# 2008 YEAR END REVIEW OF MARKETS: THE GREAT UNWIND

"And so castles made of sand fall into the sea, eventually."

*Jimi Hendrix, "Castles Made of Sand", from the album "Axis: Bold As Love", 1967*

The travails of markets and investors in 2008 have been, by now, well described by the mainstream press, online commentators, and every manner of casual observer. However, there is far more to 2008 than meets the eye, and we hope this review will provide insights and analysis that are useful.

One of the key takeaways from our last Semi-Annual Review was as follows: *"It is important for investors to be positioned for what we continue to believe is a massive and ongoing de-leveraging of the world's financial system…rather than viewing the process as nearly complete, we believe the first phase has now passed and we are now entering the most dangerous period of this adjustment process, as the need to cleanse the system of bad debts and paper will be challenged by government efforts to re-liquefy (i.e. "bailout") the system, producing additional stress and potential fracture points."*

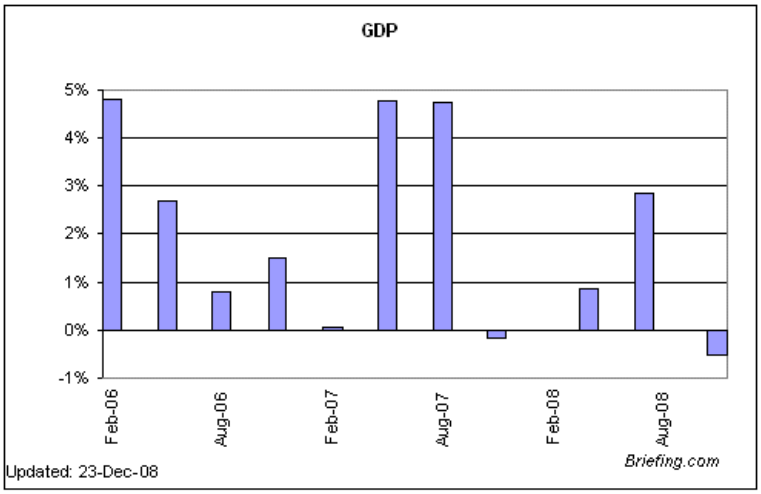
The magnitude of the stress and additional fracture points far exceeded even our most pessimistic forecasts, producing negative returns in nearly every asset class (except US Treasury bonds). For US equities, it was the worst year since 1931. Summary Returns are reviewed below:

| | 2008 | Last 3 Years | Last 5 Years | Last 10 Years |
|---|---|---|---|---|
| S&P 500 | -38.49% | -27.64% | -18.77% | -26.52% |
| Value Line Composite | -48.69% | -45.24% | -37.71% | -48.32% |
| MSCI EAFE | -43.06% | -19.36% | 10.97% | 12.41% |
| MSCI Emerging Markets | -53.18% | -13.23% | 47.04% | 143.50% |
| Citigroup 5 Year T-Note | 14.13% | 28.98% | 32.10% | 77.83% |
| Barclays Five Year Muni | 5.79% | 14.93% | 19.16% | 56.22% |
| DJ AIG Commodity Index | -35.65% | -23.66% | 1.13% | 108.23% |
| CPI | 1.14% | 7.94% | 15.25% | 29.61% |

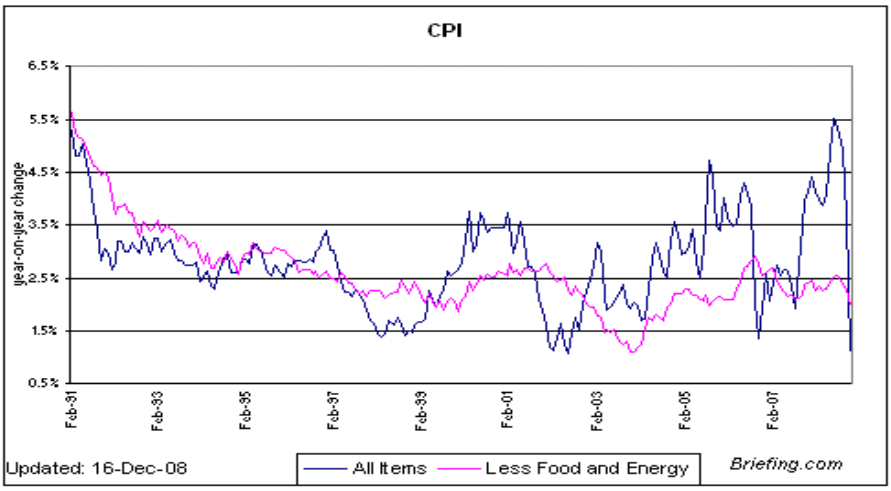
Investors should note the disparity between the average/median stock return (Value Line), versus large cap stocks (S&P 500). Longer term, "riskier assets" like emerging markets have vastly outperformed US stocks, as have commodities. More recently, bonds have opened a wide return margin versus stocks.

