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ASSET MANAGEMENT

Market Musings

June 29th/30th

Dear Friends,

I have been thinking a lot about this Musings over the last month or so and I would like to address what I think has been topical and highly debated. Frankly when I decided on the topic, I was convinced of the outcome; however, after reading or rereading some of my favorite economists, I am less certain. Thus, I have been more influenced by them then I had originally thought. Indeed, I have changed some of my pre conceived notions. Now I know why this month's Market Musings topic has been **so hotly debated in the press and by economists.**

INFLATION/ RECESSION/ STAGFLATION

These words seem to elicit lots of debate, YES/NO/YES/NO, etc. for each. My initial thoughts and in fact conclusion was YES/YES/YES. Now I am more of the **cautious type and say yes, but not capitalized; YES, but not as bad but longer; and NO, I have been convinced** to my surprise that we **are not in the same situation** as in the early 70's when Stagflation was "invented".

While I am certainly not a trained economist, I do enjoy spending time on and have a great deal of interest in observing the markets and what may cause them to move one way or another. Thus **my comments are as an observer**!

INFLATION

I think almost all of us would agree that we are in a **dramatic inflationary cycle** based on soaring prices for oil/fuel, food and most commodities. Oil is certainly a headline grabber and has been front and center for months on end. We are in the **$143 per barrel** range these days and natural gas has finally found its way to much higher levels, say $13.50 per MCF, although still less than its comparable fuel value…which would bring it well into the $20's. I am not predicting that, just noting it for the record.

I might add that the **president of OPEC** said this past week that oil could rise to **$170** per barrel this summer. Some are even saying $200 later in the year. The **head of Gazprom**, the Russian government controlled oil and gas giant, provided a very strong and insistent position on the power and "glory" of Russian oil power and "stood by his prediction of oil would hit **$250 a barrel next year**." (Per the FT on 6/27.)

Food prices increases are lead in large part by the significant increases in grains. Prices have been skyrocketing with **corn** continuing to hit new highs approaching $8 per bushel exacerbated by the **twin evils of ethanol use and floods** in the main corn growing areas in the Midwest. Around the world we are seeing record prices for rice and other staples and shortages in many countries where rice is the main food for much of the populace. In fact, Morgan Stanley reported last week that the percentage of **the world's population living under double-digit inflation is 42%**. Also, six out of 10

of the most populous countries have inflation running at **more than 10%,** as rising food and fuel make up the largest share of the population's spending.
Clearly the **Fed is putting a renewed emphasis on inflation,** as indicated by significant tough talk in early to mid June and now followed by a not surprising **"no move"** on Fed rates on Wednesday. But while a moderate explanation of concern, there still are lots of indications that they are very concerned about the prospects of inflation.

The Fed, as mentioned in Thursday's WSJ:

> "…displayed more concern about inflation risks while **backing off** modestly from worries about growth. The policy committee maintained its view that 'uncertainty about the inflation outlook remains high,' because of continued price increases for energy and other commodities and the `elevated state' of some indicators of inflation expectations.
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> 'Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased,' the Fed said.
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> The statement suggested that **Fed officials** would continue trying to balance the **twin risks of stubborn inflation and continued weak growth** through the rest of the year. As a result, an **interest-rate increase is probably not imminent**, though it can't be ruled out if the inflation problem worsens." (Emphasis added.)

All of this leads to the new debate as to when and by how much the Fed will increase rates this year to dampen inflation expectations. I read that **Bill Gross of Pimco** thinks rates will stay at 2% for the remainder of the year and the Fed is simply jaw boning. It is a tough situation for the Fed with the specter of recession weighing heavily on us.

