

I have rarely looked forward to the prospect of a new year as much as I have in recent months. 2008 was a year for the record books but not one I would care to experience again. What a shame it is that after many prescient moves during the early stages of the financial crisis that began with the sub-prime mortgage meltdown, our central bank and treasury department took their eye off the ball at a critical juncture.

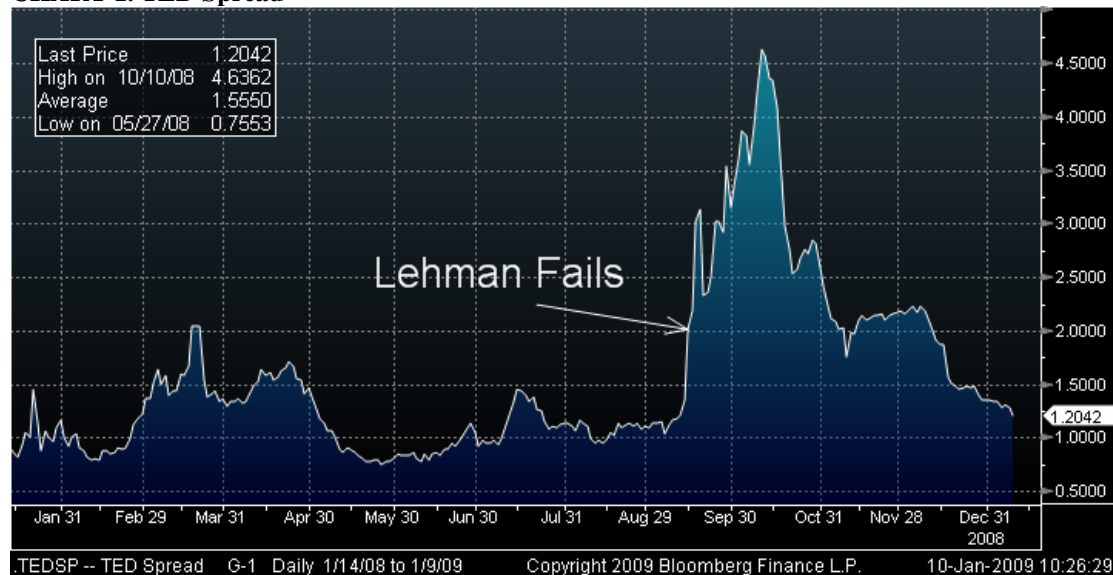
Since the Spring of 2007 I have written about various aspects of the sub-prime mortgage problem as it grew from an interesting problem to full blown credit crisis. But sub-prime mortgages alone could not create the problems we see today in the world economy. In total they were “only” about a trillion dollars of notional amount. If even half of that amount could be realized by distressed real estate sales it would equal about four percent of GDP. This is certainly a large amount but hardly crippling to the world’s largest economy. Yet, even as recently as the auto-company bailout hearing, Congressman Barney Frank was still talking about sub-prime mortgages.

Only weeks before the stock market’s panic the August survey of Chief Executive Officers by the Business Roundtable showed an up-tick in confidence, and from a relatively high level. As late as last September 11 a highly regarded economist reported there were “indications of a global slowdown.” “Slowdown”, not recession. His forecast at that time for our economy was “no recession, no recovery.” So what happened? How did we come to suffer a stock market panic which resulted in the third worst annual decline in a hundred years, with a synchronized global recession, as commerce collapsed all over the world?

Lehman Brothers was left to fail. The Fed and the Treasury decided to defend the principle of limited exposure to the taxpayer. Both moral and economic efficiency arguments said the losses should be borne by those who took the risks. On rare occasions, policymakers step in to prevent a fire sale in asset prices by moving sector losses onto the public sector balance sheet, but not this time. Unlike in March when Bear Stearns failed but the credit markets were kept whole, Lehman creditors were not saved. Confidence was lost (not a good thing in a system that uses fiat money). The credit markets seized.

Chart One, below, shows the yield of the TED spread. It measures the difference between Euro-dollar rates and treasuries. It is considered a measure of risk because treasuries are considered risk free and the Euro-dollars reflect the credit ratings of corporate borrowers. Normally the spread is around half a percent. On September 15, the day that Lehman failed the spread rocketed from an elevated 1%+ to over 2 percent. Within two days it had reached 3 percent. A month later, as the stock market panic hit its crescendo, it was higher than 4.6%. Borrowing and lending world wide dropped to a trickle as lenders lost confidence in even the highest rated borrowers.