## Macroeconomic Outlook

Economic trends began slowing into the summer, and then decelerated rapidly along with the stock market this fall. GDP growth contracted in the third quarter of 2008 by -.5%:



On the inflation front, CPI has fallen markedly, with many economists now touting the danger of a deflationary spiral:




For enterprises, both service and manufacturing industries are contracting. The ISM Manufacturers Index, created in 1948, measures US industrial output. On a scale of 0-100, any reading above 50 indicates an expanding economy. In December 2008, the Index fell to 32.4, and should pierce the all time low of 29.4 set in May of 1980. The New Orders component of the Index is already there. There has been no bottoming yet in US manufacturing, and it is clearly a global phenomenon:


Payrolls shrank by 2.6 million jobs over the course of 2008 - the largest annual decline since 1945. The unemployment rate rose to 7.2% - the highest level since the early 1990s. We expect the next several quarters to be sharply negative, as consumer spending/confidence has plunged, industrial output is dropping precipitously, and export driven growth has vanished with the stronger US dollar and anemic foreign demand.

The size and speed of implementation of the upcoming US Government fiscal stimulus program will largely dictate the pace of the economy for the foreseeable future, along with confidence and investor psychology. It will be a time when traditional correlations and trends in macroeconomic variables have little influence on the economic outlook. Investor psychology will be deeply impacted by the tone of the ongoing debate, size and allocation of stimulus funds, and most especially the speed of implementation. None of these variables are measured by the Bureau of Labor Statistics or other government data mills, so perhaps the average investor now has a leg up on the hard core economists.

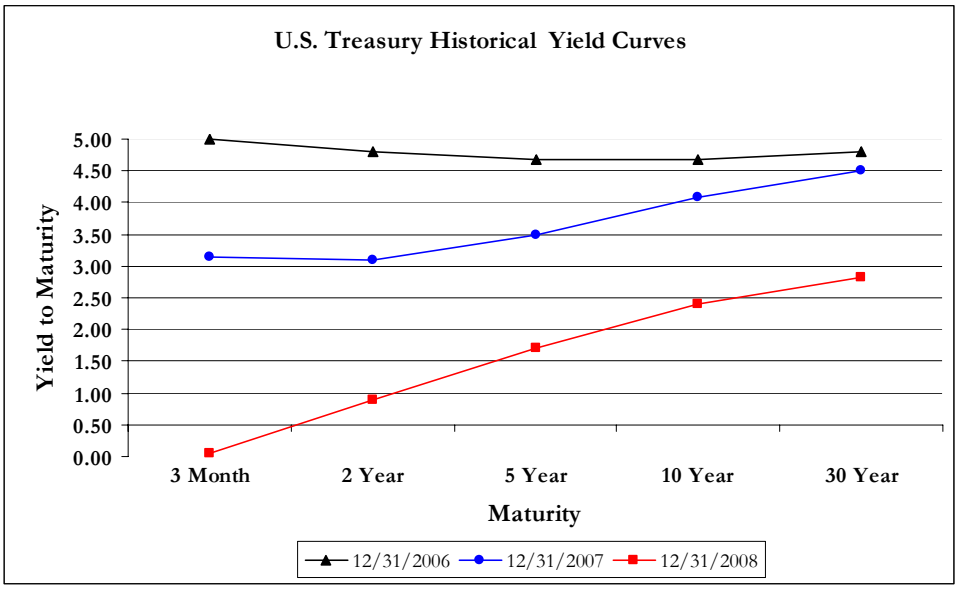
## Bonds

Amongst all the carnage in the markets that has occurred, we think this headline is perhaps the most provocative of all (from the *Financial Times* 1/9/09):

**UK CUTS RATES TO 315-YEAR LOW TO BOOST LENDING**

That is not a typo. The last time the bank of England saw a 1.50% official lending rate was the year of its founding in 1694 (if there remains any doubt that "it's different this time", it should now be buried).

In the US, short rates have crashed to zero, and longer maturities raced to 50 year lows:




The Fed has effectively enacted what Chairman Bernanke has previously described as ZIRP (Zero Interest Rate Policy) in his 2002 speech "Deflation: Making Sure 'It' Won't Happen Here". (Serious students of the markets should read the whole speech at):

http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm

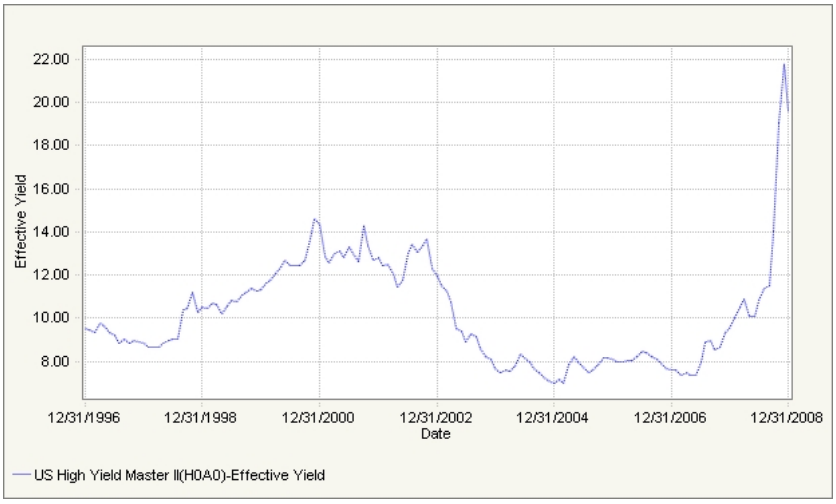
In normally functioning credit markets, lower interest rates would be considered stimulative. In fact, an upward sloping yield curve as seen above is usually one of the most reliable indicators of future growth in GDP. Now however, this policy tool is effectively impotent as credit dries up (the inability of low interest rates to stimulate growth has been called "pushing on a string", and it is an apt description).

