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Monthly Market Commentary

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From Deflation to Reflation to Inflation

Measuring Left Tail Risk

We are living through an historic period of market history, one that we will be talking about for decades. My thesis is that there will be three phases for this super cycle: deflation (where we have been since 2007), "re-inflation" or reflation (the next phase, likely in 2009-2010), and finally inflation (the final chapter of this secular bear market, in 2011-2014).

For investors, the choice is binary: either we are in another Great Depression (in which case we have much further to fall) or we are in something short of that (in which case this is a tremendous buying opportunity). I suspect it is the latter and that stocks will enjoy a reflationary bull market in 2009.

But, there will be a price to pay down the road, and that price is inflation. But, that's tomorrow's worry.

The deflationary spiral started with the peak in home prices in 2006 but really accelerated in mid 2007 and especially in 2008 when the credit markets froze up and consumers started to save again. For years, consumers thought they were saving because their assets were going up in value. This was called "asset saving". Saving the old-fashioned way (out of our paychecks) was not an attractive proposition because interest rates were low and because it just wasn't necessary with home prices rising 10-20% per year (or so we thought).

Now the chickens have come home to roost and the savings rate is rising at the same time that the ratio of household net worth to disposable income is falling. In fact, the two lines are a mirror image of each other. This retrenchment will likely continue for years.

The Fed, Treasury and Congress have responded to this credit crisis with overwhelming force. This is good news, because the first step in curing the disease is to make a correct diagnosis and to then treat it aggressively. This is being done. The Fed's balance sheet has exploded to over $2 trillion and the Fed is now engaged in quantitative easing (buying debt without sterilization).

So far, however, all this new liquidity and stimulus have not resulted in an increase in private sector credit growth, with consumers and banks both continuing to hoard cash. This is called a liquidity trap. Also, while the aggressive response has caused the money markets to thaw out somewhat, the credit markets remain seized up with spreads on investment grade and high yield bonds continuing to widen (to 600 bp and 2000 bp, respectively). Why? Because the leveraged buyers (hedge fund and prop desks) have disappeared. Hedge funds were the marginal buyer in recent years, the ones who had an insatiable appetite for spread product, bought on tremendous leverage. That game is over and so is the hedge fund industry as we know it.

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So, we are not out of the woods by any means. Spreads need to come in and private sector credit growth needs to pick up. Thus, the deflationary spiral continues, with many market analysts drawing parallels with the Great Depression. However, during the Great Depression, the doctor did not make the correct diagnosis and did not provide the right treatment. The gold standard prevented the Fed from printing money, and the Hoover Administration refused to intervene in the banking system. As a result, the money supply contracted and the banking system imploded. This turned a recession into a deflationary depression.

Has the Government learned enough from that experience to effectively treat the patient this time? It sure looks like it. The maximum amount of bailouts so far is $8 trillion, with $3 trillion already committed! That's an overwhelming response. And now President-Elect Obama is promising massive fiscal stimulus as soon as he takes office.

Furthermore, the stock market has already declined 52% since October 2007, so clearly a lot of bad news has been priced in. Valuations are extremely low and are pricing in a worst case scenario. I suspect that 2009 will be a much better year for risk assets, and that we are due for a reflationary cyclical bull market. In that respect, I think the better analog is the 1973-75 "super-recession", with the 1975 analog right around the corner.

While the aggressive intervention has so far not sparked inflationary expectations (because the increase in Fed liquidity is not being passed on to the real economy), eventually that will change, and when it does we will have an inflation problem. We will also have monster deficits and over-regulation.

When that happens, gold and hard assets will be the asset class of choice. But, let's enjoy the reflation in 2009-2010 before we have to start worrying about what comes after.

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Definitions:

S&P 500 is an unmanaged index of the common stock prices of 500 widely held stocks and includes reinvestments of dividends

Russell 1000 Growth Index is a market capitalization-weighted index of those stocks of the 1,000 largest U.S. domiciled companies that exhibit growth-oriented characteristics.

Russell 2000 Index is a markets capitalization-weighted index measuring the performance of the smallest 2,000 companies, on a market capitalization basis, in the Russell 3000 Index

Russell 3000 Growth Index is a market capitalization-weighted index of those s tocks of the 3,000 largest U. domiciled companies that exhibit growth-oriented characteristics.

Russell 3000 Value Index is a market capitalization-weighted index of those stocks of the 3,000 largest U.S. domiciled companies that exhibit value-oriented characteristics.

Morgan Stanley Capital International (MSCI) Europe Index is an unmanaged index that measures the performance of stock markets in Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom.

Morgan Stanley Capital International (MSCI) Emerging Markets Free – Latin America Index is a market capitalization-weighted index of approximately 170 stocks traded in seven Latin American markets.

LB Aggregate Bond (Barclay's Capital Aggregate Bond Index) is a market value-weighted index of investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage backed securities, with maturities of one year or more.

Merrill Lynch High Yield Master Index is a market value-weighted index of all domestic and Yankee high yield bonds. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3 but are not in default.

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