



Reality Bites

By Michael Lewitt

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“So long as risk is effectively concealed from borrowers and lenders or actually shifted to others, risk-taking will be excessive. The initial phase of excessive risk-taking will manifest itself as an economic boom, but eventually, when actual losses begin to change the perceptions of borrowers and lenders and begin to impinge upon unsuspecting others, the boom will give way to a bust...[A] market system whose credit markets involve risks that are partially concealed from the lender and partially shifted to others will be biased in the direction of excessive risk-taking. And excessive risks are converted in time into excessive losses.”

Roger Garrison¹

The problem with bailouts is that you have to know what you're bailing out. But neither the U.S. government nor anybody else is capable of estimating the ultimate cost of bailing out such corporate giants as Citigroup, AIG, General Motors, Fannie Mae, and Freddie Mac (and the list goes on). There are two reasons for this. First, on a stand-alone basis, these companies are opaque and indecipherable entities. Financial innovation left transparency in the dust. Wall Street devoted much of its intellectual and political capital to concealing the risks it was creating. This concealment was deliberate; products needed to be priced inefficiently to produce profits. Second, these companies are integral parts of a networked global economy; as such, their value is completely dependent on the overall health of that network. Unless the network can be restored to health, these assets will remain severely devalued. Right now, the network is very sick. When a system is allowed to hide risk for so long, it is ill-equipped to manage that risk when it finally emerges from the shadows.

The Economic Policy Conundrum

The Obama Administration is facing a near-impossible task trying to bail the U.S. economy out of the muck of years of ill-begotten economic policies. The biggest challenge facing policymakers is not short-term recovery, however. Eventually,



stimulus is likely to arrest the forces of economic collapse and stabilize matters – at least temporarily. But the real problem is sowing the seeds of long-term, sustainable, organic economic growth. This is really the crux of the policy challenge. The United States in the midst of the worst economic downturn in 80 years as the result of a panoply of extremely poor economic policy choices. Economist Roger W. Garrison draws an important distinction between “healthy economic growth, which is saving induced (and hence sustainable), and artificial booms, which are policy-induced (and hence unsustainable).”² In other words, monetary policy that kept interest rates low for an extended period of time, tax policy that favored debt over equity, regulatory policy that allowed financial institutions to operate opaquely, and social policy that pushed home ownership regardless of affordability, all combined to create artificial economic demand that could only be financed with debt because the savings (i.e. equity) to purchase them did not exist.

Moreover, as more and more debt was created through financial engineering and policy prescription, the prices of these were bid up higher and higher. This led these products to become grossly inflated in value compared to any inherent economic worth they might possess. Once the bubble burst, their value dropped precipitously. Unfortunately, the face amount of the debt used to purchase these assets did not adjust downward at the same time. Assets that were purchased at inflated prices are now worth a fraction of what they were purchased for, leaving behind a serious dilemma for the owners of these assets and their creditors.

Following conventional economic thinking, the government believes that the solution lies in policies designed to reflate the value of these assets. The problem with this approach is that it is based on the incurrence of trillions of dollars of additional debt to create the demand needed to purchase these assets. Debt begetting more debt is a poor prescription for sustainable long-term economic growth. At best the government may be able to provide a short-term boost to the economy, but what the economy really needs is a solid, organic foundation for growth. Debt financed government demand can't be sustained indefinitely, which is why this policy is doomed to fail in the long run. The U.S. balance sheet is not a bottomless pit, although it is increasingly coming to resemble a Black Hole. At some point, the economy will have to generate sufficient tax revenue to pay for this government spending or the country will lose its AAA rating and ultimately become a troubled credit. Economic demand will ultimately have to become savings driven or it will again collapse.

This does not necessarily mean that the government should walk away from creating short-term demand, but it should be extremely circumspect in how it does so. This is where political reality collides with economic reality. The optimum long-term economic solution would be to allow the economy to hit bottom and then begin to rebuild demand naturally. But such a scenario would



likely entail an unemployment rate on the order of 15 or 20 percent and an even worse human toll than is already being exacted by the downturn. But it would give the economy an organic base from which to rebuild. The government's job in such a scenario would be to provide the right kind of safety net (not only of financial support but also job and educational training) to see the citizenry through the crisis. What the U.S. really needs is an economic Marshall Plan to rebuild itself, with all of the sacrifice and public service that would entail. Apparently, that is asking too much in today's me-first society. Accordingly, the government finds itself compelled to follow policies that may or may not create unsustainable short-term growth and will have to be carefully targeted to promote sustainable long-term growth.

