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Breaking The Loop

Our financial system is trapped in an “adverse feedback loop,” a classic debt-deflation cycle where falling asset prices and declining consumer demand transmit deflation throughout the economy. Consumers respond to the uncertainty and rising debt burden by cutting spending and saving more. Businesses respond to weakened demand by cutting production and employment. Rising unemployment causes consumers to cut back more, feeding the downward spiral.

The forced deleveraging that this process perpetuates is the fuel for the economic fire. Stopping or slowing the deleveraging process to a more orderly pace is the key to preventing unnecessary destruction. So, how can we break this feedback loop exactly? While no single potential catalyst seems capable of stabilizing the financial system and getting the economy moving in the right direction on its own, we do believe a combination of factors — we’re calling them the “Four Ts” — could prove effective:

T**RANSPARENCY** We need to know how assets will be valued on bank balance sheets. This should happen as a result of the policies being engineered by the Treasury, Federal Reserve and other government authorities. We’ve had the Troubled Asset Relief Program (TARP) I, TARP II and now a new set of initiatives is on its way. One of its prime components is the Public-Private Investment Fund (PPIF) and the Term Asset-Backed Securities Loan Facility (TALF), which will target areas, such as autos, starved for credit.

T**IME** The policies and programs that have been announced in the past few months — the PPIF and the TALF initiative — have not had time to get going in a meaningful way, and yet many have pronounced them dead on arrival. These policies need time to develop momentum and have a material impact on the economy and financial system.

T**RUST** As determined Treasury and Federal Reserve efforts begin to have an impact on the massive ocean liner of an economy and repair the capital markets, we’ll see how assets are valued. We’ll be able to do our own discounted cash flow analyses. Trust and confidence will build.

T**AKERS** The first three “Ts” will lead to the fourth — the “takers.” As we make our way toward the new year, as transparency improves, as stimulus programs have an impact and as trust builds, institutional and private investors, sovereign wealth funds, government institutions and other holders of cash should return to the markets and begin investing in more risky assets.

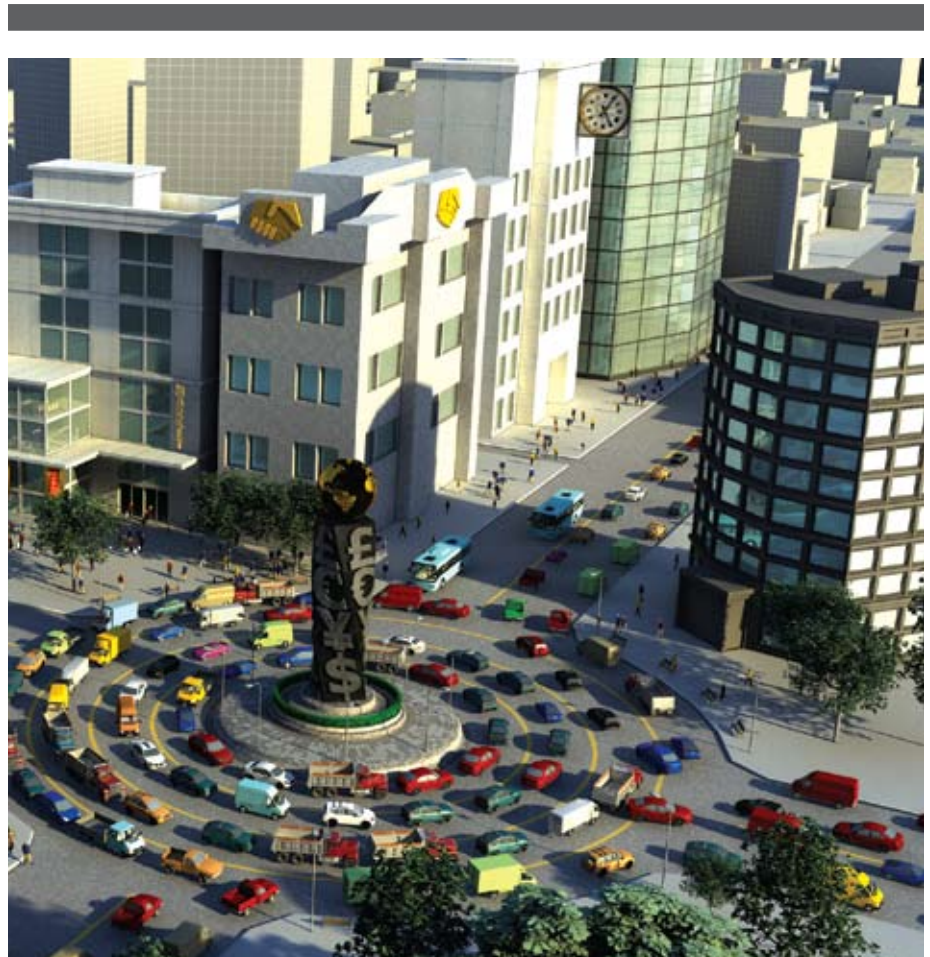
NOT OUT OF THE WOODS YET, BUT REASONS FOR OPTIMISM

While progress through the “Four Ts” should help, the difficulties are by no means over. Longer-term headwinds remain — deflation, deleveraging, balance sheet repair, a shifting global balance of payments, the transition from a shadow banking system to a more traditional banking system — and they should restrain global growth as the world rebalances. The consumer isn’t likely to relevel and start spending any time soon, and the economy isn’t likely to stage an abrupt turnaround. In other words, we’ll probably see more bad news before we see good. Still, we are becoming increasingly optimistic for a number of reasons:

- **For now, we’re progressing through the first two of the Ts — Transparency and Time — as the administration and the Federal Reserve, along with other major central banks, are showing the “political will” and aggressiveness needed to combat deflationary forces and provide needed relief.** Policies are being adjusted and flexibility is being added (the TALE, possible changes to mark-to-market accounting and perhaps a reinstatement of the uptick rule) and the Fed has announced its intention to buy Treasuries to reduce interest rates. Its purchase of mortgage-backed securities to narrow the spread of mortgages above Treasury interest rates has already brought 30-year fixed rates down to record-low levels.
- **The economic cycle is hinting at a turn, but definitive signs of a longer-term turnaround aren’t likely until later this year.** Specifically, the momentum in the ratio of leading indicators to coincident indicators has turned sharply higher and suggests a turn in growth in the next few months. At the same time, reflationary assets are showing signs that global trade is poised to turn after falling off a cliff in last year’s fourth quarter, retail sales are actually running ahead of expectations, the second derivative (the speed of the decline) is moderating in most economic statistics, and various purchasing manager surveys are showing improvement around the world. This does not mean that we’re expecting the economy to stage a v-shaped recovery, but these signs of improvement are necessary preconditions for recovery.

- **Valuation readings, sentiment and market metrics are starting to favor the longer-term investor moving to rebalance portfolios back into riskier assets like equities.** It does appear that the “great washout” has occurred; in early March, the number of equity markets around the world above their 52-week moving average was zero. Also positive, the bear market appears to be well advanced and the amount of investable funds on the sidelines is extremely high. Bottom line: valuations appear attractive for long-term investors and recent equity market gains hint at tentative investor confidence in a recovery.

We’re still not confident of a sustained uptrend for equities, but we do believe a bottom is building. In the short term, we are optimistic that a reflationary “moose” rally — that is a series of sharp technical rallies — can continue into the beginning of the summer months and help to establish a solid base for a more sustainable rally over the longer term, perhaps in 2010, when we suspect the economy will be in a clear upturn. ■



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Date of First Use: May 29, 2009.

AR80779