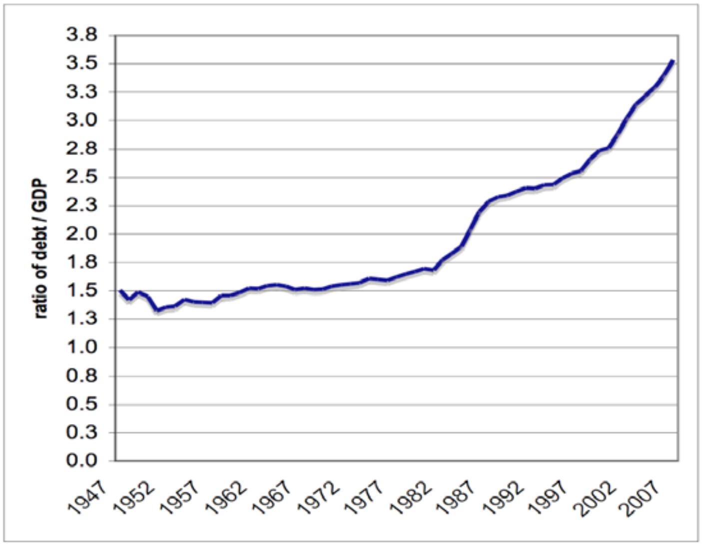
SPDR Gold Trust (GLD): *BUY*

Ratio of outstanding Debt / Gross Domestic Product [1]



-- The main macroeconomic challenges facing the world today are an excess demand for commodities and an excess supply of financial services.[2]

Thesis

Credit expansion recently ceased and credit is now contracting. The responses by the Federal Reserve and Treasury to this contraction are inflationary. Gold appreciates in inflationary environments. We will provide evidence of the following:

1. Credit expanded rapidly over an extended period (8x since 1980) resulting in asset inflation (e.g., PE expansion, housing appreciation). Default rates started to accelerate 24 months ago causing credit contraction and asset deflation (e.g., housing depreciation).

2. The policy responses to accelerating default rates are all inflationary e.g., increase money supply, backstop insolvent financial institutions, increase fiscal stimulus.

3. In a low interest rate environment characterized by high inflation, gold is an inexpensive asset to hold and is likely to appreciate.

In addition to likely continued appreciation of gold, if something should go wrong, cascading defaults in one of the derivatives markets for instance, the dollar could lose much of its value vis-à-vis gold in a short period of time. We plan to purchase GLD shares, recently $84.43, in the near future.

[1] U.S. Federal Reserve Z.1 releases, tables L.1 and F.6 1946 - 2008, Hackett analysis.
[2] Rogoff, Kenneth, Harvard economics professor and former chief economist at the International Monetary Fund. Excerpted from his Op-Ed piece published in the Financial Times, 7/30/08.

This report is intended only for institutional and accredited investors and only for informational purposes. This report is based on information available to the public; no representation is made with regard to its accuracy or completeness. This document is neither an offer nor solicitation to buy or sell securities. © 2008 by Chris Hackett, all rights reserved.

Contents

-- All credit expansions end in deflation because asset prices and capacity outstrip the purchasing power of the public.[3]

1. What Happened

Debt / GDP [4]

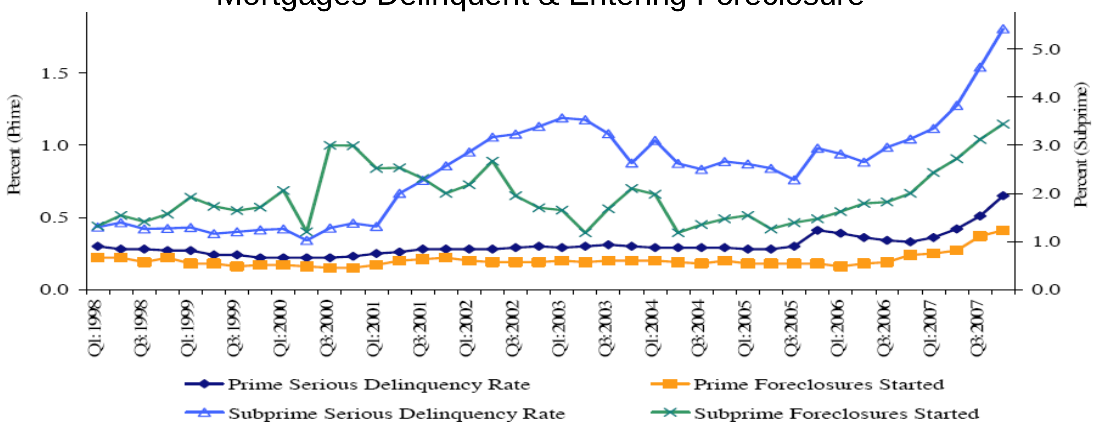
Year	U.S. Gross Domestic Product (trillions $)	U.S. Credit Market Debt (trillions $)	Debt / GDP	Debt growth, year-on-year
1970	1.0	1.6	**1.5**	**7%**
1971	1.1	1.8	**1.6**	**9%**
1972	1.2	1.9	**1.6**	**11%**
1973	1.4	2.2	**1.6**	**12%**
1974	1.5	2.4	**1.6**	**11%**
1975	1.6	2.6	**1.6**	**9%**
1976	1.8	2.9	**1.6**	**11%**
1977	2.0	3.3	**1.6**	**13%**
1978	2.3	3.8	**1.6**	**15%**
1979	2.6	4.3	**1.7**	**13%**
1980	2.8	4.7	**1.7**	**10%**
1981	3.1	5.3	**1.7**	**11%**
1982	3.3	5.8	**1.8**	**10%**
1983	3.5	6.5	**1.8**	**12%**
1984	3.9	7.4	**1.9**	**15%**
1985	4.2	8.6	**2.0**	**16%**
1986	4.5	9.8	**2.2**	**14%**
1987	4.7	10.8	**2.3**	**10%**
1988	5.1	11.9	**2.3**	**10%**
1989	5.5	12.8	**2.3**	**8%**
1990	5.8	13.8	**2.4**	**7%**
1991	6.0	14.4	**2.4**	**5%**
1992	6.3	15.2	**2.4**	**5%**
1993	6.7	16.2	**2.4**	**6%**
1994	7.1	17.2	**2.4**	**6%**
1995	7.4	18.5	**2.5**	**7%**
1996	7.8	19.8	**2.5**	**7%**
1997	8.3	21.2	**2.6**	**7%**
1998	8.7	23.3	**2.7**	**10%**
1999	9.3	25.3	**2.7**	**9%**
2000	9.8	27.0	**2.8**	**7%**
2001	10.1	29.2	**2.9**	**8%**
2002	10.5	31.7	**3.0**	**8%**
2003	11.0	34.5	**3.1**	**9%**
2004	11.7	37.6	**3.2**	**9%**
2005	12.4	40.9	**3.3**	**9%**
2006	13.2	44.8	**3.4**	**9%**
2007	13.8	48.9	**3.5**	**9%**

[3] Duncan, Richard, *The Dollar Crisis*, John Wiley & Sons, 2003, p. 31.
[4] U.S. Federal Reserve Z.1 releases, tables L.1 and F.6 1946 - 2008, Hackett analysis.

The table above shows that total credit market debt in the U.S. has expanded from $1.6 trillion in 1970 (1.5x Gross Domestic Product) to $49 trillion in 2007 (3.5x GDP). Clearly credit has expanded much faster than income. It is also apparent from the table that we have not had a credit contraction in many years.

What is the limit to how much credit a household, a company or an economy can bear and how do we know when we approach that limit? Credit cycle theory holds that credit will expand until debtors can no longer meet their obligations. There is evidence that we reached that limit, at least in the housing market,[5] about 24 months ago.

Mortgages Delinquent & Entering Foreclosure [6]

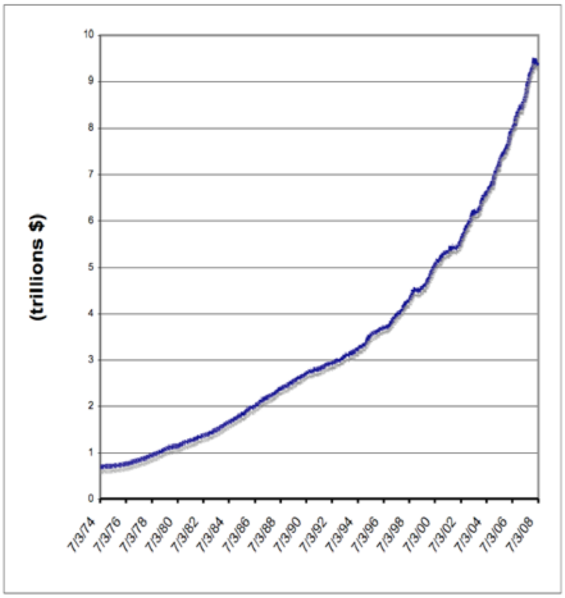


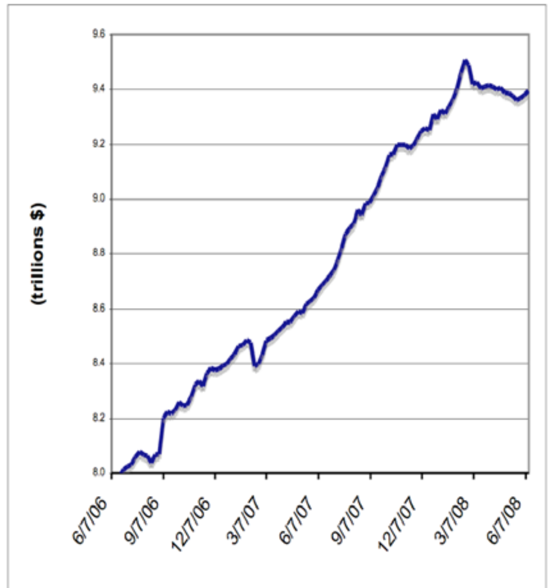
Note that mortgage delinquencies and properties entering foreclosure have been on the rise since Q1 2006, i.e., two years of data indicate that there is a growing collection problem. The data on the following charts show bank credit growth.