There is a profound difference between healthy, sustainable demand and unhealthy, unsustainable demand, just as we are living the unhappy lesson that there is a great difference between healthy economic activity (i.e. activity that contributes to the productive capacity of the economy) and unhealthy economic activity (i.e. speculative trading and corporate finance transactions). Propping up bad banks through a "good bank/bad bank" model would simply direct funds to the sustenance of past unhealthy economic activity. Starting a new Economic Reconstruction Bank, as *HCM* has recommended, could make loans available for new productive projects and direct funds into healthy long-term economic activity. Another bout of policy-induced growth will not only repeat the mistakes of the past, but leave the economy even weaker, teetering on an unstable foundation of government support that cannot be sustained indefinitely without impairing America's balance sheet, credit rating, and ultimately its geopolitical might. Whether America's short-term political orientation can ever address this conundrum is the greatest question facing policymakers today. *HCM* has no hesitation in saying that much of what the government has proposed thus far to deal with the crisis won't come close to dealing with the long-term issue of creating savings-induced or organic growth. This means that any near-term relief (i.e. relief that occurs within the next five years) is most likely to give way to years of below trend growth because the economy will be lacking the organic foundation of growth it needs.

Dow 5000 Update

Year-to-date through February 27, the S&P 500 was down 18.62 percent and the Dow Jones Industrial Average was down 19.52 percent. Moreover, strategists and investors are increasingly coming around to the conclusion that corporate earnings are going to be nothing short of horrendous this year and that stocks are headed even lower, as *HCM* has been arguing for months (without pleasure, we hasten to add). Very recently, three of the smartest forecasters on Wall Street sharply lowered their earnings forecasts for the S&P 500.



- On February 13, David Rosenberg, Bank of America's North American Economist, recently reduced his 2009 and 2010 S&P 500 operating EPS forecast to \$46 (from \$56) and \$55.50 (from \$63), respectively. Mr. Rosenberg is now forecasting an S&P 500 low of 666 based on a 12x multiple of forward (i.e. 2010) earnings.
- Francois Trahan of ISI Group dropped his S&P 500 earnings forecast from \$60 to \$45 on February 23. Mr. Trahan used a 13x multiple to forecast a potential market low of 585.
- On February 26, Goldman Sachs' David Kostin dropped his 2009 and 2010 S&P 500 operating EPS forecast to \$40 and \$63, respectively, after deducting \$23 and \$8, respectively, for provisions and write-downs. Mr. Kostin uses a 13.2x multiple of 2010 earnings (pre-write-downs and provisions) to come up with a year-end 2009 S&P 500 target of 940.

These sharply lower forecasts are consistent with *HCM's* dim view of corporate earnings, but we believe that all three analysts are clinging to overly optimistic earnings multiples in predicting ultimate stock market lows. At this point, there is clearly a growing Wall Street consensus that S&P 500 earnings will come in well below \$50 in 2009 and that the correct multiple on these earnings should be in the 12-13x range. *HCM* continues to believe that the multiple should be lower based on the fact that (a) we are in a debt deflationary spiral, and (b) government yields are artificially depressed and signal economic distress and do not signal an attractive investment alternative, and corporate yields are extremely high and offer real competition for investor funds.

Last November, *HCM* set 2009 price targets of 5000 on the Dow Jones Industrial Average (DJIA) and 475 on the S&P 500 based on applying a 7x multiple to Goldman Sachs' then 2009 S&P 500 earnings estimate of \$65. (See *The HCM Market Letter*, Nov. 15, 2008, "Dow 5000") At the time, the S&P 500 was at about 850 and the DJIA was at about 8600. Our low multiple was based on our view that an environment characterized by debt deflation deserves a 6-8x multiple. Now that Mr. Kostin and others have lowered their multiple, it is only fair to raise the question whether we should be further lowering our target prices on these equity indices at this time based on applying our multiple to a lower earnings number.

