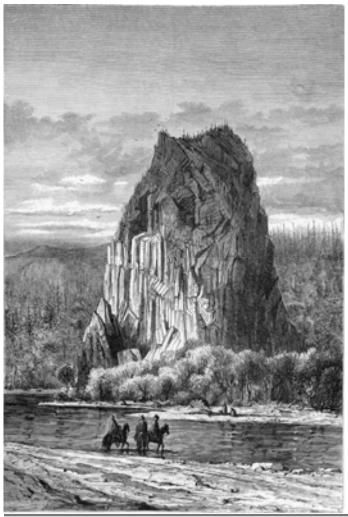

BEACON ROCK RESEARCH

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MARKET COMMENTARY

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

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

Gold Price Spike Says it's Not All About U.S.

The jump in the price of gold Tuesday to a record $1,083.30 per ounce, following the announcement of the $6.7 billion sale of 200 metric tons of gold by the International Monetary Fund (IMF) to India's central bank, should serve as a clear indication to U.S. investors that they are no longer the center of the economic universe. It is evident that occupants of closed systems become more unstable over time. This includes investors within the United States, and potentially more important, the occupants within the Beltway in Washington D.C.

The danger is that as those in the bubble become detached from the realities of their external environment, they will find themselves increasingly jeopardizing their ability to survive on their own terms. U.S. investors would do well to ponder yesterday's move in the price of gold, the direction of the global economy, and the alignment of government policies in the U.S. An independent and thoughtful analysis of the times may be more important than ever.

The jump in gold on a day when the dollar rose against foreign currencies should not suspend the case for gold as a hedge against further devaluation of the U.S. dollar. The move relative to the U.S. dollar is not too surprising, considering the purchase by India's central bank was one of the largest sales in history. Interestingly, the sale of gold by the IMF was anticipated, but it came as a surprise that the buyer was India and not China. India and China can be seen as competitors for hard assets as world currencies, particularly trading currencies such as the U.S. dollar, may become gradually less important. Both India and China cannot be faulted for wanting to diversify out of U.S. Treasuries and into gold considering their relatively low level of gold to foreign exchange reserves of only about 6% and 1%, respectively.

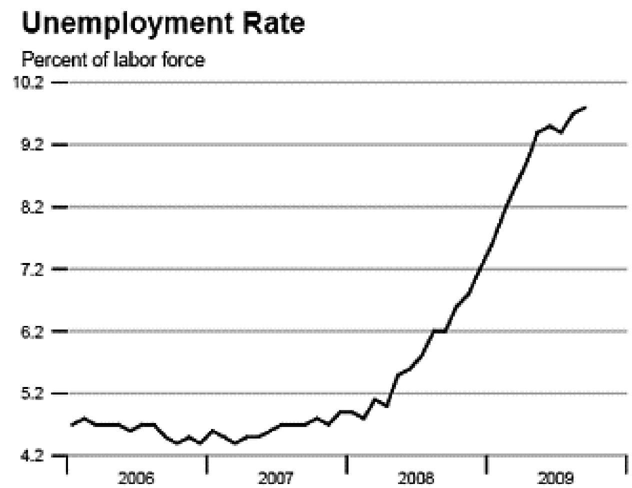
It is becoming increasingly apparent that central banks and foreign investors are looking to diversify away from holding U.S. government securities and U.S. denominated financial instruments. The U.S. economy is not showing the requisite strength to satisfy government spending even without the looming cost of health care reform. While businesses and households in the U.S. are deleveraging (hoarding cash, increasing savings and reducing debt), the U.S. government appears to be its own perpetual-motion crisis-generating cash machine. Even countries such as Venezuela are entering currency markets to support the U.S. dollar in order to sustain their ability to maintain their exports. Actions by foreign central banks are temporary and ineffective compared to stable domestic and monetary policy.

Accommodations by foreign central banks are simply protecting their own domestic constituents while managing a seemingly indifferent U.S. on its way to oblivion. It would appear that the last line of resistance to the U.S. government proceeding down that path of excess, and the brutal judgment of global currency markets, would be an independent Federal Reserve refusing further accommodation by absorbing new Treasury issues or allowing interest rates to rise. At some point, domestic and foreign investors will get their fill. Current meetings of Fed presidents may provide some indication of direction. Certainly, gold bugs should fear real or perceived threats for interest rate hikes as they will likely inflict even greater volatility into gold price movements.

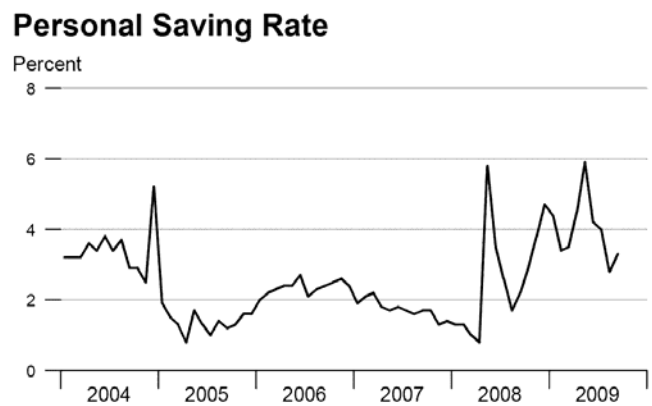
Reported GDP Last Hurrah for Stimulus Program Credibility?

