

November 15, 2012

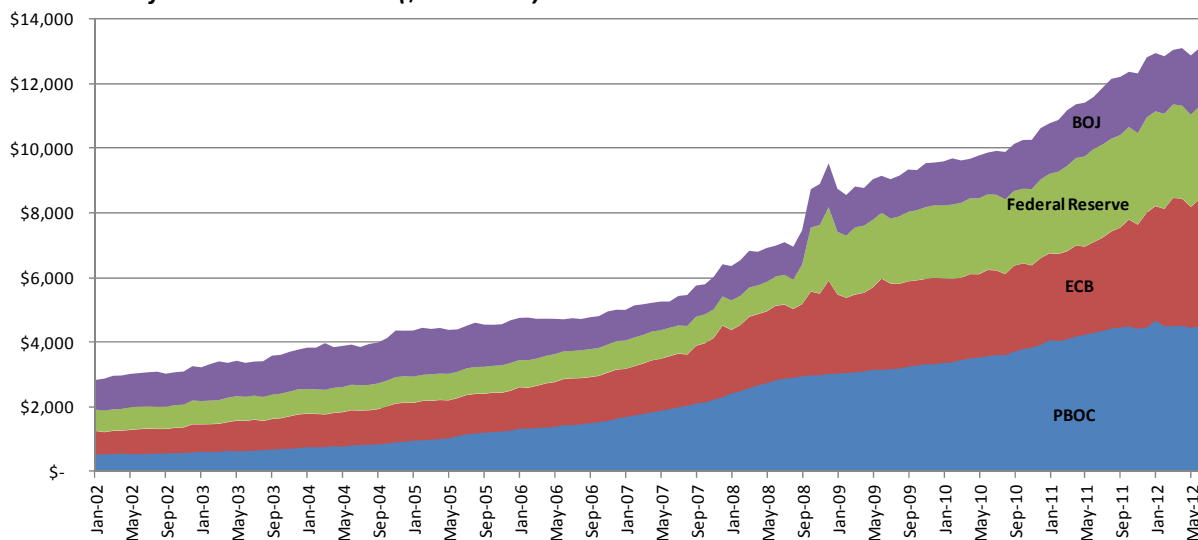
The Central Bankers' Potemkin Village

It seems to us that we have already witnessed the peak of political support for austerity and fiscal consolidation. Instead, battle cries for stimulus (read: money printing to finance deficit spending) emanate from the Krugman-esque disciples demanding more and more cowbell¹.

Converting all balances to USD, central bankers around the world have expanded their balance sheets beyond \$13 trillion, from only \$3 trillion ten years ago. Global central banks' assets now comprise at least a quarter of all global GDP – up from only 10% in 2002.



Total Assets of Global Central Banks (\$ in Billions)



Source: Bloomberg.

¹ http://en.wikipedia.org/wiki/More_cowbell

As investors, what do we think about the quadrupling of central bank balance sheets to over \$13 trillion in the last ten years? It certainly doesn't make me feel any better to say it fast or forget that we moved ever so quickly from million to billion to trillion dollar problems.

It has become increasingly clear over the last four years that the common denominator in policy response to financial crises is, and will continue to be, more central bank easing (printing money) to finance fiscal deficits. Let us recap the actions of three of the four most prominent, powerful and influential central banks in the world over the course of the last several weeks:

| <i>Endless Money Printing: Central Bank Asset Purchases Announced September - October 2012</i> | | | |
|---|--------------------------|--|---------------------------|
| | Announcement Date | Action | Cap |
| European Central Bank | September 6, 2012 | Introduced new unlimited bond buying program, Outright Monetary Transactions ("OMT"), through which the ECB will purchase 1-3 year bonds of distressed Eurozone nations | Unlimited |
| Federal Reserve | September 13, 2012 | Announced plan to purchase \$40 billion of mortgage-backed securities every month indefinitely, which, when combined with the ongoing Operation Twist, will add \$85 billion per month in long-term bonds to the Fed's balance sheet | Unlimited |
| Bank of Japan | October 30, 2012 | Increased the total size of its Asset Purchase Program by ¥11 trillion, from ¥80 trillion to ¥91 trillion. This follows the prior month's release which increased the program from ¥70 trillion to ¥80 trillion. | ¥91 trillion (for now) |

Source: ECB; US Federal Reserve; BOJ.

Central bankers are feverishly attempting to create their own new world: a utopia in which debts are never restructured, and there are no consequences for fiscal profligacy, i.e. no atonement for prior sins. They have created Potemkin villages on a Jurassic scale. The sum total of the volatility they are attempting to suppress will be less than the eventual volatility encountered when their schemes stop working. Most refer to comments like this as heresy against the orthodoxy of economic thought. We have a hard time understanding how the current situation ends any way other than a massive loss of wealth and purchasing power through default, inflation or both.

In the Keynesian bible (*The General Theory of Employment, Interest and Money*), there is a very interesting tidbit of Keynes' conscience in the last chapter titled "Concluding Notes" from page 376:

[I]t would mean the euthanasia of the rentier, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity value of capital. Interest today rewards no genuine sacrifice, any more than does the rent of land. The owner of capital can obtain interest because capital is scarce, just as the owner of land can obtain rent because land is scarce. But whilst there may be intrinsic reasons for the scarcity of land, there are no intrinsic reasons for the scarcity of capital.

...

Thus we might aim in practice (there being nothing in this which is unattainable) at an increase in capital until it ceases to be scarce, so that the functionless investor will no longer receive a bonus[.] (emphasis added)

This is nothing more than a chilling prescription for the destruction of wealth through the dilution of capital by monetary authorities.

Central banks have become the great enablers of fiscal profligacy. They have removed the proverbial policemen from the bond market highway. If central banks purchase the entirety of incremental bond issuance used to finance fiscal deficits, the checks and balances of “normal” market interest rates are obscured or even eliminated altogether. This market phenomenon does nothing to encourage the body politic to take their foot off the spending accelerator. It is both our primary fear and unfortunately our prediction that this quixotic path of spending and printing will continue ad-infinitum until real cost-push inflation manifests itself. We won’t get into the $MV=PQ$ argument here as the reality of the situation is the fact that the V is the “solve-for” variable, which is at best a concurrent or lagging indicator. Given the enormity of the existing government debt stock, it will not be possible to control the very inflation that the market is currently hoping for. As each 100 basis points in cost of capital costs the US federal government over \$150 billion, the US simply cannot afford for another Paul Volcker to raise rates and contain inflation once it begins.

“Road to Serfdom”

The current modus operandi by central banks and sovereign governments threatens to take us down Friedrich von Hayek's “Road to Serfdom”. Published in 1944, its message, that all forms of socialism and economic planning lead inescapably to tyranny, might prove to have been prescient. In the 1970s, when Keynesianism was brought to crisis, politicians were vociferously declaring that attempting to maintain employment through inflationary means would inevitably destroy the market economy and replace it with a communist or some other totalitarian system which is the “perilous road” to be avoided “at any price”. The genius in the book was the argument that serfdom would not be brought about by evil men like Stalin or Hitler, but by the cumulative effect of the wishes and actions of good men and women, each of whose interventions could be easily justified by immediate needs. We advocate social liberalism, but we also need to get there through fiscal responsibility. Pushing for inflation at this moment in time will wreak havoc on those countries whose cumulative debt stocks represent multiples of central government tax revenue.

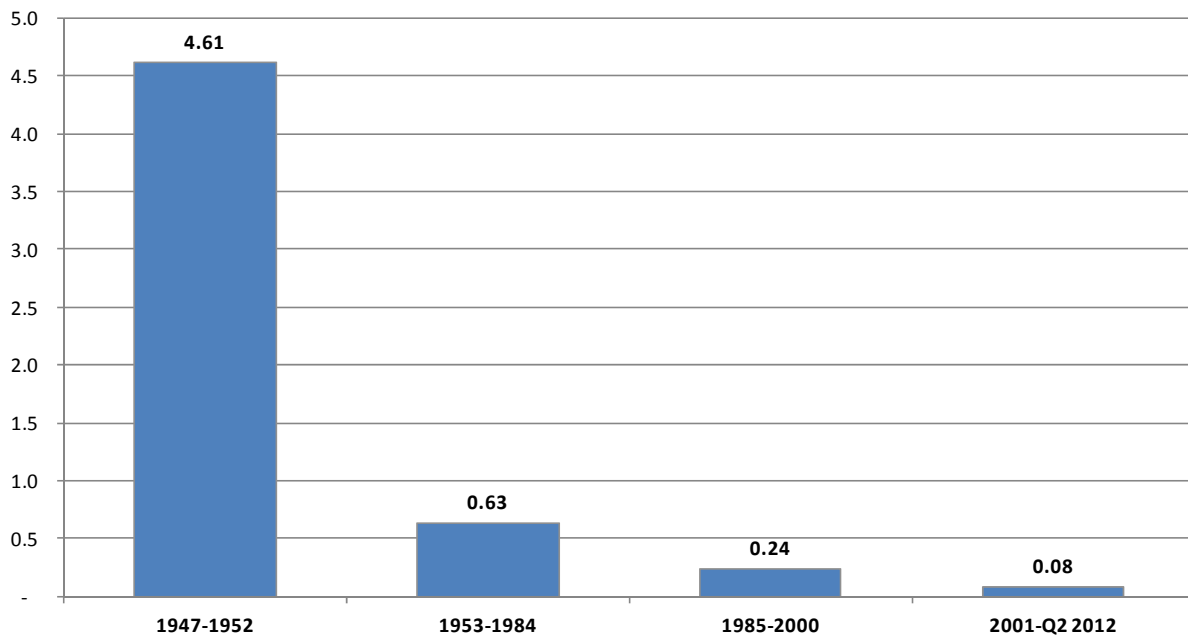
The non-linearity of expenses versus revenues is what will bring them down.

