

MARKET REVIEW

Quarterly Review and Outlook

Fourth Quarter 2009 Report

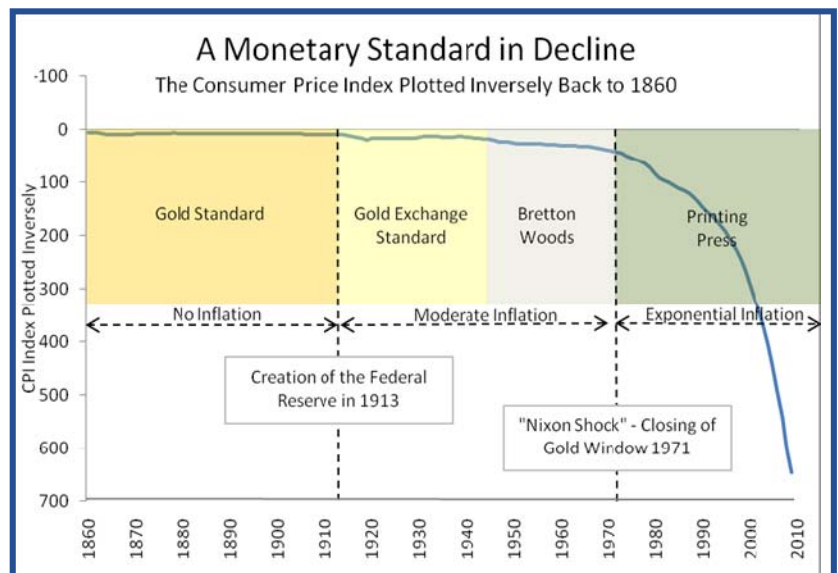
"The more debt we owe, the wealthier we are."
Congressman Pete Stark, D-California, August 2008

"The nation must continue to spend our way out of this recession."
President Obama, December 8, 2009

While at first blush, the above quotations would seem to serve no useful purpose except as literary ploy for launching into a scathing rebuke of the deplorable level of economic literacy and the general degree of intellectual inanity prevalent among our public servants today. And at other times, that might indeed be our purpose. However, as Bob Dylan once so famously intoned, *the times they are a-changin'*, and so must we. Not our principles regarding how the world works mind you, for those they will have to pry from our cold dead fingers. No we are referring rather to our methods for conveying those principles. For as you know, desperate times demand desperate measures. And along those lines, we find the above quotations to be both useful in illustrating our views regarding the imminent actions of the stabilizers, and in this era of the **"new normal"**, even technically correct. However, for us the "new normal" did not commence with the onset of the **Great Recession** in 2007, but was rather inaugurated with the initiation of the **Great Experiment** which began in earnest nearly 40 years ago.

"We're all Keynesians now." That was the famous line uttered by yet another US President back in 1971 shortly after he closed the gold window, thereby permitting the US to **"default"** on its' obligations under the 1944 Bretton Woods Treaty which required the US to redeem dollars for gold with other countries. This unilateral action was informally referred to by the international community as **"Nixon Shock."** And while our long-term readers are aware that the history of the decline of the US monetary system certainly predates 1971, nevertheless, August 15, 1971 is a date that will *forever live in infamy*. For it was on that date, that the Great [monetary] Experiment and its' economic corollary, the **"financialization of the economy,"** began in earnest.

Figure 1



The financialization of the economy is a euphemism that we have often employed to refer to the new economy created by the stabilizers that is overly dependent on the continuing expansion of credit, rising asset values and debt-based consumption. A key part of the stabilizers program to make credit easier to obtain and lighter to carry was the transition from a monetary standard governed by the automatic stabilizer of gold, to a paper standard governed by the 'stabilizers' at the Federal Reserve. The demonetization of gold was a calculated effort to dissociate credit movements from gold movements, and by so doing, obfuscate any market signals that a rise in the price of gold may have communicated about the coming **devaluation of the dollar**. (Figure 1) As such, with the closing of the gold window in 1971, the last remnant of the gold standard was thrown off, removing the last impediment to the statist's goal of overturning nature's seemingly serendipitous economic allocation in favor of the more democratic expediency of the printing press. Writing in 1966, a young idealist named Alan Greenspan trenchantly observed that *"the abandonment of the gold standard made it possible for welfare statists to use the banking system as a means to an unlimited expansion of credit."*

