

# INVESTMENT UPDATE

What a year. Recession. Collapse of the entire brokerage industry. Receivership for Fannie and Freddie. The trillion dollar-plus expansion of Government stimulus programs. The worst year ever for relative performance of high-grade corporate bonds. US car companies on the verge of bankruptcy. The return of Britney Spears. Bad stuff.

We've used up a lot of ink writing about the problems in our markets, and quite frankly, we're tired of it. We suspect that you, too, are feeling a bit fatigued by the seemingly endless litany of negative headlines. So, in the interest of "lighting a candle rather than cursing the dark" we offer up some reasons to be positive, and some promise that all is not hopeless. Despite all that's happened (and in some ways, because of it) we are feeling pretty hopeful as we look towards 2009. Here, in no particular order, are some reasons to look forward to the coming year:

**You're Alive.** As obvious as it seems, there's a lot to be said for being alive. The world is a big, beautiful place, filled with wonder and beauty, diverse cultures, food and music. Friends and family. A dog that greets you when you walk in the room. A favorite pair of shoes. Laughter. Or, as Woody Allen would have it, "Life is full of misery, loneliness, and suffering—and it's all over much too soon." So, to paraphrase Frank Sinatra: swing, baby!

**You're Employed.** Unless you're fortunate enough to be one of our retired clients, if you're reading this, you've got a job, and chances are you've got a pretty good job. While it's true that unemployment is rising, and will certainly continue to rise for at least part of 2009, most of us are still gainfully employed and will remain so for the foreseeable future. We should also take some comfort in the fact that the US, for all its problems, has one of the lowest unemployment rates among highly-developed countries, as well as arguably the most flexible and adaptable work force in the world.

**Home Prices are Bottoming.** Note that we didn't say "bottomed"—prices are still falling, but the rate of decline is slowing. If current trends continue, we could see the low point in average US home prices sometime around the middle of 2009. This is an extremely important piece of the current financial puzzle—once home prices flatten out, holders of weak mortgage loans and securities based on those loans can have some confidence that the write-downs of these assets will finally come to an end. This, in turn, will encourage both individuals and institutions to

begin reconsidering their current highly risk-averse posture.

**Iraq is More Peaceful.** Hasn't it been great to see the situation in Iraq improve, not just for our servicemen and women, but for the citizens of Iraq? Sure, there's still a lot of work to do, and in many ways it's still a very dangerous place (more than just flying shoes), but there has been real progress between the warring factions, and that means that the US' role can be reduced significantly. The timing is fortuitous, as the expense of sustaining a massive fighting force is especially burdensome given the host of economic stimulus expenditures, both current and prospective.

**Inflation is Falling.** Propelled by the sharp drop in petroleum and other commodity prices (which are at least partially attributable to weaker global economic demand), the rise in consumer prices has slowed measurably. Currently, nominal CPI is just 1.5% higher than at this time last year, a rate that's fallen more than 4% from July's recent high of +5.6%. Core (ex-food and energy) CPI is stickier at +2.0% but is expected to fall to below 2% early next year. In fact, central bankers are beginning to once again talk about the possibility of price deflation; we'll leave THAT discussion for another time.

**Energy Prices are Plummeting.** While lower overall inflation is good news for the average bond investor, tumbling gasoline (and home heating oil) prices are even better news for the embattled consumer sector. Year-over-year, the current drop in gasoline prices is equivalent to a \$600 to \$700 billion tax cut for US consumers. Meanwhile, consumers in the northern climes are breathing a collective sigh of relief as the cost of heating one's home with heating oil, which this past summer was looking like it would cost 50% more, now looks like it will cost approximately 25% less than last winter.

**Leverage is Being Wrung Out.** It's now crystal clear, with the full benefit of hindsight, that the global financial system was excessively dependent on borrowed funds. What made this disastrous, of course, was that this excess leverage was used to buy poor quality assets. That top-heavy structure is now being unwound, at great cost and pain to anyone who owns financial assets, especially with borrowed funds. The combination of bad paper and too little capital wiped out the entire brokerage industry, as the business model itself (at least the way it was operated in the last decade) was proven to be far too vulnerable to a loss of confidence of those who funded the brokers' daily



operations. But the unwinding of leverage extends well beyond Wall Street, as households have found that an absence of personal saving and an excess of household debt is no way to build a secure financial future. The benefit is hard to see now, but will become more apparent with the passage of time—delevering is a short-term negative that should be viewed within the context of a long-term benefit for the US economy.

