The Financial Commentator

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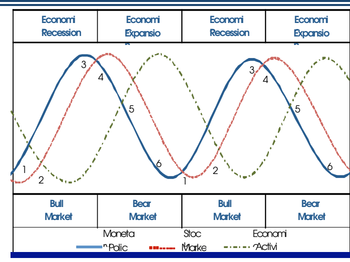

A GUIDE TO FEDERAL RESERVE MONETARY POLICY, THE ECONOMY, AND FINANCIAL MARKETS
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ECONOMY

On Friday, February 13, Congress passed the $787 billion stimulus plan. I'll bet every member in Congress stayed up until the wee hours of Friday morning reading every one of the 1,434 pages needed to express the vision of the 110th Congress. About 40% of the total will be discretionary spending on education and job training, highway and bridge construction, modernization of the electricity grid, health and science research, housing programs and extending food stamp benefits. About 24% of the total will be spent in direct aid to states to supplement Medicaid costs, extend unemployment benefits, and expand health care programs for the needy. And almost 30% of the total goes for tax breaks for individuals and families, a temporary alternative minimum tax patch, state tax credit bonds to finance public education facilities, renewable energy incentives, and a $3 billion tax break for General Motors.

This legislation has ignited a contentious debate on whether it is too big or not big enough, or whether it contains too little or too much in tax cuts, at the expense of those who have lost their job or home in this crisis. Even more remarkable, not a single defender or detractor noted the inauspicious date it was passed – Friday the 13th! Yikes! Those who have consistently underestimated the magnitude and scope of the credit crisis, and its impact on the economy, seem impressed and hopeful about the plan's effectiveness. They believe it is the right medicine to not only arrest the deep economic contraction and serious wave of deflation we're experiencing, but also believe it will have enough muscle to launch a sustainable recovery. This is stimulus on steroids.

My concern is that this plan is being cheered by those who still don't appreciate the structural nature of the problems we're facing. It's like a doctor who prescribes aspirin for a patient with a fever. Hours later, the fever is down, but the patient is admitted to the hospital with acute appendicitis. The doctor treated the symptom successfully, but not the cause of the fever. The Federal Reserve initially misdiagnosed the problem, thinking it was just a sub-prime mortgage problem that would run its course by the end of 2007. The collapse of Bear Stearns in March 2008 was certainly a wake up call. But over the next few months, two Fed members were more worried about inflation and voted against additional easing. It really wasn't until the demise of Fannie Mae, Freddie Mac, AIG, Merrill Lynch, Washington Mutual, Wachovia, and of course Lehman Brothers that the Federal Reserve and Treasury Department realized how far behind the curve they were. Unfortunately, they are still behind the curve, and now the patient has more than just a fever. In fact, an emergency room doctor might describe it as multiple organ failure. Large segments of the U.S. banking system are effectively insolvent. The securitization markets remain inoperable. The consumer is still in shock, and the global economy has pneumonia. The triage needed to save and revive the patient goes well beyond the scope of the stimulus plan. Remarkably, the majority of economists and investment professionals still believe all that's needed is aspirin.

In my September 2007 letter I used the metaphor of a tsunami to describe the convulsion that swept through the credit markets in August 2007. Seismologists usually know within hours whether a 100 foot tsunami traveling 500 miles per hour, or a 2 foot wading wave was created by an underwater earth quake. I noted then we wouldn't know for a number of months the full economic impact, but the displacement in the financial markets left no doubt that a significant seismic event had occurred. The majority of economists and investment professionals saw it as nothing more than a speed bump. There is the perception that a tsunami is a single giant wave of water that sweeps away everything in its path once it reaches land. As financial market participants have painfully learned since August 2007, a tsunami is actually a series of giant waves, each one causing more destruction. After the first wave hits, survivors feel a sense of relief, as the sea water retreats. But that respite is brief, as the second, third and fourth tsunami waves crash on shore. They seem to arrive without warning.

