



Full economic recovery, U.S. inflation, and the Fed removing accommodation – still years away

Summary and Contents Guide

- How too much focus on equities (the “less bad” rally) and the anticipated end of recession *wrongly calibrates* today’s place in the business cycle -- and overlooks consistent patterns of falling inflation and Treasury yields after recessions end. **(page 1 & throughout)**
- U.S. economic indicators *throughout 2009* point to strong *disinflationary* trends and enormous slack in resource utilization – while higher prices on commodities only act as a “tax” on consumers who can’t demand higher wages **(page 2)**
- Too little money is now *moving in the economy* as households differentiate saving from investing, and as a historic share of unemployed remain out of work for six months or more. **(page 3)**
- The Fed signals it will keep rates historically low and keep policy options open (despite self-serving media hype) a Fed posture underscored by major absence of the demographic and business conditions which accelerated an unusual and vicious cycle of U.S. inflation in the late 70’s. **(page 4)**
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Full economic recovery, U.S. inflation, and the Fed removing accommodation — still years away

Anyone setting their investment strategy these days by watching what the financial markets are doing day to day — as many market participants would appear to be engaged — would be confused in 2009. Particularly influential is activity among equities and along the U.S. Treasury yield curve. Assumed relationships between these asset classes have been self-reinforcing. Hot money is visibly reacting to each piece of economic and corporate data (and each breath of political rhetoric). Traders then pile in (or out) — often supporting market-moving bets on momentum with complex hedged positions in futures and options which are *not* immediately reflected in directional moves in equities markets averages. (Also, some participants now use ETFs that may differ from index funds in their impact on index averages and debt issues.)

The hot money reactions and media chatter about them are not necessarily based on thorough research. For example, day to day commentary on financial markets uniformly fails to identify the typical fall in inflation which has lasted roughly 1.5 to 3 years after recent recessions have ended. Similarly, market observers do not seem cognizant of the overriding trend downward in 10-year Treasury yields during that period. Only in this deep recession is the public finally being made aware of the historical pattern of joblessness — and economic weakness — persisting and even increasing after the formal end-date of recession.

Informal commentary often confuses the technical end of recession (when real GDP stops falling) with recovery to the nominal levels of real GDP (rather than its rate). Recovery requires a return to actual measured level of economic productivity prior to the onset of decline. Historically, only at this point of full recovery is the U.S. economy vulnerable to inflationary forces *overriding* longstanding slack in the labor force and other productive capacity. Otherwise, a rise in GDP may be termed “growth,” in popular parlance, but except in isolated pockets of the economy it will not look, feel, or operate like growth. Similarly, equities gains that *do not* exceed earlier index averages *do not* operate in the broader economy as a positive wealth effect. While relief over the anticipated end of recession is legitimate, false impressions are easily fostered. **The “end of recession” does *not* signal that:**

- The economy has recovered to its levels of production before GDP started falling;
- Inflation must take off (especially not from consumers bidding up prices in stores or demanding wage increases);
- Jobs have stopped disappearing (or that everyone will be quickly rehired); or,
- Interest rates must rise, (particularly not longer-term rates associated with 10-year Treasuries).

In due time and with ample historical precedent, however, fundamental economic forces do assert themselves and market prices do revert to underlying measures of valuation.

A variety of economic indicators show disinflation firmly entrenched

Reality again began to filter in as the Bureau of Economic Analysis *revised away a previously reported* upward trend in core inflation as measured by the core PCE deflator (a number once watched closely by former Fed Chairman Greenspan and the markets). The new analysis revised the core PCE deflator downward in April and showed it falling in May. Then it slid in June to 1.5% year-over-year. Also, non-farm unit labor costs plummeted in Q2 to produce a negative measure for four quarters.

Fundamental relationships again prevailed as the popular CPI (Consumer Price Index) measures of inflation made news, inflation fears abated, and Treasury yields dropped, particularly on the inflation-sensitive 10-year maturity. The overall CPI was *unchanged* for July and posted a historic 2.1% *decrease*, year over year. Core CPI rose only 0.1% in July, and fell to a 1.5% rate year-over-year, the lowest in 2009. **This week, releases of the PPI (Producer Price Index) also showed a clear pattern of *disinflation*. The *monthly* July figures were both negative (core and overall).** More important, the volatile *overall* year-over-year figures have remained in *negative* territory since December, while the year-over-year *core* rate for July of 2.6% was *lower than any in the previous 12 months*, and has trended downward since December.

Despite a monthly gain in Industrial Production for July, on a year-over-year basis it fell by 13.1%, the kind of decline last seen in the mid-1970s and late 1950s. While capacity utilization, *the primary measure of slack in resource utilization*, also edged higher in July, at 68.5%, it languished far below previous lows in the early 1980s — and even further below its record of capacity being put to work any time in over 40 years. Even though manufacturing has continued to migrate overseas, over-investment in overall economic capacity in the boom years has given economic *growth* enough rope to hang itself. Concrete resources are in great excess, from labor to retail space to office space. *In a slump*, the ability to use technology to enhance productivity lets companies jettison jobs and overhead, *rather than* contribute to expansion.

