The HCM Market Letter *Since 2000*

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Deficits Monetary and Moral

> "[T]he entire Western world has suffered from a deficit of moral authority for decades now. Today we in the West are reluctant to use our full military might in war lest we seem imperialistic; we hesitate to enforce our borders lest we seem racist; we are reluctant to ask for assimilation from new immigrants lest we seem xenophobic; and we are pained to give Western Civilization primacy in our educational curricula lest we seem supremacist. Today the West lives on the defensive, the very legitimacy of our modern societies requiring constant dissociation from the sins of the Western past – racism, economic exploitation, imperialism and so on."
>
> Shelby Steele[1]

Second Half Outlook

As we enter the second half of 2010, it is increasingly clear that the S&P 500 is unlikely to return to the 1200 level *HCM* anticipated earlier in the year. ***HCM* now expects the index to remain in a lower trading range for the remainder of the year bounded by 975 on the downside and 1150 on the upside** (admittedly a wide range, but this is a volatile market driven by computers). Based on the sharp drop in Treasury yields, we expect the market to occupy the lower rather than the higher end of this range. The markets are wrestling with the reality of slow growth in the U.S. and Europe, a relapsing housing market, public and private deleveraging, higher taxes in 2011, more regulation and an increasing acknowledgement that our political and business leaders are hollow men.

HCM's new target range is decidedly lower than the 1250-1275 range set earlier in the year, when we expected market momentum to carry the S&P higher than the economic recovery justified. Obviously the earlier view was wrong. But the Greek crisis coupled with the BP oil spill have focused the market on the fact that the economic recovery was largely a product of government stimulus and not organically based. *HCM* remains unpersuaded that the economic data is pointing to a sustainable or organic economic recovery, and is therefore lowering its stock market target even though the stock market is inexpensive by historical measures. A survey of 2000 economists by *Bloomberg* forecasts S&P 500 earnings to come in at $81.27 in 2010, so a 1200 level on the S&P 500 would be a very reasonable (indeed historically low) 12x if earnings materialize as expected.[2] Nonetheless, we still don't think we will get there by year end.

The market is telling investors that both the economy and corporate earnings are going to slow down in the second half of 2010. *HCM* is inclined to believe that corporate earnings will come in on target because corporations have taken significant steps to lower their cost structures and their interest costs are quite low. At the same time, we believe economic growth will be extremely sluggish and that the possibility of a return to negative growth must be taken seriously,

[1] Shelby Steele, "Israel and the Surrender of the West," *The Wall Street Journal*, June 21, 2010, p. A23.

[2] On the upper end of the range, MKM Partners LLC's chief economist Michael Darda, an extremely smart guy, is looking for $92/share in S&P 500 earnings in 2010, and the legendary Barton Biggs of Traxis Partners is looking for $85-90/share if second half GDP growth comes in at 3 percent and no less than $80/share in any case. As noted above, we do not expect corporate earnings to be the problem.

although if the economy does experience a double dip it would not be until the first or second quarter of 2011. Fears of a double dip are one obvious factor influencing the market to place a lower multiple on earnings than in the past.

But there is another non-fundamental factor that is depressing stock prices: the hegemony of quantitative/computer trading. When investors watch stock prices move dramatically without any identifiable reason related to the fundamental business operations or results of a company, it destroys confidence in basic market processes. We are still waiting for a satisfactory rationale or explanation of the May 6th 1000-point plunge in the Dow Jones Industrial Average. Unfortunately, we will probably be waiting another 1000 years because we are looking in the wrong place if we are expecting a fundamental or rational explanation. The reason the market plunged was entirely based on the operations of the computer programs that dominate today's markets. The answer lies buried within the algorithms of the trading firms that have been permitted by our toothless regulators to dominate modern markets. This has destroyed confidence in basic market mechanisms even among the most sophisticated and experienced traders, not to mention John Q. Public. This type of price action is also inimical to capital formation, which dries up in volatile markets like today's.[3]

As *HCM* has written many times (although we were unable to include a chapter on quantitative trading in The Death of Capital because of our publishing deadline), computer-driven trading strategies are the epitome of speculation and add nothing to the productive capacity of the economy. Instead, they are inexorably destroying confidence in the capital markets and diverting intellectual and financial capital into activities that enrich a small elite at the expense of the rest of society. Moreover, as described further below, many of these activities are little more than legalized theft. Our regulators, politicians and business leaders (in particular those who engage in this noxious activity) are harming the rest of society by allowing these activities to continue. They must be regulated out of business as soon as possible.