The next phase of policy action has begun, and it is called **Quantitative Easing**. The Fed is now purchasing bonds of all types, but especially mortgage backed bonds, to reduce the ***quantity*** of bonds outstanding and add money to the system (easing). The theory is that such a large and steady buyer will force longer term rates down, encouraging borrowing (credit expansion). In Japan, this policy was in place for over a decade in the 1990's and did not succeed in boosting growth. Time will tell what Chairman Bernanke has learned from the Land of the Rising Sun.

With respect to corporate bonds, we wrote last July: "Our view remains that corporate default rates will be rising for some time to come, and thus spreads will approach or even exceed those seen during the last recession of 2001-02" (they blew through those levels quickly in the fall). While brief rallies are possible, the stresses on corporate bonds are likely to remain for some time to come as the economy contracts and defaults rise, so investors should have opportunities buy credit at attractive levels at various points throughout 2009 and 2010.

The unprecedented decline of US Treasury rates in 2008 was driven by a massive "flight to quality" as leveraged investors of all types were forced to sell "risky" assets like stocks and commodities. US Treasury

securities were the only major asset class to have a positive return last year. Corporate bonds, and especially US high yield bonds, collapsed in price, as yields rose to all time highs:




*Source: Merrill Lynch*

It is quite possible that this shakeout in publicly traded high yield bonds will now be followed by a shakeout in private equity, as leveraged buy-out firms who gorged on "covenant light" debt provided by eager beaver Wall Street banks pursuing fee income and leads in the ranking tables threw caution to the wind. We have seen some estimates that project another $300 billion in write offs globally from just this one narrow asset class, where some 60% of the debt is now trading at distressed levels (default probable).

A very attractive sector in bonds remains "inflation protected bonds", especially of the government guaranteed variety, like TIPS (Treasury Inflation Protected Securities). When these types of bonds price in negative inflation rates for the next decade, as they have done recently, disbelief should be cast aside in favor of buy tickets. This disconnect may persist throughout early 2009, as the CPI records successive negative monthly prints.

Likewise, municipal bonds (tax-exempt) have risen in yield due to the collapse of monoline insurers (MBIA, AMBAC etc.) and perceptions of weakening state and local government finances. We find particularly good value in pre-refunded or escrowed to maturity municipals, which are defeased issues collateralized by US Treasury securities. In some cases, investors can buy these issues at twice the nominal yield of equivalent duration Treasuries, with the tax exemption thrown in "for free" as a kicker.

## Equities

In the US, the sector scorecard for 2008 read like a bad dream:

| | |
|---|---|
| Consumer Staples | -17.66% |
| Health Care | -24.48% |
| Utilities | -31.55% |
| Telecommunications | -33.62% |
| Consumer Discretionary | -34.73% |
| Energy | -35.93% |
| ***S&P 500*** | ***-38.49%*** |
| Industrials | -41.52% |
| Technology | -43.68% |
| Basic Materials | -47.05% |
| Financials | -56.95% |

*Source: Standard & Poors*

Among major markets globally, the bad dream morphed into a nightmare, as Japan fell by 42%, the UK by 31%, China by 51%, and Hong Kong by 49%. For ANY equity investor last year, there was no safe haven. The consensus view among street analysts and strategists for mild recession and modest profit declines at the beginning of the year was rendered meaningless. We believe the same holds true as we start 2009, as

government actions worldwide to spend (fiscal stimulus) will "crowd out" private capital, at least that which remains solvent and has retained some risk appetite. Profit growth, meanwhile, has been contracting, and is highly dependent on these government spending programs going forward.

As equity investors adjust to the reality of tougher earnings to come (income statements), they will increasingly turn a critical eye to balance sheets. We believe that investors holding individual equities will be well served by owning companies with low debt burdens ("debt to equity ratios"). Examining the structure of the debt will also be important (i.e. how much comes due when and can it be re-financed?).

Another very important exercise will be to re-examine the concept of "book value". Frequently value investors will point out how cheap a company is trading versus its book value ("trading below book"). But included in "book value" is a pesky little item called "Goodwill & Intangibles" which is a bookkeeping entry to record how much managements have overpaid for acquisitions ("premiums"). In many cases now, the market capitalizations of large, well known blue chip companies are less than the value of this asset on their balance sheet. Here are just a few:

| Company | Market Cap | GW/Intangible Value | Gap |
|---|---|---|---|
| Bank of America | $87.2 | $112.1 | $24.9 |
| Sprint Nextel | $5.5 | $27.1 | $21.6 |
| News Corp | $24.3 | $31.9 | $7.6 |

Accounting rules require companies to reduce this asset when it has been "permanently impaired". Given the decline in operating environments globally, and the multi-generational change now upon us, investors should not be surprised by large write-downs in goodwill and intangibles in coming years. (Be especially wary of the stated book value of banks and other financial institutions.)