With more infrastructure and workers idle than at any time in the memory of most market participants, we find it bizarre that any serious student of economics or markets would believe that GDP *merely turning around from depressed levels* would spark an inflationary spiral. **In this environment, incidence of higher commodity prices imported from overseas (or prices on consumer goods tied to oil or other commodity price spikes) can only act as a “tax” upon the consumer (and on business), not spark cost-push inflation.** Anecdotal accounts in the press uniformly report that consumers are *trading down* (or simply acquiring better goods at discount prices) not bidding prices up. **Most important, unemployed consumers simply cannot demand a raise**, and the employed workforce, worried about losing their jobs and the survival of its employers (corporate or otherwise) is in no position to do so. Many small business owners have stopped taking salaries. *The inflationary*

feedback loop is broken. Many retailers have surrendered pricing power and the hotel industry has slashed its rates.

On the too-much-money front: *government spending is being criticized as inadequate stimulus...state government spending is suffering from lower tax revenues...the Fed balance sheet reportedly has not expanded in months...and lack of velocity (lack of circulation of money) tempers overall money supply concerns.* If you listen carefully to officials reflecting on the worst days of the credit crisis, it is easy to understand why a chunk of domestic stimulus money went to state budgets. In addition to the usual pork barrel spending, the Congress made sure that the states could funnel money to municipalities to pay the police, firemen, and teachers if worst case scenarios were realized, and federal officials did not protest. (Central government may have learned its lessons from the failures of centralized response to Hurricane Katrina once essential *local* services broke down.)

Unprecedented actions were taken to avert and forestall (and potentially deal with) economic *collapse*. Comparatively little has been done to counteract the more gradual recessionary forces of deleveraging and the additional dampening outcomes associated with reining in banks and the so-called shadow banking system. Consumers are under great pressure. **Households are beginning, as they did several generations ago, to differentiate *saving* from investing, and the savings rate is returning to familiar levels.** With the exception of 2001, when the savings rate was 1.8%, savings rates associated with recessions dating back to the end of World War II reached 7.0% to 10.9%. Savings may be held in cash, used to invest, or used to pay down debt — but they do not represent *spending*.

Outside of Treasuries, it is hard to find an investment that does not carry substantial economic risk. Domestic purchases of Treasuries have *increased*. Yet recently, a spasm of outflows from longer-maturity Treasuries had apparently flooded into equities, seemingly on the flimsy hope of corporate profits being driven up by fewer job losses. This occurred even as *lost income savaged the ability of households with unemployed workers to meet financial obligations on homes and credit cards* — and to increase or continue retail spending. At the same time as Treasury yields fell and equities indices rose, ***The New York Times* drilled down into the data and reported on August 8 that the share of unemployed (one third of a total 14.5 million unemployed) remaining out of work for at least six months (27 weeks) is the greatest in 61 years of recordkeeping.** While overall household savings rates are rising, members of this group are spending down what savings they have accumulated and, in the absence of savings, working their way through credit lines. This reporting points to major “disconnects” between *underlying conditions* in the U.S. economy and the *headline* equity and commodity market *reactions* to harbingers of eventual growth.

Equity markets which historically *anticipate* improvements in GDP, appear to have their antennae reaching out *only* for forward-looking catalysts that signal growth. Equity investors have fastened on reports of each incident of incremental “second derivative” news about a *less steep* rate of negative change. This is especially true of professional investors bent on getting fully invested ahead of

recovery. Call it the “less bad” rally. *Yet, overriding conditions of massive unemployment, lost wealth, and limited access to credit* appear to control — and hold down — the real U.S. economy, inflation, and those interest rates which are based on high quality credit.

Hard for the Fed to stimulate growth, expand its balance sheet, or jawbone freely

These sober realities are reflected in the most current statements from last week from the Federal Open Market Committee (FOMC) of the **Federal Reserve, which has determined to *maintain a historically powerful accommodative stance and to telegraph that it will keep interest rates low well into the future.*** We agree with other commentators that in signalling (with its statement) that it would *phase out* rather than more quickly fulfill its quantitative easing commitment, the FOMC appears to be *buying itself some time and retaining powerful policy tools.* With the world tuned in to its public pronouncements, it is walking a tightrope.

Any benefit the Fed would hope to achieve by “talking up” economic improvements or by painting a happy face on its research and projections seem to be overridden by *its need to justify* its stimulative policy stance in the face of *recent market hysteria that any bottoming out in the economy equals a full fledged rebound and imminent inflationary spiral.* Even media coverage of the Fed is contaminated by television journalists raising teaser questions designed to keep viewers tuned in. Throw-away *segue phrases* keep asking audiences over and over again, “When the Fed will raise rates?” and “Will inflation and interest rates soon rise?” The suggestive repetition validates worries picked up from superficial analysis.

Moreover, market participants who were not economic adults during the anomalous high inflation years in the U.S. tend to conflate limited above-trend inflation of a percentage point or two with the threat of runaway double-digit inflation. We reiterate here that a number of factors which drove up inflation as the baby-boomers reached maturity have disappeared or are *no longer so influential.* These include: the effects of a sharp bulge in population as the first baby boomers started earning, spending, and competing for consumer goods...enlargement of the workforce from increased participation of women (whether as two-income households or independently in new household formation) driving per capita earned income higher...the collective bargaining power of a unionized workforce being proportionately very much larger than that of today and *negotiating contracts with automatic raises tied to the CPI...*an employment culture of stable workforces and mutual loyalty between employees and employers *that embedded annual cost of living increases* and punished “job-hopping”...a comparative absence of outsourcing...and finally, a far smaller and slower ability to ship manufacturing production and service abroad than exists today (at the minimum, think of current competition from overseas call centers run by banks and technology companies and electronic delivery of the output of knowledge workers of every sort.) *The accelerators that once boosted feedback in vicious inflation cycles are not in place.*

Yet each time that fear of inflation (from any source) takes hold and long term rates

back up, economic damage *increases*: mortgage and refinance rates rise, applications fall — and property values, homeowner equity, and consumer spending are undermined. By now this pattern is familiar. Mortgage interest rate trends may be self correcting, but the economic damage is *cumulative*, with real *cascading effects of asset deflation* from foreclosure, and with the *corrosive disinflationary impact* of bankruptcies, demand destruction, profit losses, and job losses. Houses do not get “un-foreclosed.”