[5] Total credit market debt in the U.S. was $49.6 trillion as of 3/31/08 according to the Federal Reserve; of this, $14.8 trillion was mortgage debt. Of the mortgage debt, $11.2 trillion (23% of total credit market debt) was mortgages on single family homes. Total household debt (including mortgages) stood at $13.9 trillion, 28% of the total debt outstanding. Clearly, mortgages and consumer debt are important components of the U.S. credit market.

[6] Mortgage Bankers Association as published by The Office of Federal Housing Enterprise Oversight in their report *Mortgage Markets and the Enterprises 2007*, July 2008, p. 12.

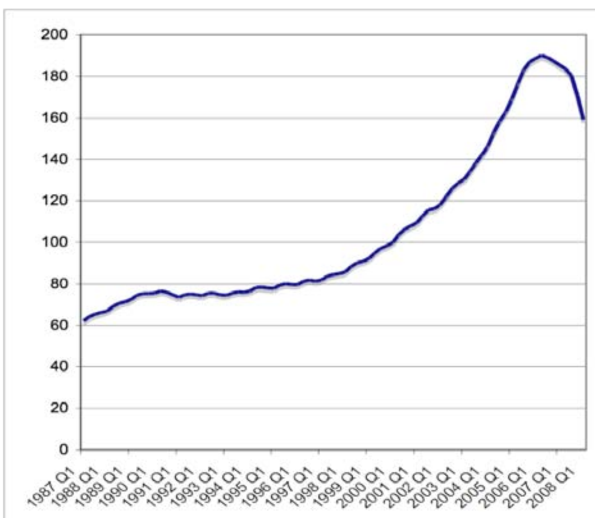
Credit of All U.S. Commercial Banks [7]





The charts show that bank credit peaked during the week of 5/21/08 and started to fall. Is this a turning point? It has been asserted that all credit expansions end in deflation because the asset prices and capacity outstrip the purchasing power of the public[8] (this would appear axiomatic). With that in mind, look at the data presented in the following graph:

S&P/Case-Shiller U.S. National Home Price Index

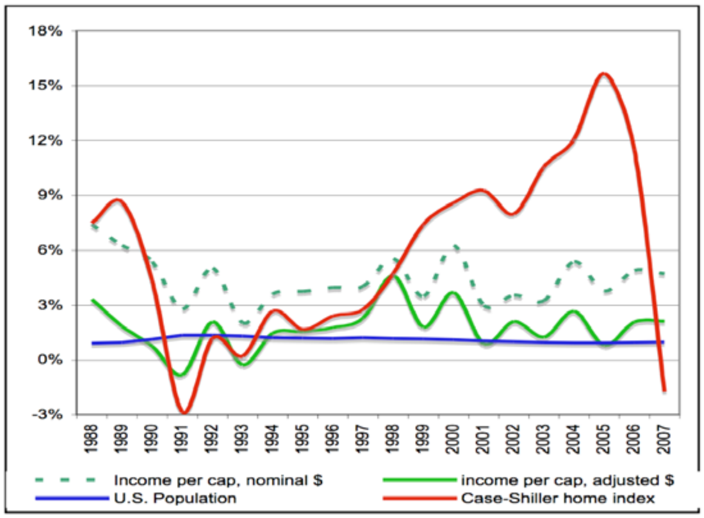


[7] Board of Governors of the Federal Reserve System.

[8] Duncan, Richard, *The Dollar Crisis*, John Wiley & Sons, 2003, p. 31.

Note that house values increased for most of the last two decades and soared from 1998 to 2006. The table on page three of this report shows what is special about 1998: annual debt creation accelerated from 5-7% per year rate (1990 – 1997) to 7-10% for subsequent years. Also note that house prices have been deflating since the second quarter of 2006 (down 16% through 3/31/08), coincident with the increase in delinquency rates. Two years of deflating prices are probably more than an anomaly, but let us consider what drove housing values in the first place. Using first principles, one would expect real estate to appreciate in proportion to the following three conditions: 1) Increasing income 2) Increasing population 3) Increase availability of finance.

Year-on-Year Change: Income, Population and House Prices [9]



Note that housing prices are clearly correlated with inflation-adjusted income through 1998 when they decoupled and real estate soared. The table on page three shows that 1998 is coincident with an acceleration of credit growth from 7% in 1997 to 10% in 1998. The inference we draw from this data is that real estate appreciation over the last 10 years was driven by availability of cheap finance, not rising incomes or population growth.

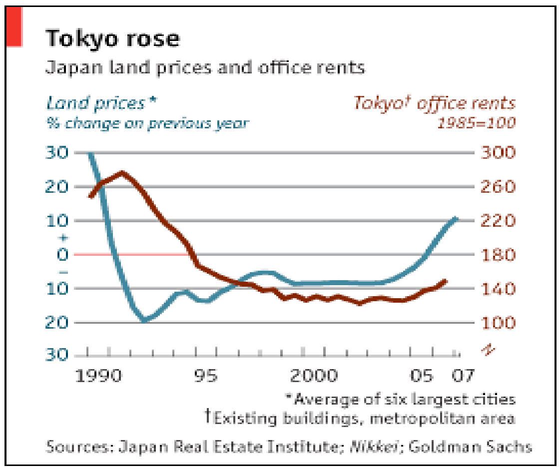
Other assets have recently begun to depreciate e.g., the residual value of used cars (this was a reason Chrysler cited for exiting their leasing business) and antique furniture valuations. Price earnings ratios of businesses have been compressing since the Telecom / Internet implosion earlier in the decade. Of course, any one of these markets may be falling due to changes in tastes e.g., less demand for gas guzzling SUVs, but collectively they suggest, after many years of asset inflation, we now have asset deflation.

So far we have established that credit has expanded faster than income for several decades and has been particularly pronounced in the last ten years. This credit expansion is the likely cause of the rapid appreciation of housing since the late 1990s; rising defaults rates since 2006 are the likely cause of recent house depreciation.

How much housing depreciation is possible? Note that per capita income, adjusted for inflation using the CPI as a deflator (which may understate inflation), has been growing at 3% or less since 1998 (it slightly exceeded 3% in 2000). If we assume 3% per year appreciation for real estate from Q1 1998 to Q1 2008, real estate would fall another 28% (on top of the 16% it fell from

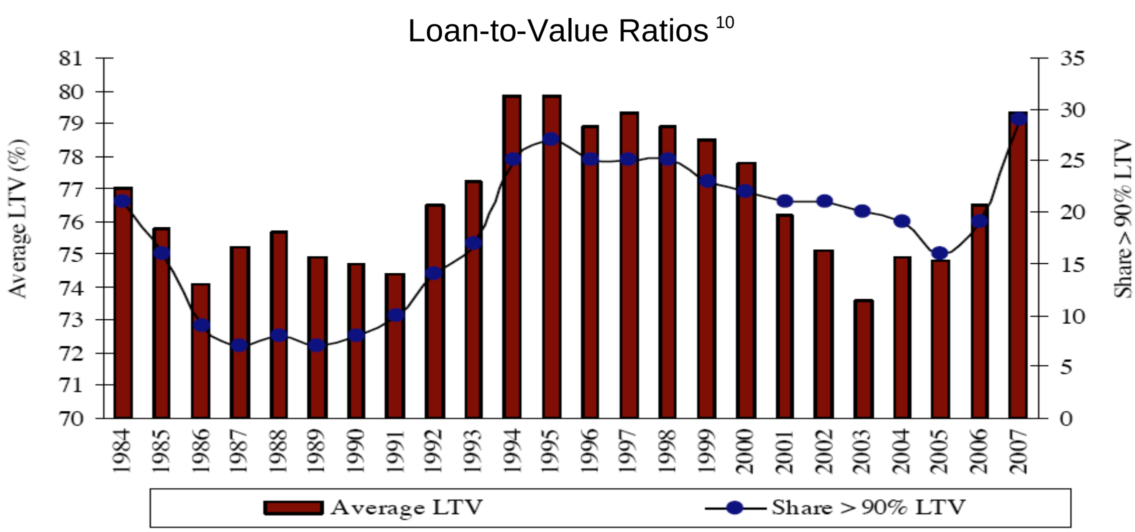
[9] Sources: U.S. Department of Commerce, Bureau of Economic Analysis, Standard & Poors, Hackett analysis.

Q2 2006 to Q1 2008) to reach fair value, i.e., total depreciation would be 47% from the peak reached 24 months ago. Of course, real estate could overshoot on the way down (as people conclude that houses are not investments as much as consumables) and real incomes probably have grown less than 3% annually for the last 10 years. To reality check this, one can reason that the median house must be affordable to a person with a median income, therefore it is unrealistic for housing appreciation to meaningful exceed income growth for extended periods. Consider the data in the following chart which indicates that Japanese land prices fell 14 years in a row.



Source: *The Economist*, 10/11/2007.

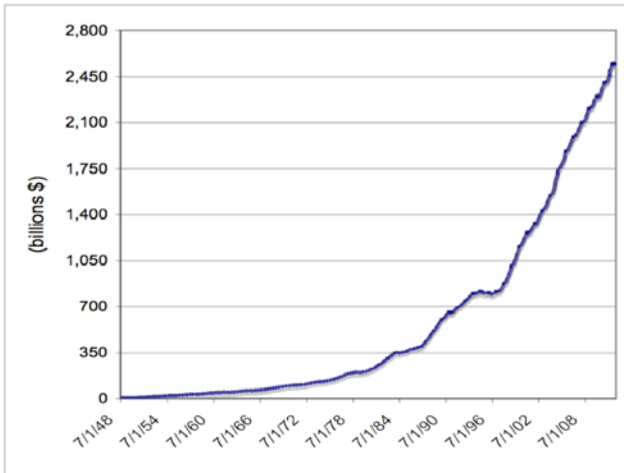
The chart below shows that high loan-to-value ratios (over 90%) have been a prominent feature of the U.S. real estate industry since the mid-1990s. Since 1994, between 15% and 30% of loans written each year had a loan-to-value above 90%. This becomes particularly significant when coupled with rapid appreciation because it suggests that a large proportion of real estate was over-financed (and over-priced) and may now be worth less than the outstanding mortgage.