Under a monetary standard based on gold, a free banking system is able to extend credit (claims against existing or saved property) according to the production requirements of the economy as determined by the condition of scarcity. However, the situation is quite different under the **paper monetary system** of a central bank. Here it is not scarcity that drives valuations, market prices and the structure of production. Rather it is the ability of banks to create **titles to property** not backed up by actual or real property that determines the **availability of capital**, thus artificially displacing the critical role played by scarcity. And so it is that under the current money monopoly, capital, which is properly defined as ownership claims against real property, the availability of which was properly determined by the owners' willingness to part with them at a given price (scarcity), is being falsely represented by **competing paper claims against capital**, the quantity of which are not subject to scarcity, only the speed of the printing press. Because of the leverage inherent in **fractional reserve banking** (a 7% capital ratio implies a 14:1 ratio), these **competing claims** vastly outnumber authentic ownership claims, a condition which has led to the magnified importance of all things financial and the transformation of the economy [financialization] whereby economic activity is re-directed toward claim management and trading (Wall Street) and away from the production of real things and Main Street. [This explains our structural trade deficit as speculation in shares yields far greater rewards than labor. Also this does not include the massive rise in off-balance sheet **"claims on claims"** represented by financial derivatives] And because under this paper monetary system, all money is loaned into existence, i.e., **all money is debt**, each competing claim begets **new claims** in the form of interest paid, which inexorably drives the **exponential growth of debt**. And it is this endogenous exponential growth in claims (debt) which ultimately exposes the **Achilles heel** of all paper monetary systems, the potential **contraction of claims**, i.e., a **debt deflation**.

And so this brings us to the very situation facing the stabilizers today. By dissociating the growth in money and credit from the production of real things, choosing instead to displace capital with debt, the stabilizers have erected a massive **ponzi debt scheme** consisting of too many paper claims chasing too few real things, the resolution of which ultimately requires the elimination of the malinvestments built on competing claims and a concurrent reduction in wealth. However, as we oft repeated, so repugnant is the negative outcome of the debt deflation that awaits us on our present course, that every ounce of human ingenuity has been deployed in an all-out effort to forestall the **day of reckoning**. To that end, according to the Levy Economics Institute, more than **\$23.7 trillion** has been deployed to date in the form of spending, lending and guarantees to preserve the status quo and so avoid a deflationary contraction. However, all of the

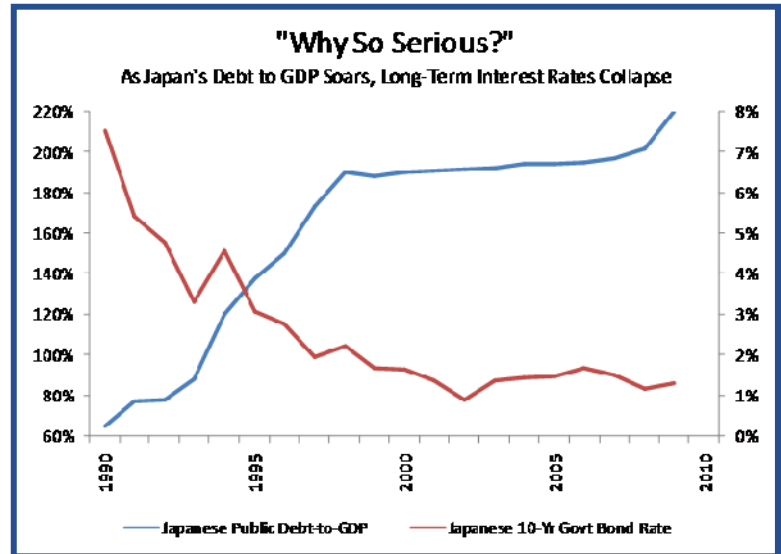
efforts to maintain the status quo prevent the very activity which can bring about the correction, the write-down and revaluation of the malinvestments. As such, the problem as we have stated on previous occasions and have so painstakingly documented in this report is not the bust *which we have not experienced*, but the perpetual expansion of competing claims (credit) *which we continue to pursue*.