A Culture of Deficits

The word "deficit" has come to epitomize not only our economic dilemmas but also our moral and intellectual failures to address them in an era that should be boasting of new breakthroughs in the social and physical sciences. Instead, our ability to solve complex problems is weighed down by flawed and corrupted government processes and the lack of courage to forthrightly change them.

Frustrations are rising among those of us who write about the markets and watch the continued abasement of our markets by politicians, lobbyists, policymakers and business leaders. On the political front, our friend Christopher Wood writes of Barack Obama, "Anyone who paid the slightest attention to what he was saying in his speeches, or to his legislative record in Congress, would understand that Obama is a socialist. The way bond holders were treated in the GM bankruptcy, the way healthcare reform was pursued and the gratuitously hostile rhetoric aimed at BP all reflect this political disposition. There is a consistency here which seems to have been lost on *The Economist* and other mainstream media who fell sheep-like in love with an

[3] The current dearth of initial public offerings is one example of this. Nonetheless, as *The Wall Street Journal* reported on June 29, 2010, it did not stop eight Ukrainian and Russian shell companies from sneaking their bogus offerings through the Securities and Exchange Commission over the past several months. The Commission's response was that the agency is not really responsible for preventing fraudulent offerings if they meet the technical requirements such as disclosing all of the risks involved. In other words, an offering can disclose the risk that a company has no business, no assets, no revenues and no reasonable prospects for profits, and the SEC feels that it must allow the offering to go forward. When I read this kind of stuff before, I didn't know whether to laugh or cry. Now I just want to scream.

image and not the message."[4] *HCM* would add that Obama's latest abrogation of the rule of law – forcing BP to place $20 billion into an escrow account as a down payment on damage payments related to the oil spill – was given a free pass by the liberal press. The rule of law is meant to protect every one – big and small, rich and poor, the innocent and the guilty – from the arbitrary and unchecked power of government. BP will be made to pay for its reckless business conduct, but the Constitution and the rule of law need not become additional casualties of its wrongdoing. It is both frightening and appalling to *HCM* that Barack Obama chose to surrender to the basest parts of his political nature and act as he did.

A far more trenchant critique of Obama's first year can be found in a recently published book by progressive political commentator Robert Kuttner, A Presidency in Peril. In 2009, the same Mr. Kuttner wrote what can only be described as a hagiographic account of Obama's possibilities as a transformational president: Obama's Challenge: America's Economic Crisis and the Power of a Transformative Presidency (2009). While it likely would have been impossible for Mr. Obama or any president to live up to Mr. Kuttner's hopes, Mr. Kuttner makes a persuasive case in his new book that Mr. Obama did little to break with the policies of the past. Mr. Kuttner harshly criticizes the president's performance during his first year in office and takes particular aim at Larry Summers, who became the Chairman of the National Economic Council when, according to Mr. Kuttner, it was determined that the confirmation process might be difficult if not impossible for Mr. Summers to survive in view of his troubled tenure as President of Harvard University, where he managed to offend virtually every political constituency possible. According to Mr. Kuttner, Mr. Summers is an equal opportunity offender hiding behind the cloak of intellectual superiority.

