The Financial Commentator

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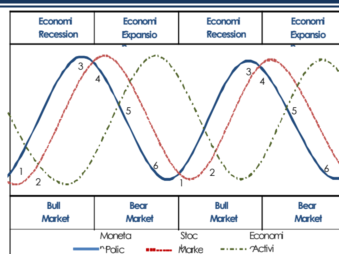

A GUIDE TO FEDERAL RESERVE MONETARY POLICY, THE ECONOMY, AND FINANCIAL MARKETS
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SECULAR TRENDS?

Throughout history, there are events that are recognized as being momentous as they occur. Those old enough, remember where they were when we learned that President Kennedy had been assassinated. We remember the images of commercial airplanes crashing into the towers of the World Trade Center. As we are witnessing these events, we know we are directly experiencing history. We understand that the course of history is being etched into our memories, and careening in a way we couldn't have imagined only moments before. Sometimes change literally announces its arrival.

But most of the time, change occurs slowly, incrementally. No earth shattering single event. Just many small steps that collectively, and quietly over time usher in a new era. When change occurs gradually over time, the recognition of just how much things have changed is only gained with the benefit of hindsight, well after the agents of change have already left their mark.

Sometimes it's good to stand back and look at the big picture. Between 1946 and 1982, the U.S economy experienced 8 recessions, averaging 10 months in duration. Since 1982, there have only been 2 recessions, and both ended after 8 months. Clearly, in economic terms, the last 25 years have been remarkable. As I have noted previously, credit creation has played a significant role in fueling economic growth. Between 1975 and 2000, annual credit growth exceeded GDP growth by 2.4%. Between 2000 and 2007, the annual growth in credit grew 3.7% faster than GDP. This growth in credit not only boosted the economy, but it also lifted asset prices. As real estate values and stock prices rose, many consumers cut back on savings. In 1982, the U.S savings rate was near 10%, but fell to near 0% in 2000, and has remained low ever since. Since 401K contributions are not included in the savings rate calculation, the decline from 10% to 0% is clearly understating the amount of savings. But 401K's are more exposed to the stock market than the CD's that were the investment of choice in savings accounts in the early 1980's. The savings rate may not be as low as published, but the pool of savings is more dependent on fluctuating asset prices.

From 1950 to 1982, consumer spending averaged 62.3% of GDP. After the great bull market in stocks began in 1982, consumer's spending contribution to GDP has risen to more than 70% of GDP in recent years. This increase in consumer spending was partially made possible by the rise in

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home values, and the extraction of home equity. Over the last 25 years, American home owners have reduced the ratio of home equity to home values from more than 80% to 47.9% at the end of 2007. In 2005, the amount of home equity extraction exceeded the ***total*** increase in disposable income from wages. Household debt as a percent of GDP has soared from 44% in 1982 to 98%.

In 1981, short-term interest rates peaked at 21%, and long-term Treasury bonds topped out at 15%. Over the last quarter century, the bond market has been in a ***secular bull market***, which has reduced the cost of short-term debt by 90%, and 75% on long-term borrowing. Obviously, the decline in the cost of credit made it possible for consumers to buy more expensive homes, and extract equity from their homes for cars, vacations, college educations, second homes, and a lot of stuff!! Since credit creation has been growing faster than GDP growth for a long time, total credit market debt has ballooned from 165% of GDP in 1982 to 353% at the end of 2007.

There is nothing inherently wrong with high levels of debt, as long as the economy grows well enough to generate the cash flow needed to service the debt, and support the asset prices of the collateral. When debt levels are high, interest rates become increasingly important, since the cost of money largely determines just how much cash flow will be needed to service the debt. After a 26 year ***secular decline in the cost of money***, a significant increase in asset values and a huge increase in debt levels, we may be approaching a tipping point. Or have we already crossed the line, and we just don't know it yet?

In the December letter, I discussed how credit creation within the banking system has evolved over the last 25 years. Before the advent of securitization, our local bank or savings and loan would loan money to buy a home or car, and would hold that loan until it was paid off. Since the bank or S&L was holding the loan, it had a keen interest that it would be paid off. The total amount of loans a bank could make was dependent on its capital base, total deposits, and reserves set aside for existing loans. If a bank wanted to increase its lending volume, it had to increase deposits or its capital base. With the introduction of securitization, a bank could make a mortgage loan, and then sell it to a Wall Street firm, which would bundle hundreds of similar mortgages together into a security. This alchemy converted a single home loan on Main Street into a security that could be sold to mutual funds, insurance companies, and pension funds worldwide.

