John Williams'
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Section Two of Four

MARKETS PERSPECTIVE

Extreme volatility became the norm for most markets in 2008, as the U.S. systemic solvency crisis triggered the worst financial panic since the period surrounding and including the Great Depression in the 1930s. While the crises continue, and while extreme volatility may be dormant temporarily, almost anything can happen in the current circumstance.

I continue to argue that investors should be looking at the long-term and at preserving their wealth and assets in what eventually will become a hyperinflationary great depression. With severe economic, inflation and currency displacements ahead in the United States, those who can ride out the turmoil, eventually, should see tremendous investment opportunities. As to preserving capital and assets for someone in a U.S. dollar-denominated environment, holding some assets in physical gold (and some silver) and holding some assets outside the dollar (i.e. Swiss franc) in high-quality, liquid assets remains my best thinking. Again, this is for the long-term. Short-term conditions still can show extreme volatility in the U.S. dollar and precious metals as seen in the last year. Putting aside risks of political instabilities tied to the economic turmoil or any short-term liquidity concerns, real estate also remains a prime long-term hedge against the severe currency debasement that lies ahead.

Looking beyond the summary statistics in the preceding table, consider that in the two-year period from December 31, 2006 to December 31, 2008, gold gained 37.6%, the Swiss franc gained 14.3%, and the Dow Jones Industrial Average fell by 29.6%. Two years ahead, I would expect to see similar direction on the mentioned assets (using an inflation-adjusted DJIA), but with greater percentage movements.

General background note: The broad outlook is ***little changed***, with ***ongoing*** crises in systemic solvency and in a deepening inflationary recession. Over the long-term: U.S. equities will continue to suffer in a severe bear market; long-term U.S. Treasury yields will spike in response to inflation, eventual dollar dumping and mounting Treasury borrowing needs against a market with weakening demand; selling will intensify against the U.S. dollar, evolving into dollar dumping and dumping of dollar denominated assets. Precious metals, particularly gold, will rally against mounting monetary and inflation pressures (***and likely higher oil prices from a weakening dollar***), weakness in the dollar, and as safe-havens against increasing systemic instability. Holding gold and holding assets outside the U.S. dollar (such as in the Swiss franc and the Canadian dollar) remain the best long-range hedges against all the real risks facing investors and the system.

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Closing Financial-Market Indicators as of December 31, 2008