Over the past year, the Fed and the Treasury and various government officials did massive damage via high profile talk about the *exceptional seriousness* of the credit crisis, helping to frighten corporate leaders into precipitate reductions in their workforces. Repercussions of the resulting job cuts and reduced corporate spending were also serious. Understandably, **scary pronouncements by officials** were designed to counteract popular resistance to extraordinary economic measures, but they **helped precipitate an “alternate universe” recession**, one not caused *directly* by a collapse (averted) or freezing (realized) of the global credit system, but one triggered *indirectly*, via massive layoffs and cost cutting.

Now the twin forces of downturn (*direct* reduction in capital from losses in real estate and investments based on securitized mortgages and *indirect* damage from moves to *avoid business losses*) are converging, compounded by *the ongoing march of the overall deleveraging process* that necessarily accompanies the removal of the *easy* credit that spawned the crisis. **Yet cheap credit (not easy credit) is needed more than ever. Since there is no room to cut the Fed funds target rate, and since ideologues rail against any mention of quantitative easing that would lower benchmark rates, there is little benefit to any public Fed focus on economic weakness.** The Fed leaves it to other economists to hypothesize on double dip recessions. They are hard pressed to limit enduring damage and overcome whatever history will tell us we are experiencing.

No one seems to be trading on consumer credit being cut off abruptly

News that is less familiar and *upon which few market participants trade* is the **wholesale shutting down of U.S. consumer credit lines**. These actions are, in part, a response to the passage of the Cardholders Bill of Rights and are, in part, a response to supervisory crack-down and the need to strengthen banking balance sheets. The responses encompass a corporate effort to pre-empt restrictions that do not come into effect until February 2010 by reducing bank exposure, as documented in a full page article in the July 6 *Barron's*, entitled “How to Live With Less Credit.” Such news accounts of single or “one-off” events that identify and document structural change in the economy do not lend themselves to trading (whether of the knee-jerk or thoughtful variety). The article cited Senior Loan Officer Surveys published by the Federal Reserve this year, noting that the 45% of senior bank officers cutting credit in January subsequently increased to 65% (finally putting a public spotlight on the obscure but increasingly critical report on lending practices which we had cited earlier). **With its July survey (published in August), the Fed reported that “domestic banks continued to tighten standards and terms over**

the past three months on all major types of loans to business and households....” The tightening may be less severe or pervasive than earlier actions, but it is *cumulative* — each turn to the screw compounds borrowers’ difficulties. Big news about such structural change is *not* moving the markets. It will do so *after* effects flow through to impact conventional data.

A more anecdotal and equally powerful record of the growing *consumer* credit crunch was the August 12 article in *The Wall Street Journal*, on the D1 front page of the “Personal Journal.” section, entitled “Cardholders Get a Rude Surprise At the Register.” **This documents the growing practice of card issuers and banking institutions legally cancelling credit cards and reducing longstanding credit lines without prior notice to cardholders (in some cases with no notice to card holders).** The headline on the jump page reads “Credit-Card Issuers Pull the Plug.” According to this article, these reductions in credit are *not* being made in response to late payments or other delinquencies, or even to borrowers carrying excess balances. Lines of “available credit” being reserved by consumers under economic pressure as a back-up resource are being *targeted for cancellation for lack of use*. Banks are quoted in the article as stating that open credit lines are “a credit risk to the bank” and present “large potential liabilities.” **The newspapers report that the unceremonious terminations of credit are far from isolated instances.** Banks aren’t just cleaning house on generous credit lines extended earlier. Other articles report on banks granting fewer new credit lines to fewer *new* applicants. The pervasiveness of these unilateral actions suggest several far-reaching implications:

- One, that investors who enthusiastically are returning banks to earlier market capitalization are ill advised to assume that the future operating practices of these institutions will bear *any* resemblance to the practices under which they achieved the earnings that warranted the earlier prices and p/e ratios;
- Two, the *implicit new banking models* characterized by far less extension of credit, along with much more stringent lending standards, are largely dependent on the various artificial forms of support, including U.S. Federal Reserve and Treasury support that fit hand-in-glove with increased scrutiny and reserve requirements — and little *guidance is being given for profitability* (at eventual lending levels far below the former volume of business), once the temporary supports are removed;
- Three, that *the will of consumers to spend and thereby drive up inflation is being systematically and thoroughly overridden by a factual inability to spend as massive deleveraging is enforced* (and enforced without adequate notice) by lenders.

Congressional efforts to protect overextended consumers from seemingly arbitrary, heavyhanded, and sometimes sly practices of credit card issuers seemingly have backfired. **Banks and consumers alike are scrambling in an odd and frantic dance to protect themselves from each other.** Investors have been blissfully ignoring this rather methodical panic, while national economic leadership continues to downplay (or ignore) the need to “bail out” the balance sheets of consumers — who make up 70% of the economy and who are defaulting at an unrestrained rate (now well over

a quarter of a million per month) on the toxic mortgage-backed assets responsible for the credit crisis.