Securitization made it possible for banks to make more loans, ***without increasing their capital base or loan reserves***. The success with the securitization of mortgage loans led to the securitization of car loans, credit cards, corporate accounts receivable, and other assets. This increased the flow of credit into many sectors of the economy. Just as Henry Ford's introduction of the assembly line dramatically increased automobile production, securitization accelerated the creation of credit and economic growth.

It follows then that any meaningful drop in securitization will reduce credit creation, and result in slower economic growth. In the first quarter of 2007, the securitization of residential and commercial mortgage-backed securities totaled just over $300 billion. In the first quarter of 2008, less than $30 billion were sold, a drop of 92%. In the first quarter of 2007, securitization of car and student loans totaled $180 billion. A year later, the total was just $43 billion, a decline of 75%. ***Between July 2007 and March 31, 2008, total global debt underwriting plunged $2.2 trillion, a collapse of 71% since March 2007***.

Last month, I noted that Independent Strategy, a London based consulting firm, had estimated that global credit losses will total $1.4 trillion. In their opinion, that will cause U.S. GDP to decline 5%, which would represent a serious recession. They also expect world GDP to be cut in half to 2.5%. Two weeks ago, Goldman Sachs suggested that total credit losses will total $1.2 trillion. Last week, the IMF put expected losses at $945 billion. To date, about 25% of these projected losses have been written off. Even if all these estimates are off by 30%, we aren't even halfway through this crisis.

It took more than 20 years for Wall Street to build the securitization apparatus needed to handle trillions of dollars. An integral part of this financial assembly line was the trust credit market participants had in the products peddled to them by Wall Street. This trust was aided and abetted by the rating agencies – Standard & Poor's, Moody's, Fitch – who bore the responsibility of analyzing the quality and risk of securitized loans. For a long time, the rating agencies did a good job, which provided the trust Wall Street needed to sell securitized loans, and the confidence credit market participants needed to buy them, ***with few questions asked***. In recent months, as billions of securitized loans went from AAA to junk in a matter of weeks, the trust that took decades to build was trashed. The breakdown in the securitization apparatus isn't just a question of retooling the process to 'fix' it. After the securitization process is changed to prevent the ***next*** breakdown, it's going to take a fair amount of time for credit market participants to trust the rating agencies and Wall Street. And I'm not talking about a few months.

The credit market represents the distribution network for the securitization process. The origination of loans that initiate the securitization process starts with banks and investment banks. The business model of banks has depended on being able to move loans off their balance sheets, so they can make more loans. Since the distribution network for securitized loans has ground to a halt, banks have not been able to move loans off their balance sheets. They were caught with $350 billion of levered private equity 'temporary' bridge loans last summer that they are still trying to unload. Last week, Citigroup announced a deal that would enable them to sell $12 billion of levered loans. This sounded like good news to some analysts, but the terms were less than satisfying. Citigroup is receiving less than $.90 on the dollar, so they will write off $1.2 -

$1.4 billion. Citigroup loaned the buyers $9 billion for the purchase. Basically, Citigroup took a $1.2 billion hit to their capital, and moved just $3 billion off their books.

The write down of loan losses has seriously dented the capital base of many banks, which is why they are being forced to raise capital, even if it means diluting existing shareholders, and cut dividends. More importantly, it reduces the future lending capability of the banking system. Since January 2007, banks have progressively and aggressively raised their lending standards. This is restricting the flow of credit to even good borrowers. ***The Fed has lowered the cost of money, but, more importantly, banks have restricted the availability of credit***. If the estimates of total losses by Independent Strategy, Goldman Sachs, and the IMF are on target, bank balance sheets are going to remain under pressure well into 2009. Banks aren't going to lower their lending standards, if they are booking losses, cutting their dividends, and roaming the world for capital.

