

A Year of Transition toward “Normalization”

Economists often refer to “normalized” conditions or “normalized” assumptions. Generally, this term captures economic outcomes that reflect the influence of recurring, sustainable, or trend-like factors. One time events or circumstances which are unlikely to repeat are removed from analytical frameworks. In this manner, the focus is squarely on the determinants of long term growth.

It is quite clear from the market debacle of 2008 that many factors behind economic growth this decade proved unsustainable. In particular, the dependence upon leverage (i.e., borrowed capital) reached its breaking point. Numerous analyses suggest that much of the economic growth of the past decade would not have occurred absent huge sums of debt. This is not unusual. Economic growth in the past has also depended upon borrowed money, and consequently, most economic crises develop when leverage becomes excessive. The unusual nature of this crisis is its magnitude and the means by which capital was distributed globally. In several ways, the markets are undergoing a transition – a “normalization” – toward an environment with considerably less leverage. For those dependent upon leverage, this transition will require significant adjustments, many of which will be involuntary. For all, the financial markets could be returning to a simpler structure which should facilitate sustainable long term growth. It is likely that this period, as is the case with any transition, will prove volatile and, for some who remain unprepared or in denial, quite painful.

Discussion of Leverage

Leverage is the use of **OPM** (i.e., “Other People’s Money”). Leverage is fixed cost financing, and in order for leverage to remain manageable, either income or asset values must grow substantially. Leverage is a means of borrowing from future income as most debt is long term in duration. Leverage benefits from inflation as debt is repaid over time with cheaper currency. Leverage facilitates economic growth as many consumers would otherwise lack the capital to purchase major capital items.

Illustrations of leverage:

A person buys a \$400,000 house with equity of \$80,000 (i.e., 20% down payment). This implies leverage of 80% -- a leverage factor of **4-to-1**. The house appreciates 5% over the next year. The equity in the house, however, appreciates **25%** because of this leverage. See table on the next page.

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	<u>Year 1</u>	<u>Year 2</u>
House Value	\$400,000	\$420,000
Mortgage	\$320,000	\$320,000
Equity in the House	\$80,000	\$100,000
House Appreciation		5%
Equity Appreciation		25%

This model works well when asset values continue to rise, and the naïve assumption behind the housing market was that home prices would always rise. Residential real estate, on a national basis, had fallen in just one year out of the past 75. That is a fairly remarkable track record for an asset class – as close to a “sure thing” as one could possibly imagine. As is taught in introductory finance, however, merely extrapolating historical trends is a practice fraught with danger. Thus, when property values tipped over and began their descent, investors learned quickly that leverage is symmetrical (i.e., it has the same economic impact on the way down as it does on the way up):

	<u>Year 1</u>	<u>Year 2</u>
House Value	\$400,000	\$380,000
Mortgage	\$320,000	\$320,000
Equity in the House	\$80,000	\$60,000
House Appreciation		-5%
Equity Appreciation		-25%

Even though a **5% decline in property values** does not sound disastrous, the equity in the house **declines 25%** when applying a leverage factor of 4-to-1. To compound the misery of falling property values, lenders become concerned about future losses and tighten credit. For those who need to liquidate their asset or refinance, they discover that banks will require additional capital because the leverage factor has consequently risen with the decline in equity.

Now consider the banking industry: following the misguided relaxation of some regulations in the late 1990s, investment banks were permitted to greatly expand the leverage they utilized in their daily operations. Then, with the explosive growth in securitized markets, financial whiz kids developed products that effectively allowed for the greatest expansion of leverage in world history. In effect, banks utilized their own leveraged business models to provide ever greater amounts of leverage to their customers. Eventually, the amount of leverage reached ridiculous proportions, in some cases factors of **40-to-1**, which rendered the entire system vulnerable to very small declines in asset values. Consider the following hypothetical impact on a bank's balance sheet:

