BLUE WATER'S Market Perspective

May/June 2012 Blue Water Capital Advisors, LLC



Kevin M. Wilson
ChFC, Ph.D.
President/CEO

Ted A. Pavlovich
WMS
Vice President/ Wealth Management

Dheenu V. Sivalingam
MBA
Assistant Vice President

We welcome back all of our long-term readers, and extend a warm welcome to those who are new readers. We will present our usual review of the economy (authored by Wilson), market trends (authored by Sivalingam and Wilson), and a segment on wealth management (authored by Pavlovich), followed once again by a brief discussion of a special topic (authored by Wilson). **This time the special topic for discussion will be "Resolving the Global Debt Crisis to Generate Growth."** We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions. For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bi-monthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions.

BLUE WATER CAPITAL ADVISORS, LLC

Medical Arts Building
325 W. Superior St., Suite 1405
Duluth, MN 55802
Dir: (218) 464.4399
Fax: (218) 730.0280
Toll: (877) 327.5062
E-mail: kwilson@bluewater-cap.com
Website: www.bluewatercapitaladvisors.com
Blog at http://bluewatercapital.wordpress.com

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Economic Commentary:
Rogue Waves and White Squalls Ahead

By Kevin M. Wilson

Overview: Operation Twist Extended, Fiscal Cliff Looms

The Federal Reserve voted on June 20th to extend "Operation Twist," a monetary easing program in which the Fed buys long-dated bonds to replace its holdings of short-dated bonds. This is intended to keep mortgage rates low in order to help the housing sector recover from its deep recession. The Fed committed to exchanging another $267 billion worth of shorter term bonds for the same amount of longer term bonds by the end of the year. The markets were hoping for more, as they always do, and as a result were disappointed. It now appears the Fed will be waiting for much more evidence of an economic slowdown or recession before it acts. That means there will probably be no "QE3" before August. Some economists have pointed out that certain leading economic indicators show that the U.S. is already in a recession.[1] We actually predicted a recession beginning by mid-2012 about 10 months ago in our newsletter, so we are not very surprised by this potential development. And while the stock market consensus is clearly not in agreement with this idea, the bond market is another matter. It is pricing in a serious recession, or worse, according to many financial market observers.[2] The bond market, we should note, has called the major turning points in the economy and markets over the last 12 years fairly accurately, in sharp contrast to the stock markets.

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Rogue Waves and White Squalls (Continued)

Unfortunately, the end of the Fed's renewed bond-buying program will exactly coincide with the so-called "fiscal cliff" coming at the end of the year, when federal budget cuts, the renewal of the debt ceiling debate, and greatly increased income tax rates will automatically kick in, potentially knocking down GDP by as much as 4% or even 5%.[3] If we actually go over the cliff, i.e., fail to change the tax increases, some observers suggest that stocks will get absolutely crushed, based on the expected huge hit to the value of dividend payouts, and thus to the value of stocks themselves.[4] Note however that the expected federal spending cuts will actually have no lasting effect on GDP growth trends, according to rigorous empirical studies on the economic effects of stimulus spending.[5] In other words, since Keynesian stimulus spending failed, its termination can hardly be very damaging in the long run.

Euro-zone Crisis Continues: Watch Out for Squalls

The Greek and French elections are over, and the results are a mixed bag. The French voted for more socialism by electing Francois Hollande as President. Mr. Hollande promptly lowered the retirement age in France by two years, almost simultaneously with increases in the retirement age in Germany and elsewhere. The Greeks avoided instant catastrophe (but not eventual catastrophe[6]) by electing a coalition government that favors the EU bailout, but wants better terms. Meanwhile the Spanish banking sector has gotten in big enough trouble to require a $125 billion bailout, and their balance sheet holdings of Spanish government debt seem to guarantee another sovereign debt bailout of enormous scale at some point in the near future.[7] These events have shifted the focus a bit, from just trying to bail out Greece, to worrying about financial contagion in Europe. The ECB and IMF have done well to avoid a meltdown of the financial system, but they have used only temporary, stopgap measures in order to buy time. The many ECB loan programs and liquidity boosts may have built a debt bridge, but it is now effectively a bridge to nowhere, as one observer recently put it.[8] Easy money has allowed European policy makers to "kick the can down the road," and the ECB now seems to understand this. Investors may have to weather a storm before any further relief is forthcoming. The fear is that the first notice of the storm's fury will arrive as a white squall or a rogue wave – without much warning. Certainly many market observers are concerned about a potential meltdown, and have started to plan for "tail risk," i.e., a big and unpredictable event that could cause a market crash.[9] There are a few parallels to 1931 in Europe,[10] and it will take rapid action to prevent markets from taking the sum of their fears.