The Largest Peacetime Accumulation of Total Credit Market Debt in World History

It took the United States 193 years (1789-1981) to aggregate \$1 trillion of government debt. It then took 20 years (1981-2001) to add an additional \$4.8 trillion and, in the last 10 years (2001-2011), a whopping \$9.8 trillion has been added to the federal debt. Since 1981, the US increased its sovereign debt by 1,560% while its population increased by only 35%.

Remember the old economic theory of diminishing marginal utility?

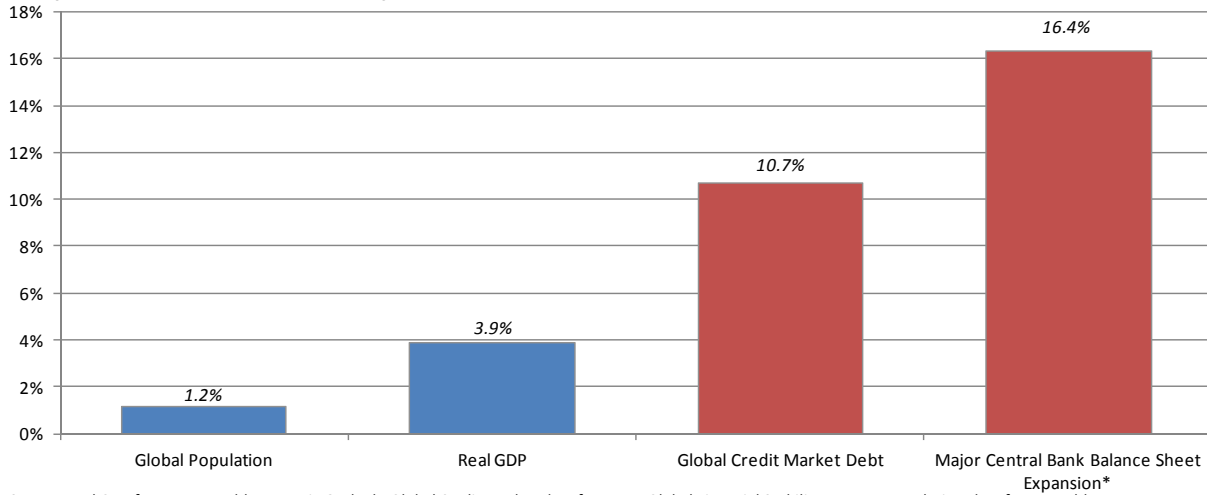
United States Increase in Real GDP per Dollar of Incremental Debt



Source: Ned Davis Research; US Federal Reserve; Bloomberg.

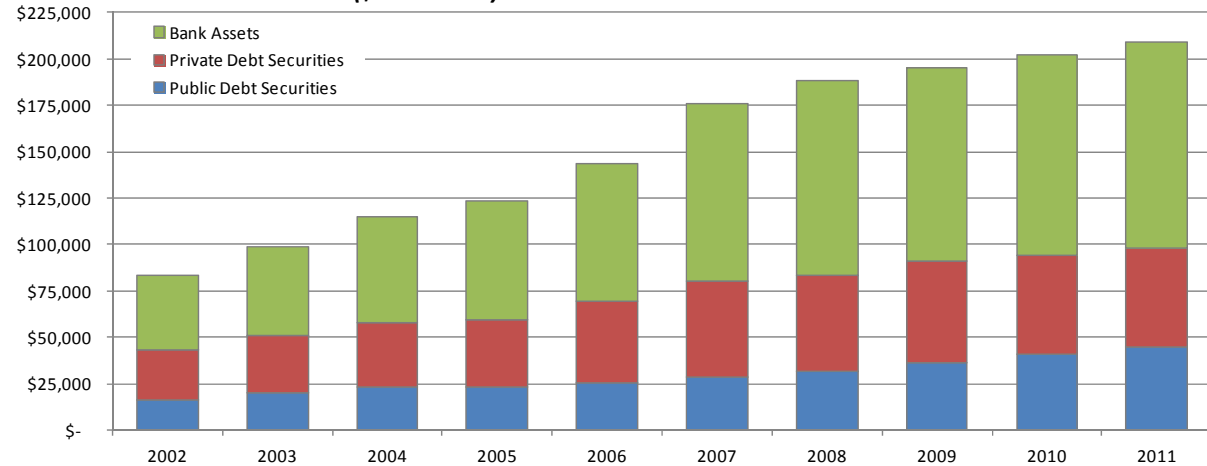
Similar amounts have been accumulated all over the developed world. Total global credit market debt has grown at over a 10% annualized pace for the last 10 years while global population has grown at only 1.2% and global real GDP has grown at 3.9%.

Compound Annual Growth Rate of Various Economic Indicators (2002 - 2011)



Source: Real GDP from IMF World Economic Outlook; Global Credit Market data from IMF Global Financial Stability Reports; Population data from World Bank; Central bank asset data from Bloomberg.

Total Global Credit Market Debt (\$ in Billions)



Source: IMF; BIS.

Japan has reached a new milestone in its fiscal profligacy. They have reached over one quadrillion yen in government debt. That's a 1 with 15 zeros after it for those keeping score at home (¥1,000,000,000,000,000). Assuming that it takes 1 second to count each number, it would take you 31,688,087 years, 297 days, 7 hours, 46 minutes, and 40 seconds to count to one quadrillion². It is simply foolhardy for anyone to think this debt can ever be repaid (more to follow on Japan later). While we generally agree with Alexander Hamilton that a sovereign nation does not have a finite life span and therefore can support a certain amount of debt into perpetuity, he should have defined "excessive" when he wrote in 1781: "A national debt, if it is not excessive, will be to us a national blessing."

² Timing considers leap years so that each year is 365.25 days long.

As investors mull the fate of the peripheral European economies, the broader monetary union and its foundational currency, the proverbial forest is finally coming into view through the trees. As our thoughts evolve, we intend to share our views on how and, more importantly, why we believe the world sits at a crossroads (with one road now completely washed out). The behavior of market participants is what we will be focused on over the next few years.

Pavlov's Party Coming to an End

Through travel and meetings around the world, it has become clear to us that most investors possess a heavily anchored bias that has been engrained in their belief systems mostly through inductive reasoning. Using one of the Nobel Laureate Daniel Kahneman's theories, participants fall under an availability heuristic whereby they are able to process information using only variables that are products of recent data sets or events. Let's face it – the brevity of financial memory is shorter than the half-life of a Japanese finance minister.

Humans are optimistic by nature. People's lives are driven by hopes and dreams which are all second derivatives of their innate optimism. Humans also suffer from optimistic biases driven by the first inalienable right of human nature which is self-preservation. It is this reflex mechanism in our cognitive pathways that makes difficult situations hard to reflect and opine on. These biases are extended to economic choices and events. The fact that developed nation sovereign defaults don't advance anyone's self-interest makes the logical outcome so difficult to accept. The inherent negativity associated with sovereign defaults brings us to such difficult (but logical) conclusions that it is widely thought that the powers that be cannot and will not allow it to happen. The primary difficulty with this train of thought is the bias that most investors have for the baseline facts: they tend to believe that the central bankers, politicians, and other governmental agencies are omnipotent due to their success in averting a financial meltdown in 2009.

The overarching belief is that there will always be someone or something there to act as the safety net. The safety nets worked so well recently that investors now trust they will be underneath them ad-infinitum. Markets and economists alike now believe that quantitative easing ("QE") will always "work" by flooding the market with relatively costless capital. When the only tool a central bank possesses is a hammer, everything looks like a nail. In our opinion, QE just doesn't stimulate private credit demand and consumption in an economy where total credit market debt to GDP already exceeds 300%. The UK

is the poster child for the abject failure of QE. The Bank of England has purchased over 27% of gross government debt (vs. 12% in the US). UK bond yields have all but gone negative and are now negative in real terms by at least -1%. Unlimited QE and the zero lower bound (“ZLB”) are likely to bankrupt pension funds whose expected returns happen to be a good 600 basis points (or more) higher than the 10-year “risk-free” rate. The ZLB has many unintended consequences that are impossible to ignore. Despite reading through Keynes’ works, we didn’t find a single index referencing the ZLB or any similar concept. In his *General Theory*, there are 64 entries in the index under “Interest” but no entry for the ZLB, zero rates, or even “really low rates”.

Our belief is that markets will eventually take these matters out of the hands of the central bankers. These events will happen with such rapidity that policy makers won’t be able to react fast enough.

The fallacy of the belief that countries that print their own currency are immune to sovereign crisis will be disproven in the coming months and years. Those that treat this belief as axiomatic will most likely be the biggest losers. A handful of investors and asset managers have recently discussed an emerging school of thought, which postulates that countries, as the sole manufacturer of their currency, can never become insolvent, and in this sense, *governments are not dependent on credit markets to remain fiscally operational*. It is precisely this line of thinking which will ultimately lead the sheep to slaughter.

