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March 2009 Commentary

For the past several quarters we have been anticipating a widening horizon of healing within capital markets. Our view has been predicated on an assumption that monetary policy would address the fundamental dislocations within the markets and their institutional participants. In both respects, thus far, we have been wrong.

The extent of the problems in real estate and finance has been no surprise, but the ineptitude of policy response throughout the developed world has been something of a shock. The decision of the ECB to raise interest rates during the summer of 2008 still commands the "Ship of Fools" award for this cycle, but it now seems that the U.S. is doing its best to catch up. While we remain impressed at the fortitude and scope of the FRB's activity in recent months, activity outside this organization has become even more troublesome. The most recent budgetary and regulatory proposals set forth by the new administration have been breathtakingly destructive and lacking in principle. Their eagerness to raise marginal tax rates on dividends, income and capital gains during a cycle of capital asset deflation reveals a profound lack of economic competence. The imposition of carbon taxes and the prospect of de facto price controls within the entire health care and insurance sector have extended the cloak of uncertainty to an ever-widening range of industry. The eagerness of the President to get a dog must be an attempt to give Messrs. Volcker and Summers something to do during their days, as they are clearly not involved in policy matters. Instead they are apparently destined to be used as illusory proof of competence much in the manner that Colin Powell was to perform for the first Bush administration.

Explicit hostility to the accumulation and deployment of capital (also known as wealth) has not been lost on the equity markets. Those sectors that are directly in the path of proposed regulatory and tax changes have collapsed. These include areas previously regarded as defensive and insulated from the direct effects of credit deflation. Pharmaceuticals, biotechnology, utilities, hospital managers and insurers have, in the past month, behaved like leveraged financials. The destruction of value in these sectors has combined with the continued lack of clarity among financials to push the U.S. markets well

below their fourth quarter lows. All that is missing for a repeat of the 1931-32 sequence is a resumption of protectionism and the passage of legislation meant to compel union organization among domestic companies. This latter effort will provoke a wholesale migration of technology capacity out of the U.S. and will severely undermine the efficiency of those remaining. The President's stated opinion that unionization will be helpful to the long term prospects for the economy would be true if the economy benefited from ever rising unemployment. We have gone from a President whose celebrated difficulties with English syntax and vocabulary gave the impression of general ignorance to one who, despite clear gifts for both the spoken and written word, is, in economic matters, actually ignorant.

In the face of declining demand for labor, forces that artificially increase wages or prevent them from adjusting will simply diminish the number of employed. Decreased demand for any good or service can be manifest by either a decline in price or a decline in units. To the extent that labor policies compel employers to pay above market wage rates, the unit demand for labor must be lower than would be the case in a free market environment. If neither price nor quantity adjusts, employers will simply fail, as is now the case in the unionized portion of the American automobile industry.

The market's severe and immediate reaction to domestic political developments has not been lost on either policymakers or commentators. Our hope is that a general realization about the dangers of radical action in the midst of a collapsing credit cycle will dawn on members of both political parties, including the President, and provoke a diversion of policy toward a more moderate path. Given the current level of pessimism embedded in all quarters of the economy and capital markets, any improvement in the political climate would constitute very good news for markets.

Political concerns in the U.S. have, as might be expected, a disproportionate effect on domestic equities. Despite continuing (albeit temporary, in our view) strength in the dollar, equity markets in Peru, Brazil, Chile, Taiwan, China, Korea, Thailand and a host of other emerging economies have managed to avoid revisiting their fourth quarter lows, even when viewed in dollar terms. In a period of extreme turbulence and risk avoidance, the strength relative to the S&P shown by these markets is an extraordinarily unusual turn of events and may represent a secular convergence of risk premiums between developed and developing markets. This is not to suggest that political and regulatory risks in emerging economies are equivalent to those in the U.S. The gulf, however, continues to narrow. Much of the developing world has had plenty of recent experience with the heavy hand of the state, while we seem to take our economic liberty for granted.

In light of the forgoing, we continue to move assets to sectors of the domestic markets that are somewhat independent of regulatory risk and have direct links to economic activity within the developing world. In addition, we have gradually shifted more of the portfolio directly into emerging market equities. We have reduced our position in precious metals as the popularity of that sector increased dramatically, and replaced this with a larger allocation to industrial metals. Our net equity is somewhat lower than was the case a month ago, given the increased risks that have arisen in recent weeks.

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