[10] Federal Housing Finance Board Mortgage Interest Rate Survey as published by The Office of Federal Housing Enterprise Oversight in their report *Mortgage Markets and the Enterprises 2007*, July 2008, p.20.

Finally, housing is not the only sector that the credit financed; the following table shows consumer credit, excluding housing, since 1948. Note the acceleration of debt growth beginning in the late 1990s.

Total Consumer Credit Outstanding [11]



Credit also flowed into business during the late 1990s and is coincident with Price / Earnings (PE) multiple expansion and what became the Telecom / Internet bubble. Credit was extended and PEs expanded until companies faltered under too much debt, e.g., WorldCom, Global Double-Crossing. High quality businesses such as Wal-Mart and General Electric experienced PE multiple expansion during the second half of the 1990s (especially pronounced after 1998) and have suffered multiple compression for the last eight years, e.g., Wal-Mart's PE reached 60 in 2000 and currently stands at 15.

Wall-Mart: Price / Earnings Ratios

[11] Source: Board of Governors of the Federal Reserve System. Total consumer credit outstanding includes most short-term & intermediate-term credit extended to individuals, excluding loans secured by real estate.

There are, however, at least three differences between the current situation and the telecom / Internet fiasco.

- Houses, unlike businesses, are consumer items, i.e., even high quality houses consume cash-flow. Obviously, most other consumer credit (except, for instance, student loans) is used to finance consumables which do not generate cash flow. As of 3/31/08, U.S. household debt stood at $14 trillion, or 28% of all outstanding credit and just over one year of GDP.

- Houses are more levered than most businesses, and there is considerably more leverage now (3.5x GDP) than in 2000 (2.8x GDP).

- The policy responses that mitigated the fallout from the bursting of the telecom / Internet bubble (more money, lower interest rates, exhortations by the President to spend money) probably contributed to the current situation and probably will not solve the current problem.

To be clear, we are not predicting that the world as we know it is coming to an end, we are citing a collection of data which we think suggest that a long-term expansion of credit has run its course.

-- Inflation is always and everywhere a monetary phenomenon.[12]

2. The Policy Response

Below we discuss four policy responses to the current credit crisis.[13] Our conclusion is that all four policies are inflationary and collectively represent a continuation of the policies that caused the problem in the first place. Inflation may even be an unspoken policy objective. Twenty-eight percent (28%) of all outstanding debt (equivalent to about one year of GDP) is consumer debt, the bulk of which is financing highly levered, cash-flow consuming assets (houses). As these assets begin to depreciate, one way out of the bind is to create inflation so that the debts may be repaid with less valuable dollars. Regardless if this is an unspoken objective or not, the following are the four policy responses of which we are aware and all are inflationary:

- Increase the money supply
- Lower interest rates
- Fiscal stimulus
- Backstop insolvent financial institutions

One more point: all of these policies are being implemented under the auspices of providing liquidity at a time of financial distress. As pointed out above, it is likely that the cause of the current problems is in fact the result of too much liquidity over too long a period of time. In addition, there is evidence, e.g., increasing default rates, that the problem we are facing is not one of liquidity, but of solvency.

Starting with money supply, the following table shows money supply (as measured by MZM) growth rates since 2004.

U.S. Money Supply is Currently Growing > 1% per month[14]

Period	Months	MZM Growth	MZM Growth / month
1/1/04 - 6/1/08	53	35.8%	**0.68%**
1/1/05 - 6/1/08	41	30.4%	**0.74%**
1/1/06 - 6/1/08	29	26.1%	**0.90%**
1/1/07 - 6/1/08	17	19.7%	**1.16%**
1/1/08 - 6/1/08	5	5.9%	**1.18%**

[12] Friedman, Milton, Schwartz, Anna, *A Monetary History of the United States 1867-1960*, Princeton University Presss,1963.

[13] We will refrain from discussing the silliest responses, e.g., cracking-down on naked shorts and the spreading of rumors, other than to observe that such policies smack of desperation. We also do not cover changes in regulation because they are not likely to solve the current problems, though they may help prevent future problems.

[14] Money Zero Maturity (MZM) is the broadest monetary aggregate currently published by the Federal Reserve. MZM is defined as M2 minus small-denomination time deposits plus institutional money market mutual funds. This data is calculated by the Federal Reserve Bank of St. Louis, Hackett analysis.

Note that MZM has increased 36% since January 2004: it is hard to imagine that the economy has increased anywhere close to 36% in the last four years. The difference, of course, between the growth in the money supply and GDP is inflation. Also note that MZM growth is accelerating – it is currently growing at 1.2% per month, almost twice as fast as the average for the last four years. The following table shows another data set (Central Bank Foreign Exchange Reserves) from a different source (the IMF) which also indicate that a large amount of money was created over the last several years.

Central Bank Foreign Exchange Reserves [15]

Date	FX Reserves, all currencies (trillions)	Delta	FX Reserves, $US denominated (trillions)	Delta
12/31/95	$1.4		$0.6	
12/31/96	$1.6	13%	$0.8	25%
12/31/97	$1.6	3%	$0.8	9%
12/31/98	$1.6	2%	$0.9	7%
12/31/99	$1.8	8%	$1.0	10%
12/31/00	$1.9	9%	$1.1	10%
12/31/01	$2.0	6%	$1.1	4%
12/31/02	$2.4	**17%**	$1.2	7%
12/31/03	$3.0	**26%**	$1.5	**22%**
12/31/04	$3.7	**24%**	$1.8	**19%**
12/31/05	$4.2	**11%**	$1.9	**9%**
12/31/06	$5.0	**21%**	$2.2	**14%**
12/31/07	$6.4	**27%**	$2.6	**20%**

The table shows that dollar denominated foreign exchange reserves have been increasing between 10% and 22% since 2002. This money creation is particularly important because of the multiplier effect of money held by central banks (depending on the sterilization policies of each central bank). The table also indicates that other currencies are being created at a rapid rate i.e., we are not just seeing dollar inflation, we are seeing inflation across most currencies. For context, note that during the post WWII expansion from 1949 and 1969, total Central Bank reserve assets grew by 55%.[16] Given the rapid pace of money creation over an extended period of time, it is disingenuous for central bankers to complain about rising energy and food costs as if these rising costs were an exogenous problem they had to deal with – central bankers are contributing to the problem by aggressively increasing the money supply.

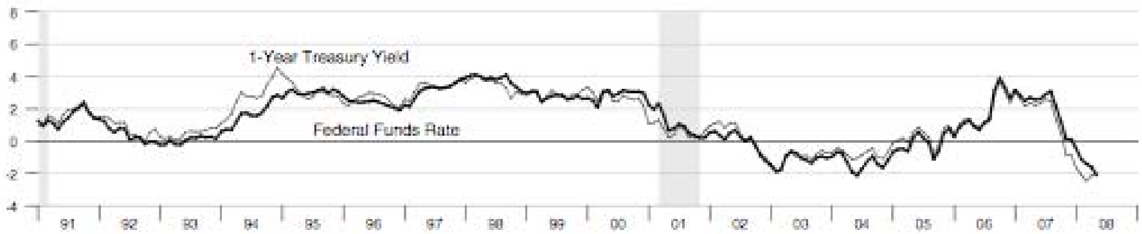
Increasing the money supply faster than the economy grows is inflationary by definition. We find it difficult to believe that the current credit issues will be helped by increasing the money supply; at best, the day of reckoning may be delayed as debts are repaid with less valuable dollars.

[15] Collected and reported by the International Monetary Fund (IMF) in their quarterly report entitled *Currency Composition of Official Foreign Exchange Reserves* (COFER). Foreign exchange reserves consist of the monetary authorities' (central banks) claims on nonresidents in the form of: foreign banknotes, bank deposits, treasury bills, short-term and long-term government securities, and other claims usable in the event of balance of payments needs. Foreign exchange reserves do not include holdings of a currency by the issuing country. Very little estimation is used in producing these tables. Estimation is undertaken only for data gaps of four quarters or less.

[16] Duncan, Richard, *The Dollar Crisis*, p. 121.

Turning to interest rates, the following chart shows that, using the consumer price index (CPI) as a deflator;[17] **real interest rates have been zero or negative for 5½ of the last seven years**. While real interest rates can be negative, the practical limit for nominal interest rates is zero. The Fed Discount rate currently stands at 2.25%.down from 6.25% a year ago. Three month treasuries currently yield 1.69%. We conclude that nominal rates are approaching zero.