The discussion about **headline inflation and core inflation** also rages on. Headline includes of course energy and food, which have historically been very volatile while core does not include them and therefore is expected to be a better reflection of long term trends. Merrill's David Rosenberg, one of my favorites, did extremely interesting pieces in both his June 6th and June 12th Morning Market Memos regarding **which is more accurate as an indicator and why.** This is a somewhat lengthy couple of discourses and also difficult to summarize but the essence is in today's environment, **core is the more accurate measure** and has proven to be so over a very long period of time. He also points out that it is **unlikely that commodity prices will continue to escalate** at the rate that has already been evidenced, for example, we are already seeing a decrease in oil usage in the US. Also, it is unlikely that with the slack in employment and diminished Union strength that **inflation would pass into wages**. There is also the deflation from housing and equities which plays into holding down inflation. He concludes the discussion by stating: "Core inflation has a historical 94% correlation with headline…that **headline follows core**, not the other way around!"

He also raised the question about hedonics. **Hedonics is an adjustment** by the government to reflect improvements in the use of equipment and other items. The easiest explanation being if you bought a computer 5 years ago for $1000 and wanted to buy a similar model today which also costs $1000, the improvement in computing power and memory would be adjusted such that a calculation would suggest that there had been a substantial **decrease in the cost of the computer**….hedonics. This concept frequently bothers many observers and along with other adjustments to CPI, and thus distorts and "reduces" the actual inflation according to many critics.

I was a guest lecturer not too long ago for a few years for an undergraduate economics **class at Harvard** and had to prepare to lead the class on a discourse on hedonics, not much fun for a non-academic, non-economist!

I think it is also important to mention **worldwide inflation** and, in my view, the inability to ignore this in the US. There is so much headline news on this that I think we are all reasonably familiar with it, so I will not elaborate in massive detail. The cover of **The Economist** on May 24th showed a group marching up stairs complaining about all the inflation with the person at the top noting "except for my house." Even though there have been updated numbers in some of the more recent press, I think it is comprehensive and I will quote from it (any update would prove to be even worse).

> "China's official rate of consumer-price inflation is at a 12-year high of 8.55%, up from 3% a year ago. Russia's has leapt from 8% to over 14%. Most Gulf oil producers also have double-digit rates. India's wholesale price inflation rate…is 7.8%, a four-year high. Indonesian inflation, already 9% is likely to reach 12% next month…
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> **Inflation in Latin America remains low relative to its ignominious past**. Even so, Brazil's rate has risen to 5% from less than 3% early last year. Chile's has leapt from 2.5% to 8.3%. Most alarming are Venezuela, where the rate is 29.3%, and Argentina. Officially, Argentina's inflation rate is 8.9%, but few economists believe the numbers. Morgan Stanley estimates that the true figure is 23% up from 14.3% last year.
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> "Yes, food inflation is likely to slow later this year; but that does not mean rising headline inflation can be ignored. The synchronized jump in global food prices suggests that there is more to the story than disruptions to supply. Prices are also rising partly because **loose monetary conditions in emerging economies** have boosted domestic demand. These economies **counted for over 90% of the increase in global consumption of oil and metals** since 2002 and for **80% of the rise in demand for grain**. This partly reflects long term structural forces, but it is also the product of a money-fuelled cyclical boom….
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> "Another reason why central banks cannot ignore agflation is that it can quickly spill over into other prices. **Food accounts for 30-40%** of the consumer-price index in most emerging economies compared to 15% in the G7 economies. So food prices weigh more heavily on **inflation expectations and hence wage demands** than in the rich world. Tighter monetary policy would help anchor expectations and stop higher commodity prices spreading into the wider economy."

This is also **exacerbated by food and fuel price controls which are now being reduced** by China, India, Vietnam and others leading to riots and other social unrest and higher wage demands. At the same time most of the central banks are trying to put on the brakes, a little bit, by raising interest rates and other mechanisms such as reserve requirements for banks. **I think this leads to a combustible situation** and one which cannot be ignored by the US. I don't think that the decoupling argument is a winning one, albeit a complicated and controversial topic. I do think that we have a world wide issue and there is no doubt that **China is exporting inflation** to the US and the EU, and elsewhere, particularly Japan. There will be consequences from all of this and how the Fed walks the tightrope as it relates to US policy will be interesting, to say the least, over the next 6 months or so.

