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Serving Your Personal Investment Needs Since 2003

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INVESTMENT ADVISORY

Leverage & Its Impact on the Global Economy

Summary:

The global economic system is adjusting to the realities of the de-leveraging that took place after mid-2008. Interestingly, the de-leverage process can be numerically defined if we assume that current money supply levels reflect the completion of the de-leveraging process. If that is the case, and I think that it is, what it means is that the Shadow Banking system (leveraged hedge funds, investment banking and creative financing techniques) is regrouping and once again having a positive impact on economic growth.

Leverage has declined about 20% since mid-2008

Analysis: This tells us that during the years since 2004, leverage has increased every year until it peaked in mid-2008. The total amount of the increase is reflected in GDP growth during this period - which corresponds very closely to the growth in money supply (think M1) during the time from mid-2008 to the present. During the 2004-2008 years, money supply (M1) showed very little growth; while in the shadow banking system, increasing leverage increased the growth of the shadow bank money supply, thereby causing the economy to grow. This growth in money supply is not captured in the data provided by the St. Louis Federal Reserve Bank.

Leverage is needed to make the economy grow.

Analysis: Leverage will return to the system. In fact, it appears to me that the re-leveraging process has already begun. The results of re-leveraging can be seen in various corners of the financial industry: IPO's, borrowing through the issuance of public debt, stock sales, stock market price action, all-cash investment deals done at discount purchase price levels. Stock market technicians are adamant about the coming market crash. This crash may well occur. I doubt that the coming break will be as severe as it was - and still is - anticipated to be. The reason for this dampened volatility is reflected in my notes above.

Commercial Paper borrowing is down about 19% from mid-2008.

Analysis: This tells us that corporate operating capital needs are lower by that amount. Forward revenues have fallen along with current inventory levels.

Commercial and Industrial Loans are down about 7% from mid-2008.

Analysis: Investment in capital equipment and technology, using borrowed capital, is shrinking, but not at the same rate as expected revenues. Why has it not fallen more? Answer: Increased productivity and innovation are important for corporate survival. In fact, it probably has fallen less than this 7% number, because profitability is up due to increased productivity, and, I suspect, some of this money is going toward increasing capital investment without borrowing.

What does all of this data and speculation suggest? It suggests that the US economy is growing with sustainability, even though the numbers are not yet confirming such growth. It means that we should be investing for the long term once again.

With this in mind, expect to see further recommendations for more investment into equities. We will recommend a dollar-cost-averaging approach to reinvestment. Investment recommendations will reflect continued evaluation of the numbers as they are released. Because there is never real certainty about a forecast such as this, we will want to follow well defined stop-loss guidelines so that, should the market not act as predicted, capital will be preserved.

Now is the time to once again make a commitment to long term investments in the stock market.

Analysis: The caveat to this recommendation is that there must be a clear plan for exiting these investments should my

analysis be wrong. I outlined this step-one recommendation and an exit plan in my September 21, 2009, Investment Advisory (refer to below). The recommendation is to invest 20% of the money currently designated for equities investment - virtually all of our investors have no equities investments today - and then limit losses using two technical tools for determining when to exit.

Note that we have already increased the recommended percentage directed to fixed income investments by 30%. This planned increase will continue for perhaps 2-4 years, depending on what happens in the global economy.

If my analysis (above) is correct, I expect that we will be fully invested in 3-6 months or sooner. The first step in this process is to do 20% of the total. If the numbers continue to prove out my analysis, then we will add to this investment until we are fully invested.

Below, I have attached the notes from my July 26, 2009, letter for reference. You might like to reread that letter for its market perspective.

We have been out of the stock market for almost a year now - since last November, 2008. At that time, I would have said if asked, that there was a 100% probability that we were entering the "Great Depression II". Today, that probability is much, much lower. The possibility isn't 'off the table' for discussion purposes, but it now seems likely that our economy will find sustainable growth for the foreseeable future.

Dick Brackett
High Desert Investment Advisors LLC

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JULY 26 LETTER:

I want to review where we have come from since last November and then outline what I think is ahead for us in the next six months.

Since last November, and on a year-to-date basis:

- Virtually all of our investor portfolios have grown between 3% and 8%.
- None of them suffered thru the 25%-30% market losses between January and March.
- None were reinvested in the market at the March lows.
- Some took advantage of the "Option A" strategy and invested 10%-20% of their equity money for a short term trade in the S&P Index ETF (exchange traded fund). That trade is still open and is profitable - up more than 4%.
- Most of our investors preferred to continue with the steady fixed income strategy rather than to try the "Option A" trade.
- The stock market is in the midst of a pretty decent rally that could take it as high as S&P Index = 1100. Today it is at about 980.

It is still time to be patient! When the market rallies, we tend to get anxious, not wanting to miss any profits. If this is you, consider doing our "Option A" trading strategy.

The issue to dwell on, what can upset all of that market enthusiasm, is the large number of potential upsets that could cause the economy to "hic-cup". Thus far, the best we can say about the economy is that it is no longer declining at such a rapid pace as it has over the past 10 months.

There are too many variables just waiting to cause more difficulties for the world economy. Variables such as these are not included in the Models that experts tend to rely upon to predict the future. During times like these, “resilience” is more important than strong profits.

- Resilience is a measure of how much disturbance a system can absorb before it breaks down so fundamentally that it cannot easily return to the way it once was. Achieving the maximum stable yield - in portfolio management terms - is determined by how fast the portfolio adapts to change, and how well it anticipates change.
- A system that keeps options open will be resilient.

What is happening now is the construction of new economic and regulatory systems, systems designed not so much to save the existing system, but to preserve its resilient nature such that over time, our economy can adapt.

How can we invest profitably under conditions like this?

Let me offer some guidelines:

- Think in terms of steady growth.
- Avoid losing money. Invest in assets that will not go to “money heaven”.
- Buy good quality, “survivor-company”, stocks and bonds.
- Look for an average portfolio yield that exceeds 6%.
- Buy fixed income securities - not bond funds - that provide consistent yields over the next several years. Build a ladder of maturities out to about 10 years.
- Interest and dividend income are important components of our profitable investing, during the next several years.
- Dividend income can go away. Interest income is more dependable.
- Government guaranteed assets are attractive.
- Increase the amount of fixed income in your portfolio.
- Find a way to make profitable trades when the market is going sideways.
- A buy and hold strategy for stock market investing is an invitation to large losses.

Be patient. It appears that our systems are moving toward stabilization. We are beginning to see trends that indicate resilience. Subtle directions - underlying the big headlines - are moving deflation out of the picture and also suggest that hyperinflation is less likely to occur. The path toward solvency needs a domestic GDP growth rate greater than 2%. Even this goal seems possible now, where it was completely unrealistic last November.

Look for another retest of the March, 2009, stock market lows. Until then, be patient and wait for the subtle trends to reach the surface and demonstrate that the system is once again resilient. We will be recommending longer term reinvestment into the stock market, perhaps sooner than I think possible even now.

In times like these there is little or no assurance that the future is sufficiently predictable or reliable to allow for longer term risk taking.

In the meantime we wait; and we are happy to have a 6% portfolio growth rate - until it is time to invest for higher levels of growth.