After the first wave in August 2007, the second wave took Bear Stearns down in March 2008. The third and fourth waves hit in July and September 2008 and brought the financial system to its knees. The fifth wave has pushed every developed economy into recession, creating the deepest synchronized global economic contraction since the 1930's. Although not yet visible, there is a sixth wave coming, as the global recession creates more losses for banks, prolonging this period of weakness and increasing the risk of a much deeper contraction.

Two weeks ago, the *Commerce Department* reported that fourth quarter GDP fell at an annual rate of 3.8%, which was the largest drop since 1982. Though bad, that figure grossly understates the degree of actual weakness. Since sales were weaker than production, inventories grew. If sales and production had been in balance, GDP would have been lowered by 1.32%. Instead, the unwanted inventories will cause companies to reduce production in the first quarter. The GDP report measures ***domestic output***, so the *Commerce Department* subtracts imports to determine domestic production. In the fourth quarter, imports plunged and boosted GDP by 2.93%. The collapse in domestic demand for imports is hardly a sign of economic strength. Without the misleading additions from inventories and imports, GDP would have been down 8.0% in the fourth quarter.

In last month's letter, I discussed how the slowdown would create excess capacity, forcing companies to reduce investments in new plants, equipment and software. In the fourth quarter, business investment dropped at a 28% annual rate. This is significant since business investment is a key driver of growth, representing up to 15% of GDP, and a big contributor to gains in productivity. The decline in sales volume and increase in excess capacity is forcing companies to aggressively cut costs. In the last five months, almost 2.5 million jobs have been eliminated and the average work week is at a record low of 33.3 hours. Personal income fell .2% in December for the third consecutive month. Personal spending has declined for five consecutive months, after plunging 1% in December.

In the last twelve months, the unemployment rate has soared from 4.9% to 7.6%, and could exceed 9% by the end of 2009. ***The surge in unemployment will result in higher default rates on every type of***

consumer credit and lead to more losses for banks. A 1% increase in unemployment leads to a 1% increase in the credit card charge-off rate. The huge jump in unemployment over the last year, and especially the past five months, means banks are facing a big increase in credit card losses. As the unemployment climbs further, more prime borrowers, who tend to have larger loan balances, will be affected. This suggests bank losses could accelerate, as the unemployment rate rises in coming months.

From 2002 to 2006, banks originated an average of $557 billion a year in jumbo mortgage loans, according to *Inside Mortgage Finance*, and a total of $750 billion of option adjustable-rate mortgages. As of December, the percent of jumbo loans that are at least 90 days delinquent has surged to 6.9% from 2.6% in December 2007. *Moody's Investor's Service* has downgraded 75% of all prime jumbo loans originated in 2006 and 2007 that previously carried the top rating of triple-A. According to *LPS Applied Analytics*, 28% of option ARM mortgages are delinquent or in foreclosure. More than 55% of borrowers with option ARMs owe more than the value of their home, which means these borrowers have no option to refinance.

A year ago, I noted that it was not a good sign for the banking system or the economy that the Federal Deposit Insurance Corp. was hiring. Although FDIC bank examiners have increased the frequency of examinations for at-risk banks, many are falling into trouble faster than in previous downturns. Of the 25 banks that failed in 2008, 9 collapsed before regulators could respond, including Washington Mutual and IndyMac, two of the largest failures in history.

In recent weeks, the International Monetary Fund increased its estimate of total global banking losses from $1.4 trillion to $2.2 trillion. The IMF said the world's advanced economies – the U.S., European Union countries, Britain, and Japan – are "already in depression." The IMF estimates that United States banks have a capital shortage of $500 billion, and that's if things aren't worse than expected. Keep in mind that future lending will be reduced $10 for every $1 of capital shortage. A reduction of $5 trillion or more in future lending will dampen economic growth for at least two years.

