BEACON ROCK RESEARCH

OCTOBER 12, 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

Is the Liquidity Lifting the Dow and Gold Sustainable, or a Bubble?

Record liquidity in the markets has temporarily welded the optimism of both bulls and bears in stocks and commodities. The Dow closed at 9712.28, up 15% in the third quarter, the best quarterly performance since 1998, and up 52% from the March bottom. Gold appears to have stabilized above $1,000 per ounce, the highest level since March of 2008 during the Bear Stearns meltdown. There may be a showdown for stocks and commodities, with High Noon rapidly approaching.

Strong performance in the stock market may be only a reflection of restored confidence in financial institutions. Despite the rapid climb, the stock market may not be overvalued. Market indices have attained only a level of 15x to 17x earnings, which is close to average for the last couple of decades. Full value at this level suggests that a point of equilibrium may have been reached based on earnings expectations for 2010 and 2011, but are these reasonable expectations? There is growing skepticism of a "V-shaped" recovery in the financial media and even whispers that the recovery may indeed be "L-shaped." (Depending on your font type, an "L" may not necessarily turn up at the end.)

Gold, from a U.S. perspective, has appreciated to new highs based on the weakness of the U.S. dollar. From a less provincial point of view, gold continues to perform well overall from a global perspective. The origins of this stem from moving off a gold standard with central banks achieving financial stability by managing interest rates and the international arbitrage of currencies. This has allowed nations in Europe to fund entitlement programs, and in the U.S., fund both the Cold War, the recent Gulf Wars, and as of late, the stimulus and preservation of the global financial system.

It is unsettling that it is not gold that has appreciated, but rather it has been the accelerating depreciation of global currencies that is accountable for this movement. Globally, central bankers, aware of the damage of inflation following their stimulus programs, are ready to increase interest rates. Recently, Australia hiked its rates a mere 25 basis points, sinking the U.S. dollar and sending U.S. dollar denominated gold to new highs. The U.S., on the other hand, has committed to a program of trillion dollar deficits and wealth redistribution to spur growth in climate-sensitive alternative energy solutions. The Federal Reserve is talking tough on raising rates, but the financial media is beginning to hedge its bets. With few alternatives for protection, more bubbles may be on the way.

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 Financial Media is Looking for Inflation Hedges

With gold piercing the $1,000 level and resting easily, the financial press is now comfortable bringing, for investment, options to hedge against inflation. Much space has been devoted to Treasury inflation-protected securities (TIPS). At first glance these may be the safest option to hedge against inflation. These financial instruments are tied to an inflation benchmark and are expected to have a high correlation to inflation.

There may be some issues to be aware of with TIPS. These securities have not been tested during periods of high inflation or volatile changes in interest rates. Returns may actually come up short during low inflation, or if the inflation index understates inflation. Yields on these securities might be subject to demand and supply, and there may be tax consequences for gains on principal as well as interest. While other drawbacks may exist, TIPS may provide more protection against inflation compared to money markets or common stocks.

Gold remains one of the best hedges against inflation due to its high correlation to inflation over the long-term. This is intuitive, based on the expansion or contraction of money relative to a fixed amount of gold. Investing in gold mining stocks may provide additional benefits due to a high beta to gold as they potentially represent increased fundamentals for resource expansion or operating upside. Potential upside when investing in mining stocks contains “company risk,” and stock selection and timing is important.

An increasingly popular and simple means to get exposure to gold as a hedge is through a gold ETF. Some may prefer to own physical gold as a literal store of value to address concerns over confidence with markets and rule of law. While physical gold does not pay interest, currently Treasuries don’t pay much either, and contain a potentially commensurate level of volatility.

Warning! Is the Fed a Paper Tiger?

Fed Officials appear to keep straight faces when offering testimony to the U.S. Congress. One can only wonder what they are really thinking. Certainly they are confident in their positions (potentially their careers) and their ability to withdraw a trillion dollars from the monetary base to avert inflation. The Fed and the Obama Administration, along with the U.S. Congress, have made their bed, and the addition to the money supply is passing the point of being considered temporary.