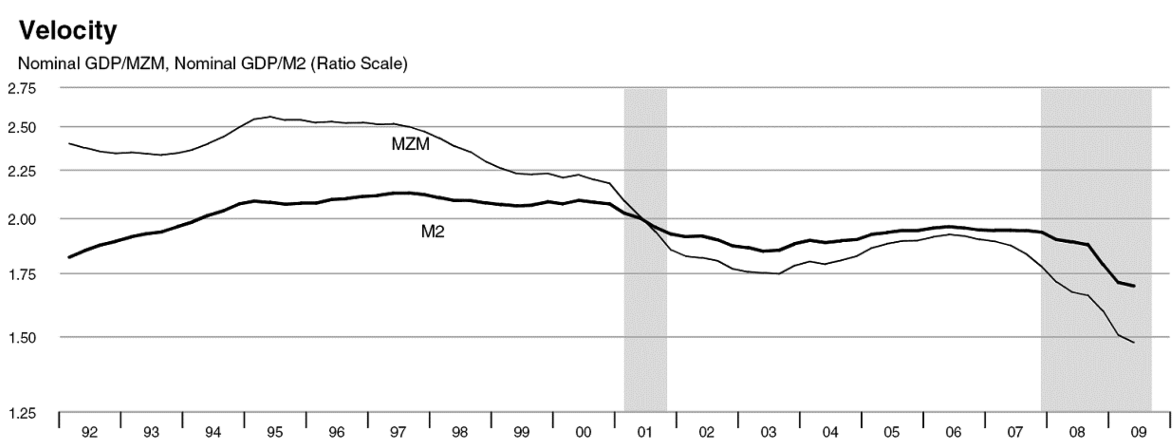
It is too early to start back slapping over a confused 3.5% U.S. gross domestic product (GDP) for the third quarter of 2009. Only a climatologist could be capable of making the necessary adjustments for government stimulus necessary to complete that calculation. While investors appear relieved as much as pleased, optimism is anything but universal as government policies, actions, and conduct insert significant uncertainty into the recovery.

A new economic metric was produced for "jobs saved" to help the masses understand the stimulus program. Interestingly, the complimentary calculation of "GDP without stimulus" was conspicuously absent. The beneficiaries of the stimulus program include an estimated 300,000 teachers and 80,000 construction workers. Actual non-government/non-stimulus related job creation should be weighed against the burden of paying off the debt created. There may be no clear path to reduce this burden without inflation or transitioning to European-style taxation. In the meanwhile, the media's near silence about the growing ranks of unemployed (now over 15 million) when compared to past lamentations over homeless individuals, brings to mind a quote by Joseph Stalin that "one death is a tragedy, a million is a statistic."



The U.S. economy is to be congratulated for not rolling over in the face of the greatest economic challenge in a generation. Reductions in household debt and efforts by small businesses to keep doors open speak volumes for individual responsibility and the entrepreneurial spirit in the United States. As a matter of survival, both households and S&P 500 corporations are hoarding cash at record levels. Despite the creation of record monetary reserves, the circulation of money (Velocity) has slowed significantly, resulting in low rates of inflation. Should non-stimulus related GDP (Output) fail to materialize before cash starts moving through the system, without an increase in interest rates, inflation and higher levels for gold are more or less certain. Coincidentally, U.S. consumers and investors may find their "hoarded" currency not going as far overseas as before.



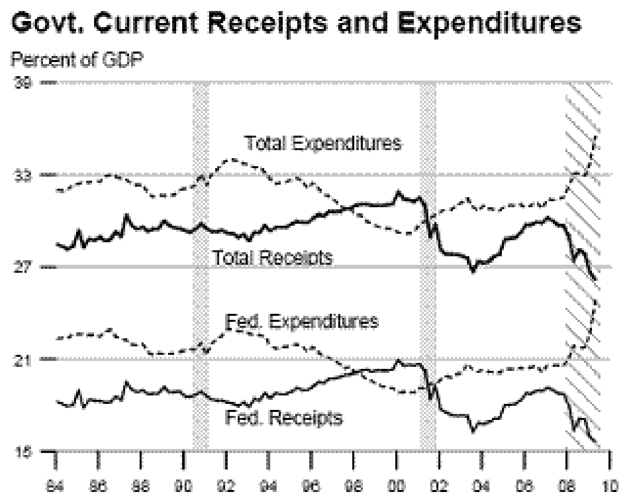


Source: Federal Reserve Bank of St. Louis

Questionable Mid-term Grade on the Stimulus Program

Treasury Secretary Timothy Geithner unflaggingly defended the stimulus program on the Sunday morning news hour *Meet the Press* on November 1, 2009. Geithner appeared sincere in his position that the downturn would have been much worse without the stimulus program. He was generally correct that half the money in the program had been reserved for 2010, in time for the mid-term election, and he presented a reasonable argument that it was too early for the administration to abandon the program. There could be no confusion that there is no “Plan B” by the current administration to reverse course, and that unspecified “hard choices” would need to be made to figure out how (and who) would pay for it.