Pattern Recognition and Hysteresis

As investors, we tend to recognize and extrapolate patterns. As these patterns repeat themselves, they become axiomatic through induction. As repetitive events become truths, hysteresis sets in. The pro-cyclicality of thought takes over and this process moves markets far from normalcy. The path dependency of some of the largest global sovereign debt markets is a concept that will be studied, posthumously, much more in the future. When central bankers invoke the word “confidence” in their communiqués, they are centering on the holy grail of sovereign debt markets. Once the belief in the debtor is lost, it is next to impossible to regain. As there are follow-on restructurings to Greece, this confidence will be incrementally chipped away in the psyche of sovereign investors. The qualitative perceptions of participants will therefore change over time. It is this timing of change in the beliefs of the participants that is most difficult to gauge. Given the recent default and restructuring of Greek debt plus the intractable problems with Spain, Cyprus, Portugal, Ireland, Italy, Japan, and dare we say, France, the qualitative assessments of sovereign investors are becoming the single most important variable in

the equation. We believe that the only reason the European Monetary Union (“EMU”) has not let Greece go and devalue into the Drachma is the simple fact that Luigi is focused on what happens to Stavros’ bank deposits. For as soon as Stavros’ deposits are “Drachmatized”, Luigi will send all of his euros to Jurgen’s bank.

In the end, the EMU won't look the same, if it exists at all. This is even before the tide turns on some of the world’s largest sovereign debtors like the United Kingdom, and of course the biggest debt zombie of them all: Japan. Trillions of dollars of debts will be restructured and millions of financially prudent savers will lose large percentages of their real purchasing power at exactly the wrong time in their lives. Again, the world will not end, but the social fabric of the profligate nations will be stretched and in some cases torn. Sadly, looking back through economic history, all too often war is the manifestation of simple economic entropy played to its logical conclusion. We believe that war is an inevitable consequence of the current global economic situation.



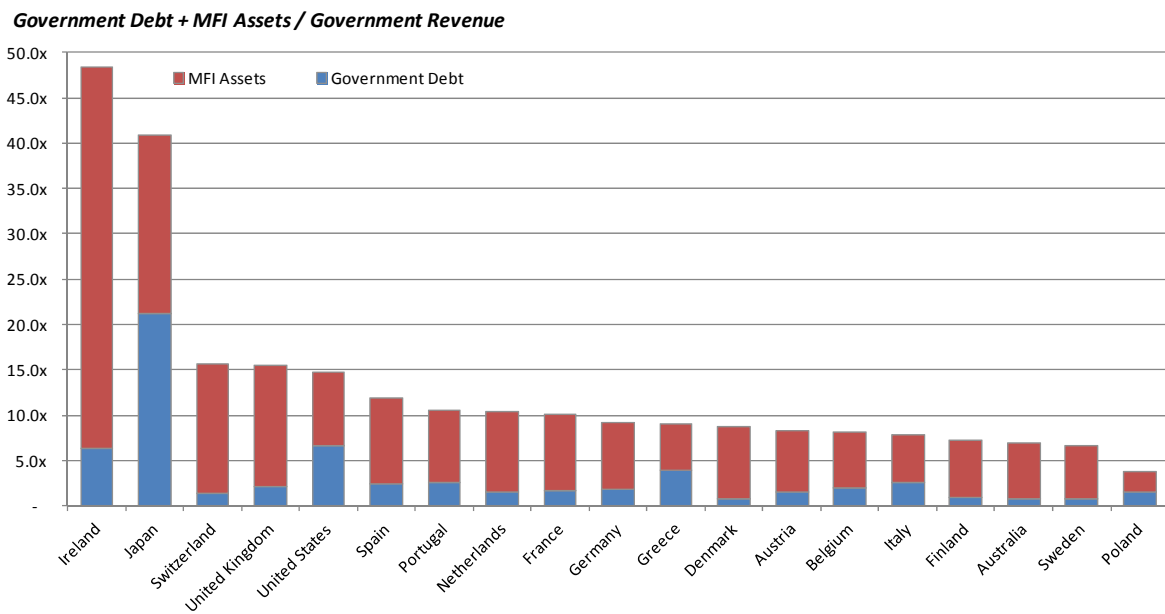
“When it becomes serious, you have to lie.”

*-Jean-Claude Juncker (April 20, 2011)
Prime Minister of Luxembourg*

Chairman of the Eurogroup Council of Eurozone Finance Ministers

How Many Market Participants Actually Study the Numbers?

Throughout the course of our research and discussions with market participants over the past several years, one thing that that is fascinating is that very few (even those “expertly” opining on the issues) have actually studied the numbers carefully. Think about it, how many people that follow the US fiscal situation have read (cover to cover) through the CBO report on the US national budget? How many Europeans understand how large host-country banking systems are in relation to government tax revenues?



Source: ECB; Moody's; US Treasury; US Federal Reserve; RBA; SNB; BOJ; Japanese Ministry of Finance; Ireland Department of Finance. Figures include 2012 revenue estimates, latest available or 2012 year-end estimated government debt, and latest available MFI assets. MFI assets generally include assets of banks, credit institutions, money market funds and other financial institutions whose business is to take deposits and/or close substitutes for deposits. Fixed assets are excluded where available data permits.

How many Japanese have questioned how (if ever) a quadrillion yen of debt will ever be repaid when it represents over 20X central government revenues? (Answer: it can't be)

Very few participants are aware of the enormity and severity of the problems the developed world faces. Those that are aware are frantically trying to come up with the next “solution” to the debt problems. In our opinion (which hasn't changed since 2008), the only long-term solution is to continue to expand program after program until the only path left is a full restructuring (read: default) of most sovereign debts of the developed nations of the world (a la late 1930s and early 1940s when 48% of the world's countries restructured their debts).

Joint and Several Liability with Extended Family? No Way.

How many of your extended family members would you assume all past and future debts with jointly and severally? As complex as the EMU, European Stability Mechanism (“ESM”), European Financial Stability Facility (“EFSF”), Long-Term Refinancing Operation (“LTRO”), Outright Monetary Transactions (“OMT”) and the rest are, it all really boils down to one question in the near-term. Will Germany assume the past and future debts of the profligate members of the EMU without all of them ceding their fiscal sovereignty – and effectively their national sovereignty? As much as I love my extended family, I would never agree to be jointly and severally liable with any of them.

Germany currently has 82% on balance sheet sovereign debt to GDP and they themselves have not even restructured their banks, which are levered three times more than US banks. Does anyone really think Germany is the fortress of fiscal rectitude that they are made out to be? The Target2 (Trans-European Automated Real-time Gross Settlement Express Transfer System – an expression of intra-EMU credits and debts) claims against Germany coupled with EFSF and ESM commitments exceed €900 billion today. The newly proposed EU Banking Union could see trillions more in bank deposit guarantees added to this total. These types of systems are deliberately opaque as the general public finds it difficult to decipher between commitments and hard-money contributions (which is exactly how the Eurocrats designed it).

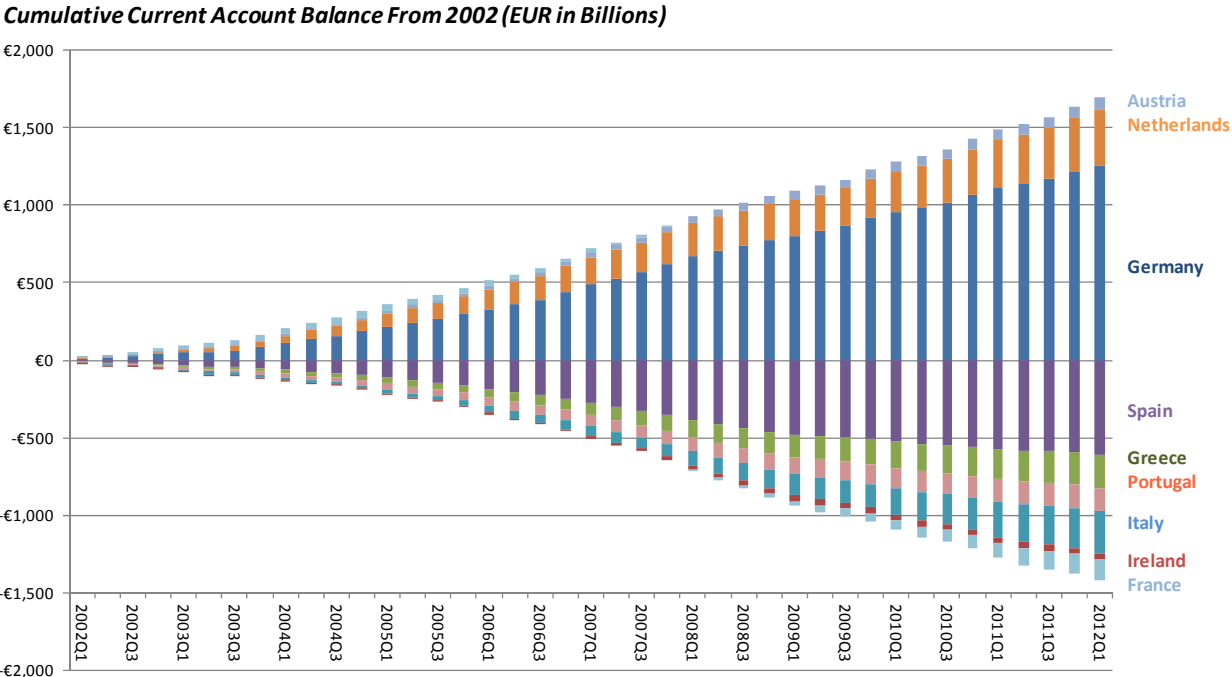
“Merkelavellianism”

In our discussions with European participants about the deliberate complexity and opacity of the various systems proposed or devised to save the EMU, we have come across a term, “Merkelavellianism” (which we cannot take credit for), the core ideologies of which are succinctly captured in the following key points:

1. *Keep all options open, but do it decisively.*
2. *Show calculated hesitation.*
3. *Don’t ever say it, but let everyone know – Better a German euro than no euro at all.*
4. *Hide behind the complexity – It is much easier than approving the third, fourth and fifth bailouts of Greece through the German Parliament and German people.*

Merkel has executed the German playbook flawlessly to date. One question we have is: At what point is the German public asked their opinion on the matter? There is a view among the leadership that the German people have begun to resign themselves to a state of relaxed fatalism, although we've also been told that Eurobonds are about as popular as the Italian soccer team in Germany. As public support for further transfers continues to decline, we believe in the end, Germany will balk at unlimited commitments to the profligate nations of the South.

