

Present Financial Conditions & What to Expect

May 8, 2006

1. Speculation is rampant
2. Why? World awash with liquidity. Where did it come from?
 - 1.) Housing refinancing and home equity loans
 - 2005 - \$719 Billion
 - 2004 - \$633 Billion
 - 2001-05 - \$2,000 Billion (\$2 Trillion)
 - 2.) Negative corporation financing gap (after tax earnings and depreciation exceed capital spending.)
 - 2005 - \$566 Billion more than needed
 - 2005 - \$1,300 Billion in liquid assets at year-end (\$1.3 Trillion)
 - 3.) World Central Banks Reserves
 - 2005 - \$4,000 Billion (\$4 Trillion)
 - 2000 - \$2,000 Billion (\$2 Trillion)
 - 4.) World money supply growing 6% annually (2 times real growth)
 - 5.) Pension Funds
 - 2005 - \$46,000 Billion (\$46 Trillion)
 - 2000 - \$36,000 Billion (\$36 Trillion)
 - 6.) Hedge Funds
 - 2005 - \$934 Billion
 - 2000 - \$450 Billion
 - 7.) Government is draining funds, but money is recycled due to current account deficit (2 ½ x deficit) (\$800 Billion vs. \$320 Billion)
3. How come? – Government creates a moral hazard to halt recession
 - 1.) Government action 2001 (recession offset)
 - a. Tax cuts \$870 Billion
 - b. Interest rates 6 ½% to 1% (FF rate)
 - c. Defense spending +39% 2002-2005
 - 2.) Strong Market action to date as a result of the above
 - a. Housing – now cooling and critical to the future
 - b. Low grade bonds
 - c. Packaged debt obligations
 - d. Commodities
 - e. Private equity firms (EBITA 5 – 7 1/2 x)

f. Venture Capital (valuations +50%)

g. Foreign stocks

- 4. Risk is no problem today, only returns (investors want 20%)**
- 5. Upward Spike in yields today – Reversal tomorrow in government yields (much higher prices)**
- 6. Worldwide recession or worse to come, which will result in**
- 7. Strong dollar and Government bonds being the best place to be (rush to quality and safety)**
- 8. Investors will want a return of their money rather than a return on their money.**