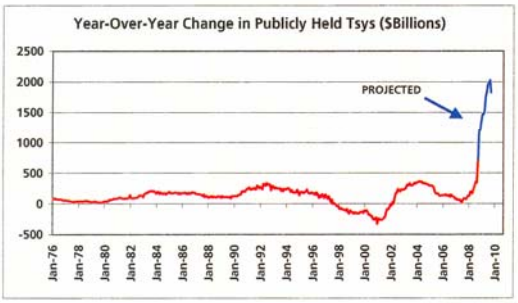
"Profits on the exchange are the treasures of goblins. At one time they may be carbuncle stones, then coals, then diamonds, then flint stones, then morning dew, then tears."

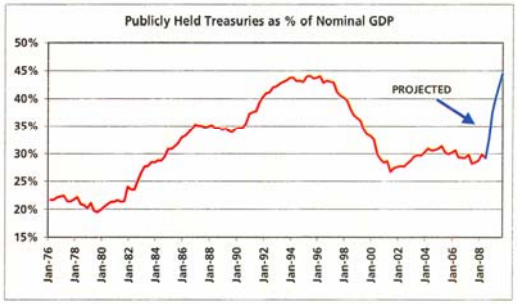
Felix Lope de Vega, 1562-1635
From the Financial Analysts Journal,
January/February 2009 p.6

The vagaries of the U.S. Treasury market played out again in January. Whereas in December 2008, the darling of the bond market returned 3.39%, January turned a perfect pirouette as U.S. Treasuries turned into pyrite, returning (2.92%), reversing much of the previous month's gain. This is not a review of January's fixed income markets. I merely reference it to highlight an opinion that U.S. Treasuries have outlived their welcome and may have already established their low yields for this cycle. The ten-year troughed at 2.06% on December 30. Today, the ten-year yield is 2.77%.

As a medium of exchange in turbulent, dislocated markets, U.S. Treasuries are a fine investment. As a store of value, they appear hyperextended.

The projected massive infusion of U.S. Treasuries into the markets in 2009 will not help. Data from Bill O'Donnell at UBS Securities reveals the following year-over-year change in publicly-held Treasures and the supply of Treasury debt as a percentage of nominal Gross Domestic Product.





Source: U.S. Treasury, UBS

Let's quantify the sea change of supply expected over the next two years.

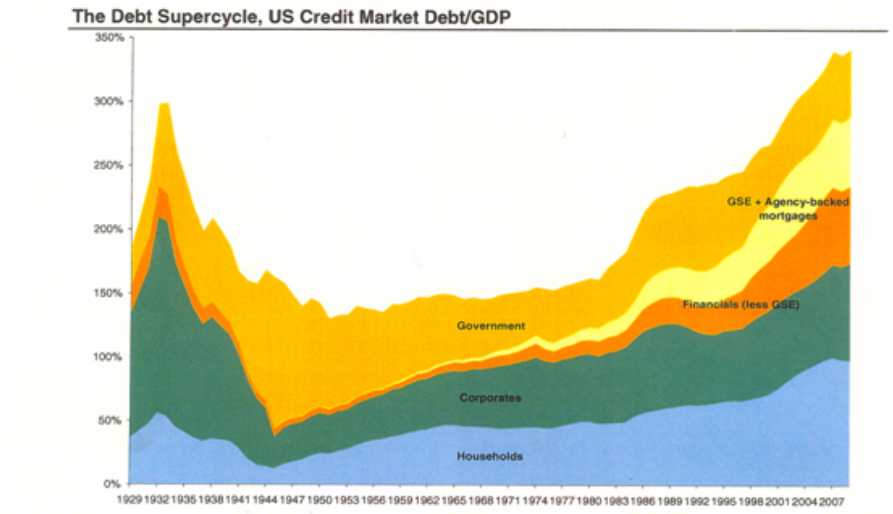
U.S. Treasury Debt Issuance

2007	2008	2009	2010
Actual	Actual	Estimated	Estimated
$135 billion	430 billion	2.0 trillion	2.5 trillion