Many factors have supported the ***secular bull market*** that began in 1982 in the stock market. Lower interest rates reduced the cost of capital, which made financing expansion and capital expenditures affordable. Credit creation spurred consumer demand, which pushed corporate revenue growth. Tremendous gains in productivity lowered costs and increased output. All of these enabled the P/E for the market to rise from 6 in 1982 to over 30 in 2000, and a reasonable 16 now. But stock prices have also been supported by merger and acquisition activity, buyouts engineered by private equity firms, and corporate stock buybacks, which reduce the supply of stock. Much of this demand was financed by credit, either from banks or the credit market.

During 2006 and first half of 2007, more than $1 trillion of M&A deals and private equity transactions were executed, with another $500 billion of stock purchased by corporations. This demand provided a floor under the stock market, and certainly contributed to rising prices, as I repeatedly noted in 2006 and early 2007. Over the last year, the volume of M&A deals is down 44%. The volume of private equity transactions is down even more. The amount of corporate stock buybacks is also off. Given the contraction in credit creation, and the significant role it played in financing the deal making, an important source of demand for stocks has changed for the worse.

During 2006 and early 2007, the economy consistently met investor's expectations, so investors rarely were provided reasons to sell. With selling pressure very low, the demand from deal activity and buybacks, could easily push the market higher. When bumps in the road appeared in the summer of 2006 and March of 2007, this demand helped arrest those declines. Since the market topped last October, investors have been served a seemingly endless stream of negative news. With the demand from deal making so much lower, the bouts of selling cause more damage, and aren't reversed as quickly. If I'm right, and the economy remains sluggish well into next year, investors are going to be fed a steady diet of disappointment in coming months.

Interest rates fell after peaking in 1981 because inflation dropped, and bond investors gradually became more confident that inflation would continue to recede. In the 1990's, advancements in technology brought forth huge gains in productivity. This allowed the economy to grow above trend without inflation. The addition of millions of workers from Eastern Europe, India, and China to the global labor pool kept wages low, and added a measure of disinflation. When the dot.com bubble burst, these disinflation forces were strengthened, raising the risk of deflation, forcing the Federal Reserve to lower rates to 50 year lows.

India and China only represent 7.5% of world GDP, but combined are consuming 20% to 35% of the world's cement, iron ore, aluminum, copper, and other raw materials. Higher labor costs and material prices have raised the cost of production in China. Since the end of 2006, prices on imported goods from China into the U.S. have risen from -1.6% (disinflation) to 4.0% in March. Overall import prices have soared from less than 1% at the end of 2006 to a gain of 14.8% in the last year. Although imports only account for 12% of GDP, the increase in import prices shouldn't be overlooked.

As worldwide growth improved since 2003, the surplus of oil between supply and demand has narrowed, which has pushed oil to $115 a barrel. The tightness in supply and belief global growth will remain strong, coupled with the instability of some producers, has created a bullish psychology. In recent weeks, energy prices have risen, even as stockpiles climbed and demand fell. In 1982, Congress passed legislation that prohibited drilling off the east and west coasts, despite estimates of huge deposits of oil and gas. In the last 10 years, Congress has thwarted every attempt to drill in ANWR, which conservatively contains more than 10 billion barrels of oil. ***Crude oil would not be at $115 a barrel, if drilling had been allowed off the coasts and in ANWR***. Since 1982, our imports of oil have climbed from 30% to 60% of our daily consumption, which translates into 12 million barrels a day. Oil imports add almost $250 billion to our annual trade deficit. Although members of Congress have decried our dependence on foreign suppliers, the high cost of energy, and our large trade deficit, does anyone believe Congress has the wisdom to increase domestic oil production?

Even with millions of people around the world battling starvation every day, Congress chose to use food (corn) for ethanol, even though it produces 30% less energy than gasoline, just to appease global warming alarmists. The Al Gore Groupies believe those who starve to death will have, at least, given their life for a worthy cause. But by subsidizing corn ethanol, Congress diverted planting acreage from soybeans, wheat, and other grains to corn. Worldwide stocks of wheat are at a 60 year low. This has contributed to higher food prices that hurt the poor, and has led to food riots around the world. In this country, food prices have risen 4% in the last year, the highest in 17 years.