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	Change in Asset Values	
	<u>Year 1</u>	<u>Year 2</u>
Assets	\$ 40,000,000,000	\$ 39,100,000,000
Liabilities	\$ 39,000,000,000	\$ 39,000,000,000
Equity	\$ 1,000,000,000	\$ 100,000,000
Leverage Factor	39	390
Change in Equity		-90%

So, a **mere 2.25% decline** in asset values is sufficient to **eliminate 90%** of the equity of a banking institution with a leverage factor of **39-to-1**. Ironically, as the decline in asset values eliminates much of the equity, the leverage factor rises considerably, rendering the institution less creditworthy. Eventually, the diminished equity reaches a point which might not support the operations of the bank. Capital injections are therefore needed, in certain instances, to preserve the public mission of many of these institutions – i.e., to provide capital to creditworthy customers.

The Virtuous Cycle turns Vicious

One other important aspect of leverage is the fact that it magnifies returns when asset values appreciate. Rising asset values provide support for additional leverage. Leverage additionally facilitates transaction activity which further helps to elevate asset levels. As certain assets are liquidated for various reasons, the resulting gains enhance the income for those that had borrowed. As realized gains are recycled back into the markets, leverage fuels an expansion of investment opportunities. Leverage also contributes to a consumption binge. With securitized markets broadening the availability of credit (i.e., leverage), investing in illiquid, leveraged asset classes like real estate becomes a form of savings that highly depends on continually rising asset values. Broadening markets fuel competition among lending institutions, and as lending institutions compete for greater market share, credit standards are lowered. Eventually, consumers secure credit for specious ventures, and formerly non-creditworthy borrowers obtain capital. Manifestations of this cycle were “no down payment, no documentation” mortgages. People without sufficient income or poor credit histories were approved for home equity lines and high credit card balances. Inevitably, the credit bubble bursts, and the capital spigot is abruptly shut off. However, the liabilities from a decade of excessive leverage remain, and those debts need to be redeemed.

It begs the question, of course, how fast our economy would have grown if banks had not been permitted to greatly boost their leverage. There was an opportunity in 1998 for our policy makers to address leverage in the banking system, but they opted for the opposite route – i.e., greatly relaxing the limitations of banks in their use of leverage. In effect, our policy makers rewarded speculation and excessive risk taking because they operated under the fallacy that the markets would “self correct” before conditions grew out of control. Undoubtedly, both

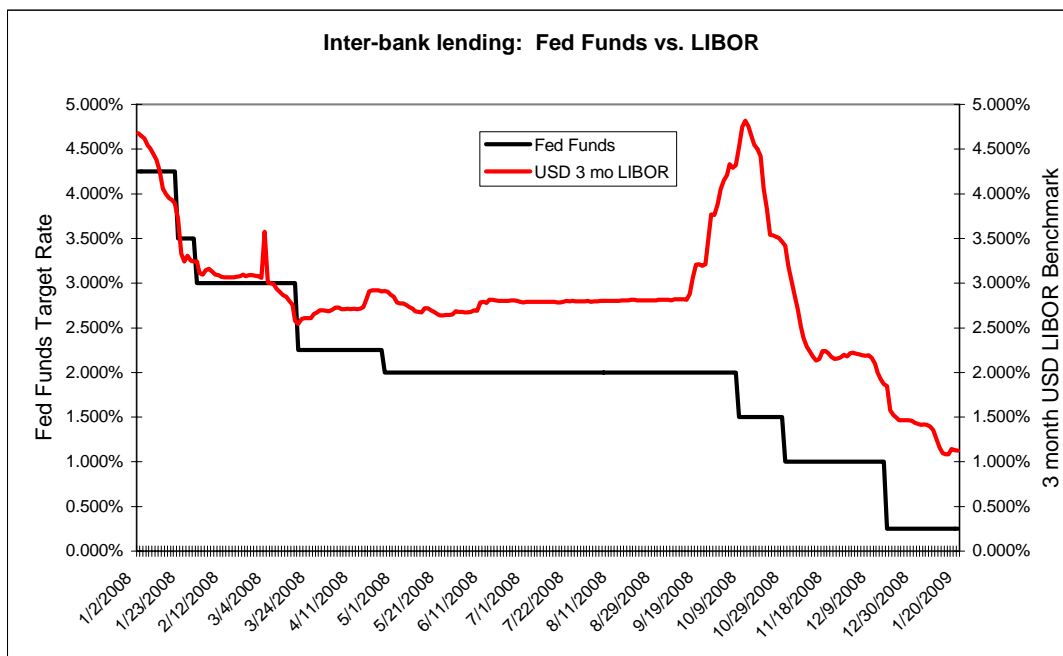
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economic growth and corporate earnings would have proved unsatisfactory to some participants had leverage been curtailed. It has been proven yet again, however, that economic growth which is overly dependent upon leverage is unsustainable. Eventually, the markets “tipped over” and leverage began the process of being unwound. This de-leveraging process obviously began in 2007, accelerated throughout 2008, and has continued into 2009. It is also global as many European banks are succumbing to the same pressures as our institutions.

