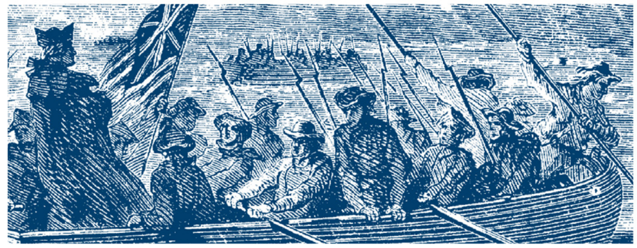

Market Commentary
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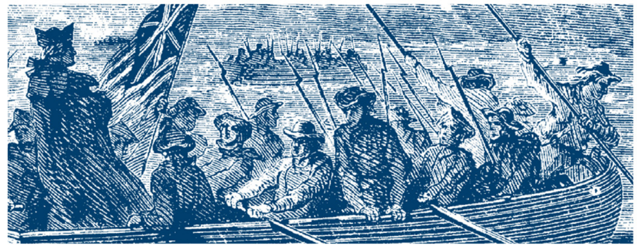
Bernanke's Prayer

During the 1970s, former Federal Reserve Chairman Paul Volker reviled inflation and prayed for an end to rapidly rising prices. Today's Chairman, Ben Bernanke, is cursed with a world of falling prices which is hurting the economy and adding to unemployment and foreclosures. In a monetary sense, he knows that inflation may be the only thing left that he can influence that has any chance of stemming the tide of destabilizing asset write-downs, defaults, and foreclosures. So in the fall of 2008, the Fed and Treasury, along with a host of other central bankers and governments, went "all in" to try to stem the liquidation of debt and assets that began with the sub-prime mortgage market in 2007. In some sense, this appears to have worked, albeit at a very high price.

In the United States alone, over $10 trillion of loans, investments, and taxpayer-financed guarantees were put in place just to convince lenders that borrowers will pay – even if the investments went bad. This backstopping of private obligations took the form of government guarantees of private loans, which is to say that the taxpayer was forced to cosign obligations of private companies regardless of price or rate of return. Whatever the ethical implications of such a thing might be, policymakers were in crisis mode and felt that it was the only possible alternative to achieve the immediate goal of averting meltdown. So far, it appears like that objective has been achieved. Over the past six months, confidence in financial markets seems to have improved, financial capital has begun to flow, and asset prices have shown some initial signs of stabilization. At the same time, inflation expectations have begun to rise, as seen in a steepened yield curve, higher commodity prices, and a higher inflation rate priced into inflation-protected Treasury bonds. Thus, it seems as if Bernanke's prayer has been answered.

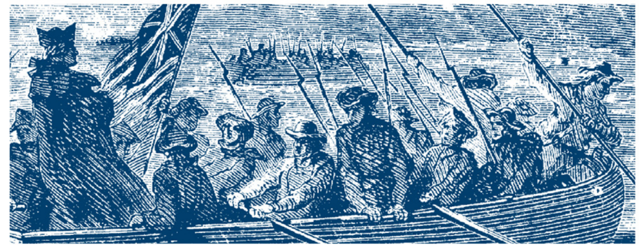


Our own quantitative assessment of the economy shows that such backstopping has been effective in turning around markets and various economic indicators. Our diffusion index, which measures changes in thirty different indicators of health in the U.S. and foreign economies, bottomed last winter and now shows that most measures are in the process of turning for the better. We see that banks are lending to one another again at reasonable rates; we see that larger companies can get access to short-term financing at economically attractive rates; there are some signs of slowing in the rate of job losses; inventory levels are improved relative to sales; and so forth. All of this is positive news and a welcome development.

The improvement is also seen in new data compiled by the Federal Reserve. That data shows the value of household real estate rising right alongside the value of equity markets since the spring. As a result, household net worth has increased from $48 to $53 trillion in six months. All of this is positive and has created some sense of optimism that the economy may be coming back from the recession and has already begun an economic recovery. We hear nightly about "V"-shaped growth and "green shoots."