For this reason, the unprecedented efforts of the stabilizers to place their *“finger in the dike”* and so hold back a deflationary deluge, has achieved only a **“successful failure”**. Successful in averting an imminent deflationary collapse, but a failure as neither the malinvestments nor the economic distortions have been addressed, nor has the formation of market prices, the process critical to proper economic calculation, been restored due to the massive scope of government intervention. As we discussed at some length last quarter, with respect to the financial markets and the economy, their efforts to date have only been able to secure **“medicated markets”** and a **“statistical recovery”**. All credit markets are now directly or indirectly influenced by the presence of the stabilizers. Either through the governments’ direct investment of capital with TARP, or through specific liquidity and lending operations of the Fed such as TALF (asset-backed securities), CPFF (commercial paper), MMIFF (money market funds), or through lending facilities to banks and primary dealers such as PDCF and TSLF, or through the Fed’s direct purchase of Treasury, mortgage-backed and agency securities via their **\$1.8 trillion quantitative easing program (QE)**. On top of this, the government has also provided numerous stimulus programs including the \$787 billion ARRA, the “cash-for-clunkers” program, the first time homebuyer tax credit, and a myriad of loan modification and foreclosure avoidance programs including HOPE Now and HAMP. In addition, they created an *innovative* new **“Build America Bond”** program, a cross-over program which seeks to tap the larger and more liquid taxable bond market for municipal bond issuance, a market heretofore dominated by individual investors seeking tax-exempt income. Under this program, municipalities are *encouraged* to issue taxable debt in lieu of tax-exempt debt, since under the program the US Treasury is obligated to pay **35 percent of the interest expense** on the bonds issued. By transferring a portion of municipal issuance to the taxable market at higher federally subsidized rates, the program increases the demand for, and the price of, tax-exempt municipal bonds by effectively reducing the supply of traditional tax-exempt municipal bonds. This action was taken to shore up the municipal bond market which had been devastated in 2008 by the sudden collapse of the auction rate securities market and the loss of the monocline insurers. Finally, we would be remiss if we did not mention the centerpiece of the stabilizers **program of postponement**, their **zero interest rate policy**, or ZIRP. And while this list is by no means exhaustive, the degree of intervention and market manipulation is nevertheless, staggering. And yet juxtaposed against this picture of government’s unprecedented effort to *“hold the weight of heavens on its’ shoulders”*, much of the current discussion by mainstream analysts is centered squarely on the importance of the stabilizers correctly executing their **exit strategy**. Clearly then, the most pressing question for investors is *“will Atlas shrug?”*

Perish the thought. As we stated previously, we are Japan, only better *and worse*. Japan has been mired in a two-decade-long life and death struggle with a **debilitating debt deflation**. Their credit bubble, manifested in hyper-inflated stock and real estate prices, succumbed to the force of inevitability and collapsed in 1990. As part of Japans’ **“survivor”** program instituted to avoid being *voted off their island*, the Japanese stabilizers, including the Bank of Japan (BOJ and Ministry of Finance (MOF), pioneered the groundbreaking ZIRP and QE programs recently adopted by the stabilizers in the US. The Japanese government also responded with a rapid succession of deficit-driven stimulus programs, which included temporary tax cuts and massive government deficit spending programs targeting infrastructure, infamously dubbed a **“bridge to nowhere.”** However, like their western apprentices after them, their strategy was