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Hence, all of Europe is now looking to Germany for a solution, both because they are the only major creditor left, and because they have the most economic power in the Euro-zone. The Germans face a real dilemma, because they must either spend trillions saving the Euro, or lose trillions when the Euro collapses.[11] In order to save the Euro, it may be necessary for the EU to form a banking union to prevent bank runs, create a "bad bank" fund to retire debt, and create "Eurobonds" to mutualize the heavy debt load in the periphery.[12] However, there is little agreement at present amongst the key players on how to do all of this in a timely fashion. The biggest fear right now, in both the halls of power and in global markets, is that financial contagion will strike unexpectedly. As was seen in the 1998 Asian currency crisis, contagion effects can impact seemingly unrelated economies due to pre-existing, seemingly minor links.[13] This may explain why the prospective demise of Greece, a very small economy, has caused such widespread consternation. The apparently never-ending EU crisis, which has already run for 30 months, will continue until markets feel better about the solutions being offered up by the EU.

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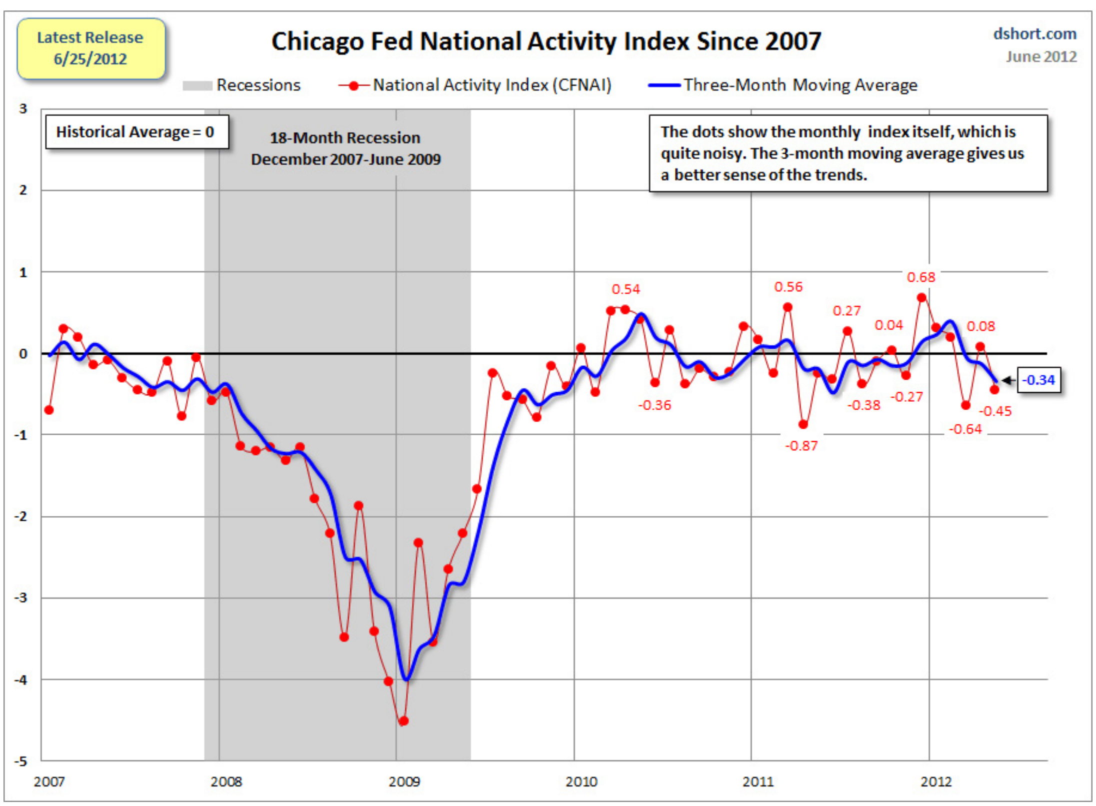