It is hard to push away from this topic. Just for example, **China has finally raised fuel prices** by 18% for gas and 16% for diesel, although still way below world prices. In part this was due to the two oil companies, Sinopec and PetroChina, which combine for up to 16 to 20% of the Shanghai Index, had been taking a beating as a result of subsidizing fuel. The Chinese market is down 50% from its highs in October and the **Government felt compelled** to help the stock market. Of course inflation is not helped by this relaxing of price controls. They also just agreed to a 96.5% increase YOY for iron ore, used in steel making.

One last thought on this, the Fed has two mandates, growth and inflation, and the EU central bank has one, keep inflation in check. They will lead the charge and the EU will feel the pinch as prices have

continued to rise and the economy has not. Per Bloomberg data, **corporate earnings in Europe slid 23.4% YOY** in the first quarter versus a drop of 13.4% in the US. Also, **the stock markets in the EU have almost all decreased this year by 20%,** for example, Germany's DAX down 20+%, CAC 40 in France 22%, Euro Stoxx 50 a gauge of the 15 nations Euro-zone down 24%, etc. In contrast as bad as it seems, the US markets are only down about 14%.

Finally, the front page of the Financial Times on last Wednesday: **"SPECHTER OF INFLATION OVER GLOBAL ECONOMY"….** a good lead article if one doubts we have to be worried!

RECESSION

Interestingly, at the beginning of the month a headline in the ML Market Memo (6/2) indicated "**Recession Debate Alive and Well**". It points out that the Investor's Business Daily does a huge "I told you so" in its editorial that a recession was averted. ML says:

> **"This has now become a consensus view. We totally disagree**…We are not cheering on this theme at all as much as claiming it as a fundamental risk for investors. The data **clearly show the onset of recession** and what we will point to is the fact that domestic real private sector spending from the GDP data show a 0.4% slip in the first quarter at an annual rate after a 1% contraction in the fourth quarter. At **no point in the past 60 years** has this ever happened — back-to-back decline in private sector GDP activity—without the **economy being in a recession**? Soft landings or mid-cycle slowdown or growth pauses—as we saw in the mid-1960's, mid-1980's or mid-1990's—do not see successive contractions in real private demand."

We have been talking about the fact that we are in or about to be in Recession since January and believe that in the end this will be confirmed. **Warren Buffet** this past week **confirmed his view that we are in a Recession** and most of the Investment Banks and Banks that had asserted that we were likely in a recession have not backed off this assessment to my knowledge. I believe this is not as deep a turndown as I had expected, but it is **one which is likely to be long and perhaps mild** but just as distressing to the stock/bond and ultimately commodities markets. (I liked the Deutsche Bank comment: a "Platte River Recession: **'A Mile Wide and an Inch Deep'.**" Their view is a lengthy but shallow recession.) Of course, there are lots of wild cards out there from the BRIC economies roaring along with oil continuing to be at historical levels and continuing its climb, as have a number of grains and of course corn hit by the double whammy of ethanol use and Midwest floods, as noted above.

The **housing market continues to deteriorate** and while there were some glimmers of hope in the most recent Case-Shiller report (price drops slowed from a decrease of 2.2% in April to 1.4% in May and seven out of 20 cities actually had an increase), the general news is lower prices, **dropping a record 15.3%** in April, in virtually all markets, greater defaults and accelerating foreclosures**….not a pretty picture**. Almost all experts are predicting more of the same for the next many months, noting that there still is 11 months of housing inventory.