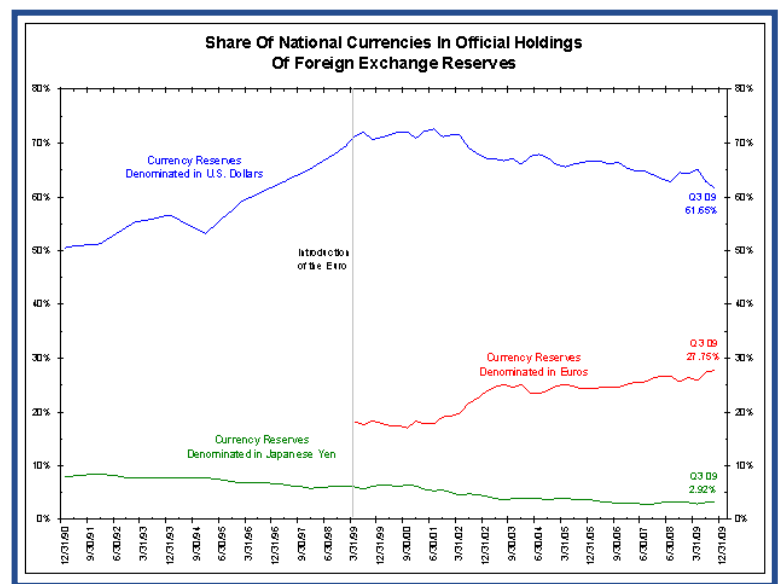
designed to postpone the problem rather than address the root of the problem, the massive volume of malinvestments in the form of bad loans in bank portfolios, which to one degree or another, remain to this day. The ultimate result of their **strategy of postponement** has come to be known as Japan's "**Lost Decade(s)**", with the only prize achieved being the attainment of the **largest national debt in the developed world**. This can be seen in **Figure 2** as Japan's public debt-to-GDP ratio soared from **60 percent** in 1990, to **220 percent** by 2009. However, what can also be seen in **Figure 2**, and is a never-ending source of encouragement to US policymakers, is that Japan has thus far been able to finance its' own deflationary avoidance scheme using the Bernanke printing press while at the same time having long-term interest rates collapse to ultra-low levels. Surely this monetary version of "**having your cake and eating too**" should dispel all doubts regarding the superiority of a paper monetary system and the sagacity of the stabilizers chosen strategy? Shouldn't we simply heed the Jokers' advice of "**why so serious**" and lighten up on our criticism of the stabilizers and move on out both the yield and risk curve with our portfolios?

Figure 2



Well as we said, we are Japan, only better and worse. The **better** refers to the US stabilizers' ability to deploy a level of intervention exponentially larger than Japan without spiking long-term interest rates and destroying the currency. This we attribute to America's unique position as the sole purveyor of the world's **global reserve currency**, the dollar. Over 70 percent of world trade and nearly 95 percent of oil purchases are denominated in dollars. As such, foreign countries must amass dollar-based currency reserves, both to settle trade and to defend their own currencies from destabilizing attacks. (**Figure 3**) In addition, the US is in the enviable position of not having to earn foreign currency exchange through exports to pay for our imports. Instead, to the extent we run a trade deficit, we can simply print the dollars we need to settle our debts and so, as Jacques Rueff once observed, "**run a deficit with no tears.**" This **position of privilege** has played a key role in ensuring that there

Figure 3



has always a “**bid**” for our debt. However, the exercise of this privilege comes at a steep price, including the gradual yet permanent **loss of manufacturing jobs**, a massive **global transfer of wealth**, and an **ever increasing dependence** on the appearance of foreign central banks at our Treasury auctions to underwrite our largesse. And as we can also see in **Figure 3**, the **gradual decline** in dollar-denominated reserves in favor of euro-denominated reserves is a reminder that it is a privilege we should not take for granted.

The **worse** is closely related to that last point, our increasing dependence on the kindness of strangers. While it is true that Japan has the dubious honor of having the largest national debt in the developed world, they also have something we do not have; the **largest pool of private savings in the developed world**. As such, only **6 percent** of Japan’s \$10 trillion in marketable public debt is held by foreigners. This large pool of domestic savings is the primary reason Japan has thus far, been able to finance their massive “**deflation avoidance program**” at ultra-low long-term interest rates. Contrast this happy circumstance with the fact that **49 percent** of US public debt is held by foreigners (and growing), and you begin to comprehend the risks. Foreign central banks hold 28 percent of US public debt, while China alone holds (officially) **10.2 percent**. In a world of **global competing paper claims**, the risks associated with a foreign sovereign nation such as China, holding the **proxy** on a large and growing level of US Treasury debt, are substantial. And while we concede to the existence of the faustian “**extend-and-pretend**” bargain with China, we also continue to assert that their decisions regarding the valuation of the Yuan, and by extension, their appetite for US Treasury debt, will be driven **solely by self-interest**. Unlike Japan at the 1985 Plaza Accord, China will not **fall on their sword** to extricate a profligate US. Instead, their actions over the past several years, reflects not benevolence, but rather the sage advice of Napoleon who once observed; “*Never interrupt your enemy when he is making a mistake.*”

