UPDATE

March 2008

"Why don't we just cut to the chase and start calling a spade a spade. If these credit agencies ever would like to have one shred of credibility again ever, they might as well start now. But of course, just like every aspect of sanity that some of us might like to see break out, it seems to be politically unacceptable for anyone in a position of real responsibility to act like an honest adult.[1]"

-Bill Fleckenstein, President of Fleckenstein Capital

The Deleverage Sasquatch

The Federal Reserve defines price stability as inflation between 1.5 - 2.0%. By that measure, overall inflation has averaged 2.8% since mid-2004. Core inflation, which excludes food and energy, has averaged 2.2%.[2] For four years running, the average overall and core inflation rate has been above the Fed's target level. And now, it is accelerating.

Chart 1

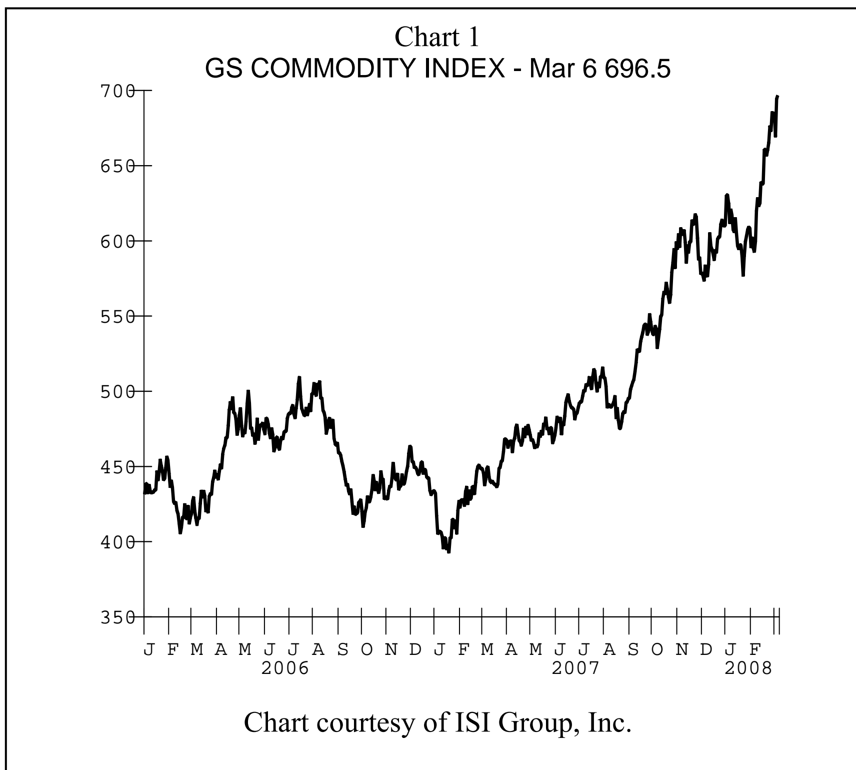

Chart courtesy of ISI Group, Inc.

Commodities prices are raging. The S&P / Goldman Sachs Commodity Index (GSCI), a broad measure of changes in commodity prices, has risen a remarkable 54.3% year-over-year (see Chart 1). Precious metals prices have skyrocketed, as evidenced by the 54.4% year-over-year increase in the price of gold and the 56.7% year-over-year increase in the price of silver. Energy prices continue to soar. From already record-high levels, oil has soared 73.3% over the last year to $100+ a barrel, a new inflation-adjusted record, and coal is up 65.2%. Food prices are roaring as well. Since last year wheat is up 120.9%, cocoa is up 65.2%, corn is up 35.6% and sugar is up 21.0%. These commodity price increases are a bad omen for future inflation and economic growth. "Commodity prices, far from reverting quickly back to the mean, are early-warning indicators of the future

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[1] Marc Faber, *The Gloom, Boom, Doom Report*, March 1, 2008.
[2] Greg Ip, "Fears of Stagfaltion Return As Price Increases Gain Pace," *The Wall Street Journal*, February 21, 2008.