Indicator	*4th-Quarter/Year-End 2008*			*3rd-Quarter 2008*			*Year-End 2007*	
	Level	*Qtr/Qtr*	*Yr/Yr*	*Level*	*Qtr/Qtr*	*Yr/Yr*	*Level*	*Yr/Yr*
Equity Market								
DJIA	**8,776.39**	-19.12%	-33.84%	**10,850.66**	-4.40%	-21.39%	**13,264.82**	6.43%
S&P 500	**903.25**	-22.45%	-38.49%	**1,164.74**	-9.00%	-23.71%	**1,468.36**	3.53%
DJ Wilshire 5000	**9,087.17**	-23.48%	-38.68%	**11,875.40**	-9.16%	-22.70%	**14,819.60**	3.94%
NASDAQ Comp	**1,577.03**	-24.61%	-40.54%	**2,091.88**	-8.77%	-22.57%	**2,652.28**	9.81%
Credit Market (1)								
Fed Funds (2)	**0.00%**	-200bp	-425bp	**2.00%**	0p	-275bp	**4.25%**	-100bp
3-Mo T-Bill	**0.11%**	-87bp	-325bp	**0.92%**	-98bp	-290bp	**3.36%**	-166bp
2-Yr T-Note	**0.76%**	-124bp	-229bp	**2.00%**	-63bp	-197bp	**3.05%**	-177bp
5-Yr T-Note	**1.55%**	-143bp	-190bp	**2.98%**	-36bp	-125bp	**3.45%**	-125bp
10-Yr T-Note	**2.25%**	-160bp	-179bp	**3.85%**	-14bp	-74bp	**4.04%**	-67bp
30-Yr T-Bond	**2.69%**	-162bp	-176bp	**4.31%**	-22bp	-52bp	**4.45%**	-36bp
Oil (3) *US$ per Barrel*								
West Texas Int.	**44.60**	-55.68%	-53.55%	**100.64**	-28.11%	23.23%	**96.01**	57.24%
Currencies/Dollar Indices (4) *US$/Unit*								
Pound Sterling	**1.4619**	-17.89%	-26.33%	**1.7804**	-10.56%	-12.68%	**1.9843**	1.31%
Euro	**1.3919**	-1.15%	-4.68%	**1.4081**	-10.59%	-0.97%	**1.4603**	10.65%
Swiss Franc	**0.9369**	4.83%	6.14%	**0.8937**	-8.82%	4.32%	**0.8827**	7.64%
Yen	**0.0110**	16.68%	23.04%	**0.0094**	0.22%	8.52%	**0.0090**	6.54%
Canadian Dollar	**0.8170**	-13.43%	-19.27%	**0.9437**	-3.88%	-6.02%	**1.0120**	17.92%
Australian Dollar	**0.6983**	-11.65%	-20.43%	**0.7904**	-17.34%	-10.74%	**0.8776**	11.31%
Weighted Currency Units/US$ (Jan. 1985 = 100)								
Financial (FWD)	**52.49**	5.93%	11.07%	**49.55**	10.33%	4.93%	**47.26**	-7.64%
Change US$/FX	**--**	-5.60%	-9.96%	**--**	-9.36%	-4.70%	**--**	8.27%
Trade (TWD)	**57.15**	4.33%	8.40%	**54.78**	7.29%	2.34%	**52.72**	-10.00%
Change US$/FX	**--**	-4.15%	-7.75%	**--**	-6.79%	-2.28%	**--**	10.01%
Precious Metals (5) *US$ per Troy Ounce*								
Gold	**869.75**	-1.67%	4.32%	**884.50**	-4.92%	19.04%	**833.75**	31.92%
Silver	**10.79**	-16.74%	-26.90%	**12.96**	-26.57%	-5.06%	**14.76**	14.41%

bp: Basis point or 0.01%. (1) Treasuries are constant-maturity yield, U.S. Treasury. (2) Current Fed Funds target is 0.00% to 0.25%. (3) Department of Energy. (4) Shadow Government Statistics, Federal Reserve Board (see Dollar Index Section for definitions). (5) London afternoon fix, Kitco.com.

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U.S. Equities -- At year-end 2008, from their all-time closing high levels of August 2007, the DJIA was down by 38.04%, the S&P 500 was down by 42.29%, the Dow Jones Wilshire 5000 was down by 42.56%, and the NASDAQ Composite was down by 44.84%. This bear market has been savage, but likely it is not over, with the potential of roughly an 80% loss from current levels, which would bring total losses -- peak-to-trough -- into the 90% range as seen in the 1929 to 1933 period.

Downside movement in the equity markets is not continuous. There often are intervening sharp rallies with the sell-offs, as was seen in the 1929 to 1933 period. The 1929 high in the DJIA was not recovered in 1955.

Promising an ongoing bear market, the economy faces a deepening recession/depression with no sustainable economic recovery in sight. Even with a big stimulus package, the economy faces at best some bottom-bouncing before its next downleg. Also, with heavy dollar selling, renewed inflation and mounting issues as to the long-term quality of U.S. Treasuries, long-term interest rates eventually will rise sharply.

Barring the Federal Reserve or the U.S. Treasury entering the equity markets as a buyer of last resort, stocks have entered a particularly protracted and savage bear market that still has a long way to run. Equities have begun to catch-up with the underlying economic, financial and systemic fundamentals, but the aggregate downside adjustments to stock prices still should be quite large over a number of years, eventually rivaling the total 90% decline in equities seen in the 1929 crash and ensuing four years. The current decline might have to be measured in real terms, however, as a hyperinflation eventually will kick in, with the Fed moving to liquefy the system and monetize federal debt. Stocks do tend to follow inflation, since revenues and earnings get denominated in inflated dollars. Hence with a hyperinflation, a DJIA of 100,000 or 100,000,000 could be expected, but such still would be well below today's levels, adjusted for inflation (see the *Hyperinflation Special Report* of April 8, 2008).