For the moment, the market remains far above our previous targets. Our targets are intended to be directional in nature and we see no reason to lower them further at the current time. We have made our point, which is that the stock market is likely to head sharply lower in the months ahead. Moreover, the earnings estimates have been lowered primarily based on expectations for



further write-offs by financial companies (and non-financial companies that wandered into the financial space). Investors may treat these write-offs and provisions as nonrecurring items and look to higher recurring S&P 500 earnings in pricing the market. While we The HCM Market Letter March 1, 2009 continue to believe that the multiple should be in the single digits, the correct recurring earnings number remains a moving target. Accordingly, at this time it would be premature to lower our estimate further. Needless to say, we remain extremely comfortable with our prior estimates of 475 on the S&P 500 and 5000 on the DJIA.

A bear market rally is possible at any time. Investors should be aware that as the market moves lower, rallies have the potential to be extremely sharp since they are starting from compressed levels. Such rallies should be used to reduce overall equity exposure. That does not mean that equities should be abandoned totally. There are a number of stocks that are trading at well below book value (even taking into account the declining transfer value of their assets) that may be worth buying in the months ahead. The debt of these companies, which *HCM* is particularly active in, is even more compelling as an investment. But investors need to identify longer term changes in market behavior and the economic environment before becoming bullish again on stocks. Right now, there are no such signs, such as better employment, housing or GDP numbers, or tightening credit spreads, or improving market technicals. *HCM* is starting to sense that the forces of denial, as potent as they are, are starting to weaken. Accordingly, investors should structure their portfolios for further equity declines.

The “D” Word

The fourth quarter GDP loss of 6.2 percent (did anybody really believe the 3.8 percent estimate?) illustrates just how deep a hole our economy has to climb out of. The economy fell into this hole almost literally overnight, but it's going to take much longer to climb out. A quick recovery is out of the question. *HCM* expects first quarter GDP to be in the -6.0 to -7.0 percent range based on our reading of employment, housing and other economic data as well as the data we are seeing from the 200 or so companies in our portfolios across a wide variety of industries. Moreover, based on our view that the stimulus plan will be largely ineffective this year and that more large-scale business failures are in the works (many of them slow-motion car wrecks), we do not expect to see positive economic growth until sometime in mid-to-late 2010 (and then only modest growth).

Investors expecting a conventional bear market/bull market cycle are likely to be sorely disappointed. Over the past several decades, U.S. stock market investors have been conditioned to believe that the market will bottom and then rebound. Bear markets have been brief within the context of a long bull market that stretches back to the 1980s. But the current environment is likely going to be



different. We are now experiencing a destruction of wealth on a scale that is both unprecedented and permanent because much of that wealth was built on a fragile foundation of debt; in reality, much of that wealth didn't really exist in the first place. As a result, what people believed to be economically valuable and stable was in fact nothing of the kind. In many respects, the latter stages of the bull market were little more than an illusion. Real corporate earnings and genuine productivity peaked years ago, and the economy has been operating on debt-induced fumes for years.

Accordingly, investors need to prepare themselves for a future that will not resemble the recent past. Ray Dalio, the wise man who runs Bridgewater Associates, noted in a recent *Barron's* interview that investors need to recognize that the current environment more resembles a depression than a recession: "Everybody should, at this point, try to understand the depression process by reading about the Great Depression or the Latin American debt crisis of the Japanese experience so that it becomes part of their frame of reference. Most people didn't live through any of those experiences, and what they have gotten used to is the recession dynamic, and so they are quick to presume the recession dynamic. It is very clear to me that we are in a D-process." (*Barron's*, February 9, 2009, "Recession? No, It's a D-process, and It Will Be Long," pp. 38-40.) Mr. Dalio's view is consistent with *HCM's* long-argued view that we are in a debt-deflationary spiral whose end is nowhere in sight.

The characteristics of our current economic situation are as follows:

- Interest rates have dropped to zero.
- Bank stocks have plunged by 90 percent or more.
- The Federal Reserve's balance sheet has exploded.
- Credit spreads have widened to historic levels.
- The economy is seeing massive asset deflation.
- Debt is being destroyed in record amounts.
- Unemployment is increasing each month.
- The financial industry is shrinking radically.
- Manufacturing activity has slowed sharply.

