The BOECKH INVESTMENT LETTER
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GLOBAL DISEQUILIBRIA:

Don't expect lasting stability

Our basic view remains unchanged; we remain positive on equity markets, credit spreads and most commodities because liquidity flows are still very positive and key indicators discussed below are supportive. However, we still are very concerned about the artificial nature of the economic recovery and financial markets and when the relatively benign environment might change for the worse.

Past issues have pointed to the widespread and huge disequilibria in the U.S. economy and financial system. That is also true globally. No one knows what's real and what is not when it comes to the economic recovery and market prices for assets and currencies. Market forecasts are always a big part of the game; in today's context, we can't attach much confidence to any of them. Rather, it makes more sense to think in terms of whether the environment is favorable for assets or not and to watch for benchmarks to gauge when that might change and how it would affect the different markets.

One thing we do know: markets eventually correct disequilibria and it is usually painful. However, time lags are variable and frequently longer than most people can imagine. But when the adjustment comes it is usually swift and substantial. This makes for an uncertain environment because the risks are not easily quantifiable.

There are a number of important components to the issue of disequilibria that relate to the sustainability of the economic recovery, the future of the U.S. dollar, the two-tiered unstable global monetary system, potential bubbles in asset markets, the government rigged housing market, near zero interest rates, the $10 trillion private debt overhang, the hundreds of billions of dollars of underwater and illiquid structured financial products, and many more.

In this issue, we look at one of the key problem areas - funding the U.S. budget deficit. It is projected by the President to be $1.6 trillion or 10.6% of GDP this year. The resulting impact on U.S. government debt ratios of this deficit and many more into the future will have serious consequences. In the next few issues of our letter, we will look at some of the other imbalances and disequilibria mentioned above. These must be addressed if the investment environment is to have some hope of lasting stability.

Financing the U.S. Treasury Debt

As we have pointed out frequently in past letters, the explosion in the deficit and the government debt to GDP ratio is not a problem in the short run when the U.S. economy is in recession, inflation is low, private savings are rising, the dollar is firm and the existing debt ratios relatively moderate. But now that the economy is growing, possibly quite fast, financing the deficit may not be easy at existing interest rates as people are looking ahead to government debt ratios which will be anything but moderate.

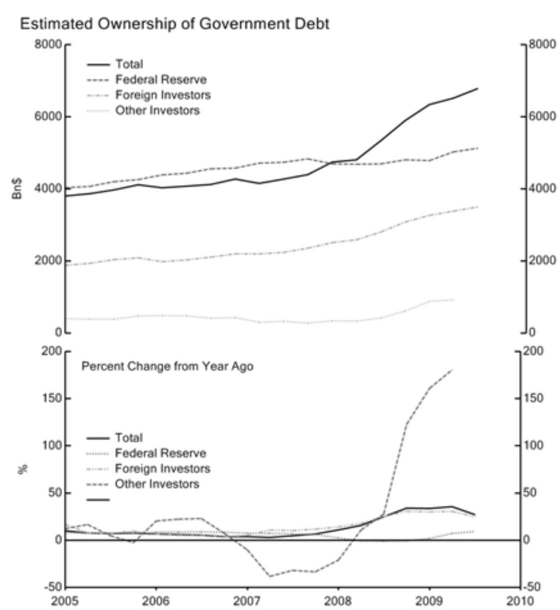
Who has been buying the massive issues of U.S. government debt? In an interesting recent piece, *"Is it all Just a Ponzi Scheme?,"* Eric Sprott and David Franklin looked behind the published numbers to see who bought the $2 trillion of net new U.S. government debt last year to finance the budget deficit and other cash requirements. The Treasury data shows the

"Other Investors" sector increased its holdings of government debt by 200% in 2008 and 2009 (Charts 1& 2). Similarly, flow of funds data shows that the 'Household" sector was the largest net purchaser in late 2008 and 2009. These two categories - "Other" from Treasury statements and "Households" from FRB statements are residuals: if the figures don't add up, they are used to "balance" the numbers.