Rogue Waves and White Squalls (Continued)

U.S. Economic Growth Continues to Decline

The Citigroup Economic Surprise Index (CESI), a measure of whether government economic data are better or worse than expected by the markets, has been trending downwards for many weeks now.[14] In the past, markets have followed the trend of this index with a minor time lag of a few weeks. The CESI has fallen because most recent economic data have been both negative and lower than the consensus expected. There are early signs that the troubles in Europe are starting to have an impact here in the U.S. For example, the year-over-year trend in capital goods orders by corporations, excluding defense and aircraft orders, has been falling for two years, but is now approaching a negative reading.[15] Consumer confidence survey readings were rising through the last few months, but turned downwards again in June, and in any case have remained at deep recessionary levels. Retail sales, excluding motor vehicles, (YOY) have fallen for many months now, accelerating in the 2nd Quarter.[16] Producer prices on finished goods have also been falling for about 18 months and are near zero now on a YOY basis, suggesting that disinflationary or even deflationary pressures are impacting the economy, much as they did in 2009. The Chicago Fed's 3-month moving average for its National Activity Index (CNAI), a sort of monthly version of GDP, has declined now three times in a row, to the lowest reading in a year (-0.34). A moving average reading for CNAI of less than -0.70 has generally been associated with recessions. Real disposable personal incomes have fallen (YOY) to near zero, continuing a downward trend dating back to 1998.

All of these data indicate a slowdown is in progress, and as mentioned above, there are also hints of an imminent recession. Out of a list of 12 historically accurate recession indicators that we monitor, 5 high-probability measures are already flashing red, and several more are flashing amber. The near-synchronous recession in most of Europe, together with a major slowdown in China, indicates that a global recession is entirely possible. The effect of such a slowdown on global markets can be expected to be profound, and we are planning accordingly.

Market Summary: Divergences Indicate the Need for Caution

By Dheenu V. Sivalingam and Kevin M. Wilson

We have seen a sharp reduction in correlations between equity markets and a number of commodities over the last few weeks of the quarter, but this may be a reflection on the somewhat directionless state of the equity markets. On the other hand, actual commodity returns over the last few months have sharply diverged from those of equities. For example, the Thomson-Reuters/Jefferies CRB Index has lost over 15% since its February high, while the S&P 500 has lost only about 6% since its later high in April. Given the normally high correlation between these indexes, this divergence is somewhat unsettling, and if these correlations return to normal, it is likely that stocks will fall in the process. The correlation between stocks and bonds has also diverged sharply, suggesting that the commodity market sees a much different picture in the near term than the stock market does.[17]

From a risk management standpoint, our tactical book right now reflects our assessment that there is substantial downside risk over the intermediate term (a few weeks or months). We are using technical indicators that are set at that time scale, and the trend has been down since early April; thus they still indicate a fairly one sided bet against stocks. However, it is not difficult to imagine a sharp counter-trend rally in equities that also leads to short-term paper losses on the shorts we hold as hedges against a sell-off. The same is true of the longer term bond positions we currently hold. There are several options for managing this hedging risk, but our combined methods seem to indicate that one could accept being positioned at a

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near market-neutral overall portfolio stance right now, with a tilt to the defensive side.

