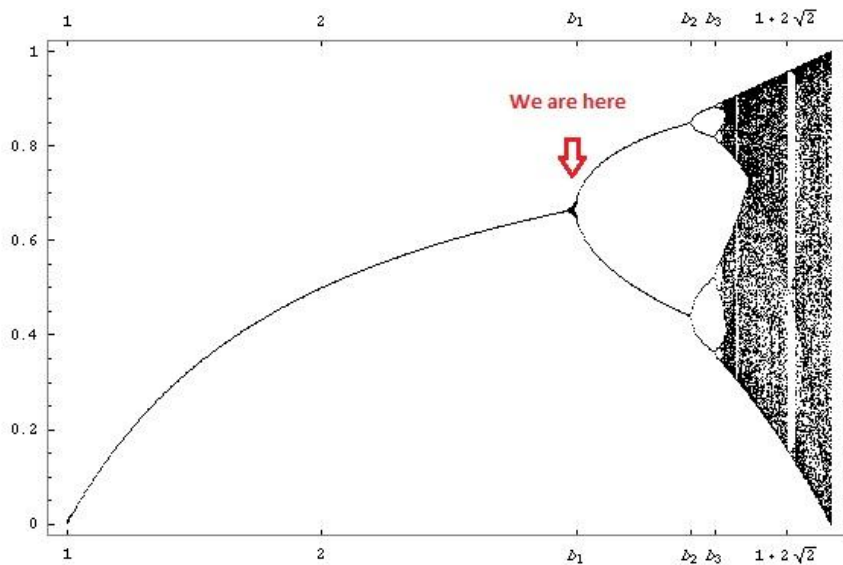




ORACLES

Q4: BIFURCATION

By: Robert Shambora



Bifurcation theory: Most commonly applied to the mathematical study of dynamical systems, a **bifurcation** occurs when a small smooth change made to the parameter values of a system causes a sudden 'qualitative' or topological change in its behavior. -Wikipedia

In Cern, Switzerland, buried under 100 meters of earth, lies the Large Hadron Collider or LHC. The LHC, a \$5 Billion particle-collider, designed to help physicists hunt for new sub-atomic particles, is a wonderful example of a complex system. In November of 2009, the LHC was fired up in a test to search for the Higgs-Boson particle. Not too long into the test, in which protons are run into one another at 99.9% of the speed of light, something went horribly wrong. Part of the LHC had started to overheat, and the power was cut off. The cause? A bird had dropped part of a baguette down a shaft housing a power line. That's right: a piece of bread, carried by a bird, was all that it took to disrupt this complex system.

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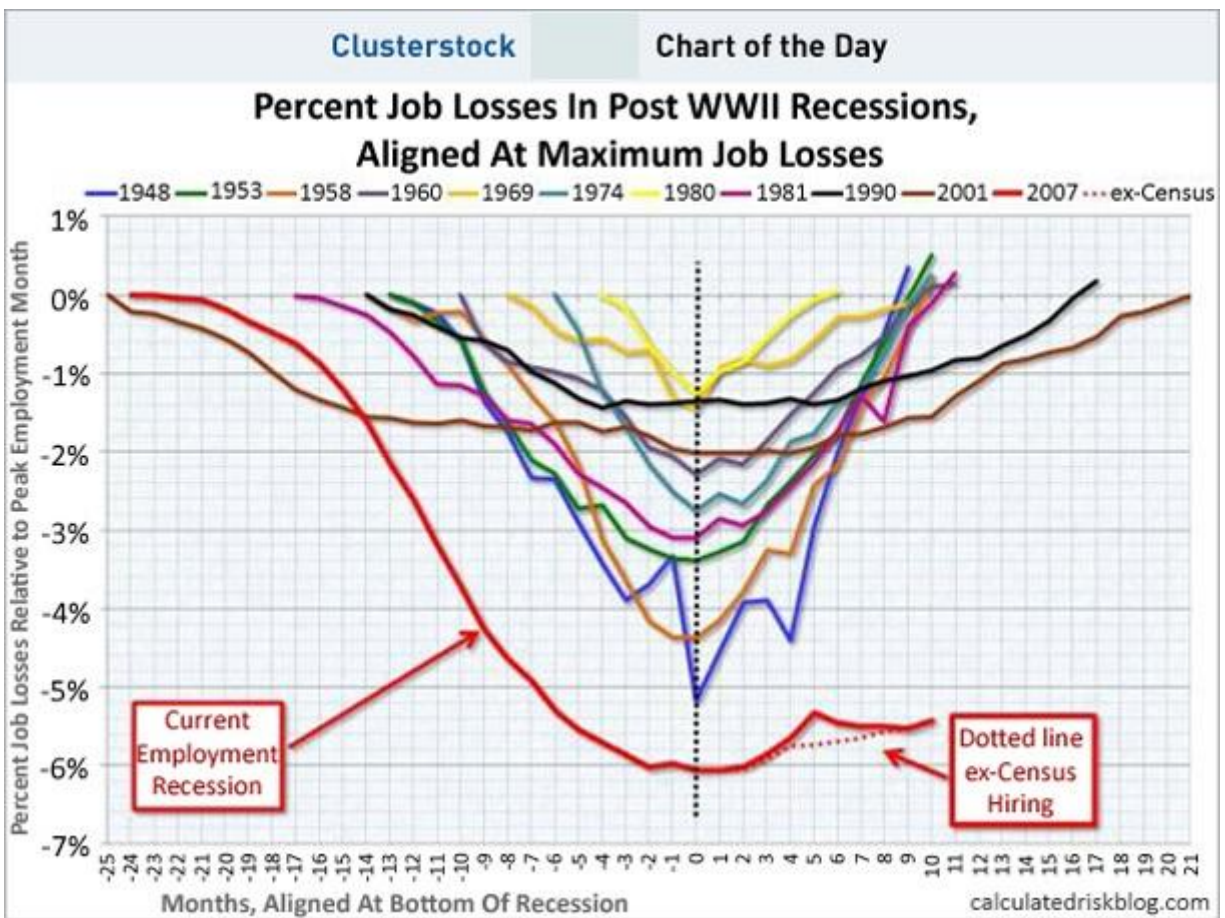
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The world's financial systems are now every bit as complex and dynamic as the LHC, and they involve a greater weighting to that so-unpredictable component of human behavior. Our financial system is not only complex, but very fragile, and the changes we are making to it are unprecedented and carry massive unintended consequences.

