

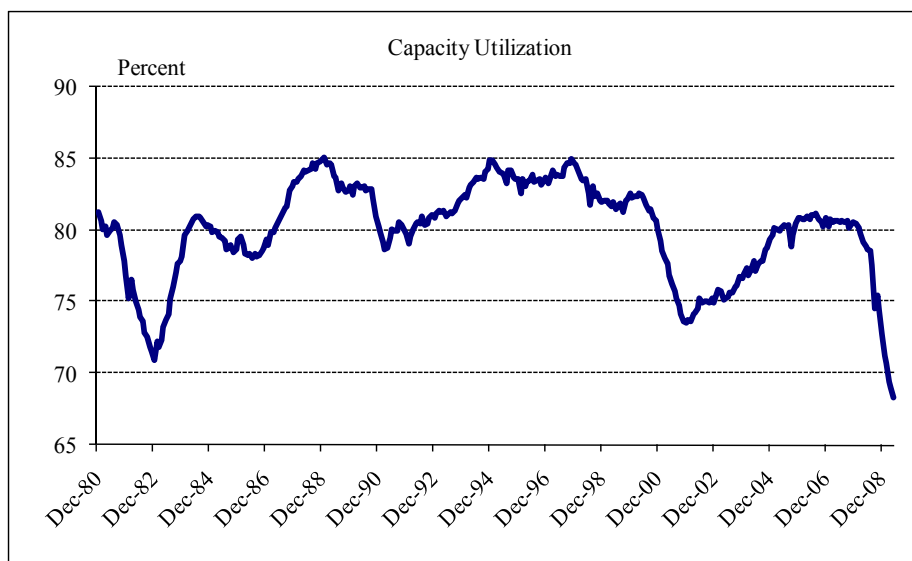
July 2009: Where do we go from here?

Someone once said “Life is a long lesson in humility;” this is particularly true in the investment business. If you asked the top 100 investment advisors what will happen within the economy and financial markets over the next 1, 3 and 5 years, you would get 100 different answers – and none of them will be exactly right.

That being said, our current perspective is that while stocks have had a significant rally off of the March lows, there still exists an emotional battle between fear and greed among market participants. The rally in the 2nd quarter 2009 was the strongest quarterly rally since 1998 and the first positive quarter since the 3rd quarter of 2007. However, while we have had pretty good confirmation that the financial crisis is mostly in the past, the economy remains soft.

To offset the challenging economy, the government has initiated many programs to provide stimulus, effectively substituting public credit for the withdrawal of private credit. This means expanding fiscal deficits at a time when the economy is still contracting (which diminishes tax revenue) and when Wall Street is badly damaged.

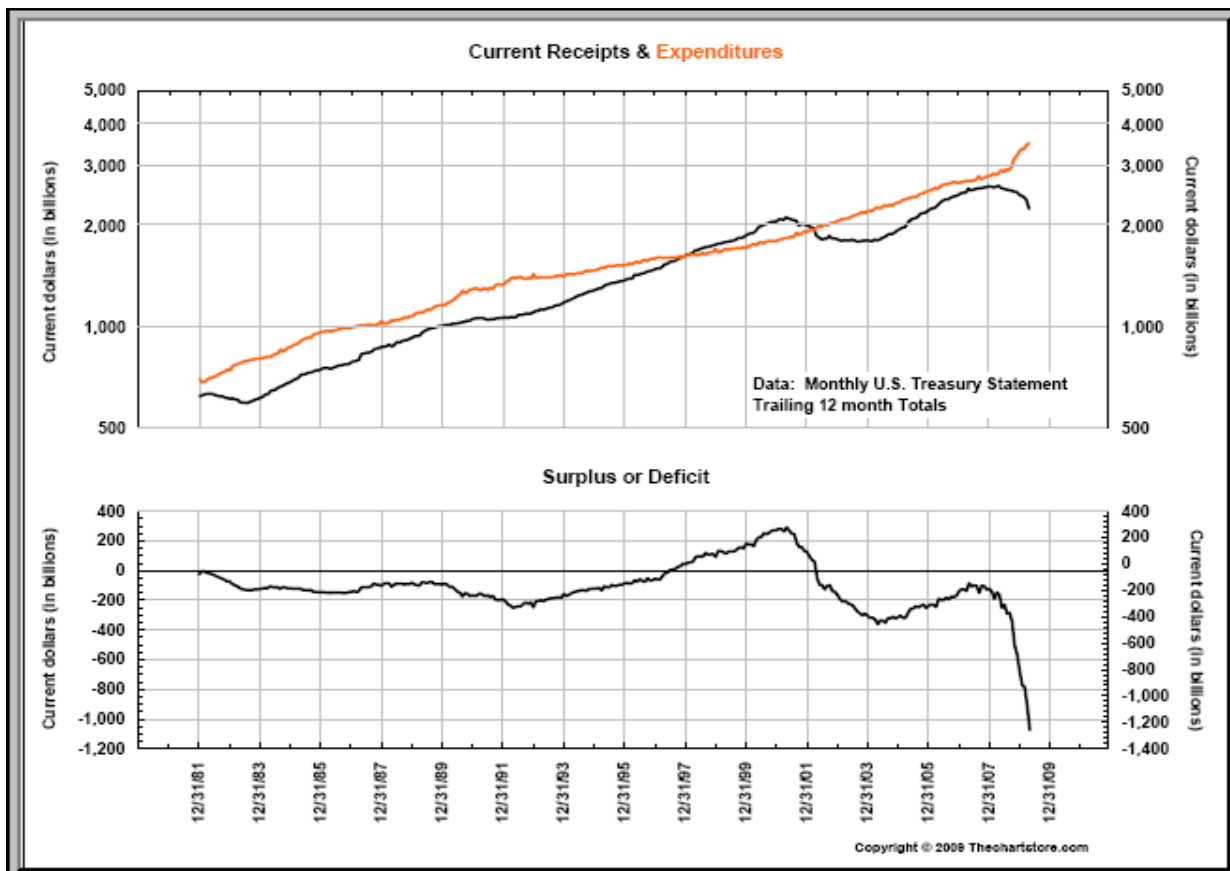
During this period, there are two opposing forces – one disinflationary and the other inflationary. The disinflationary force is the large negative output gap – the difference between the productive potential of the economy and the actual output, which shows up in a low capacity utilization number. This puts downward pressure on the pricing power for businesses, in turn pressuring profit margins.