It will be important in the near-term to see how these tendencies play out, i.e., whether one side (bulls vs. bears) has the conviction to push markets into a strongly up or down directional move, or whether we spend another few weeks mired in consolidation. Major indexes appear to have rolled over near the end of June, and if this continues due to market structure, it should at least lead to a retest of the recent lows. Failure on this leg down would confirm the short-term shift into a fully neutral bias, and we could turn our attention to positioning long on equities, in accordance with more bullish technical patterns. Longer-term equity investors may well be picking up individual names that look cheap, or they could be selling their losers heading into this expected decline. Certainly we should remember that there is a possibility that the selloff could extend much further than expected by the consensus.

Longer term investors who are looking to control their risk exposure while making money should consider two aspects of the problem: first, it is important to consider more defensive posturing, should the current decline be extended, especially if a major bear market seems likely. Second, it will eventually be important, regardless of whether a bear market occurs, to seek the best equity opportunities by sector, industry and individual stock holding during the next major rally. This, of course, is potentially a hard call. This is the essence of the tactical allocation question—should we be reducing or increasing exposure into the current selloff? There is no perfect answer, but, at this point, we do not favor increasing stock allocations until sentiment indicators improve and valuations reach better levels for the overall market. We continue to think the best broad sector opportunities for earnings growth leadership in the next rally are probably to be found in Industrials, Consumer Services, and Technology, but we are becoming more interested in potential opportunities in Financials as well. Consumer Services and Staples are interesting because they should be resilient in a decline, but also may be positioning to drive a rally as well. It is not often that these defensive sectors can potentially offer this two-sided advantage.

One of most telling statements about the Euro crisis in recent weeks was Italian Prime Minister Monti's assertion that the EU summit at the end of June must result in an action that could stop the bond market meltdown and banking sector carnage in Europe, thereby preventing a fresh cycle of crises. In the absence of a plan of action now, his prediction is that market forces will rapidly overwhelm stop-gap measures and set up a chain of "speculative attacks on individual countries, with harassment of the weaker countries." While we do not agree that free market trading strategies should be characterized as "attacks", we do largely agree with his analysis. A true solution will require structural changes among the individual sovereign states as well as the union itself, with a growth strategy to help close the gap between weaker and stronger economies and a true fiscal union (both sovereign debt and banking). Without real structural overhauls, executing a stop-gap solution to buy more time, such as an emergency ECB bond purchase facility, will again prove to be insufficient. Based on the poor management by elected leaders and policy makers of the crises that have beset the EU in recent years, we have little confidence that the political will exists to take these bold but necessary steps in a timely fashion. But there is sure to be a dramatic announcement of yet another "comprehensive" solution, followed by disappointment days or weeks later. The markets seem always to go for the easy answer in the short term, only to fall into despair when actual analysis of the "breakthrough" occurs in the aftermath of the press releases. There is no doubting the willingness of many Europeans to somehow weather the crisis – the question is when they will quit trying stopgap measures.

Wealth Management Commentary:
Panic and Profit

By Ted A. Pavlovich

I learned at the beginning of my investment career that panic and profit are only close to each other in the dictionary, not in the stock market. Note however that profit comes after panic in both cases. Over the years we have all witnessed political chaos, economic crises, and on more than one occasion large-scale wars. After the September 11th attack on the U.S., I took the position that the world was not ending, and so I counseled my clients to seek some perspective and avoid panic. The stock markets were closed for three weeks, but when they re-opened, life (however changed) resumed. During the early stages of the national crisis, the only business done was addressing client concerns about their well being, the likely recovery of their investments, and the probable course of action our country was going to take. I have often cautioned clients to remember that despite what the media may tell you, it's never wise to bet on the end of the world (it only happens once in an eternity). Just a few short years earlier I had cautioned clients about the Dot.com stock bubble. I told people back then that, "Only in fairy tales like Jack and the Beanstalk does something grow straight to heaven." Working in this industry can be many things – intense, high pressure, physically and mentally punishing, and on more than a few occasions, emotionally chaotic. But in my 28 years in this field I have also found it exhilarating and challenging. I have been fortunate to make life-long friends