So, here we are. Now what?

Clearly, economic growth, with or without much governmental assistance, is difficult to achieve with a dysfunctional banking system. Banks help allocate capital by serving as intermediaries between those that have capital (i.e., lenders) and those that need capital (i.e., borrowers). Ultimately, interest rate adjustments help to equilibrate the supply and demand forces driving the capital markets. So, Step One in the process of restoring a sound financial system involves shoring up the banks. On December 16, 2008, the Fed initiated Step Two:

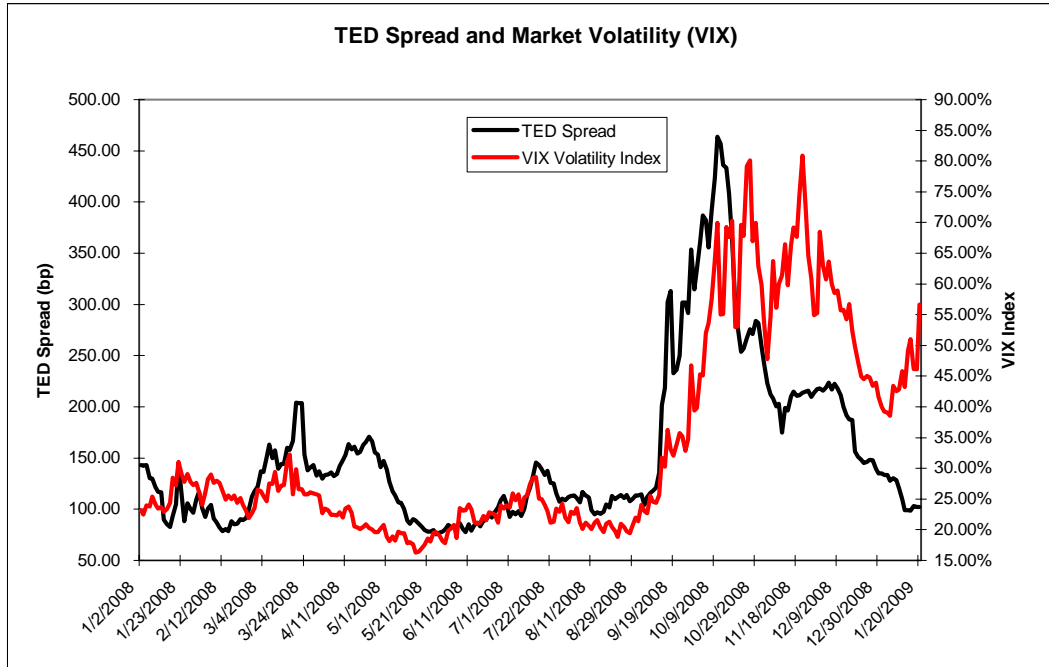


The manifestation of frozen credit markets is the widening of yield spreads – the relative cost of funds in the form of a yield premium demanded by investors – i.e., the wider the spread, the weaker the credit. The Fed’s actions prior to December 16th had been engineered to “unclog” the short term credit markets in which banks provide financing to other banks. The relative cost of funds (i.e., the yield spreads) in the inter-bank market is measured by LIBOR’s relationship to T-Bills (i.e., the TED Spread). During the Third Quarter, both LIBOR and the TED Spread remained at stubbornly high, historic extremes. Banks were simply not willing to lend to each

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other. That has since improved, and it is likely that the Fed's massive injections of liquidity have succeeded in reducing the cost of funds for banks. That was step one.



