

December 17, 2007

I Don't Know

I have been giving serious thought to the US economic mess and have been wrestling with my 'Outlook for 2008 and beyond'. Fortunately, we have been early in recognizing the credit crisis, but now must look beyond just the sub-prime mess. One of the trading commandments I live by is that 'what the market knows isn't worth knowing'. This is just another way of saying that when 'news' makes it to the front page of my local newspaper it is time to focus your attention on the next potential issue. We need to focus on the UNKNOWN. The unknown is what can undermine portfolios and wreak the greatest amount of havoc in the future. Which bring me to the title of this piece - 'I Don't Know'.

I feel fortunate to have a good handle on the macro-economic situation we are facing, as grim as it feels. But what bothers me, and what I don't know, is the following—We are now in uncharted and waters for leverage, risk, derivatives, and moral hazard—more than has ever been seen before, and quite possibly, more than we ever may see again in our lifetime. The unwinding of these enormous risks may likely be corrected by some event(s) that we have never witnessed before. Deflation? Hyperinflation? Recession? Depression? Stagflation? Or some unkindly combination?

In the movie "Fast Times at Ridgemont High", Sean Penn plays a lovable stoner without a clue who is named Jeff Spicoli. One of his memorable moments in the movie was an exchange with his history teacher Mr. Hand.

Jeff Spicoli: I don't know.

Mr. Hand: [*Mr. Hand goes to blackboard and writes the words 'I Don't Know', then underlines them*]
[*reciting*]

Mr. Hand: I like that. 'I Don't Know.' That's nice.
(For the video clip: <http://www.youtube.com/watch?v=D4AZCnH4PYg>)

I am not proud to say "I don't know", but it is honestly the way I feel about the markets. If you are unsure about what is next while managing money, play it safe, close to the vest and don't try to be a hero. We will prudently attempt to squeeze as much return as possible from the markets until the future seems less opaque. We will not hide from risk nor will we hide from the truth. For the one thing we do know is that on the other side of this uncertainty lies THE LAND OF OPPORTUNITY. By not losing during times of uncertainty we are in a position to profit afterwards. The key to winning is, NOT TO LOSE.

Bulls, Bears, HOG's and Objectivity

I know many people that are permanently bullish and some that are permanently bearish. The perma-bulls tell you to remain 100% invested in the 'long run' as stocks are the highest returning asset class over very long periods, like 100 years. I have no argument with the long term rate of return, but I have yet to meet an investor that either has a 100 year time horizon or can actually sit through all of the bear markets that occur during 100 years. In fact, most that I know have difficulty sitting through any down move at all. It is very difficult to 'turn off your screens' or 'turn off your TV' for 100 years.

The perma-bears on the other hand wake up 'praying for rain'. They will look at all of the market data and simply focus on the bad news. This process is fruitless as the perma-bear can be hibernating in his cave for decades at a time.

I have not been terribly constructive on stocks over the past 10 years, and alas, stocks are at the same level (using the S & P 500 as a proxy) as they were nearly 10 years ago. If I were a perma-bull, I would have sat through those 10 years, absorbed tons of volatility and had not much to show for it except that I had burned through a ton of 'emotional capital' which comes with volatility, particularly downside volatility. On the other hand, if I was a perma-bear, I would have missed out on all of the wonderful intermediate term trading opportunities along the way, many of which we have been fortunate to catch for our investors.

We are in a secular bear market in stocks that began in either April 1998 (the NYSE net 'advance/decline line' topped then) or in March 2000 (the S & P 500 topped then), depending on your perspective. But within secular moves that last 20 years or so, there are usually 5 to 10 'cyclical' markets. With the advent of exchange traded funds (ETF's), the choices that we have as investment managers has increased, which has benefitted our investors. We took the opportunity with the latest 'Fed rally' to reduce our equity exposure to our lowest in a number of years.