As for the hard asset (commodity/energy) and precious metals areas, we remain of the view that these groups will prove to be among the most prized of all investment assets over time, in spite of recent sharp price declines. Gold mining stocks have significantly underperformed the metal, setting up for a large reversal. The resource stocks are now "in play", as market caps have been reduced, and large, cash buyers are set to have a field day sifting through the many opportunities at hand. Expect to see a wave of mergers and consolidations in these industries during the current downturn. Despite a potentially protracted global slump, investors should monitor these groups closely and add to positions during periods of weakness. When global aggregate demand returns, these assets will soar in value, as they are the ultimate in scarce resources.

For a longer term equity orientation, we attach the following table and highlight the shrinkage of market cap in OECD economies, whose populations are aging, and the growth in emerging economies, whose populations are expanding. This trend is irreversible, and will impact investors for a generation to come:

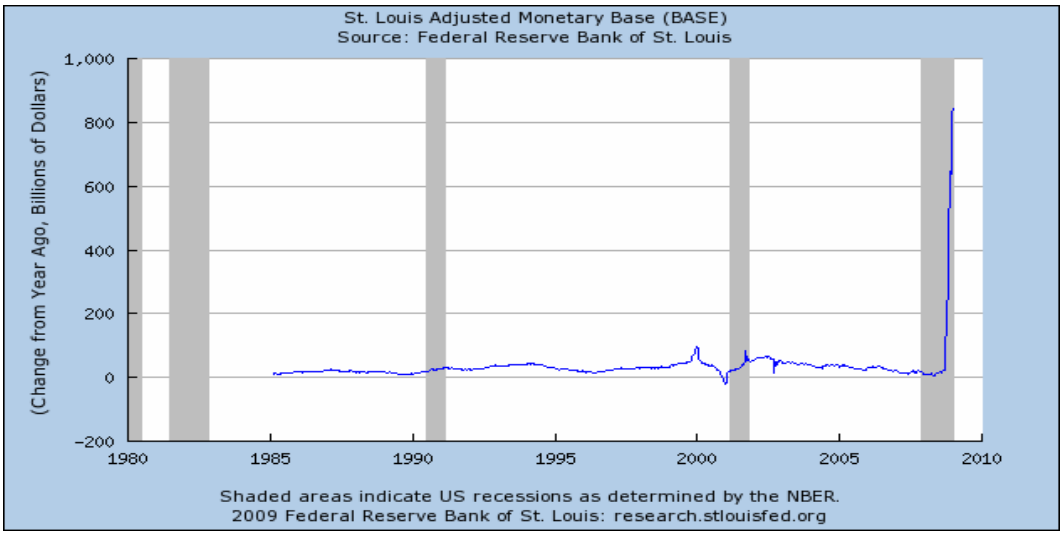
**% of World Stock Market Cap by Country**

| Country | Jan. 04 | Current | Country | Chg Since Jan. 04 |
|---|---|---|---|---|
| US | 43.7% | 29.9% | Saudi Arabia | 877.5% |
| Japan | 10.3% | 8.2% | Egypt | 561.6% |
| UK | 7.8% | 6.8% | Qatar | 310.2% |
| China | 1.7% | 5.4% | Brazil | 266.6% |
| France | 4.6% | 4.4% | UAE | 241.0% |
| Hong Kong | 2.4% | 4.3% | China | 218.7% |
| Canada | 2.7% | 3.7% | Russia | 173.5% |
| Germany | 3.5% | 3.6% | India | 123.7% |
| Brazil | 0.8% | 2.8% | Kuwait | 111.0% |
| Australia | 1.8% | 2.6% | Argentina | 85.2% |
| Switzerland | 2.2% | 2.2% | Hong Kong | 81.6% |
| India | 0.9% | 2.1% | South Korea | 67.8% |
| Italy | 2.0% | 1.8% | Mexico | 65.9% |
| Spain | 1.6% | 1.8% | Israel | 57.0% |
| South Korea | 1.1% | 1.8% | Singapore | 55.7% |
| Russia | 0.6% | 1.8% | Australia | 45.0% |
| Taiwan | 1.4% | 1.5% | Chile | 41.2% |
| Argentina | 0.6% | 1.1% | Canada | 36.4% |
| Sweden | 1.0% | 1.0% | South Africa | 34.9% |
| Saudi Arabia | 0.1% | 0.9% | Spain | 10.9% |
| Netherlands | 1.2% | 0.9% | Taiwan | 6.1% |
| Singapore | 0.6% | 0.9% | Germany | 3.2% |
| Mexico | 0.5% | 0.8% | Sweden | 1.2% |
| South Africa | 0.6% | 0.8% | Switzerland | -0.2% |
| UAE | 0.1% | 0.4% | France | -4.8% |
| Kuwait | 0.2% | 0.4% | Italy | -10.7% |
| Chile | 0.3% | 0.4% | UK | -12.3% |
| Israel | 0.2% | 0.4% | Japan | -20.2% |
| Egypt | 0.0% | 0.2% | Netherlands | -28.2% |
| Qatar | 0.1% | 0.2% | US | -31.6% |

*Source: Bespoke Investment Group*

## The Government Printing Press

Monetary policy has been in hyper-drive, as the government has bailed out many financial institutions, and now GM and Chrysler. We have referenced in prior Reviews the unlimited ability of the Federal Reserve to create dollars out of thin air (electrons) by issuing more debt. In fact, the money supply doubled in 2008. The actual amounts are recorded weekly by the St. Louis Fed, and the graph below shows how radical the Fed's actions have been:




According to the Congressional Budget Office, the US deficit will nearly double this year to $1.18 trillion, the largest since World War II. As banks and industry continue to struggle, this deficit will rise, to reflect plunging tax revenues, TARP II, and bailout and stimulus programs yet to be named.