One chart, produced by our friends at the Lindsey Group and included below, so vividly conveys why the EMU was unsustainable from its inception. Whether the Germans realized it at the time or not, they are certainly aware now of the extreme imbalances within the EMU which only seem to be worsening by the day. Based on the symmetry of the chart below, it appears to us that Europe does most of its trading with itself, and without different currencies that conventionally adjust to keep the state of trade more-or-less in balance over long periods of time, these imbalances will only persist.



Source: The Lindsey Group.

The EFSF, IMF, and a Lesson on Circular References

Each subsequent “save” of the European debt crisis has been devised by the Eurocrats coming up with some new amalgamation of an entity that is more complex than its predecessor that is designed to project size, strength, and confidence to investors that the problem has been solved. Raoul, a friend of mine who resides in Spain, put it best:

“Let’s just clear this up again. The ECB is going to buy bonds of bankrupt banks just so the banks can buy more bonds from bankrupt governments. Meanwhile, just to prop this up the ESM will borrow money from bankrupt governments to buy the very bonds of those bankrupt governments.”

The EFSF, the IMF, the ESM, and the OMT (and who knows what other vehicles they will dream up next) have all been developed to serve as an optical backstop for investors globally. The Eurocrats are sticking with the Merkelavellian playbook of hiding behind the complexity of these various schemes. All one has to do is review the required contributions to said vehicles from bankrupt nations to realize that the circular references are already beginning to show in broad daylight. Does anyone stop to consider that the two largest contributors to the IMF are the two largest debtor nations in the world? Are things beginning to make sense now?

You may recall a reference we made in November 2011 to a team of mountain climbers tethered together for safety (Stavros, Seamus, Pablo, Jose, Francois, Luigi and Jurgen), ascending a dangerous peak. In checking back in on their progress, Stavros is now dead weight, hanging by the rope as the rest attempt to carry him up. Pablo and Jose appear to have contracted frostbite and are hanging on by one hand, and Luigi is delirious from oxygen deprivation. Francois is barely supporting his own weight, so Jurgen is left attempting to drag himself along with the dead, the sick and the exhausted up the mountain. He is somewhat comforted by the fact that he could grab the sat-phone and call Uncle Sam

EFSF Guarantors of Spanish Bank Bailout

| Country | Guarantee Commitment (EUR in MM) | % of Total |
|--------------|----------------------------------|---------------|
| Germany | 27,210 | 27.2% |
| France | 20,434 | 20.4% |
| Italy | 17,956 | 18.0% |
| Spain* | 11,932 | 11.9% |
| Netherlands | 5,731 | 5.7% |
| Belgium | 3,485 | 3.5% |
| Austria | 2,823 | 2.8% |
| Finland | 2,790 | 2.8% |
| Slovakia | 2,515 | 2.5% |
| Slovenia | 1,802 | 1.8% |
| Estonia | 1,596 | 1.6% |
| Luxembourg | 996 | 1.0% |
| Cyprus | 472 | 0.5% |
| Malta | 257 | 0.3% |
| Total | 100,000 | 100.0% |

* According to the EFSF framework agreement, it is expected that Spain will remain a guarantor of the EFSF.

Source: EFSF.

and Takehiro for help; unfortunately, they are facing their own challenges on another face of the same mountain.

Top Ten Contributors to the IMF, EFSF, and ESM

| IMF | | EFSF | | ESM | |
|----------------------------|------------------------|-------------|------------------------|-------------|------------------------|
| New Arrangements to Borrow | | As Amended* | | | |
| Country | Commitment (SDR in MM) | Country | Commitment (EUR in MM) | Country | Commitment (EUR in MM) |
| United States | 69,074 | Germany | 211,046 | Germany | 190,022 |
| Japan | 65,953 | France | 158,488 | France | 142,702 |
| China | 31,217 | Italy | 139,268 | Italy | 125,398 |
| Deutsche Bundesbank | 25,371 | Spain | 92,544 | Spain | 83,328 |
| France | 18,657 | Netherlands | 44,446 | Netherlands | 40,019 |
| United Kingdom | 18,657 | Belgium | 27,032 | Belgium | 24,339 |
| Italy | 13,578 | Austria | 21,898 | Greece | 19,719 |
| Saudi Arabia | 11,126 | Finland | 21,639 | Austria | 19,481 |
| Swiss National Bank | 10,905 | Slovakia | 19,507 | Portugal | 17,563 |
| Netherlands | 9,044 | Slovenia | 13,974 | Finland | 12,579 |

* Amended guarantee contributions take into account the stepping out of Greece, Ireland and Portugal.

Source: IMF; EFSF.

The US and Japan, the world's two largest debtor nations, are the largest contributors to the IMF by a factor of two.

Europe's most troubled nations are the very countries that are expected to contribute to and support each other.

The IMF and the Federal Reserve serve as very important mental crutches for the investing public. The Federal Reserve was created in the years leading up to 1913 and was formed as a direct result of the Panic of 1907 in the United States. It serves as an enigmatic institution behind a wall that was designed to placate depositor fears of losing their money. Early on, forget dual mandates, it served (and still does serve) as the mental crutch of depositors along with the FDIC.

Born of the United Nations Monetary and Financial Conference in July of 1944 (better known as the Bretton Woods Conference), the IMF at its inception was formed as a global organization to promote fair international trade by putting in place and enforcing mutually agreeable rules preventing unfair monetary exchange practices, and if need be, to provide short-term capital to alleviate the pressures created by severe trade imbalances. Nowhere is it stated that the IMF should act as a financial backstop for over levered fiscally profligate nations (using capital provided by other, slightly less fiscally profligate member nations). Much like other financial and monetary authorities around the world, the function of the IMF has been bastardized and manipulated away from its original intent into a global “lender of last resort”.



Harry Dexter White (left) with John Maynard Keynes (right) at the first meeting of the IMF and World Bank governors in 1946. Two years prior, both attended the United Nations Monetary and Financial Conference (more commonly known as the Bretton Woods Conference) in July 1944 at the Mount Washington Hotel in Bretton Woods, NH. At the conference, Keynes represented the UK and White represented the US.

Four years after the conference, in August 1948, among accusations that he passed sensitive US Treasury documents to the Soviets during World War II, White testified to defend himself to the House Un-American Activities Committee. He died of a heart attack three days later.

The idea that over-levered nations can and will support other even more over-levered nations into perpetuity, by whatever mechanisms they may attempt, will prove to be unworkable in short order. In a recent conversation with a well-respected central banker, he said “the monetary authorities *are the only game in town*. This situation is not sustainable.” Another central banker, Richard Fisher, expressed it even better when he stated³:

The truth, however, is that nobody on the committee, nor on our staffs at the Board of Governors and the 12 Banks, really knows what is holding back the economy. Nobody really knows what will work to get the economy back on course. And nobody—in fact, no central bank anywhere on the planet—has the experience of successfully navigating a return home from the place in which we now find ourselves. No central bank—not, at least, the Federal Reserve—has ever been on this cruise before.



“No central bank has done more in recent months to flood the system with liquidity than the ECB – one trillion Euros injected through two long-term refinancing operations. Those two operations demonstrated that liquidity is not the issue because after a few months we are back to where we were. The problem is one of solvency.