Prior to August 2007, more credit was created by the securitization markets than through bank lending. Unfortunately, the securitization markets are in worse shape than the banking system, with the volume of securitization down 70% over the last year. In November, the Federal Reserve announced a plan to resuscitate the securitization of auto loans, student loans, and credit card debt. Almost 3 months have passed since the Fed announced its plan, but nothing has been done. Obviously, the complexity and size of the task has proven more daunting than expected. It took years for the securitization markets to develop, and central to that growth was the trust buyers of securitized debt placed in the rating agencies. That trust was destroyed, when investors were told their 'AAA' holdings were really junk, virtually overnight.

The collapse of the banking system and almost complete breakdown of the securitization markets represent a structural fissure in the credit creation process. ***What many economists and investment professionals have failed to understand is that there is no easy or quick fix. By their nature, structural problems take years to repair, not just a few quarters***. Unfortunately these are not the only structural problems challenging policy makers.

As discussed in the April 2008 letter, household debt as a percent of GDP has climbed from 44% in 1982 to 98%. The ratio of total credit to GDP has more than doubled, rising from 165% to 353%. As debt levels were growing over the last 26 years, GDP grew as consumers used debt to buy homes, cars, vacations, and lots of 'stuff'. With GDP now falling, the burden of these debt loads is growing, ***without the benefit of economic growth***. The decline in home values is making mortgage debt more onerous, as the ratio of equity to home prices continues to sink to all time lows. ***The next secular period of economic growth will need the ratios of total debt and household debt to GDP to be lower than they are today***. This will require a painful adjustment, either from forced debt liquidation, or an extended period of reduced consumer spending and borrowing. If the ratios of debt are lowered from forced debt liquidation, the odds of a depression will increase. And we are going to have some forced debt liquidation. But if the adjustment comes more from consumers embracing the ***less is more*** philosophy I discussed last month, the economy will be lousy for years, but not dreadful. This is a longer term structural problem that will not be solved with one stimulus package.

Consumer spending represents 70% of GDP. Job losses, the shrinkage in hours worked, the resulting negative impact on personal income, and the reduction in the availability of credit, will keep consumer spending weak into 2010. With additional declines in home prices and equity values likely in coming months, consumers who can, have no choice but to increase their savings from disposable income. From 1994 until 2008, the personal savings rate fell from just under 8% to 1%. If the savings rate increases just 1.5% in each of the next 3 years, it will almost be back to its level in 1994. But in doing so, annual GDP growth will be 1% weaker. In the long run, an increase in the savings rate is both necessary and a good thing. However, in the short run, the lower level of consumer spending is a structural factor that will depress growth.

Another structural challenge is the global nature of this crisis. With more than 75% of world GDP in a serious recession, there is no place to hide. In the fourth quarter, the 16 countries in the European Union saw their economies shrink 1.5%, or at a 6% annual rate. Industrial production in the EU was off 11% from year ago levels, and exports to countries inside and outside the Euro zone were also down 11%. Japan experienced a 12.7% decline in fourth quarter GDP, the largest since 1974. Britain's economy shrank at an annual rate of 5.9% in the fourth quarter, the biggest decline since 1980. With all the developed countries in the tank, the emerging countries are not doing a very good job of 'decoupling', as many economists and investment professionals were forecasting a year ago. Exports account for nearly half of South Korea's output. After plunging 19% in November and 17.9% in December, exports fell 32.8% in January. Some of the weakness was due to the Chinese New Year, but the trend is clear. Industrial production in Brazil fell a historic 12.4% in December, ***from the previous month***. Taiwan's exports plunged a record 44% in January from year ago levels. J.P. Morgan forecasts that South Korea, Taiwan, Russia, Turkey, Mexico, and at least 6 more emerging economies will contract in 2009. As I wrote in the March 2008 letter, *"The United States represents 27% of global GDP. The combined total of the 16 countries in the European Union comprise just over 28% of global GDP. Throw in Japan and Great Britain, and all these countries represent 71% of world GDP. China and India combined are 7.5% of world GDP. The U.S. is in a recession, most of the countries in the European Union are growing less than 2% and are slowing, Great Britain is slowing toward 1% GDP growth, and Japan is growing less* *than .5%. If 71% of world GDP is slowing and only grows 1.5% or less in 2008, how and where is the decoupling going to take place? Malaysia?"*

In December, exports from Japan and South Korea to China plummeted by 36% and 35% from December 2007, which tells us something about the state of Chinese domestic demand. Measures of consumer confidence have fallen since August, housing sales have declined every month since last April, and car sales have dropped in four of the past five months. Meanwhile, export growth turned negative in December, for the first time in years. Since most electricity usage is industrial in China, it is telling that electric utility use is down 8% from December 2007. It is estimated that 20 to 25 million migrant workers are now without a job, which will lead to unrest as it persists in 2009.