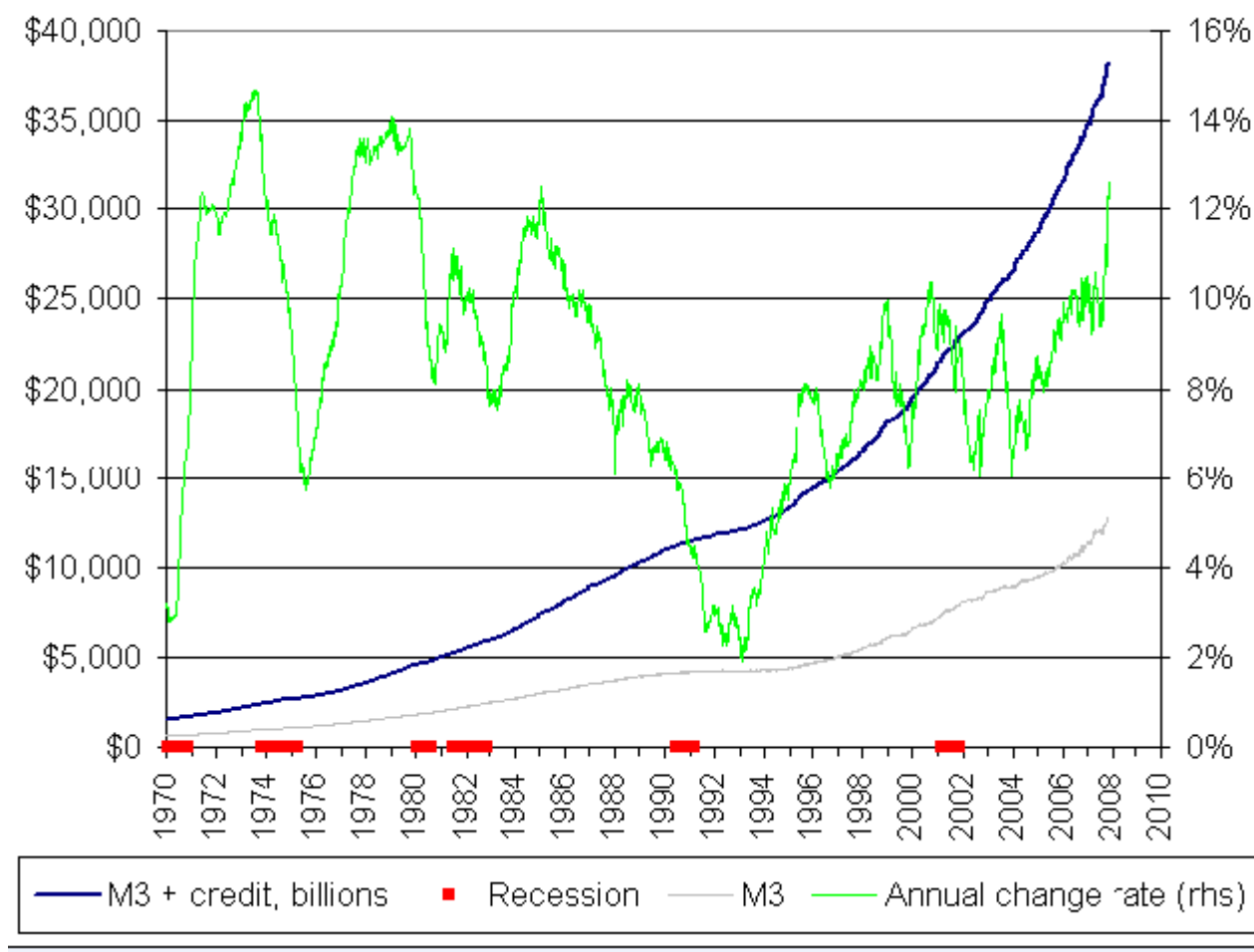
In my opinion, we are either in a recession, or very close to being in a recession. Further, it appears that we may be in the early stages of a stagflationary period when the economy contracts as inflation increases. Just how much is inflation increasing? We use inflation numbers that included food and energy in our firm as it is a farce to exclude them. We also use the relationship between 10 year Treasury yields and annual CPI or PPI changes as a guide to see whether yields are too high or too low. A prudent investor should demand a higher 10 year Treasury yield than inflation, but recently announced CPI and PPI year-over-year statistics show that real yields (interest rate minus inflation) are in fact negative. In the two charts below, I have gone back 42 years and shown the relationship of yields versus inflation. Real yields in CPI are now slightly negative and real yields versus PPI are decidedly negative. There are two possible outcomes—either inflation needs to decline or yields need to increase. As such, we are cautious as it regards longer term Treasuries.