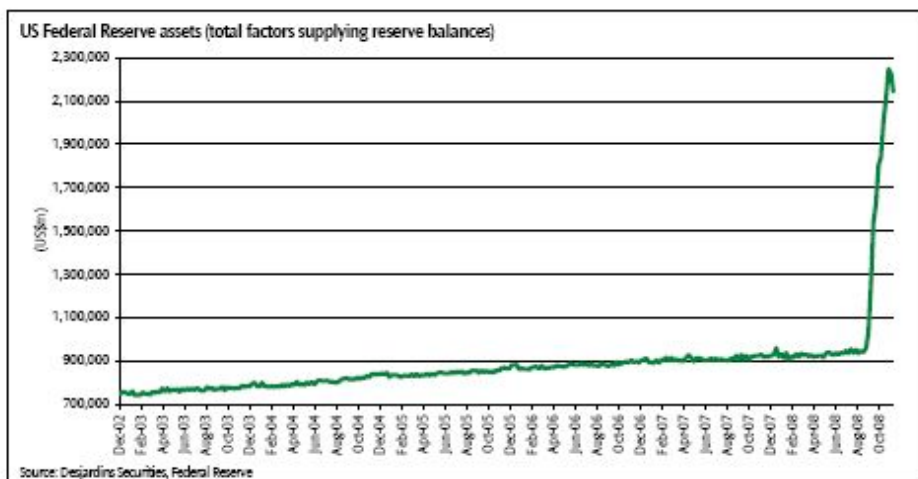
CHART 1. TED Spread



Since that mistake the policy response by the Fed and Treasury has been unprecedented. While Congress debated “the Bailout” (otherwise known as the Troubled Asset Relief Program, or TARP), Fed Chairman Bernanke acted. Chart Two shows the assets on the Fed’s balance sheet. In very short order the Fed’s balance sheet tripled, an amount equal to about three Bailouts. Between commitments and funding there is about \$7.5 trillion dollars worth of stimulus in the pipeline with maybe another trillion coming from the new administration’s plan. And that’s just the US.

CHART 2. Federal Reserve Balance Sheet

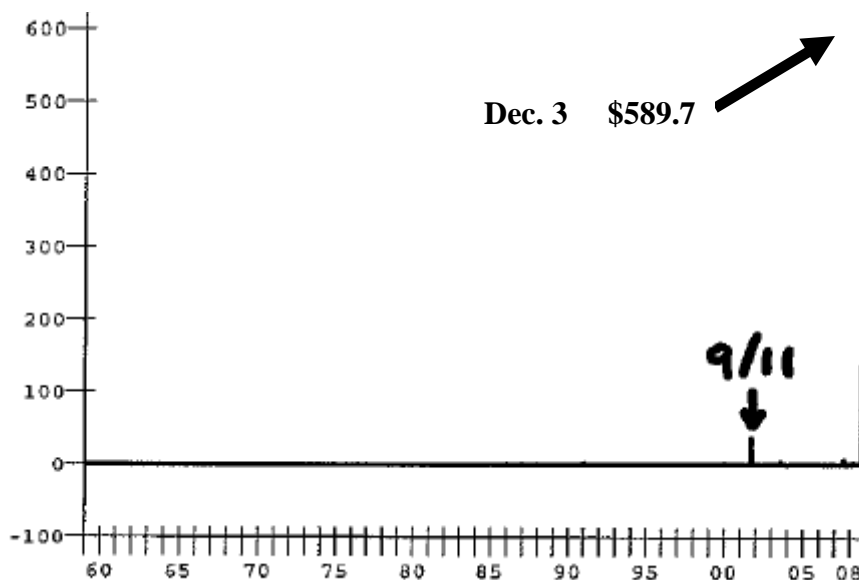
Foreign governments around the world have also opened the stimulative floodgates. Interest rate cuts, cash infusions, tax cuts, and fiscal spending have all found their way into governments’ plans to revive sagging economies.