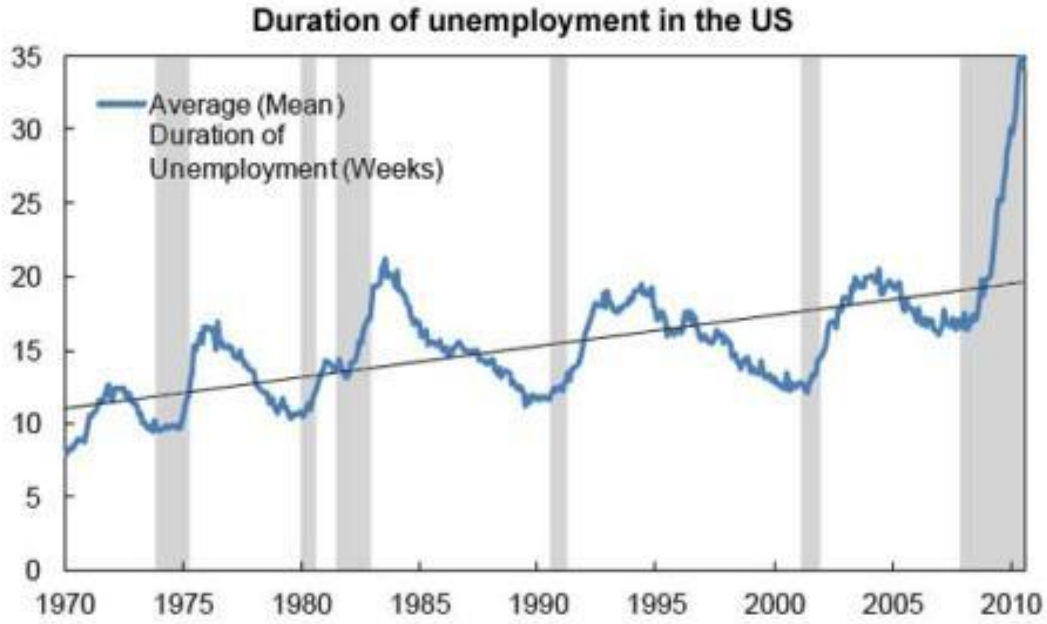
A Recap

In our last report, we laid out a thesis that the enormous and unprecedented stimulus had NOT succeeded in its objective, and that the economy – despite the continued propaganda that everything was improving – was already, once again, in decline. That thesis has not changed. In fact there is even greater evidence today to support that claim.

To recap, first let us turn to unemployment. Even using the official numbers from the Bureau of Labor and Statistics (which are often in a perpetual state of downward revision), this is the worst Post - World War II unemployment situation.



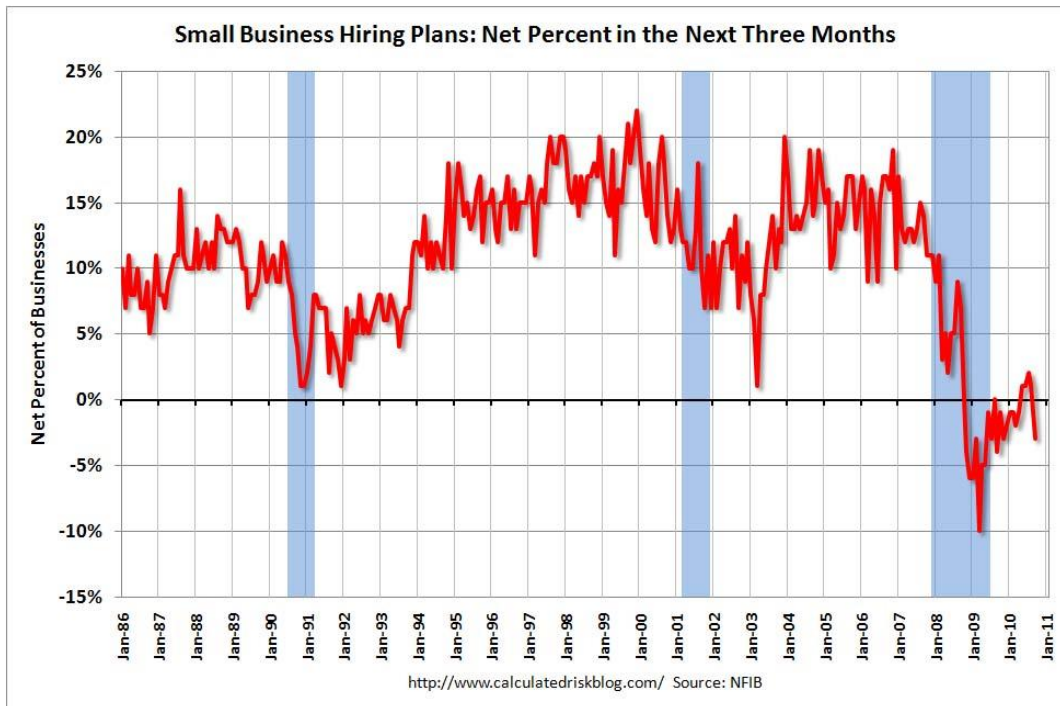
And as everybody should be aware of by now, the official unemployment rate is artificially low since individuals who are assumed to not be looking for a job are removed from the workforce. Once unemployed, workers are now staying unemployed longer than at any time since the Great Depression, although that record may still be beat.



Source: St. Louis Fed

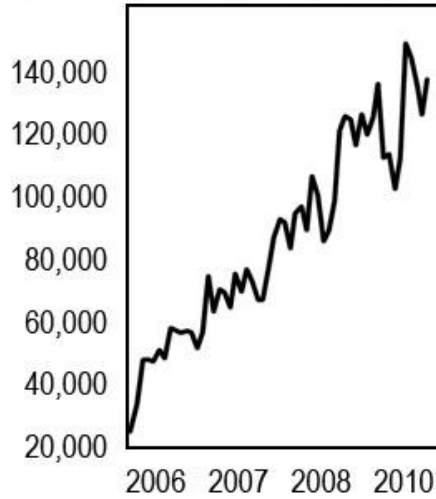
If one were looking for evidence that jobs are truly being created, you would probably start where, historically, 80% of new jobs are: Small Businesses.

And are they hiring? No. In fact their hiring aspirations have turned negative again (read: firing).