The gist of Mr. Kuttner's argument is that rather than break with the failed policies of the Bush administration, Mr. Obama enlisted advisors who were responsible for those policies (primarily followers of Robert Rubin such as Mr. Summers, Timothy Geithner, and others) and extended the regime of socializing losses and privatizing gains that has been operative in this country for the last two decades. Mr. Kuttner writes that, "[g]iven the abject failure of the financial deregulation that Rubin championed as Clinton's top economic adviser, followed by the collapse of the business model that he promoted as a senior executive at Citigroup, it is remarkable that a consummate political outsider like Barack Obama did not view Rubin (or his protégé Summers) as fatally damaged goods. On the contrary, Obama felt he needed men like Rubin and Summers for tutelage, access, and validation. That itself speaks volumes about where power reposes in America."[5]

And indeed, as the pending financial reform bill demonstrates, the Obama administration has been unable or unwilling to foment genuine regulatory change on Wall Street or meaningful economic reform or recovery, particularly in the all-important housing market. In every case, it has favored the interests of the rich and powerful over those of the disenfranchised, and the formation of another government agency that will ostensibly protect the interests of consumers will do little to change that if history is any guide (the efforts of the wonderfully outspoken Elizabeth Warren notwithstanding). Investors should be prepared for more of the booms and busts that they have experienced over the past two decades and treat their capital accordingly.

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[4] Christopher Wood, *GREED & fear*, June 18, 2010, p. 10.

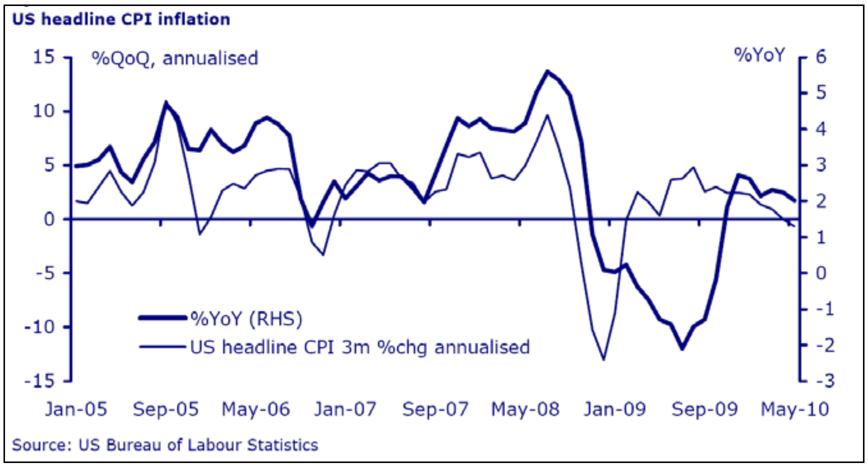
[5] Robert Kuttner, A Presidency In Peril: The Inside Story of Obama's Promise, Wall Street's Power, and the Struggle to Control Our Economic Future (White River Junction, Vt.: Chelsea Green Publishing, 2010), pp. 6-7.

<u>Deflation, not Inflation, is the Current Threat</u>

In addition to a weak stock market, another key feature of the recent trading environment has been sharply declining Treasury bond yields. During the last week of June, the 10-year Treasury bond yield pierced the key 3 percent level for the first time since the financial crisis.

Graph 1

<u>Inflation RIP?</u>



This is a result of a combination of a flight to safety and growing deflationary fears. As illustrated in Graph 1, inflation is dormant if not dead for the moment and the near-term environment is decidedly deflationary. As Christopher Wood notes in the July 1, 2010 issue of his indispensable *GREED & fear*, the rally in the Treasury market is sending a strong deflationary signal to the equity market. Based on current trends, **HCM expects the 10-year Treasury yield to end the year much closer to 2.50 percent than 3.0 percent.** Think how remarkable these low Treasury yields are in view of the monumental volume of government debt that the United States must issue to fund its annual trillion-and-a-half dollar deficits. As noted above, however, the 10-year Treasury yield is no longer simply a risk-avoidance trade (a matter of dancing with the least ugliest girl or boy); it is also an important deflationary signal based on the fact that governments in Europe and the United States (particularly states and municipalities) are cutting spending by dramatic amounts in the coming months and years, which will suck enormous amounts of money out of the global economy and undoubtedly have a significantly deflationary impact on prices.