In financial markets as in other markets, supply always equals demand. That is a tautology and an *ex post* (after the fact) identity. What is interesting is the *ex ante* (before the fact) supply and demand balance. If supply is greater than demand, the price must fall to clear the market. The U.S. savings rate rose sharply during and after the crash which created liquidity to buy the greatly increased government bills and bonds. The savings rate may now be starting to fall again as consumers start spending more as the government sincerely hopes. Foreign and international buyers, who were by far the biggest purchasers last year, are getting noticeably nervous about the dollar and their U.S. investments. It is, therefore, likely that *ex ante* demand will shrink relative to supply. Prices, therefore, may have to start falling a little more briskly to clear the markets (i.e. interest rates rising).

If that is the case, what are the Treasury's options?

Chart 1& 2



The first option is a pre-emptive one. The Treasury via the Administration could appeal to Congress to cut the borrowing requirement by slashing expenditures and raising taxes. In an election year, with the Democrats in a precarious political situation and the Republicans smelling blood, forget it. Congress won't act until after a debt crisis.

If the Treasury begins to have trouble funding its cash requirements, by definition that means interest rates will be rising and Treasury auctions will start to go badly or fail. Because interest rates are below equilibrium levels, a moderate rise in interest rates will not make Treasury bonds much more attractive unless investors think it is a one off price level adjustment. The reality is that if Treasury yields start to rise, investors will actually become more bearish as they would begin to anticipate further increases in the future and, hence, sustained capital losses. Funding the deficit would then become more difficult, setting in motion a vicious circle that would tend to push prices down rapidly to the point at which expectations of further declines or increases would be evenly balanced.

That is the second option open to the Treasury in this event – letting prices fall until the market clears. The risk is that the fall in price could be huge and trigger a credit downgrade by rating agencies. Sovereign credit downgrades is a very hot topic in the media these days and a U.S. downgrade would be a disaster. Rating agencies tend to react late and pile on to protect their eroding reputations. In the event of a U.S. downgrade, expectations could become totally unhinged. A world which has been getting addicted to near zero short-term U.S. rates and 3.5% on 10 year Treasuries may not react very well if there is a sudden and large change in rates.

The third option for the Treasury is to shorten the maturities of the bonds they sell to points on the yield curve where interest rates are much lower. For example, the two year yield is about .8% compared to 3.6% at 10 years and 4.6% at 30 years. Selling short-term bonds because the longer-term ones can't be sold would be widely noted as the overall term to maturity would shrink. At present, government debt held by the general public is 49 months, a moderate but certainly not a conservative figure and much lower than the 70 months average term in 2001 (Chart 3). It would shrink even more rapidly than in recent years if the Treasury sells large amounts at the short end of the yield curve. Typically, a falling average term to maturity in circumstances like today is interpreted as moving towards debt monetization. As the term shrinks, outstanding bonds have to be rolled over increasingly often and in huge amounts which compounds the problem of funding ongoing large cash requirements. This creates a dangerous, vicious circle and makes government finances extremely vulnerable to any bad news.

The fourth option is the end point; the Treasury runs out of willing buyers and must sell to the central bank. This has been going on for over a year in the U.S.; the Fed purchased $435 billion in the past 12 months (Chart 4). These purchases were needed to support the Fed's program of quantitative easing because the money multiplier – the ratio of bank reserves to money supply - had collapsed (Chart 5). We call this financial