The question at hand is will the Fed seek to restrain inflation and bolster the dollar with higher interest rates, or will the Fed fund ongoing deficits through monetizing the debt and unfunded entitlements? Certainly, inflation will push more workers into a higher tax bracket through a progressive income tax scheme. In addition, all will pay more with inflation; as Milton Friedman may be quoted, “inflation is a tax without legislation.”

Gold, in its many forms, appears to remain as the best hedge against looming inflation. Despite the apparent direction for gold, there may be significant volatility given Fed actions to fight perceptions of inflation. Beating gold down through raising interest rates, “moral suasion,” or other means is certain, which imply greater volatility.

Fed Chairman Ben Bernanke testified that “There is no immediate risk to the dollar; it’s a relatively long term issue.” He added the following qualifying statement, “If we don’t get our macro house in order that will put the dollar in danger, and the most critical element there is long-term fiscal stability.” Still, he remains “confident that we can manage our policies to support the economy without inducing inflation in the medium term.” In conclusion, he has said, “We are committed to low inflation and we fully believe we have the political tools and the political will necessary to achieve that.” This was a calming statement, but considering improving visibility on the size of the deficit, “political tools and the political will” sounds ominous.

Fed governor Kevin Warsh warned that the Fed could “begin normalization…possibly with greater force than is customary.” Considering the trillion dollars in excess liquidity, it would be shocking and irresponsible if he said otherwise. When combined with Bernanke’s “political tools and the political will” comment, this does imply that a potential shock is ahead for traders or others presuming a steady upward glide for gold prices. Whether or not the Fed is a paper tiger, as long as gold appreciates to higher levels, more volatility may be expected in the near-term due to Fed actions to manage the money supply and blunt inflationary expectations.

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.

Equation of Exchange Suggests Inflation Ahead Through Lost Production

Irving Fisher's Equation of Exchange (MV = PQ) warns that inflation is possible even without an increase in both demand and supply of credit or increased consumer confidence (increased circulation of money, or Velocity). It is logical that with the Fed significantly increasing the money supply, if velocity should increase and reserves multiply increasing liquidity, either higher production (Q) or inflation (P) on the right side of the equation would follow. The most frightening parallel of the current downturn with the depression of the 1930s is that inflation did exist due to ample liquidity not offset by increasing production.

If the equation holds, and optimistically the Fed shrinks the money supply and seamlessly offsets increased circulation of money (Velocity), without an increase in real production inflation is a given. In reality, lending and confidence appear muted by precarious attitudes toward jobs by the employed. Even the employed are universally familiar with those who have either lost their jobs or whose wages have been squeezed. Analysis of small business activity, while not showing up in marquee financial indicators, may be at the heart of an anemic recovery.

The Fed is now at risk of taking the fall for failing to achieve its primary mission: to promote price stability and full employment. While the Fed has influence over reserves and lending regulations, it does not create jobs. It is generally accepted that small businesses and entrepreneurs are the backbone of economic development, the source of future innovation, and the creators of wealth in the U.S.

Stock Market Performances Obscures Crisis for Small Business

Blame for the economic downturn in 2008 may be attributed to Congressional neglect and failure of the capital markets at the highest level. While this was beyond the direct responsibility of small businesses and individual workers, they unfairly continue to bear the brunt of the folly. These innocents are outside of the protection of the government's "Too Big To Fail" doctrine or governmental stimulus for non-governmental organizations. Wall Street, with friends in high places, is on the rebound, but the impact on Main Street or Back Street may present an unappreciated drag on the recovery.

The purchasing managers' index of manufacturing activity prepared by the Institute for Supply Management indicated an increase to 54 in September from 52.9 in August. An index greater than 50 indicates a potential expansion in the factory sector. This seems to be consistent with inventory replacement and increasing exports, which would provide assurance to the stock market. The index may overstate the strength of the economy as it surveys midsize and large manufacturers with greater access to credit than smaller manufacturers.

Small businesses employ about 50% of the workforce and contribute 38% of the GDP in the U.S. About 80% of small businesses depend on credit cards as a vital source of funding, and an equal percentage find this source of funding has been decreased materially. Credit card lines have been reduced by 25% since 2008, and by about $1.25 trillion over the last two years. Some industry experts anticipate this will be reduced by an additional $1.5 trillion by the end of 2010. Also, home equity lines of credit have become problematic as a source of credit, with close to a third of the homes in the U.S. worth less than their mortgages.