According to the *Bureau of Economic Analysis*, state and local spending grew 34% between 2003-2007, while inflation rose 19%, and population grew just 5%. Since 1998, state and local budgets have almost doubled to $2 trillion, with debt increasing from $1.4 trillion to $2.23 trillion in 2008. According to the *Census Bureau* these figures do not include the nearly $1.5 trillion in unfunded health and pension liabilities. States have been living large, but that's going to change. With tax revenues from sales taxes, personal taxes, and real estate falling, states are facing a $200 billion short fall that will force many states to raise taxes and fees and cut services. Although the stimulus plan will cushion some of the pain that states are experiencing, many states must learn in coming years how to operate in a world far different than the spending spree years of the past decade.

In sum, the breakdown of the banking system, collapse of the securitization markets, necessary retrenchment by consumers, the synchronized nature of this global slowdown, and the new fiscal reality confronting state legislatures each represent a significant structural adjustment that will take time to fix. Collectively, they represent a daunting challenge that is without precedent. As I said last month, "*I think President Obama's stimulus plan could play a significant role in keeping the worst recession since the 1930's from becoming a depression."* As for jump starting a recovery? Not likely in 2009.

PROTECTIONISM

After the Smoot-Hawley Tariff Act was passed in June 1930, world trade plunged 40% over the next 18 months, clearly deepening the Great Depression. Protectionism is one of the few topics both liberal and conservative economists agree. Protectionism is bad economic policy. However, I'm not comforted by this consensus. People know you shouldn't drink and drive, or smoke cigarettes, but they do. Politicians bemoan our nation's dependence on foreign oil suppliers, but fight any effort to increase domestic oil drilling or building nuclear power plants that would reduce our dependence. We're building a wall on our border with Mexico to lower illegal immigration, but provide free education and health care for those who make it across. We consistently pursue policies that are illogical and inconsistent.

The IMF has forecast a 2.8% decline in world trade for 2009, which would be the first decline in 27 years. Although a recent *World Trade Organization* report found that most countries are keeping domestic protectionist pressures at bay, 16 countries launched 85 new anti-dumping cases during the first six months of 2008, compared with 61 in 2007. As unemployment rates climb around the world, so will the temptation for local politicians to launch 'buy local' campaigns that will resonate with unemployed and anxious voters. Already, banks in a number of countries that have received public funds are being 'urged' to lend to businesses in their own countries. The *Institute of International Finance* expects investment in emerging European countries to drop from $254 billion in 2008 to $30 billion in 2009. As investment capital retreats back into developed countries, a form of financial mercantilism emerges. This could easily be the first step toward trade protectionism. If the global slowdown intensifies as I expect, a form of 'every country for itself' survival instinct could overcome the knowledge that protectionism is bad economic policy.

STOCKS

More than $500 billion in corporate bonds mature in 2009, and the majority of companies will face higher financing costs as they attempt to roll their debt. The increase interest expense will narrow profit margins for those who successfully refinance. A record number of companies will not be able to roll their debt. *S&P* estimates high-yield default rates will hit 13.9% in 2009, but could reach 18.5% if the recession is prolonged. *Moody's* predicts a default rate of 16.4%. If these estimates are accurate, U.S. companies will default on almost $500 billion of corporate bonds and bank loans over the next two years. This represents another wave of stress for banks, credit markets, and the economy.