Chart 3

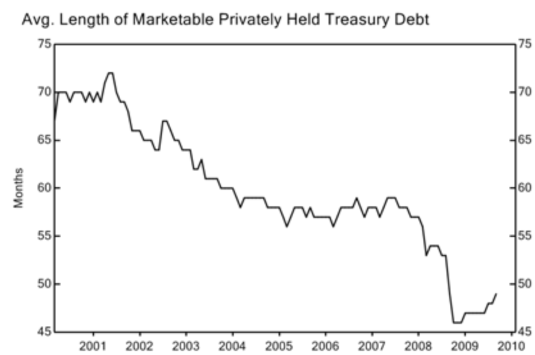
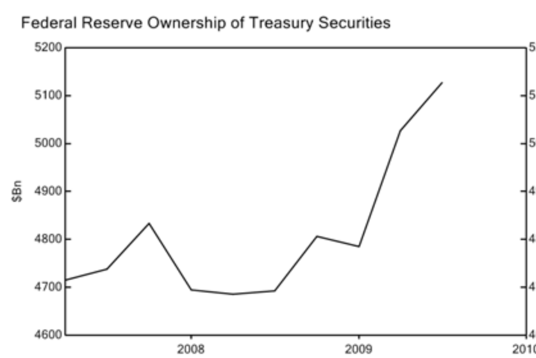


Chart 4



constipation because commercial banks increased their demand for reserves dramatically while private credit demand collapsed; the Fed had to supply those reserves by buying assets in order to sustain liquidity flows.

The Fed can monetize Treasury bonds in the short run with little consequence under particular conditions, as we saw in 2009. The first is weakness in the money multiplier, confirmed by liquidation in bank lending. The second is a relatively stable dollar, indicating that foreign support for the dollar, while not great, is still available. The third is relatively stable long-term bond yields. The fourth is weak price inflation.

Charts 5-8 show that all four of these indicators illustrate that the environment remains benign and hence favorable for prices of risk type assets. These continue to be our main benchmarks and must be watched closely for any sign of significant negative change.

Chart 5

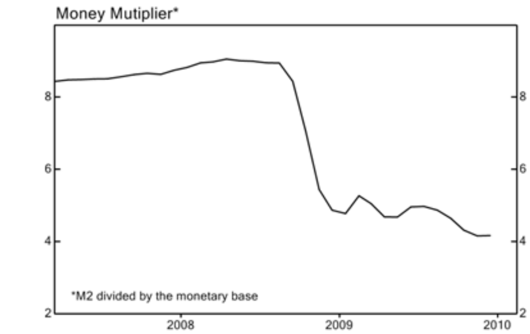


Chart 6

Chart 7

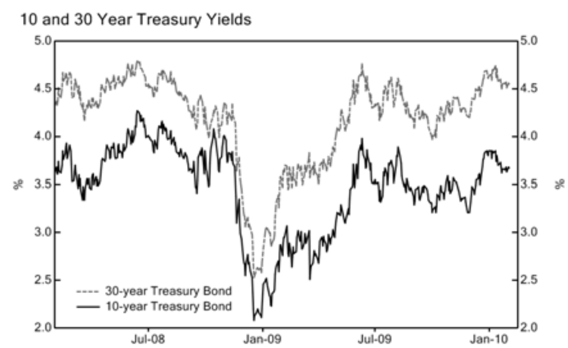


Chart 8

Investment Conclusions

January was a month of correction. U.S. and international stock markets were virtually all down, some by negligible amounts, others such as the key Shanghai market, by as much as 10%. Shanghai was hit hard because the government ordered a clampdown on bank lending and increased reserve requirements to counter too rapid economic growth and strong asset price increases in some real estate markets. Commodities and precious metals also sold off in January.

U.S. 4th quarter GDP data indicate almost 6 % real growth and many are predicting a mini boom to last for some time. One of the main arguments used to project strong growth is based on past experience which shows deep recessions are followed by rapid recoveries. If this occurred, the expectations of continued easy money and ultra low interest rates would soon evaporate. We don't buy this argument of sustained rapid economic growth.

Much of what lies behind the U.S. economic recovery is artificial and temporary and it is dangerous to use past cyclical experience to project growth in the next few years. It is far from clear that strong growth can be extended much beyond the first half of 2010 when inventory adjustments will have been made, the stimulus money will be spent, interest rates will probably be higher and the housing rebound may well have faded.

China, however, is likely to remain an important positive. The authorities are unlikely to risk a significant economic slowdown. They are still obsessed with the millions of factory jobs lost as a result of collapsed exports; their objective is to take the steam out of excessive growth, not kill it.