10 Year U.S. Treasury Yields minus Year-over-Year Overall CPI



Copyright 2007 Bloomberg L.P.

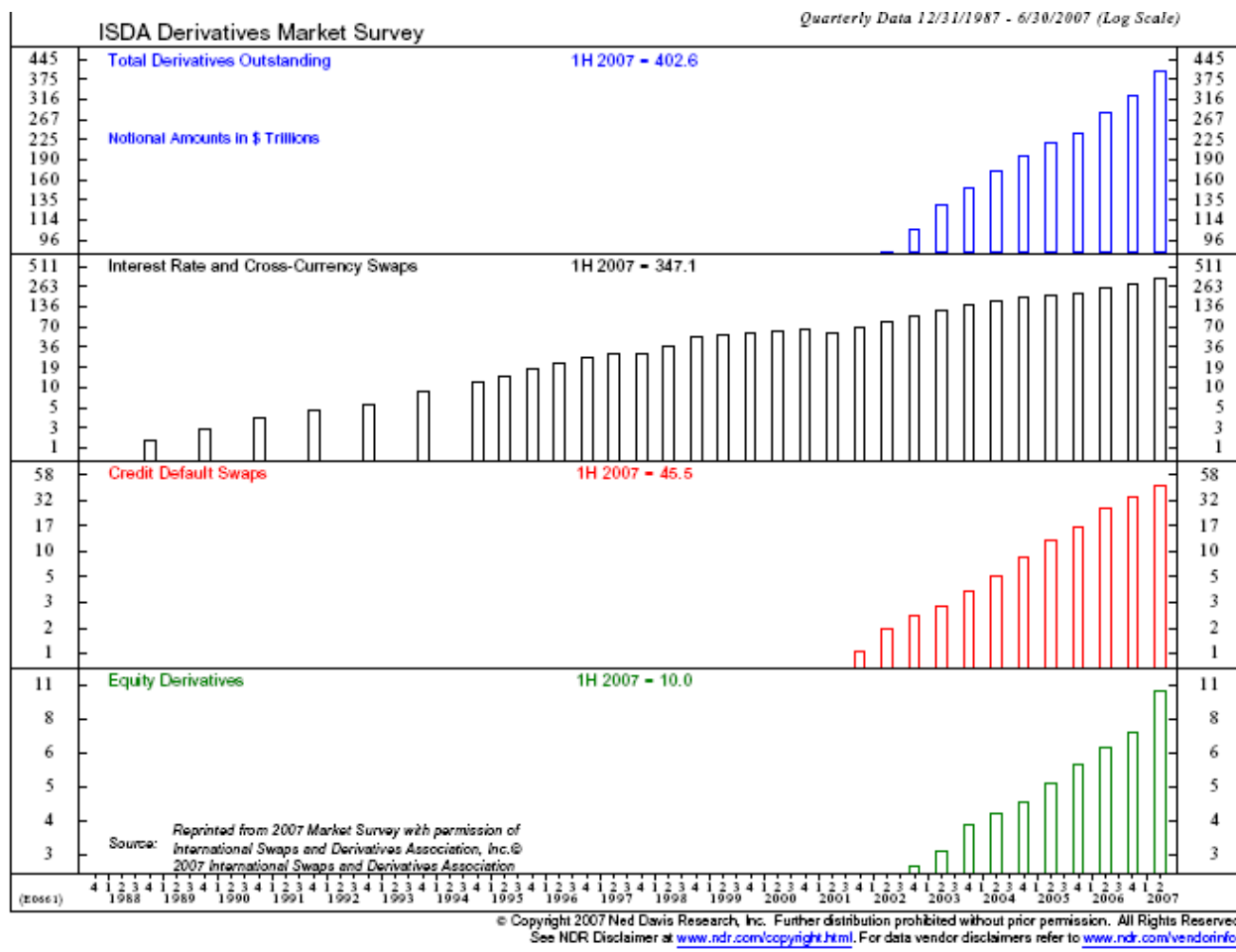
Combined M3 and Credit Market Debt Growth