This is not a situation that is consistent with recent American experience. *HCM* has previously described a depression as an economic condition in which traditional monetary and fiscal policy is rendered ineffective. For the moment, we are deeply entrenched in such a situation. The question is how long the economy will remain depressed before some of the remedies that have been proposed start to work. Unfortunately, *HCM* fears we may be in for an extended stay.



For these reasons, *HCM* believes that after the stock market bottoms, it will drift along at a depressed level for an extended period of time. The American economy will experience less than-trend growth for a similarly prolonged period of time. The economy will have to absorb trillions of dollars of bad debts and transition its resources away from speculative activities and toward new productive endeavors. The economy has to be completely retooled, and this process will not happen overnight, particularly because such a program must be directed by a highly inefficient democratic political system that is inefficient in reaching consensus about its goals and how to achieve them. Unfortunately, the deeper involvement of the government in the financial and other sectors of the economy is likely to stifle growth, innovation and creativity and further contribute to lower growth for years to come.

Investing Today

This by no means is intended to suggest that investors will be unable to make money. It does suggest, though, that the era of bull market geniuses is probably over. Too many were paid too much for doing too little over the past several decades. Being at the right place at the right time is not going to cut it anymore. But as the debt destruction process plays out, new investment opportunities will arise in the capital structures of restructured and surviving companies.

As investors go about reallocating money to new opportunities, they may want to keep in mind something that *HCM* recently read in *The Economist*.

“Over the past 35 years it has seemed as if everyone in finance has wanted to be someone else. Hedge funds and private equity wanted to be as cool as a dotcom. Goldman Sachs wanted to be as smart as a hedge fund. The other investment banks wanted to be as profitable as Goldman Sachs. America’s retail banks wanted to be as cutting-edge as investment banks. And European banks wanted to be as aggressive as American banks. They all ended up wishing they could be back precisely where they started.” (*The Economist*, “A special report on the future of finance,” January 24, 2009, p. 17.)

There are a limited number of investment opportunities that make sense in today’s market, and there are a limited number of managers qualified to execute those strategies. Unfortunately, managers in out-of-favor or discredited strategies are now trying to reinvent themselves as managers of the few in-favor strategies in which they have limited or no experience. *HCM* is seeing this occur in the corporate credit space, where firms that have previously operated in areas peripheral to the credit markets such as private equity or mortgages are suddenly touting their expertise in corporate credit. These managers are wading into uncharted territory. Investors must insure that managers possess the expertise



that is required for the strategies for which they are being hired. They have already experienced the disastrous results of private equity firms thinking that doing deals would prepare them for investing in bank loans.

Bank Nationalization

We are quickly learning the flaws of the half-baked approach to supporting the nation's banks that the Bush Administration adopted and the Obama Administration seems hell-bent on continuing. At least the Bush Administration had an excuse – the former Treasury Secretary was a career investment banker who saw the world through the eyes of Wall Street. Perhaps *HCM* was naïve in hoping that the new Treasury Secretary, having been a career regulator who viewed matters through the opposite end of the glass, would see things differently. We probably should have known better since Mr. Geithner participated in the Bush Administration's bailout. But the quasi-nationalization approach is clearly a disaster for all concerned (the recent article describing the hall of mirrors that used to be Citigroup is a case in point - see *The Wall Street Journal*, February 25, 2009, "Citigroup Chafes Under U.S. Overseers," p. A1.) There seems to be little disagreement that two of the country's major banks – Citigroup and Bank of America – are in the zone of insolvency. Their assets are worth less than their liabilities and their shareholders have been wiped out in all but name (and in the little drill-bits of stock that trade publicly as make-believe options on their long-term recovery). But the system can't seem to bring itself to admit that these banks have been effectively nationalized in all but name and that taking the final step of nationalizing them is in many respects just a matter of form over substance. The only thing worse than a banking system that has been privatized is one that has collapsed, but that is the choice we are faced with. The Rubicon has been crossed and we need to clear away tons of debris that are clogging up the river before we can cross back to the other side.