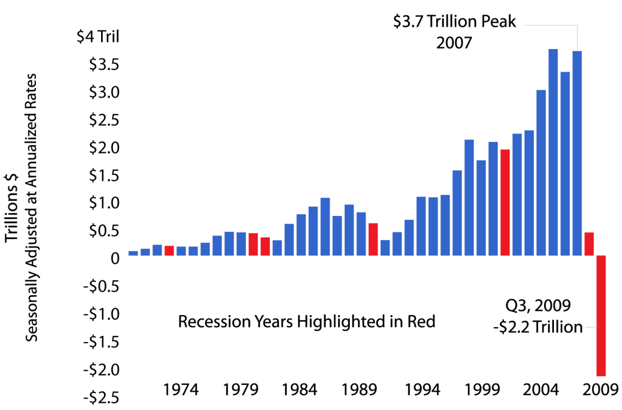
Yet, for many, there remain some unsettling aspects about the current situation. We know this because the savings rate has risen to 4% from below 1% in April 2005. This increase in savings is certainly not about capturing a high rate of interest offered by banks, since those rates are near 0%. Nor is it about consumers having lots of cash burning a hole in their pocket. The increase relates to uncertainty about the future. Based on Federal Reserve data, the average person now holds 36 weeks of income in the form of deposits versus 34 weeks a couple of years ago. It is common now for retirement and other savings plans to be under-funded – in part because of ten years of an underperforming stock market but also due to changes in assumptions about assets such as real estate. Similar shortfalls are being recognized by national government, state and local governments, large and small businesses, and charitable organizations. Individuals are aware of these imbalances, and the threat of higher tax burdens adds to already tight personal finances.

Since individuals and businesses are not yet convinced that a turn is at hand, the drive to savings is also accompanied by a desire to avoid and reduce debt. As for debt reduction, it can be achieved through pay-down or default and, in the case of another government intervention, forgiveness. The Mortgage Bankers Association now reports a foreclosure rate of 4.5% on all loans compared with a 1% rate, which has been the more typical experience over the past couple of decades. Ironically, just as savers are piling into savings at very low rates, there is scant evidence to suggest that record low mortgage rates are encouraging a massive new round of borrowing.



The Federal Reserve's data shows that the private sector debts belonging to households, businesses, and financial companies are actually contracting, in total, at an annualized rate of -$2.2 trillion (see chart above). There are three things I want to bring to your attention about this -$2.2 trillion number. First, the -$2.2 trillion is a "net" number. In other words, there is some amount of new borrowing that is occurring, but the amount of borrowing that is being paid off or written off is greater than the amount being incurred by -$2.2 trillion. So the amount of debt extinguishment is actually much higher than the -$2.2 trillion net number. Second, the -$2.2 trillion number is the only negative number on record with the Federal Reserve's data series dating all the way back to 1946. When debt expansion slows, there is a strong tendency for the economy to falter. This is apparent when comparing changes in private sector net borrowing to changes in private sector employment.

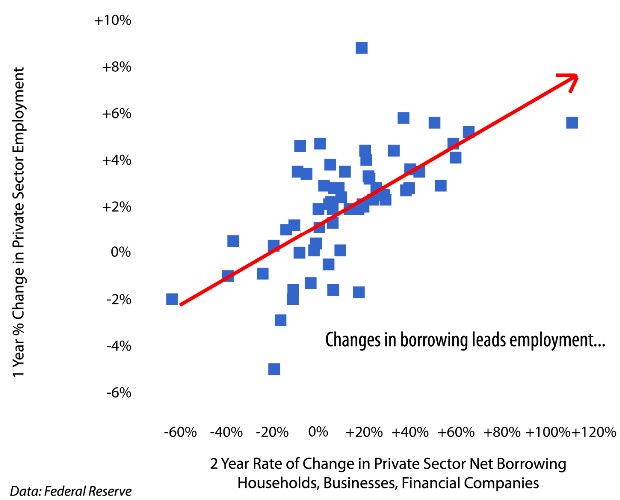
U.S. Private Sector Borrowing Collapse
Total Net Borrowing of U.S. Households, Businesses, and Financial Companies