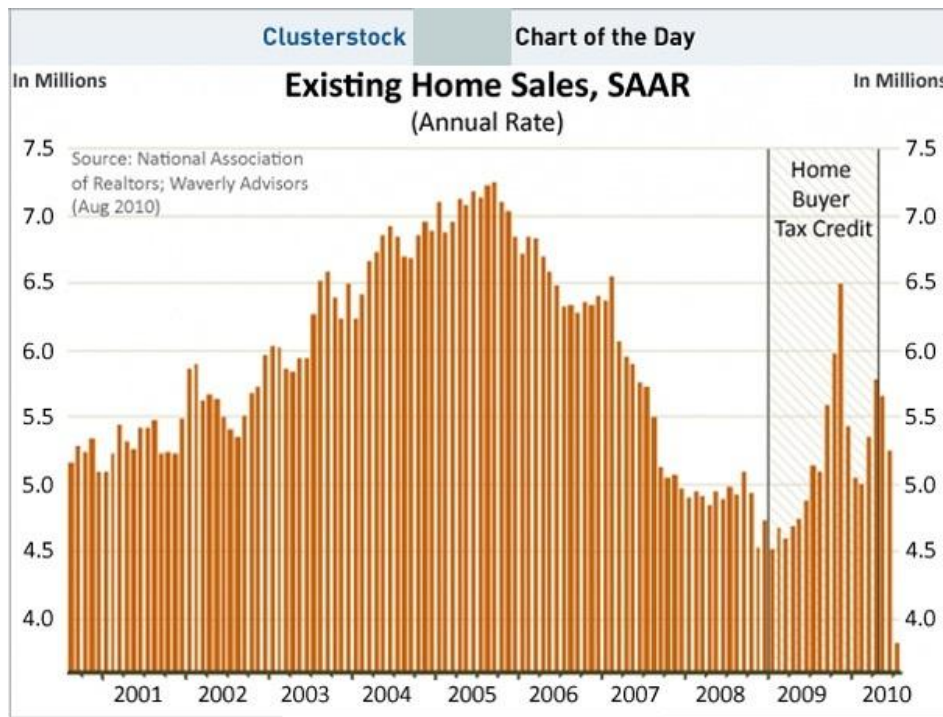
Today, we have the longest Unemployment Benefits in history – 99 weeks. At this writing, it is very unlikely that the Emergency Unemployment Benefits will be extended, due to cost. If that remains the case, over Six Million families will lose those benefits before the end of 2011. Two Million of those will lose their benefits by the end of this year. It is no wonder that personal bankruptcies continue to surge.

Personal Bankruptcies SURGING!

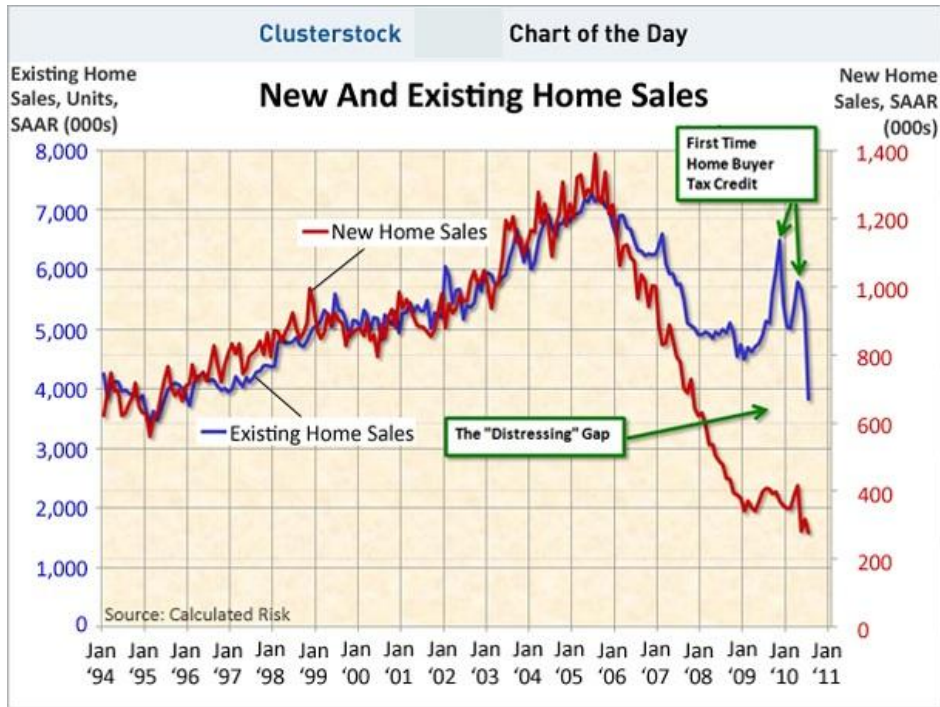


Source: Weis Research

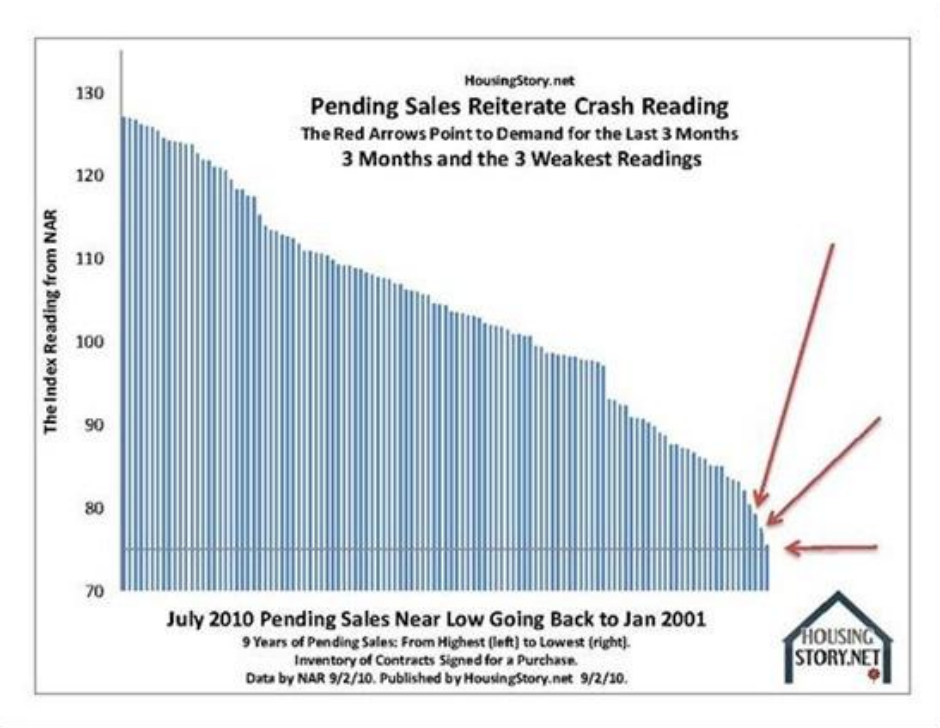
Existing Home Sales continue to decline. The New Home Buyer Tax Credit had little effect other than pulling sales forward in a decaying environment.