To summarize, in our view, the somewhat stable status quo in financial markets will remain in place for the time being, probably at least until mid-year, subject to the risks outlined above which relate to the massive disequilibria everywhere.

The overall environment will remain highly liquid and awash in nearly free money - not bad for financial and commodity markets. Economic growth should slow by mid-year but remain positive. The Fed will continue to monetize a large part of the Treasury borrowing requirement if need be. Price inflation will remain very low, hovering on either side of zero depending on the particular measure. On a rate of change basis, the jump in energy and food prices will head back toward zero after mid-year.

The sharp rise in stock, corporate bond and commodity markets last year was mainly a catch-up, rebound from very oversold levels. The recent correction is healthy and gains will be much more muted than in 2009. However, the overall environment will remain conducive to good investment profits for those who do their homework in searching out compelling value.

Profits will continue to recover well, corporate liquidity is good on balance and leverage in that sector is falling. But it is no time for complacency. We cannot emphasize too strongly that the investment and economic world is totally artificial and at some point an adjustment will come. Alice-in-Wonderland economics don't last forever. Keep overall exposure to risk below normal. Wealth preservation should be paramount. Watch the key benchmarks for significant negative change. To re-iterate, these benchmarks are: the trade weighted value of the U.S. dollar, the 10 and 30 year Treasury yield, and the spreads between risky corporate bonds and Treasuries. These indicators continue to be stable and as long as this is the case, the overall environment will remain favorable for risk assets. The money multiplier should also be watched for signs that the Fed’s effort to expand its balance sheet and bank reserves is finally gaining traction. As Chart #5 shows, the money multiplier is still very weak. When it starts to strengthen significantly, super expansionary liquidity conditions will begin to reverse. That will mark a time to become more concerned about valuations. In the meantime, investors should continue to ignore the widespread view that “the markets have outpaced fundamentals”. They always do in the first leg up in a cyclical bull market.

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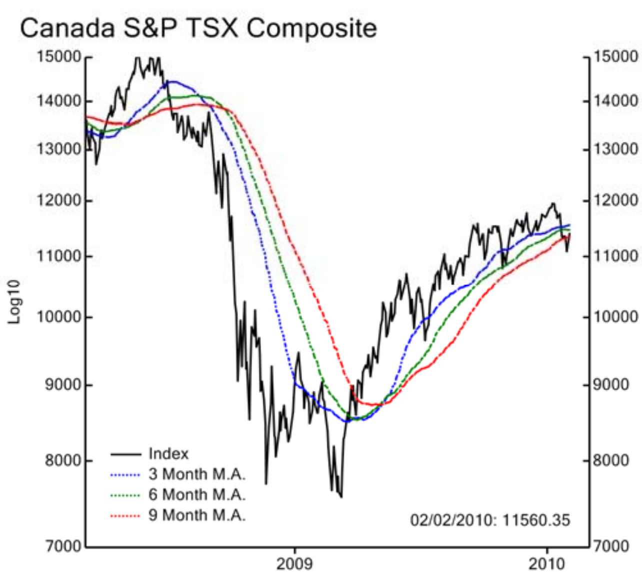
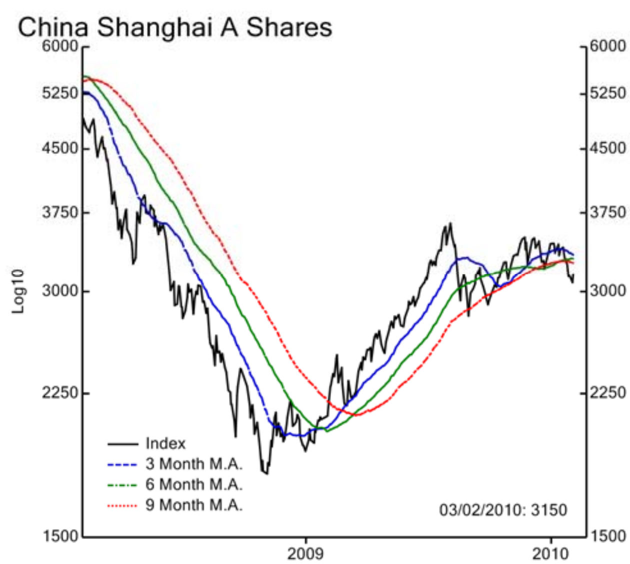
Stocks


