

Date: April 3, 2009
To: Valued Clients and Friends
Re: Mercy for Those Who Are Suffering
1st Quarter 2009 - Markets and Economy in Review
The Great Debate – Inflation or Deflation
The Credit Crisis in Review
Abracadabra - Credit Crisis Solved

Mercy for Those Who Are Suffering

Let me begin by acknowledging those who are suffering, people we know and love, as this recession translates into job losses and financial hardship. It's real. There is no magic elixir to cure the ills, but we can be empathetic and understanding, consoling and encouraging, helpful and serving, and we can pray for strength, wisdom and perseverance for all those in need.

1st Quarter 2009 - Markets and Economy in Review

1st quarter 2009 market performance reflected the severity of the economic recession. Other than Gold (+4.4%) and the Chinese markets (+30.7%), and selected classes of the technology sector, negative returns ruled. A recap of 2008 performance is as follows: Dow -13.3%, S&P 500 -11.7%, NASDAQ -3.1%, Russell 2000 Small-Cap Index -15.4%, S&P Mid Cap 400 -9.2, DJ International (xUS) -11.7%.

There is a bright side to the markets, as March 9 looks (fingers crossed) like the day market lows were established. Since then, the equity markets staged historic increases through the end of the quarter with the Dow up +16.2%, Nasdaq +20.5%, S&P 500 +17.8%. What we are seeing now is the disconnect between the markets and economic reality. While the stock market is ascending, the economy continues to reflect evidence of a downward spiral with increasing unemployment (8.5%, over 13 million unemployed) and continued declines in consumer spending, housing, construction and manufacturing. There are some signs that the end of the recession may come before year end. Fed Chairman Bernanke reported to Congress the possibility of the recession's end if the government fixes achieve the intended results. But there are too many unknowns at this point to get overly optimistic. The drivers for recovery - credit and housing - remain unresolved problem areas. As for the stock market, remember that, at the end of the day, prices will reflect achievable earnings, not just the hope of earnings.

The Great Debate – Inflation or Deflation

The great economic debate going on now amongst noted scholars and economists is whether inflation or deflation is eminent. It is important to understand the underpinnings of the debate because it explains the coordinated monetary and policy responses to the current recession. It is rare when the White House, Congress and the Federal Reserve are in agreement – especially with such massive deficit spending.

We naturally worry about inflation because we have more experience with it. Most of us can relate to the late 70s when inflation was in the teens and short term interest rates exceeded 21%. And we know that the current crisis is a result of unbridled leverage and debt creation. It is worth noting that Paul Volcker was the Fed Chairman at that time and established monetary responses necessary to halt inflation. Specifically, he cut off money growth, raised rates and put the economy in recession until price increases subsided. Ironically, Paul Volker is now one of Barack Obama's chief economic advisers supporting the massive stimulus and deficit spending being used to re-inflate the economy.

Why then should we not be concerned about the inflationary effects of massive government stimulus and deficit spending? The simple answer is inflation is the lesser of evils. It is not that our leaders are unconcerned about inflation; it is that they are more concerned about the risk of deflation. Deflation is rarely good and is most often associated with economic depressions. The last deflationary period experienced in this country was during the Great Depression. Deflation occurs following periods of excessive debt creation and the bursting of asset bubbles supported by the debt. As assets are liquidated to relinquish debt, prices fall faster and faster and the demand for goods evaporates. Market psychology shifts to an attitude of waiting to buy knowing prices will be lower tomorrow. A devastating cycle of falling prices and economic depression follows. When deflation is set in motion it is difficult to stop. The only cure is to create money in dangerous portions to re-inflate the economy.

Fed Chairman Bernanke is a depression scholar and nick-named "helicopter Ben". A few years ago he made a speech wherein he spoke on the dangers of deflation (like the decade of deflation in Japan) and stated he would drop money from helicopters if necessary to avoid deflation. In 2003, Bernanke made the following comments in Japan:

"... it is important to recognize that the role of an independent central bank is different in inflationary and deflationary environments. In the face of inflation, which is often associated with excessive monetization of government debt, the virtue of an independent central bank is its ability to say "no" to the government. With protracted deflation, however, excessive money creation is unlikely to be the problem, and a more cooperative stance on the part of the central bank may be called for."

Clearly, inflation does not seem to be the concern of the Fed or the Obama administration. The Fed, the Treasury and the administration are all working together. If the trillions of dollars being committed appear irresponsible, it is because deflation and economic depression are deemed a far worse outcome. The price we are going to pay for government waste and inefficiency throughout this process must be viewed in the context what is at stake. If 8.5% unemployment is painful now, how much more painful would 15-20% unemployment be? Let's hope our leaders are correct and the stimulus programs work.