(These “assets,” which to some extent are “written off,” are still on the books of banks, pension funds, and other institutions, perhaps in false hopes of an earnings pop when asset values might be restored. *Academic analysis of a securitization pool of 3.5 million mortgages*, many handled by the largest home loan servicing banks, *showed an average loss of 64.7% of the original loan balance on 32,000 liquidation sales in June*, according to a report by Gretchen Morgenson in the July 5 “Sunday Business” section of *The New York Times*.) With the exception of the investment banking firms that underwent metamorphosis into bank holding companies, and which profit from trading and activities other than direct lending, zombie banking is here. *Comparisons to interest and “inflation” rates in Japan, and to minimal growth there, can no longer be dismissed or discounted.*

For consumers — many of whom did not appreciate all the fuss about keeping liquidity flowing between financial institutions and making counterparties whole — **the credit crisis is only beginning** (renewed auto financing offers by a automakers notwithstanding). Otherwise solvent, but illiquid, households are now feeling greater strains. Many households had enough ready credit to *not* be worried about having to mark their house to market (via an appraisal) in order to borrow. No longer. Reports that circulated of families that surrendered their homes, but kept their credit card payments up to date to finance relocation or to maintain living standards, resonate with irony.

Congress has now moved on to other concerns. The FDIC is busy with failures of institutions that are *not* too big to fail. The Fed and the Treasury still have not taken sufficient action to assure availability of consumer credit and to bring down consumer and mortgage borrowing costs. The resulting local and regional economic damage *increases the potential* each day, month, and quarter for a *prolonged and deepening recessionary and disinflationary cycle* to continue.

Consumers who can save are doing so, as the higher savings rate attests. The absence of robust business activity *throughout* the U.S. is not without strong consequences. **Financial news reports are starting to transmit a drumbeat from the so-called “next shoe to drop” of commercial mortgage defaults**, and we think it could be a centipede of dropping shoes. While defaults on office towers do make headlines in the twenty-first century, unlike the downturns of earlier decades (think the 1970s and 1980s), the visual and physical representation of an increasingly devastating business downturn is *not so much* urban decay but the spreading rash of empty storefronts in still well-kept “strip malls” not far from suburban interstate highway exchanges. In spite of falling rents, chain stores and mom-and-pop retailers alike are closing up shop.

Cataclysmic events usually don’t make headlines until strains from less visible fault lines add up. With all the attention to the crises and defaults in the banking sector, it is easy to forget the revealing pattern of consumer mortgage defaults. The foreclosures progressed from *expected* defaults caused by “exploding” subprime rate resets on properties with little equity (which could have been relatively easily

counteracted by prompt Fed rate reductions), through the *unanticipated* defaults on holdings of the better credit classes which started out with better loan-to-value ratios, and ultimately to *surprising* absolute auctions on high-end trophy properties. New strains on borrowers — falling property values, massive job losses, and “small” business failures — have helped keep defaults and foreclosures at historic high water marks.

It is less apparent that the U.S. is now facing the second-order effects of recession which in turn are being *compounded* by constrictions in credit similar to those that slammed homeowners so severely once the effects of toxic waste kicked in. New categories of lenders are feeling the strain. Only in the last month did a major financier of retailer inventory hit the wall. (“Factors” are not too big to fail.) Most financing on commercial buildings in the U.S. needs to be rolled over frequently; prevailing market valuations and local costs-per-square foot for leasing matter as much as financing rates. Rigid accounting rules limit flexibility — and foster vacancies when prospective tenants can not or will not pay market rates. The emerging challenges in commercial real estate will reveal the potential for any “covenant light” contracts written in this arena during the liquidity boom to flummox holders of obligations. While sectors and regions may rebound, the full effects of the reversal of easy credit are far from being played out.

We maintain that recovery turns on whether the economic leadership wakes up and gets U.S. rates down far and fast, or whether they keep propping up the institutions they lead and supervise, while ignoring the crumbling consumer economy — in which case rates simply will get lower *later*. Borrowing costs are the fulcrum. Excess attention on the stock market and on the timing of the end to falling GDP are a distraction. (The path of recovery to nominal real GDP levels matters, too; see chart p.16.) **In times of historically low rates, it is *not* intuitively obvious that the costs of carrying debt are too expensive,** but consider the continual ramping up of household indebtedness since 1992. Interest rate costs currently remain simply too expensive *given the size of the household debt already assumed*. **Overly burdensome debt is *only resolved* by two means of deleveraging:**

- By one means, debt can be eliminated via a process of **default on obligations and, alternately, by forced or unfavorable liquidation sales** that diminish or wipe out borrowers’ equity;
- By another means, **debt can be paid off** — slowly from revenues and personal income and more quickly by liquidating assets.

The only antidote that mitigates damage to the lenders and borrowers alike is *to lower the cost of carrying debt*. *Savings from lower rates can be used to pay down debt — or spend.* Yet, on the whole, consumer and corporate borrowing costs are now *relatively* close to their levels prior to the crisis, especially when viewed through a lens adjusting for the depth, breadth, and length of this recession. (In the extreme example, since financing costs had already reached zero for some borrowers prior to the Chrysler and GM bankruptcies, no one expects cheap financing to return these automakers to profitability.) Anticipation of a full and

fast economic recovery under such conditions is clutching at straws (green shoots or otherwise).