U.S. S&P: 500
Index
3 Month M.A.
6 Month M.A.
9 Month M.A.
02/02/2010: 1103.32
Log10
2009
2010

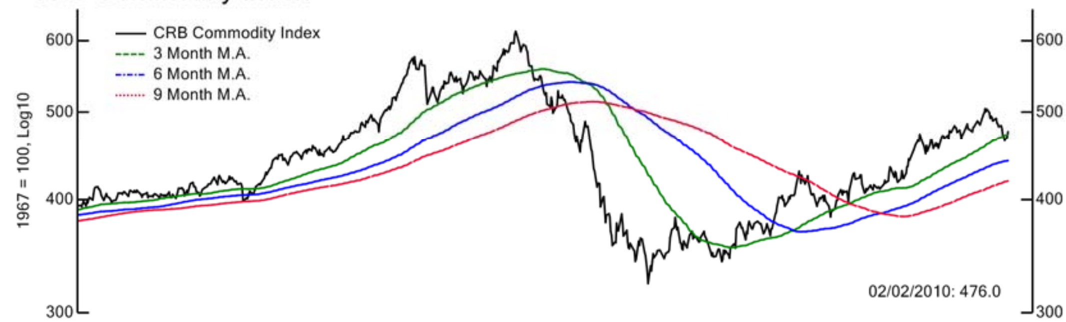

Europe DJ Stoxx 600
Index
3 Month M.A.
6 Month M.A.
9 Month M.A.
02/02/2010: 250.80
Log10
2009
2010


Canada S&P TSX Composite
Index
3 Month M.A.
6 Month M.A.
9 Month M.A.
02/02/2010: 11560.35
Log10
2009
2010

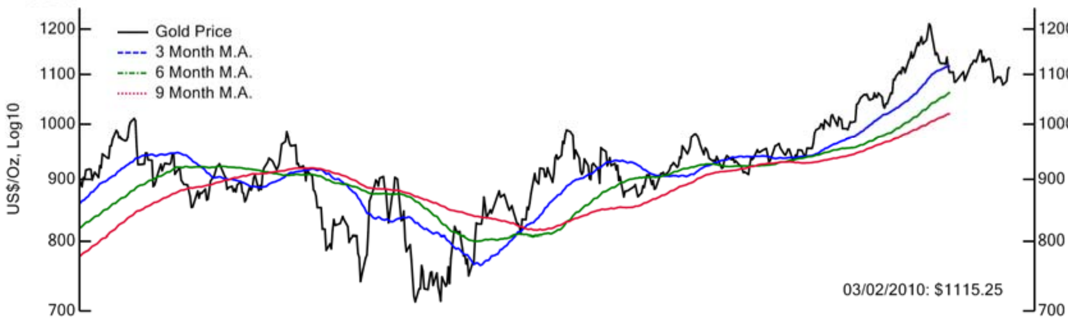

China Shanghai A Shares
Index
3 Month M.A.
6 Month M.A.
9 Month M.A.
03/02/2010: 3150
Log10
2009
2010