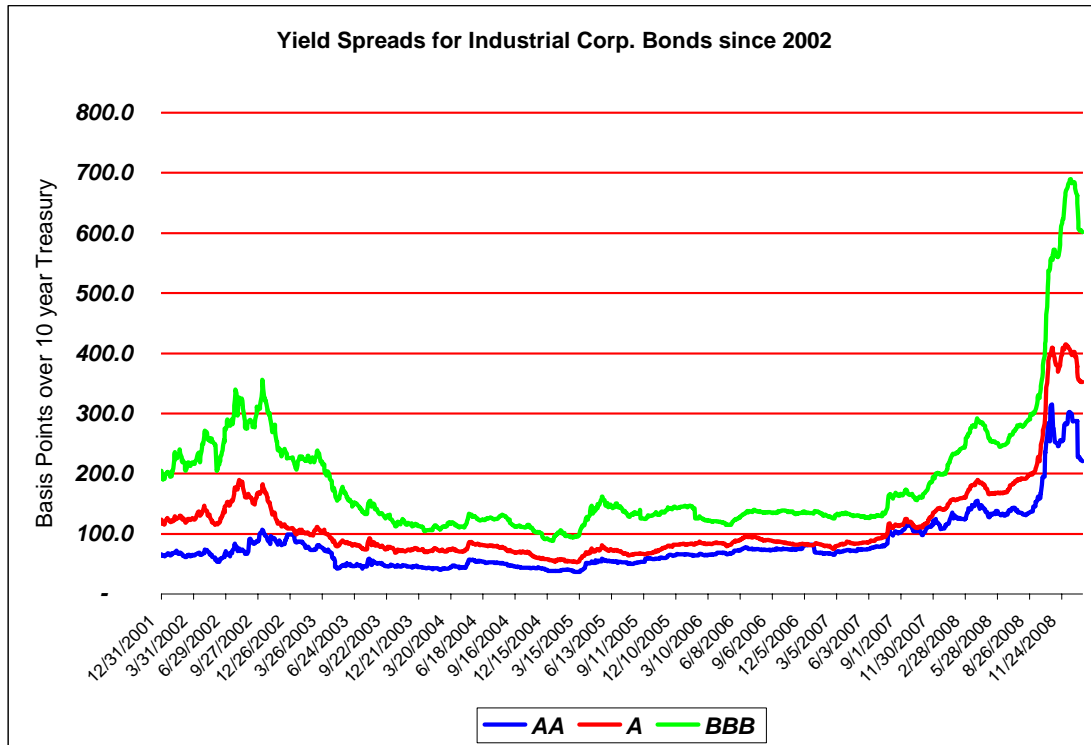
Step Two. It seems the Fed's change of course on December 16th indicates that they have now turned their attention to reducing the cost of funds for everybody else. This is a natural progression of their policies to date. While the actions during the Third Quarter began to have their desired effect, yield spreads for every sector and asset class remained stubbornly high. So, while the banks regained comfort with lending to each other, they were not comfortable lending to anybody else.

