive elements of society and pulling back on intrusive non-productive regulations. This was the policy in the early years of the Reagan administration, and growth exploded while inflation remained caged. This proved that economic growth and low inflation may occur simultaneously. Optimistically, this provides a course out of the current situation, but given the current administration's policies, optimism and reality are at odds.

This Information is obtained for sources believed to be reliable, but its accuracy and completeness are not guaranteed. Copying, faxing, replicating, or quoting from this report without permission is in direct violation of copyright laws. Beacon Rock Research employees and affiliates may have positions and effect transactions in the securities or options of the issuers reported herein. Please refer to the company index in the back of this issue for additional disclosures.

The government priority of exerting control over the economy appears more attuned to political careerism than improving the plight of the poor. As inflation pushes more people into higher tax brackets, more "rich" will be manufactured and the tax burden will move deeper into the middle class. This will confirm Friedman's maxim that "inflation is a tax without legislation." The erosion of the middle and entrepreneurial class in the U.S. may, unfortunately, help the government reach its goal of redistribution and equality.

The U.S. is now competing in a global economy. Other nations and their populations, including China and India, become more desirous of holding hard assets and precious metals as a store of value as opposed to U.S. debt and other U.S. denominated securities. A slowing economy will erode the U.S.'s security and leadership role in the world.

## Theory and Reality May Intersect in the Next Twelve Months

The current situation may provide a good case for rapid inflation and exuberance in the price of precious metals fueling yet another bubble within the next twelve months. This may produce an opportunity for traders with close connections and insights of Fed action. In general, one may anticipate that the seasonal factors of increased demand for gold will soften at higher price levels, with the balance absorbed in investment, as less valuable currencies are traded for gold.

While most economists see a rebounding U.S. economy in mid-2010, it is conceivable that if commodity prices increase rapidly, Bernanke may raid and recapture excess liquidity early in 2010. If this coincides with falling seasonal demand in early 2010, commodity prices and metals and mining stocks may be subject to a significant correction, or buying opportunity, depending how you look at it.

Beyond focusing on careers, the priority of the Fed is to maintain "full employment." Clearly, as reported unemployment inches toward 10%, (while understating actual unemployment, or excess labor capacity, is possibly in the high teens), inflation is not yet a pressing concern. This perspective may encourage the Fed to continue easy money policies until it loses its nerve. Clearly, more money with fewer goods produced is inflationary, consistent with Friedman's maxim on inflation, making gold attractive until the Fed pulls back.

An ideal perfect storm is forming for inflation, and the Fed may have difficulty implementing the appropriate remedy at exactly the right time. The volatility may actually favor longer-term investors invested in precious metal producers, or lucky traders weathering dilution in precious metal exploration stocks. Until the liquidity tide pulls back, and seasonal buying recedes, gold and precious metal stocks may see increased demand. Important for investors, the direction of gold over the next twelve months may again supersede or exacerbate past seasonal patterns, quite possibly due to unforeseen and unpredictable actions by the Fed.

This Information is obtained for sources believed to be reliable, but its accuracy and completeness are not guaranteed. Copying, faxing, replicating, or quoting from this report without permission is in direct violation of copyright laws. Beacon Rock Research employees and affiliates may have positions and effect transactions in the securities or options of the issuers reported herein. Please refer to the company index in the back of this issue for additional disclosures.

## DISCLOSURES:

Beacon Rock Research, LLC provides information and analysis on selected companies, with a focus on small-cap and micro-cap companies.

This report has been written in accordance with current SEC regulations and the Standards of Practice developed by the Chartered Financial Analyst Institute (CFAI). Our research has been conducted by employing analytical practices generally accepted as standard within the analytical industry. In this instance, a comparison of financial strength, a bottom-up earnings projection based on a recovery in the U.S. economy, and relative multiples, were employed. Target prices are calculated on comparative EPS, sales and book value multiples, and our knowledge of small-cap markets when enjoying both a sector and a cyclical rebound. Our conclusions are, by the very nature of forecasting, speculative, but are also reasonable, supportable and consistent.
Key to disclosures:

1. The research analyst principally responsible for preparing this research report received compensation based upon various factors, including SLB Equity Research, LLC total revenue.
2. This report was prepared exclusively for the benefit of institutional investors and may or may not receive compensation directly or in soft dollar arrangements.

The analyst, Mike Niehuser, hereby certifies that the research conclusions and recommendation contained herein accurately reflects his personal views about the industry, company and shares and also hereby certifies that no part of his research compensation was or will be directly or indirectly related to the earnings estimates, target price or recommendation about the security.

The research provided herein should not be considered a complete analysis of every material fact regarding the companies, industries or securities named above. The opinions expressed herein reflect the analysis and judgment of the author on the date of publication and are subject to change without notice. Facts have been obtained from sources considered reliable but should not be construed as complete and are not guaranteed to be accurate. Beacon Rock Research, LLC; its members; employees and their families may have positions in the securities covered within the research material above and may make purchases or sales while this report is in circulation. Additional information on the subject companies is available upon request.

### EQUITY RECOMMENDATION SYSTEM:

**Strong Buy** Immediate purchase is recommended. The security is expected to outperform the market over the next six to 12 months.

**Buy** Immediate purchase is recommended. The security is expected to outperform the market over the next 12 to 18 months.

**Hold** Holding the stock is recommended because the share price's appreciation potential is less than or equal to the market.

**Sell** The stock has reached the target price objective and/or conditions have changed sufficiently to alter the outlook for the stock.

### EQUITY RISK SYSTEM:

**High** The security is more volatile than the market and/or the company is more leveraged than its peer group.

**Moderate** The security has about the same volatility as the market and/or the company carries a level of leverage in line with its peer group.

**Low** The security is less volatile than the market and/or the company is less leveraged than its peer group.

### DISTRIBUTION OF RECOMMENDATIONS:

At this time, there are an insufficient number of companies under coverage to generate usable distribution information or draw any conclusions regarding bias about the research methodology. Prospective companies are screened and evaluated by sales personal and research analysts with the investment thesis and overall research recommendation developed before the commission is established.

This Information is obtained for sources believed to be reliable, but its accuracy and completeness are not guaranteed. Copying, faxing, replicating, or quoting from this report without permission is in direct violation of copyright laws. Beacon Rock Research employees and affiliates may have positions and effect transactions in the securities or options of the issuers reported herein. Please refer to the company index in the back of this issue for additional disclosures.