Commodities

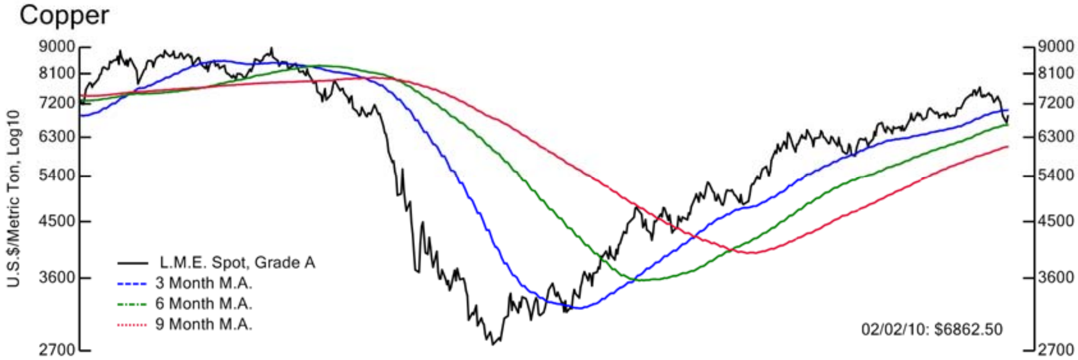
CRB Commodity Index



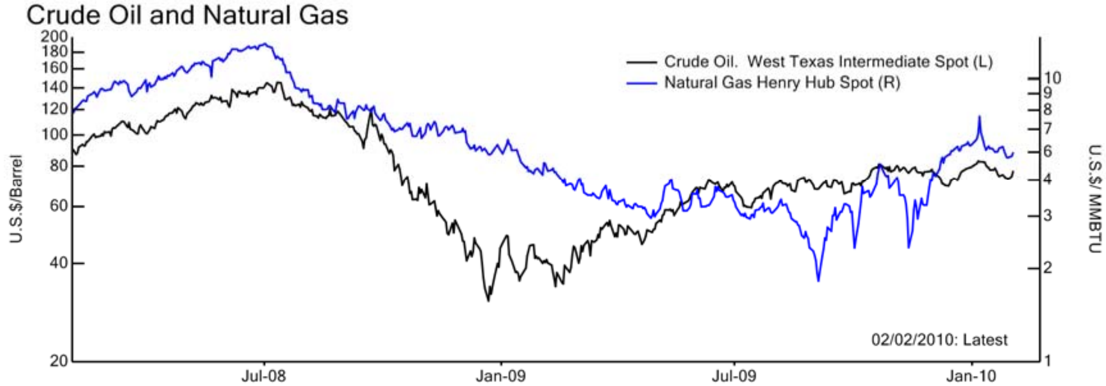
Gold



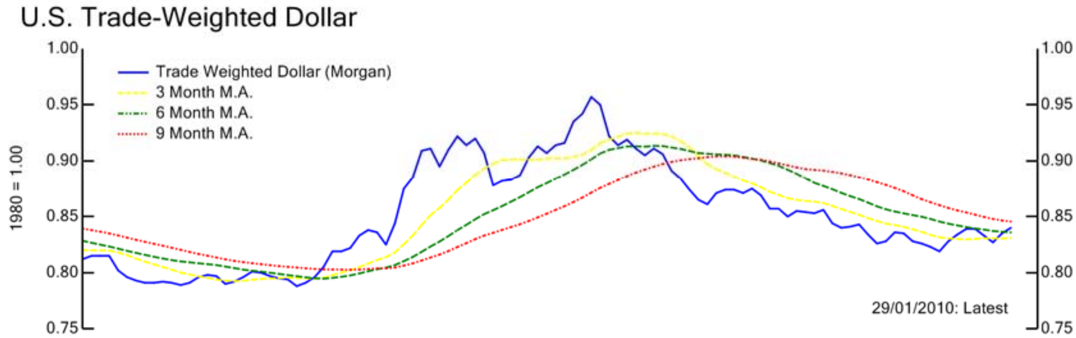
Copper



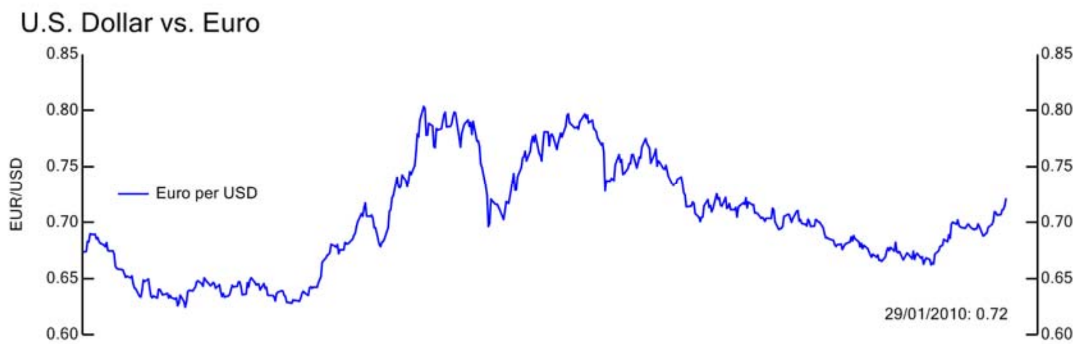
Crude Oil and Natural Gas