CPI," wrote David Ranson, head of research at H. C. Wainwright & Co. Economics. "Last year's large increases in energy and food imply that consumer price inflation is going to be much closer to today's "headline" rate of 4.3% than the "core" rate of 2.5%."[3]

Over the past 12 months, wholesale prices as measured by the producer price index (PPI) have soared 7.4%, the fastest rate of wholesale inflation in over 25 years. "When PPI inflation gets over 4%, this has nearly always been associated with a sharp decline in the growth rate of the leading economic indicators," wrote Ned Davis of Ned Davis Research, Inc. (see Chart 2). "For companies that must pay higher producer prices, they either need to try to pass them onto customers or take a hit to their profit margins – both of which are not healthy.[4]" After years of cost cutting, companies are left with little operational fat to cut, thus they are less able to absorb these cost increases and must pass them on. "Food inflation has got to go up," said the CEO of a meat processing company. "Major producers are going out of business. There have been dramatic reductions in meat production. It's a tough environment in the meat business, and it's happening worldwide.[5]" "With commodities reaching unprecedented levels," said John Harris, the spokesman for a U.S.-based food company, "it is quite likely we will take pricing up again.[6]" Due to soaring cocoa prices, a large candy company announced 13.0% price hikes on its standard chocolate bars. With coffee prices up, a major coffee maker just increased prices for its coffees by 6.0%[7].

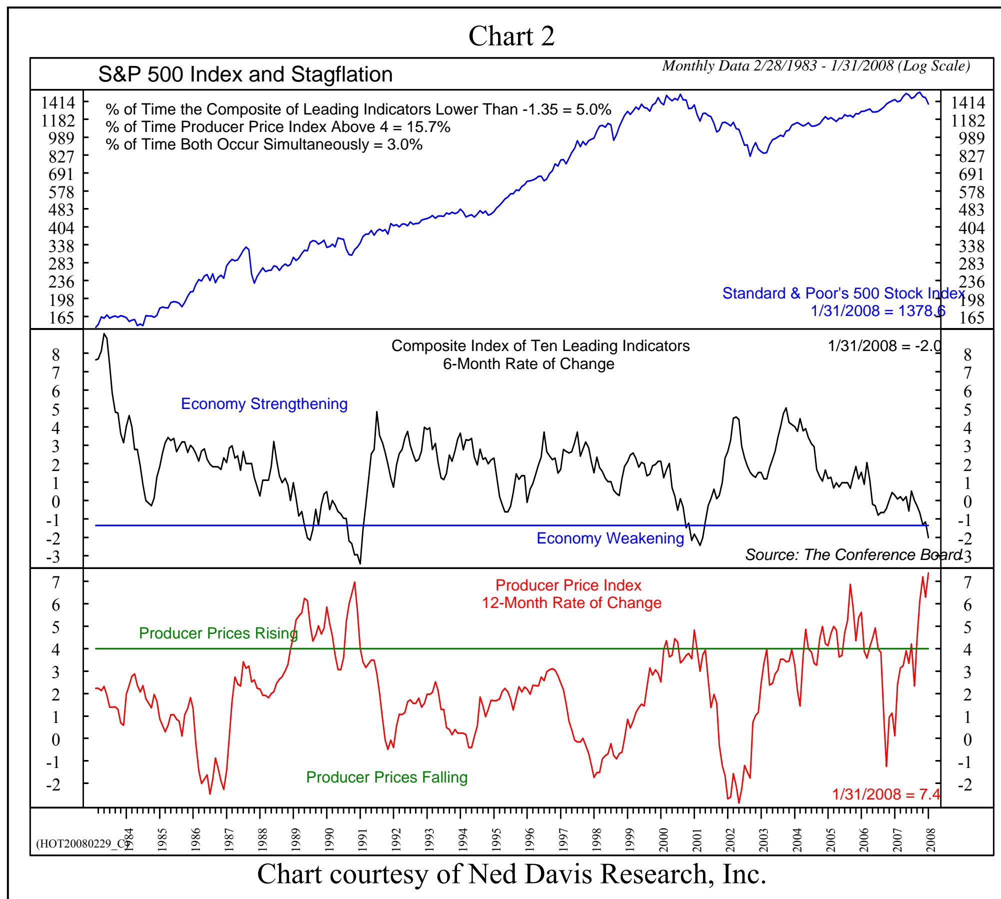

Chart courtesy of Ned Davis Research, Inc.