The growing frustration with fiscal policy makers is evident in the words of Societe Generale's Albert Edwards, who writes: "The clowns pulling the levers of fiscal and monetary policy will take us back into recession. But this time outright deflation beckons and we will all be turning Japanese. Yet the fiscal hawks are right to say that the fiscal situation is unsustainable. Our view is that governments are indeed insolvent. But the doves are *also* right that current tightening will take us back into recession and drive the deficits even higher. There is no 'good' way to end this. Ultimately central banks will be forced to print for fear of the alternative. And maybe 20%+ inflation will indeed prove to be the 'best' (or least bad) way out of this mess."[6] Mr. Edwards is correct that inflation may ultimately be the solution to this mess, but that day

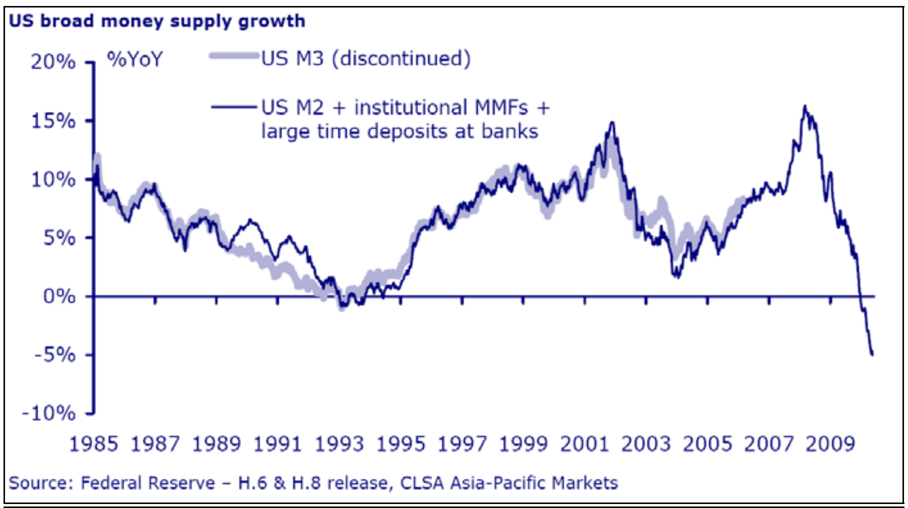
[6] Albert Edwards, Societe Generale, *Global Strategy Weekly*, "We are now walking on the deflationary quicksand," June 24, 2010.

currently appears to be far away. Right now investors need to be prepared for a prolonged period (3 years at least) of deflation.

Further support for this deflation thesis is provided by the sharp drop in the money supply, as shown in Graph 2 (again, like Graph 1, borrowed from Christopher Wood's GREED & fear, June 10, 2010).

Graph 2

Shrinking Money Supply Is Only Part of the Picture



Suffice it to say that just as inflation is driven by increasing money supply, deflation is driven by the withdrawal of liquidity from the system. In addition to the shrinkage in M2 (the Federal Reserve no longer publishes M3 for reasons best known to itself), other liquidity engines such as securitization have also departed the scene. Accordingly, Graph 2 only shows a partial view of the withdrawal of liquidity from the financial system. The overall picture is actually worse than this, although such a phenomenon is ultimately what will be needed to purge the excesses of the past and return the global economy to greater stability. Unfortunately, the interregnum period will involve a great deal of pain, as the markets appear to be acknowledging.

Financial Reform?

Liberal pundits and administration supporters are talking about how President Obama is about to declare victory on financial reform. Nothing could be further from the truth. The financial reform bill that is emerging from Congress leaves so much essential work undone, and is so obviously a sell-out to special interests and expensive Wall Street lobbying efforts, that it can only be considered the latest example of all that is wrong with the American political system. In addition to leaving untouched the single biggest threat to financial stability – naked credit default swaps – it also fails to address the bleeding ulcers of Fannie Mae and Freddie Mac, ignores the deficiencies of the credit rating agencies[7] and leaves most of the details of financial reform to be filled in by regulators, whose track record in effectively doing their jobs is, to put it more politely than it deserves, pathetic.