Source data: Federal Reserve

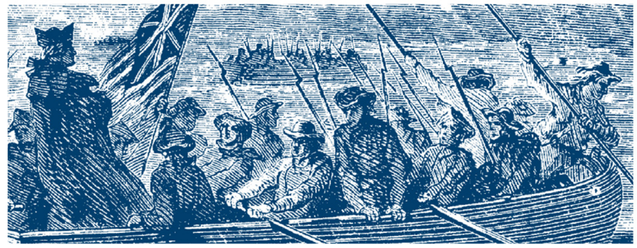
The graph below depicts the relationship between debt and employment growth in the private sector. We see here that there is a strong tendency for private sector employment (seen along the x-axis) to rise and fall in response to a change in private sector borrowing (seen along the y-axis). Thus, the larger the contraction in private borrowing, the larger the expected falloff in private employment.

Strong Relationship Between Growth in Private Borrowing and Jobs



Data: Federal Reserve

It is not at all surprising that the rate of unemployment has reached 10% with the rate of underemployment reaching near 17%, in light of the fact that private borrowing peaked in the third quarter of 2007 at a net annualized growth rate of $4.7 trillion and has now slid to a contracting rate of -$2.2 trillion on an annualized basis. It is hard to envision how private sector employment would increase alongside private sector debt liquidation.



One other surprising fact about this data is that, despite the improvement in financial markets during the second and third quarter, the pace of debt liquidation appears to be accelerating. Households were liquidating debts at an annualized rate of -$160 billion in Q1; -$215 billion in Q2; and -$351 billion in Q3. Similarly, companies were growing debt at an annualized rate of $53 billion in Q1; began net liquidation to the tune of approximately -$249 billion in Q2; and liquidated at a rate of -$283 billion in Q3. Financial companies, which hold the largest concentration of debt among any sector at over $16 trillion, have been liquidating debt at a $1.5-$2 trillion pace this year. This process has been aided by the Federal Reserve, which has injected capital into the banks by buying up roughly $1 trillion of assets from those same banks. We anticipate that the Fed will attempt to engineer additional purchases well into 2010, which could further balloon the size of their balance sheet. Stay tuned.

The seemingly counter-intuitive fact that accelerating private sector debt liquidation is occurring alongside a wide variety of observations showing improvement in the economy can only be explained by two potential phenomena. It could be that the public senses that the improvements are superficial and tentative because they do not see the positive effect of government actions in their immediate circumstances. On the other hand, the trend toward higher savings rates and debt liquidation could have longer-lived secular characteristics.

As we have written about in the past, potential drivers for longer-run, secular shifts are:

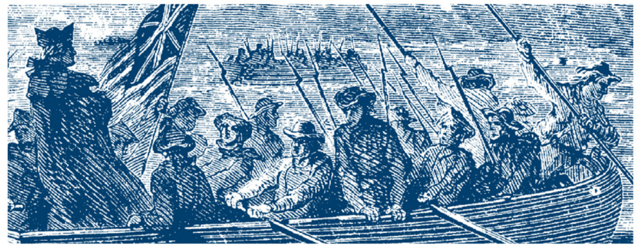
1. A much higher degree of private sector debt and leverage than in the past;

2. Boomers' exit from peak spending years;

3. A negligible change in the cost of money from boom years;

4. Structural changes to regulatory and tax code that inhibit risk-taking.

Ultimately, time will whether this is just another credit cycle and will follow the normal cyclical pattern leading to a sustained recovery, or whether these secular changes produce a markedly different outcome. So far, markets have answered Ben Bernanke's prayer. Soon, we will see if the private sector is similarly inclined.



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