Prices of consumer goods in the U.S. are up 4.3% year-over-year, near a 16-year high. Over all, Americans are spending 13% more on food and energy now than a year ago, with a 22% increase in gasoline prices and a 6.0% increase in food costs.[8] Spending on necessities drove an overall increase in consumer spending in January, but since consumers are paying more for their daily needs, there is less left in their pockets for other, non-discretionary items. According to Ed Hyman at ISI Group, Inc., "The price increases from oil to wheat are particularly negative on two fronts. First, they keep upward pressure on headline CPI… Second, they limit

[3] David Ranson, "Inflation May Be Worse Than We Think," *The Wall Street Journal*, February 27, 2008.
[4] Ned Davis, "Chart of the Day," *Ned Davis Research, Inc.*, February 28, 2008.
[5] Staff, "Food Producer: Prices Must Rise," *Atlanta Journal and Constitution*, February 22, 2008.
[6] Greg Ip, "Fears of Stagfaltion Return As Price Increases Gain Pace," *The Wall Street Journal*, February 21, 2008.
[7] Fred Hickey, "The High-Tech Strategist," February 20, 2008.
[8] Floyd Norris, "Buy Less but Pay Lots More, and Get a Misleading Rise in Sales," *The New York Times*, February 16, 2008.

consumer purchasing power, acting very much like a tax increase."

Prices are on the march the world over. China is no longer the deflationary force it once was as it now is leading an inflation boom in Asia. In January, the Chinese CPI rose 7.1%, the highest increase in 11 years. The price increases were led by food inflation, despite the government's long-held price controls on many foods. In nearby Singapore, consumer prices increased 6.6% in January, a 25-year high. In Australia, consumer prices are expected to increase at a 4.0% annual rate in February, above the Reserve Bank of Australia's (RBA) 2.0-2.0% target range despite 11 increases in the RBAs benchmark interest rate to 7.0%.[9] Inflationary pressures have fueled civil unrest in the Middle East where Saudi Arabian inflation reached an official level of 6.5%. In Jordan, the cost of maintaining fuel subsidies amid the surge in prices forced the government to remove almost all the subsidies this month, sending the price of some fuels up 76% overnight, drastically increasing transportation costs and sending ripple effects down the economic food chain that caused the cost of basic foods like eggs, potatoes and cucumbers to double or more[10]. Many of these developing economies have pegged their currency to the dollar. So, despite strength in their economies, they have been forced into expansionary monetary policies to match the Fed's aggressive easing campaign and maintain their dollar pegs. "The Fed is America's central bank, but the dollar is the world's currency," wrote Jim Grant, editor of Grant's Interest Rate Observer. "More than a billion people work and save and spend in the non-American portion of the U.S. dollar bloc. It seems fair to guess that more than a few of them are fed up, if not with the distant institution that sets an interest rate, then with an inflation problem over which they seem to be powerless."[11]

In Europe, rising inflationary pressures led both the European Central Bank (ECB) and the Bank of England (BoE) to leave interest rates unchanged at their respective March 6, 2008 meetings despite a considerable downturn in the European economy. "The latest information has confirmed the existence of strong upward pressures on inflation," said ECB President Jean-Claude Trichet. "Looking ahead, we expect a more protracted period of relatively high inflation rates.[12] The hawkish inflationary posture taken by the ECB and BOE led to strength in both the Euro and the British Pound and weakness in the U.S. Dollar, which closed at a record low 73.0 on March 6, 2008, down -12.9% year-over-year (see Chart 3). A falling dollar further adds to U.S. inflationary pressures.

