WASHINGTON CROSSING ADVISORS

Market Commentary
January 7, 2009

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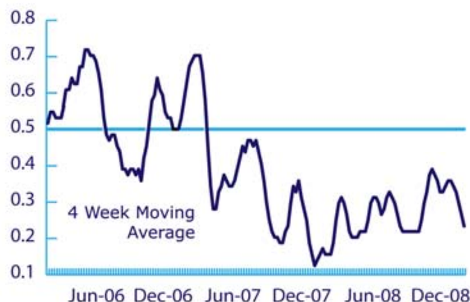
Can Policymakers Create Just a Little Inflation?

In our last commentary, we pointed to the ongoing slide in net new credit creation by households (the largest component of the private sector in the United States) as a historic event that signaled a dramatic change in the country's financial inner workings. This raises two important questions. First, can government spending spur a sustainable recovery in the absence of private sector borrowing and spending? Second, will the Federal Reserve and the U.S. government be able to stimulate risk-taking as households, corporations, and investors seek to reduce leverage? The answer to these two questions will largely determine what kind of year 2009 turns out to be.

To date, we have seen that markets have responded with tepid enthusiasm to what now amounts to over $8 trillion of rescue and stopgap measures taken by the Fed and the Treasury to shore up the financial system. Our "Credit Thermometer," seen below, which measures a collection of credit indicators, has shown modest improvement, but more than half of the index's components continue to show contraction. Some credit spreads, such as the spreads that affect inter-bank lending, have stopped widening, and have narrowed. Other spreads, such as those found in the mortgage market, continue to widen despite new efforts by the Fed and the Treasury to intervene in those markets. Thus, it is not clear that the efforts of central bankers and governments have been completely successful in driving the market outcomes they desire. It is also not clear what the long-run effects of market interventions will be.



Therefore, in the face of contracting private sector demand for goods, services, and credit, we remain skeptical that the policymakers will be able to simply create the desired amount of modest inflation and economic growth they seek on command.

Signs of Deflation

In modern times, inflation has been the primary concern of government and central bankers. The corrosive effects of a rapidly rising price level were a destabilizing and painful process during the 1970s. Price controls, automatic wage adjustments in employment contracts, and multiple oil shocks rapidly destroyed the ability of the economy to supply goods and services, and impaired the purchasing power of dollars. Today, we are confronted with the opposite dilemma of falling prices and supply gluts. In recent months, we have seen an across-the-board collapse in prices. Asset prices have dropped, consumer goods prices have dropped, and input prices have dropped. Inventories of unsold homes, commodities, and automobiles have all risen sharply. The bond market now is pricing in a 0.1% long-run inflation expectation compared to a 2.5% inflation expectation just last summer. The institute of supply management's index of input prices has fallen by the largest amount since just after the end of World War II. At the same time, household equity has fallen by $7.1 trillion, the largest year-over-year drop on record, according to Federal Reserve data. In turn, this has prompted a massive shift in behavior as U.S. households have rapidly transitioned from net borrowing to net savings for the first time since the 1930s, based on Federal Reserve data.

Such a reversal in spending and savings patterns poses a problem for government and bankers. Historically, they have relied on the steady expansion of private sector credit and borrowing as the primary spigot for money creation. This process has served central bankers and the overall economy exceptionally well for most of the past seventy years, as monetary expansion and modest inflation prompted consumers to spend rather than hoard cash and prompted risk-taking investors to borrow and invest rather than hold cash in unproductive, but safe investments. Now that households hold roughly $1.40 in debt for a dollar in income, rather than $0.40 in debt for a dollar of income as was the case after World War II, households appear to be more concerned with increasing their rate of savings from disposable income. We believe that until debt-to-income and debt-to-asset ratios stabilize at lower levels, it will be likely that the savings rate will continue to rise and that households will act as a drain rather than a source of net new money and credit creation. These ratios can be improved by a combination of debt retirement, income gains, or asset price appreciation. Current trends have not supported job creation or asset price inflation. Instead, the onus has been placed on increased savings and debt retirement to make up for lost wealth related to declining home equity and financial market losses. These trends are particularly evident among "baby boomers" who are moving closer to retirement and whose funding requirements for savings are now higher, and consumer spending needs are more moderate in the wake of the housing bust. Without U.S. households acting as willing borrowers, our trade partners and our policymakers will attempt to use the U.S. government as a "borrower of last resort" to act as counterparty to the central banks' role of "lender of last resort."

A Drive For Savings

A higher rate of savings is something that we have seen before. As recently as the early 1990s, the savings rate was closer to 10% than the 0% seen in recent years. With roughly $10 trillion in disposable income in the United States, a return to a 10% savings rate would mean that roughly $1 trillion

would, on the margin, not be available for spending and consumption. In addition, households have eliminated, from peak levels, $1.4 trillion of annualized net borrowing seen in 2006. Thus the potential shift from borrowing and spending to savings could amount to a $2.4 trillion shift. This shift is not what the global economy has in mind and is part of the reason why this downturn could be deeper and longer than past cycles and why there has been a coordinated slowdown in the global economy.