[7] In the latest example of "the pot calling the kettle black," the following headline was flashed on CNBC on June 30, 2010: "S&P Places Moody's on CreditWatch Negative." It's not that you can't make this stuff up, it's that you wouldn't want to waste the energy doing so.

Putting an exclamation point on the poverty of leaving the regulators in charge was the United States Supreme Court's wholesale rejection of the "theft of services" doctrine in the cases of Jeffrey Skilling and Conrad Black, which were issued at the same time the final brushstrokes were being painted on the financial reform bill. The Supremes once again reminded prosecutors that the threshold for holding businessmen criminally liable is extremely high, and that business conduct cannot be criminalized after-the-fact by the politically ambitious even if they are justifiably disgusted by greedy and immoral behavior.

And as if these rulings weren't sufficient repudiation of the current regulatory apparatus, U.S. District Judge John Koeltl rejected the SEC's first attempt to bring insider trading charges involving credit default swaps against a Deutsche Bank AG salesman and a hedge fund manager. Not to put too fine a point on it, but the judge rejected every aspect of the SEC's theory, including the fact that the alleged confidential information wasn't "material" and the allegation that the defendants violated any duty to Deutsche Bank to keep the information confidential. The press report did not disclose what the judge had to say about the SEC's attempt to create a fiduciary duty with respect to an insurance product, a concept that is itself a legal absurdity. The meager quality of lawyering at the SEC has become an embarrassment not only to the government but to lawyers in general, a profession that is not easily shamed.

In view of these rulings, *HCM* would strongly recommend that Goldman Sachs reconsider any efforts it is making to settle the suit brought against it regarding the ABACUS transaction. It would do far better to spend its time figuring out how to treat its clients better than succumbing to an ill-founded and politically motivated lawsuit by an agency that can't get out of its own way when it comes to regulating the financial markets. *HCM* has little doubt that Goldman would easily trounce the SEC on the merits before any federal judge hearing the case. Having already suffered untold reputational damage, Goldman would be much better served by pursuing an easy court victory (how many more ugly emails can the prosecutors dig up that weren't already aired in Congressional hearings – everybody already knows that Goldman did some shitty deals) than being forced into a settlement in order to mollify the torch and pitchfork brigade.

Of course, if you listen to the individuals called to testify before the Financial Crisis Inquiry Commission, the financial crisis wasn't anybody's fault and everybody should skate. The latest financial innocent to appear before the commission was former AIG employee Joseph Cassano, who believed that it was prudent to insure AAA-rated subprime securities for a mere 7 basis points of annual premium ($7,000 per $1,000,000 of insurance). Despite evidence to the contrary in the form of the $180 billion of taxpayer money that was required to bail out Mr. Cassano's prudence, Mr. Cassano had the gall to tell the Commission not only that he didn't misjudge the risks of the financial instruments that he was insuring (many of which defaulted), but that "I think I would have negotiated a much better deal for the taxpayer than what the taxpayer go." (He may actually be correct on this last point, but the standard he says he could have beaten was set very low by Geithner & Co.) He managed to blame Goldman Sachs and everybody but himself for his errors of judgment (which he refused to acknowledge despite tens of billions of taxpayer dollars of evidence to the contrary). Mr. Cassano escaped criminal prosecution only because being criminally stupid is not yet indictable, although we can only hope that in the next world he will be suitably punished for his fecklessness and arrogance. In this world, as far as we can tell, he is still enjoying the $280 million he was paid for losing more money than anybody in history. But his performance in front of the Commission, following others such as Robert Rubin (who also denied any responsibility) has helped to make the commission another source of public anger at Wall Street and distrust of the financial markets, which is the opposite of the Commission's intended goal. We certainly don't need the Commission to tell us what caused the crisis – as outlined in <u>The Death of Capital</u> (and many other excellent books on the topic); it was the result of years of flawed fiscal and monetary policies, lax regulation, and a failure to understand the true nature of capital.