“Where there are debtors who cannot afford to repay, there are creditors who will not be repaid. Until losses are recognised, and reflected in balance sheets, the current problems will drag on. An honest recognition of those losses would require a major recapitalisation of the European banking system.” (emphasis added)

*-Sir Mervyn King (June 14, 2012)
Governor of the Bank of England*

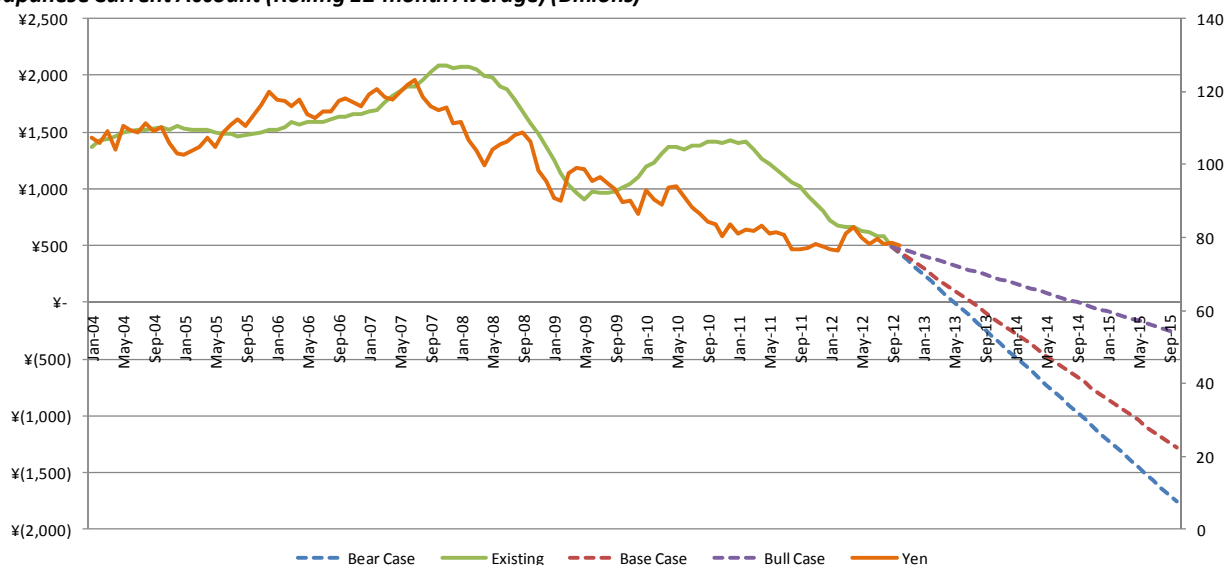
At the Lord Mayor’s Banquet for Bankers and Merchants of the City of London

³ <http://www.dallasfed.org/news/speeches/fisher/2012/fs120919.cfm>

Japan – Crossing the Rubicon

Japan now sits on the doorstep to its own demise. We believe they have reached zero-hour, where things will begin to unwind altogether. For the past twenty years, Japan's exports and industrial sector have moved in tandem with the pan-Asian industrial cycle (even as the rest of their domestic economy has been in a deflationary spiral). In fact, Japanese output recovered with the rest of Asia during the global economic bounce in 2009. On the other hand, even before the Fukushima tragedy, Japan's output had decoupled from that of the rest of Asia. Today, Japan faces secular problems that are bad and only worsening. We had previously forecasted full current account negativity (on a rolling 12-month basis) taking place between Q3 and Q4 of 2013 (see the chart below).

Japanese Current Account (Rolling 12-month Average) (Billions)

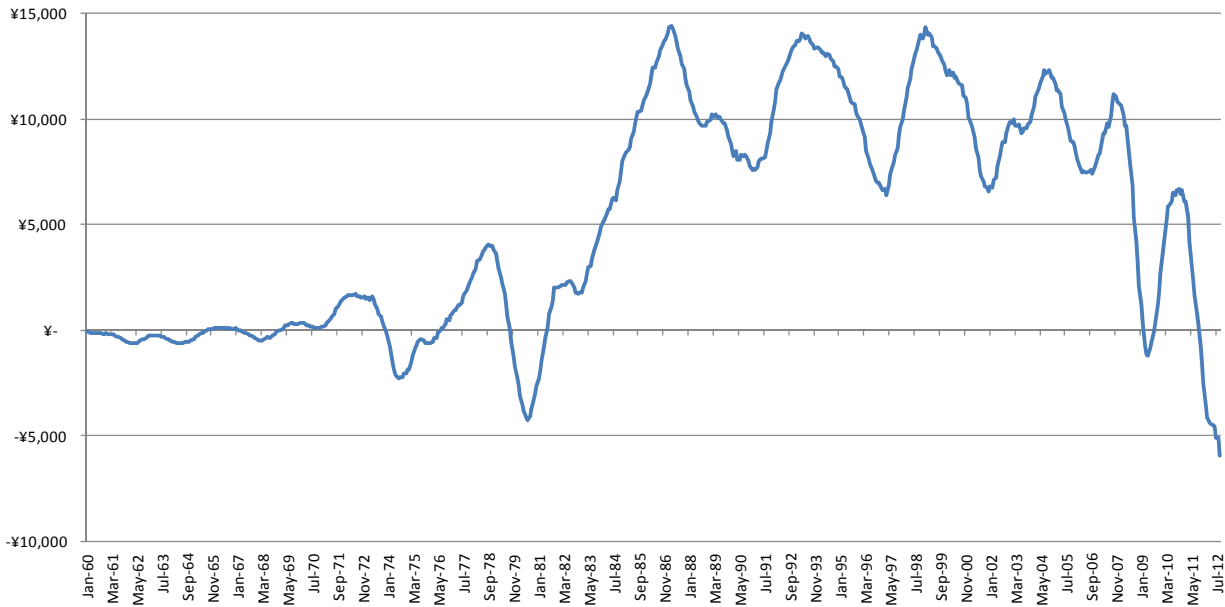


Source: Bloomberg; Hayman Capital estimates.

We now expect the monthly October current account balance to be negative and believe it could be negative for the entirety of Q4 2012.

Severe stresses are beginning to show in this once sleeping giant of a bond market. Their balance of trade is the worst it has been in the post-World War II era, and the data released to-date only encompasses a brief period in September when the unofficial economic boycott of Japanese exports by the Chinese companies and state-owned enterprises was just beginning.

Japanese Trailing 12-Month Trade Balance Since 1960 (Billions)



Source: Bloomberg.

During the past twenty years, the balance of trade has been a significant contributor to the positive current account surplus to the tune of at least 1-2% of GDP. The trade balance is now on track to be a drag on the current account of approximately -2% of GDP *before* the impact of the Senkaku crisis. If the Japanese auto manufacturers are a relevant barometer, the decline in exports to China could drag the trade balance down by another 1-2% of GDP.



China has been the only bright spot in Japan's economic future for the last decade. Since 2002, Japanese export volumes to China are up +76% while they are down -30% in the EU and -27% in the US. If relations are as strained as they appear, this will be an unmitigated disaster for Japan. For those who believe Abe will be able to negotiate a path back to China-Japan normalcy, we think the gravity of the situation is being underestimated. Abe is known as a hardliner, while Xi Jinping's father was an active communist revolutionary and political leader during the Second Sino-Japanese War. There is absolutely no love lost between these two.

The current freefall in the balance of trade, while primarily secular, is occurring at a time when the global economy is concurrently slowing down. Whether it is Japan's reliance on imported LNG, coal and crude oil or whether the Chinese are unofficially boycotting Japanese goods, Japan now faces a secular problem in exports simultaneous with a secular population decline.

"We'll take it from here Shirakawa-san"

Since he was appointed as Minister for National Strategy and the Economy at the beginning of October Seiji Maehara has become the first Japanese Government minister to attend Bank of Japan ("BOJ") policy meetings since April of 2003. Maehara is on record supporting BOJ purchases of foreign assets as a tool of monetary policy and has publicly urged the BOJ to do as much as possible to end deflation.

We see the presence of government ministers at the policy meetings along with verbal instructions as part of the reason the BOJ chose to ease twice in rapid succession in September and October. Even more interesting to us was the unprecedented joint statement issued by the BOJ and government, cosigned by BOJ Governor Shirakawa and Minister Maehara and his colleague, Finance Minister Jojima. The statement laid out in direct terms the commitment of the BOJ to use extraordinary measures to end deflation. This comingling of authority comes at the direct expense of the BOJ's independence – independence that will be further undermined when the BOJ Governor and two deputy governors are replaced in March and April of 2013.

In addition to the actions of the current government, there is ongoing discussion amongst opposition parties of the need to re-write the legislation that governs the BOJ to include explicit inflation targets of 2% to 3% as well as a mechanism for the Diet to haul the BOJ Governor in front of a committee once per

year to explain his success or lack thereof with regard to hitting the inflation target, and fire him if he fails.

We are witnessing nothing less than the steady co-option of monetary policy by the parliament and fiscal authority of Japan, and consequently the revocation of the BOJ's independence. What it presages is more and more aggressive action in order to realize the broadly popular goals of a weaker yen and higher inflation. Japan has now reached a multi-decade inflection point. The ever-strengthening yen will reverse and begin to weaken. Capital flight out of the yen will intensify and then Japanese interest rates will begin to rise. Evidence of these projections has begun to surface in the last few months of M&A activity. Softbank, controlled by one of Japan's wealthiest individuals, has just announced that it will spend \$20 billion to purchase a struggling US wireless carrier. In July, Dentsu announced its acquisition of Aegis Media, a British advertising company, for \$5 billion in one of the largest advertising deals ever. The "smart money" is beginning to leave at just the right time.

Japan's Softbank Snaps Up Sprint in \$20 billion Deal¹

- "Japanese mobile operator Softbank Corp said it will buy about 70 percent of Sprint Nextel Corp for \$20.1 billion, giving Softbank the American toehold it has long desired and Sprint the capital to expand its network and potentially buy peers."
- "The deal for the third-largest U.S. wireless carrier represents the most a Japanese firm has spent on an overseas acquisition."
- "Announced by Softbank's billionaire founder and chief Masayoshi Son and Sprint Chief Executive Dan Hesse at a packed news conference in Tokyo on Monday, the transaction gives Softbank entry into a U.S. market that is still growing, while Japan's market is stagnating."
- "But the 55-year-old [Masayoshi] Son, a rare risk-taker in Japan's often cautious business circles, is betting U.S. growth can offer relief from cut-throat competition in Japan's saturated mobile market."