Governmental Stimulus May Not Trickle Down to Long-Term Unemployed

The well-publicized September jobs report indicated a loss of an additional 263,000 jobs in September. This marked 21 consecutive months of job losses, increasing the unemployment rate to 9.8% from 9.7% in August, to the highest level in 26 years. Temporary workers, an early indicator of increasing demand, were also down for 20 months in a row to the lowest level since 1995. An estimated 7.2 million workers have lost their jobs since the end of 2007. The official total number of unemployed is now 15.1 million.

For the first time in 30 years, more than a majority (54%) of the unemployed are not temporarily but permanently out of work. The proportion of those unemployed longer than 6 months increased to 35.6% from about 33% in August. As the labor force declined 571,000 in September, increasing unemployment suggests that some workers have given up trying to find work, thus swelling a growing number of unreported long-term unemployed.

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 increasingly competitive labor market currently benefiting Wall Street has had a most dire impact on Generation Y. Overall, the unemployment rate for teenagers is 16% above that of adults. Teen unemployment increased to 25.9% in September, the highest rate since WWII, up from 23.8% in July. The most unfortunate demographic was black male teens, which increased to 50.4% in September, up from 39.2% in July. Teenagers are five more times likely than adults to earn the minimum wage. An argument can be offered that minimum wage laws meant to help provide a "living wage" have reduced the demand of unskilled labor by setting an artificially high price. This increases the numbers of unemployed and presents yet another challenge to small businesses.

Interestingly, about 330,000 teens have lost their jobs since a minimum wage of $7.25 per hour took effect in July of 2009. Congress raised the minimum wage to $5.15 per hour in July of 2007. Since that time, there are 691,000 fewer teens working. This would support studies that the least skilled and the young are penalized when the minimum wage is increased. While minimum wage jobs are generally considered "starting wage," most get raises within a year on the job. The most perverse loss in fewer teens working is not the loss of tax revenues but the loss of useful work experience. Teenagers that don't work tend to have lower long-term wages and less employability for longer terms.

A reduction or elimination of the minimum wage would stimulate the economy by moving demand and supply of labor to equilibrium. The experience gained by teenagers on the job may provide valuable education "tax free" to the public while increasing the nation's human capital. The increased business activity would increase production relative to liquidity which would be anti-inflationary. Considering recent announcements to spend millions of stimulus dollars on at-risk youths in Chicago, the repeal of minimum wage laws may be one of the simplest, long-lasting, and most cost effective policies not up for consideration.

The U.S. Congress is now advancing a second stimulus plan to maintain payments for 65% of the cost of health insurance policies under the COBRA program. They are resisting the call for an extension to be a second stimulus plan, as it may suggest growing insolvency of the economy. Presently, only about 60% of the initial $787 billion stimulus package remains unspent, not obligated to projects. Some consider the money unspent and not obligated to appear as a political "slush" fund. As payrolls are cut, the $787 billion stimulus program may grow to over $900 billion. Extending the unemployment benefits through 2010 may cost $100 billion.

Wall Street may find out sooner than later that increasing the labor force and reducing unemployment is important for increasing confidence and consumer spending. Factory orders increasing inventories above base levels is essential evidence of a growing economy. It is also important to absorb excess liquidity and avoid inflation. Not least important is that increasing employment and spending raises taxable income and the tax base.

Employment Crisis Spilling Over to Government

The economy is still anemic outside of temporarily stimulated sectors such as autos and housing. These efforts may have sustained confidence but may be short lived as they have cannibalized future sales. Construction, manufacturing, and professional and business services are down big, 8% to 20%, since the beginning of the recession in 2008. Mining and logging are down 4.7%, or flat.

Health care and social services is the only sector up in September and since the beginning of 2008. Government, utilities, and educational services, all up since the beginning of the recession, were off in September. Interestingly, Government was a big loser in September, erasing gains made since the beginning of 2008. While it has been said that "a recession is when your neighbor loses his job" it may be a depression is when a bureaucrat losses his job.

