HOOVER CAPITAL, L.L.C.

Year End 2010

Money printing and continued bailouts of over-indebted nations and entities remained a strong theme in worldwide financial markets throughout 2010. As a result of being properly positioned for this likely outcome, our performance showed exceptionally strong gains in a year where virtually all major asset classes acted well while global central banks fought to debase their own currencies.

Our strategically large cash position held back performance somewhat, but that is the extent of any possible regrets on the year. Our largest positions, gold and silver, had fantastic gains once again in 2010, adding 29.3% and 82.5%, respectively. Energy positions also fared well as the broad energy sector likewise outperformed the equity markets with gains of 21.5%.

[Client portfolios showed gains far greater than the broad market averages in 2010.] This performance is significantly better than that of the equity markets, as the S&P 500 ended 2010 with much more modest gains of 12.8%. I am quite pleased to report another quarter whereby client portfolios continue to make new all-time highs despite the S&P 500 still remaining more than 20% below it's all-time high.

Looking to 2011 and beyond, I foresee an outlook whereby worldwide financial markets remain characterized by the level of fiat (paper) money printing. As a nation, we continue to have ever mounting budget and deficit problems. And we aren't alone. As a general theme, virtually all major nations around the globe continue to face a very perplexing dilemma: spend less as a nation than you take in as revenue (and likely face a renewed recession), or continue to spend beyond your means to maintain economic growth (at the expense of unsustainable debt and/or additional money printing).

I have been hoping for years that level heads would prevail. While nobody wants to endure a harsh economic recession, they are ordinary and normal aspects of the business cycle whereby leverage and misallocated capital can be worked off, leaving a sound footing for future growth. However, politicians and central banks around the globe see things differently. As debt levels worldwide, for both governments and consumers remain off the charts from any historical perspective, it remains clear that their choice is to stem the risks of any recession by continuing to bail out over-indebted, over-leveraged, and otherwise insolvent entities.

While I understand their logic, I don't agree with the policies that merely keep kicking the can down the road for future generations to deal with. It hinders those acting prudently and rewards the select privileged entities able to obtain additional funds by privatizing their gains and socializing their losses. It delays the point from which a solid economic foundation for growth can begin, and in the process, drags down many more individuals and entities that might otherwise have been adequately prepared.

However, my objections to the current flawed Keynesian economic policies notwithstanding, the governments and central banks look destined to continue the failed policies that helped get us into this predicament in the first place. Of course, they strain their arms in self back patting to highlight how we have staved off financial crisis and are now back to pre-recession economic growth. By cherry-picking the data, they would have you believe that all is well as we are emerging out of recession and returning to a strengthening economy.

Unfortunately, the recent recession did not end like most recessions do. The excesses of misallocated capital were not worked off, and many otherwise insolvent companies and entities were not forced out of business or into restructuring. In fact, just the opposite happened. Those entities deemed "too big to fail" (whether it be corporations or sovereign nations) were injected with as much capital as necessary to maintain their unsustainable practices. As a result, the difference between this recession and almost all other historical recessions ending is due to the simple fact that trillions of dollars in stimulus and bailouts around the globe helped provide a bridge loan for otherwise insolvent entities.

Many smart minds agree to disagree as to whether or not the bailouts and money printing were (and are, as it is still happening) the best of many difficult choices. Regardless of your thoughts on that particular topic, it is clear that as the United States (and the rest of the world, for that matter) emerge out of this last recession, it is coming from debt and deficit levels substantially higher than the levels leading up to the recession. This fact alone distinguishes the current expansion from that of any other sustainable beginning of economic growth.

Put simply, the systemic risks to the financial system have only increased from pre-recession levels. And the Federal Reserve even admits that this is far from a self-sustaining recovery. This puts the worldwide financial markets in a precarious situation. While we are currently enjoying economic growth, risk remains exceptionally high as the growth is coming from increased stimulus rather than a virtuous business cycle.

I won't bother to rehash the data describing why I feel stocks generically remain too risky to invest in, and therefore much prefer direct beneficiaries of the money printing process (please see my 2009 Year End Report on my website for more detailed and still relevant information on that topic). But the Fed's announcement of another $600 billion in quantitative easing on November 3rd seems to clearly highlight that money printing will be used in the event that the economy may face any additional weakness.

The Federal Reserve seemingly understands the dilemma I am describing. With interest rates effectively at zero, debt and deficits running at historic highs, and the economy at risk of a substantial renewed recession without some form of stimulus, they are essentially left with only two binary options: do nothing and let the economy falter on its own, or continue to print as much money as is necessary at the expense of the dollar.

Given the history of the Federal Reserve and verbiage of Ben Bernanke, I think the odds of the former alternative are roughly nil. It isn't even worth discussing at this point as the only likely way this would happen is if the dollar declines so rapidly that additional quantitative easing is removed as an option. While I do see risk of a currency or funding crisis in the future (whereby the dollar drops too far and/or interest rates rise dramatically, taking both money printing and debt issuance off the table as viable financing options), we remain quite a few steps away from discussing those scenarios beyond academia at this point. Instead, it remains much more probable, and highly likely in my opinion, that the money printing will simply continue for the indefinite future.