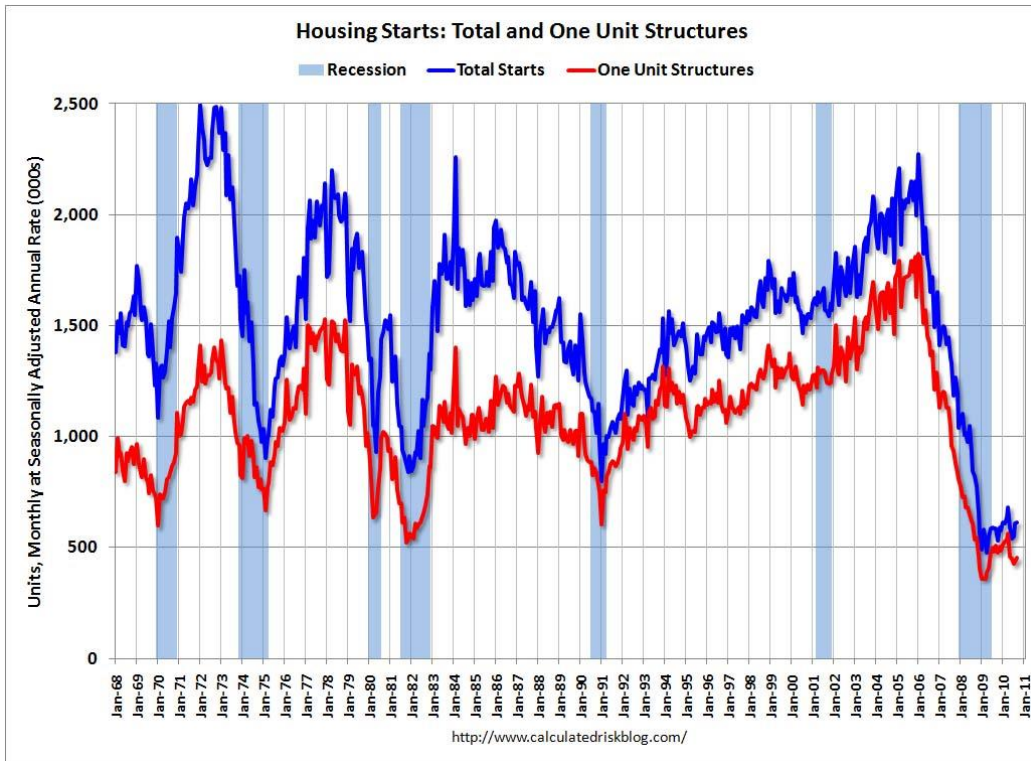
Notice from the chart above that Existing Home Sales in August dropped below 4 million units! As alarming as that is, reference the following chart, which would indicate that relating to New Home Sales, Existing Home Sales may have quite a way further to fall.



Pending Sales (whether they actually close or not) have continued to shrink drastically as well.



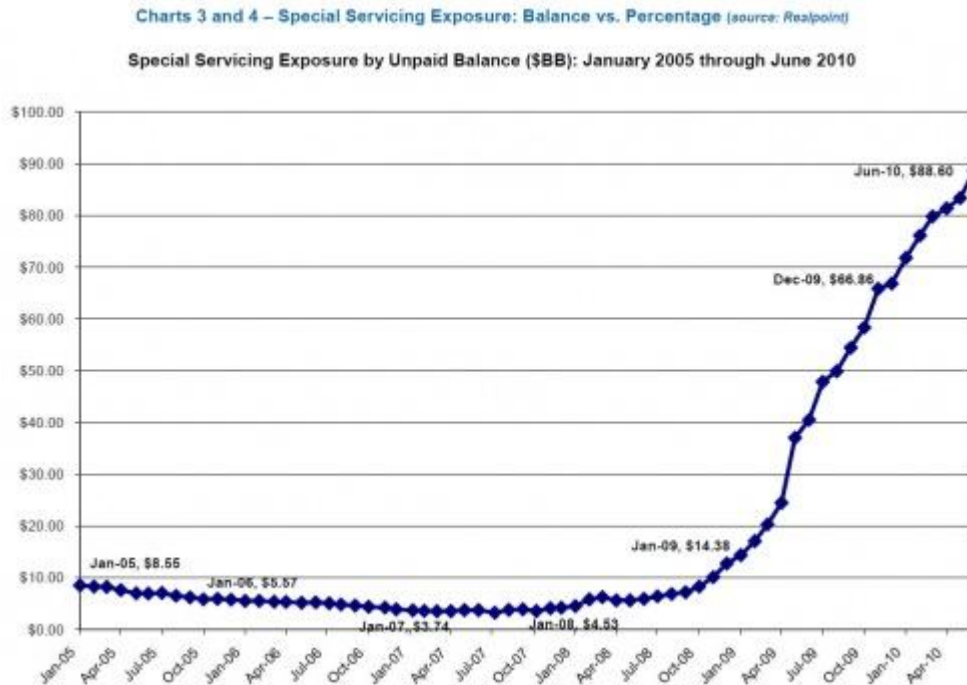
New Home Starts are as low as they have been in forty years.



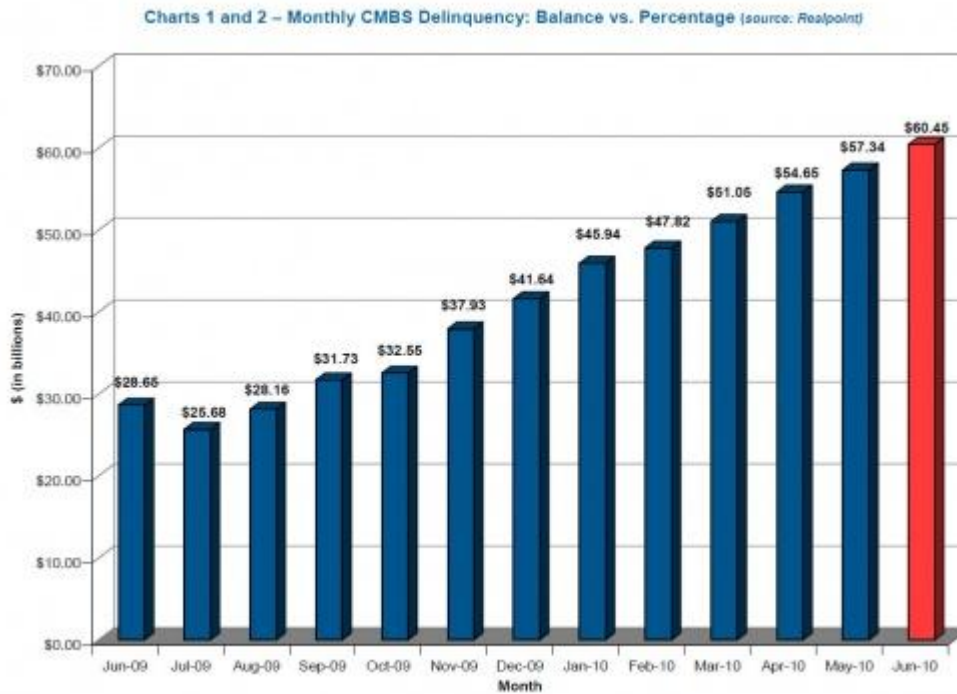
And as one would expect, Mortgage Applications related to a purchase continue to fall.