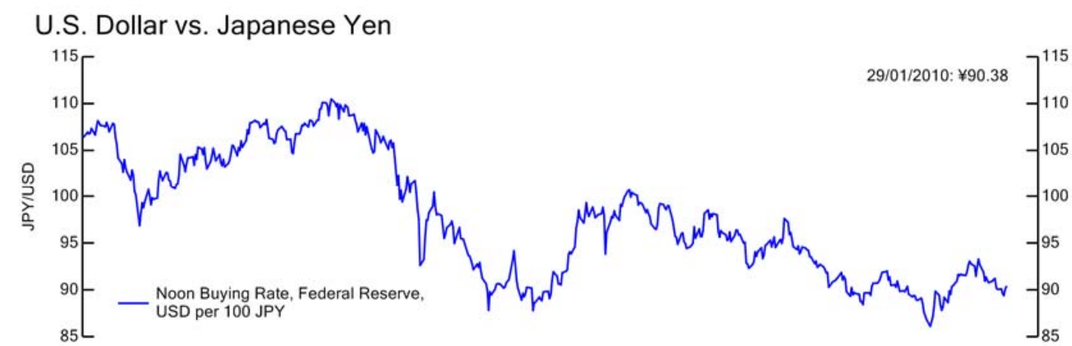
Currencies



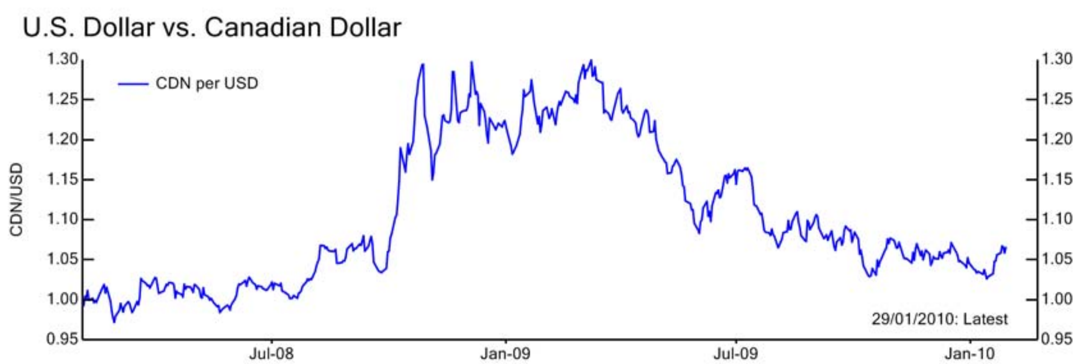
U.S. Trade-Weighted Dollar
1980 = 1.00
Trade Weighted Dollar (Morgan)
3 Month M.A.
6 Month M.A.
9 Month M.A.
29/01/2010: Latest



