MORNING NOTES **Monday February 9, 2009**

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Today's Notes:

1. The Invisible Man
2. A Look at the Past from July's Perspective

1. THE INVISIBLE MAN

No, this is not H G Wells fictional invisible man, not Ralph Waldo Ellison's portrayal in 1953 of the plight of African Americans in US society and it is not about President George Bush. They may all be invisible to us but I write this AM on Federal Reserve Chief Benjamin Bernanke. Chairman Bernanke boasted in a 2002 speech that the government had a printing press – implying that the Fed was capable and prepared to rescue the US economy should another economic depression occur. Let's face it, Bernanke studied economics at MIT. Stanley Fischer was his Thesis adviser. He also wrote the book on the role of central banking in restoring the economy. He defined **inflation targeting** – widely accepted.

To be fair, I am certain that Dr. Bernanke could never have imagined the egregious debt loads that have grown in the US economy (though some were on his watch), the moves away from tighter regulation (espoused by CEA Chief Larry Summers), the infatuation with personal wealth creation by investment & commercial bankers (Citigroup's Robert Rubin extolling the virtues of sub prime and ALT-A markets till the bitter end), the removal of the Glass Steagall barriers between Investment and Commercial banking (on the Clinton / Summers Watch) and the naïve and politically correct programs of Presidents Bush, Clinton and Carter (Community Reinvestment Act) that **every** American **deserves** a "house." It was a crescendo of optimism and hubris that followed the decline of the Soviet Union in 1988. The economic disaster has breathed new life into that monster.

Nevertheless we were all assured that this new Fed Chief had the solution. The solution was, always and everywhere, to induce inflation. He would do this by lowering Fed Funds interest rate targets and mortgage / lending rates. If that failed the Fed would invoke the magic of **quantitative easing** by entering the Treasury and GSE markets to purchase 10 and 30 year bonds to keep interest rates low. Evidently we were all naïve.

But a funny thing happened on the way to the party. Over the past 30 years as the US $ was debased to provide inflation to the rest of the world and make credit freely available to all consumers, the US consumer carried the world's increasingly unbalanced economy. China was all for this as her export base thrived, employment increased her QOL rose and she piled up trillions of $s in forex reserves. But this is no more. On July 13th fearing Chinese withdrawal from the GSE (Fannie and Freddie) debt markets, a move which would deflate the US housing crisis further, Treasury Secretary Paulson spoke to Asia to guarantee that the US would support rapidly failing Fannie Mae and Freddie Mac (they were eventually nationalized Sept 8th). Till mid year 2008 China had invested $46 billion in GSE debt thus supporting lower US mortgage rates. But all that has changed. Since the Paulson speeches of July 13 and 22, through November China has been a seller of $26.1 billion in GSE debt.

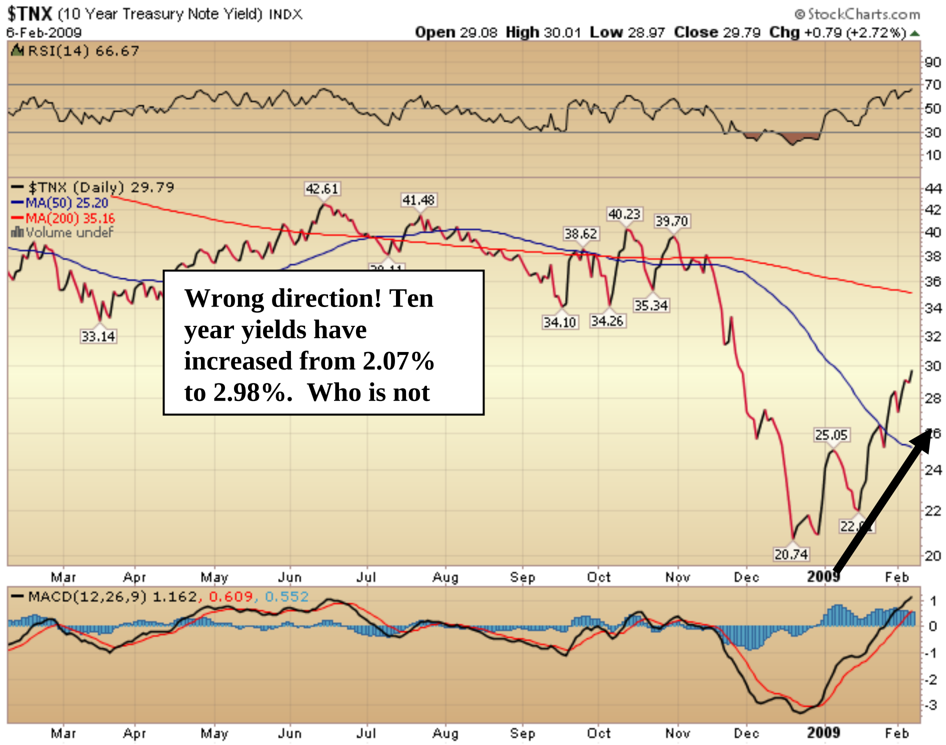
At Davos, a few weeks ago, both the Chinese and Russians (leaders!) sent stark public warnings to the new American Administration. The messages: do not expect the rest of the world to finance the US banking bailout. Both China and Russia have their own serious economic problems. Russia has drawn down 40% of her precious surplus. China is embarked on a big fiscal spending program. The Chinese program – similar to the US in 1950 – makes sense. The Obama stimulus is badly designed because he allowed the Pelosi House complete freedom. It will miss its mark. In the meantime the US Treasury markets will see less foreign investing – and rates must rise commensurately.