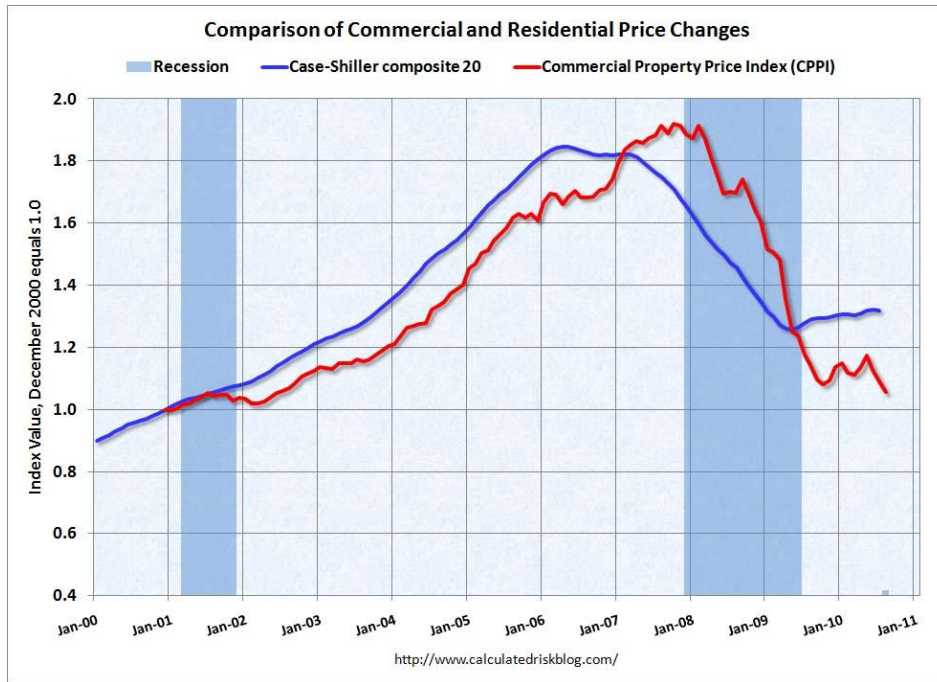
Moving on to Commercial Real Estate, the deterioration continues unabated. The following chart demonstrates the number of Commercial Mortgages that have entered “special servicing” has more than doubled in the past 12 months.



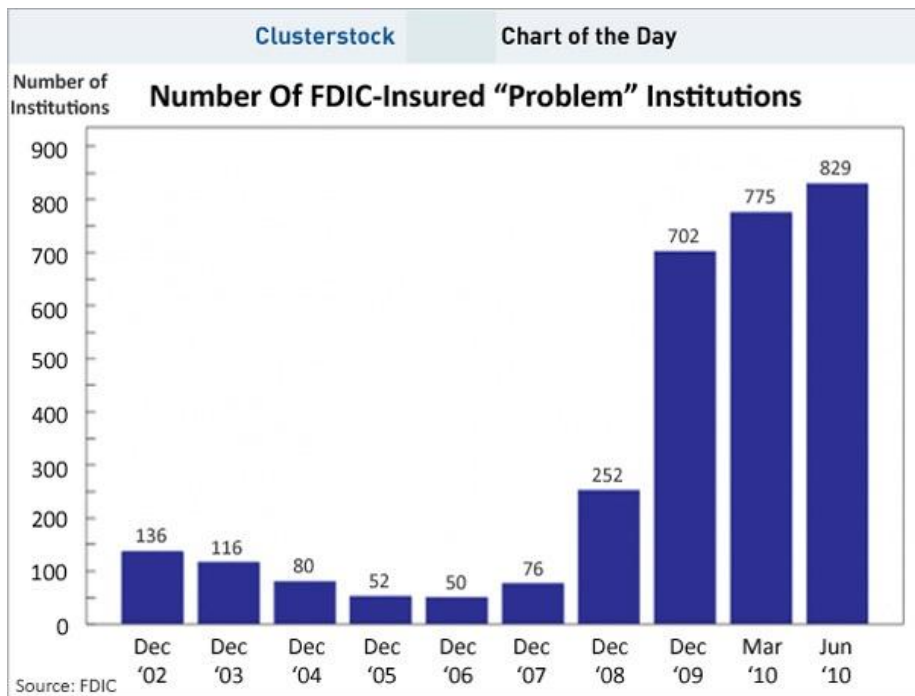
Over \$60 Billion in Commercial Mortgages are Delinquent as of the end of June.



As supply increases and demand decreases, values continue to fall for both Residential and Commercial properties.

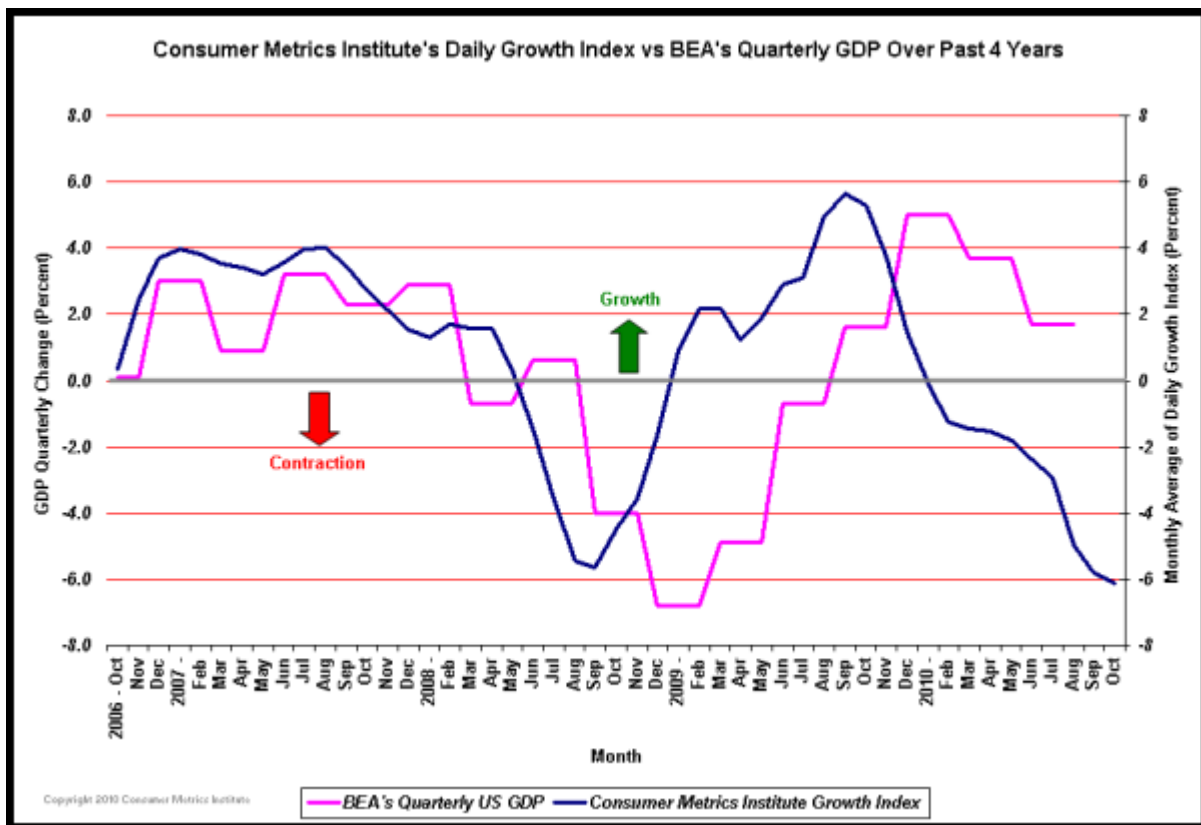


Falling Real Estate values and Bankruptcies subsequently continue to put pressure on the banking system. Even without the effects of “Foreclosure-gate”, the official number of problem banks, as defined and reported by the FDIC, continues to grow.