Since that time, 10 year Treasury yields have collapsed nearly 200 basis points. Ironically, yield spreads have continued to widen somewhat. That implies that credit spreads remain stubbornly wide. There is a valid interpretation that credit conditions continue to worsen. That view has merit, but part of the spread widening relates to the collapse in Treasury yields. Bonds are now trading on a nominal yield basis – i.e., investors seek a minimal yield regardless of the strength of the underlying credit. In other words, the cost of funds for companies, municipalities, mortgages, etc. has yet to drop commensurate with the decline in benchmark Treasuries. In effect, the Fed's recently announced intentions are designed to reduce the nominal cost of funds for most other sectors, and as confidence improves, we are likely to see credit spreads begin to fall. That should prove to be the most reliable lead indicator for all markets, since this was a collapse in the global credit markets. As global credit markets regain

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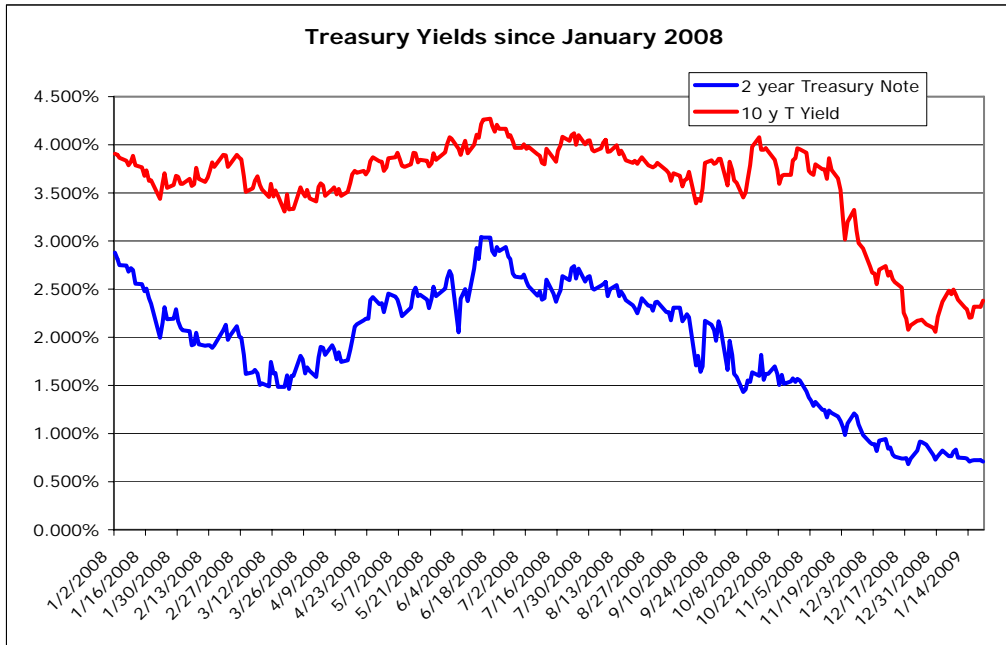
confidence, as manifested in spreads, liquidity should improve and markets will respond in kind, including equities.



Two other motivations for the Fed's actions: first, they clearly wanted to drive real interest rates (i.e., nominal rates less inflation) into negative territory. This effectively creates stimulative monetary policy. Heretofore, policy rates became arguably neutral or restrictive after inflation disappeared. The Fed's actions equilibrate policy with the new environment of deflation. It also penalizes those that seek to remain in cash, which could be their ultimate goal. The Fed clearly desires investors seek more risk. Second, the Fed likely sought to flatten the yield curve in order to "encourage" bank lending. As is well documented, banks have been hoarding cash for the past year. The money supply has grown exponentially, but the velocity of money has collapsed. Banks were not given the proper incentive to lend as they could simply arbitrage their low cost of funds. That is, while the Fed's actions succeeded in reducing the cost of borrowing through the interbank market, banks could simply reinvest those proceeds in higher yielding Treasuries and watch their net interest margins expand. With the change in direction from the Fed and the corresponding reaction by the bond market, banks can no longer passively benefit from policy maneuvers through an expansion of net interest margins. In other words, the same message was delivered to the banks: we will penalize you if you stay in cash/Treasuries.

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Is a world without leverage “normal”? No. Is a world with less leverage “normal”? Yes.

Eventually, credit markets will function properly, and capital will be allocated more efficiently. Yet, it is also likely that tighter regulations will restrict the amount of leverage in the system. That implies a slower rate of economic and earnings growth. For a while, governments will serve as the engines of economic growth. To some, that will prove frustrating. Longer term, investors should greet this “*new normal*” with enthusiasm as it implies a more stable system which, in turn, should facilitate sustainable growth.