Well let it never be said that we did not give credit where credit was due. Clearly the stabilizers in the US have been able to replicate their own version of Japan’s “**spending our way out of recession**” strategy without incurring the oft-threatened wrath of the bond market vigilantes, **soaring long-term interest rates**. Given both the overriding importance of the financial sector and the dizzying degree of interrelatedness among the leveraged speculators, coupled with the sheer fragility of a Hyman Minsky-like **ponzi debt scheme**, a sharp and rapid rise in long-term interest rates would have the potential to collapse the house of cards in a heap and set the US on the path to **Weimar** (hyperinflation), followed promptly by a collapse of the US currency. However, setting aside such an unthinkable scenario, the US has indeed been fortunate to finance its’ largesse at below market interest rates. Not as low as Japan, but still, at yields far lower than would be expected given the size of the intervention, which, as we briefly sketched out earlier, is exponentially larger and infinitely more complex than that of Japan. However, that long-term interest rates have been kept low is at once both **laudable** and **laughable**. Laudable because the alternative is, as we mentioned, simply unthinkable. Laughable because like the great **Wizard of Oz** behind the curtain, the happy condition of low long-term interest rates is due more to smoke and mirrors than to any laudable achievement.

Figure 4 is a chart reproduced from a presentation given to the Treasury Borrowing Advisory Committee by the US Treasury Office of Debt Management on November 3, 2009. The chart graphs the total US **net fixed income purchases** by sector on an annual basis since 2003. The red line highlights the total net fixed income purchases after deducting the purchases of the Federal Reserve, and as such, highlights the **level of intervention** by the Fed. What is striking about this chart is the revelation that in 2009, out of a total of **\$1.4 trillion** in net fixed income issuance, the Federal Reserve purchased **\$1.5 trillion!** However, it is the implications of the Treasury’s estimates for 2010 that are most revealing. For all of 2010, the US

Treasury estimates that the level of net fixed income issuance from all sectors for which the market will have to **provide a bid** (purchase), will double to **\$3.1 trillion** – and it assumes **no assistance from the Fed**. With our apologies to the hymn writer Charles Wesley, we must respectfully ask “*how can it be?*” We suggest that it cannot, and as such, is indicative of “**an inconvenient truth**”, namely that the stabilizers have **been the bid**, and despite their rhetoric to the contrary, they cannot exit, but must instead, **stand in the gap** and continue to *be the bid*.

And given President Obama’s stated goal of “*spending our way out of this recession*”, that gap, which is already

gaping, is set to **grow rapidly**. According to the latest estimates from the Congressional Budget Office which are reflected in **Figure 5**, the US can expect to run annual fiscal deficits in excess of **\$1 trillion** for several years to come. This data reflects the coming **further transfer of debt** from the private sector to the public sector, due to rising retirement and healthcare costs, particularly for ageing baby boomers. These factors and others not included, such as the cost of health care reform legislation and a second stimulus package, are among those which will drive a massive increase in Treasury issuance and a soaring public debt for many years to come. Under these circumstances, it is difficult to conceive that the Fed can or will remove their finger from the dike anytime soon.

Interestingly, there have been recent indications that the Fed has engaged in **shadow QE operations** in an effort to keep their continuing operation clandestine while *pretending to exit*. Specifically, recent auctions of US Treasury notes have shown surprisingly strong demand in the form of “**direct bids**”, a term used for US institutional investors who bypass the so-called primary dealers that underwrite government bond sales. In one recent auction, direct bids accounted for **17 percent** of the sales of \$21bn in 10-year Treasury notes, a level far higher than the average of **7.5 percent**. In another example, direct bids accounted for a record **23.4 percent** of the bidding for \$40bn in 3