We see and hear comments on the financial news shows, relating the present day crisis to the Great Depression. I agreed with Chairman Bernanke when he was queried about this relationship after a speech he made on December first. There is “no comparison between now and then,” he said. In the early 1930’s we saw deflation of 10% per year. Monetary policy was tightening. GDP fell by a third. There was no Fed action as banks failed and the financial system collapsed. “Now,” he said, “we are being aggressive as possible to allow the system to recover.”

So, why are we still seeing deterioration in the economy? Well, it takes time for the fixes to work. Let's consider the TARP for instance. Both the Treasury and the Fed have infused the banking system with huge amounts of money. Chart Three, provided by the ISI Group, shows how unprecedented these actions have been. Consider the magnitude of today's bank infusions as compared to what Chairman Greenspan did after 9/11. But, even though the banks have a lot of capacity to lend it takes time to loan money. Of course, it also takes inclination and there is little doubt that is in short supply these days.

CHART 3. Banks Excess Reserves



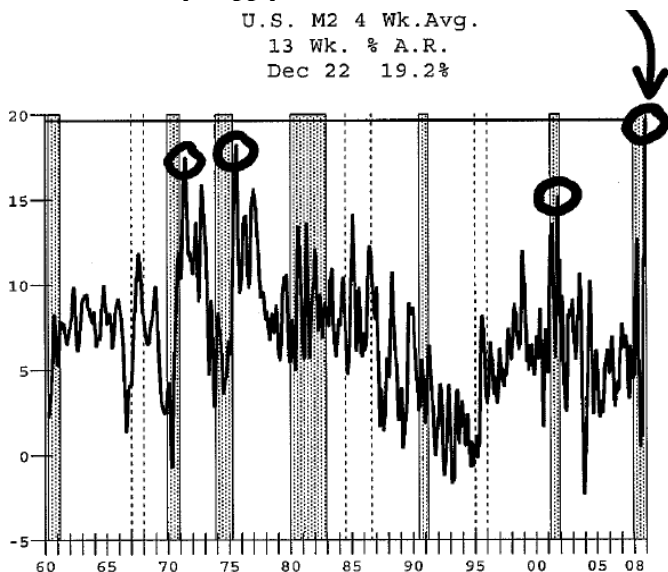
However, there are signs that a recovery may be not too far off. Go back to Chart

One. Recent levels of the TED spread are around 1.2%. Still elevated, but 75% less than in October. Likewise, spreads in other areas of the credit markets have begun to tighten. The main corporate bond spread I follow has tightened by more than 25% since its peak at the beginning of December. The ISI Group shows in Chart 4, that money supply growth now exceeds the levels that has marked the end of past recessions. Even car sales have begun to up-tick in the past couple of weeks.

As usual, I'm trying to be a contrarian and the above points provide some reason for optimism amongst the gloom and doom being reported everywhere. Unfortunately, there have been very few signs the deterioration in the global economy is slowing. Until that happens the markets will continue to be problematic.

CHART 4. Money Supply Growth

U.S. M2 4 Wk. Avg.
13 Wk. % A.R.
Dec 22 19.2%



In coming months we will probably see the employment numbers worsen. But this is a lagging indicator so not one to follow as far as investing goes. We will see deflation for the first time since the 1950s. The collapse in commodity prices after their incredible rise last year, coupled with falling rents due to the real estate problems, should be

enough to offset rising areas, like healthcare. A sign of health in the economy will be if we see rising, or perhaps at least not falling, interest rates for treasury securities when deflating CPI numbers are reported. We expect the American economy to recover first among major world economies. Current estimates are for positive growth to be first recorded in the third quarter. A concern we will be watching is how the Fed reverses the stimulus in the system as the economy recovers. So much extra money in the system could trigger an inflation problem in the future. But that is nothing we have to be worried about today.

For the past few years there has been scant premium being paid in the markets for assuming risk. Our investment tactics were then to take little risk. We were defensive with both stock and bond investments. We are now facing a completely opposite situation today as investors have been reluctant to assume risk for any price. We are investing with the expectation of a recovery in our economy. Over time we will be lowering our over-weight in defensive sectors of the stock market and over-weighting areas with more sensitivity to economic growth. Unlike years past, we are trying to limit our exposure to foreign economies and are looking for companies with mainly domestic businesses. In fixed income portfolios we are back looking at corporate bonds for taxable portfolios.

We wish you, and expect, a Happy New Year!