U.S. Credit Market -- The Federal Reserve has cut the targeted fed funds rate to 0.00% to 0.25%, as low as it can go. U.S. Treasury yields already are at or near historic lows and are not sustainable at those levels. Accordingly, interest rates eventually and generally should head higher from here, with long rates spiking sharply. Promising higher yields will be renewed inflation, mounting problems with the U.S. dollar and concerns as to U.S. government solvency.

Yields were driven lower by direct intervention and by flight-to-safety during one of the great financial panics of all time, despite ongoing heavy borrowing by the U.S. Treasury and Federal Reserve efforts to debase the U.S. dollar significantly. The debasement efforts are beginning to work and should become a major factor in the markets in the year ahead. If inflation rises strongly in the year ahead, as I expect (but not at hyperinflationary levels), it would tend to support double-digit long-term yields.

U.S. Dollar -- Central bank intervention and the last eight-to-nine months of systemic and financial turmoil reversed much of the dollar selling seen over the preceding year, running counter to significantly negative U.S. dollar fundamentals. A more-stable system in the last several weeks and a bottoming of growth in the broad money supply, however, have been accompanied by periods of significant renewed selling of the U.S. dollar. For the year, though, of the major Western currencies, only the Japanese yen and Swiss franc gained on the greenback.

In terms of underlying fundamentals for the U.S. dollar, little has changed: they remain abysmal and are deteriorating. Accordingly, as the global financial system shows early signs of stability, heavy selling of the U.S. dollar has started anew, albeit still sporadic. The long-term outlook for the dollar remains for a massive sell-off, with flight

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from the dollar eventually evolving into a flight to safety outside the dollar.

The U.S. dollar's portfolio of underlying fundamentals generally could not be much worse. Relative to major trading partners, the U.S. economy is much weaker; interest rates are lower; inflation has been and will be higher, although the December CPI will take another oil-price related downside hit; fiscal and monetary conditions are worse in the extreme; relative trade-balance conditions are horrendous; and relative political/systemic concerns are high, although the incoming Obama Administration likely will enjoy some grace period with markets.

Deteriorating in the fundamentals, whatever limited U.S. fiscal and monetary discipline existed is gone. The U.S. is moving quickly to debase its currency in a manner unprecedented for the world's reserve currency. The U.S. economy also is in much worse shape than previously recognized by the rest of the world, sinking rapidly, and it is relatively much worse off than its major trading partners.

The proximal trigger for a full dollar panic already may be in place, given the Fed and Treasury's responses to the ongoing systemic solvency crisis. Otherwise it could come from a particularly bad economic statistic, political missteps by the current or incoming Administration, negative trade or market developments outside the United States, or a terrorist attack or expansion of U.S. military activity. When the trigger is pulled, what likely will be broad selling pressure will turn into an outright panicked dumping of the greenback, which should overwhelm any short-lived central bank intervention and roil the domestic financial markets, further. Generally, the greater the magnitude of the dollar selling, the greater will be the ultimate inflation pressure and liquidity squeeze in the U.S. capital markets, on top of an otherwise ongoing systemic and intensifying economic crisis.

As shown in the accompanying graph, the sharp rally in the U.S. dollar, since the market distortions and interventions following the Bear Stearns crisis, may be close to having run its course. The financial- and trade-weighted indices have fallen back in the last month, with the latest data points shown for the indices as of year-end 2008.

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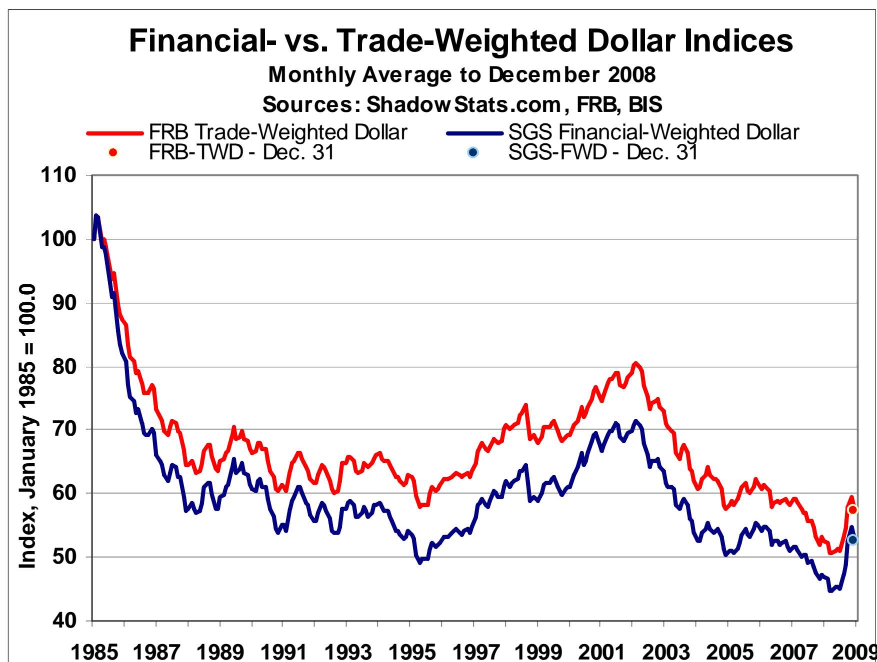