Source: Federal Reserve Data, Bloomberg.

The inflationary element is the government stimulus in the form of mounting fiscal deficits. These deficits will be required to be paid back at some point and it will be very tempting for the government to print money outright (some say the government has no choice), debasing the dollar in the process.

There is a lot of controversy about what the government is doing at the moment because it's beyond anything that has been tried before. The government currently estimates that the fiscal deficit will approach \$1.8 trillion in 2009 – up from a \$1.2 trillion deficit estimate just 3 months ago (see graph below). As such, it is not surprising to see the bond market react negatively, with the yield on the 30-year treasury rising from 2.5% in December to over 4.5% recently.



Source: www.thechartstore.com

While most people are fixated on the employment situation and “green shoots,” we’re worried about the longer-term problem of how the government will pay for everything. As we’ve mentioned before, the government can only effectively procure money by borrowing, taxing or printing it. Given the magnitude of the problem, the government will endeavor to utilize all three. In the nearer-term, we are also worried that health care reform (without tort reform), as well as

the proposed cap-and-trade regime, while well-intended, will not be stimulative to the economy – and will instead be a drag on growth.

Piling on debt in an attempt to jump-start the economy is the classic political reaction to a debt and banking crisis. However, this crisis came about in the first place precisely *because* of too much leverage, so adding the same medicine to the structural imbalances that caused the debt crisis, while politically popular, is a dubious proposition at best. After all, it was Paul Volcker who said, “We live in this peculiar world where 3 percent inflation is stability but a half percent decline in the price index is deflation.” Because we agree with this observation, we expect that if there is any significant decline in asset prices or in finished goods prices, there will be yet another “stimulus” package which will likely spell doom for the dollar as the world’s reserve currency.

Niall Ferguson, financial historian and author of *The Ascent of Money*, expressed similar concerns during his session at the Aspen Institute’s Ideas Festival this week. He likened the current financial situation to a King Kong/Godzilla movie where King Kong represents deflation, and Godzilla represents inflation. At the moment King Kong has the upper hand, but ultimately Godzilla wins the battle. The reason he gave is the sheer size of debt in the U.S., accompanied by slow economic growth will lead to a crisis in confidence of the dollar. When interest payments on the debt represent 1/5 of all tax revenues, the value of the currency of the debt issuer has only one direction to move: down. This shift from a deflationary environment to an inflationary environment could take a couple of years to unfold, but it could happen violently if fiscal discipline is not imposed (and soon).

Our clients hire us to be concerned on their behalf, and to allocate their portfolios as best we can given the world’s problems. As such, several of our positions should benefit from a weaker dollar/ inflationary environment. While we don’t claim to have a crystal ball, our informed perspective guides us to be cautious *and* opportunistic, increasing the likelihood of a favorable outcome for our clients.

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