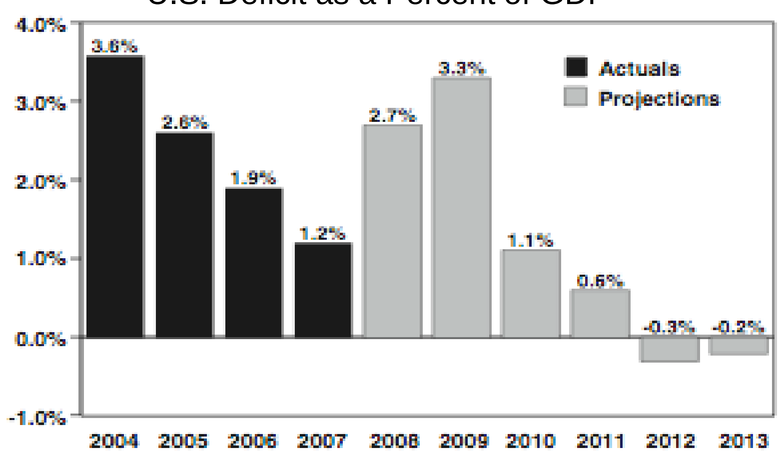
Real Interest Rates [18]



Given that real interest rates have been so low for so long, again it is hard to believe that holding interest rates down will solve the current credit problems; again, it is more likely that they are a contributing factor to the current credit problems. Negative interest rates can prop-up insolvent financial services businesses by providing them with ultra-cheap capital and increasing the slope of the yield curve, but this condition cannot last forever because it causes inflation.

How about fiscal stimulus? The following table shows that the government is planning to increase the rate of deficit augmentation from 1.2% of GDP in 2007 to 2.3% in 2009. We are skeptical that this will help the credit crunch, but are reasonably certain that increased fiscal spending is inflationary.

U.S. Deficit as a Percent of GDP[19]



---

[17] Some argue that the CPI systematically understates inflation. We are sympathetic to these arguments and, to the extent they are correct, real interest rates have been even lower than shown in the chart.

[18] Nominal interest rate less year-over-year inflation as measured by the consumer price index. This chart was originally published in *Monetary Trends*, August 2008, Federal Reserve Bank of St. Louis p. 8.

[19] Office of Management and Budget, *Budget of the U.S. Government Mid-Session Review Fiscal Year 2009*, p. 1.

A New Type of Nationalization: socialize the downside <u>after</u> privatizing the upside.
Finally, we turn to the extraordinary measures the Federal Reserve and U.S. Treasury have recently taken. These steps are meant to provide liquidity to distressed financial companies. Being generous to the Federal Reserve and Treasury, their underlying assumption for this aid is that our financial industry is suffering from a liquidity crisis.[20] However, as discussed above there has been an enormous amount of liquidity created in the form of debt, central bank reserves, and MZM over an extended period of time. This being the case, what the Federal Reserve and Treasury are really doing is adding liquidity to support firms that are insolvent, and they are insolvent because of poor investment decisions made due to too much liquidity over an extended period of time. This is not likely to work - how can more liquidity solve a problem that at its root is based on too much liquidity. To our point, however, one consequence is increased inflation.

Below is a brief review of three recent extraordinary actions.

A. <u>Thirty billion dollars of financing provided for $1.5 billion acquisition.</u> On March 14, the Federal Reserve extended $30 billion of non-recourse financing to JP Morgan Chase to facilitate its acquisition of Bear Stearns (BSC). The $30 billion facility amounted to the Federal Reserve accepting at par $30 billion of BSC's most distressed assets, assets that literally no one in the world would buy, certainly not at anything close to par. In this way, the Federal Reserve has become the hedge fund of last resort. Note that $30 billion is an amazing amount of finance considering JP Morgan Chase eventually paid $1.5 billion for all BSC equity ($10 per share x 146 million shares) up from $300 million they originally agreed to pay. Although the benefits of preventing the BSC collapse from triggering a financial meltdown are obvious, such actions increase the risk of moral hazard and, to our point, are inherently inflationary, i.e., the $30 billion of assets the market would not purchase are purchased by the Fed and the dollars are then relent by JP Morgan Chase and the process continues.

B. <u>Fed backstops securities industry which is levered > 25:1.</u> At the same March 14 meeting, the Federal Reserve established a credit facility for primary securities dealers allowing them to swap illiquid assets for dollars at par. In effect, the Federal Reserve is now back-stopping the entire securities industry. Apparently, the Federal Reserve concluded that the primary securities dealers, many levered more than 25:1, were in danger of collapsing which would not be good for the overall economy. But with 25:1 leverage (and higher), these companies are not suffering from a lack of liquidity, they are over levered and probably insolvent, i.e., a 4% depreciation of their assets would consume their equity, and it is reasonable to assume that many (most?) of their assets have depreciated more than 4% in the last twelve months.

Are we being too alarmist in our judgment of these measures? Is this business as usual? Here is what Paul Volcker[21] said in a recent speech:

> *Simply stated, the bright new financial system[22] - for all its talented participants, with all its rich rewards - has failed the test of the marketplace. To meet the challenge, the Federal Reserve judged it necessary to take actions that extend to the very edge of its*

[20] Being less generous, they Fed and Treasury are postponing the day of reckoning.

[21] Paul Volcker was chairman of the Federal Reserve from 1979 to 1987; these comments were delivered in a speech to the Economic Club of New York on April 8, 2008. A transcript of the speech is included in the Appendix of this document.

[22] From the context of Mr.Volcker's comments, we infer that the "the bright new financial system" referrs to the process of disintermediation and securitization of debt products. A complete transcript of Mr. Volkers speech is included in the appendix of this document.

> *lawful and implied powers, transcending certain long embedded central banking principles and practices ……. What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time-honored central bank mantra in time of crisis – "lend freely at high rates against good collateral" -- to the point of no return.*

Of course, with such high gearing, it is amazing the wheels did not come off the cart sooner. Nevertheless, the effect of the Federal Reserve providing credit to these institutions is inflationary – in fact, inflation is the intention of the backstop, i.e., to facilitate the broker dealers to fund themselves not only to prevent a financial meltdown, but to create more debt.

C. <u>Now for some real leverage - 85:1</u>. On Sunday July 13, Treasury Secretary Paulson asked for authorization to provide financing to Freddie Mac (FRE) and Fannie Mae (FNM), the two Government Sponsored Enterprises (GSEs) with the largest balance sheets. Specifically, Paulson requested authorization for the GSE's to borrow from the Federal Reserve as necessary and permission for the Treasury to purchase securities, including equity, from the GSEs. Legislation authorizing these remedies (The Housing & Economic Recovery Act of 2008) was signed into law by President Bush on July 30.

There are many important elements to this situation, but here are some numbers that we find fascinating:

FRE & FNM combined book value, 3/31/08	$ 0.066	trillion
FRE & FNM combined market capitalization, 8/5/08	$ 0.017	trillion
FRE & FNM combined value of off-balance sheet securities guaranteed	$ 5.625	trillion
Ratio of guarantees / book value	**85**	
Ratio of guarantees / market capitalization	**331**	

First, these numbers are more like government budgets than company balance sheets. For instance, the $5.6 trillion of securities guaranteed by these two organizations represents 11% of the total credit market debt outstanding in the U.S. and about half of all the outstanding mortgages. Some would argue that because the guarantees are for securities backed by mortgages, they are not risky, and besides, the GSEs are now explicitly backstopped by the full faith and credit of the U.S. We find little solace in this line of thinking for the following reasons:

1. The U.S. housing stock appreciated 120%[23] from Q1 1998 to Q1 2006. As discussed above, this appreciation was driven neither by demographics nor rising incomes, but by a flood of easy financing. Once default rates started to accelerate, housing valuations began deflating, down 16% since Q2 2006.

2. As many are coming to realize, houses are consumer items, not investments. They require ongoing maintenance, tax payments and insurance costs.

3. The U.S. national debt currently stands at $9.56 trillion, i.e. the GSE's are on the hook for debt with par value equivalent to 59% of the national debt. This is enough to strain even Uncle Sam's deep pockets.

Secondly, the implied leverage inherent in the GSE guarantees (85:1) is beyond comprehension – it demands the question: what were they thinking? In case there is any doubt about what

[23] Based on the S&P Case-Shiller National Housing Index.

common sense tells us, here is what William Poole[24] pointed out in an op-ed piece published in *The New York Times* on 7/27/08:

> ***Freddie Mac, according to its own fair-value accounts for the end of March, is technically insolvent*** *– the estimated market value of its liabilities is greater than the estimated market value of its assets. Fannie Mae has a small positive net worth. In coming quarters, these figures may deteriorate because of account adjustments (some of the assets are questionable) and continuing defaults on mortgages.*

Mr. Poole's characterization that some GSE assets are "questionable" may prove more prescient than any of us would like and echoes Paul Volcker's characterization of "mortgage-back securities of questionable pedigree." And what do the management teams of the GSEs have to say for themselves? On Friday July 11, two days before Paulson asked for explicit authorization to backstop the GSEs, Chuck Greener, Senior Vice President of Fannie Mae said:

> *As we work through this tough housing market, we are maintaining a strong capital base, building reserves for our credit losses, and generating solid reserves as our business continues to serve the market. We also have access to ample sources of liquidity…… OFHEO has reiterated that Fannie Mae is adequately capitalized, the highest capital designation given by our regulator.*