In the meantime, the ongoing de-leveraging in the markets has resulted in massive asset deflation. As a general rule of thumb, it is preferable to be a creditor/lender during periods of deflation. It is better to be a borrower during periods of inflation. This relates to the future purchasing power of one’s currency. In deflationary times, the purchasing power of cash rises. This present condition favors a strategy which emphasizes credit instruments (e.g., certain bonds). For example, while the cost of capital for many corporations remains relatively high because of yield spreads, this represents opportunity for investors to boost income as the markets traverse this period of transition.

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What should investors do?

We favor business models and asset classes that do not depend on leverage. Until we emerge from this recession, we also favor business models that depend on non-discretionary income as opposed to discretionary income. We currently prefer credit over equities:

1. **Risk spreads provide good income and long term rewards**: the yield spreads currently available in **high grade corporate bonds** are compellingly attractive.
2. **Protect against rising taxes**: likewise, the nominal yields available in **high grade, tax free municipals** are attractive. If tax rates rise as expected, municipals will only increase in their appeal as an asset class.
3. We favor **gold** as a hedge against devalued currencies.
4. As a hedge against inflation, we recommend instruments like **TIPS** (Treasury Inflation Protected Securities). We have confidence that recent policy measures will prove successful in reinvigorating our economy. In that event, we believe investors will need to hedge themselves against latent inflationary pressures.
5. Equities: Remain **defensive**, but think long term and be **opportunistic**: the panic has rendered attractive many high quality companies with stable cash flows, solid balance sheets, and good business models. We prefer stocks with attractive dividend yields. Position accounts with an emphasis on capital preservation. However, do not abandon the markets and also remain positioned for "the turn." Market uncertainty is generally ripe with opportunities for long term investors. Patience will be rewarded, as will discipline. **There is a tremendous amount of cash "sitting on the sidelines."** Eventually, these funds will be re-allocated to other asset classes. Cash will re-enter the capital markets once confidence is restored.
6. **Commodities** sectors: the collapse in various commodities sectors, as well as the prices for actual commodities, presents long term opportunity. Price collapses below the marginal cost of production discourage development, which threatens the long term supply balance especially for crude oil. We feel commodities will be one of the first sectors to respond positively to a rebound in global economic activity.

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Long Term Investment Areas to which we remain favorably disposed:

Financials: selective inclusion of certain franchises with solid balance sheets and sustainable business models. We feel it is important to maintain limited exposure to this sector, but we do not advocate complete avoidance. Mohammed El-Erian of PIMCO believes that bank business models, in a world with substantially less leverage, will resemble those of utilities – i.e., negligible growth potential; low valuation; restrictive capital structures; attractive dividend yields. Fundamentally, the sector is unlikely to experience demonstrable improvement absent massive consolidation.

Energy: the collapse in crude prices could discourage exploration and production, as it did in 1998. Long term, this dynamic renders the sector attractive as supply shortages will facilitate prices to rise over time.

Agriculture: We favor investment opportunities along the entire “food chain”: hybrid seeds; fertilizer; equipment; processing; storage. Driven by commodities prices, this sector is also prone to occasional price spikes that render valuations unjustified.

Water: perhaps the most important environmental and economic issue facing the world. We believe investment in all aspects of water development -- irrigation; sanitation; delivery; purification – are vital.

Alternative Energy: until a particular type of energy source becomes prevalent, we favor a “basket” approach using diversified ETFs. However, we feel that this sector, too, represents an important long term investment allocation.