Dentsu of Japan to Buy Aegis of Britain for About \$5 Billion²

- "Dentsu, a Japanese advertising powerhouse that has struggled to expand internationally, made a big leap into Western markets on Thursday, saying it had agreed to buy Aegis, an agency company based in London."
- "The planned acquisition, valued at £3.167 billion (\$4.92 billion), is one of the largest ever in the advertising business, rivaling the purchase of Young & Rubicam by the WPP 12 years ago and a deal for the parent company of Leo Burnett by Publicis Groupe in 2002."
- "International expansion is critical, because the Japanese ad market has been shrinking in recent years. Dentsu this year acquired a boutique agency in New York, ML Rogers, and Bos, with offices in Toronto and Montreal."



1. Reuters, 10.15.12 – *Japan's Softbank Snaps Up Sprint in \$20 billion Deal*.
2. New York Times Dealbook, 07.12.12 – *Dentsu of Japan to Buy Aegis of Britain for About \$5 Billion*.

At this point, a decline in the yen will not help restore competitiveness of the Japanese steel companies, electronics companies or the shipyards. This will be the case regardless of how long the Senkaku standoff lasts. Now is the time to be short the yen as the problems Japan faces are now intractable. For the most part, we have stayed away from delta-one yen positions (until just recently). Japan has now reached the critical turning point that has been discussed for decades.

Dispelling the Myths of Japanese Self-Funding

Japan has the worst on-balance-sheet financial situation of any country in the world today. This is no secret. Many theories as to why Japan might be able to “hang on” frequently propagate throughout the financial markets. After spending years closely studying the various theories, we will discuss the most frequent objections in this section.

Myth #1: Japan’s Current Account Surplus Allows Japan to Self-Finance its Deficit

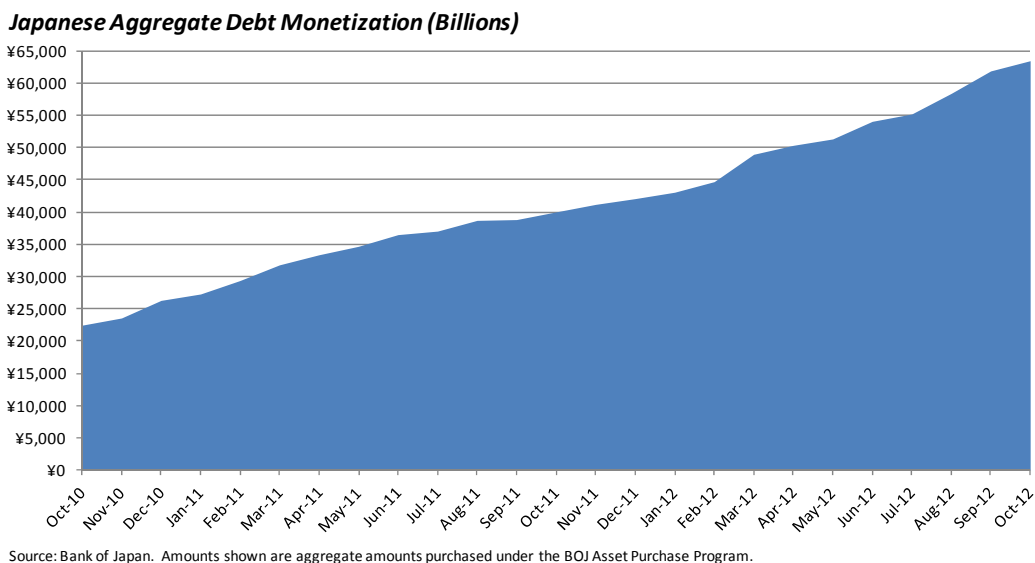
First and foremost, we tend to hear that since 93.8% of Japan’s debt is held internally, and that 95% of that 93.8% is held institutionally that Japan is much better off than those countries that finance more or most of their debts externally. The thesis further expands that as long as Japan has a current account surplus, they will be able to continue to “self-finance” their fiscal deficit.

We tend to find broad statements like this to exhibit a colossal naiveté. How can one make a statement like this without taking into account the amplitude of the fiscal deficit and the current account? The plain and simple fact is that this statement that has become axiomatic through repetitive use is patently false as Japan stands today. We expect Japan’s current account surplus to amount to less than 1% of GDP this year and that it will decline into deficit next year, while the fiscal deficit is running at a sustained 10% of GDP. We didn’t need to get out our calculators to determine that the math doesn’t work.

The bottom line is that Japan has reached a secular turning point in its trade balance and current account, following decades of surpluses. The current dispute with China has only served to accelerate the process. Investors can no longer make the blanket assumption that a current account surplus will provide a funding source for financing fiscal deficits into perpetuity.

Myth #2: The BOJ is not Monetizing Debt

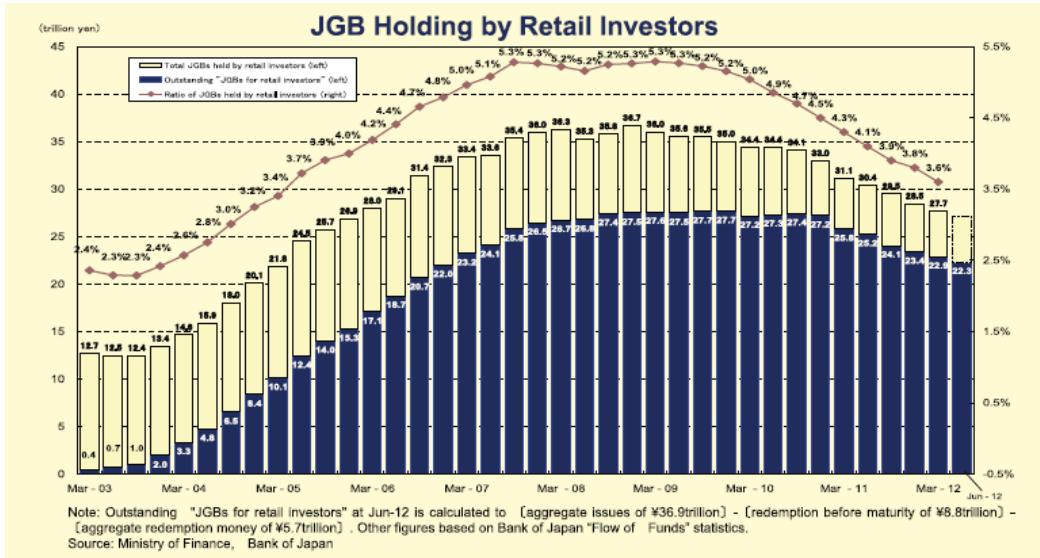
This fiscal year the BOJ will buy at least 56% of government bonds issued (approximately ¥29 trillion of ¥44.5 trillion in total new issuance) in order to finance the current fiscal deficit (not to mention its purchases of corporate bonds, stocks, REITs, ETFs and loans). In fiscal 2011, Japan ran a ¥44.3 trillion deficit (excluding ¥11.6 trillion of bonds issued for the reconstruction effort) and the BOJ purchased ¥9.9 trillion of government securities. Under the Asset Purchase Program which began in October 2010, the BOJ has amassed over ¥60 trillion in government bonds, corporate bonds, stocks and loans. In September the BOJ increased the total targeted size of this program to ¥80 trillion from ¥70 trillion, and then just last month they increased it again to ¥91 trillion. The punch line here is that *they are already unable to “self-fund”* as it stands today. The self-funding axiom appears to be a mirage.



Recently, a Hayman Capital representative had dinner with a key member of the Bank of Japan and was afforded the opportunity to question him about the expansion of the BOJ’s balance sheet to purchase Japanese Government Bonds (“JGB”) (monetizing debt). The BOJ representative had just finished a statement where he denounced monetization of debts when we asked him how he defines monetization (we define it as central bank balance sheet expansion in order to purchase sovereign debt). After a long pause, he said “It is only monetization when the market tells us it is monetization. When yields go up, not down, when we buy bonds, then the market says we are monetizing.” When we pressed further, he acknowledged it was out of the hands of the BOJ and entirely up to market psychology. Wow, we wonder how that makes JGB investors feel.

Myth #3: Retail Investors Will Always Support the JGB Market

Interestingly enough, retail investors continue to exit the JGB marketplace which is leading the Ministry of Finance (“MOF”) to engage in desperate advertising campaigns to encourage retail investors to buy JGBs. As the population retires, it is logical that participants will dis-save (or harvest) more savings than they will incrementally accumulate.



Here is the aggressive marketing schedule and some photos of the celebrities chosen to help promote JGB investment (pulled right from the MOF’s website):

| The 2012/2013 JGB Marketing Extravaganza | |
|--|--|
| Summer | Hakuho (69 th Yokozuma; the highest rank in sumo wrestling) |
| Autumn | Homare Sawa (women’s football player) |
| Winter | AKB48 (idol group) |
| Spring | Kiyoshi Hakahata (professional baseball manager) |

Champion Sumo Wrestler

Pop Band AKB48

Source: <http://blogs.wsj.com/japanrealtime/2012/05/29/japan-gets-akb48-bond-girls-on-the-cheat/>. Japan Ministry of Finance.

A Review of the Age-Old Lesson of Ponzi

Japan Holds Adult Diaper Fashion Show



Japanese model the latest styles of adult diapers during a Tokyo show held in 2008. Before the show, players acted out skits demonstrating how to help loved ones use the products.