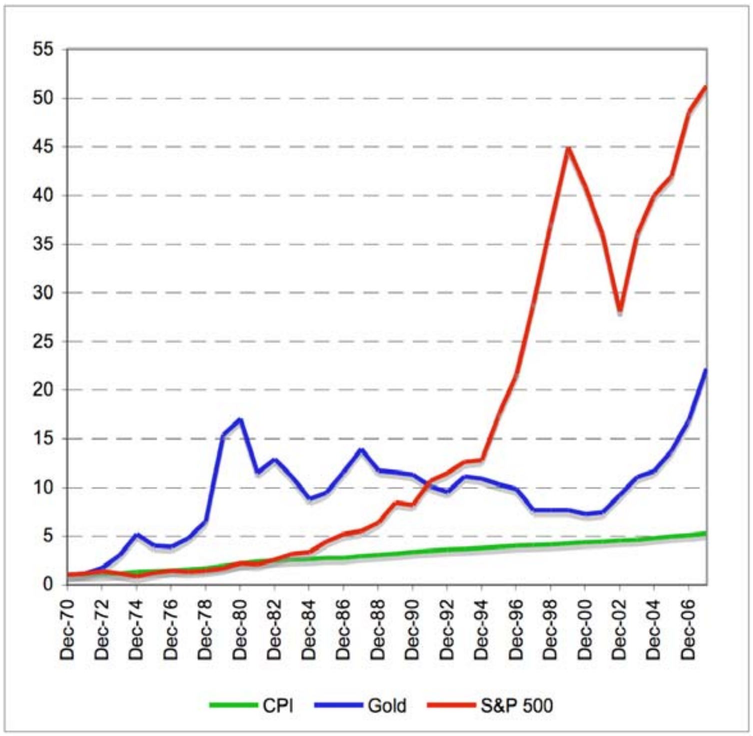
Mr. Greener was right regarding adequate sources of liquidity, as we found out on the following Sunday afternoon (full faith and credit of the U.S. Government – the Treasury may even purchase their equity). And like a mortgage broker who checks all the boxes on the mortgage application before submitting the mortgage to be guaranteed by Fannie Mae, Mr. Greener can say that Fannie Mae meets its capital requirements as determined by the Office of Federal Housing Enterprise Oversight (even if the capital requirements allow 85:1 leverage and common sense tells us that this is ridiculous). Freddie Mac's web site includes a response to an article that ran in *The New York Times* on 8/5/08 in which management claims the article "fell short of the standards of *The New York Times*." They too point out that they exceed their regulatory capital – one is left to conclude that since they exceed their regulatory capital, everything is peachy. Normally, we would suggest that the market should sort this out, but the implicit government guarantee of the GSEs has become explicit: the market will have little to do with the fate of the GSEs. It is reasonable to conclude that the remedies to the GSE's current problems will involve more money from the government – given the scale of their problems, potentially much more money and thus will increase inflation.

[24] William Poole was the chief executive of the Federal Reserve Bank of St. Louis from 1998 to 2008.

3. Why Gold?

In a low interest rate environment characterized by high inflation, gold is an inexpensive asset to hold (i.e., low opportunity cost) and is likely to appreciate. The following chart shows the relative performance of inflation as measured by the CPI, gold prices and the S&P 500 including dividend reinvestment.[25]

Indices: CPI, Gold and the S&P 500 [26]



Note that gold's performance during the 1970s, the last time we faced serious inflation, outpaced inflation as measured by the CPI and stock performance as measured by the S&P 500. Specifically, gold appreciated 31x during the 1970s while the CPI increased 5x and the S&P 500 appreciated 2x. Part of gold's performance was likely due to the fact that the gold price had been artificially depressed by the existence of the Bretton Woods agreement which, among other things, defined the value of a dollar as 1/35th of an ounce of gold. When president Nixon closed the gold window in August 1971, gold appreciated very rapidly. There are, however, two other contributing factors to gold's performance during the 1970s which are relevant to today's circumstances: 1) during periods of high inflation, businesses find it difficult to pass-on higher costs and 2) a higher inflation rate suggests that future cash flows from businesses should be discounted at a higher rate, thus depressing the present value of the businesses, i.e., PE compression. At the same time, gold is considered by many (including central banks which hold 18% of the world's gold supply) to be money because it represents a store of value and medium of exchange. It's value tends to increase inversely proportionate to currencies depreciating; this

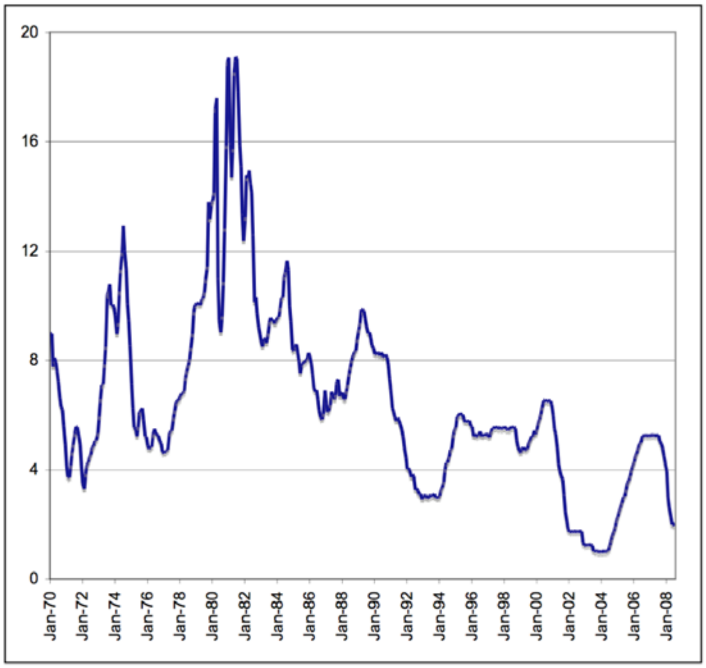
[25] The data depicted in the chart begins in 1970; we selected this time-frame because up until August 15, 1971, the value of an ounce of gold had been fixed (since the 1930s) at $35.

[26] Sources: Gold prices from www.finfacts.ie, CPI from the U.S. Federal Reserve, S&P 500 including dividends from the Berkshire Hathaway annual report, Hackett analysis. 1970 = 1.

is probably because currencies depreciate as they are debased while gold is not subject to debasement.

The inflation of the 1970s was eventually killed and the price of gold began to fall when short-term interest rates were raised over 19% in June 1981. The following chart shows the Federal Funds Rate from January 1970 through June 2008; it currently stands at 2%.

Federal Funds Rate [27]



Given the fragility of the financial system as outlined in the first section of this report (e.g., large debt in relation to GDP, accelerating delinquencies and foreclosures, deflating asset values) it is unlikely that raising interest rates is an option for the Federal Reserve. This conclusion is corroborated by the policy actions currently being taken, as described in the second section of this report. The inference we make is gold is likely to continue its appreciation.

This demands the question, if gold is likely to appreciate, why not purchase shares in a gold mining company. There are four issues which we think make investing in the underlying commodity more attractive than investing in a mining business:

1. Mining is the bottom of the rung in terms of business quality e.g., mining companies are price takers, who have little ability to differentiate themselves and their value-added is limited (they dig dirt, refine it and sell it).

2. The cost of mining is going up so gold mining companies are faced with margin compression.

3. Execution risk. Gold mining companies face a multitude of execution difficulties ranging from political risks, environmental remediation issues, ore body quality issues, hedging

[27] Source: The U.S. Federal Reserve. The federal funds rate is the rate of interest that banks lend to one another on an overnight basis.

decisions and complex re-investment decisions. Taken together, mining companies often produce negative cash flows even in robust markets for their products.

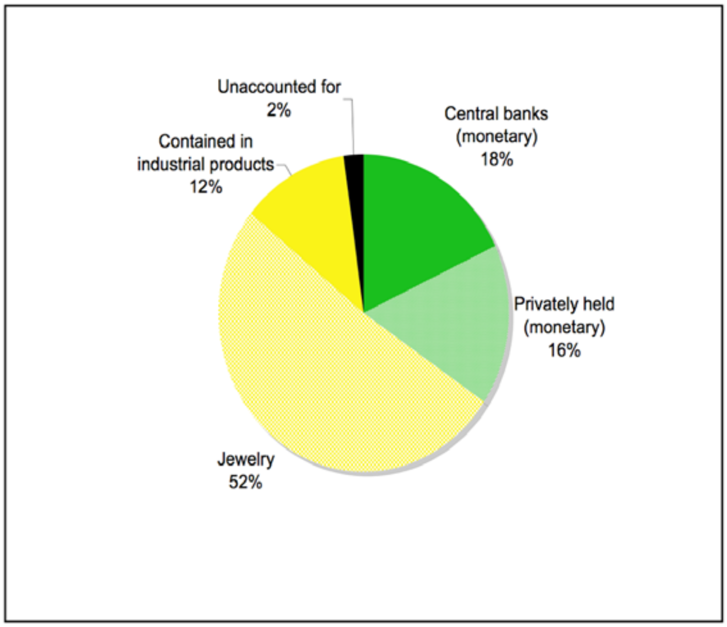
4. Higher inflation pushes market participants to discount future cash flows at higher discount rates, depreciating the enterprise value of mining companies.

There is, however, a tax disadvantage to purchasing gold (or a gold exchange traded fund): in the event the gold purchase is profitable and is in an account subject to U.S. taxes, capital gains will be taxed at 28% vs.15% for traditional securities. The obvious ways around this are to purchase the ETF shares in a non-taxable account or to use gold futures contracts.

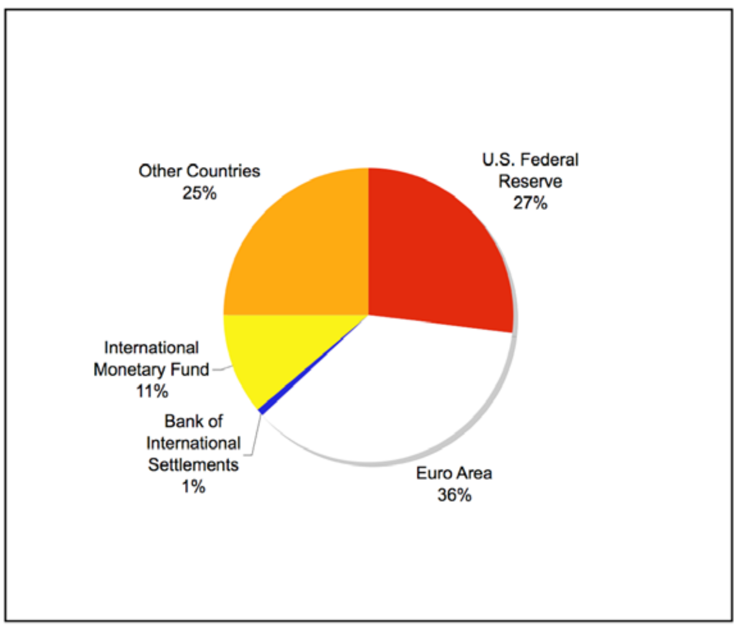
Then the Gods of the Market tumbled, and their smooth-tongued wizards withdrew
And the hearts of the meanest were humbled and began to believe it was true
That All is not Gold that Glitters, and Two and Two make Four -----
And the Gods of the Copybook Heading limped up to explain it once more. [28]

[28] Kipling, Rudyard, excerpted from *The Gods of the Copybook Headings*, 1919, stanza 8.