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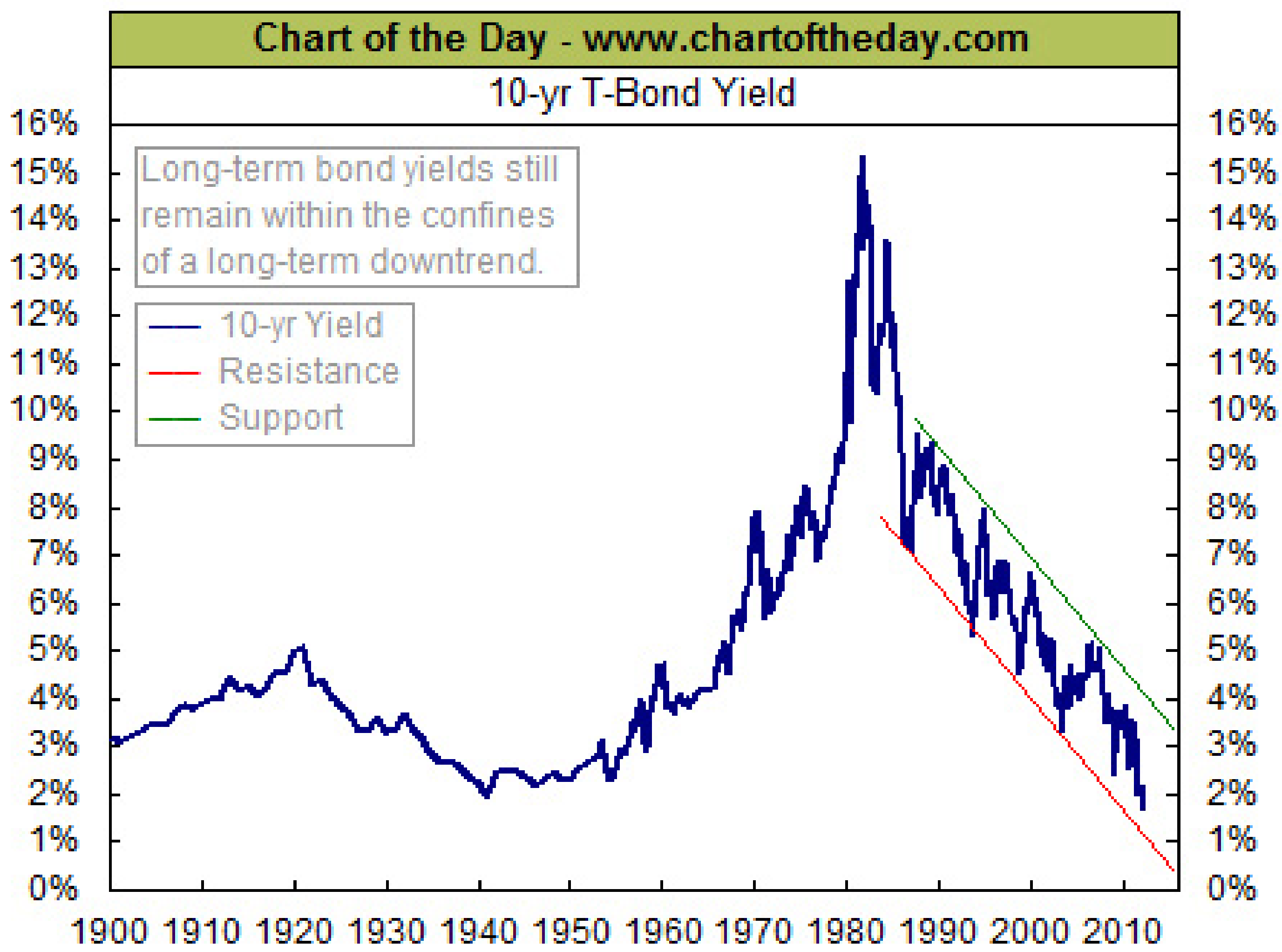
Panic and Profit (Continued)

with clients and people in the industry. Many of our clients and industry friends are financially conservative. As a result, we tend to subscribe to the Will Rogers investment model ("Being more concerned about the return OF your money versus the promised return ON your money!"). To do this as an advisor, you must sometimes use every tool at your disposal. Sometimes, experience can be a better guide than theory, and learning from your own or other people's failures can be a better teacher than success.