U.S. Dollar vs. Euro
EUR/USD
Euro per USD
29/01/2010: 0.72

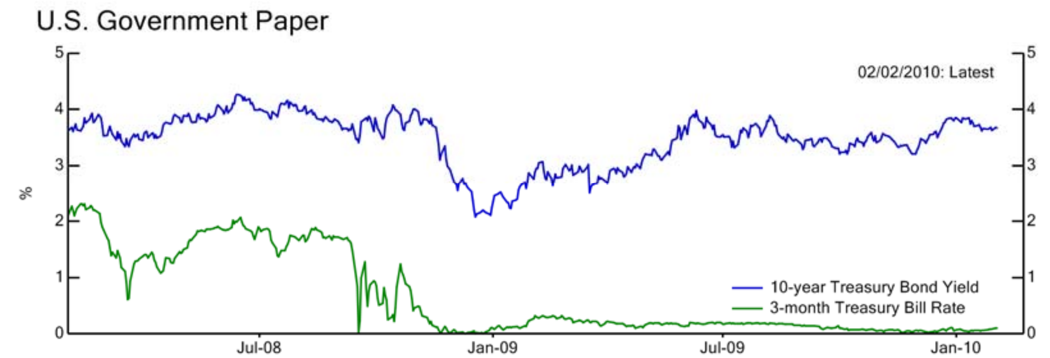


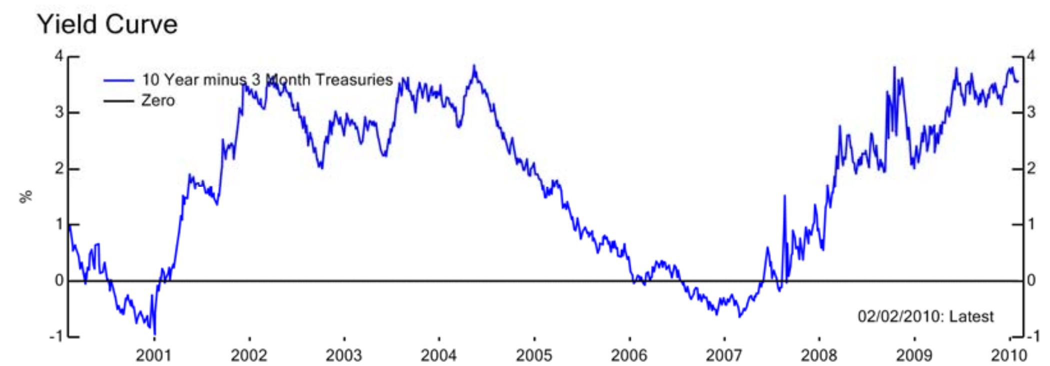
U.S. Dollar vs. Japanese Yen
JPY/USD
29/01/2010: ¥90.38
Noon Buying Rate, Federal Reserve, USD per 100 JPY

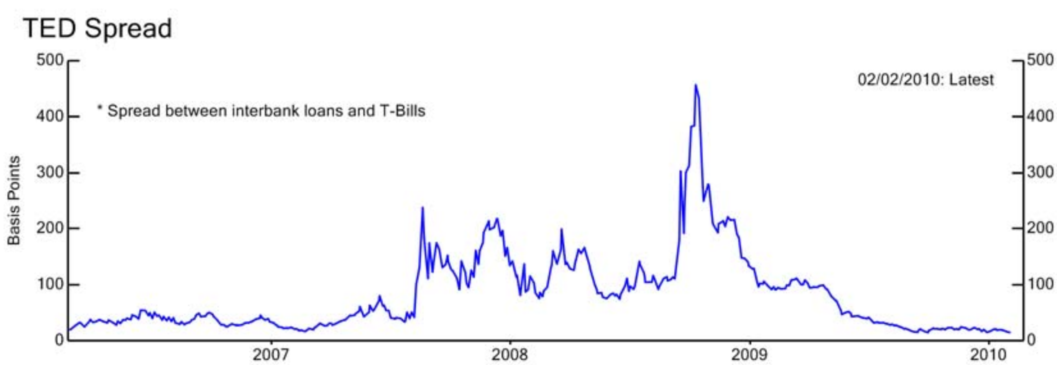


U.S. Dollar vs. Canadian Dollar
CDN/USD
CDN per USD
29/01/2010: Latest
Jul-08
Jan-09
Jul-09
Jan-10

Interest Rates







Corporate Spreads and Vix