Figure 4

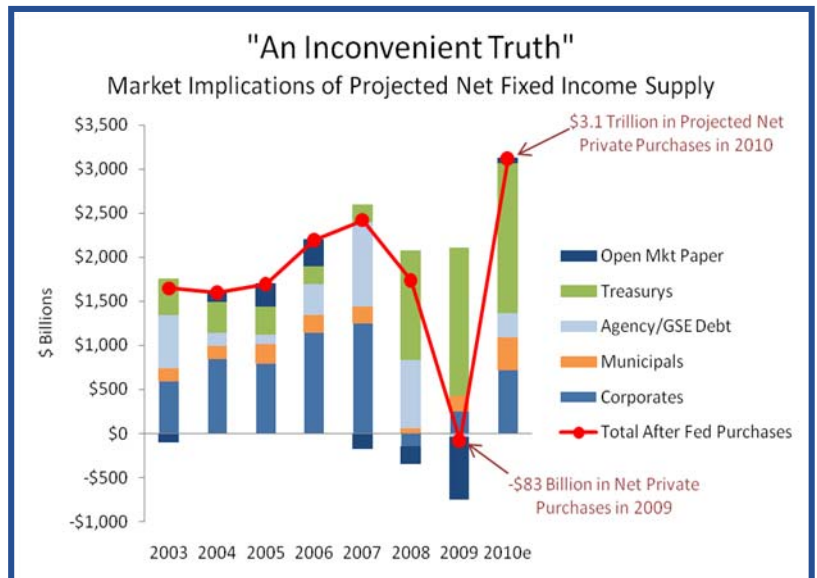
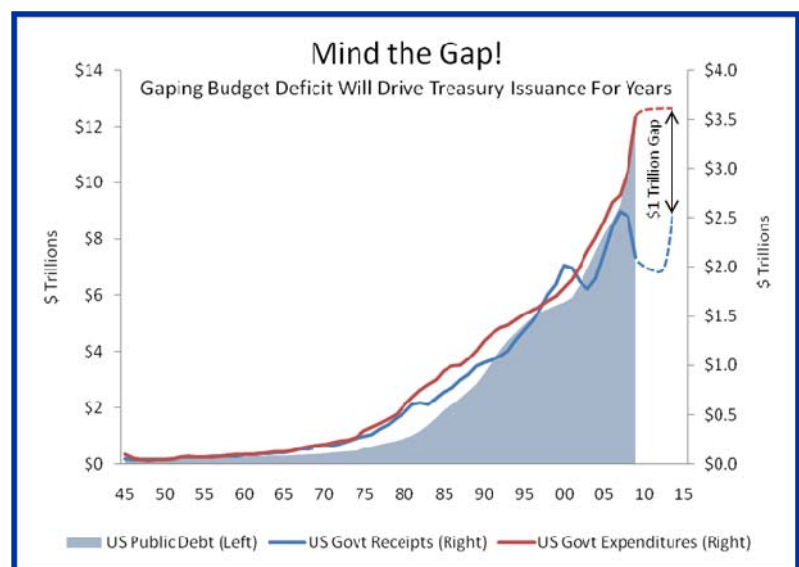


Figure 5



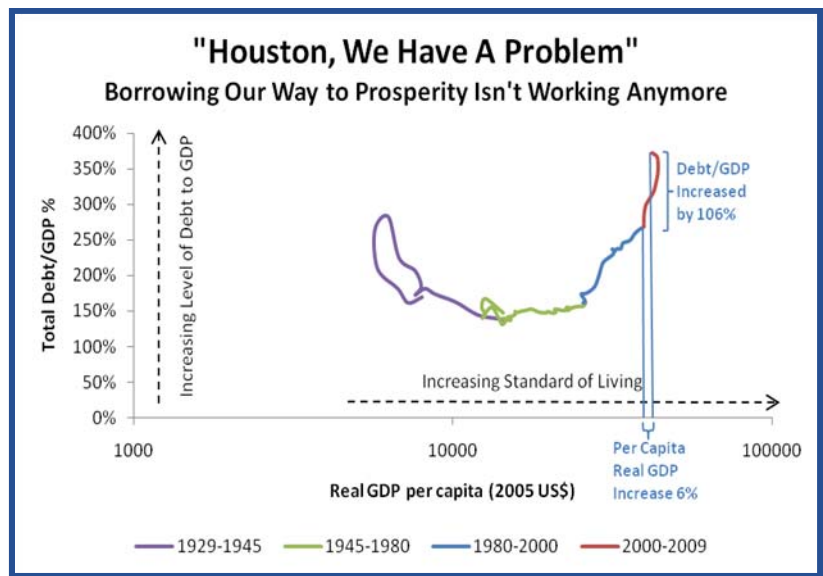
-year notes, up from an average direct bid of **6 percent**. The unusually high level of direct bidding suggests the existence of a large investor who is looking to accumulate Treasuries without alerting primary dealers to its intentions. The most intriguing suspect to turn up thus far has been China. Rumors are abounding regarding the possibility that China may be engaged in a **stealth QE operation**, perhaps even with the blessing of the Fed. *"It is no secret"*, as zero hedge.com recently reported, *"that the two main beneficiaries of the current Keynesian experiment in **extend-and-pretend** are China and the US."* And a **failed auction** would be an unwelcome **"black swan"** that would certainly derail any prospect for a statistical recovery in the US and would equally devastate China, a country with a massive pile of dollars, who like the Greek character Sisyphus, is forced to acquire ever more dollars to sustain growth, but is prohibited from selling, for fear of destroying their currency peg, the dollar. If true, this would a long way towards explaining just how the Fed can continue to herald their intention to permit their QE operation in Treasuries to lapse later this month, since this operation will have been informally **offloaded offshore**.