Moreover, maintaining the illusion of public ownership has enabled some of the individuals running these institutions to engage in some of the most irresponsible behavior ever seen in the history of American business. *HCM* is speaking specifically of the pay-out of billions of dollars of bonuses to the executives and employees of Merrill Lynch on the eve of its forced takeover by Bank of America. This act, which Bank of America's Chairman Ken Lewis claims he was powerless to stop (*HCM* does not believe him) and former Merrill Lynch Chairman John Thain, in what can only charitably be described as a gross breach of conscience and good judgment, somehow sanctioned, are *prima facie* evidence that the hybrid public/private TARP model is totally untenable and should be shelved immediately. Those banks that can repay the TARP money (or produce a believable plan to do so within three years) should be permitted to do so forthwith, and those that are teetering on the brink of insolvency should be nationalized. Otherwise, the managements of these firms are going to pay more



attention to figuring out how to game government compensation limitations than maximizing the value of their troubled assets over the next several years. *HCM* never thought we would say that there are worse things than nationalization, but there are and we saw them when billions of dollars was paid out to the people who lost even more billions of dollars at Merrill Lynch. This has to have been one of the most brazen thefts in American history.

Let GM Go

General Motors has been insolvent for years. Yet political expediency has prevented recognition of this harsh truth. The company's unions have blocked efforts to bring the company's cost structure into line with changing economic realities. Michigan's powerful Congressional delegation has blocked efforts to improve American automobiles' fuel efficiency, creating an opening for foreign manufacturers with lower cost structures to steal the hearts and minds and pocketbooks of American consumers. Years of bad choices have now left the U.S. government with a terrible choice – whether to give GM billions of dollars of money inside or outside of bankruptcy. The correct decision, as unpalatable as it may be, is painfully obvious. All of the king's horses and all of the king's men are not going to be able put GM back together again. It is time to let this American icon declare bankruptcy in order to maximize the chances of salvaging something out of this American tragedy.

GM is still paying or accruing billions of dollars of annual interest payments on the company's more than \$40 billion of debt. The company is negotiating with holders of \$27.5 billion of this debt, which is unsecured, to reduce it to \$9.2 billion (by exchanging stock for bonds). Yet all of this debt and stock is worthless. Instead of wasting time haggling with debt holders over exchanging a portion of their worthless claims for worthless stock, the company should declare bankruptcy so these claims can be wiped out. GM's ability to meet the government's February 17 deadline was delayed by its inability to come to an agreement its bondholders. The bondholders are institutional investors who believe they are exercising their fiduciary duty to their beneficiaries by trying to squeeze the best deal possible out of the automaker. But the sad reality is that they made a bad investment and should suffer the consequences. We need to stop trying to save everyone from the consequences of their errors or else they will keep making them.

The unions are also trying to salvage an ownership stake out of this mess. The company is negotiating to exchange half of approximately \$20 billion of Voluntary Employee Benefit Association (VEBA) obligations into equity. Unfortunately, 100% of the VEBA obligations are likely worthless since GM will never be able to pay them. The VEBA was part of the bargain that the unions made with GM over the years. Workers gained generous wages, benefits and work rules that



rendered the company uncompetitive. This was not a secret – the company's loss of market share and weakening financial position was apparent for years to the unions as well as to everyone else. The unions won the bargain but they lost the war. The company doesn't owe the workers anything more than what can be granted in bankruptcy, which is likely a meaningful equity stake in exchange for the VEBA and the billions of dollars of other healthcare and pension obligations owed to current and retired workers. This is undoubtedly a tragedy of enormous human dimensions, but responsibility for it is shared by all Americans who sat by while their politicians and business leaders allowed GM to sink into insolvency. Accordingly, America owes the workers a safety net when they lose their jobs and benefits. But this should be the same safety net society owes all of its displaced workers, not a special one for former GM workers.

Allowing GM to file for bankruptcy will be a blow to the American psyche. But GM has already gone bankrupt in all but name. In suggesting that it will require \$125 billion in financing to undergo a bankruptcy, the company may be playing chicken with Congress but is more likely indicating just what a Black Hole of liabilities it has become over the decades. America must have the courage to deal with this reality. Bankruptcy will give the company, and the country, an ability to make the hard decisions that it refused to make before. Either way, GM's failure is going to cost taxpayers tens of billions of dollars. But until we are willing to be honest about our failures, we are never going to put ourselves in a position to avoid future ones.