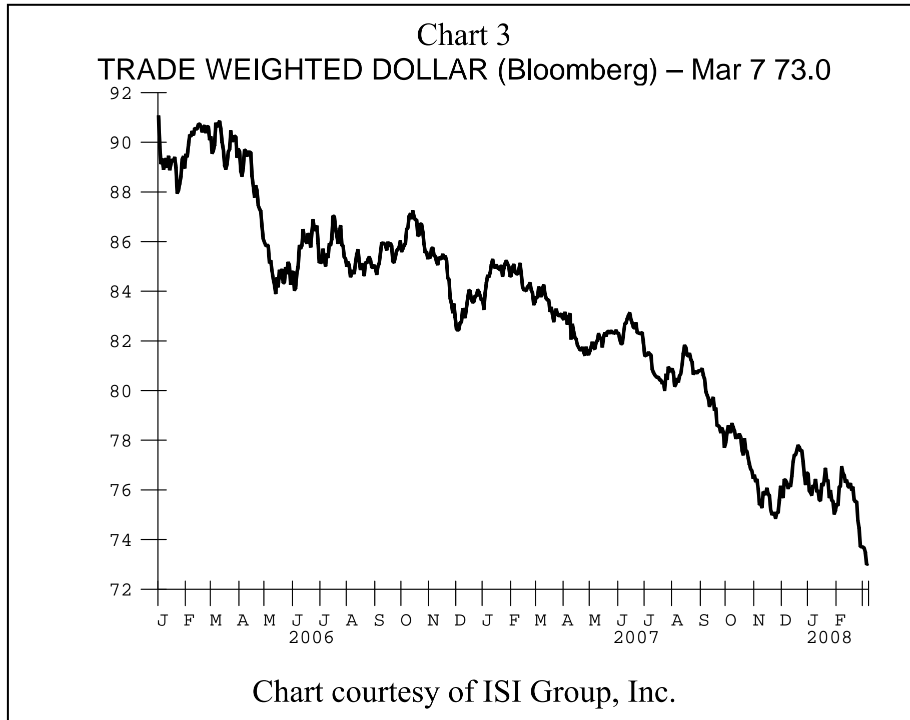

Chart courtesy of ISI Group, Inc.

Unlike its counterparts across the Atlantic, the Fed seems to have turned its back on inflation. So what is the Fed's problem? Why can't they get their act together and get serious about supporting the dollar and bringing

[9] James Glynn, "Amid 17-Year Boom, Australia Walks Fine Line With Rates," *The Wall Street Journal*, February 25, 2008.

[10] Robert F. Worth, "Rising Inflation Creates Unease in Middle East," *The New York Times*, February 25, 2008.

[11] Jim Grant, *Grant's Interest Rate Observer,* February 8, 2006.

[12] Gavin Finch, "Euro Stays High Versus Dollar as Trichet Warns on Inflation," *Bloomberg News*, March 6, 2008.

inflation back within their own range of acceptability? Are they incompetent? We don't think so.

To be sure, the Fed is well aware that there is a pick-up in inflation that is posing a real threat to consumer purchasing power and a long term threat to economic stability.. "Since the summer [when the Fed began to cut the fed funds rate] almost all of the measures of inflation that we look at have begun to accelerate again, and in some cases pretty sharply," said Dallas Fed President Charles Plosser. "Perhaps the inflationary pressures are more broad-based than just energy.[13]" In testimony before Congress, Fed Chairman Ben Bernanke added, "Any tendency of inflation expectations to become unmoored or for the Federal Reserve's inflation fighting credibility to be eroded would greatly complicate the task of sustaining price stability and could reduce the flexibility of the F.O.M.C.[14]"

So if the Fed sees that inflation is accelerating and understands the risks associated with such an acceleration, why do they continue with their campaign of aggressive monetary stimulus? We believe the best answer to this question comes from Art Cashin, floor trader for UBS Securities. "Federal Reserve Vice Chairman Donald Kohn spoke yesterday afternoon… He seemed to say – If you're worried about inflation; get over it," Cashin wrote. "There are a lot of worse things out there. He alluded to the potential drastic damage that could evolve quickly as financial markets reinforce the fears of the consumer who sees his (or her) wealth and savings disappearing… We think he says there's a Sasquatch out there and that the Fed will concentrate on that rather than inflation…for the near future.[15]" A Deleveraging Sasquatch. [Sasquatch, also referred to as Bigfoot, is a mythical seven-foot hairy creature whose existence has never been proven.]

As evidence supporting the Deleveraging Sasquatch theory, look no further than the massive government cover-up in the financial markets, starting with the folly that is the reiteration of AAA ratings for the monoline bond insurers that guarantee the bond offerings of municipalities. If the monoline insurers were to lose their AAA rating, it is believed that many funds that hold municipal bonds would be forced by investment mandate to unload their holdings, sending the prices of municipal bonds lower and the cost of funding municipal projects higher. "Giving [these companies] a AAA rating underscores the hoax being perpetrated by the ratings agencies. Some might call it conspiratorial," wrote Doug Kass, general partner and investment manager for Seabreeze Partners. "Remember that, in only the last few days, [one monoline insurer] has posted a $1.9 billion loss in its latest fiscal year, has eliminated its dividend, has temporarily stopped writing guarantees on asset-backed securities, its CEO 'has questions' regarding the company's preliminary results reported in January and has refused to sign off on the company's 2007 financial statements, and the company was forced to raise $2.6 billion in capital.[16]" To illustrate the ridiculousness of the AAA blessing these monoline insurers have been given by the rating agencies, Michael Shedlock, editor of *Mish's Global Economic Trend Analysis* compares one top-rated monoline insurer to a large pharmaceutical company which recently had its Moody's rating downgraded from AAA. The pharmaceutical company has annual revenue of $48.6 billion, earnings per share of $1.20, profit margins of 17.1%, total debt of $8.7 billion and cash of $20.3 billion. In contrast, the monoline insurer has annual revenue of $3.1 billion, losses per share of -$15.22, profit margins of -61.7%, total debt of $17.5 billion and total cash of $5.7 billion. Again, the monoline insurer is considered to be a AAA-rated credit by Moody's, while the pharmaceutical company is not.

