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From the Desk of Karl Denninger

September 20, 2007

President George Bush
1800 Pennsylvania Avenue
Washington DC
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Dear President Bush:

A few days ago I wrote you to note that we were risking ***severe*** devaluation of the dollar, ***and thus extreme inflation***, if something was not done to prevent Ben Bernanke from cutting interest rates precipitously.

I understand the political pressure to "save homeowners."

As I noted, *it will not work* and risked provoking an even greater crisis – one that might not be able to be controlled.

Well, Ben did cut rates. Precipitously.

The Dollar went off the cliff, as I predicted.

The Saudis have decided they will not follow our rates down, and are threatening to unpeg their currency.

The Dollar cratered ***again*** last night.

If you have **any** concern for inflation at all, and what it will mean to you and the Republican Party **politically**, you need to act.

Today.

We just added 1% to real inflation in less than 18 hours! Extrapolate that out for a few months and see what you think we have coming to this nation!

There is only one fix for the housing industry. **House prices must come down.** The way we stabilize the housing industry is to **stop trying to bail people out and instead defend the dollar, because the bailouts will not work and instead of the pain being taken by the people who did foolish things, including bidding houses up to FIVE TIMES average incomes, we will instead end up screwing EVERYONE as we revisit the 1970s inflation monster!**

There is no bottom in housing coming soon, and there is no way to prevent the housing market from correcting. ***Trying to prevent it will bring us not a modest recession which will clear by next summer, but a far more serious downturn that, if the government doesn't stop screwing around, might look more like the 1930s!***

Oil has gone up tremendously in the last few days. Why? **Oil is priced in dollars but is a foreign product – as the dollar craters oil goes sky high!** Want $5/gallon gas **on your political watch?**

You're going to get it!

Cutting interest rates into a commodity bull market was last done in the 1970s **and we know what happened the last time.** You're old enough to remember Jimmy Carter walking around on National TV in a sweater and so am I! I <u>**also**</u> remember my middle-class family trying to figure out how we were going to manage to pay a grocery bill that was rising at **20% a year.**

Inflation – real inflation – is not running at 2% as the government claims. Buy <u>MILK</u> lately? The price has gone from $3.25 to over $4.00 in less than two months. That's 23% <u>in two months</u>! Other products based on milk (e.g. cheese, butter, etc) have seen similar price rises. Meat has skyrocketed. Wheat is at all-time highs.

<u>***If the government does not act now these days are returning to the United States. This is not just a government spending issue, although that's important. It is also a matter of fiscal responsibility from our banking system.***</u>

Serious policy mistakes include:

- **Mr. Bernanke's Fed has removed <u>critical</u> safety factors from the banking system by waiving Affiliated Capital limits.** This risks a potential banking system failure **should this "bailout" measure fail.**

- **The Fed Funds cut was an ill-advised attempt to bail out Wall Street asset prices and has now backfired.** I predicted that it would, <u>**and the results are now in – it HAS**</u>. The destruction of the Dollar has been instantaneous and critical. <u>***This must be immediately reversed or we risk a potential FIFTY PERCENT devaluation over the next few years***</u>. Such a plunge in the dollar's value will make travel outside the US impossible for Americans, result in $200/barrel oil, inflation rates in the double digits and a cratered economy. **It is very likely that absent immediate intervention oil will be unlinked from the Dollar which will result in the end of The Dollar as a petro reserve currency. This will cause a catastrophic wave of dollar selling, both in terms of dollars themselves and also linked assets such as treasury securities.**

- **Instead of dropping real interest rates <u>Ben's interest rate cut actually raised them</u> where it matters – in mortgages.** 30 year fixed money is most closely linked to the 10 year treasury bond rate. <u>**That rate has gone UP, not down, since Ben's change in rates.**</u> Not good and exactly the opposite of what he intended to achieve.

- **The government needs to stop spending like a drunken sailor.** I know this is difficult politically but it simply must happen. **We are a debtor nation and have become dependant on foreign governments to finance our debt.** Ben's actions have now critically destabilized this relationship.

- **Refusing to accept the business cycle.** This mistake was the same one made in 2000. You know what we got out of that with the stock market **going in the ditch.** We are headed there again and the results this time will be **far worse** because in attempting to prevent the business cycle from working its way out Alan Greenspan created an ***enormous*** asset bubble in residential housing.

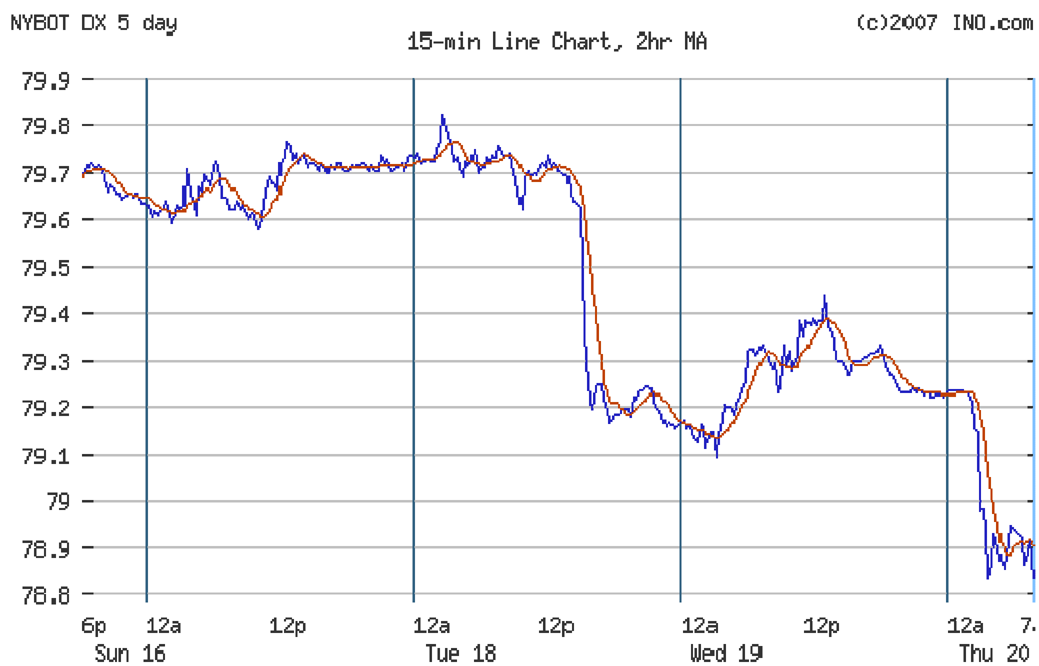
Sir, we cannot prevent this bubble from unwinding. **We can, however, confine the damage to the buyers of homes between 2004 and 2007, the lenders who made those inappropriate loans and the knock-on effects in the greater economy, or we can attempt to prevent those losses from**

being taken and the result will be <u>at least as bad as the 1970s when we had sky-high inflation and a stagnant economy for nearly a decade</u>.

The voters are watching, and the inflationary impact of this foolishness will be clearly visible before the elections next year.

Either our government acts and fixes this in the immediate term or come fall of 2008 you are going to be facing an incredible problem with the voting public as it becomes evident that you have "cooked" the inflation numbers, fixed income ***<u>senior citizens</u>*** will have had their purchasing power destroyed, and the middle class will have been decimated.

Those are the two largest voting blocks.



Sincerely,

Karl Denninger