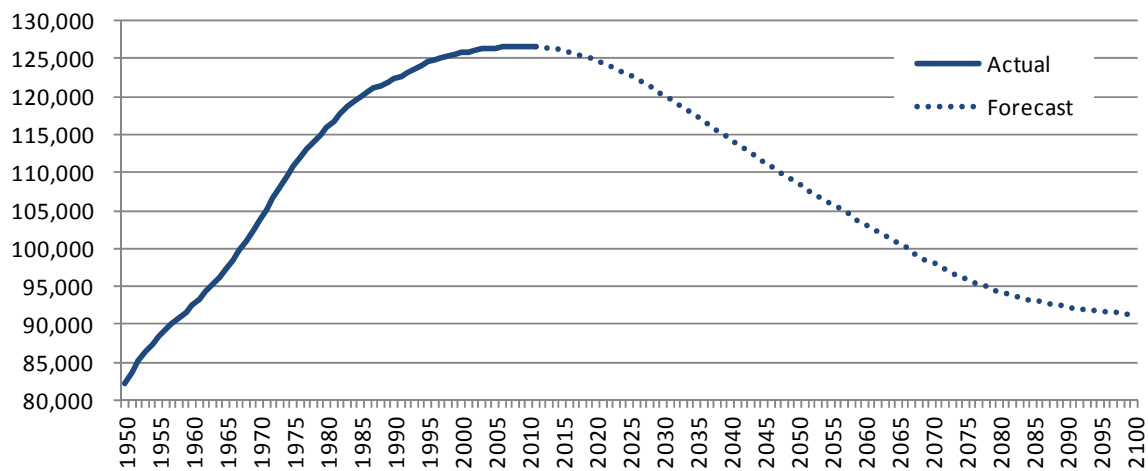
Last year, in 2011, sales of adult diapers exceeded those for babies for the first time. Over the last decade, sales have more than doubled and currently exceed \$500 million annually. Japanese companies are clamoring to grab a bigger piece of the growing market as the number of Japanese citizens over 65 hit a record 23.3% of the population in October 2011.

Source:

*Bloomberg, 05/10/2012 – “Elderly at Record as Japan Stores Chase \$1.4 Trillion”.
USA Today, 09/2/2008 – “Japan Holds Diaper Fashion Show for Adults”.*

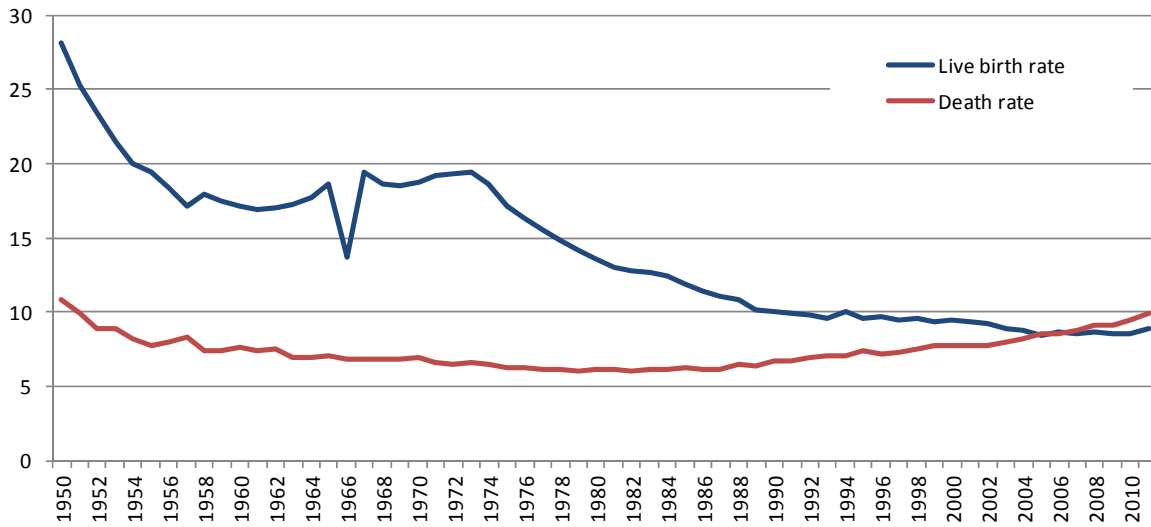
What did Bernie Madoff’s titanic Ponzi scheme teach the world? A key takeaway should have been that you can make outlandish promises for the future as long as you maintain one key ingredient: more victims entering the scheme than exiting. Japan is facing that very real situation as we sit today. After nearly a century of relatively steady population growth, Japan’s population has reached a plateau, having been essentially flat since the early part of the last decade (within a margin +/- 25 bps), and every indication is that the population curve has reached its crest and is poised for a long-term secular decline.

Japanese Population Entering Secular Decline



Source: United Nations Department of Economic and Social Affairs.

**Japanese Death Rate Now Exceeds Birth Rate
(Figures per 1,000)**



Source: Statistics Bureau of Japan.

Mr. Madoff and his predecessor, Mr. Ponzi have taught us that the Japanese government, with an aging and declining population (which equals (i) less tax payers each year; (ii) more pension / social security recipients each year; and (iii) less market participants available domestically to fund the growing deficits resulting from items (i) and (ii)), face a systemic breakdown unless more external investors are enticed to purchase JGBs (which actually may happen at higher interest rates, which the government cannot afford).

Japan's Perfect Recipe for Disaster

Let's review the situation:

- 1) Japan persists with one of the largest structural fiscal deficits in the world.
- 2) The aging population has strangled tax revenues and inflates expenditure on a growing basis.
- 3) We are of the opinion that the fragility of the Asian economy as a whole, and more specifically that of Japan, will subvert Japan's ability to implement their newly-passed consumption tax rate hike. Simply put, we believe it cannot and will not happen.
- 4) The flow of new domestic buyers is drying up so fast that the BOJ is on track to buy a majority of new issuance this year.
- 5) Despite the massive intervention by the BOJ a strong currency persists and the trade balance is in such structural decline that the entire current account threatens to turn negative next year.
- 6) The incumbent government is in such disarray it has just appointed the 5th finance minister of their 3 years in power (the 10th Japan has seen since 2006) and will be forced into an election soon.
- 7) Diplomatic relations with Japan's three largest neighbors: China, South Korea and Taiwan have been thrown into chaos over disputed territories in the South China Sea.
- 8) Japanese nominal GDP will contract in 2012 for the 4th year out of the last 5, during what is clearly a synchronized global growth slowdown.

And yet Japanese interest rate risk is priced close to the all-time lows? This is an example of perhaps the greatest suppression of volatility in modern financial markets. Like all bubbles, the suppression of volatility and the suspension of disbelief is strongest right before the reversal of fortune. The quantitative data and trends are already well established. All that is missing is the qualitative shift in market appreciation of the risk. We hold the view that the Black-Scholes option pricing model and the Black swaption pricing model each dramatically misprice risk at secular turning points. Two key ingredients of these formulas are the risk free rate and volatility – the latter of which is based on historical data which quickly becomes irrelevant when a bond crisis manifests itself.

We believe that Japan is teetering on the precipice of financial collapse, and any number of data points or events in the coming weeks and months could be the proverbial tipping point. It could be as

significant as a negative structural current account, a revocation of BOJ policy independence, or even political and economic conflict with regional neighbors or perhaps something as innocuous as ratings actions or Basel III regulations that force financial institutions to reduce their hugely concentrated exposure to JGBs.

What we do know is that when it does break loose, 20 years of suppressed spring-loaded interest rate volatility on the back of the largest peacetime accumulation of sovereign debt will afford no time to readjust portfolios to get out of the way.

“Please do not worry”

It’s all good. Direct from the Ministry of Finance website (translated using Google Translate; please excuse the Japanese-to-English translation):

The screenshot shows a web browser displaying the Ministry of Finance website. The URL is www.mof.go.jp/faq/jgbs/04be.htm. The page is translated from Japanese to English. The main heading is "If Japan has financial collapse, how do government bonds will". Below this, the text states: "Government bonds will be redeemed because the government is responsible for, please do not worry." The phrase "please do not worry" is circled in red. The page includes a sidebar with navigation links such as "Budget and Accounting", "Taxation", and "Government Bonds". Social media sharing options for Twitter, Facebook, and others are visible.

As an attachment to this letter, we have provided an update on the latest developments in the Non-Agency Residential Mortgage-Backed Securities (“RMBS”) market (Appendix A), which remains a key area of focus for our firm. Given the macro backdrop, we continue to invest in Non-Agency (Subprime and Alt-A) RMBS, distressed liquidations, event-driven credit, select equities, and of course we continue to maintain significant positions in both Japanese rates and currency. We tend to expect a benign grind of an investment environment until significant volatility rears its ugly head once again. We have been fortunate to have had a good year thus far in 2012 despite our dogmatic views on Japan and the global sovereign situation.

We will continue to work diligently and tirelessly to navigate the volatility and instability in the marketplace, with our key goals, first and foremost, of preserving your capital, and second, of generating above-average risk-adjusted returns.

Best Regards,

A handwritten signature in black ink, appearing to read "J. Kyle Bass". The signature is fluid and cursive, with a long horizontal stroke at the end.