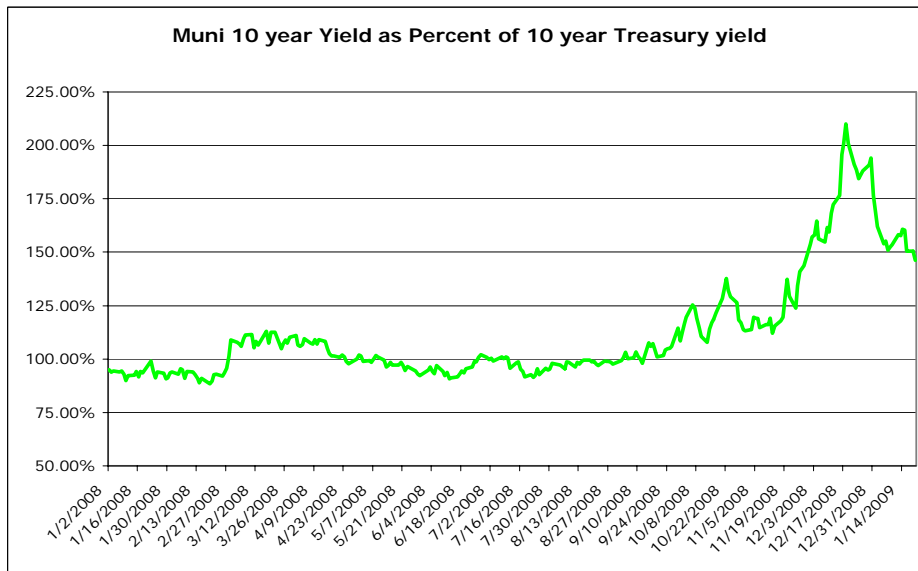
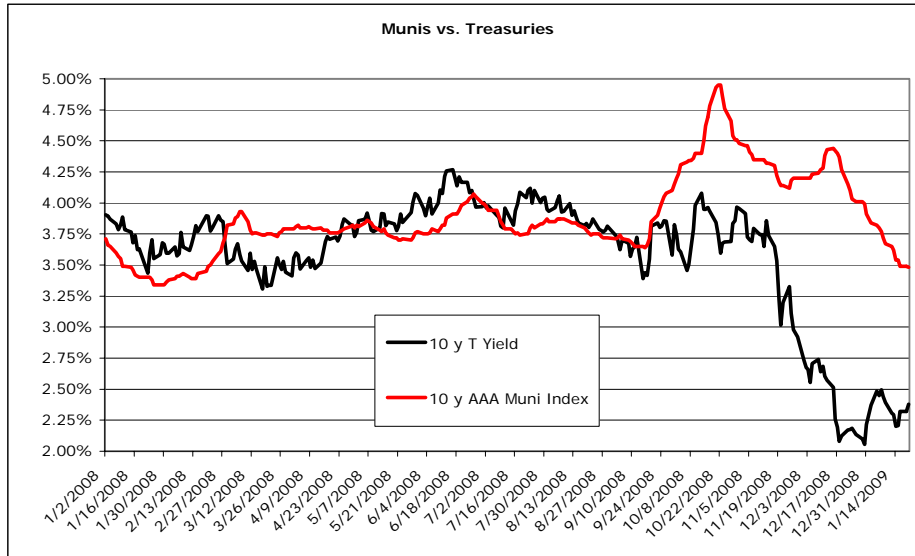
Global Infrastructure: much hinges on the continued rapid expansion and build out of emerging Asia, particularly China and India. We believe many US companies are well positioned to provide the resources necessary for the Eastern hemisphere to improve its standard of living.

Tax-Free Municipals: given US fiscal pressures, we anticipate higher tax rates in the future. High quality tax-free municipal bonds could provide a stable source of income with attractive nominal, as well as taxable equivalent, yields.

International: no economy will be immune from a global slowdown, but we feel certain countries are better positioned long-term than others. Brazil, in particular, has the potential to become both an agricultural and an energy superpower.

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Other markets that are *“not normal”* – tax-free municipals have historically offered yields **80 – 85%** of comparable taxable bonds. When higher nominal yields are available in tax-exempt instruments, investors have the opportunity to capitalize on such dislocations as they likely will prove temporary. We believe tax-exempt yields will *“normalize”*, eventually, to their traditional relationship to taxable bonds.

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