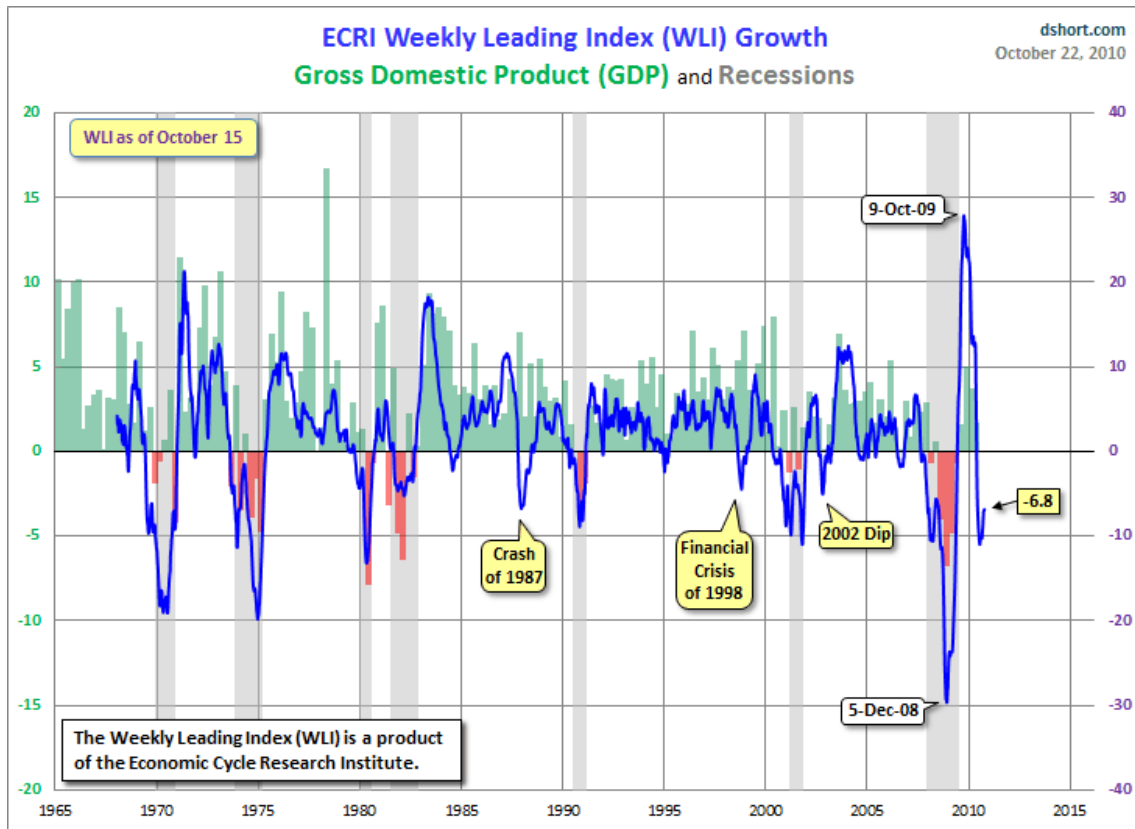
One may note that the weaknesses in the system continue to be self-feeding. A weak economy begets job losses, which begets foreclosures, which begets troubled banks, which begets cash and liquidity contraction (for businesses and consumers), which weakens the economy further. As we noted in our Third Quarter Outlook, there has been much evidence that the economic weakness has been accelerating.

The latest reading of the Consumer Metrics Institute's Daily Growth Index, a tool to estimate where GDP growth will be in six months, was -2% in our last report. It is now -6.1%. This means that the index is estimating a GDP contraction of over 6% by the beginning of the 2nd Quarter, 2011, **a rate of contraction GREATER than the worst part of this recession in late 2008**. If the government insists that the recession ended in the summer of 2009, this would indicate a major second leg down.

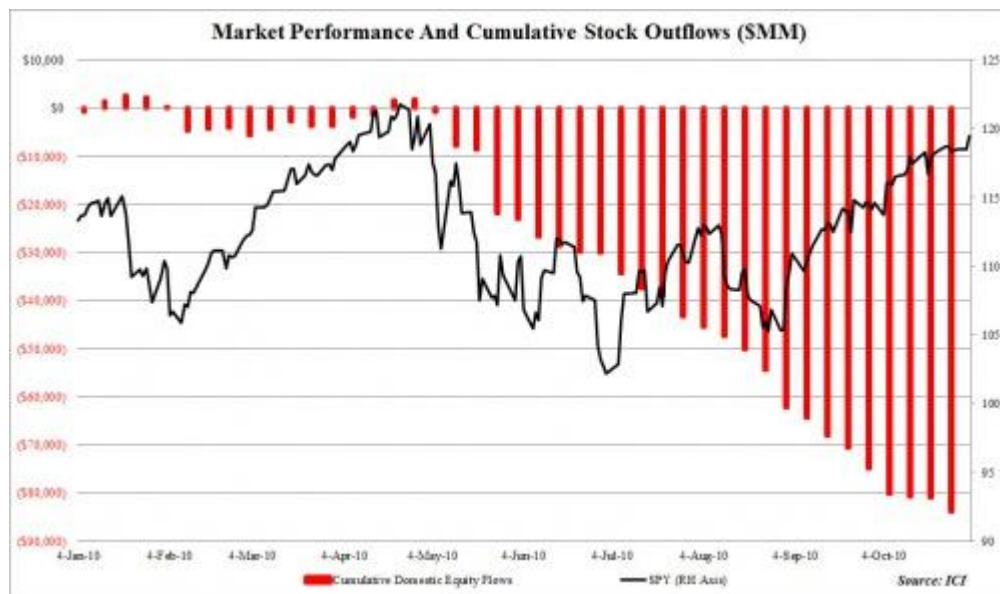


Even the ECRI Leading Index, the grand-daddy of Leading Economic Indicators is suggesting we are very likely back in recession/contraction territory. Although there is a small bump off of the worst reading in September, we expect the drop in this index to resume and meet or exceed the December, 2008 low reading. Note that in the history of the ECRI, we have never had a reading this low and not been in a recession. Furthermore, note that the year-over-year drop is the greatest in the history of the index.