Current Gold Uses [29]



Reported Gold Holdings by Monetary Authorities [30]

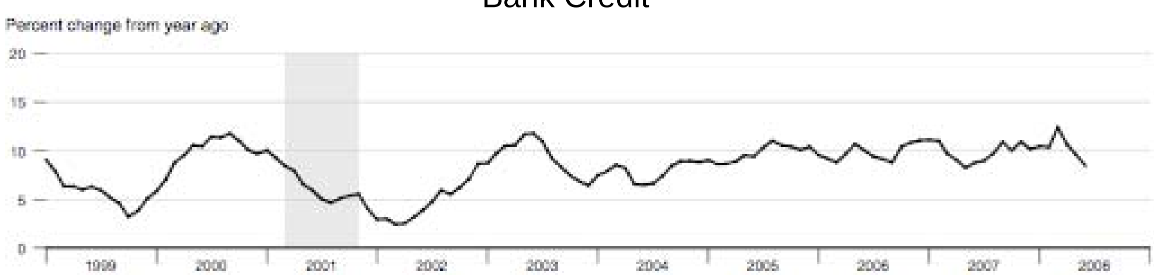


[29] GLD 10-K, p. 4.
[30] GLD 10-K p. 6.

Gold Supply & Demand[31]

(metric tonnes)	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Mine production	2,527	2,574	2,602	2,618	2,645	2,612	2,620	2,492	2,550	2,471
Official sector sales	326	363	477	479	520	547	617	469	674	328
Old gold scrap	631	1,105	615	616	713	841	944	849	886	1,108
Net producer hedging	504	97	506	(15)	(151)	(412)	(255)	(422)	(86)	(373)
Total supply	**3,988**	**4,139**	**4,200**	**3,698**	**3,727**	**3,588**	**3,926**	**3,388**	**4,024**	**3,534**
Jewellery fabrication	3,294	3,169	3,139	3,204	3,008	2,660	2,482	2,614	2,707	2,279
Electronics	234	226	247	283	197	206	233	260	279	304
Other industrial / decorative	115	103	99	99	97	83	81	83	86	86
Density	70	64	66	69	69	69	67	68	62	61
Investment	452	263	359	166	357	343	332	473	594	640
Total demand	**4,165**	**3,825**	**3,910**	**3,821**	**3,728**	**3,361**	**3,195**	**3,498**	**3,728**	**3,370**
Supply less demand	**(177)**	**314**	**290**	**(123)**	**(1)**	**227**	**731**	**(110)**	**296**	**164**

Bank Credit [32]



Commercial & Industrial Loans at Commercial Banks [33]

[31] GLD 10-K p. 5.
[32] *Monetary Trends*, August 2008, Federal Reserve Bank of St. Louis, p. 14.
[33] IBID, p. 14.

Source: The Economist, 7/24/08 p. 34.

The Economic Club of New York

101st Year

395th Meeting

Tuesday, April 8, 2008

Grand Hyatt

New York City

Program

GUEST OF HONOR

THE HONORABLE PAUL A. VOLCKER

Former Chairman, Federal Reserve System

PRESIDING OFFICER

R. GLENN HUBBARD

Chairman of the Club

QUESTIONERS

Peter G. Peterson

Former Chairman, The Economic Club of New York

Senior Chairman, The Blackstone Group

Edward S. Hyman

Chairman, ISI Group, Inc.

Introductions

R. Glenn Hubbard

Paul A. Volcker: Mr. Chairman, members of the Economic Club, Fellow New Yorkers,

Fellow New Yorkers: That was the salutation of my last speech to the Economic Club of New York, delivered more than 30 years ago. For me, the timing was auspicious. As the newly minted President of the Federal Reserve Bank of New York, I naturally shared the intense concern that this great city was unable to finance itself. Beyond the parochial concern was the risk that default by New York might spread a sense of financial crisis through an already recession-weakened economy.

There were calls for the Federal Reserve to step in, to resort to a long dormant emergency lending authority enacted in the depths of the Great Depression. Those calls were resisted. Discipline would be enforced and any precedent to "bail out" a large but irresponsible borrower would be avoided. The city had to declare a moratorium on its short-term debt. Eventually the Federal Government, after contentious political debate, did provide limited liquidity support, but highly conditioned.

In time, the city, with new management and the installation of strict oversight and budgetary controls, regained its financial footing. It came to flourish as the world financial center, attracting talent and a capacity for innovation that has been at least partly replicated and implemented throughout the world.

Well, that may sound like ancient history to most of you, more evidence of my age than of current relevance. However, some of the differences -- and some of the parallels -- to today's financial turmoil strike me as relevant.

Until the New York crisis, the country had been free from any sense of financial crisis for more than 40 years. In contrast, today's financial crisis is the culmination, as I count them, of at least five serious breakdowns of systemic significance in the past 25 years – on the average one every five years. Warning enough that something rather basic is amiss.

Over that time, we have moved from a commercial bank centered, highly regulated financial system, to an enormously more complicated and highly engineered system. Today, much of the financial intermediation takes place in markets beyond effective official oversight and supervision, all enveloped in unknown trillions of derivative instruments. It has been a highly profitable business, with finance accounting recently for 35 to 40 percent of all corporate profits.

It is hard to argue that the new system has brought exceptional benefits to the economy generally. Economic growth and productivity in the last 25 years has been comparable to that of the 1950's and 60's, but in the earlier years the prosperity was more widely shared.

The sheer complexity, opaqueness, and systemic risks embedded in the new markets – complexities and risks little understood even by most of those with management responsibilities – has enormously complicated both official and private responses to this current mother of all crises. Even previously normal trading relationships among long-established institutions are questioned. What has plainly been at risk is a disorderly unraveling of the mutual trust among respected market participants upon which any strong and efficient financial system must rest.

Simply stated, the bright new financial system - for all its talented participants, for all its rich rewards – has failed the test of the market place. To meet the challenge, the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending certain long embedded central banking principles and practices. The extension of lending directly to non-banking financial institutions – while under the authority of nominally "temporary" emergency powers – will surely be interpreted as an implied promise of similar action in times of future turmoil. What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time honored central bank mantra in time of crisis -- "lend freely at high rates against good collateral" -- to the point of no return.

The implications of these decisions, and the lessons from the unfolding crisis itself, surely deserve full debate and legislative review in the period ahead. It is certainly right that in this instance, the Federal Reserve acted with full support of the Secretary of the Treasury. In their technical details, the issues are terribly complicated. That is true in large part because of the mind-bending complexity of the world of derivatives and securitization. There are also cross-cutting bureaucratic and political concerns – political concerns at the high level of the proper use and allocation of government power and at the low level of embedded economic interests.

In sum, it all adds up to a clarion call for an effective response.

Before turning to the specifics of the needed debate, I want to emphasize that we are not dealing simply with problems of financial structure and regulation, of repairing or papering over weak links in markets, or of realigning supervisory responsibilities. Financial crises typically emerge after a self-reinforcing process of market exuberance marked by too much lending and too much borrowing, which in turn develop in response to underlying economic imbalances.

The New York case was illustrative. The city had spent beyond its means for years. Aided and abetted by the local banks, a seemingly profitable but rickety financial structure was built. It was dependent on the rollover of short-term financing and rested on the unspoken presumption that major cities don't go broke.

That was child's play relative to recent years. It is the United States as a whole that became addicted to spending and consuming beyond its capacity to produce. The result has been a practical disappearance of personal savings, rapidly rising imports, and a huge deficit in trade. The process has been extended by the willingness of other countries – foreign investors, businesses, and governments – to close the gap by buying our Treasury securities, by directly indirectly financing our home buyers as well as our banks, and increasingly by buying into our businesses.

It all seemed so comfortable. There was no pressure for change, not in Washington which was spending money and keeping taxes low, not on Wall Street which was wallowing in money, not on Main Street with individuals enjoying easy credit and rising house prices, not in China or elsewhere dependent on booming exports and content to build huge financial reserves.

But in the end, just as in the case of New York, no financial legerdemain could long sustain the unsustainable. A breaking point, usually not anticipated, appears - in this case triggered by some softening of the housing market. The excesses of the sub-prime mortgage were exposed, doubts about financial values spread and adjustments – painful but necessary adjustments – are forced on the economy.

A second generic point is worth emphasizing. Financial crises have been a recurrent feature of free and open capital markets, not least in the United States. Those 40 years of relative tranquility were the exception, not the norm. Any return to heavily regulated, bank dominated, nationally insulated markets is pure nostalgia, not possible in this world of sophisticated financial techniques made possible by the wonders of electronic technology. Markets are international, and so are businesses and individuals. We cannot regulate and supervise without taking account of, and even learning from, practices elsewhere.

But it is equally compelling that a demonstrably fragile financial system that has produced unimaginable wealth for some, while repeatedly risking a cascading breakdown of the system as a whole, needs repair and reform.

The nub of the problem is the inherent risks involved in financial intermediation, a process vital to the success of any free economy. On the one hand, there are those who need funds – reliable long-term funds – to build businesses, to buy homes, to finance education. On the other hand, many of those with available funds insist upon safe, highly liquid outlets for their money. Reconciling those different requirements inherently involves uncertainty, and risk -- credit risk and maturity risk.

