

DAY(S) THE CREDIT MARKETS STOOD STILL

The End of an Era

The economic locomotive which left the rail yard in December 1982 with Ronald Reagan and Paul Volker as conductor and engineer, delivered 25 years of Pax Americana hegemony, via sequential 92 month, 120 month and 73 month expansions with only 11 months of recession per decade. The exorcism of inflation from the term structure of interest rates (October 1979 Volker), deregulation supply-side economic policy and a \$1.83 trillion dollar eight year defense expenditure, lifted America to a uni-polar superpower status and relegated the Soviet Union to the ash heap of history.

The accommodating monetary policy of the Greenspan Federal Reserve fostered a 30 year U.S. Treasury rate decline from 15.26% (August 1981) under Volker to 4.19% on June 9, 2003. Alan Greenspan managed a policy of liquidity excess or monetary accommodation due to the financial period of 1986 - 2006 which experienced a crisis nearly every two years, including: the Savings and Loan/RTC bailout (1989 - 1995), stock crash (1987), Mexico peso crisis (1994), Thailand floating the baht (1996), IMF/Russia loan default and LTCM collapse (1998), NASDAQ dot.com bear market (2000-2003), and the deflation threat of the 9/11 Al-Qaeda attack (2001).

The stability of long-duration economic cycles, low levels of inflation and minimal interest rates combined to form a sentiment of apathy, self-entitlement and high octane greed for profit. The unfortunate by-products of this environment included the LBO mania of the 80's, the technology dot.com NASDAQ bull market of the 90's and most recently the 14-year 1991-2005 residential real estate cycle in which the U.S. saw values more than triple from \$7.3 trillion in 1991 to \$22.4 trillion in 2006. This 300% hike in residential real estate and a -11% decline in 30-year U.S. Treasury rates heightened a consumption and leverage cycle amongst U.S. consumers and created a wealth effect of unequaled proportions. The most prominent wealth stimulus of the 80's and 90's was an equity market inflated in nominal value from \$1 trillion in 1982 to peaks of \$17.4 trillion in March 2000 and \$19.6 trillion in July 2007.

A study by the Federal Reserve under Greenspan calculated for every \$1 in stock and bond or real estate wealth growth, the consumer would spend (income) or borrow (debt) an additional 3% to 5% of the total wealth gain. During the period from 1991 to the summer of 2006, consumption spending rose to 71% of GDP from 63% - 64% and single family home ownership rose to 69% from post WWII levels of 63% - 64%.

These historically high numbers were caused by a number of events including the evolution of a shadow banking system (mortgage brokerage, consumer finance, structured investment vehicles), the Community Reinvestment Act of 1977, a 5-year 2003-2007 home equity loan underwriting rate of \$135 billion and the creation of exotic financing tools including ARM floaters, 125% LTV, interest only, sweat or co-equity, teaser rates and no document underwriting. The aforementioned factors spurred a reverse cash monetization of real estate equity, which peaked at \$860 billion in 2nd quarter 2006 from early 1990's levels at \$115 billion per year in normal markets.

The era of credit intoxication is perhaps best highlighted by the chart of U.S. Debt % to GDP amounting to 356% in the first quarter of 2008 from a level of 132% in 1951. The 1980's bond vigilante, James Grant of Grant's Interest Rate Observer, postured the era as "the democratization of credit and the socialization of risk".

The deflation spiral initiated with the collapse of the sub-prime loan and Alt-A mortgages in August of 2007 caused the following tremors to captivate the market and culminated in a 10-day aftershock which assailed the stock and bond markets in early October 2008.

1. The Federal Reserve balance sheet inflated from \$843 billion to \$2.217 trillion in 18 weeks coupled with the U.S. Treasury auctioning debt for an additional \$692 billion, (since reaching the September 30, 2008 level of more than \$10 trillion). This auction amount over 13 weeks was equal to the consolidated accumulated U.S. Treasury debt from January 1, 1789 to September 30, 1977.
2. BBB 10-year corporate debt traded at 527 bps vs. auctions of 3-month U.S. Treasury notes priced at 0%. TED spreads were at 3.30% vs. 1.94% norms. Three-month LIBOR rates were priced at +400 bps compared to U.S. T-bills.
3. Deflation exhibited by the collapse of U.S. Treasury 30 Year TIPS bond spread which declined from 281 bp to 54 bp on November 20, 2008.
4. Bankruptcy or negotiated consolidation of AIG, Bear Stearns, Merrill Lynch, FNMA, EHLMC, Washington Mutual, Wachovia, and the expenditure of \$350 billion of the TARP I facility.
5. Volatile decline in oil as the governor of global commerce, declining from \$147 a barrel to less than \$34.
6. YOY growth of M2 (+\$453 billion) MZM money supply + 24% and the adjusted reserve base growth of +17%.