Since I have been highlighting M3 and credit growth for years, you may ask yourself why I am no longer focused on it. It's not that it isn't important, just less relevant than DERIVATIVES which have grown so large that any major 'event' in the derivatives market could tear the financial system apart at the seams. According to the Bank for International Settlements (B.I.S.) there are now more than *HALF A QUADRILLION DOLLARS OF DERIVATIVES OUTSTANDING*, even growing now at 25% quarter-over-quarter.

Note that the chart I have attached, courtesy of Ned Davis Research ends on June 30th 2007 and doesn't include the latest data. Note not only the size of the market, but the **TRAJECTORY** of the growth. Again, it is parabolic. But if something goes awry in this market, what will the impact be? I have a fairly lame response—**I don't know**. Last year, I highlighted this during a presentation in New York as one of my fears for the future and someone asked me, 'surely the risks are hedged away, no?' Again my answer is that I doubt it, but truly, **I don't know**.

Derivatives by Sector Ending June 30th 2007

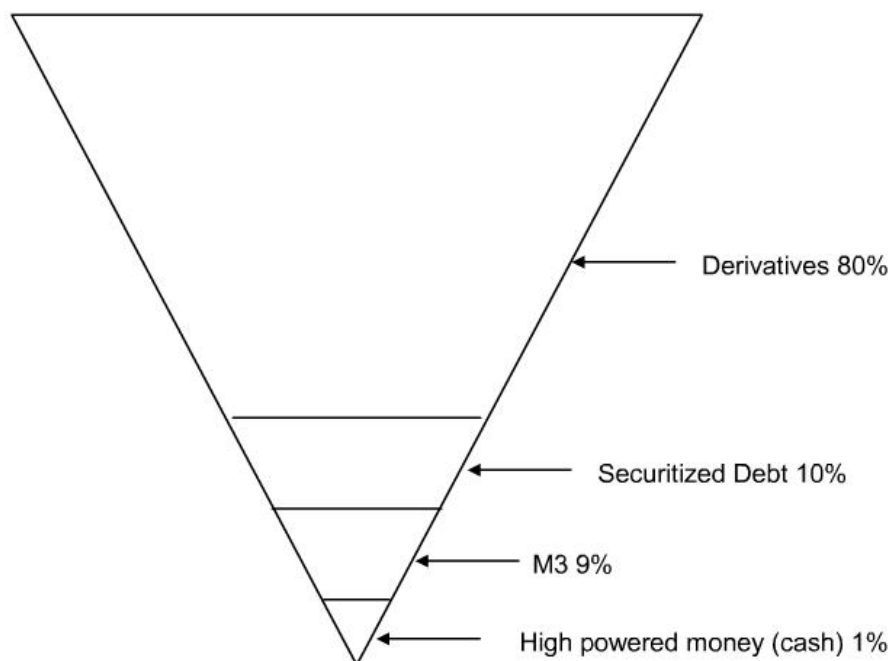


I read an article the other day on www.minyanville.com that highlighted just how large the derivatives market was in comparison to the rest of the 'capital structure' worldwide.