The cover up does not stop there. As losses from bad mortgages and mortgage-backed securities climb past the $200 billion mark, talk among banking executives for an epic government rescue plan has escalated. A confidential proposal from banking executives warned Congress that up to $739 billion in mortgages are at

[13] Graham Bowley, "That '70s Look: Stagflation," *The New York Times*, February 21, 2008.
[14] Edmund L. Andrews, "Bernanke Says Sagging Growth is Chief Concern," *The New York Times*, February 28, 2008.
[15] Art Cashin, *Cashin's Comments*, February 27, 2008.
[16] Doug Kass, February 27, 2008.

"moderate to high risk" of defaulting over the next five years and that millions of families could lose their homes[17]. The House Financial Services Committee, the Bush Administration and the Treasury Department are said to be seriously considering a bailout in which the government would buy troubled mortgages, at what would probably be a big discount to the original loan amount. "Public policy is a hostage to the news. The grimmer the headlines, the more activist the government," wrote Jim Grant. "The incumbent Republicans are implementing a mortgage forbearance scheme that, in its principles, is as radical as anything that sprang from the New Deal.[18]"

At a recent conference of bank leaders, Fed Chairman Bernanke urged bankers to practice principle forgiveness of loan balances to their customers. This would involve banks writing off the negative equity portion of a consumer's mortgage loan, likely resulting in hundreds of billions of losses on bank balance sheets. "The problem with any bailout plan is very simple: in order to keep distressed borrowers in their homes," wrote Andy Laperierre of ISI Group, Inc., "someone (either the holders of the loans or the taxpayers) needs to come up with a lot of money. There is no way around that."

We could not agree more. The Deleverage Sasquatch is real. This is no myth. The process that has now been set in motion is a secular unwinding of unsustainable levels of debt amassed during an era of stimulative Fed policies and financial market innovation. Too much credit was extended to too many borrowers, consumer and corporate alike, who had neither the merit to borrow nor the means by which to repay their loans. "This parlor game is best defined by leverage and not the assets that have been dealt out to more than willing players over the past decade," wrote Bill Gross, captain of the ship at PIMCO Bonds. "Tighter lending standards, reduced risk budgets, and increased regulatory scrutiny all promise to produce a reduction in the growth rate of lending.[19]"