Consumer sentiment was just reported and **is at a 16-year low** (56.4 in June vs. 59.8 in May). Faced with record gasoline prices and the upcoming winter costs for oil and natural gas, this will be a tough next 6 to 9 months on the consumer's pocketbook. Of course one can't forget the dramatic increase in food costs for most people, which is a further hit. I have been reading that there is some relief on rentals, both for apartments and homes, but this is of little solace to the great number of homeowners who have seen their mortgage rates skyrocket and their equity in their house plummet, **another ugly picture.**

Most consumers are being further pinched as the **drug of easy credit** has been eliminated both for housing, in the form of low interest "teaser" rates and easily available low/no down payment mortgages, and readily available credit cards with high limits. Now each not only costs more, but increased lending standard stringency has seen this **ready source of cash drying up dramatically** for most consumers. Many bank analysts now are concerned that the **next shoe to drop** will indeed be the credit losses for the banks from these **overextended consumers** unable to pay their credit card bills….along with auto loans, student loans, etc.

We have reported on this before but the losses to date for the Banks worldwide is about $400 billion and the IMF as well as TIAA-CREF both suggest it could top out at $1 Trillion….**John Paulson suggests $1.3 Trillion** (remember him, he is the hedge fund guy who made $1.3 billion personally last year betting there would be the sub prime debacle). In any case some very smart institutions and people are convinced that there is much more to come. In fact the next shoe to drop is likely to not only be consumer credit but **home equity loans, which represent $1 trillion** in bank exposure, and they come behind the first mortgage. So if one is into "negative equity" on their home, isn't it unlikely that this would be a loan that they would repay? I also have been most concerned about Alt A mortgages….in any case the banks over the next many months have lots more to worry about. Interestingly, the European banks have actually written off more loans than the US banks!

Just last Thursday, Citi's stock fell 6.3%, B of A, 6.8% and Washington Mutual, 9%. **Citi has seen its stock fall 69% from its 2006 high**, to a 10-year low. WaMu is down 89% from its 2003 high, ML 66% from its high, Lehman 74%. In Friday's WSJ, they make the case that: "The financials haven't fallen as rapidly as tech did after their boom ended. At this stage in its decline, the tech-stock-dominated NASDAQ Composite Index was down 60%, about 10 percentage points more than the financials have fallen.
"Banks, however, are the lifeblood of an economy—playing a much bigger role than technology companies." **The chart that accompanied the article is eerily similar to the NASDAQ decline**, I might add, dramatically demonstrating a significant potential further decline!

In my April Musings I noted 5 reasons it was too early to buy bank stocks and what metrics point to when it might be the right time to purchase them, based on the historical perspective from the 91-92 comparable period. I think we are closing in on when one might want to buy….not yet, but closing in!

Consumers were still spending in May, as their disposable incomes jumped 5.7% in the month after being **boosted by government tax rebate payments** designed to stimulate the economy. The FT quotes Michelle Meyer of Lehman: "The rebate will act as **a shot of caffeine,** boosting growth in the third quarter, but pushing growth into negative territory in the fourth when the **caffeine kick fades**." I think the consumers fear over job loss and higher inflation, mostly daily purchases of food and fuel, will cause a slowdown in buying. Tighter credit as noted above just makes things that much tougher. ML points out that this could be the **toughest period for consumer cyclicals since 90-91** as spending is on necessities, so less is available for discretionary spending.

One last thought on the consumer, reported again by ML: "Once the tax cuts subside post-July, we think we are going to see what a consumer recession really looks like: Not 2001 or 1990, which were mild forms of a downturn. We are talking about something **closer to a 1973-74 six-quarter consumer downturn** which saw the S&P retail index **decline 50% peak-to-trough, not 25%."** They go on to validate this with consumer sentiment at a low matching 1980 and note their "financial situation had worsened"….highest since …1946 and then added that **9 out of 10 respondents said the economy is in recession**! The ML conclusion: the **consumer has sealed the debate** and there is no question that we are in recession.