(Full article here: <http://www.minyanville.com/articles/Fed-banks-debt-liquidity/index/a/15121>) The chart is staggering and can be found below.

The World's Capital Structure-Total Liquidity

Total Liquidity



A Few Quotes from Warren Buffet

“Risk comes from not knowing what you're doing.”

“Rule No.1: Never lose money. Rule No.2: Never forget rule No.1.”

“If past history was all there was to the game, the richest people would be librarians”

“We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.”

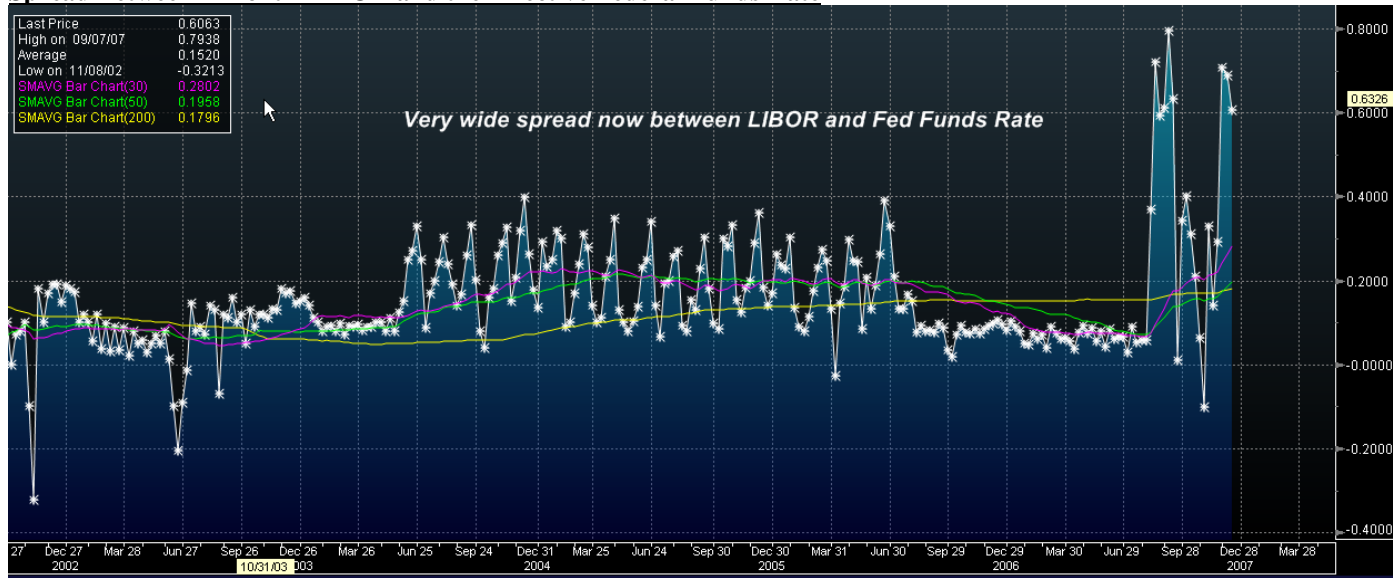
“**Derivatives** are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”

Warren Buffet is known as one of the best investors of all time and he only buys things that he understands and that can be held for extremely long periods of time. Forget for a moment that he is sitting on a gigantic cash hoard. Just look at the last quote. I would bet that if you asked him whether counterparty risks were developing between financial institutions, and what he thought would happen to the markets, the answer would likely be either ‘**there is no way to know**’, or ‘**I don’t know**’. Those are my answers.

This leads me to the very interesting possibility that banks no longer trust each others as counterparties. LIBOR is the rate that banks charge each other around the globe. For many years 1 month LIBOR traded virtually even with the effective Federal Funds rate. But this is no longer the case. No matter how much the ECB and Fed inject into the system, the spread is now very wide, a sign of market stress. Could it get wider? Yes. What would be the implications? Likely an ‘event’ would occur in the credit/credit derivatives market. What impact will this have

on the economy as a whole? Probably not a very pretty impact which is why we continue nearly void of credit risk. But the honest to goodness answer is **‘Mr. Hand, I don’t know’**. I only know to be cautious.