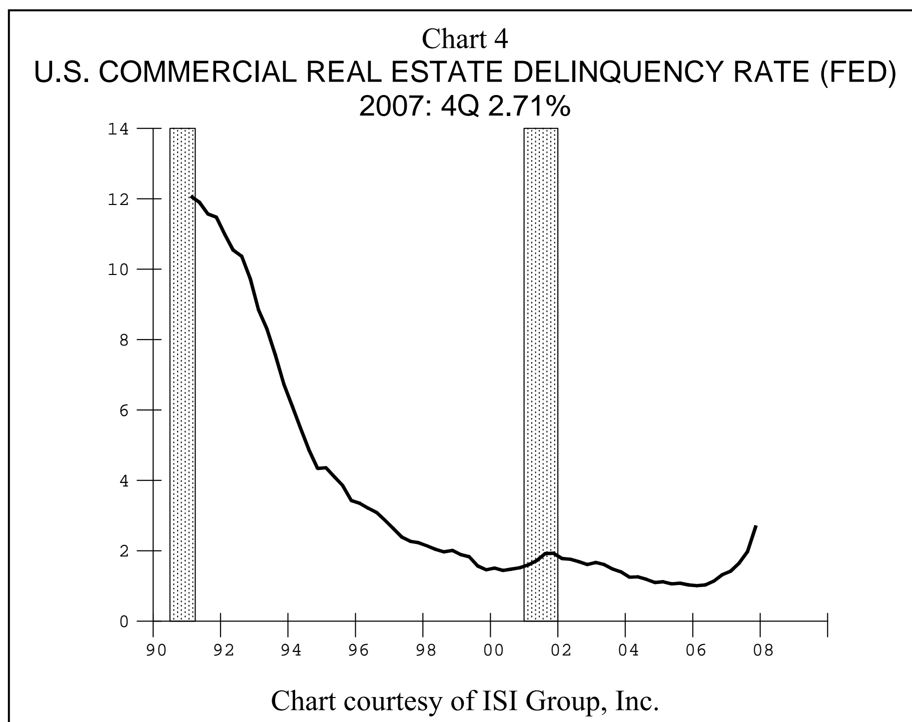

Chart courtesy of ISI Group, Inc.

That is precisely what is now taking place in the credit markets as one part of the debt market after another has buckled. High-risk loans used to finance corporate buyouts have plummeted in value, causing forced selling by hedge funds and collateralized loan obligations (CLOs) that hold these securities. Some estimates suggest that companies could default on more than $220 billion of high-yield corporate bonds, leveraged loans and other non-bank debt this year and next[20]. "The warning signs were there when you saw companies that had seven-times leverage decide the answer to their problems was to add more debt," says Henry Miller, chairman of Miller Buckfire, a financial restructuring firm. "They were

[17] Edmund L. Andrews, "Who Should U.S. Help in Subprime Debacle? Banks, Suffering Home Buyers, Wall St.?," *The New York Times*, February 23, 2008.
[18] Jim Grant, *Grant's Interest Rate Observer*, February 22, 2008.
[19] Bill Gross, *PIMCO Investment Outlook*, March 2008.
[20] Jeffrey McCracken, "Lending Squeeze Hits Ailing Firms," *The Wall Street Journal*, February 21, 2008.

doing that when the economy was getting soft. You do the math.[21]" Securities backed by commercial real estate mortgages have fallen sharply as the commercial real estate delinquency rate has risen to 2.7% (see Chart 4).

As the credit losses spread, banks will be forced to take additional write-downs, further impairing their already weak balance sheets. "The banks themselves, because they owned so much of this different kind of affected paper ranging from leveraged loans to mortgage-backed bonds, have simply got their snoot full," said Roy Smith, a former Goldman Sachs Group Inc. partner who teaches finance at New York University's Stern School of Business. "They don't have their usual amount of room to step up.[22]" With mounting losses, capital will be less ample and risk appetites will continue to shrink, cutting off loan availability. "At present, lenders are more worried about future losses that may exist on their balance sheet, not just what they have written off," wrote Rajeev Dhawan, Director of the Economic Forecasting Center at Georgia State University. "They are unable to figure out the credit worthiness of [their borrowers]… Ergo this mentality of hunkering down has reduced drastically their propensity to lend and conduct normal business.[23]" As a result, "There will be big, sound, reasonable companies out there that will be left on the sidelines looking in," says John G. Chigounis, chairman of Global Investment Advisors, a $1.8 billion investment fund and division of Reich & Tang Asset Management LLC. "They didn't get their refinancing when they should have, and now the window is shut and the credit markets have closed.[24]"

This great leverage unwind is prima facea evidence that the Fed is pushing on a string with its stimulative monetary policy. As credit spreads have widened and the debt markets have ground to a halt, we have returned to a net short position in financials. That said, it is likely that, fearing an asset market deflation, Ben Bernanke, Treasury Secretary Paulson and our leaders on Capitol Hill will continue to throw the interventionist spaghetti against the wall until something sticks. By doing so, they may be sowing the seeds for the creation of the next policy-induced bubble; inflation.

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[21] Jeffrey McCracken, "Lending Squeeze Hits Ailing Firms," *The Wall Street Journal*, February 21, 2008.
[22] Pierre Paulden, Caroline Salas and Jody Shenn, "Wall Street Abandons Neediest Clients as Banks Withdraw Credit," *Bloomberg News*, February 20, 2008.
[23] Rajeev Dhawan, "Forecast of the Nation," *Georgia State University Economic Forecasting Center*, February 2008.
[24] Jeffrey McCracken, "Lending Squeeze Hits Ailing Firms," *The Wall Street Journal*, February 21, 2008.