As I wrote about in my November 4th Interim Report (just after the Fed's announcement), I strongly disagree with this latest round of quantitative easing. (Clearly, I was not alone, as the backlash around the world prompted Ben Bernanke to defend his actions on 60 Minutes.) The first round of QE was sold as a necessity to stave off a financial collapse. However, the latest round (QE II) was specifically utilized to keep assets from falling to "dangerous levels." He was referencing deflation, but his official statement specifically mentioned stock and bond prices, stating that their rise *in anticipation* of the move was justification *for* the move.

I cannot overstate the importance of that meeting's statement. It clearly shows that the Fed's mandate has expanded to include targeting stock and bond prices, and not just financial stability and employment. By defending his move several times since, it looks as though they are left with little options other than money printing, in hopes that asset prices rise enough that the wealth effect takes over. And he has opened the door for much more money printing in the future.

The government and the Federal Reserve, of course, continue to hope that somewhere along the line the economy will begin to grow at a self-sustainable rate from which deficits, debt, unemployment, and stimulus can then be unwound through organic growth. While anything is possible (it is what everyone seems to be counting on), I see extremely low odds in this scenario. *Printing money simply does not create wealth*. But even if it did, we still face several significant issues on the horizon that could likely derail any near-term potential of a self-sustainable recovery. Just a few of which include:

1. State and local government deficits. Estimates for funding shortages due to account deficits, municipal bond payments, and pension obligation shortages are estimated as high as $3 trillion with upwards of $1 trillion likely needed within the next several years.
2. Renewed mortgage delinquencies. A substantial number of mortgages are due to reset again later in 2011 and into 2013 (this time in the "pay-option ARM," the size of which is estimated as similar to that of "subprime").
3. Sovereign debt issues (primarily in Europe). The most pressing of the now notorious "PIIGS" is the next infusion needed for Greece in March 2011.
4. Unemployment. U-6 (which is how unemployment used to be calculated) is about 19%. A self-sustaining recovery needs *at least* 175,000 jobs per month just to keep up with population growth.
5. Financial Accounting. FAS 166/167 accounting regulations for financial institutions and pensions have enabled another postponement of properly marking many assets (the delay is generally understood as "necessary" because more proper accounting would show many such institutions are insolvent).

This short list is not a prediction, but is meant to simply highlight a few headwinds that would undoubtedly lead to more money printing. As recently as just a few years ago, any one of these issues could dramatically derail the economy, as it would lead to massive bankruptcies and a subsequent ripple effect. However, now that bailouts and money printing has been set as the precedent, I would presume that such shortfalls in the future will not be left to the free markets, but instead met with more of the same money printing and bailouts.

Thus, I anticipate that investors need not be too worried about the next shoe to drop. Rather, investors should be concerned with the *ramifications* of the policies used to deal with it. Holding municipal bonds from states like California, New Jersey, and Illinois (to name the most dire of states at present) would previously have me quite nervous about principle being repaid. Anymore, I would simply expect that these states would themselves get a bailout, as it would be quite difficult to save AIG and GM, but then let California go bankrupt. So while we may not need to worry about the next crisis itself, the risk has shifted to the unintended consequences of the policies used to deal with the crisis. The money will need to be created out of thin air. As more money printing is on the way, it is likely to lead to the dollar continuing to slide over time.

This continued money printing could well keep a bid in the financial markets generically. But prudence dictates that investing in assets like stocks and bonds, which would likely be far lower if left to find their own equilibrium without the help of the Federal Reserve, is typically a losing proposition. They may do just fine while the Fed continues to purchase them (either directly or through financial institutions in repo agreements), but that remains a dangerous game of musical chairs. Instead, I continue to anticipate that direct beneficiaries of the money printing itself should perform far better, and is why I foresee the precious metals and other hard assets as a more superior investment choice.

I have long felt that the most prudent policy would be to allow the capital markets to self-regulate the business cycle. However, the policies of government and the Federal Reserve over the last few years (and most specifically November 3rd), has clearly tipped the scales away from free market capitalism toward intervention and money printing.

While I may not agree with that path, it has been reasonably easy to forecast and stay ahead of the curve. This has greatly benefitted our portfolios by continuing to protect us with investments like the precious metals, other hard assets, and occasionally foreign currencies which all help maintain wealth in the face of a declining currency. As the money printing only looks to continue, I anticipate further absolute and relative outperformance for the foreseeable future. But as always, I will certainly keep a diligent eye out for anything that looks to alter that forecast.

Wishing you a very happy and prosperous 2011 and beyond.

Sincerely,

Shane Hoover
Hoover Capital, LLC