A majority of economists and investment professionals expect the economy to rebound in the second half of 2009. Given the structural challenges we're confronting, I don't think that's likely. Economic data points will likely become less negative, but that should hardly qualify as a rebound. Obviously, corporate profits will prove disappointing if a second half recovery fails to materialize. Optimists are comfortable with a P/E of 15, which seems nuts in this environment. Over the last 75 years, the average trough P/E has been 10. If S&P earnings are $60, a 15 P/E would peg the S&P at 900, about where it was in early January. S&P earnings of $50, would mean revisiting the November low near 740. Of course, if a P/E of 10 is used, and earnings are $50, the S&P could lose another 30% from current levels. Needless to say, I think the upside is fairly limited.

In the October 2008 letter I wrote*, "My guess is that the DJIA will drop below 7,882, but hold above 7,200 in coming weeks. If this develops, a one to three month rally could follow, as analysts convince themselves that a narrowing in credit spreads and a second bigger stimulus plan will mean the economy will begin to recover by mid 2009. My guess is that after this rally is over, the DJIA will likely drop* ***below*** *7,200 by next spring."* In the November 2008 letter, I suggested*, "If the DJIA drops below 7,882, traders should look for an entry. Where ever you choose to go long, use DJIA 7,200 as a stop, and raise the stop to the DJIA low, if the DJIA climbs above 8,200."* The stop was raised to DJIA 8,600 on December 10, which was triggered. Not much has changed since last month's letter. *"Sometime in the first half of 2009, the S&P will challenge and likely break below the November low at 740. I don't know if this decline will end at 739 or 699. The DJIA will fall below 7,450, and ideally below the 2002 low of 7,197. That's the bad news. The good news is that once that decline is over, the market will enjoy the largest rally since the bear market began in October 2007. It will be ignited by economic statistics* *showing that the rate of decline in the economy is getting less bad. The optimists will jump to the conclusion that less bad equals recovery."*

BONDS

As stated last month, "*Bonds are likely to remain in a trading range, with the 10-year Treasury holding between 2.2% and 3.07%. In coming months, Treasury bonds will rally when the economy looks terrible, and sell off on any piece of news that is not as bad as expected. A good environment for short term traders*." Since last month, the 10-year Treasury yield climbed from 2.3% to 3.05%, before dropping to 2.66%. There is a good trading opportunity coming in corporate bonds. I just don't think we're there yet.

DOLLAR

The Dollar continues to benefit from the global nature of this financial and economic crisis, as noted last month. *"After mid July 2008, the Dollar rallied as the financial crisis intensified, and then sold off sharply as the stock market rallied off the November lows. I think we are past the acute phase of the credit crisis, which is why credit spreads have narrowed. But we are heading into the teeth of the economic crisis, which will likely give the Dollar another boost. I think the Dollar will at least run up to 90 – 92, in coming months."*

GOLD

"*Inflation has been defined at times, as too much money chasing too few goods. What we are experiencing could be best described as too little money chasing too many goods. The Fed has added reserves to the banking system. But banks are not lending, and are actually restricting credit availability. Although the money supply measures have been growing, the velocity of money has slowed markedly. Unemployment is soaring, and worldwide factory utilization rates are dropping like a stone, which means there is plenty of excess capacity in the global economy. All of these factors will change some day, but not anytime soon. In the meantime, there will continue to be downside pressure on raw material prices and labor costs. In coming months, consumer prices will register declines, driving home the larger risk of deflation. If the Gold market is anticipating a surge in inflation, those buying now must be using binoculars, or even a telescope. As long as February Gold does not close above $900, a decline below $700 is still expected in the first half of 2009*." Given the deterioration in the global economy since the January letter, these comments are more valid today. However, the gold market has clearly been stronger than I expected. But I don't think the pattern has changed. From a charting stand point, the decline from the high in March 2008 near $1,030 to the low last September just below $700 is wave A of a large A-B-C correction from the March 2008 high. This pattern suggests that the rally from the September low is wave B, which will be followed by a C wave decline below the September low. Bullish sentiment is also quite high, which means a good short trade in gold could set up in the next few weeks, even if gold pushes above 1,000.

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