Absent sufficient central bank intervention, rates (and profit margins and inflation) *necessarily will drift down on their own* — but only when the full “bust” cycle plays out. At some point, higher rates will not be extended to less creditworthy borrowers, they will simply be cut off entirely. Even the high yield — or junk — market can shrink. Private equity needs rates to be even lower in a recession than in a robust growth economy. **Unfortunately, too many players in today’s economy seem to think the Fed has overplayed its hand, when its moves have been entirely insufficient in addressing the credit crisis in the consumer sector, asset deflation, and other recessionary forces.**

Mortgage defaults remain at the heart of consumer and banking problems. *Mortgage rates have simply not been brought down proportionately to the cost reductions that occurred around much milder recessions and “jobless” recoveries.* The Greenspan Fed famously signalled that it did not need to identify and address asset bubbles, as it could compensate for their collapse by cutting rates. Now that such efforts have been proven inadequate (or at least incomplete), asset deflation is bleeding out consumers and fostering disinflation. The retail consumer pays up to borrow, yet earns less interest.

Not only are banks slashing consumer credit lines, but also they seem to be scrimping on rates they pay on “time deposits” such as certificates of deposit (CDs). Lack of return may have driven investors of working age back into equities, but not all depositors. For a still-large population of retirees whose childhoods were colored by the immediate effects or family memories of the Great Depression, any drop in interest rates on CDs simply diminishes their spendable income or forces them to consume capital, which in some cases runs out. These are the people whose houses are as yet unencumbered by borrowing. With property taxes elevated or rising, their next step is to downsize and throw more housing inventory on the market. *This is the mechanism of a bust cycle*, and although there will be well-publicized triumphs, the evidence is *not* that a downward trend has been reversed, just slowed. We wrote often throughout the years about *the potential* of longest, strongest economic expansion in history, and the longest bull market, *to correct*. The Fed’s efforts to extend that cycle *indefinitely* now seem deluded, as the pendulum is swinging heavily back from overexpansion over a protracted period. **It’s no surprise to us that the dimensions of correction are turning out to be commensurate with that of over-expansion.**

Economies, financial markets diverge amid battles over ideology & terminology

To be sure, earlier in the year, many financial markets were priced for: global economic collapse, another Great Depression, unremitting seizure in the credit markets, accompanying pricing aberrations, and a variety of market events that have been successfully *averted*. Understandably, subjective bets on worst case scenarios are *unwinding*. That does not mean that financial markets have reverted to rational pricing, or that institutional and private traders have sufficient insight

(or a true factual basis) for evaluating the *direction* in which markets over time will thrash out that pricing. So, yes, we dare suggest that financial markets sometimes fail to reflect hard facts, and the renewed buoyancy of equities in 2009 does nothing to disprove this observation.

Suffice it to say that some of the growing public complaints about market “speculation” seem to be grounded in the inability of investors to reconcile *the supposed omniscience of equity market pricing with wild swings in that pricing*. Investors wonder how the equities market, in particular, could be *right* about prices and values *a year ago* (last August), and then also *right this past March*, and then also *right again now*. Doubt is especially strong on valuing corporate common stock, as billions in market capitalization *evaporated quickly* — and in *some cases* permanently, while in *other cases* only temporarily. These divergent outcomes were not suggested by earlier market pricing.

Certainly, if we all returned to **the days where corporations were compelled to pay out most of their earnings in dividends to compensate investors for accepting the risk of having the stock price fall** (even perhaps to zero) and *in order to compete with Treasuries (and we should)*, then apologists for equities would be less defensive about acknowledging the universal “speculative” component of investment in equities, as distinct from excess capital driving markets in a speculative fever. Taking a risk related to corporate *performance* is different from taking a risk that a rapid *market run-up* in equities prices will stall or collapse. Commodity markets, too, have reminded investors how rapidly they can retrace a parabolic price spike, calling into question the reliability of prices posted immediately prior to the reversal. These days there is a lot of “story” in equity and commodity pricing, as prices in electronic exchanges to move rapidly on a free exchange of ideas (some without much factual basis). We raise warning flags when flawed strategies seem to leak over into Treasury markets, particularly when the ideas assume a fixed correlation with other markets.

So we go back to basics. We remind our investors that ***the short end of the U.S. Treasury yield curve anchors all maturities and remains governed by U.S. central bank monetary policy***, observed in its most basic form as a transparent Fed funds target rate. We contend that the **long end of the yield curve is substantially governed by inflation** (and only to a lesser extent the component inflation *expectations*), plus the available **real rate of return** (as calculated against measured inflation). In many ways even the risk-return dynamics of investment grade corporate debt are more akin to equities than to these benchmark debt securities (because corporate debt issues rely on corporate performance and exposure), but that does not create fixed negative (or positive) correlations — either with *returns* or with the *direction* of price-and-rate fluctuations.