In my February Musings I noted the conventional **definition of a recession** was two consecutive quarters of negative GDP growth but the **actual definition is determined by the National Bureau of**

Economic Research and in making the decision, the committee places particular emphasis on the behavior of four economic indicators: (1) real income less transfers, (2) employment, (3) industrial production and (4) real retail, manufacturing and wholesale sales. At that time even Goldman Sachs who believed we were in a recession could not point to all of these elements being definitive. I have read that we are much closer to such a determination but it is not totally obvious, although evidence is clearly mounting. We can only **wait to see what they determine** which is likely to be when we are on the way out of or already out of recession!

STAGFLATION

I had become convinced that we were heading towards stagflation but after reading several articles, I believe that it will **not be stagflation** as we had it in the 70s and probably not at all. Yes, we will have inflation and a recession! But that does not mean we will have the malaise that we previously encountered back then. I will quote from Ben Stein, Goldman and ML. They have all done a good job of explaining what caused stagflation of the 70s and also why it is unlikely to be duplicated. They also no doubt can say it better than I.

> **Ben Stein's column** in the 6/22 NYT: "Since World War II, there have been two major economic discontinuities in this country. The first came with the Arab oil embargo of 1973. Reacting to fears of damage from fuel shortages, price increases and a budding recession, the **Fed flooded the economy with money**. And there were **price controls on oil**. (I was a speechwriter at the Nixon White House and cringed at these mistakes on oil, so obviously wrong even then. Many of my colleagues also knew that these were mistakes. The White House went through with them anyway. Such is life at the top.)
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> '**The result was stagflation: high inflation, high interest rates and slow growth.** Interest rates rose, but prices rose more as **wage demands** factored in expectations of higher inflation. The Fed's policy, monetary ease combined with higher interest rates, was akin to having a foot on the accelerator with a light foot on the brakes. This was done under intense political pressure to keep the economy out of a deep recession…..
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> "The second shock came when the new Fed chairman, Paul Volker,….put the economy through the wringer to squeeze out inflation….**unemployment rose above 10 percent and interest rates approached 20 percent**…..it set the stage for more than 20 years of **growth without much inflation**…..in other words the Fed got one wrong and one right.

He goes on to talk about the current crises in oil today and asks the question **will Bernanke have the political will and backing to persevere?**

Goldman is concerned about inflation, but not overly so, and notes in an Economics paper on 6/6, which is titled: **"Commodity Inflation, Not Commodity Contagion"**;

> "Commodity prices have soared to new records, and the last time that the United States experienced increases of this magnitude—in the 1970's—they were associated with a decade of rampant inflation and dismal growth.
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> "We think the **differences between the 1970's and the present situations are more important than the similarities.** The oil shocks of that period were predated by a broad based wage-price spiral that pushed wage growth and core inflation over 6% at the *beginning* of the decade. Several factors accentuated the impact of higher oil prices, including a **more commodity-intensive economy**, a lower level of **spare capacity**, and **greater prevalence of collective bargaining** in wage negotiations.

> "Furthermore, the **Fed has learned from its mistakes** in the 1970's. Policy in that era suffered from misconceptions about the potential and actual growth of the economy, a flawed conceptual framework about the tradeoff between inflation and unemployment, and insufficient resolve to carry out the inflation mandate. Arguably, each of these risks is less threatening now.
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> "We continue to think headline and core inflation will remain uncomfortable during 2008, but expect headline inflation to begin drifting down late this year and **core inflation to ease slightly in 2009**, to about 2% by the end of the year.