For example, I can remember in 1983 when long term bond rates were 12% and I had to literally beg clients and prospects to consider investing in them. It turned out to be the trade of the century, better even than buying and holding stocks for the next 17 years! Many clients wouldn't even look at them, let alone invest in them. Most clients back then were disgusted with stocks after their market experiences in the 1970s, and had jumped to bonds just in time to get clocked by rising yields. So although the long term rate was the best way to go, the allure of 18% to 21% short-term bond and money market yields trumped any kind of analysis. Fear and greed can and do commonly drive decision making in the stock and bond markets.

I am confident that we as a country will work our way through this current crisis. Any kind of crisis created by man can be resolved by man. The global bankers of the IMF and ECB now appear to have the same opportunity to prevent a possible worldwide depression as the U.S. Federal Reserve did in 2008. If they get it right we could see a strong market recovery, solid job growth, and substantial debt retirement. In the meantime we are waiting for their firm action in a serious situation. Politicians will need to address the global economic crisis with practical, realistic solutions. Investors should remain skeptical of easy answers and stay defensive for the time being. Once again, as in 2008, investors must protect their profits, preserve their principal, and avoid thinking with the crowd. In these ways the damage from market panics will be kept to a minimum. In fact, those who are savvy may even make money.



Special Topic:

Resolving the Global Debt Crisis to Generate Growth

By Kevin M. Wilson

The Keynesian Approach Has Failed

The global debt crisis continues to challenge policy makers in many countries, but especially those in Spain, Italy, Greece, Ireland, Portugal, Japan, the UK, and of course the U.S. In Japan, the total level of debt as a percentage of GDP reached 491% in 2011.[18] During the period from 1989 to 2011, Japanese government debt rose four-fold while private sector debt dropped by 55%, as the dominance of government debt growth increasingly financed unproductive activities. This is a huge refutation of Keynesian theory, with equally huge implications for the resolution of the current debt crisis; yet the financial news media seem barely aware of the story or its implications. However, it is my impression that the general public are fully aware that policy has failed (for whatever reason), and that world "leaders" don't know what to do, with one or two exceptions. The situation is worsening as politicians dither and theory continues to triumph over evidence almost everywhere.[19] For example, in Europe, the average total national debt/GDP ratio is now 450%, but for the Netherlands it is 700%, for Denmark it is 600%, and for Belgium and France it is just under 500% for each.[20] Incidentally, if you count unfunded mandates like Social Security and Medicare, the total debt/GDP ratio for the U.S. is now 394% and rising rapidly.[21]

Austerity and Devaluation Have Worked

Hoisington and Hunt,[22] and others[23], have shown that the historically tested solutions to debt crises are austerity and increased private sector savings, currency devaluations, and structural reforms. For example, the real reason the high debt levels of the Great Depression were substantially cut, allowing growth to resume in the 1940s, was not FDR's war spending, as is popularly believed.[24] On the contrary

The debt crisis has lasted longer and done more damage than was perhaps necessary, in part because the essentials learned in other crises have mostly been ignored.

– there was a huge surge in private sector savings to 25% of GDP in 1942-45 as a result of the war's rationing programs. The increased income from exports during and after the war also added to the surge in savings. Since the savings and income surges allowed debt service to be reduced sharply, the economy was able to recover rapidly. Now compare this to what happened in Japan over the last 22 years. The Japanese savings rate plummeted from a famous high of 25% in 1989 to a current low of 1%, leaving nothing to pay off the massive debts accrued during the real estate bubble of the 1980s. Japanese GDP completely stagnated at the same time, freezing real wages for most workers. Meanwhile government spending surged as Keynesian stimulus was applied a total of 20 times. Since the stimulus didn't work, Japan has never fully recovered, and her government debt/GDP ratio has soared to an estimated 225%. We are now on that same trajectory, for the same reasons, as demonstrated by the alarming similarity between our 10-year Treasury yield trend over the last 12 years, and the first 12 years of Japan's 22 years of declining yields.[25]