There has been an alarming drop in Federal, State, and Local tax revenues while expenditures escalate. Falling business profits and consumer confidence have put a crimp on income and sales taxes. At the local level, falling real estate values have reduced the tax base and lowered property taxes, often a major source of funding. Alaska's state tax revenues declined 72% in the first quarter of 2009. All other states but five suffered declining revenues. Of the five enjoying an increase, Wyoming experienced the greatest increase of 19.8%. The pain was fairly evenly distributed across the lower 48 states and Hawaii.

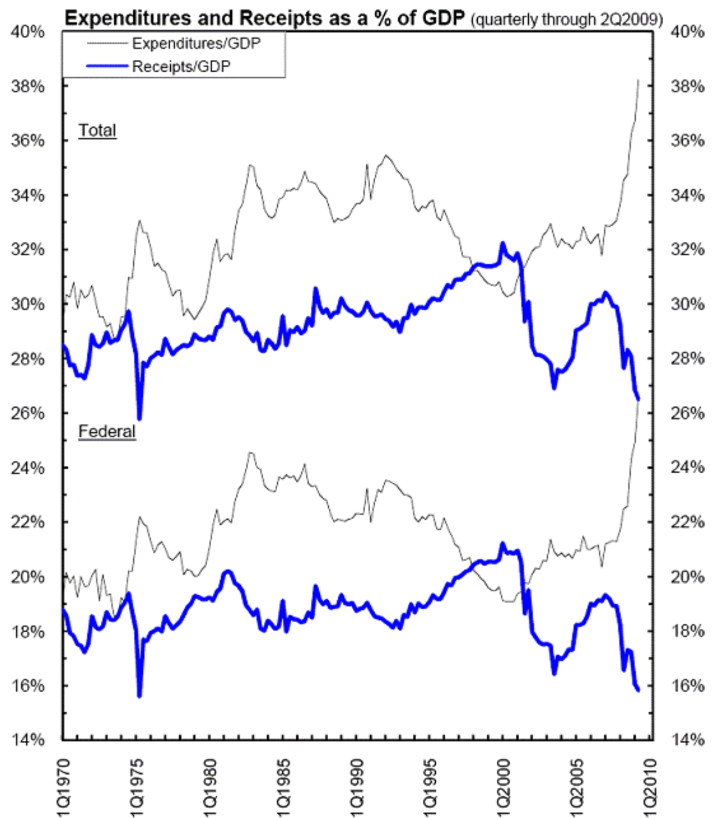
This Information is obtained for sources believed to be reliable, but its accuracy and completeness are not guaranteed. Copying, faxing, replicating, or quoting from this report without permission is in direct violation of copyright laws. Beacon Rock Research employees and affiliates may have positions 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 decline in government revenues was brought on by a sluggish economy and growing ranks of unemployed. States unable to print money (save California printing IOUs) will be forced to either increase taxes or reduce spending to balance their budgets. There is the looming prospect that states may abdicate their independence by soliciting assistance from the Federal government, as states may also be considered "too big to fail." Failing to accept fiscal responsibility at the state level by accepting Federal assistance is inflationary, and a potentially ominous permanent expansion of the Federal government. In any event, with increasing budget deficits, it is difficult to imagine a situation where the government would not immediately look to increase taxes, which would reduce output and produce inflation.

Looking Ahead: Who Makes The Golden Rules

U.S. Senator John Thune (R – South Dakota) recently made the claim that the federal government now owns 600 financial institutions and banks, two automakers, an international insurance conglomerate, and other businesses. While stopping short of a comparison to fascism, clearly the U.S. President now has unprecedented control, unthinkable by previous administrations, by consolidating power of independent public companies, and is in a position of directing their activities. Sen. Thune is arguing for winding down the TARP by the end of 2009.

The way in which the U.S. Congress handles unspent stimulus funds or an extension of TARP should be instructive for those pondering bubbles in the stock market or commodities. Sen. Thune argues that about $300 billion available to TARP that has not been deployed should be applied to reduce the deficit. It may be argued that failure to do so may signal either expected difficulties in banks deemed less than "too big to fail" or a design to maintain a slush fund to meddle in the market. In either case, extension of TARP in its present form with undedicated funds is inflationary, and even worse, may be an indication that markets in the U.S. are now less free and less attractive due to erosion of the rule of law. This would make the U.S. stock market less attractive relative to owning physical gold.



Source: Laffer Associates

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.