Isn't it amazing there are economists and pundits who still insist that there will be no "double-dip" or continuation of this contraction?



The retail investor knows we are still in trouble, as evidenced by TWENTY SEVEN consecutive weekly withdrawals out of Equity mutual funds. [Update: Now TWENTY NINE]



Corporate insiders are very well aware, as evidenced by the fact that the most recent insider trading demonstrated Insider Selling over Insider Buying by a rate of 3177 to 1!!

Large corporations know we have a problem, evidenced by the largest amount of cash held on corporate balance sheets in nearly 50 years, and their continued resistance to make capital expenditures. Recently, Fortune 500 CFOs surveyed showed that 73% were “Very Pessimistic”.

And if the largest corporations know we have a problem, rest assured the Federal Reserve does too. They have known this since summer. In August, Ben Bernanke hinted that the Federal Reserve may be required to intervene again. By September, it was made even clearer that intervention would be necessary. By November 3rd, a \$600 Billion Quantitative Easing program was announced.

No Global Cooperation This Time

At this point, I would like to bring you back to March, 2009. As referenced in our last “Outlook”, that is when the rules were changed on many levels. Not only were banking rules changed to allow “Mark to Model” accounting instead of “Mark to Market” (allowing banks to hide losses), but on a grander scale, there was a coordinated effort by the Central Banks of the world to stimulate the world’s economy and prevent a Global Depression. Initially, there was acceptance of this effort by members of the G-7, but the Emerging Countries weren’t so sure. Monetary (Quantitative Easing) and Fiscal (Government Spending) Stimulus would surely damage the value of the Dollar. As Emerging Countries hold so much of our debt, and as their banks must hold Dollars to conduct international trade, what assurances would they have that their holdings of Dollars and Dollar-based assets would be protected?

In order to pull off this coordinated effort in Spring 2009, the banks of China, India, Brazil, Russia, Indonesia and other Emerging Markets needed reassurance, and demanded more participation. The result? The G-7 was reduced to near insignificance, and global policy decisions were put on the agendas of the G-20. Additionally, the world was assured that although the Federal Reserve would be expanding its balance sheet (creating more Dollars) to purchase assets, *when the global economy began to recover the Federal Reserve would sell back assets, reduce its balance sheet, thereby reducing the number of Dollars in the system.*

How do you think Emerging Market countries feel now? The contraction of the U.S. Economy and much of the G-7 has resumed, and not only is the Fed *NOT* reducing the size of its balance sheet, but expanding it further!

Central banks around the world have been alarmed at the Fed’s actions since September, and have begun “Beggars Thy Neighbor” policies and actions in efforts to protect themselves, their currencies, and the value of their U.S. Dollar holdings. China and other countries have increased interest rates, raised bank reserve limits and taxed foreign investments as methods to protect themselves. Additionally, being forced to hold the Dollar as a world reserve currency, Japan, Indonesia, Brazil, Mexico and Chile have at times over the past 60 days created more of their currencies out of thin air, used to buy up Dollars and Dollar-based assets!

We must all note: When countries venture down the road of trying to “out-print” each other, what the U.S. Dollar is worth against a currency index becomes far less important than what the Dollar or any other competing currency will buy! This creates global monetary inflation, and is an intolerable situation

for all countries, especially Emerging Market Countries. There are over a billion people who live on less than \$1 per day, and another billion live on less than \$2. What happens if food prices double?

Make no mistake, there is NO global policy coordination any longer. The world has entered an “Every Man for Himself” stage. At the G-20 meeting in November, NO agreements were reached. Acrimonious discussions between the US and China occurred, with China’s state media declaring the US the “Great Currency Manipulator”. Germany referred to the Fed’s policy as “clueless”, and Brazil boycotted the meeting altogether.

Since the G-20 meeting, further “tit-for-tat” exchanges have continued. The Obama administration released its report declaring China a “Currency Manipulator”. China’s DaGong Credit Agency responded by reducing the US credit quality by two notches to A+, with a Negative Outlook. Australia and other countries have boosted their lending rates, and China has announced three unexpected increases to bank reserve limits within weeks.

European Woes Masking Otherwise Weak Dollar

In the midst of this unprecedented disequilibrium, the European Debt Crisis has resumed with Ireland taking center stage. Although an entire report, much longer than this one, could be dedicated to explain the nature of the European Crisis, it is important to recognize that the problems with the European Union and the Euro make the Dollar look like a safer bet, temporarily.

Will an Irish bailout take place successfully? If so, Greece, Portugal, Spain and Italy will be in line for their handouts next, while the world watches the Irish people react. The European Central Bank will have to employ massive quantitative easing of their own to fund the sequential bailouts (there is NOT enough money in the Bailout Fund for Spain).

And if the Irish bailout fails? Bank and Sovereign debt defaults will ripple through Europe. Even if the Irish bailout succeeds, it is likely we may see some combination of Quantitative Easing AND Debt Defaults. Not a good time for the Euro or the European Union.

However, the United States may have its own bailouts on the way. What becomes of the burgeoning Municipal defaults? Illinois, California, Michigan and New York all have their own debt crises, and their economies are mostly larger than Ireland, Portugal or Spain. Truly, as one economic commentator recently said, arguing that the Dollar is in better shape than the Euro is like arguing which is the prettiest horse in the glue factory.

Does the chart below look sustainable? Note the new projected debt levels, given by the CBO. Reality is likely to be worse.

Notice the next chart. The Debt of the US is 358% of Tax Revenue!! That is worse than Ireland OR Greece! Our creditors surely know this.

