JUNE 2009 — MARKET REPORT

GREAT INFLATION SPECULATION

Now that the highly touted deflation fears have been put to rest, we are now trying to climb the next "wall of worry", hyper inflation. Holding the attention of investors with calls for a gradual recovery can be difficult when one reads competing calls for hyper inflation ala "Zimbabwe" or "double-dip depression" on alternating days.

Away from the shrill dialogue, a good deal of what is going on in financial markets still looks like a gradual "normalization." While the structure of credit markets and financial institutions will likely be changed forever, financial market pricing has been moving toward conditions somewhat closer to those before the Lehman Brothers' demise.

Against this backdrop, it's hard to view 10-year U.S. borrowing costs at 3 1/2% as some sort of new disaster when 2% yields at their December low were tied to the very real disaster. Importantly, the latest backup has occurred while access to corporate debt markets and even mortgage refinancing has improved some. Mortgage and corporate bond yields have varied by just 25 basis points in the past three weeks. Recalling many conversations with investors, the frenzy of Treasury purchases in 2008 was tied to the view that severe U.S. economic contraction would continue for years, not quarters. Assuming nominal U.S. growth returns to some semblance of its past trend, 5% 10-year Treasury yields should be seen in future years, independent of the latest speculation on external demand for Treasuries, debt ratios, ratings agencies, etc.

We would expect the newly enlarged federal sector to at some point present competitive "crowding" issues when private credit demand recovers. Longer term entitlement spending is of course on a completely unsustainable track, which was the case before the present downturn and financial crisis. But the rise in Treasury yields to date seems largely a function of evolving growth and inflation expectations, not a suddenly overwhelming public financing burden. A caveat is that the shift up in recent weeks has been too rapid to be sustained in the face of still weakening current economic conditions.

Neither the Fed nor Congress will make the goods and services that will see heightened demand from monetary easing steps in the years ahead. As such, both theory and reason suggest that monetary easing will show through more potently to a higher inflation rate than real growth when measured over a 10-year window.

Real growth assumptions hadn't fallen as substantially as the inflation component in Treasury pricing on the way down. Considering how much concern has been expressed about the ability to substitute Treasury debt for private credit, it is worth considering that U.S. Treasury yields have surprisingly fallen 40 basis points over the past year even as the marketable Treasury supply has risen a record $1.75 trillion.

How is this possible? Despite robust gross debt issuance for refinancing purposes, net private credit demand is diminishing. We would expect first quarter data from the Federal Reserve's Flow of Funds accounts to show a more extreme weakening in private credit relative to Federal debt than in a 2008 when the trend began.

Meanwhile, warnings on the U.K. sovereign rating, and the U.S. implicitly got the attention of investors. But a look at the performance of foreign bond markets is more suggestive of 2% 10-year Treasury yields representing the miss-pricing than the current sell-off. All 10 foreign developed country bond markets saw yields rise in recent weeks, consistent with global recovery expectations, not substantial ratings divergence.

The rise in U.S. and global bond yields has occurred as the Fed has purchased Treasuries, with these purchases failing to prevent the rise. But the Fed is not alone. Official data show foreign central bank holdings of Treasuries increasing despite a diminished external financing need now that the U.S. trade deficit has halved. We know, this runs completely counter to popular reports, and there are nuances to this data. For example, federal agency holdings have fallen. But we continue to distinguish hard data from anecdote and commentary.

Early Cycle Price Recovery, Not Late Cycle Inflation

While we expect a gradual and muted recovery in global economic activity, declines in consumption, production and trade flows at the start of 2009 seem akin to the overshoot seen in financial markets. As utilization climbs, related industrial commodity prices are likely to see sustainable gains from recent lows, quite in contrast to the speculative push into the teeth of the global downturn in 2008. We would rather be buyers of crude materials and related securities after their largest one-year drop in history than at the top of an overextended global expansion reached near this time last year. The magnitude and timing of these commodity price gains are a world apart from finished wholesale product prices, much less final consumer prices, including services. So many seem to give the U.S. a bitter choice between 1930s style depression or 1970s style inflation irrespective of fundamental differences. While excessive monetary accommodation in the 1970s didn't create sufficient supplies to match demand, it did accommodate a 10% pace of nominal wage gains, a world apart from current declines.

It is only reasonable to be concerned that extremely large and potent easing steps might someday get the upper hand if the financial restraints on demand are put completely behind us. But how much effective accommodation is really going to be achieved? And why would it be sustained beyond necessity? Among many other indicators, we might wonder if policy easing steps were proving sufficient if richly valued Treasuries weren't falling at least some in price.

We cannot close without broaching the General Motors disaster scenario. What has happened to this old-line American icon is one of 'politics-turned-to-economics result.' Meaning -- most management teams would not have fallen so deeply to the unions as evidenced here unless there was another hammer (government) in the background. Our thought is that had management turned down the UAW their next phone call would have been from either the Executive or Legislative branches in Washington, DC. The American electorate voted for change in the most recent Presidential election. We all will hope it will only get better than this.

Meanwhile, we are enjoying higher stock prices.