The Fed avows that all this money they are adding to the system can also be withdrawn at the appropriate time to shrink the monetary base. We are highly skeptical of that claim. On January 7, 2009 for instance, we quote from Bloomberg that "Germany's sale of 10-year bunds lured the least demand in six months as investors shied away from a flood of government securities, raising the prospect of increased borrowing costs for Europe's biggest economy….investors bid for 5.2 billion euros ($7.1 billion) of the bonds offered today, a level of demand that prompted the Bundesbank to retain *32 percent* of the securities." At some point, the US will be facing the same prospect as bidders demand higher yields in the face of gushing supply. The only sure-fire way to avoid this outcome for the US is to move with deliberate haste to issue more long term bonds (lock in ultra-low yields) while the getting is good, and cut spending until the prospect of surpluses returns (the reader should draw their own conclusions as to the likelihood of this latter event coming to pass).

## The Great Balance Sheet Repair

If all this rescuing/government spending is going on, why isn't it helping? Put simply, banks are not lending these newfound funds, they are re-depositing them with the Fed to bolster their reserves (balance sheets). In the techno speak of Wall Street, excess reserves (notes and coins in circulation plus reserves held at central banks---M0) have surged, so that they now exceed M1 (currency, travelers checks and funds held in demand or current accounts). This is a very rare occurrence. Until these funds are lent out (i.e. until the velocity of money increases), there will be little stimulative effect on output or inflation. When the economy begins its next recovery, the Fed will be tasked with damping inflation as quickly as they have fought deflation in recent days.

But there appears to be much more bailing out to come. The table below shows the extreme acceleration in bond downgrades in H2 2008 (the ratings agencies, as usual, are a day late and much more than a dollar short):

## BOND DOWNGRADES BY AGENCY

| Date | Agency | | | Grand Total |
|---|---|---|---|---|
| | Fitch | Moody's | S&P | |
| 7/2007 | 542,083,920 | 5,716,512,124 | 10,562,596,679 | 16,821,192,723 |
| 8/2007 | 15,654,053,000 | 22,800,687,848 | 5,474,378,232 | 43,929,119,080 |
| 9/2007 | 19,275,973,203 | 489,982,500 | 4,843,994,000 | 24,609,949,703 |
| 10/2007 | 9,318,597,429 | 38,539,534,363 | 59,513,390,482 | 107,371,522,274 |
| 11/2007 | 22,227,926,621 | 19,525,674,351 | 12,658,847,736 | 54,412,448,708 |
| 12/2007 | 14,312,679,118 | 24,935,740,927 | 36,279,853,012 | 75,528,273,057 |
| 1/2008 | 5,336,229,168 | 14,816,099,368 | 69,254,195,205 | 89,406,523,741 |
| 2/2008 | 144,280,148,516 | 108,047,438,944 | 120,320,914,296 | 372,648,501,756 |
| 3/2008 | 27,339,244,678 | 115,044,325,826 | 134,548,672,156 | 276,932,242,660 |
| 4/2008 | 61,432,166,632 | 299,738,079,620 | 71,992,785,718 | 433,163,031,970 |
| 5/2008 | 24,601,373,351 | 51,115,412,305 | 71,308,770,104 | 147,025,555,760 |
| 6/2008 | 10,227,518,666 | 51,679,798,540 | 199,069,703,701 | 260,977,020,907 |
| 7/2008 | 28,728,651,926 | 57,012,135,600 | 71,958,139,167 | 157,698,926,694 |
| 8/2008 | 130,233,998,390 | 166,747,023,198 | 147,828,579,433 | 444,809,601,021 |
| 9/2008 | 11,010,870,307 | 158,744,911,369 | 184,329,577,361 | 354,085,359,037 |
| 10/2008 | 7,032,271,752 | 467,034,431,450 | 270,648,211,151 | 744,714,914,354 |
| 11/2008 | 214,476,893,378 | 309,142,187,376 | 218,629,058,970 | 742,248,139,724 |
| 12/2008 | 294,523,721,598 | 460,709,658,660 | 125,278,477,275 | 880,511,857,534 |
| Total | 1,040,554,401,653 | 2,371,839,634,370 | 1,814,500,144,679 | 5,226,894,180,702 |

As of: 12/31/2008

*Source: Oppenheimer & Co.*

Note that in December 2008 things were getting worse, *well after* the first round of TARP funds were "invested". $750 billion is only a start: these bond downgrades can only be repaired/rectified with new capital (profits and or debt/equity sales). 2009 will be the Year of Balance Sheet Repair, with lots of help from Uncle Sam. The banks will remain at the front of the line, but there will be lots of interlopers.

### The Housing Conundrum

Banks will compete for these government funds with politicians determined to help the housing market stabilize. Statistics show it continues on a downward trend. We believe, like any other economic event, supply and demand must come in balance to renew the industry, not the amount of bailout money applied to the wound.