Watching the daily trading action of the market, it is difficult to slough off the feeling that the powers-that-be are fiddling while Rome burns. But it is particularly appalling to watch the regulators stand by and allow what can only be considered outright stealing to continue. The latest manifestation of this is a type of front-running – an activity that is irrefutably illegal –that has been dressed up in the fancy term "latency arbitrage." The writer in me has to acknowledge the sheer linguistic beauty of that term, but my admiration gives way to nausea when it turns out that the words describe a process whereby certain fast-moving computer-trading operations simply obtain market data a nanosecond before other traders and then use this data to their advantage. According to our friend Bill King, "[t]he firms gain that advantage by buying data from stock exchanges and feeding it into supercomputers that calculate stock prices a fraction of a second before most other investors see the numbers. That lets these traders shave pennies per share from trades, which when multiplied by thousands of trades can earn the firms big profits." [8] Earlier this year, the SEC and Congress made a lot of brave noises about limiting flash trading and other computer-generated trading strategies that were obviously corrupting the markets, but little seems to have changed. In this case, it is definitely time to pull out the torches and pitchforks and storm the castle.

"The fault, dear Brutus, lies not in our stars…"

I recently wrote an opinion piece that appeared in the Spanish newspaper *El Mundo* (I am a bi-monthly Sunday columnist for that publication) in which I wrote the following:

> "In a democracy, a country gets the government it deserves. Unlike countries that are ruled by non-democratic means (despite the fact that they hold elections), democratic societies freely choose their leaders. The great tragedy of today's Western democracies is that voters continue to demand that their leaders engage in self-destructive economic policies instead of demanding accountability and tough choices. The political systems of the major Western democracies have become captive to powerful special-interest lobbies that place their interests ahead of those of society as a whole. This makes it almost impossible to develop sound policies to deal with complex problems. The hegemony of powerful special interest groups also distorts economic incentives and the directions in which economies evolve. The result is that massive amounts of intellectual and financial capital are diverted to unproductive uses as society's most powerful interest groups fight over the distribution of wealth rather than focusing their energies on increasing society's overall wealth."

The manner in which financial reform legislation has been effectively neutered by special interests is a testament to the ascendancy of special interests, particularly financial interests, in the United States. The full story of this is told in Robert Kuttner's A Presidency in Peril. But as noted in my essay in *El Mundo*, how can we expect meaningful reform when the very constituents who would benefit from it do not have the courage to demand it? A case in point is the recent criticism aimed at Wall Street eminence Byron Wein, who was called on the carpet by clients of his employer The Blackstone Group after daring to speak the truth about public pension benefits. In a January 5, 2010 webcast (this should be old news, but apparently clients are still upset by what Mr. Wein said), Mr. Wein noted that "the retirement benefits for state workers, really not only in New York, California and New Jersey, but throughout the country, are very generous. Too generous. And it is very hard to change that…But I think we have to be more

[8] *The King Report*, June 4, 2010, p. 2.

realistic. We literally can't afford the benefits we have given our retirees in state and local governments. And we have to change that."

About a month later, *Pension & Investments* published a letter from Steve Cochrane, who at the time was executive director and chief investment officer of the $3 billion North Dakota State Investment Board. In reference to Mr. Wein's comments, Mr. Cochrane wrote that if North Dakota were a Blackstone client, "I would choke on my next fee payment to The Blackstone Group." Blackstone was subsequently criticized by a number of other state pension officials who were unhappy with Mr. Wein's comments. But Blackstone – a publicly-traded private equity firm whose stock *HCM* views as a terminal short[9] – and Mr. Wein have nothing for which to apologize in this case. Mr. Wein's comments were dead on, and public pension officials do themselves little good by ignoring reality. If they want further evidence of the folly of forcing states and cities to pay them unaffordable pension benefits, they should revisit what happened to the unions at General Motors and Chrysler. President Obama will not be around forever to ignore the rule of law and bail them out when their employers are forced into insolvency by their unrealistic demands. At the same time, many of the same pension funds that are critical of Mr. Wein's truth-telling continue to pour capital into Blackstone and other private equity funds, which offer them little more than poor risk-adjusted returns and egregiously high fees (or, in (Groucho) Marxist terms, membership in a club in which they should not be seeking membership). That is the reality about which they should be complaining.