To combat this, a combination of monetary and fiscal stimulus is being formulated. To date, we do not have a precise understanding of the fiscal stimulus. We have a better understanding of the monetary framework, however. The Federal Reserve has aggressively and quickly lowered the Fed Funds rate to effectively 0%. Such a low rate should provide a disincentive for savings and encourage more borrowing – precisely the opposite direction the public is leaning given their new desire to save and pay down debt. In the past, low yields at the bank (such as the Federal Reserve's maintenance of a 1% rate for overnight money following the 2001-2002 recession and terrorist attacks) created the necessary incentives for increased borrowing and leverage that, in turn, created rising asset and consumer prices. Thus, the return to near 0% short-term rates, along with other untested policy actions, undoubtedly hopes to create a replay past easy-money cycles as a way to enliven the expansion of credit, expand the money supply, and drive higher the overall price level as a way of preventing a deflation-driven policy trap.

Bernanke's Plan

In November 2002, for example, Ben Bernanke discussed alternative policy options that could be used in a deflationary environment once the Fed Funds rate reached 0%. The speech was given in Washington, DC before the National Economists Club. During the speech, Dr. Bernanke downplayed the likelihood of deflation in the United States, suggested that it is easier to avoid deflation in the first place rather than to fight it once it begins, and defended the idea that, under a paper money system, government can always generate a positive rate of inflation. He also outlined six alternative policy actions that the Fed, in conjunction with cooperative efforts from other parts of government, could turn to once the Fed Funds rate reached the "zero-bound." In no particular order, the list includes:

1) Commitments to holding the overnight rate at zero

"…One approach, similar to an action taken in the past couple of years by the Bank of Japan, would be for the Fed to commit to holding the overnight rate at zero for some specified period."

~ Bernanke (November 2002: *"Deflation: Making Sure "It" Doesn't Happen Here"*)

2) Ceilings for yields

"…A more direct method, which I personally prefer, would be for the Fed to begin announcing explicit ceilings for yields on longer-maturity Treasury debt (say, bonds maturing within the next two years)."

~ Bernanke (November 2002: *"Deflation: Making Sure "It" Doesn't Happen Here"*)

3) Agency debt

"…Yet another option would be for the Fed to use its existing authority to operate in the markets for agency debt (for example, mortgage-backed securities issued by Ginnie Mae, the Government National Mortgage Association)."

~ Bernanke (November 2002: *"Deflation: Making Sure "It" Doesn't Happen Here"*)

4) Yields on privately issued securities

"…If lowering yields on longer-dated Treasury securities proved insufficient to restart spending, however, the Fed might next consider attempting to influence directly the yields on privately issued securities."

~ Bernanke (November 2002: *"Deflation: Making Sure "It" Doesn't Happen Here"*)

5) Exchange rate policy

"…Exchange rate policy has been an effective weapon against deflation. The Fed has the authority to buy foreign government debt as well as domestic government debt. Fed purchases of the liabilities of foreign governments have the potential to affect the market...for foreign exchange. Although a policy of intervening to affect the exchange value of the dollar is nowhere on the horizon today, it's worth noting that there have been times when exchange rate policy has been an effective weapon against deflation."

~ Bernanke (November 2002: *"Deflation: Making Sure "It" Doesn't Happen Here"*)

6) Direct open-market operations in private assets

"…If the Treasury issued debt to purchase private assets and the Fed then purchased an equal amount of Treasury debt with newly created money, the whole operation would be the economic equivalent of direct open-market operations in private assets."

~ Bernanke (November 2002: *"Deflation: Making Sure "It" Doesn't Happen Here"*)

We can clearly see how these policy ideas discussed in 2002 are making their way into current policy decisions. The December 16 Federal Open Market Committee statement that accompanied their decision to reduce the Fed Funds' target rate to a range of 0 - ¼% included language that specifically mentions many of the alternative policy actions outlined in Dr. Bernanke's 2002 deflation speech. In the statement, the FOMC mentions that they will support financial markets through open market operations and other measures that sustain the size of the Fed's balance sheet at a high level. The Fed is also expanding its balance sheet by purchasing a large quantity of agency debt and mortgage-backed securities to provide support for the mortgage and housing markets. Plans have been floated which envision reducing the rate on conforming 30-year mortgages to as low as 4.5%. According to the statement, the Fed is also evaluating the potential benefits of purchasing longer-term Treasury securities. These actions, along with recently created

loan facilities, allow the Fed to inject capital into the financial and banking system by expanding the size of its own balance sheet through the issuance of newly issued Treasury debt and the simultaneous purchase of these non-Treasury assets.

What About Japan?