The supply side is still working off huge inventories of unsold homes, built in better times when loans were freely available and historical returns justified the investment. Prices are down, but buyers are scarce, as they see evidence of increasing foreclosures. They are assuming the vulture stance, waiting for their prey to exhibit one last death spasm before striking. But the bodies keep twitching.

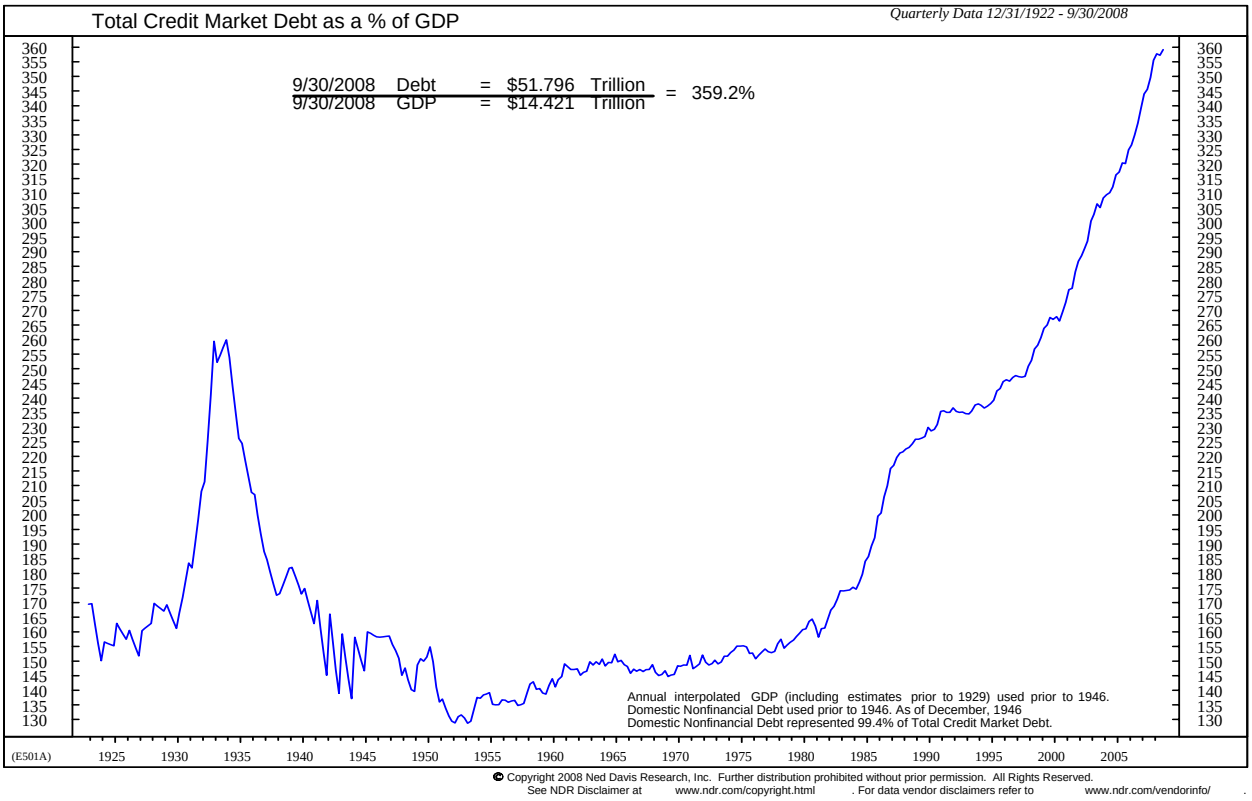
This overhang will be cleared when sellers relent and drop prices to the "new" affordability level (some astute observers have projected further declines of 20% and higher). In fact, the foreclosure issue is the fly in the ointment due to the securitized nature of most of these whole loans. If there is no one the bank can negotiate to work out a problem mortgage (since the loans have been sliced up into many different pieces and distributed around the world through the sale of asset-backed securities), how can forbearance or workouts occur? As Fed Chairman Bernanke recently opined: "Despite the substantial costs imposed by foreclosure, anecdotal evidence suggests that some foreclosures are continuing to occur even in cases in which the narrow economic interests of the lender would appear to be better served through modification of the mortgage. This apparent market failure owes in part to the widespread practice of securitizing mortgages, which typically results in their being put into the hands of third-party servicers rather than those of a single owner or lender." The demand side, meantime, has shriveled, as the consumer, and now businesses retrench. They will be back, at the right price (lower).

In the meantime, activist legislators are going to mandate "cramdown" provisions (where bankruptcy court judges will force banks to absorb/cancel part of the delinquent loans) in the name of helping to alleviate growing foreclosures. Why would a bank want to lend at all facing these uneconomic actions? Is this really going to help the growth of credit, which is the only surefire cure? As students of financial history, we note that there is perhaps no other scandal in the history of the US which compares to the brazen acts of Congress to subsidize and mandate "affordable housing" through the federally chartered duopoly of Fannie Mae and Freddie Mac, while accepting massive campaign contributions all along the way. Now that

the inevitable housing derailment has occurred, they blame the lenders, who were forced by the Community Reinvestment Act and other federal mandates to make uneconomic loans. Instead of practicing the time tested method of *caveat emptor* (buyer beware), legions of wannabe homeowners were led down the siren path of riches tomorrow by borrowing today. So yet another class of "victims" has arisen, whose poor choices will now be rewarded, while those who demonstrated prudence and common sense are marginalized. Our disgust knows no bounds.