There is an approximate 6x multiplier effect of projected new debt issuance between 2008-2010. If the supply side of the equation isn't daunting enough, the demand side is likewise not comforting. A source of funds for the U.S. Treasury market has been interrupted by the "crash of 2008." For years, the U.S. has run large trade deficits with China and Japan, and those two countries have invested their surpluses in large part in U.S. Treasury securities. Through November 30 of last year, China held $681.9 billion in Treasuries, a 48.5% rise from $459 billion a year earlier. Japan, while having reduced its holdings to $577.1 from $590 billion, remains our country's second largest creditor. For dramatic effect, China and Japan account for almost 65% of total Treasury securities held by foreign owners, 19% of the total U.S. national debt, and over 30% of Treasuries held by the public.

With economic problems of their own in combination with political friction involving "Buy America" protectionist policies, it is uncertain we can rely on these traditional buyers of our debt to ramp up their purchases. What happens if these buyers boycott our debt? That leaves our friends at the Federal Reserve. So, with great predictability, Fed Chairman Bernanke in published statements in December 2008 stated the Fed would consider buying long-maturity Treasury debt. The Fed, as lender of last resort, will monetize Treasury financing through the guise of "quantitative easing." The Fed will, by purchasing U.S. Treasury debt, liquefy the monetary system through the injection of the printing press. This taboo-free style of monetary and fiscal policy must stop.

From a purely macro overview, it appears we are about to witness a secular demographic change in the composition of debt in this country. The research staff at Morgan Stanley compiled a graphic showing the distribution of U.S. credit market debt as a percent of GDP dating back to 1929.



Morgan Stanley Source: Federal Reserve, Morgan Stanley Research

Total U.S. debt as a percentage of GDP is approaching 350%, surpassing the prior peak in the early 1930s which approximated 300%. This is unconscionable. Household debt has mushroomed, as one might expect, but government-financed debt surprisingly shrunk. Compare the present-day debt burden of the government to that of the war years or as recently as the early '90s. Financial institution and GSE/agency-backed mortgage (Fannie Mae/Freddie Mac) debt levels have exploded over the past twenty years. The propagators of easy money have made it so.

The debt supercycle that commenced after the depression years is being unwound in the household and corporate sector. On a positive note, the savings rate is beginning to reassert its importance on consumer balance sheets. It is conceivable the consumer's ever-declining propensity to save is about

to reverse. This trend is not necessarily favorable for consumption and GDP growth, but a modicum of consumer restraint is refreshing in my judgment.

What will grow without question is federal debt as a percentage of GDP. President Obama almost promised as much with the $800 billion stimulus bill, bailouts of financial institutions, and a pledge to the American people that "the government will do whatever it has to in order to get us out of this crisis." The pump has been primed, the gauntlet has been thrown down, printing presses will roll and dollars will drop from helicopters.

I intimated a few months ago that in the midst of this bear market one has to be bullish about a larger government role. It's about to be our Hydra. A decade after forcing former President Bill Clinton to abandon his ambitious spending plans in favor of a balanced budget, investors in Treasury securities are bedeviling President Obama as he and his administration embark on the most costly spending plan in U.S. history. My concern is we have no projections as to what the government's return on capital will be. How much revenue will be generated? We are in uncharted waters with nary a well-defined, logical, rational, transparent theory. Borrowing costs for the government will invariably rise, threatening to "crowd out" other borrowers who have to compete with the U.S. Treasury for capital. It is highly probable the price of gold will certainly rise as we depreciate our paper currency.

I could continue, but the subject is long and intertwined. In my opinion, what we can expect to see over the next 12-24 months is more spending, taxes, regulatory forbearance, rules, restrictions, bureaucracy, protectionism, more spending. The expanding waistline of U.S. Treasury debt financing will invoke inflationary consequences. In my opinion, this is Meathead Economics.

Perhaps my sentiment can best be summarized by P.J. O'Roarke, who wrote:

"Giving money and power to government is like giving whiskey and car keys to teenage boys."