It should be noted that the Bank of Japan also bought asset-backed securities, equities, and extended the terms of commercial paper operations. Despite Japan’s efforts, they were unsuccessful in reversing the deflationary tendencies in their economy. Some have argued that they acted too late and, hence, the rapid response by policymakers over the past year by the Fed and the Treasury. So far, market response has been tepid as evidenced by generally down-trending stock prices, elevated high credit spreads, and the ongoing slide in real estate values. The tepid-but-positive market response to last year’s actions suggests that doubts remain as to their long-run effectiveness but also demonstrates that swift action may have prevented even greater deterioration.
To further paraphrase Mr. Bernanke's speech, these kinds of actions are untested, and it is impossible to "calibrate" the economic effects of such nonstandard means of injecting money. Of particular concern is the Chairman's suggestion that Japan was unable to thwart growing deflationary problems because of the size of the bad loans that were never properly purged from their banking system. These bad loans, coupled with the inability of Japan to come together politically on a course of action for reform, helped produce a calcified financial system and undermined BOJ efforts to stimulate growth through monetary policy. In response to why the Japanese experience was not transferable to the United States, Dr. Bernanke stated that "the U.S. economy does not have Japan's massive financial problems." It is unclear whether or not the ongoing financial sector write-downs, which have recently topped $1 trillion, along with ongoing loan impairments, places the U.S. financial system in a condition similar to that of the Japanese or not. In our view, the proof will lie in the volume of loan creation that follows.

Conclusion

With the household sector retreating from the use of borrowed funds to make purchases, and the re-emergence of a drive to higher savings and lessened risk appetites, we believe that policymakers will face an uphill struggle to create growth and inflation. Ben Bernanke, however, seems to believe that "policymakers should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero." We are skeptical, especially given the fragile condition of our financial system, rising distress among borrowers, and ongoing declines in collateral values in the form of real estate and stock portfolios. To again use Dr. Bernanke's words, a "well capitalized banking system and smoothly functioning capital markets are an important line of defense against deflationary shocks." Since the banking system is tied to housing as collateral for its loans, we believe that until we see housing prices stabilize, this important "line of defense" will remain under assault and be potentially ineffective in transmitting the desired monetary policy stimulus.

In 2009, we believe $500 billion to $1 trillion of new money should be created to offset rising private sector losses and increased savings requirements, and to offset a similar amount of financial sector asset losses in order to maintain upward pressure on prices. Without robust private sector lending, the

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obvious alternative way to inject money into circulation is through direct Federal Government spending. Such spending used to be called "pump priming" and had the aim of propping up demand and employment until private sector businesses again ramped up spending and hiring plans. As the Federal Government embarks on massive spending in 2009, we wonder if such spending will actually spark the creation of sustained expansion or whether it will produce illusive or uneven results. If the stimulus is only focused on demand creation, without adequately incentivizing entrepreneurial risk-taking in the private sector, it is hard to envision a sustained expansion taking root from the effort. If, on the other hand, more comprehensive legislation emerges that improves the landscape for entrepreneurial risk-taking, such efforts would likely have a more positive effect, because they will prompt the kind of autonomous investment spending and, with it, produce the kind of multiplier effects in the economy that lead to sustainable job and income growth.

In the meantime, we remain skeptical of the ability of policymakers to offset the drive by households to bolster savings at the expense of current consumption and the need for financial intermediaries to curtail leverage and bolster capital positions in anticipation of fresh losses. 2009 will likely bring a rising tide of unemployment, bankruptcies, and compressed profits. We recognize that stock and credit markets will sniff out opportunity before the actual turn in the economy, but given the size of the distortions in the years leading up to this crisis, coupled with our skepticism over the ability of policymakers to engineer desired outcomes at will, we remain cautious at this time with a heavier emphasis on cash and bonds over stocks.

Recommended Asset Allocation

	Growth	Balanced	Conservative
INCOME & OTHER	41.0%	66.0%	91.0%
DOMESTIC BONDS	39.8%	64.0%	88.2%
Money Market	1.2%	2.0%	2.8%
Short-Term Treasuries	8.7%	14.0%	19.3%
Intermediate Term Treasuries	6.8%	11.0%	15.2%
Long-Term Treasuries	6.2%	10.0%	13.8%
Extended Duration (LT Strips)	6.2%	10.0%	13.8%
Investment Grade Corp Bonds	7.5%	12.0%	16.5%
High Yield Corporate Bonds	3.1%	5.0%	6.9%
COMMODITIES & OTHER	1.2%	2.0%	2.8%
Preferred Equity	1.2%	2.0%	2.8%
COMMON STOCKS	59.0%	34.0%	9.0%
DOMESTIC COMMON STOCKS	59.0%	34.0%	9.0%
U.S. SIZE & STYLE	59.0%	34.0%	9.0%
Large Cap Growth	17.4%	10.0%	2.6%
Large Cap Value	17.4%	10.0%	2.6%
Mid Cap Growth	6.9%	4.0%	1.1%
Mid Cap Value	6.9%	4.0%	1.1%
Small Cap Growth	5.2%	3.0%	0.8%
Small Cap Value	5.2%	3.0%	0.8%
TOTAL PORTFOLIO	100%	100%	100%

Recommended Sector Allocation

	Suggested Weight	S&P 500 Weight*
U.S. Equity Sectors		
Energy	0%	13%
Technology	12%	17%
Materials	4%	3%
Industrials	4%	12%
Consumer Discretionary	10%	8%
Health Care	26%	12%
Utilities	13%	4%
Consumer Staples	16%	10%
Telecommunications	0%	4%
Financials	14%	18%
Total	100%	100%

* Source: Bloomberg

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