U.S. Dollar Indices. The Shadow Government Statistics' Financial-Weighted U.S. Dollar Index (FWD) is based on dollar exchange rates weighted for respective global currency trading volumes. For December 2008 the FWD fell by 2.41% for the month after a gain of 4.28% in November. The December 2008 monthly average index level of 53.41 (base month of January 1985 = 100.00) still was up by 12.84% from December 2007, but such slowed from November's 17.73% annual gain. As of December 31st, the FWD stood at 52.49.

Also falling in December was the Federal Reserve's Major Currency Trade-Weighted U.S. Dollar Index (TWD). The December 2008 average declined by 2.47% from November, which, in turn, was up by 2.87% from October. The December 2008 index level of 58.06 (base month of January 1985 = 100.00) was up by 9.49% from December 2007, versus an annual 12.84% increase in November. As of December 31st, the TWD closed at 57.15.

The differences in the two series can be accounted for largely by the much heavier weighting of the Canadian dollar in the TWD series.

General background note: Historical data on both dollar series are available for download on the Alternate Data page of www.shadowstats.com. See the July 2005 SGS Newsletter for methodology.

Gold and Silver -- Although gold closed up slightly for the year, both gold and silver were pummeled from their historic or multi-year highs seen in March. Beyond some normal profit taking, the non-fundamentally driven rally in the U.S. dollar, central bank manipulations, and forced liquidations of gold to raise cash for troubled institutions, there were no solid fundamentals for the collapse in precious metals that followed the Bear Stearns bailout in mid-March.

Falling from its all-time high London afternoon fix of $1,011.25 per troy ounce on March 17th, amidst extreme volatility, gold hit a subsequent bottom of $712.50 in October. It closed

December 30th at $869.75. In like manner, silver plunged from its March 17th high of $20.92 per troy ounce, hitting a subsequent low close of to $8.88 in October. It closed on December 31st at $10.79.

For December (per Kitco.com for both and silver prices), the monthly average London gold afternoon fix was $816.09 per troy ounce, up from $760.86 in November, but still well shy of the historic monthly-average high of $948.43 hit in March. For the year, the average price of gold was $871.96, up from $695.39 in 2007, and up from $603.46 in 2006.

Silver averaged $10.29 per troy ounce in December, up from $9.87 in November, and still well off the monthly-average high for the year of $19.51 in March. For the year, the average price of silver was $14.99 per troy ounce, up from $13.38 in 2007 and up from $11.55 in 2006.

Since the turmoil following the Bear Stearns machinations, the fundamentals actually have gotten stronger for gold as both an inflation hedge and as a safe-haven store of wealth. Where the recent strength in the U.S. dollar likely was the major factor in the recent weakness of the prices for precious metals and oil, those pressures should reverse, as nascent U.S. dollar selling intensifies. Deteriorating global political conditions, a looming major new inflation scare, and rapidly deteriorating U.S. fiscal and monetary conditions all promise extreme upside potential for gold and silver prices over the long haul.

When the dollar turns meaningfully to the downside -- and that process may have begun -- gold prices should rebound sharply and could regain $1,000 fairly quickly.