The Carried Interest Tax Lives On

After months of negotiating and Herculean lobbying efforts by private equity chieftains (they have nothing else to do since the private equity industry is mercifully in the dregs these days), the Senate and House Finance Committees reached a compromise on raising the taxes paid by private equity and other partnerships on their investment profits. While imperfect (arguably venture capital partnerships should retain such a tax incentive, and the compromise delayed implementation and didn't fully equalize carried interest and ordinary tax rates), the compromise went a long way to eradicating the special treatment that had been undeservedly meted out to unproductive private equity and real estate investments. Unfortunately, this bill was part of a larger bill dealing with the extension of unemployment benefits to the long-term unemployed and has not yet mustered the requisite number of votes in the Senate to become law. Forgive us for being cynical, but perhaps the carried interest tax was never intended to be raised. After all, the arguments in favor of taxing the labor of private equity and other speculative investments partnerships at the same rate as the labor of teachers, policeman and fireman are irrefutable. It would be a simple enough matter to separate out this part of the bill from the issue of unemployment benefits and pass it separately, but the Senate does not want to do that. Accordingly, this tax injustice remains on the books. One can only hope that it will be corrected. Need we mention that the Obama administration has been largely silent on this issue while complaining about the failure to extend unemployment benefits and threatening to raise the taxes of virtually every other American of means still alive (as well as those who die after the end of the year)? Might this have something to do with his donor base, which consists of many private equity executives?

[9] BX has traded back below $10/share recently. We believe BX is worthless if the company accurately valued its private equity holdings. Speaking of which, we got a huge kick out of the June 28, 2010 story in the *Financial Times* reporting that TPG and Blackstone were carrying their joint investment in the Freescale Semiconductor buyout at dramatically different valuations. Blackstone is carrying (and reporting to its investors) its Freescale holding at 45 cents on the dollar while TPG is carrying it at 20 cents on the dollar. Each firm contributed approximately $1 billion in equity to the overleveraged $16.6 billion deal in 2006. This means that Blackstone is valuing the same investment at $250 million more than TPG. Something is rotten in the Kingdom of Denmark. The reality, by the way, is that both firms' stakes are currently worthless.

Iran, Israel and Moral Deficits

Moral certitude tends to make people uncomfortable. We live in an age when we are taught to be nonjudgmental. But it is abundantly clear that this nonjudgmental approach isn't working. The quality of life is not improving. Problems are not being solved despite the advances we are making in science and technology. We can decipher the human genome, but we are incapable of discerning the human heart. There are more people going hungry than ever before, and more people threatened with extinction by human action than ever before in the history of man. Now is not the time for moral equivocation – it is the time for bold and forthright action to prevent the threats staring us in the face from materializing and wreaking havoc. Lord knows there are enough hidden threats that we will have to deal with when they are unleashed.

Nowhere does the Obama administration appear to be more out of its depth than in dealing with the growing nuclear threat of Iran. CIA director Leon Panetta made some statements on ABC's Sunday show "This Week" on June 27 that should alarm every member of the community of civilized nations (which does not include Iran). What Mr. Panetta told ABC discredited for once and for all the fairy tale that Iran stopped work on nuclear weapons in 2003. "We think they have enough low-enriched uranium right now for two weapons. They do have to enrich it, fully, in order to get there," said the CIA chief. "And we would estimate that if they made that decision, it would probably take a year to get there, probably another year to develop the kind of weapon delivery system in order to make that viable." With respect to sanctions, Mr. Panetta did not mince words either. "I think the sanctions will have some impact…It could help weaken the regime. It could create some serious economic problems. Will it deter them from their ambitions with regards to nuclear capability? Probably not." In other words, the head of America's spy agency is publicly saying that sanctions won't work. Yet this is the policy still be pursued by the Obama administration as Iran moves inexorably towards possession of weapons of mass destruction that directly threaten Israel, Europe and other interests of vital importance to the United States. It is difficult to determine which is more disturbing - the seeming naiveté of the administration that sanctions will actually deter Iran from its nuclear ambitions, or the lack of urgency in dealing with the problem.