Our primary investment strategies are unfamiliar to many investment advisors and market strategists. Our uses of the repurchase and futures markets are designed to benefit investors by the correct determination of primary market trends and by efficient yield curve management and by efforts to extract additional

value over time by calibrating duration exposure. Investment managers who do *not* use these tools do tend to regard Treasuries as a benchmark for returns on other securities. They tend to *dismiss* strategies that can achieve highly attractive and competitive returns over time at relatively low quoted yields. **As a result, our market calls often face considerable headwinds. *It should go without saying that if this were not the case, the opportunities for attractive returns would be diminished greatly.***

Investors in any Treasury market strategy, whether going long or short, investing for the long term or the short term, holding Treasuries for cash, or using repo or futures, are all able to benefit from ***comprehensive historical data on market rates and prices in relation to economic data, and accompanying mathematical analysis.*** The same analysis cannot be produced *with mathematical rigor* for individual corporate debt issues that bear different ratings at different times and may move from investment grade to junk and back, and cannot be applied *with any reliability to IPOs or new companies.* Those trades operate in the realm of “animal spirits.” The data on Treasuries and the factors that impact them allow sophisticated historical comparisons and correlations with the performance of other asset classes and categories — *and most critically* with central bank policy and economic indicators that *reliably* affect prices, value, and the direction and volatility of pricing.

Such research is very different from simplistic assertions that outlays by the Federal government or the Federal Reserve — or the end of recession — must result necessarily in runaway inflation and rising Treasury yields. If we were to unearth evidence that inflation was about to shoot up — or skyrocket — we would quickly communicate our findings, and invest accordingly. **Our modeling is objective and sensitive to a reversal in primary yield trends and we keep strategies poised to exploit such moves. Yet, we have found no such evidence of an upcoming inflationary spiral.** Inflationary forces are not “coiled like a tight spring” as retail brokers like to say. **After one-and-a-half decades of over-consumption, there is *not much pent up demand* in the U.S. or developed countries,** and consumers elsewhere have much lower (not higher) incomes with which to buy goods and services, an unlikely recipe for bidding up prices. Inflation which other countries may produce at home need not transmit to the U.S.

At present, we believe various market mis-perceptions centered on variations in the *rate of change* of economic data (and on bullish equities-oriented interpretations of weak corporate revenues and earnings) *temporarily* have damaged returns on longer maturity Treasuries, especially in Q1 and Q2 of 2009 and into the present. ***It does not surprise us that what appears to be the biggest domestic bear market equities rally in living memory has had some overflow effects on the market for U.S. Treasuries.*** However, as we have stated, in the end, returns on Treasuries are *not determined* by price movements in other asset classes or categories.

Among those ideas we think are *unfounded* is a prevalent assumption that Treasuries will or should remain inversely correlated with equities, a link which

did *not* maintain in July, but which recurred in early August. Even though gross assumptions about asset class correlations and even currency and GDP can promote sporadic money flows such as we have seen (and move markets in the short term), in general they do *not* drive returns on Treasuries. ***We remind investors that inverse correlation of Treasury markets with equities is far from a constant in the markets.*** Even, from time to time, prices at one end of the yield curve move inverse to equities prices, and at the other end move with equities. Similarly the U.S. dollar can track with or against equities or even Treasuries (or certain commodities) under various conditions. Lock-step Treasury market reactions to moves in other markets can be something more than market noise, but they are *seldom a causal factor establishing primary market trends* — and are *not so* right now.

Equities rallies mask profound and continuing economic weakness

So why are we paying so much attention to equities here? We do so because these markets are *overlooking underlying economics* and seem to be providing false signals about near term and intermediate-term economic growth and inflation. **Rallies in equities index averages seem to be getting a wrong understanding of the economy in much the same way these markets (and the Fed) misunderstood excess liquidity did before problems at Bear Stearns, Lehman, and AIG brought to light vulnerable fault lines.** In other words, the “cash coming in from the sidelines to drive the markets higher” has limits — and has other purposes to which it may be applied in the future as deleveraging continues (such as living expenses for retail investors and operating expenses and capital investment for corporations). The analysis on which the equities markets and the Fed all dine seems to offer little appreciation for the importance of the weakness that can derail trends dramatically. Think of the rusty link in the chain, the bulge in the front tire, the storm clouds (or drought) beyond the horizon. (Pick your analogy.) Some of the *uniquely artificial* stimulus and discrepancies we see are as follows.

- Rallies in homebuilders, automakers, and banking/financial stocks are *not* riding on a rising tide of growth in those spaces, but are clearly dependent on government support. The dubious engines of growth include generous (expiring) one-time tax breaks for first time homebuyers, automaker bailouts that encompassed reductions in price competition by closing dealerships, “clunker” subsidies to auto buyers that supposedly destroyed gas-guzzler inventory that would otherwise be auctioned off to second-line used car dealers, and most important, all of the historically cheap borrowing and special guarantees supporting banks and their counterparties. **Even municipal spending is being propelled by the Federal government, via “Build America” guarantees.** Artificial support eventually ends.

Plaudits about energy independence notwithstanding, such extreme *reflationary* efforts as destroying inventory and reducing retail outlets suggest to us that Congress and federal officials think deflation — not inflation — is a real threat. However, diverting a couple of hundred dollars a month from discretionary expenditures into vehicle payments (including financing) is *likely to backfire as a deflationary force* in an environment where consumer borrowing has been capped.

- Reductions in temporary housing market stimulus have implications for banking. *It bears repeating that some of the toxic assets in banks and other financial institutions have been written off, but they have not gone away.* Many securitized obligations are deteriorating further with foreclosures in the housing market and threats to the commercial real estate mortgage market as vacancies rise and mortgage terms expire, requiring renegotiation. Since banking institutions continue to hold assets that are not marked-to-market on a daily basis, they *remain vulnerable to an unprecedented extent and are being propped up — for the moment — with an ability to invest in a lucrative carry trade or lend at unprecedented multiples.* This backing is apparently *not enough* for bankers' efforts to earn their way out of their balance sheet problems. In addition to cutting off that consumer credit the banks had extended on a longstanding basis, these efforts reportedly involve saddling consumers with much higher fees and charges, and raising rates on non-collateralized borrowing such as credit cards. Such increases "tax" consumers and reduce discretionary spending.
- On a global basis, some rebounds in commodity prices appear tied to speculative inventory building and even hoarding. Increasingly, commodity players are admitting to "learning" that fair value has been obscured. Increasingly, former advocates of the rough and tumble "free-for-all" version of free market trading admit that liberalization of rules governing commodity trading has led to an era of market participants *holding outsized positions* and affecting forward pricing to the extent that costs yet-to-be-realized often *flow through* to current retail price points.