Obama's Budget

President Obama's is in many respects a dramatic break with the past, although in many respects it falls short of the type of radical tax and other changes that are really needed (but may simply not be politically feasible). We just hope that Mr. Obama's reach does not exceed his grasp. Many things may have changed economically in recent years, but one thing has not: a country can't tax and spend its way into prosperity. Moreover, we are confident that the growth rate assumptions used in years 2, 3 and 4 of our new president's proposed budget are unrealistic. The economy is unlikely to grow at anything close to 3 to 4 percent in those years, and relying on that much growth to close the budget deficit by the end of Mr. Obama's first term will only lead to disappointment. This economy, which shrunk at an annual rate of 6.2 percent in the fourth quarter of 2008 and will almost certainly not show any growth at all in 2009, is not going to magically spring back to life in 2010. Mr. Obama is setting himself up for failure with these projections.

HCM was very happy to see that the Administration is prepared to rid the tax code of the egregious treatment of private equity carried interests, which we have recommended before (see *The HCM Market Letter*, April 1, 2008, "How to Fix



It”). Now that private equity has become a loss-leader for its partners, we would caution those drafting the legislation to make sure that private equity does not gain an unintentional windfall from this legislation. This could occur if private equity partners were permitted to deduct claw-back payments (i.e. repayments of carried interests earned early in a partnership based on losses incurred later in a partnership) at the new higher tax rate if they were taxed on those original payments at the lower rate. In order to prevent such a benefit, if the original payment was taxed at 15 percent, repayment of that money should only give rise to a deduction at 15 percent, not the higher ordinary income tax rate.

We think limitations on charitable deductions are poor public policy. The argument that wealthier people should not receive a greater dollar-for-dollar benefit for charitable deductions than less affluent people is a red herring, particularly in view of the fact that the Alternative Minimum Tax already haircuts high earners’ charitable gifts. We also believe that limitations on mortgage deductions would be better handled by limiting deductions for mortgages over a certain dollar amount rather than by income; such a methodology would be more effective in fighting housing speculation.

We are opposed to raising taxes on capital, but we also recognize that we are in a fiscal emergency and that raising the capital gains tax from 15 percent to 20 percent on the wealthiest Americans would not impose undue hardship and would keep the rate relatively low. We would prefer to see capital gains rates implemented on a graduated scale based on the amount of capital gains reported in a single year. Someone who earns an especially large gain could certainly afford to pay a little more in tax. We commend the plan for maintaining the 15 percent tax rate on dividends, which should not be taxed at all since they are already taxed at the corporate level and remain an extremely inefficient means of returning capital to shareholders.

The biggest problem with the budget – and with any budget, not just Mr. Obama’s – is that the government just wastes so much stinking money. The reason people find higher taxes abhorrent is not because they don’t want to help those less fortunate than themselves, or fund necessary government programs, but because they don’t want their money to be treated like Congress’s personal piggy bank. We would love to see the list of the \$2 trillion of wasteful programs that Mr. Obama claimed his team has already identified for elimination. The amount of government waste is truly mindboggling, and Mr. Obama must insist on spending discipline if he is to have any chance to keep the budget deficit from exploding over the next four years.

The Coming Meltdown in Eastern Europe



By all accounts, the former Eastern Bloc countries that so successfully navigated their entry into world capitalism after the fall of communism have borrowed themselves into near oblivion and are about to inflict frightening losses on their own banks and Western European banks, their main aiders and abettors. Our good friend John Mauldin has been out front on this story, which has enormous implications for the global financial system. The ever prescient Christopher Wood has also been warning about an Asian-style banking crisis in the region, with serious ramifications for the Western European banks that loaned these institutions by some reports trillions of dollars. This is a story that needs to be followed in the coming weeks because it will have major negative consequences for world financial markets. To state the obvious, this is the last thing the world economy needs to deal with right now.

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1 Roger W. Garrison, *Time and Money The Macroeconomic of Capital Structure* (New York: Routledge, 2001), pp 111, 120.

2 Garrison, p. 56.

Disclosure Appendix

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