## The Bigger Picture

If there is one picture to describe the current state of affairs in the markets, it is this:




*Source: Ned Davis Research*

The graph above represents the epochal expansion of credit (loans) as a percent of GDP (productive capacity) of the US, going back to 1922. That party is now over. The question for investors now is what will the adjustments look like and how long will they take?

**The primary change that is coming will be reduced demand for and availability of credit, and an increasing propensity for savings, which will persist for years to come. This is an effect we call "The Great Unwind".**

The initial effect of the epic financial crisis we are passing through is a wave of mergers and consolidations in the lending industry: Wachovia subsumed by Wells Fargo, JP Morgan buying Washington Mutual, Countrywide and Merrill Lynch now a part of Bank of America. The merits of partial government intervention may be debated, but the script is very logical: a reduced demand for loans means that rampant overcapacity/lax lending standards will be rectified, one way or the other. Under this scenario, we continue to see shrinking market caps and profitability for banks for some time to come.

The longer term development for investors will be the increased difficulty of borrowing money. We like to call it the **Return To Rationality**. On the consumer side, we have long warned of the over-leveraged US household, and the time of reckoning has come. A recent *Wall Street Journal* article led with the byline "Credit Card Companies Slash Credit Limits". The article discussed how banks are reducing credit limits and canceling cards outright. For non-prime borrowers, the average reduction has been 60%. In addition, 2009 will see the publication of new FICO guidelines by Fair Isaac Corp, the developer of our national credit scoring system. We expect the bar to be raised significantly for non-prime borrowers. Finally, the Office of Thrift Supervision recently adopted new credit card regulations which have been called "the most sweeping clampdown in decades" on card issuers. The rules, which become effective in May of 2010,

limit the interest rates consumers can be charged on outstanding balances, and limit the ability of banks to collect payments in arrears. These changes, which drew the highest number of public comments ever received by the Federal Reserve, are sure to be another nail in the coffin of consumer credit growth, as banks will have little incentive to issue new cards. In short, expenditures are out, and savings are in. For a country whose GDP is largely derived from consumer spending, that spells contraction of the long lasting variety.

One need only look at the huge drop in auto sales recently to get a taste of where things might head (both domestic and foreign makers report multi-decade lows in sales, with year over year drops in US sales approaching 40%). Toyota Motors (TM), the world's leading producer, announced on December 22 that it would record the worst (and first) operating loss in its 70 year history. The CEO of TM was quoted as saying "It's a kind of emergency that we've never experienced before". We expect that all large ticket discretionary items and the industries that support them (autos, vacation homes, pro sports tickets etc.) will experience declining demand for quite some time to come.

It will be the scarcity of capital for the enterprise sector, however, which will make this downturn particularly hard to recover from, despite government efforts. Led by the banks, credit losses are now expected to crest at $1.8 to $2 trillion, meaning we are only halfway through the write off process. In the traditional lending arena (especially revolving lines of credit), the most recent survey by the US Federal Reserve showed that 95% of banks had tightened lending standards to large companies, and 90% had tightened for small to mid-size companies. In Europe, the same central bank survey revealed a 68% ratio for large companies, and 56% for smaller firms.

At the same time, corporate borrowers that need to access the bond markets to borrow are finding, and will find, the reception much less hospitable. Interest rates will be punitive for many. The market for new bonds was nearly closed for much of 2008: according to Thomson Reuters, U.S. investment-grade corporate bond issuance fell 35% from 2007, mortgage-backed bond issuance fell 80%, and junk-bond issuance fell 73%. For equity capital, 2008 was nearly non-existent: just 29 companies went public, compared to 215 in 2007, a drop of 87%.

We therefore expect significant changes in patterns of consumption and profitability going forward affecting every industry. It is for this reason that we caution against using historical references to derive expectations about future performance. Everything has changed, and so too must our investment reasoning.

## Outlook for 2009

Our job is to impartially assess markets and world events to provide our investors with a strategy that focuses on both risk management and optimal returns. To do this, we must consider a broad range of potential outcomes, and position assets across a spectrum of possibilities, some favorable (position for growth), and some unfavorable (position for income/preservation of capital). For 2009, we believe that the historic changes we are witnessing create vast uncertainties for investors, which suggests risk aversion will continue.

Equity investors should be well served by following the money trail emanating from government spending plans. In the US, infrastructure and health care providers are expected to be primary beneficiaries. Some very highly regarded strategists suggest that the massive amounts of liquidity being added to the system are creating the catalyst for a rally in all stock prices. Investors may benefit this year by such a broad-based rally, but we do not believe it will be sustainable. Tactical equity investments should be in focus.

Perhaps the biggest surprise in 2009 will be a rout/retreat in US Treasury bond prices. Respected economist Willem Buiter wrote recently in the UK's *The Telegraph* that "...the long-held assumption that US assets - particularly government bonds - are a safe haven will soon be overturned as investors lose their patience with the world's biggest economy". *Barron's* also pointed out this risk in their inaugural cover story for 2009. The US Fed, in driving short rates to zero, is essentially playing chicken with the world's savers. Should they decide that zero is not enough, the rush to spread product in bonds (mortgages, corporates, high yield etc.) and equities could be quite rapid. Hard assets, especially gold, should benefit from this change.