Electronic commodity exchanges *fed by a surfeit of investment capital* are proving to be less dependent than assumed on classic relationships of supply, demand, and capacity *in the material world*. There is only limited need for speculative positions on the opposite side of commodity hedges sought by those who produce or consume large volumes of commodities. **Observers see a difference between demand for actual commodities based on prospective use or consumption (in relation to the capacity to produce a supply of goods) — and the demand for opportunities to take financial positions on the direction of commodity prices on an electronic exchange.** Very roughly speaking, the contrasts in these two worlds are similar to the differences between the sustained investments of stable owners in breeding and training of race horses (and purses they may win) and betting by mere spectators on those horse races.

- Perhaps most important, throughout the corporate earning season, the equities markets have reacted forcefully (and bullishly) to *reports of earnings rising in relation to analyst estimates.* (We remind investors that the size of analyst communities covering a company can start at a handful, vary dramatically by targeted company, and contract or expand without warning.) **Often enough, revenues have dropped precipitously from the previous quarter, or virtually collapsed from a year earlier.** Think drops of 30% to 50% or more. Yet the very event of reports on earnings (which also may have plummeted) exceeding some arbitrary average or consensus of analysts' opinions *can light*

a fire under equities prices. (Is it right that every analyst's opinion be given equal weight?) **Where rising top line and bottom line growth were once required to push up equities prices, sometimes now it only takes "less worst" losses to achieve the same kind of pop.**

A related explanation of the flow of money into the stock of money-losing companies is the propensity for professional money managers who need to get more fully invested in equities to hold their noses and jump in. They keep their jobs by staying with the pack.

- **The most obvious boost to equities is the *overall contributions to earnings from an unusual boost in productivity for a recession*, broadly attributed to cost cutting (in general) and to reductions in labor (in specific). **Profitability trends built on cost cutting are by their nature unsustainable.** There are limits to economizing one's way into bottom line and top line growth — and not just mathematical limits. For example, firing knowledge workers in a service economy has lasting ramifications. Also, while the anticipated replenishment of inventories drawn down in crisis may boost national GDP for a quarter, sooner or later individual corporations will have to pony up the cost of restocking. In an economy that is some 70% based on consumer spending, firing workers is bound to reverberate into lower overall domestic consumer spending and lower overall corporate revenues, which is not bullish for equities.**

We can find no credible explanations for some anomalies in corporate versus market performance we have seen. In the equities markets, sometimes good news is bullish and sometimes bad news is bullish. **In the corporate bond market, simply avoiding bankruptcy has become bullish.** Equities rallies *extend* on the attractive and popular belief that they necessarily foretell economic recovery. Positive "bull run" price trends (even in isolated sectors) point to a closed system of self-referential markets that can resist becoming aligned with underlying facts and economic forces.

To a large extent, financial markets have been operating with outdated guideposts from the era of excess liquidity and free-flowing credit. Companies with p/e ratios uncharacteristic of their sector are said to "trade like" some other sector. *No one knows where acceptable p/e ratios will sift out as the economy eventually rights itself in a new credit era in a deleveraged global economy.* The critical role of shifting sentiment in setting p/e ratios established by Dr. Robert J. Shiller (whose views have been popularized and legitimized by his prescient calls on the equity and housing markets and his contributions to the Case/Shiller housing index) is *rarely* given the importance it warrants. Sentiment, we would venture, is the ultimate self-referential feedback system. **We conclude that some relatively rich market capitalizations and p/e ratios promoted by sentiment remain highly vulnerable to a recalibration of expectations that can only occur once some critical mass of market and economic participants begin to actually experience what it is like, not only to *fear* the worst recession since the Great Depression, but also to *work through it and emerge from it.***

U.S. needs to make up half a trillion dollars to get back to the GDP of 2008

Inflation fears, supply concerns, and equities market trends substantially drove the Treasury market in Q2 of 2009. Better-than-expected earnings for Q2 and better-than-expected global economic numbers created a popular argument for strength and speed of recovery — and 10-year U.S. Treasury yields backed up. **Yields had run up as markets moved on fears of low probability scenarios.** Chief among them was a damaging market trend that misconstrued rising equities markets as predicting an explosive, inflationary economic rebound that would catapult the U.S. domestic economy past recovery into true growth.