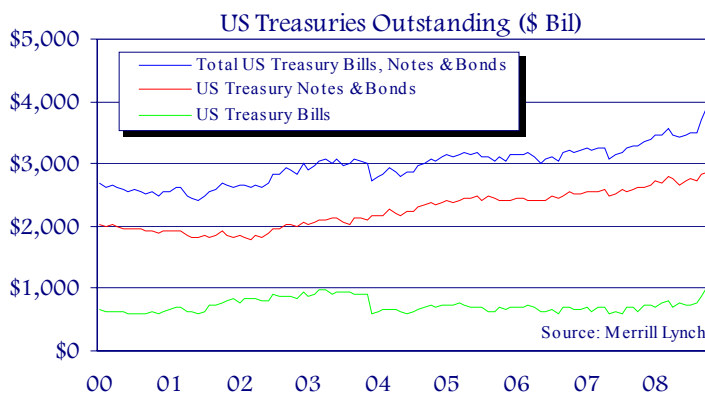
**There is No Shortage of Treasuries.** A few years back we wrote about the impending lack of Treasury issuance and how, with Federal budget surpluses (remember those?!) the global bond markets were in danger of losing their most important benchmark. Well, those days are long over. After 9/11 and the dot-com bust, Federal spending shot up and our brief dalliance with budget surpluses quickly ended. While Treasury issuance has been rising steadily over the past seven or eight years, it exploded this year as tax revenues flattened out while spending here and abroad skyrocketed. The supply of Treasury bills, notes and bonds (netted against maturing issues) has increased by almost \$800 billion this calendar year, to \$4.2 trillion at the end of November (see chart).

Given the degree of “quantitative easing” continuing into 2009, we see no shortage of Treasuries for investors for the foreseeable future. Currently, that’s a good thing, as investors cannot seem to get enough of Treasuries, even at ultra-low yields. With 3-month Treasury Bills yielding a “bury it in your mattress” equivalent yield of less than 5 basis points (0.05%) right now, Treasuries are simply a place to avoid risk, and do not represent any kind of real value for investors. The US Treasury hasn’t been able to borrow money at rates this low in decades.

**Corporate Bonds are Cheap.** Recent studies show that high grade corporate bonds are, among all major asset classes, the asset that’s projected to produce the best returns in the next three to five years. The reason is clear: High-grade corporate bonds are priced to a doomsday scenario, while US stocks are no better than “average” on a valuation basis. Meanwhile, Treasuries are at their lowest yields in five decades and offer little return potential. The average investment grade corporate bond currently offers a yield spread over comparable Treasuries of 6%; in addition, at an average price of less than 90 cents on the dollar, high grade bonds provide unheard-of opportu-

nities for capital appreciation. We’ve seen yield spreads and prices like this in the junk bond market, where defaults can rise to 10 to 20% in a bad year, but never in the investment-grade world, where the highest default rates were in 1938, when defaults maxed out at 1.6%.

**Borrowing Rates are Low.** If you’re credit-worthy, you can borrow at very attractive terms, whether you’re an institution or a consumer. Despite a yield premium over Treasuries of more than 3%, Proctor & Gamble just issued five-year debt at 4.6%. Conventional 30-year mortgage loans have fallen dramatically over the past month, and are now below 5%, the lowest rate since 1967. True, lending standards have risen, but is that a bad thing? Given the disasters that heaped up as a result of the Free Money Economy, we’re all too happy to see a return of disciplined underwriting standards that price risk appropriately.



### Regulation is Coming.

OK, we saved this one for last, because, well... we have our doubts about putting “regulation” and “benefit” in the same paragraph. Having said that, there can be no doubt that the financial meltdown of the past 18 months would have been far less corrosive to the broader US economy if there had been a modicum of regula-

tory restraint in some of the more speculative lending practices, as well as stricter rules regarding bank and brokerage capital requirements. But these regulations, and many more, will be coming to a US economy near you. In an ideal world, regulations would be put in place that perfectly balance the interests of all parties, protecting consumers, allowing businesses to pursue their profit goals, spurring innovation and growth, and keeping the US competitive in the global economy. But our world is highly imperfect and regulations will be shaped by politicians, lobbyists, and do-gooders, all equally capable of fouling up the works. Then there is the problem of enforcing the regulations, and the inevitable question of who regulates the regulators. As lovers of free markets, we wear our skepticism on our sleeves; but even the staunchest anti-regulatorian (is that even a word?) must grudgingly admit that steps need to be taken to rein in some of the excesses of the past decade.

So that’s it. A little ray of hope here as we close the year. As always, thanks for reading, and here’s wishing you the happiest and healthiest of holidays and best wishes for the New Year.