In yet another sign of that the stabilizers will not be exiting the credit markets any time soon, the US Treasury, in a surprise move on December 24th dubbed the **"Christmas Eve Massacre"**, unexpectedly **removed all limits on future government aid to Fannie Mae and Freddie Mac**, quietly placing US taxpayers on the hook for potentially very large future losses. Previously, the liability to US taxpayers was capped at **\$400 billion**, but with the passage of this legislation, the caps were removed and the sky is now the limit for US Treasury support of losses at Fannie and Freddie. This is a complete reversal from the original scenario painted by former Treasury Secretary Hank Paulson when the two mortgage giants were nationalized in September of 2008. The original bailout called for a maximum of **\$200 billion** in taxpayer support and a requirement that Fannie and Freddie each **reduce their portfolios by 10 percent**. However, within a short period of time, the cost of the bailout had doubled to **\$400 billion**. But now in the aftermath of the massacre, Fannie and Freddie have a **blank check** and the requirement to reduce their portfolios has been **suspended for three years**. The implications of this move are all too obvious. As of March 2010, the Fed was to discontinue their QE purchases of mortgage-backed securities. However, in our last report we pointed out that for all of 2009, the Fed purchased **100 percent** of all agency mortgage-backed securities issued. We also suggested that just as with their purchases of Treasuries, the sheer size of their intervention in the mortgage market is enormous and the prospect of their withdrawal without collapsing the housing market is simply inconceivable. Now, however, with this *after-hours*-passage of unlimited backing by the US Treasury and the removal of any regulatory impediment to growth in their respective portfolios, Fannie and Freddie are uniquely positioned to covertly assume the Fed's continuing QE operation in mortgages.

And as it turns out, not a moment too soon. For on January 13th, Laurie Goodman, a Senior Managing Director of Amherst Securities Group, and a well regarded expert on mortgage backed securities, released a 17-page report in which she gave estimates of the total losses that the now government-owned GSEs (Fannie and Freddie) will experience. According to Goodman's report, total losses from the combined credit-guarantee books of Fannie Mae and Freddie Mac could reach 9.6 percent, or **\$448 billion**. Goodman notes that *"overall losses on loans in the Fannie and Freddie credit guarantee books will be very close to that for the 1983-84 origination in the four most severely hit states during the oil bust in the 1980s."* Translation: Ms Goodman's analysis is not calling for unprecedented percentage loss levels. Instead the massive volume of projected dollar losses (\$448bn) resulting from a loss percentage consistent with historical experience, points up the potentially devastating impact of the **law of large numbers**. Barry Ritholtz put these numbers into context. *"From the day that Fannie and Freddie were placed into conservatorship (September 5, 2008), the US government is likely to spend more money bailing out Fannie and Freddie than they have on the Iraq and Afghanistan wars – combined."*

We continue to repeat our long-standing mantra, namely, ***the solution is the problem***. All of the efforts to forestall a meaningful correction of the malinvestments and rebalance the productive structure of the economy, have only served to increase the volume of competing claims outstanding without a commensurate increase in wealth, thereby heightening the degree of correlation and instability in the financial markets and, due to the overdependence on financial speculation, the fragility and inefficiency of the economy. Yet as highlighted at the beginning of our report, the proposed solution remains the same, *we must spend our way out of this recession*. However, the futility of the perpetual pursuit of this solution is clearly illustrated in **Figure 6**. This chart is a partial reproduction of a chart originally compiled by Robert Zielinski and found in Dr. Peter Warburton's book, "Debt and Delusion." This is a somewhat complicated chart that requires careful interpretation. The vertical axis is a linear scale of the ratio of the stock of debt in the US economy expressed as a percentage of nominal GDP. The horizontal axis is a logarithmic scale of