J. Kyle Bass
Managing Partner

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Appendix A: An Update on RMBS

On a More Positive Note:

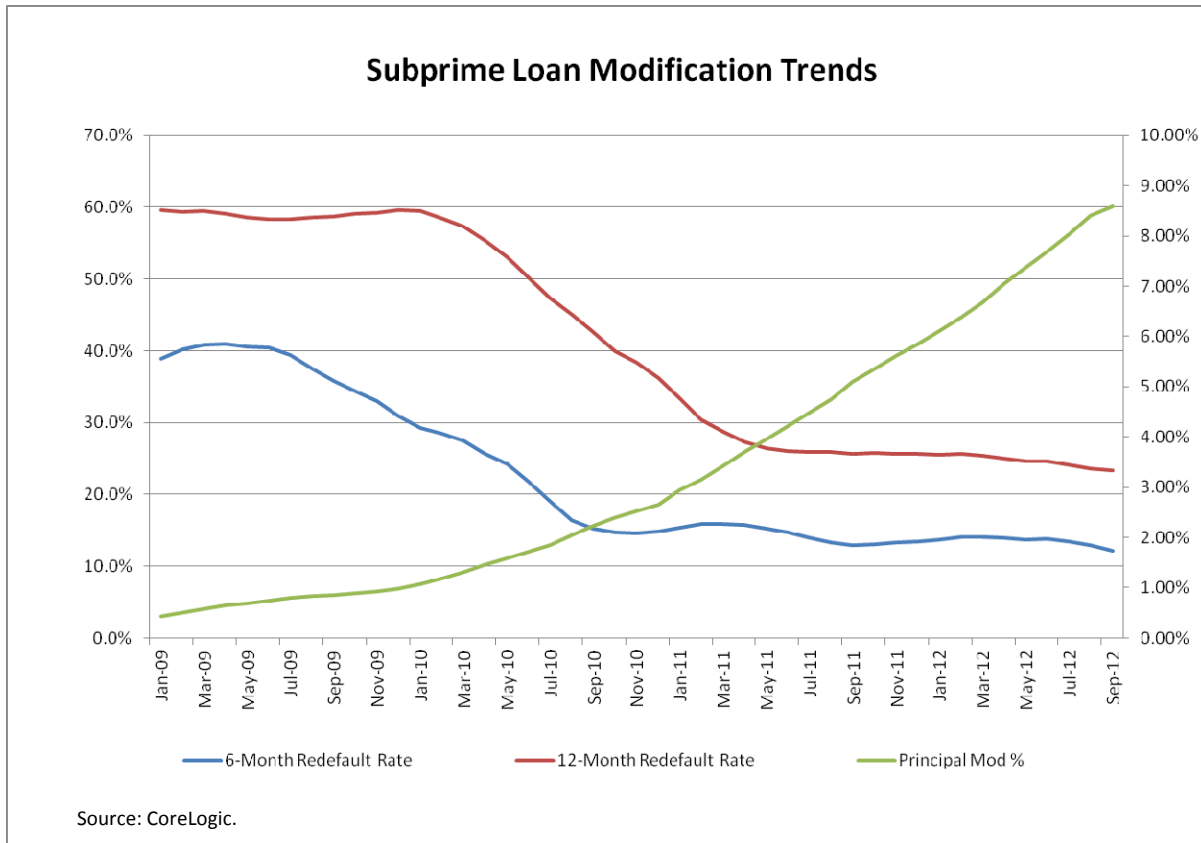
Housing and Subprime & Alt-A (Non-Agency) RMBS

It is no secret that U.S. housing has shown signs of strength throughout 2012, with some portions of the market bouncing significantly off of the bottom as distressed inventories have begun to clear. Improvement is even more pronounced for lower-priced properties where homes below 75% of the median price have increased almost 6% year-over-year. A combination of higher rent prices, better credit availability, improving inventory levels and low mortgage rates have all helped to stabilize the market. The most recent indefinite QE program unleashed by the Federal Reserve on September 13th has already had a profound impact on Agency MBS spreads (see chart below). This is making the affordability of home ownership versus renting even more attractive and will bring additional first-time buyers into the market. While twenty- and thirty-somethings across the country have surely enjoyed living with their parents for the last two or three years, the opportunity to buy a home at 2004 prices with a 3.0% mortgage rate should sound like a much more compelling opportunity to the vast majority. It is worth noting that although the average subprime mortgage rate is just under 6%, the level of refinancing activity has been negligible in this sector and is expected to remain low going forward. The possibility of refinancing activity increasing at some point in the future provides an effective free call option to the Non-Agency RMBS investor.

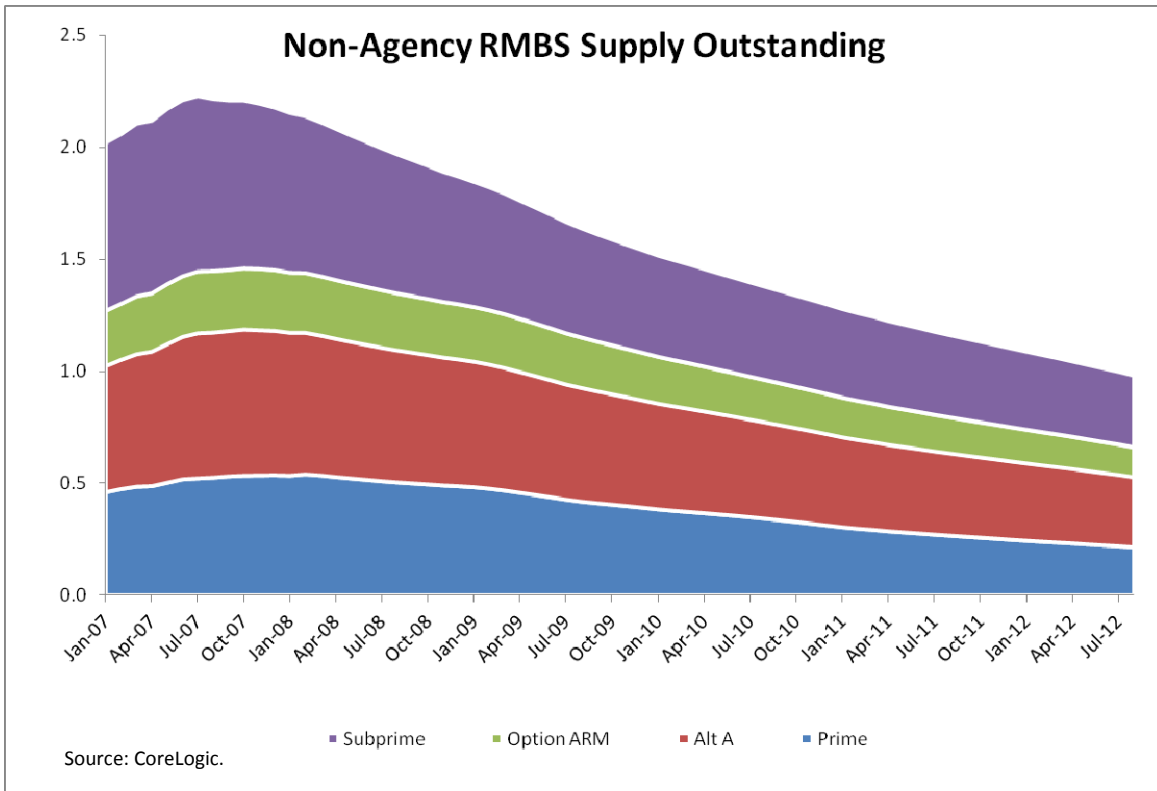
Spread Between FNMA 30-yr Current Coupon and 10-yr Treasury Rates



Non-Agency collateral trends continue to improve as the poorest quality loans default and drop out of the securitization pools. For example, the annualized rate of Alt-A borrowers that are falling more than two payments behind on their mortgage for the first time has decreased from 12.5% in 2010 and 9.6% in August 2011 to 7.8% in August 2012. Additionally, re-default rates after a borrower receives a modification continue to fall markedly which is a direct result of better loan modification programs (including principal forgiveness), as evidenced by the chart below.



Non-Agency RMBS is certainly a direct beneficiary of stabilizing home prices, lower modification re-default rates and other fundamental trends, but there are some technical tailwinds as well. The total existing supply of Non-Agency RMBS ticked below \$1 trillion this year, and we believe it will decline by another 20% by the end of 2013 leaving approximately \$800 billion outstanding. Given the fact that there is very little non-agency issuance today (it is essentially nonexistent) and future issuance is likely to be immaterial, the supply/demand imbalance will be righted at some point in the future. Additionally, the broader implication of QEP (QE into perpetuity) is that Agency MBS investors will seek yield in other asset classes including Non-Agency RMBS. This implies a future increase in demand at the same time supply is shrinking, and we expect that spreads will continue to narrow (i.e. bond prices will continue to rise) as they offer superior risk-adjusted returns compared to other asset classes. Overall, just as there was a perfect storm of lax underwriting, disintermediation of risk and lack of regulatory oversight that led to non-agency securities being overvalued before the financial crisis, the stars are aligned for a continued recovery of this asset class today.



As we have communicated to you previously, Non-Agency RMBS comprises a substantial portion of our portfolio. We believe that in a world fraught with uncertainty and instability, and with markets that are subject to the whims of the daily headline roulette dictated by policy makers the world over, the Non-Agency RMBS market is *the* place for positive-carry asset allocation. We monitor this market closely, and should the dynamics change we will adjust our allocations accordingly, but for now we believe simply that Non-Agency RMBS offer the best risk-adjusted returns the market has to offer.