The world is angry at the US for its hubris and folly over the past 3 decades. A new economic order will eventually evolve from all this economic white noise. That will occur within a decade after much pain in this effort. Perhaps the most important aspect of this **new economic order** will be an effective international exchange rate mechanism. If not, trade protectionism will re emerge in a very big way. This AM The FT notes the Bernanke Fed has failed to keep mortgage rates down.

"The US Federal Reserve's efforts to drive mortgage rates lower by purchasing home loans have faltered and rates have risen over the past month. The rise in rates is a disappointment to government officials, who had hoped that a steep fall in house prices and low financing costs would lure buyers into the nation's depressed housing market.

Since January 13 the rate on standard long-term mortgages charged by lenders to prospective home owners jumped from 5.04 % to reach 5.51 % on Friday. The jump represents an almost 10 % rise in borrowing costs."

The genesis of this crisis was the Greenspan housing bubble. There are now three years of massive mortgage resets (IO and Option ARMs) scheduled through 2011. Higher interest and mortgage rates are problematical. The ten year Treasury may foretell a chilling story.



Since the beginning of the year the Fed has purchased $92 billion of mortgage securities. The Financial Times notes that the Fed plans to raise $2 trillion in Treasuries over the 2009 time period. In spite of Friday's employment disaster Treasury yields rose – go figure! This week alone the Fed will raise $67 billion in treasuries – a mere drop in the bucket. If the Fed cannot suppress mortgage rates debt de leveraging could spiral completely out of control. We believe that the Fed will be forced in to quantitative easing, buying its own Treasury bonds. This will require the central bank to create new money and then buy assets to support their prices. The central bank simply grants itself credit to buy Treasuries (or any other asset it feels necessary). The chief risk of this approach is that inflation and hyperinflation may occur in response. QE is an end game strategy of central bankers and not taken lightly because no one knows how much QE is enough or how much is too much.

Ambrose Evans-Pritchard suggests that the US economy could "suffocate" under a higher interest rate scenario:

"The yield on 10-year US Treasury bonds – the world's benchmark cost of capital – has jumped from 2pc to 3pc since Christmas despite efforts to talk the rate down.

This level will asphyxiate the US economy if allowed to persist, as Fed chair Ben Bernanke must know. The US is already in deflation. Core prices – stripping out energy – fell at an annual rate of 2pc in the fourth quarter. Wages are following. IBM, Chrysler, General Motors, and YRC, have all begun to cut pay.

The "real" cost of capital is rising as the slump deepens. This is textbook debt deflation. It was not supposed to happen. The Bernanke doctrine assumes that the Fed can bring down the whole structure of interest costs, first by slashing the Fed Funds rate to zero, and then by making a "credible threat" to buy Treasuries outright with printed money.

Mr. Bernanke has been repeating this threat since early December. But talk is cheap. As the Fed hesitates, real yields climb ever higher. Plainly, the markets do not regard Fed rhetoric as "credible" at all."

Let's face it we have a spiraling budget deficit (forecast by many, including President Obama, to be over$1 trillion, "for many years") and now reluctant foreign buyers of our Treasuries. China is the largest owner but she will require higher yields to continue at her previous pace. The bottom line is that the debt game is over for mom and pop in Kankakee.

Savers all, we shall be forced to become. It has already begun. In addition the dollar must eventually fall – if not in value - then certainly in its importance to the rest of the world. Indeed it would appear that the Federal Reserve must now embark on a much riskier approach to stemming the downturn.

And what of the now invisible man, Dr. Bernanke? My guess is that his foot-in-mouth speech, his inflation targeting dogma and his threats to ease quantitatively will be discredited by this time next year. Look for Robert Rubin or Larry Summers to be the next Fed Chief.