A study by the McKinsey Global Institute[26] has shown that 75% of the 32 global debt crises that have occurred since the 1930s have been resolved by austerity. The remaining 25% of the crises were resolved by hyper-inflation and/or currency devaluation episodes, but all of these cases were emerging market economies with weak central banks. Currency devaluation may actually work for the Euro-zone, since it has a weak central bank that has already printed vast sums of money (>$3 trillion) under its bond purchase, LTRO, and ELA regimes.[27] In effect the ECB has recognized that Germany, with its debt/GDP ratio already above 80% (having committed to $837 billion of bailout spending), cannot be expected to continue bailing out all of southern Europe. The solution for Europe may very well be a typical emerging market solution, and either devaluation or austerity programs are major components of such an approach. Thus Mrs. Merkel (Chancellor of Germany) may have it mostly right, with perhaps too much emphasis on austerity and not enough on reform or currency devaluation.[28] On the other hand, the periphery's big spenders may have it mostly wrong, with not really enough emphasis on austerity or structural reform, and no access to currency devaluation as a tool.

A rather spectacular example of a country surviving a huge debt crisis is the British Empire after the end of the Napoleonic War in 1815. Debt had climbed over a period of 100 years as one war after another was fought, reaching its zenith of 237% of GDP in the year after Waterloo, and yet the British Empire survived.[29] A combination of currency devaluation during and after the Napoleonic War, a linking of the currency to a gold standard after 1821, and higher taxes through many decades allowed the debt to be paid off over the next 100 years.[30] Some observers have noted that there are also plenty of modern examples of austerity working as a solution to debt crises.[31] One very good example may be the U.S. depression of 1920-21, during which nominal GDP fell by 23.9%, CPI fell by 8.3%, and wholesale prices dropped by 40.8%. Unemployment soared from 2% to 14%. The administration of Warren G. Harding met this challenge by balancing the budget, and the Federal Reserve actually raised rates rather than lowering them. The result was a

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Resolving the Global Debt Crisis (Continued)

surge in industrial production during 1922 of 27.3%, and by 1923 unemployment was back down to 3.2%. This can hardly be described as a Keynesian response, and yet it worked.

Two recent examples where austerity worked rather well involved Germany and Sweden.[32] They each moved to near-balanced budgets in 2009-11 after the Credit Bubble and Great Recession, enjoying sustained strong growth. Apparently austerity didn't hurt them much, since they experienced annualized real GDP growth rates of 3.6% and 4.9%, respectively over the last couple of years. These countries still look like the best of the bunch even as Europe rolls over into another recession. In contrast, countries with high deficit spending, like Greece, Portugal, Spain, Italy, Ireland, and the Netherlands (with average deficits of 7.9% of GDP) are already experiencing the advanced stages of what may be deep recessions. Indeed, John Hussman has shown that as the debt/GDP ratio rises in Europe, GDP growth tends to fall proportionately. Naturally the reverse is also true: declining debt/GDP ratios should empirically lead to higher GDP growth over time.[33]

Two other examples, Finland and Sweden in the early 1990s, involved strong recoveries from financial crises and recessions following major currency devaluations and austerity.[34] In each country, an initial deleveraging phase was followed by substantial bank reforms and structural government spending reforms. Both countries ended up cutting their annual deficits, and then their government debt significantly within a single decade. For still another example, we can examine what happened in the U.S. during the inter-recession growth recovery between 1933 and 1937 (during the Great Depression but before the big savings surge of the 1940s). This period saw a huge surge in GDP to an average of 7% growth annually, which was caused in part by a 60% devaluation of the currency when we went off the gold standard.[35] The growth interlude within the Great Depression ended in 1937 when other countries also went off the gold standard (causing more competition), the Fed tightened monetary policy too soon, and FDR raised taxes to an 83% top marginal rate. Only after another deep recession with high (20%) unemployment had ensued, and World War II had begun, did the surge in austerity-driven savings and export income of the war years save us from the Great Depression.