More than 1% of the third quarter GDP came from auto sales. This is believed to be due in part to the overly publicized “cash for clunkers” program. Questions persist over concerns that the program cannibalized future sales and promoted purchases of foreign automobiles. It is more difficult to estimate the impact of the $8,000 federal tax credit for home buyers. These credits benefited a narrow slice of the population who were in the market for a home and in the position of making a long-term rather than a shorter term decision such as buying a vehicle. Christina Romer, president of the White House Council of Economic Advisors, said that without these stimulus programs “real GDP would have risen little, if at all, this past quarter.”



Source: Federal Reserve Bank of St. Louis

While some non-government job creation may have occurred, it is certain that the legislation stimulated the hiring of additional Internal Revenue Service (IRS) agents and Justice Department lawyers. As reported, over 19,000 filers for the credit had not purchased homes and have claimed a total of $139 million. Also, an additional 74,000 claimants for $500 million had previously owned a home and were ineligible. If this was not bad enough, the Treasury’s inspector general reported that 53 cases included IRS employees filing “illegal or inappropriate” claims. While the tax credit is well-intentioned, it did stimulate graft and other unproductive economic activities, and should stimulate additional skepticism on arbitrary application of remaining funds and legislation for future economic assistance.

Is the U.S. a Champion of the Rule of Law?

Actions by government representatives sworn to “preserve, protect and defend” the U.S. Constitution offer plenty of reasons to question if the nation is still on the same parchment. In retrospect, consider how well-intentioned programs such as insuring deposits of banks (to promote commercial stability) have led to setting CEO compensation; providing social security and medical entitlements (to provide safety nets) have led to redistributive progressive taxation; and the lowering of qualifications and guaranteeing mortgage debt (to provide affordable housing) has disrupted the availability of credit and inflicted a crisis on the financial industry.

The descendents of these good intentions are now fathering both the takeover of the health care industry, reported to be one sixth of the U.S. economy, and Cap and Trade energy legislation. Separately or in combination, the economic gravity of these legislative initiatives raise the specter of the Smoot-Hawley Tariff Act of 1930 by Senator Reed Smoot (R., Utah) and Representative Willis C. Hawley (R., Oregon). This legislation, signed into law by Herbert Hoover, initially appeared to be a success, but was eventually contributed to the depth and extent of the Great Depression. If that is not enough, intimidation of free speaking individuals by the government, exclusion of potential critics in the media (Fox News) from equal access, and threatening corporations (Humana) dependent upon government acquiescence place an inarguable chill on the First Amendment.

It is time to dust off The Economic Consequences of the Peace by John Maynard Keynes, published in 1920, a classic first-hand observation of the Allies economic treatment of Germany following WWI and its (let us hope) unintended consequences. After great detail on the specifics of reparations, Keynes stated that “Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some.”

As discussed, “inflation” could include any “arbitrary” redistribution of wealth imposed by any economic crisis exacerbated by legislation that increases social anxiety and reduces the order and civility of society. Keynes adds that “those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become… the object of the hatred.” The target of this “popular hatred [is] the class of entrepreneurs… The terror and personal timidity of the individuals of this class is so great, their confidence in their place in society and in their necessity to the social organism so diminished, that they are the easy victims of intimidation.” Eventually, “the ultimate foundation of capitalism, becomes so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.” Keynes concluded that any “Bolshevist” would have been pleased to have “designed” such a strategy.

Almost one year ago, also on *Meet the Press*, Chief of Staff Rahm Emanuel quipped “Rule one: never allow a crisis to go to waste.” In the interim a justice has been added to the U.S. Supreme Court based on her capacity for “empathy” as much as the law. It is not too surprising that “Pay Czar” Kenneth Feinberg has had free reign to mete out justice without outrage from some looking for a scapegoat. Clearly, the appointment of a “czar” to act as an officer of the President required “the Advice and Consent of the Senate” (U.S. Constitution, Article II, section 2). Without following the rule of law, the work of the czar becomes at best “a shame” (Rep. Edolphus Towns, D., N.Y.) and at worst “a little scary” (Rep. Mark Souder, R, Indiana). While Feinberg’s actions to reign in risk-taking by adjusting compensation may succeed, it is clearly an end run around Sarbanes-Oxley, another expensive legislative experiment, and democratic shareholder governance. If successful, possibly the next target for curtailing compensation would be Tort reform, and adjusting lawyer compensation for unnecessary litigation, to reduce damage on risk-taking in the pursuit of happiness.

U.S. Investors Should Seek Information Outside Their Closed System

It is becoming clearer that the current times are extraordinary. Since the dinosaurs, organisms failing to adapt have met with extinction. It is logical that incorporating information or perspective from outside an established reality is important to increase the prospects for survivability. This may include looking internationally or back in history. For U.S. investors, gold is a trusted hedge against inflation and devaluation of currencies. Gold is also a prized hedge against arbitrary and/or selective application of the rule of law.

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