Spread Between 1 Month LIBOR and the Effective Federal Funds Rate



Copyright 2007 Bloomberg L.P.

Happy Holidays to you and yours.
Bennet Sedacca

ATLANTIC ADVISORS, LLC AND HARBOR PILOT ASSET MANAGEMENT, LLC DISCLAIMER

LEGAL AND OTHER INFORMATION. Any information, data, statements, opinions, or projections made in this Newsletter may contain certain forward looking statements, projections and information that are based on the beliefs of Atlantic Advisors and Harbor Pilot Asset Management as well as assumptions made by, and information currently available to, Atlantic Advisors and Harbor Pilot Asset Management. Such statements in this Newsletter reflect the view of Atlantic Advisors and Harbor Pilot Asset Management with respect to future events and are subject to certain risks, uncertainties and assumptions (including, but not limited to, changes in general economic and business conditions, interest rate and securities market fluctuations, competition from within and without the investment industry, new products and services in the investment industry, changes in customer profiles, and changes in laws and regulations applicable to Atlantic Advisors and Harbor Pilot Asset Management). Should one or more of these or other risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this Newsletter. Furthermore, although carefully verified, data is not guaranteed as to accuracy or completeness. Any quotations of individuals other than the authors or providers of this Newsletter are provided for informational purposes only and their accuracy and veracity are not guaranteed. The statements, opinions, and/or data expressed in this Newsletter are subject to change without notice based on market and other conditions. This Newsletter is based on information available as of the time it was written, provided, or communicated and Atlantic Advisors and Harbor Pilot Asset Management disclaims any duty to update this Newsletter and any content, research or information contained therein. Accordingly, neither Atlantic Advisors and Harbor Pilot Asset Management nor its principals or affiliates make any representation as to the timeliness of any information in this Newsletter. As a result of all of the foregoing, inter alia, neither Atlantic Advisors and Harbor Pilot Asset Management nor its principals can be held responsible for trades executed by the recipients or viewers of this Newsletter based on the statements, projections, research, or any other information of any other kind included therein. *Investments in securities are speculative and involve a high degree of risk; you should be aware that you could lose all or a substantial amount of your investment if you attempt to apply any of the information in this Newsletter.*

Atlantic Advisors and Harbor Pilot Asset Management are not registered as a securities broker-dealer either with the U.S. Securities and Exchange Commission or with any state securities regulatory authority or with any foreign country. This Newsletter should not be construed by anyone as Atlantic Advisors and Harbor Pilot Asset Management solicitation or offer to effect or attempt to effect transactions in securities or the rendering of personalized investment advice (or an offer thereof) for compensation. This Newsletter, and any information and research contained herein, do not represent recommendations of investment advice to buy or sell securities or any financial instrument nor are they intended as an endorsement of any security or investment. This Newsletter is for informational purposes only and any watch list, portfolio, trading signal or information contained in this Newsletter represents the writer’s or provider’s own investment opinions, and should not be construed as personalized investment advice. Atlantic Advisors and Harbor Pilot Asset Management has not assessed, verified, or guaranteed the suitability of any particular investment to any personal situation and the reader of this Newsletter bears complete responsibility for its own investment research and should seek personalized advice from a qualified investment and/or tax professional prior to making any investment decisions. Atlantic Advisors and Harbor Pilot Asset Management may only transact business or render personalized advice, and offers of service can only be made, in those states, countries, and/or international jurisdictions where Atlantic Advisors and Harbor Pilot Asset Management is registered or where an exemption or exclusion from registration is available. Nothing herein is an offer of any service that is not legal for offer into any particular jurisdiction with Atlantic Advisors and Harbor Pilot Asset Management current licensure (if any).