Absorbing those risks was once largely the role of commercial banks, saving institutions, and insurance companies. Typically, those institutions were subject to rather comprehensive regulation. The banks also have had access to an “official safety net” in times of stress, and in recent years built substantial capital. The business model of those institutions also rested on the continuity of customer relationships implying some cushioning of the impact of market volatility.

In the new paradigm, the intermediation process has increasingly become the domain of the open market. The general idea is the inherent risks can be minimized by unpackaging the institutional relationships, separating maturity and credit risks, “slicing and dicing” so that those risks can be shifted to those most willing and capable of absorbing them. Trading would be encouraged by sophisticated packaging of obligations, and by developing “derivatives” replicating one characteristic or another of the financing relationship, derivatives that have taken on a trading life of their own. The liquidity of active open markets also encouraged thin capital positions and high leverage.

The intellectual rationale was to encourage arbitrage to close inconsistencies in pricing and to enhance market efficiency. Efficient in theory, but in practice lacking two practical imperatives in the lending process. One is the clear responsibility of a lender for judging the credit worthiness of a loan. The second is the ability of a purchaser in the secondary market to itself appraise the nature and value of the credits it is acquiring.

The first of those requirements has clearly been undercut by the tendency to package and sell a loan promptly after its origination. To the extent those originations are by a commercial or investment bank, the practice can at least be reviewed and disciplined by a relevant supervisory authority. For instance, one possibility, by market practice or official requirement, would be to insist on the retention by the originator of a significant part of the loan or loan packages.

In the domain of the secondary market, the principal "gate keepers" have been the few credit rating agencies, each of which has a certain status by means of SEC recognition as well as years of experience. Those proud agencies have a strong reputation to protect. However, it appears that their approach toward rating complex packages of mortgages and loans has suffered not only from the appearance of conflicts of interest, but also from the common difficulty of much financial engineering.

Mathematical modeling, drawing strong inferences from the past, has demonstrably failed to anticipate unexpected events of potentially seismic importance. The commonly cited "two sigma" or "once in a 50 years" event has materialized too frequently to validate that approach. Part of the problem, as I understand it, is that mathematical modeling simply cannot deal with markets where it is not random or physically determined events but human instincts that cause self-perpetuating waves of unwarranted optimism or pessimism.

The combination of herd behavior, opaque loan characteristics, and breakdowns of market function at times of crisis has also raised important questions about the characteristics and usefulness of "mark-to-market" accounting, particularly its extension in uncertain and illiquid markets to what is euphemistically known as "fair value" accounting. That is too complicated a subject for me to linger on today. Suffice it to say there cannot be much doubt that "mark-to-market" is an essential discipline for trading operations, hedge funds and other thinly capitalized financial firms. What is at issue is the extent to which it is suitable for regulated, more highly capitalized intermediaries, including commercial banks. Their ongoing customer relationships, the value of which is not automatically correlated with reversible swings in market interest rates, cannot be easily reduced to a market price or a mathematical model.

I know very well that the seemingly simple approach of "fair value" accounting is a highly complex matter extending beyond financial markets. As it should be, resolution of these questions is in the hands of independent standard setters. I am encouraged that the issues are under review, and I trust minds are not closed as to the appropriateness of "mark-to-market" under particular circumstances.

Another highly significant area of concern has been the practice of important commercial and investment banks to move certain sponsored and related operations "off balance sheet". That has been surprising in light of the well publicized problems of Enron and other industrial companies. Experience has again demonstrated that "off balance sheet" cannot be the same as "out of mind" or out of responsibility. Too much is at risk both financially and reputationally.

The recitation of particular market vulnerabilities, of supervisory lapses, of failure to close gaps or end disagreements among regulators is not surprising. In the United States, informed observers, market participants, officials themselves have long been aware of fragmented responsibilities, competing and overlapping institutional objectives, and ingrained resistance to change. Established agencies haven't been able to keep up with all the complexities. The drumbeat of lobbying pressure has not been for more effective supervision; to the contrary, it's been fear of allegedly heavy handed and intrusive official intervention damaging to the competitive position of institutions operating in international markets.

Perhaps most insidious of all in discouraging discipline has been pervasive compensation practices. In the name of properly aligning incentives, there are enormous rewards for successful trades and deals and for loan originators. The mantra of aligning incentives seems to be lost in the failure to impose symmetrical losses – or frequently any loss at all - when failures ensue. The point has been made time and again, yet, with rare exceptions, compensation committees and their consultant acolytes seem unable to break the pattern. That may not be an area that law or regulation can, or should, deal with effectively. Surely it is a matter for the leadership of large institutions, particularly those sheltered by official support.

While far from complete, I've said enough to confirm that reform, intelligent reform, will be a lengthy and arduous process. I particularly welcome Secretary Paulson's leadership in setting out a broad vision of one logical direction for change. Congressional leaders and others are preparing legislative proposals. All that is useful, but will take time to debate and mature.

Meanwhile, for the time being we are dependent on ad hoc approaches, making do with – hopefully making better – what we have. In the process, we need to take care that immediate decisions don't inadvertently prejudice more considered approaches.

The immediate response to the crisis has been to resort to untested emergency powers of the Federal Reserve. Out of perceived necessity, sweeping powers have been exercised in a manner that is neither natural nor comfortable for a central bank. As custodian of the nation's money, The Federal Reserve has the basic responsibility to protect its value and resist chronic pressures toward inflation. Granted a high degree of independence in pursuing that responsibility, the Federal Reserve should be removed from, and be seen to be removed from, decisions that seem biased to favor particular institutions or politically sensitive constituencies.

Housing is certainly a sector politically sensitive as well as economically important. So, I ask myself why, in the present circumstances, is so much of the burden of restoring liquidity in the mortgage market placed on the Federal Reserve? There are very large long-standing institutions, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, created by law explicitly to nurture and support the mortgage market they have come to dominate. They have long enjoyed direct and indirect government support. Until now, Fannie and Freddie stockholders and executives have been generously rewarded. Existing law provides for direct government financial support which could include fresh capital in time of need. Yet, given the illiquidity of mortgages, including their own mortgage-backed securities, they have been remarkably passive until very recently.

I well understand their managements feel a fiduciary duty to their stockholders. But if that duty in face of a national crisis in the mortgage market and their own statutory purposes is the overriding criterion, we can ask what is the rationale for their existence as a government sponsored (and subsidized) agency? If instead it is a matter of the budgetary consequences of overt government support, those consequences are only hidden by Federal Reserve mortgage acquisitions, not avoided. Somehow, the proper structure and role for those organizations in the face of a crisis playing out in their own front yard need to be reconsidered as part of financial reform.

In the here and now, if the illiquidity of the mortgage market is the crux of the problem, use of the existing institutions would be quicker and more effective now than building a new channel for government assistance. At any rate, the crisis is simply too threatening to rule out the possibility of government support.

There is, quite understandably, a great deal of attention being paid to the future role of the Federal Reserve as lender of last resort, regulator and supervisor. That is an area in which I hold some strong views. The Fed, by reason of its mandate, its prestige, its perceived competence, and most importantly because it is called upon to lend to troubled banks, is advantageously placed to exercise strong and effective oversight of the financial system.

That was a simple and straight-forward proposition when commercial banks, over which the Federal Reserve had direct authority, were the systemic heart of the system. Recent developments have affirmed that those institutions with relatively strong capital positions are still critical in absorbing risk when the system is under pressure. Now, we are faced with further extending and clarifying the Fed's regulatory and oversight responsibilities to investment banks and beyond or, conversely, changing direction toward a new, presumably consolidated, regulatory authority.

I have neither the time nor competence to consider this afternoon all the ramifications of the two broad alternatives, or of less sweeping possibilities. The Treasury outline published last week sets out a comprehensive vision (which, however, does not deal with the government sponsored enterprises).

The answers won't come easily, but they must come. Recent developments certainly justify a sense of urgency, permitting the Congress and the new President to cut through entrenched political and institutional resistance to change.

In dealing with the challenge, a number of points seem to be of fundamental importance:
.

- The role of the Federal Reserve as lender of last resort and as regulator does need clarification. Those functions are inextricably linked to the extent particular institutions are protected by borrowing privileges. The plain implication of recent actions is that in time of stress investment banks deemed of systemic importance are to be so privileged. Unless the Fed's initiative can somehow be contained to a single aberrant incident – which seems quite unlikely - a direct responsibility for oversight and regulation follows. I do not see how that responsibility can be turned on only at times of turmoil – in effect when the horse has left the barn.

- If the Federal Reserve is also to range further, to have clear authority to carry effective "umbrella" oversight of the financial system, internal reorganization will be essential. Fostering the safety and stability of the financial system would be a heavy responsibility paralleling that of monetary policy itself. Providing direction and continuity will require clear lines of accountability (running, for instance, to the Vice Chairman of the Board and to relevant Reserve Bank Presidents), all backed by a stronger, larger, highly experienced and reasonably compensated professional staff.

- A case can be made for consolidating all supervisory and regulatory responsibilities for "safety and soundness" into a single "super agency". While starkly contrary to the American tradition of more specialized agencies, it is the path taken by the U.K. and a number of other countries to assure consistent effective coverage. However, as recent U.K. experience emphasizes, close liaison and cooperation with the central bank would be absolutely essential for anticipating and managing crises.

- No one will benefit from regulation and supervision which is unduly intrusive and arbitrary. Venture capital and equity funds have been two successful, creative and valuable parts of American capital markets. By their nature, they are dependent on strong and sophisticated investors, so systemic implications of failure of particular funds is unlikely. Consequently the case for either official liquidity support or direct regulatory intrusion is weak.

Hedge funds, when managed carefully, may add to the efficiency of markets. However, the potential for trouble has been amply demonstrated particularly when those funds are sponsored by banks. Consideration needs to be given to ways and means of damping excessive leverage, possibly through the influence of their prime brokers. Similarly, banks in their lending need to resist the dangerous and excessive leveraging of businesses acquired by equity funds.