One last comment on stagflation which is from ML in Morning Market Memo of 5/27:

> "**Stagflation** is a condition where we get a sustained slower real growth and inflationary backdrop that stem from structural supply-side deficiencies, most notably, a **deteriorating productivity environment**. What we have today is a downturn in the economy, not caused by eroding supply-side dynamics, but rather the dampening influence on demand from the reduced wealth effect emanating from deflating housing values coupled with a contraction in credit availability.
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> "The inflation is **not coming from a ramping-up of unit labor costs or an overheated domestic economy but rather from a commodity boom** that is hinging more on global developments than anything structural at home. In fact, **productivity growth has remained very firm**, at over 3% annual rate, and this has never before been associated with a stagflationary economy.
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> "Those in the stagflation camp should keep in mind that this condition is not merely lower growth with higher inflation. It also boils down to the root cause of the inflation—i.e. declining productivity. For example, the reason why at this same stage of the commodity cycle back **in the 1970s both total and core inflation were north of 14%** was not just because of booming raw material costs because **everything in the CPI was accelerating at roughly that pace.** It was also because aggregate supply growth slowed to a crawl for an economy that started the decade at 3% **productivity growth** and was **negative** by the time the 1970s came to an end."

There are numerous other comments made that also support this view that we are highly unlikely to end up with stagflation. We have slack in our employment, the strength of unions and automatic CPI wage adjustments have greatly diminished, the Fed and in particular Bernanke is much wiser about the dilemma, inflation is limited to mostly **food and fuel not most of the other categories measured**…we would have 2% rather than 4% inflation without the commodity surge says ML. Net net, it looks to me very **unlikely we will have a stagflation economy.**

However, **one does have to worry about the rest of the globe**, it is less likely and evidence points to a lack of will in most of the central banks in the emerging markets to deal with inflation and slowing economies….they have not learned from our historic mistakes. We also have to be **concerned about Iran** and what their actions might cause, or actions against them, in the oil markets. If their production was not available, what might that cause in other countries which have a less robust and as large an economy as the US, but with even less political will to address the issues. I am also **concerned about Congress wanting to regulate the markets** and "end the speculators" influence in the commodity markets. This type of **government intervention has rarely gone well** for the economy and did not in the 70s either!

CONCLUSION

I continue to be confident that we will weather the storm and as investors we must always be looking for **the right managers to deal with difficult markets, and for opportunities that will be uncorrelated and/or benefit from the current environment**. This is a challenging time and I expect it to continue to be so for the next year or more. 2009 is not automatically going to be wonderful, in fact I think many of the problems we face today or similar ones will still be with us. I must admit that I thought the economy would be **even more difficult/slower** than it has been, at least as reported to date.

A former partner and I were talking about the markets about a month ago and I suggested that the robust increase in the markets was likely to be **a "dead cat bounce"** and many would be disappointed that the **Bear Stearns rescue was NOT the bottom** and things would not quickly be so much better. He suggested, he is in private equity and specializes in financial services, that it was like being in the **eye of a hurricane**, all was very still after the terrible winds had blown through, but the other side of the hurricane was just about to descend again. This was his metaphor for the financial services industry's continuation of problems!

I think we both are **proving to be correct** unfortunately. With the markets closing last week at or near the traditional **bear market signal** of 20% down from their highs, I think we are in for some tricky times over the next few weeks and months. We are likely in a bear market and historically they last 14 months, we may have 8 months to go, and markets **decrease on average 32%.**

Of course, the Asian and some other markets, see the EU comments above, have had even greater declines and perhaps offer some excellent current opportunities for investors. We have indicated in past Musings that our joint venture partners from Ajia Partners who run a HFOFs in Asia believe there are beginning to be **extraordinary bargains in certain Asian markets.**

Very soon, we will look forward to providing you with our Market Musings video series, the first of which will be an interview with Paul Heffner, our portfolio manager for the Ajia Parners Asian Hedge Fund-of-Funds. If you have any specific questions for Paul and his team, please send them to us, and we'll do our best to have those questions answered.
Once again, I hope this edition of Market Musings was of interest, as I do want to provide our friends and investors with a sense of how we see the markets and some of the issues facing us as investors.

We continue to always attempt to recognize the **proper balance between risk and reward** and bear that in mind in our efforts.

Please call or email with questions or comments. We do enjoy hearing from you.

Thanks for your support and good luck. We wish you **a most enjoyable Fourth of July**; please enjoy **the celebration of our Nation**.

DDL

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