A number of factors that had previously kept inflation low – cheap labor, energy, and food – have reversed higher in the last two years, as millions of workers and consumers from China and India have joined the global economy. Their influence is going to persist for years, which means the bull market in commodities has a long way to go. Many commodities have already gone up a lot, and the consensus is that global growth will remain strong, as the rest of the world decouples from a weak U.S. If global credit losses approach $1 trillion, and the U.S. remains weak well into 2009, the global economy is likely to slow more than the global growth believers expect. Going into 2008, the consensus view was that the U.S. would slow, but avoid a recession. When that expectation was proven too optimistic in early January, the stock market sold off sharply. Investors who believe in the global growth story could suffer a similar epiphany in the next few months, if global growth slows as I expect. This could lead to a quick and sharp decline in commodities in general, including oil. If you want a preview, just look at what the Chinese stock market has done over the last four months (down almost 50%), even though China is the cornerstone of the global growth story.

We've enjoyed almost 25 years of a ***secular downtrend in inflation***, which made it possible for interest rates to fall to very low levels. Low interest rates funded economic growth and securitization accelerated credit creation. This made it possible for home values to soar and the DJIA to rise from 800 to over 14,000. Household debt as a percent of GDP has climbed from 44% in 1982 to 98% now. The ratio of total credit to GDP has more than doubled, rising from 165% to 353%. The process of securitization has broken down, and the balance sheets of banks are going to remain under pressure well into 2009. Once the economy improves, interest rates will rise. Given the levels of debt, any significant rise in the cost of money will create a sizable drag on economic growth, as the cost of debt service rises. In order to work through this challenge, we're going to need the economy to grow fast enough to generate the cash flow needed to support asset prices and service existing debt levels, without putting too much upward pressure on inflation and interest rates. It's going to require one hell of a balancing act.

In 1966, few investors could have foreseen that a new era was about to unfold. The economy and stock market had just enjoyed a phenomenal 24 year run from 1942 that helped the DJIA rise from 100 to 1000. But over the next 16 years, the DJIA made no upward progress. Between 1966 and 1982, the market swung between 1000 and 600, as the U.S. economy worked through many problems. I don't know if we are on the threshold of a similar experience. I do know that we've enjoyed a 25 year secular downtrend in inflation and interest rates, and a secular uptrend in the growth of debt, stock prices, and real estate values. I believe that the dramatic slowdown in credit creation we've just experienced will have a lasting affect on the availability and cost of credit and on economic growth. The need for consumers to save more will also retard growth. Since consumers represent 70% of GDP, just a 1% increase in savings will shave .7% off of annual

GDP growth. A tidal wave of baby boomers will begin retiring in coming years, and many will need to sell their home and stocks to fund their retirement. Are these the agents of a ***secular change*** that we will look back on in a few years, and, with the benefit of hindsight, recognize just how important they were?

FEDERAL RESERVE

Between 1946 and 1982, the U.S economy experienced 8 recessions, averaging 10 months in duration. Since 1982, there have only been 2 recessions, and both ended after 8 months. Clearly, in economic terms, the last 25 years have indeed been remarkable. This record is also influencing expectations for the current recession. The consensus for the U.S. economy has been for a weak first half, followed by a rebound in the second half, as tax rebate checks are spent and the aggressive easing by the Fed lift the economy. If the recession began in January and lasts 8 months, it should be over just after Labor Day. Gee, this forecasting business isn't so hard! As I noted last month, "*Third quarter GDP could be boosted by .8% or more, as rebate checks are spent. This should convince those who are expecting a recovery that their forecast is on target*." The key question, as I have suggested the last two months, is whether the boost from fiscal stimulus will be enough to ignite a ***self sustaining economic expansion***. I don't think it will, given the contraction in credit creation that will persist into 2009.

At the last FOMC meeting, two members voted against the size of the last cut, citing inflation concerns. Clearly, in recent months, Fed policy decisions have been driven by the credit crisis, culminating with the collapse of Bear Stearns. A majority of FOMC members simply felt the crisis outweighed the risks posed by inflation. With more stability returning to the financial markets, more FOMC members are likely to give inflation concerns greater emphasis. My guess has been that the Fed will cut the Federal funds rate from 2.25% to 2.0%, when they meet on April 29. However, whether the FOMC cuts another 25 basis points or not, the more important story is that the FOMC wants to wait to see just how the economy performs in coming months as fiscal stimulus is put to work.

