



JMH Wealth Management, LLC

One Trillion Dollars

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As Yogi Berra said, “you can observe a lot just by watching” and at present there are a lot of things to be watching. The number of things that could go wrong in the U.S. and global economies over the next year or so, as we seek to find our way out of this financial crisis, can make your head spin. Asset write downs, policy missteps, credit defaults and geopolitical tensions are just a few of the more obvious challenges that global economies and financial markets have to navigate, and there is no way to rule out another leg down in the markets.

Ominously, the rise of protectionism around the world including some aspects of the U.S. fiscal stimulus plan being discussed in Congress currently, such as the bias toward only U.S. manufactured steel in infrastructure works and the firing of foreign workers before U.S. workers, are particularly worrisome. Apparently, we are failing to remember that the infamous Smoot-Hawley tariffs were a major contributor to turning a hard economic downdraft into the Great Depression. The protectionist virus is extremely contagious and can be lethal to international trade and the economic well being of every country in this interlinked world. Policy makers around the globe need to go back and reread their economic history before they turn a very bad economic recession into something much worse.

The economic data isn't pretty. The gross domestic product (GDP), a broad measure of economic activity, plummeted 3.8% in the fourth quarter of 2008 according to the official release from the Commerce Department, which was the worst decline in nearly three decades. Looking inside the data and adjusting for the buildup of inventories, which ultimately have to be worked off somehow either through future sales or inventory write offs, we find that the final sales number was a decline of 5.1%; a real stunner. I believe the final sales data rather than the headline GDP number are a better indicator of underlying demand and economic activity and I wouldn't be surprised to see another negative 5% number for the first quarter of 2009.

Not surprising, the back to back decline in consumer spending over the third and fourth quarters of 2008 was the weakest in nearly fifty years. Consumers are worried and are reining in their spending habits. Unemployment is currently over 7% in the U.S. and likely on its way toward double digits by the time we exit this recession. You can pretty much pick any economic indicator and it is flashing ugly weakness, but that is what happens in an economic recession, especially one as powerful as I suspect we're in the middle of. The news flow will be negative for quite some time.

The news overseas is no better. Most countries are in the midst of engineering rescue plans for their banking and financial sector, the sovereign debt of many nations are at risk for ratings downgrades, and many European and Asian countries have joined the

U.S. in the official recession dock. Even the high flying commodity based economies, like Russia and Venezuela, are not looking so wonderful presently as currency reserves quickly vanish and budget deficits loom. It's easy during times like the present to blame outside influences or other countries for domestic difficulties; it's the old political trick of distraction. But the truth is that most countries, including the U.S., are being buffeted by problems of their own making- excessive leverage, poor lending standards, regulatory incompetence and mispriced risk are the common denominators.

It probably sounds crazy, but I'm encouraged by what I see in the economy and financial markets. Amid all the bad news, signs of improvement are developing, albeit "Inside Baseball". The core of the financial crisis has been poor asset quality and a general freezing of transactions for any kind of lending. And yet recently, Libor lending rates have fallen to more normal levels, after spiking during the worst of the credit market freeze last fall. The commercial paper market, having been bailed out by one of the Federal Reserves' many emergency lending programs last year, improved significantly last week as maturing paper found private buyers, in addition to the Fed. Credit spreads have narrowed somewhat and junk bonds have begun to rally off of very depressed levels. This is all good news that maybe the internals of the markets are improving.

As I've noted over the past few months, it continues to feel like we are trying to put in a bottom in stock prices around the 800 level for the S&P 500 Index, which is admittedly cold comfort given that the S&P 500 peaked around 1575 last year. The recurring price action seems to be a revisiting and retesting of the 800 level every time some bad news captures the headlines in the form of either a poor earnings report, renewed concerns on banking, or misstatements from the new Treasury Chief on Chinese currency manipulation. The S&P 500 Index seems range bound between a high of 900 and a floor of 800 which might not be a bad thing if it buys us time to work out all the underlying credit and economic issues. Please note that big daily price moves are probably with us for awhile.

We will need more time. Kenneth Rogoff of Harvard has conducted some sobering analysis of prior banking crises and their impact on unemployment, output, housing prices, asset prices, and government debt. If we track the metrics of his study, we are well into the duration of our corrective cycle, but more time is required. According to Rogoff's study of prior banking crises, housing prices fall 35% over a six year period (we're down around 28% over 31 months), equity prices decline 55% over three and a half years (we're down 47% in 16 months), unemployment rises 7% over four years (we're up maybe 3% in 14 months), GDP weakens 9% over two years (we're down 4-5% over 12 months), and government debt balloons 86% (we're still counting).

Beside the elapse of time, how do we get out of this crisis? All of the fiscal and monetary policy levers are going to be utilized, plus some new innovative devices. Policy actions will have to include real fiscal stimulus, not the amalgam of Congressional pork currently in the proposed fiscal stimulus bill, and continued monetary intervention. Removing the bad assets from the balance sheets of the banks, something along the lines of the Obama Administration's rumored "bad bank" strategy is probably needed and that's where the title of this commentary comes from. My guess is that we will need at least another \$1 trillion to buy up and workout all the bad assets currently held by the banks and other financial service companies. It's also likely that more capital will have to be infused into the banking system once these bad assets are either written off or

shunted to some “bad bank” construct. More encouragingly, if we strip out the bad assets and associated write downs, many financial firms are experiencing profitable operating activity.

The stock market is a great discounting mechanism and will begin to anticipate the recovery in the economy well before it is evident in the economic data. Consequently, we will see the stock market begin to rise even though the economic news flow is still decidedly negative. Now is the time to recheck long term strategies and consider making adjustments. Focusing on companies with strong balance sheets, good cashflow and nice dividend support seems appropriate. Beginning to set up positions in some of the more solid financial firms and even some REITs should be considered. Most stocks are fairly cheap on a price/earnings basis, although the denominator of that metric, the earnings, is the critical variable looking ahead. Even factoring in a healthy discount to earnings over the next year or so, many stocks are trading at attractive valuations for long term investors.

The credit markets still pose considerable risk. Municipal bonds are cheap by historic standards relative to treasury securities, but I don’t feel comfortable purchasing them in light of the expected budget pressure affecting all municipalities. The Fed and Treasury are likely planning to purchase a ton of mortgage backed securities and possibly long term treasuries in the secondary market to drive mortgage and other interest rates lower. The lower they push long term interest rates, the more interest rate risk rises. Investors need to be wary of long term bonds.

At the same time, the credit markets are probably facing an onslaught of new supply as the Fed seeks to exercise its monetary policy. The interplay between these conflicting Fed actions, the purchase of securities in the secondary market to drive rates lower while issuing a ton on new treasury securities, will be interesting to watch. From a portfolio management perspective, the selective purchase of high quality corporate notes with maturities of three years or less seems timely. Nonetheless, short term U.S. treasuries remain the way to limit credit and interest rate risk.

Looking ahead to the other side of this crisis, the Fed along with all the other central bankers around the world are going to have to remove all this excess liquidity or else face serious inflationary pressures. While inflation concerns are not a threat anytime soon, ultimately, the losses on long term bond holdings could be substantial as rates resume more normal levels.

Yogi was right. You can observe a lot just by watching. The markets are flashing signs of internal repair and let’s watch that 800 level on the S&P 500 Index.

Jeffrey