By the way Bloomberg reports this AM that $9.7 trillion has now been committed by the US to solve the Great Contraction. Still our leaders have not come to grips with the potential for debt deleveraging and its inevitable follow on, debt deflation.

President Obama's economic guru Larry Summers, said on Sunday (Feb. 8) that it was, ***"most important the people come together and create the 3 to 4 million jobs."*** That seems a stretch given the predominance of "pork" in the Obama / Pelosi stimulus plan.

Remember, Dear D.I., our children and grandchildren both Canadian and American are going to be forced to pay for our folly. They will pay either directly (taxes) or indirectly (standard of living) for many years.

Having described this perilous environment I expect that the stimulus bill will pass within a few days. President Obama will once again be praised as our great savior and the stock markets will roar ahead significantly. Look for 20% upside. This will be a short-lived bear market rally however as the banking system continues to present problems for our leaders.

2. A LOOK AT THE RECENT PAST

I thought it informative to place the current status of the Great Contraction in perspective. While this began in 2007 it was really in July 2008 that the "wheels started to come off." China was becoming very concerned at her GSE and treasury investments and the rest of the world at the declining value of the US $. Here are a few vignettes from the July 2008 timeframe when the big discontinuities became relevant.

From Morning Notes July 17, 2008

"I do not envy the position of Dr. Bernanke. However, he may be on target. I have long maintained that he cannot raise interest rates and that, in fact, he will end up lowering rates. An evident fact is that despite all the Fed's gimmicks, including significant interest rate maneuvering, the US economy seems to be stalling. There is little talk of interest rate increases anywhere. Even the EU's Mr. Trichet's recent 25 basis point gambit looks silly in hindsight. Now, just at the time when we should be seeing growth, it appears we are descending into the netherworld. Just at the time when an economic spring should be on us, the GLOBAL banking system is under assault and credit is extremely difficult. GM and GE are both reeling and trying to sell assets and delay the inevitable. No dear D.I. we have a tough road ahead for at least another year."

July 17, 2008

Yesterday we saw a violent rally in the financial sector. Well Fargo's earnings cannot be the entire result. There is still much "hair" on the US banking system. The housing bubble must become quiescent before we can get a handle on the true health of US banks. J P Morgan reported earnings lower by 54% this AM and the stock has soared in the pre market. It was simply a better than expected loss. That gives me little comfort.

July 18, 2009

In spite of all the angst about inflation I am concerned about potential deflation, a more ominous foe than inflation. The Morgan Stanley Commodity Equity index has fallen thorough the 50 and 200 week moving average support. It must react positively here. By the same token copper, our bell weather commodity, has not yet broken down. So while

there is pressure on the commodity space, copper is holding. A move by copper to the $2.00 level would signal a worldwide economic reversal, in my view. … I caution you to be aware of the potential for a much slower growth scenario in the US which would impact the BRICS and the BRACS (Brazil, Russia, Australia and Canada).

July 18, 2009

The alternative implication is sobering. The potential for falling commodity prices concurrent with slowing economic growth, severe credit liquidation and declining energy prices may be Dr. Bernanke's worst nightmare.

July 23, 2009

Bill Gross has suggested an interest rate increase would throw the economy into a 1930s style trauma. Wachovia wrote off everything but the kitchens sink under its new head Mr. Steel – or did they? That will depend, of course, on the fate of the housing industry. Neither Mr. Doll nor Mr. Gross believes it is possible for the Fed to raise rates in 2008 to "energize" the strong dollar.

July 23, 2009

Without the proper functioning of the credit markets, the global economy is in trouble. Without a bottom to housing (prices, defaults and therefore foreclosures) the write-offs will continue and credit markets will continue to be very difficult. Perhaps Mr. Paulson does speak the truth and perhaps it "shall beareth away the victory."

July 25, 2008

I am sorry to report this AM that foreclosures have more than doubled over this period last year (up 121% in Q2). Home foreclosures have increased 14% since the first quarter of 2008. One of every 43 homes in Nevada and 1 of 65 homes in California are in foreclosure. These are troubling numbers for the banks and the economy. Citigroup still has $115 billion in questionable real estate "paper." I am especially sorry because so many families are torn from their homes. With this new data, Realty-Trac estimated, this AM, that in 2008 2.8 million foreclosures will occur. They also suggest that housing prices have another 15% downside in the next 12 months.

July 27, 2008

The markets look teary this AM and gold is slightly higher while the dollar is trading lower in pre market activity. Along with the foreclosure data and housing deflation, near recession unemployment and a commodity pullback we are carefully watching for signs of real deflationary contraction– as I am certain Dr. Bernanke is as well.

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