The potential for conflicts of interest strongly suggests the most careful consideration of the governance structure of equity and hedge funds, including independence from bank sponsorship.

- In a globalized world, regulation and supervision cannot usefully proceed in isolation. Today, that has been broadly recognized in work toward common capital requirements for banks, toward international accounting standards, toward more disciplined auditing, and perhaps most critically toward the development of more effective settlement and clearing arrangements for derivatives. The work already underway in these areas under the auspices of the G-7 or otherwise is encouraging.

For financial regulation in general, competition in regulatory laxity cannot be a tolerable approach.

I am constitutionally unable to end these remarks without re-emphasizing the point with which I began. Financial crises are most damaging when underlying economic forces are out of kilter, and when the bursts of self-reinforcing enthusiasm or fears take hold. It is the basic responsibility of a central bank – most decidedly of the Federal Reserve, the influence of which spreads worldwide - to balance and moderate those forces.

That is a tough job, especially when the markets are in turmoil and concerns about recession are rife. Then the temptation is to subordinate the fundamental need to maintain a reliable currency worthy of trust and confidence at home and abroad.

The dollar, after all, is a fiat currency, backed only by the word and policies of our government, exemplified by an independent central bank committed to maintaining a price stability. The apparent pressure of the Federal Reserve to take many billions of uncertain assets onto its own balance sheet raises questions that must be decisively answered by demonstrating the commitment to deal with emerging inflationary pressures – that is all the more important in the midst of the weakness of the dollar internationally and our dependence on foreign capital.

Let’s not lose sight of the silver lining – what can be the positive outcome of all the turbulence. The excesses of the market are surely being penalized in terms of huge losses of money and prestige. The transient pleasures of extreme leveraging have been exposed. By force of circumstances, the nation’s spending and consumption are being brought in line with our capacity to produce. The need for regulatory reform is broadly recognized.

We have the opportunity to lay the foundation for a new period of sustained growth and stability. I trust we will seize that opportunity – to the benefit of this city, the country, and, indeed, to global finance which is still so dependent upon American example and leadership.

(Q&A)

GLEN HUBBARD: Thank you very much for those remarks. As is our tradition, we do have two distinguished club members as questioners. Pete Peterson, who is the co-founder of Blackstone, a former Commerce Secretary and former Chairman of this club, and Ed Hyman, an eminent Wall Street economist and Chairman of ISI Group. Pete the first question is yours.

PETE PETERSON: Thank you. Mr. Chairman, I've known you for over 35 years, and during all of those years, I've known you to be a man of high principle, and as a founding director of the Concord Coalition I know you have a principled view of the critical importance of long term fiscal responsibility. Yet at a recent meeting that I understand was public, my wife, a card carrying Democrat, heard you make a strong statement in support of Barack Obama's presidential candidacy. Now I don't know the truth of it, but some say he has the most liberal voting record in the senate. The obvious question is this, do you feel that the senator has some special attributes, like his presumed ability to unifying the country, that might transcend the principle of long term fiscal responsibility? Or is there a relationship between your support of Senator Obama and your commitment to long term fiscal responsibility?

PAUL VOLCKER: Well I will make a great confession in this small group that I did, I thought we weren't supposed to talk about political matters here…

PETE PETERSON: You and I have never done what we should have done.

PAUL VOLCKER: …this is non-political. Some time ago I did indicate my support for Barack Obama. My confession is I had not long studied his economic program and his voting record in the Illinois legislature, let me make that clear. Nor did I long examine his oppositions voting record on these matters or their economic program, and neither of which were very clear at the time. What I do have is some fairly strong feelings, and I don't like the direction that this country has been going in for some time, in many directions. Economic may be part of it, but it is only a small part of the problem in this country. Let me give you one little symptom of a lot that's wrong.

People have taken surveys of American opinion every year for years. One of these things where they ask the same question. Do you trust your government to do the right thing most of the time? Not a very tough examination. That used to be, 20 or 30 years ago, when we first met, the positive response was 70%. Now the positive response is 25 to 30%. I think that tells you something. The quarreling in Washington, the inability to get things done, the amount of money being spent to affect political outcomes or to create political roadblocks is, I think, damaging the ability of this country to meet the very huge problems before it. Whatever it is. Foreign policy, global warming, Medicare, medical expenses, medical programs, even something as simple, straightforward as social security, that you've been talking about for five years and nobody does anything. That's got to change.

It seems to me the kind of comments that Barack Obama was making, and if you read his books it's consistent, and they go back for some period of time, there's a recognition of those problems and a recognition that that takes a change in the political climate in this country and the mutual commitment and confidence of citizens in all directions, and when I look at the various candidates it seems to me that he is best able to achieve that purpose of reaching out with some hope of restoring confidence in the American public. I would just make other comment, which has struck me, when you look at those early election returns in Iowa or elsewhere, to exaggerate a bit, everybody under 30 was voting for Barack Obama, everybody over 60 was voting for Hillary Clinton. If you ask yourself, where does the future of the country lie, I think the answer is obvious.

GLEN HUBBARD: That's a good argument.

ED HYMAN Mr. Chairman, even if it's poetic, let me wish you a happy 80th birthday.

PAUL VOLCKER: I've got a hope for the Economic Club, if I may say, I had forgotten that this is supposed to be a birthday party. My birthday was eight months ago. But I wonder if you could arrange another dinner for me next year, and maybe we can celebrate my 79th birthday and we'll go backwards.

ED HYMAN: So thank you for meeting with us and thank you for delivering such a thought provoking and substantive speech. Thank you very much. My question is what are your views on the inflation outlook?

PAUL VOLCKER: Well my views of inflation is that it's a bad thing.

ED HYMAN: We're well aware of that.

PAUL VOLCKER: I think we have to keep making that clear, but what concerns me about the present situation, of course, it's very difficult, but I have reached a certain age where I can remember quite a few things, and there are some resemblances between the present situation, I'm afraid, and the early 1970's. Not in the late 1970's when inflation really got started. But you know, there was some fear of a recession, the oil price went skyrocketing up, the dollar was very weak, commodity prices went up, and there was some understandable, I was there, I was in the government, I wasn't in the Federal Reserve, thank God, but I was in the government and the answer you got was well, you know, the oil price had come down, it's temporary, it's a special circumstance. Soy beans, remember soy beans skyrocketed. We prohibited export of soy beans for a while. It sounds like rice today. But you found out that once that process got started and the extremes of those prices did come down, but the sense of some continuing inflation began to get built in. And you know, we had great hopes of having killed that a while ago, and I don't know what to say of inflationary expectations now. I don't think they're radical the way they were in the late 1970's, but I think we're at a point where we have to worry about it, and that cannot be excluded from policy consideration.

GLEN HUBBARD: Pete, the last non-partisan question goes to you.

PETE PETERSON: Mr. Chairman, in times past you have said that there is a 75% chance of a dollar crisis within five years. What are the likely scenarios that might lead to such a crisis? What would such a crisis look like and what would its implications be, and what might we do to prevent one? Or do you believe we're already in a dollar crisis?

PAUL VOLCKER: I think that's a very simple answer Pete. I think I said crisis time, not dollar crisis, and I said it about four years ago, and we're in it. You don't have to predict it, you're in it.

GLEN HUBBARD: There we have it. It falls to me to take the punch bowl away just as this party was getting going, but thank you so much Chairman Paul Volcker for those outstanding remarks and to our questioners. We do have, as lunch is being served, a birthday cake I believe somewhere being brought out to honor you on your 80th birthday, and we're happy to do 79, 78, 77 and just roll backward with you. (Happy Birthday to You).

END OF MEETING

The Big Print

© Copyright 2008 by Chris Hackett. All rights reserved.

The information and material presented in this report is intended only for **INSTITUTIONAL AND ACCREDITED INVESTORS** and **ONLY FOR INFORMATIONAL PURPOSES.** Information herein is not to be used as or considered as an offer, or the solicitation of an offer, to sell or to buy securities or other financial instruments.

Opinions, estimates and projections constitute our judgment and are subject to change without notice. Nothing in this report constitutes investment, legal, accounting or tax advice or a representation that any investment or strategy is suitable or appropriate to your individual circumstances.

Chris Hackett trades in the securities discussed in this report; we reserve the right to change our position in any security at any time without notice.

All information herein is obtained by Chris Hackett from sources believed by to be accurate and reliable. Because of the possibility of human or mechanical error, ALL information is provided "as is" without warranty of any kind. Chris Hackett makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information.

All information contained herein is copyrighted in the name of Chris Hackett and may not be copied or otherwise reproduced, transferred, or disseminated, in whole or in part, by any person without Chris Hackett's prior written consent.

Research Service & Methodology

Hackett's Special Situation Report is an independent, value-based investment research service used by institutional and accredited investors. The *Special Situation Report* identifies and explains outstanding investment opportunities; accordingly, investment positions are consistently contrary to conventional wisdom at the time they are published. Research methodology includes:

1. Identifying potential actionable valuation anomalies through extensive reading and active stock-screening. Companies studied typically have equity market capitalizations between $500 million and $2 billion.

2. Achieving a thorough understanding of the financial statements, governance practices, business models and valuation of investment candidates. The goal at this stage is to identify all the risks entailed in a particular investment.

3. Conducting extensive primary research when appropriate e.g., interviews of sales channel participants, competitors, suppliers and customers.

4. Developing inferences from data through the application of first principles.

5. Because the emphasis is on capital preservation, the *Special Situation Report* aggressively looks for reasons not to invest. The firm invests its own capital in every recommended transaction.

The objective of *Hackett's Special Situation Report* is to move the investment process from *decision making under uncertainty,* past *decision making under risk,* toward *decision making under certainty*.

The *Special Situation Report* is available on a subscription basis; custom research is also available for institutional and accredited investors.