The interplay of the world's currency markets will also impact returns. The demand for dollars has risen recently, as it has for the Japanese Yen, but it is clear to us that alternatives are being sought. The European Union continues to grow, and with it the Euro. Middle Eastern governments continue to make plans for a unified central bank and currency. The critical factor impacting currency movements will be the demonstrated credibility of central banks to respond to macroeconomic changes in a way that inspires confidence by global investors. In large part, this means independence from political interference.

Perhaps the biggest change for investors in 2009, though, will be the likely escalation of geopolitical and international trade tensions. As 2008 was the year of financial meltdown, the steep downturn engulfing the globe will now manifest itself in the "real economy", resulting in rising unemployment, shrinking tax revenues, and the resultant political and social unrest. It will be natural for governments to find a scapegoat, and it will most certainly not be those in power.

The first phase of this retaliatory movement will be an increase in protectionist legislation. Expect tariffs and quotas to be vigorously amended. In Russia recently, for example, Mr. Putin said it was "inadmissible" to import foreign cars while Russian carmakers were struggling. While pushing ahead with sharp rises in import duties, Russia at the same time announced a general review of trade agreements, including commitments made as part of its application to join the World Trade Organization. In the US, the steel industry is actively lobbying for a "Made in USA" requirement for any federal stimulus package. Agricultural producers in Europe see this as the perfect opportunity to enact further trade barriers. These types of "soft forays" will harden if the downturn becomes more protracted.

In developed countries, populations have acquiesced to a larger role for governments, in effect socializing many industries and suspending the benefits of competition. As always, higher prices and less choice will be the result. And despite protestations to the contrary, bigger government will not give up its enlarged role, meaning tax burdens are set to rise. This is a major change in the functioning of markets which will only be incorporated into asset prices over a long period of time.

The downturn could be particularly devastating for the world's export driven developing markets, leading to violent social unrest, new foreign aggressions, and quite possibly a change of regimes.

For many years now, China, Russia, Southeast Asia, OPEC nations and others have built their domestic economies around the export model, while neglecting to put in place the institutional framework to develop domestic demand (i.e. growing the consumer / middle class base). This is now coming back to haunt them, as the river of US dollars flowing in has suddenly stopped.

The credit crisis that is gripping the globe is in many ways a reflection of this change in flows: while the good times rolled, these creditors raced to invest their surging balances of US dollars in all manner of investment exotica (including US sub-prime mortgages and Eastern European real estate) instead of their own domestic service and consumer-oriented industries. Now that they are forced to repatriate (dwindling) assets, their foreign reserves are plummeting, thus creating a self-perpetuating cycle of forced sales.

The problem with this scenario is that all of the developing countries utilize these reserves to support state enterprises/monopolies, which are the primary source of employment for many of their workers. Because they are faced with plunging reserves AND plummeting orders/production, we expect significant unemployment problems and social unrest to come.

These outlines are already clear in Russia. Trade surpluses are a thing of the past: the plunge in crude has forced Russia to spend a quarter its internal reserves already as the flow of dollars has dried up and investors flee the country. The rouble has been de-valued repeatedly in an attempt to stanch this outflow, with reports now of Russian companies offering barter services to pay bills so roubles can be converted to dollars. Putin is in serious trouble with both the oligarchs whom he bought (and who are now broke as their shares in state-owned enterprises have collapsed), and the military, which was ready to completely overthrow the Georgian government by force until held back by Putin last summer. (In fact, we are told by well placed sources that a certain un-named Swiss canton has approved a $300 million fortress/castle to serve Putin in his coming exile.) The constant threat of cutting off the flow of natural gas to the Ukraine, and thence to Western Europe, continues unabated, and this time, is having real effect as storage facilities are reporting supplies off by 40% or more. Expect Russia to make provocative moves as a means to distract attention from its internal problems and to re-assert its ingrained resistance to US dominance in the year ahead.

In China, the outlook is not much better. Factories are in a state of rampant closure, and the peasants are restless. Even more worrisome is the recent signing of Charter 08, a manifesto for peaceful political, legal, and economic reform in China that has been signed by a group of leading dissidents and intellectuals now numbering over 7,000. It warns of "violent conflict of disastrous proportions" if Beijing does not quickly move to reform the one-party authoritarian state. As typical communists do, the state has rounded up and imprisoned dissidents for questioning and ordered all media to cease all references to the Charter.

In a move reminiscent of the Great Cultural Proletarian Revolution begun in 1966 by Mao Zedong, the communist party will now seek to blame the "bourgeoise" intelligentsia and liberals for the economic woes now descending. This time, the youth and working class of China will not be fooled. The internet will make it impossible to tamp dissent, and we expect China to make headlines in 2009 as this clash intensifies.

In sum, old edifices and structures are being washed away like castles in the sand. The events of 2008 were stunning and unimaginable, and are as historic as any event in modern history. It is not an understatement to say that investors are starting over with a blank slate. At the moment, nothing is impossible to conceive. Courage and patience remain the most formidable weapons an investor may possess. Opportunities will arise, but they may look nothing like the past. Those who are best prepared will profit the most.

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