We can choose a better path than the one we have collectively been following, and bring economic growth back to life in the U.S., Europe and elsewhere.

The dilemma faced by the Euro-zone right now is just a preview, or perhaps a "canary in a coal mine," for what we in the U.S. will soon face as a result of slow growth and high debt. The pattern of government expenditures over the last 20 years provides a shining example, if one is needed, of what happens when supply-side economics is used to guide the federal budget, instead of Keynesian theory.[36] Under President Bill Clinton, government spending declined from 23.5% of GDP to 19.5% of GDP, and the deficit declined each year until there was an actual surplus when he left office. Tax rates were moderate to low. The economy did rather well during this period, as you may recall. In contrast, under President George W. Bush, tax rates were even lower, but unfortunately government spending increased to about 22.6% of GDP as the financial crisis unfolded late in his term, and every possible Keynesian gimmick was tried to stimulate the economy. Finally, under President Barack Obama the deficit spending became astronomical in scope, with total outlays climbing to a high of 27.3% of GDP in 2009. Spending slowed after the 2010 by-election, but deficits are still in excess of $1 trillion per year. In any case, we know that all of this excessive spending in recent years has been accompanied by a very weak economic recovery, which is not at all what the Keynesians predicted. Thus, the changing patterns of spending over the last 20 years, and the resulting long-term economic weakness in which we find ourselves do not support the Keynesian dogma, at least when a credit bubble and the resulting balance sheet recession are involved.

The Solutions Are Obvious, But Remain Unpopular

A huge debate thus continues in the financial media and amongst policy makers as to how we should deal with the global debt crisis. Although there are many complex issues involved, a discussion of which is outside the scope of the present commentary, we do know some simple things that have worked and would work again. The debt crisis has lasted longer and done more damage than was perhaps necessary, in part because the essentials learned in other crises have mostly been ignored. Austerity leading to high savings rates, combined with banking reform, structural entitlement reforms, moderate tax increases and in extremis, currency devaluation have been very effective in a variety of countries over many decades. We can choose a better path than the one we have collectively been following, and bring economic growth back to life in the U.S., Europe and elsewhere. What is needed is for us to act in each case on a practical basis using proven methods grounded in economic history, rather than blindly misapplying Keynesian economic theory to every situation, regardless of merit. Voters in many countries may not yet fully understand this, but their leaders will do them a great service if they set out to resolve the debt crisis using this pragmatic approach to ending the pain. The refueling and restarting of the economic growth engine could improve the standard of living in many countries relative to what it might otherwise be. ■

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We encourage you to share our newsletter with business associates, friends and family. Let them know what we have done for you to preserve and grow your wealth. We would be glad to help your contacts benefit as well. We are not a "stay the course" or a "do nothing" type of firm. We are actively researching, analyzing, and managing risk every day. We do not take our fiduciary responsibilities lightly. We work hard on your behalf to anticipate economic trends and take action accordingly based on our assessment of risk and potential returns. We have made significant investments in our business to make sure we have the best information and people that are capable and intellectually equipped to make important and timely decisions managing your wealth. Also, please visit our website at www.bluewatercapitaladvisors.com, and our blog at http://bluewatercapital.wordpress.com.

Please attend our next "Monthly Market Review" if you can; we'd love to see you, your relatives, and your friends there. Scheduled meetings will be held at 5:00 pm - 6:30 pm on September 20, 2012 at our offices in the Medical Arts Building. ("Top of the MAB"); and on October 18 at a Location TBD. We don't run the meetings in July or August due to vacations. If you can attend in September or some later time, please RSVP to Blue Water. Business casual attire suggested.

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BLUE WATER CAPITAL ADVISORS, LLC

Medical Arts Building
324 W. Superior St., Suite 1405
Duluth MN 55802