Inflation-Adjusted Historic Gold and Silver Highs. Outside of the current period's March 17th high of $1,011.25, the earlier all-time high of $850.00 (London afternoon fix, per kitco.com) of January 21, 1980 still has not been hit in terms of inflation-adjusted dollars. Based on inflation through November 2008, the 1980 gold price peak would be $2,321 per troy ounce, based on not-seasonally-adjusted-CPI-adjusted dollars, and would be $6,640 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars.

In like manner, the all-time high price for silver in January 1980 of $49.45 (London afternoon fix, per silver institute.org) has not been hit since, including in terms of inflation-adjusted dollars. Based on inflation through November 2008, the 1980 silver price peak would be $135 per troy ounce, based on not-seasonally-adjusted-CPI-adjusted dollars, and would be $386 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars.

General background note: As discussed in the *Hyperinflation Special Report (April 2008)*, the eventual collapse of the U.S. dollar -- the world's reserve currency -- will force the creation of a new international currency system. Gold likely will be structured into any replacement system, in an effort by those organizing the new currency structure to gain public acceptance.

The updated gold versus oil, Swiss franc and silver graphs show December monthly average price levels, as well as added points for closing prices at year-end, with gold at $869.75, silver at $10.79, oil at $44.60 and the Fed's published noon buying rate for the Swiss franc at $0.9369. As current market distortions subside, all four measures should trade significantly higher in the months ahead, eventually breaking the highs seen otherwise during 2008.

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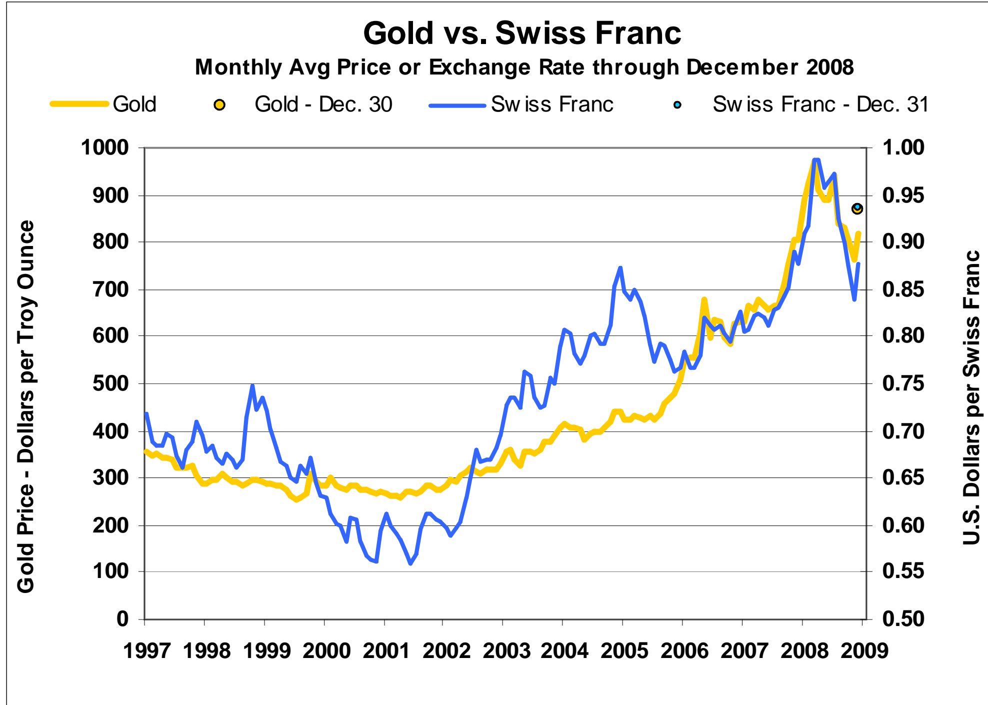