Figure 6



real GDP per capita, measured in constant 2005 dollars. The evolution of these two variables is shown as wiggly lines. The annual data runs from 1929 through 2009, with the data broken down into four date intervals, each utilizing different color line segments. And while the data points are joined up in chronological order, there is nothing to stop the line from folding back on itself or looping the loop. The interpretation of the chart is as follows. When the line moves from bottom-left to top-right (1980-2000), this represents an expansion of the debt to GDP multiplier corresponded by an increasing standard of living. When the line moves horizontally from left to right (1945-1980), this indicates real income per capita is rising in the context of a stable debt multiplier. **Both of these circumstances are praiseworthy.** The steeper the line, the smaller the benefit to living standards from a given increase in debt. In the extreme situation of a vertical line (2000-2009), **the credit system is expanding wildly without delivering any benefit to real income per capita.** And finally, a line that is moving from right to left is indicative of a **debt deflation** (1929-1945). Here, the credit system has broken down, most likely as a result of **credit quality problems**, and the living standards are falling. **Figure 6** strongly suggests we are in a period where the credit system is expanding rapidly without any corresponding benefit to real income. However, the risk of **rolling over into a debt deflation**, a la the Great Depression, are not insignificant. These risks are further exacerbated by the commitment of the stabilizers to expend every effort, whether *fair or foul*, to avoid such an outcome. As such, the interval between **cause and effect**, between *reaping and sowing* becomes so long, that people are conditioned to no longer believe in the inevitability of the consequences of actions. Nevertheless, to paraphrase Lombardi, it is clear that for the stabilizers, avoiding deflation *"is not the most important thing, it's the only thing."*

For the moment the volume of money printed has effectively replaced the volume of credit destroyed. The resulting massive liquidity injections left the markets with little alternative except to rally. The banking and financial sector have been "saved", but main street has been sacrificed on the altar of expediency, with the

ultimate result being more jobs for China. However, the equality ends there. The continued fall in both lending and broad money (M3) reflects a **net repayment of debt** as demand continues to be very weak, a condition, as we have stated before, reflects a secular shift that will last for many years. Not for the last time, let us repeat, this will be a process, not an event. As such, these factors and more underscore the massive **transfer of debt** that has taken place, and will continue, from the private sector to the public sector. And with entitlement spending set to surge due to the inalterably poor prospective demographics (ageing baby boomers), the fiscal drag from this exchange will only become more burdensome, not less as promised by the promoters of statism, as time passes. The result is that the US piling up debt at an exponential rate. In response, credit default swap spreads for US sovereign debt (a market proxy for credit risk in US Treasuries), while well off their crisis highs, have nevertheless, begun to rise again. This, in our opinion, is a troubling development as it signals a recognition that the ongoing attempt to underwrite massive losses in real economic output caused by the collapse of the previous asset bubbles, is a road that will ultimately lead to bankruptcy. And while the US does indeed, have formidable strengths that will allow its government to be profligate for far longer than other nations could get away with, ultimately the law of large numbers and diminishing returns will not be conned. Ernest Hemmingway once postulated, *"How do you go bankrupt?"* His reply, *"Two ways, gradually and then suddenly."*

Someone once observed that *"coming events cast their shadows before,"* and regarding the prospective US fiscal situation, it is casting a long shadow indeed. And a careful review of the implied rate of increase in deficit financing indicates it will outstrip the prospective growth rate in the economy, serving as a reminder that we have **not escaped the prospects for our own 'lost decade'**, replete with years of sub-par economic growth ahead. Given the degree of intervention and manipulation by the stabilizers in the credit markets, combined with the ***inconvenient truth*** that atlas *cannot* shrug and abandon their commitment to the markets, we continue to advocate a conservative investment strategy committed to high quality, short to intermediate duration bonds, with a commensurate underweighting of risk spreads. For in our opinion, the marked tightening in risk spreads is primarily reflective of the massive liquidity injections and unprecedented intervention of the Fed and the transfer of risk from the private sector to the public sector, rather than a market endorsement of improving fundamentals. As such, the fundamentals continue to augur for caution. Regarding such times of uncertainty, Woody Allen once quipped; *"More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray we have the wisdom to choose correctly."* Amen.