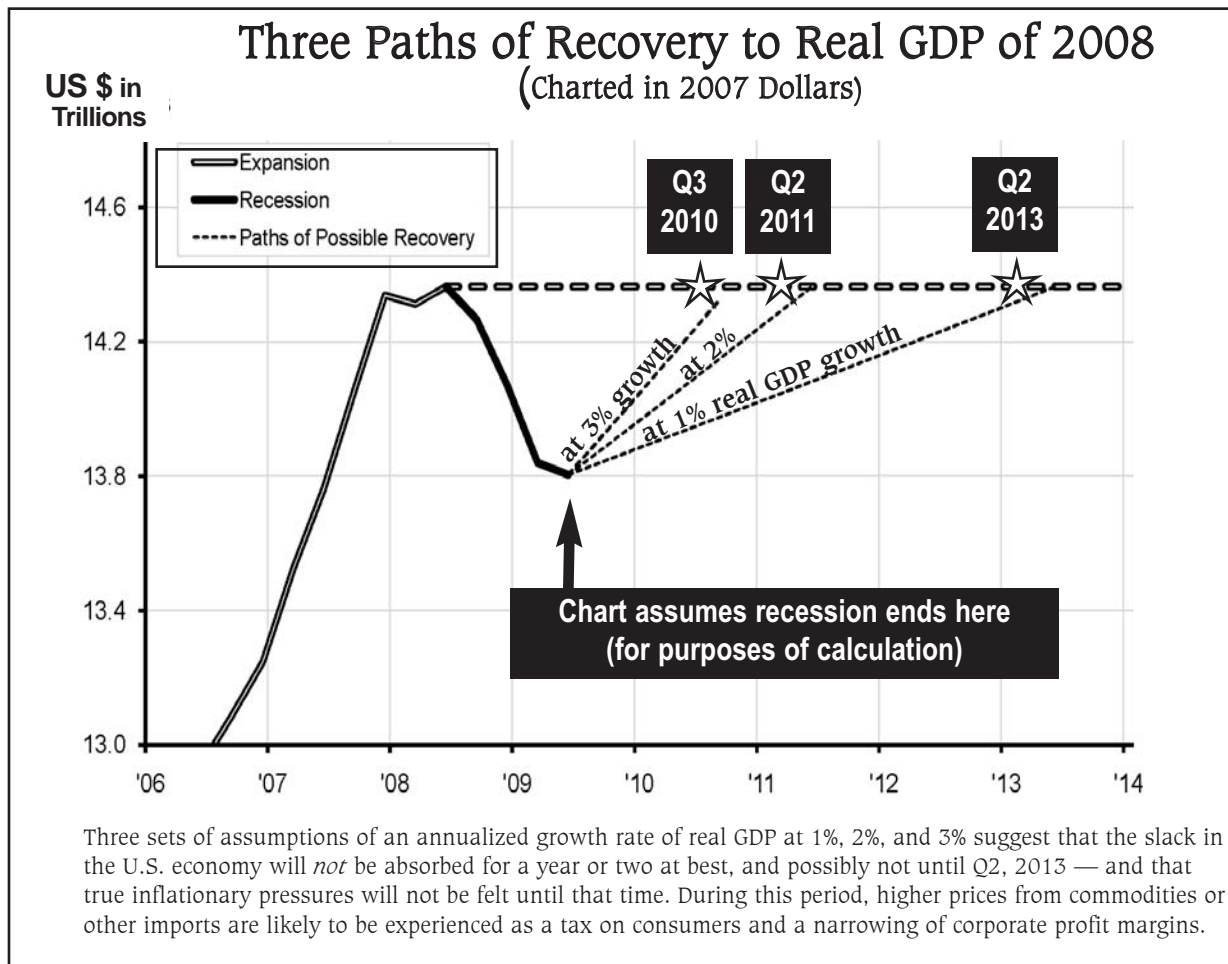
Our position is that *recovery requires the weakened U.S. economy to slowly climb out of an unusually deep hole* (and to do so without the boost of free-flowing credit). Any rebound in earnings consistent with an unusual recessionary gain in productivity (associated with wholesale layoffs) and a drawing down in inventory is *not* synonymous with corporate growth or significant overall expansion. Unfavorable yield trends are now only beginning to show themselves to be overdone as Treasury auctions succeed and fears subside. **Yields on the 10-year U.S. Treasury have not approached the 3.95% high of June.**

The most important market misperception, in our view, involves equating the end of recession (a halt to falling GDP, assuming real GDP soon stabilizes), with full recovery and with *a resumption of growth over the peak nominal real GDP of mid 2008.* A resumption of true growth remains over a half trillion “2007 dollars” away. The end of recession means that GDP stops *falling* – not that the economy has recovered. Historically, in a now typical recovery where job growth lags GDP, inflationary forces (especially as measured by annualized 6 month core CPI) do not kick in until a year or two after recession ends. **Yields on 10-year Treasuries *tend to trend dramatically lower* for 1.5 to 3 years *after* recessions end.** The yields’ eventual turn higher (in response to inflation pressures) typically is truncated by Fed dampening actions which generally raise short term financing costs for everyone. This well-established time line was largely ignored by market participants so far this year.

Even presuming that Q3 2009 will show no decline in real GDP, **when assuming a recovery which sustains an annualized real GDP rate of 3% to 1%, we do *not* project a return to 2008 levels of real GDP *before* Q3 2010, and possibly not until Q2 2013.** The time lines represent paths to recovery based on three scenarios that may return nominal GDP to the levels where inflationary forces can be a factor (as plotted in the chart on the last page of this commentary). **So, inflation might not be a factor until 2013. Even then, aggressive Fed tightening *could* let the air out of the 10-year yield.** In the final analysis, markets have been trading almost exclusively on slim news that primarily affects equities and commodities because of a news gap. The underlying conditions have *not* changed — and in this context *no news is bad news* for the economy, and is only *good news* for investors positioned long on U.S. Treasuries.

— Robert Kessler, Chief Executive Officer
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