The International Monetary Fund estimates the global charge-offs from losses on securitized U.S. and EU packaged CMO residential mortgages will amount to \$1.57 to \$1.78 trillion.

The Future

President-Elect Barack Obama issued a statement to the markets that only the government maintains the financial means and demeanor to halt the recession momentum. The Obama Administration must strike a balance; avoiding the moral hazard socialization of risk (bail outs) while fostering solutions that allow the natural cleansing mechanism of capitalism to de-leverage. Economic reflation built on a foundation of trillion dollar budget deficits poses the unwanted side-effect of the inflationary debasement of the world's reserve currency. Moreover, we must emphasize the "margin-of-safety" from Washington policy error is zero.

The estimates by the U.S. Government for infrastructure spending include water & sewage (\$550 - \$650 billion), railroad (\$180 billion), electric power grid (\$195 billion), transportation (\$235 billion), and energy at \$10's of trillions. The fundamental necessity to repair vintage 1870 - 1930 infrastructure and layering a Keynesian safety net applies to today's crisis as much as it did in the 1930's.

Throughout early 2009, equity markets will likely exhibit a grinding basing formation with episodic spasms of volatility. The bond market should foster credit quality spread declines, as the term structure of corporate rates shift along the yield curve toward government paper. We anticipate sentiment bias should navigate a bullish course supported by stimulus funding from the Obama government, although we expect earnings

power weakness could likely prevail during the 2009 quarterly earnings seasons. We believe the following trends will emerge throughout 2009 and beyond as we transition to an era of higher savings, de-leveraging of consumer balance sheets and fiscal austerity.

1. The shortfall in consumption spending from a 71% of GDP peak in 2006/2007 to a new 60%-62% level in 2008 will need to be offset by an increase in infrastructure spending. Infrastructure spending estimated at \$1.2 – \$1.6 trillion will be required to compensate for the shortfall of approximately 11% of GDP.
2. A formalization of a strategic U.S. Energy Policy to develop a portfolio of diversified sources—oil petroleum, natural gas, coal, nuclear, geothermal, hydroelectric, wind, solar, tidal wave, oil shale/tar sands and biomass, limiting OPEC exposure.
3. Following the resolution to the current panic, the federal U.S. Government should avail itself of Eisenhower Era 1950's yields after liquidating TARP debt and guarantees at a premium.
4. Supply-side tax stimulus via lower statutory corporate tax rates of near 25% along with accelerated depreciation and small business tax credits.
5. Reversion to the principal loan underwriting function of credit analysis, funding and service.
6. Update the 1930's regulatory structure to consolidate the FEDERAL RESERVE, O.C.C., FDIC, SIPC, CFTC, FINRA and PBGC.
7. A reduction in the export of petro dollars as imports from international oil fields decline, evidenced by the reduction from annualized rates of \$738 billion in July 2008 to the current \$155 billion.

Planning Ahead

The sea change of financial duress and the closure of an era will undoubtedly be debated for generations as to their cause and effect. We continue to be comforted by the dramatic defensive performance of our “fortress balance sheet” philosophy and believe the capacity of robust small and micro capitalization companies to operate with flexible, fluid and durable business models in an empowered founder/owner/operator culture will position our value stocks for a profitable reflation toward the end of 2009. As the economy recovers, capitalized multiple assignments on sales, cash flows and earnings should expand. That said, volatile sentiment bias changes and the scarcity of broad earnings power growth will be the eventual governor on valuations. Our enthusiasm as value miners is tempered by the time required to stabilize markets and reignite capital formation along with the temptation of government to control capitalism. As always, we endeavor to prospect for durable business franchises priced at a discount as we sift through our annual 10-ks.

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