The Credit Crisis in Review

The reason banks are not lending is because they are being forced to deleverage or shrink. I have mentioned this before, but it is worth repeating because it is at the center of the credit crisis. Banks must keep a minimum percentage of capital on their balance sheets. For simplicity, let's assume 10% even though the actual number is lower and varies based on the type of assets held by the bank. This means a bank can have \$10 in loans for every \$1 of capital. Banks can grow or make new loans equal to 10 times every dollar of profit it makes. Conversely, if a bank loses money in a given year, then it must shrink its balance sheet or raise new capital equal 10 times the loss in order to meet the minimum capital requirement.

As the housing bubble has burst, banks have incurred enormous losses and are being forced to sell assets at lower and lower prices, or to write down the value (market value accounting) of the loans or securities which is a loss against capital. Banks are unable to raise new capital in the market, so all the bailout money going to banks is replacing lost capital. As asset values continue to plummet and loans continue to go bad, more and more capital is needed. Banks have cash, but capital regulations are constraining lending. Consequently, credit and commerce are frozen. In essence, thus far all the bailout money going to banks is literally sitting in the bank. It is ironic that politicians, who are well aware of these issues, cry foul that bailed-out banks are not lending in one breath, and in the very next breath they are advocating more regulation. Equally ironic are the actions of our banking regulators. At the very top (Federal Reserve and Treasury) are pouring hundreds of billions of dollars into the banking system to unfreeze credit. At the same time the FDIC is going into many of these same banks and clamping down on their ability to make loans because of capital concerns. That is the problem when the government gets involved in trying to run a business.

Abracadabra - Credit Crisis Solved

The fiscal and policy responses to solve the credit crisis are creative, multifaceted and immense. Quite remarkable at least on paper, but they have yet to be fully implemented or achieve the intended result of getting credit flowing through the economy. The government has done everything from the outright takeover of banks, mortgage banks, brokerage companies, and insurance companies; to buying and/or guaranteeing loans and securities; injecting capital into automobile companies and more. The government's latest action is bold and may well get to the heart of the problem. The Fed and the Treasury, working together, have committed over a trillion dollars toward buying toxic assets from banks.

It certainly makes sense to try to get the toxic assets out of the system so banks can get back in lending mode. Initially, the problem with this plan was figuring out how to compel banks to sell assets and realize losses without also replenishing the capital lost. But then, this week - *abracadabra credit crisis solved*. Banking regulators, in conjunction with the accounting profession, have agreed to relax the market value accounting rules. With the stroke of a pen the illiquid assets (including toxic assets) can be valued internally and are no longer subject mandatory write downs. This is a huge event and may well be the most significant action taken to solve the credit crisis. It does not make the assets any more valuable in the marketplace, but it eliminates the need for banks to take losses on unmarketable securities, to raise more capital or to shrink. More importantly, it paves the way for the bailout money to be used for lending and flow into the economy.

That said, the timing of Treasury plan and the accounting ruling are a little suspicious. I think it increases the potential for toxic assets to be purchased from banks (by the taxpayers) at inflated prices. On the other hand, several bailed-out institutions may seek to return bailout funds as a result of the accounting changes. It is too soon to judge how all this will pan out, and in the end the most important thing is that it works. I admit I am a big advocate of market value accounting in business – especially financial institutions. But at the present time, if relaxing the accounting rules is what it takes to help unfreeze the credit markets and get banks back in lending mode, then go for it. I just hope the taxpayers do not get abused too badly in the process.

There are many other aspects of this recession that deserve attention, but there is not enough time to get into detail. Here is a list of things to watch out for in the months ahead:

- Commercial loan defaults are just now hitting the surface. Defaults cannot be hidden with accounting rules. This will affect bank earnings and real estate investment trusts hard in the coming months.
- Public and private pension plans are terribly underfunded as a result of market declines. Actuarial assumptions will require huge costs to companies and local governments to meet the obligation.
- Municipalities are under significant budget pressures as tax revenues have declined. Watch out for more municipal bankruptcies and bond defaults.
- As bad as things seem here in the USA, things are much worse around the globe. Entire countries are insolvent. Social unrest and protests are on the rise. Protectionist actions threaten global trade. The G20 meetings this week committed a trillion dollars to the IMF for global stimulus.
- Terrorism remains a serious threat.

In closing, here is one more example of the enormity of a trillion dollars offered by Ted Koppel during a recent NPR interview. If a business started when Jesus was alive 2,000 years ago and lost \$1 million every day, it would take almost another 1,000 years into the future to accumulate a trillion dollars of loses.

Please call me if you have any concerns or if you want to discuss any of these comments. Thank you for your continued trust and confidence.

Sincerely,

Jeffrey L. Noyes

God grant me the serenity to accept the things I cannot change; the courage to change the things I can; and the wisdom to know the difference...Amen