STOCKS

Going into 2008, the consensus was that the economy would slow, but not go into recession. After hitting a trough in the spring, analysts expected the economy to improve for the remainder of the year. When investors realized that the economy had gone from slowing to contracting, the market sold off hard, since their expectations had been so wrong. Now, the expectation is that aggressive Fed action and a dose of fiscal stimulus will get the job done. Investors believe that the market will rally, once evidence of rebound appears. No one wants to miss it. Some are willing to even be a little early. This mindset means investors are looking for the slightest hint of

improvement. Psychology has shifted from being afraid of negative news, and selling stocks, to not selling stocks on negative news, because ***the focus in on not missing the rally***. Negative news is looked at as an opportunity to buy, so portfolios will be positioned when the market takes off to the upside.

In recent days, the stock market has found encouragement that losses at a number of banks and investment banks weren't worse than expected. It has also been cheered by comments by several investment bank CEO's that the worst of the credit crisis is behind us. And we can be assured that they would only give us the straight scoop. Of course, those views overlook Goldman Sach's announcement on April 9 that their Level 3 assets soared 39% from the end of November to the end of February, rising from $69.15 billion to $96.39 billion. Level 3 assets are so illiquid and trade so infrequently that they have no reliable price, so their valuations are based on management's best guess. Where's Carnac the Great when you need him! The Level 3 Category is like the halfway house for loans that will likely be written off in coming quarters. Tellingly, commercial and residential mortgage loans increased from $1.02 billion in February 2007, to $14.57 billion in 2008. Goldman Sachs has forecast that commercial real estate values will decline by 26% in the next 2 years. Given what's happening to their own loan portfolio, they may be working with inside information. Moody's has forecast a 15% to 20% decline in commercial real estate. If anything close to that develops, there will be another wave of write downs. I don't think the stock market would handle that well, since the economy wouldn't handle that news too well either.

The market has also been boosted by the earnings of a number of large international companies (IBM, Intel, Google, Catapiller) reported earnings that were given a nice lift from their international exposure. Decoupling lives! The U.S economy went from slowing to contracting around the beginning of 2008. My guess is that the global economy will begin showing noticeable wear and tear six to nine months after the U.S turned south. That window would target the July – October window. We'll see. It might even happen sooner.

As I wrote last month, "*We are in a bear market. Most bear markets, have at least two significant declines. The bear market of 2000 to 2002 had three. I thought the market would find support in the 1225 to 1275 zone on the S&P, and it has. This suggests the first leg of this bear market probably ended last week, when the S&P bottomed at 1257. The decline from the high in October totaled 319 S&P points (1576-1257). A 50% retracement of the decline would allow the S&P to rally back to 1420. There is significant chart resistance around the 1440 level. Bear market rallies provide investors the opportunity to lower exposure*." If we are in a bear market and the economy falters after the tax rebates checks are spent, the stock market will make another important intermediate top sometime in the next few weeks to 3 months. I don't think we are there yet. If

the S&P can close above 1397, the market should get another lift that approaches the targets cited last month 1420 – 1440.

BONDS

In every recession since 1948, the inflation rate has declined whenever a recession has occurred, and it will as a result of this recession too. Although inflation has been trending lower since 1981, it will likely trough at a higher low than in 2002. If it does, it would signal that the secular downtrend in inflation and interest rates was over. At a minimum, the rate on the 10-year Treasury bond would trade between 3.5% and 5.5% for years. Over the next year, a range of 3.3% and 4.2% is likely. Last month's analysis appears on target. "*The consensus is that the economy is going to recover in the second half. Since the economy will get something of a lift as the rebate checks are spent, bond yields are likely to drift higher in coming months. In addition, the expectation of additional rate cuts by the Fed is going to lessen, as long as another credit problem doesn't emerge in the next 60 days.*" Since then, the 10- year yield has edged up from 3.52% to 3.74%. A test of 3.96% is likely. The 10-year Treasury bond would be a buy, if the 10-year yield reaches 4.1%. Higher mortgage rates are a negative for housing.

GOLD

Gold rallied almost $370 from the low last August, which started after the Fed began easing. A 50% retracement of that move would take Gold down to near $850. My guess is this correction could last until June, with Gold bottoming between $800 and $850. The next leg up could begin, once the ECB moves to cut rates, sometime over the next few months.

DOLLAR

Buy the Dollar when it closes below 70.90 on the cash Dollar index.

E. James Welsh