Atlantic Advisors and Harbor Pilot Asset Management and its respective officers, directors, employees, clients, and/or associated persons may have positions in, and may from time to time make purchases or sales of, the securities discussed or mentioned in this Newsletter. Furthermore, Atlantic Advisors and Harbor Pilot Asset Management and their respective officers, directors, employees, clients and/or associated persons may implement any strategies discussed in this Newsletter before or after such strategies are disclosed to recipients of this Newsletter. The profitability of any strategies communicated through this Newsletter may depend upon a limited number of persons implementing and knowing about the strategies. As a result of Atlantic Advisors and Harbor Pilot Asset Management and their respective officers, directors, employees, clients and/or associated persons trading and implementing the securities and strategies, respectively, discussed in this Newsletter, before or after such securities or strategies are discussed or disclosed to recipients of this Newsletter, such recipients may face decreased or no profitability and increased competition in the marketplace when seeking to implement such strategies or trade such securities. The principals of Atlantic Advisors and Harbor Pilot Asset Management might not purchase or utilize in this Newsletter, or make any reference therein to, the securities or strategies, respectively, used for any client affiliated with Atlantic Advisors and Harbor Pilot Asset Management or its principals.

NO WARRANTY. ATLANTIC ADVISORS AND HARBOR PILOT ASSET MANAGEMENT, ITS AFFILIATES, AND THEIR OFFICERS, DIRECTORS, PRINCIPALS, AGENTS AND EMPLOYEES MAKE NO REPRESENTATIONS OR WARRANTIES, EXPRESS OR IMPLIED, REGARDING THE SUITABILITY OR OTHER CHARACTERISTICS OF THE INFORMATION AND MATERIALS CONTAINED IN OR PRESENTED THROUGH THIS NEWSLETTER. ALL SUCH INFORMATION AND MATERIALS ARE PROVIDED “AS IS”, WITHOUT ANY WARRANTY OF ANY KIND. ATLANTIC ADVISORS AND HARBOR PILOT ASSET MANAGEMENT HEREBY FURTHER DISCLAIMS ALL WARRANTIES AND CONDITIONS WITH REGARD TO SUCH INFORMATION AND MATERIALS, INCLUDING ALL IMPLIED WARRANTIES AND CONDITIONS OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE TITLE, NON-INFRINGEMENT AND AVAILABILITY.

LIMITATION OF LIABILITY. IN NO EVENT SHALL ATLANTIC ADVISORS AND HARBOR PILOT ASSET MANAGEMENT, ITS AFFILIATES, OR THEIR OFFICERS, DIRECTORS, PRINCIPALS, AGENTS AND EMPLOYEES BE LIABLE FOR ANY CLAIMS, LIABILITIES, LOSSES, COSTS OR DAMAGES, INCLUDING DIRECT, INDIRECT, PUNITIVE, INCIDENTAL, SPECIAL, CONSEQUENTIAL DAMAGES (INCLUDING BUT NOT LIMITED TO, LOST PROFITS OR TRADING LOSSES), OR DAMAGES OF ANY KIND WHATSOEVER ARISING OUT OF OR IN ANY WAY CONNECTED WITH THIS NEWSLETTER (INCLUDING WITHOUT LIMITATION, THE CONTENT, INFORMATION, RESEARCH OR SERVICES INCLUDED THEREIN) WHETHER BASED ON THEORIES ARISING IN CONTRACT, TORT, STRICT LIABILITY OR OTHERWISE. SUCH LIMITATIONS APPLY EVEN IF ATLANTIC ADVISORS AND HARBOR PILOT ASSET MANAGEMENT, ITS AFFILIATES, OR ANY OF THEIR OFFICERS, DIRECTORS, PRINCIPALS, AGENTS OR EMPLOYEES HAVE BEEN ADVISED OF THE POSSIBILITY OF DAMAGES.