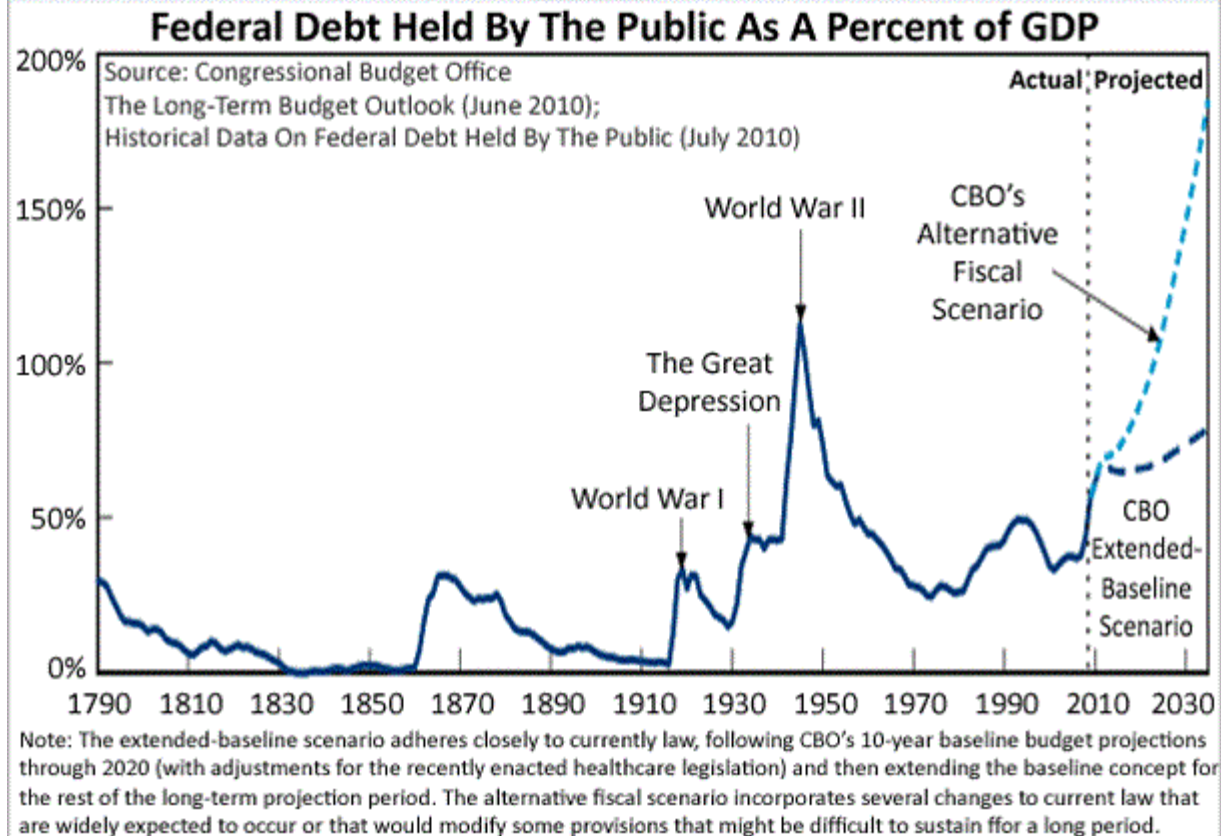


Exhibit 2

Debt/GDP and Debt/Revenue (2009)¹

	Debt/GDP (%)	Revenue/GDP (%)	Debt/revenue (%)
France	77.6	48.0	161.7
Germany	73.2	44.3	165.3
Greece	115.1	36.9	312.2
Ireland	64.0	34.1	248.4
Italy	115.8	46.6	187.5
Portugal	76.8	41.6	184.8
Spain	53.2	34.7	153.2
United Kingdom	68.1	40.2	169.2
US (federal government)	53.0	14.8	358.1

Source: Eurostat, CBO, Morgan Stanley Research

Conclusion

The title of our last Oracles outlook was “Brace For Impact”. Our focus was to convey that the contraction in the economy had resumed, that the effects of the fiscal and monetary stimulus were waning, and to be prepared for what this would mean for the Equity Markets, the US Dollar, and the Economy going forward. Our conclusion strongly suggested that we should be wary of any assumptions that “everything was heading back to normal”. It is now obvious that, despite some pockets of strength,

economic conditions in the G-7 are decaying once more (if indeed they ever stopped), evidenced by the decisions to expand Quantitatively Easing.

We wrote the following in our last report:

The likely outcomes are two. The first involves rampant Deflation, including continued declines in liquidity, State, Federal and Sovereign defaults, and a drastic decline in standards of living lasting a generation. The second involves outright monetization of debt (read: hyperinflation). The reality will resemble some unfortunate combination of these possibilities.

With the now apparent decision to monetize debt, the “Impact” thus far has not been felt, as much in the Equity Markets as in the Currency Markets and Commodity Prices. A nation CAN prop up their Equity and Fixed Income Markets by having their Central Bank print currency out of thin air, and then purchase securities. That is exactly what has now begun in earnest, but it comes with the price of putting the underlying currency at risk. It is no wonder, therefore, that many commodities, such as Coffee, Sugar, and Cotton, have surged over the past 60 days. This phenomenon should continue as long as the Federal Reserve and other Central banks continue with a currency-printing free-for-all.

What the world very much needed was an accord at the last G-20 meeting, but we didn’t get one. As a result, Economic Risks and Solvency Risks are now rapidly being transformed into Currency Risks and the future of the current Global Financial System is in greater question than ever.

In this state of instability, what possible “Black Swan” event creates the moment where bifurcation begins? Is it the inability for the U.S. to continue successful Treasury Auctions? Is it a newly-elected Congress which refuses to raise the debt ceiling? Is it the collapse of a Sovereign debt in Europe, further destabilizing the Euro? Is it the revelation of years of Silver and Gold manipulation at the Comex, and problems with making good delivery? Is it the bankruptcy of a U.S. State? How about the sudden decision by the rest of the world that the U.S. Dollar is no longer desired as a reserve currency? The list of Black Swans is long indeed.

Although a complete bifurcation of our complex and dynamic financial system isn’t a foregone conclusion, it should be obvious that we have exited a state of equilibrium. Once this occurs, the question is: To what degree of chaos and disorder must the system go through before a new point of equilibrium is found? The point of the chart at the beginning of this report is meant to convey that once a system bifurcates, the range of possible outcomes is vast!

So, is it all doom and gloom? If the world’s financial infrastructure, currently dominated by the rules and banking system of the G-7, completely breaks down, does it mean the end of everything? Are we doomed to war, insurrection, poverty, famine, and despair? OF COURSE NOT. While the vast set of potential outcomes include these, new and creative outcomes can emerge instead.

Some have commented that our outlook appears dark, negative and seemingly hopeless. This doesn’t have to be the case. The point is that we call into question the spurious hopes and assumptions that the existing financial infrastructure will magically revert to normal. If your perspective is from the hope that things will go back to the way they were, you are probably going to be disappointed.

However, it is also said that nature abhors a vacuum. The failure of one complex system can make room for a better one! To wit, recently more attention is being paid to the North Dakota State Bank. The bank is owned by the people of North Dakota, and the profit that the bank earns pours into the operating account of the State, thereby offsetting taxes. Currently, the bank is very sound, and not dependant on the Federal Reserve. Quick – any guesses to the following questions? Which State has the lowest unemployment rate? Which State is the LAST State to have a current budget surplus? North Dakota for both!

The point here is that as the current system bifurcates, to whatever degree, solutions outside of the existing system are waiting to be found. Necessity IS the mother of invention. How many examples does history give us of humanity being at its creative best at the seemingly worst of times? As things get progressively more concerning in the months ahead, we would all be better off focusing on developing solution sets. Future editions of “Oracles” will offer some new, creative ideas in that respect for discussion and consideration.

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