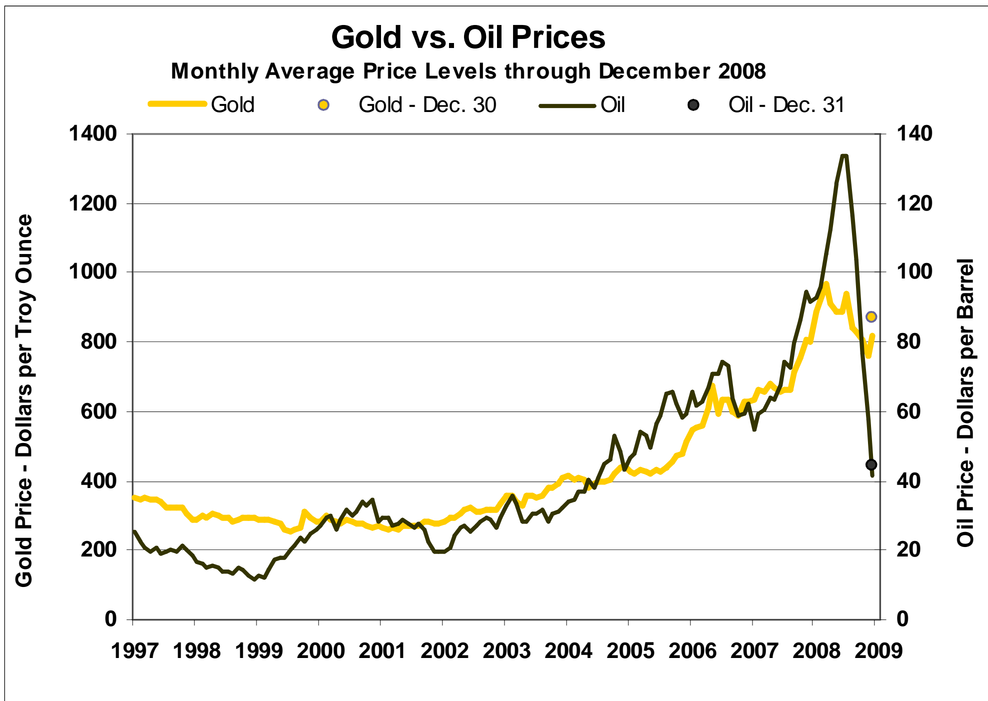

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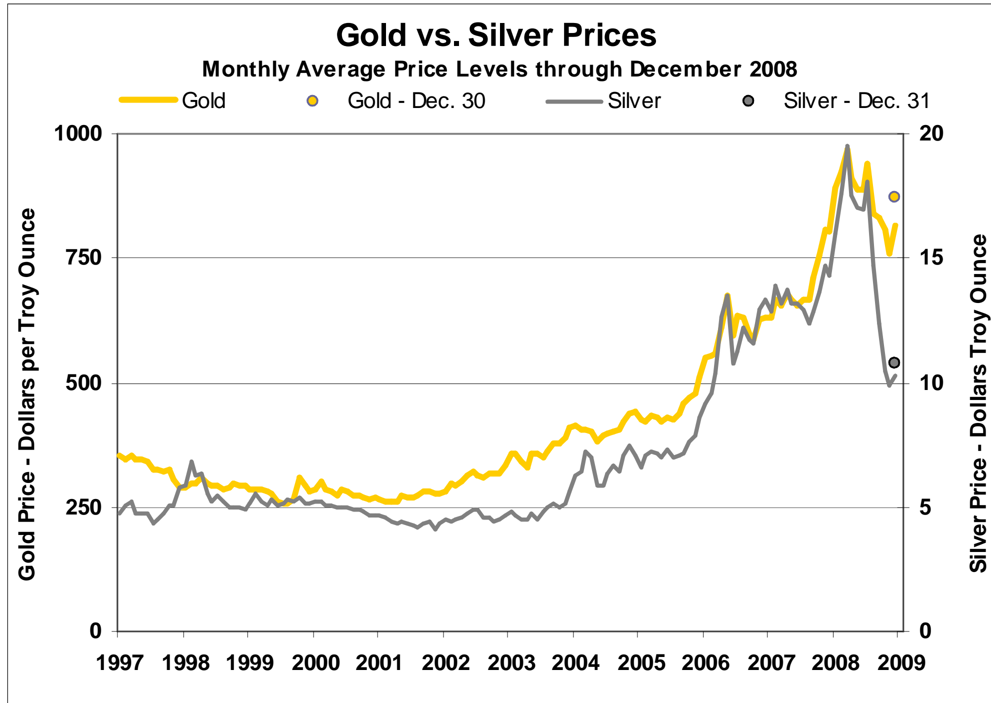

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