It is in this context that the president's lackadaisical reaction to the demise of White House correspondent Helen Thomas was particularly disappointing. While his press secretary Robert Gibbs properly deemed "reprehensible" Thomas's statement that the Middle East conflict could be solved by sending Israel's Jews back to Poland and Germany, Mr. Obama could only cough up a weak rebuke that her comments were "out of line" and "offensive" before saying that Thomas's resignation/dismissal was "a shame, because Helen was…really a institution in Washington." The very fact that Thomas was an institution when her abhorrent views were widely known is a stain on the press and the White House. Would Mr. Obama have reacted with such equanimity had Thomas suggested that the Palestinians be returned to their true homelands in the other Arab States? I think not. Mr. Obama likes to speak about teaching moments, and Thomas's hateful comments were no doubt one such moment. But instead of using her hateful statements to instruct the American people on the difference between right and wrong, Mr. Obama hedged his bets and softened what should have been withering criticism of an individual long known for her anti-Semitic views. Such a reaction is, unfortunately, completely consistent with Mr. Obama's treatment of Israel and the entire Middle East quagmire. He needs to understand that he is no longer a State Senator from Illinois but the President of the United States, and his actions and policies are placing the entire world at risk. Americans have every right to be profoundly disappointed in his leadership in what may be the most important area of his stewardship of this nation.

Fortunately, Israel has no such illusions about the existential threat posed by Iran and cannot afford the luxury of trying to win any global popularity contests. The Jewish state is therefore taking steps to deal with the problem before it is too late. The latest media revelations – which have been known to the Israeli and U.S. governments for several months - that Iran has armed Syria with a sophisticated radar system that could threaten Israel's ability to launch a preemptive strike against Iran's nuclear facilities moves closer the day when Israel will have no choice but to act unilaterally and preemptively. This radar system reportedly could increase the accuracy of Hezbollah's missiles and bolster the terrorist group's air defenses on Israel's northern border, and there is other evidence that Hezbollah has rearmed itself with far more effective weapons than it possessed the last time it went to war with the Jewish state. People should understand that a war in the Middle East is likely to be a drawn-out affair; this is no longer 1967, and the dominance of Israel's military can reasonably be questioned in view of its recent performance and changes in Israel society. Americans in particular should harbor no illusions that Israel will be able to simply walk over the Arab states if it is forced into making a first strike against Iran. Instead, an extended conflagration, with all of the attendant consequences (intended and unintended) should be anticipated. To put it mildly, such a scenario will make the current flight from risk look like a stroll in the park.

The quotation from Shelby Steele that opens this newsletter was drawn from an essay defending Israel's right to defend itself from so-called humanitarian shipments into Gaza, which Martin Peretz has properly described as "jihadist ship[s] dressed up as Mississippi River cruise boats."[10] Without disputing the fact that Israel should have found a better way to handle that matter (the Palestinians and their supporters set a trap and the Israelis foolishly fell right into it), Israel's fate is tied to the fate of the Western world as both face existential threats to their democratic way of life. The Obama administration is not simply failing to protect the interests of the United States with its misguided and weak Iran policy; it is threatening the future of Western civilization. One would think that all of the alleged geniuses in the administration – we keep hearing how incredibly smart these people are – would have learned some of the lessons of history, including the lessons of appeasing tyrants. For all of his faults – and they were many – George W. Bush understood that lesson very well.

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[10] Martin Peretz, *The New Republic*, "Homeward Bound: Notes on Helen Thomas," July 8, 2010, p. 8.

The HCM Market Letter
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