



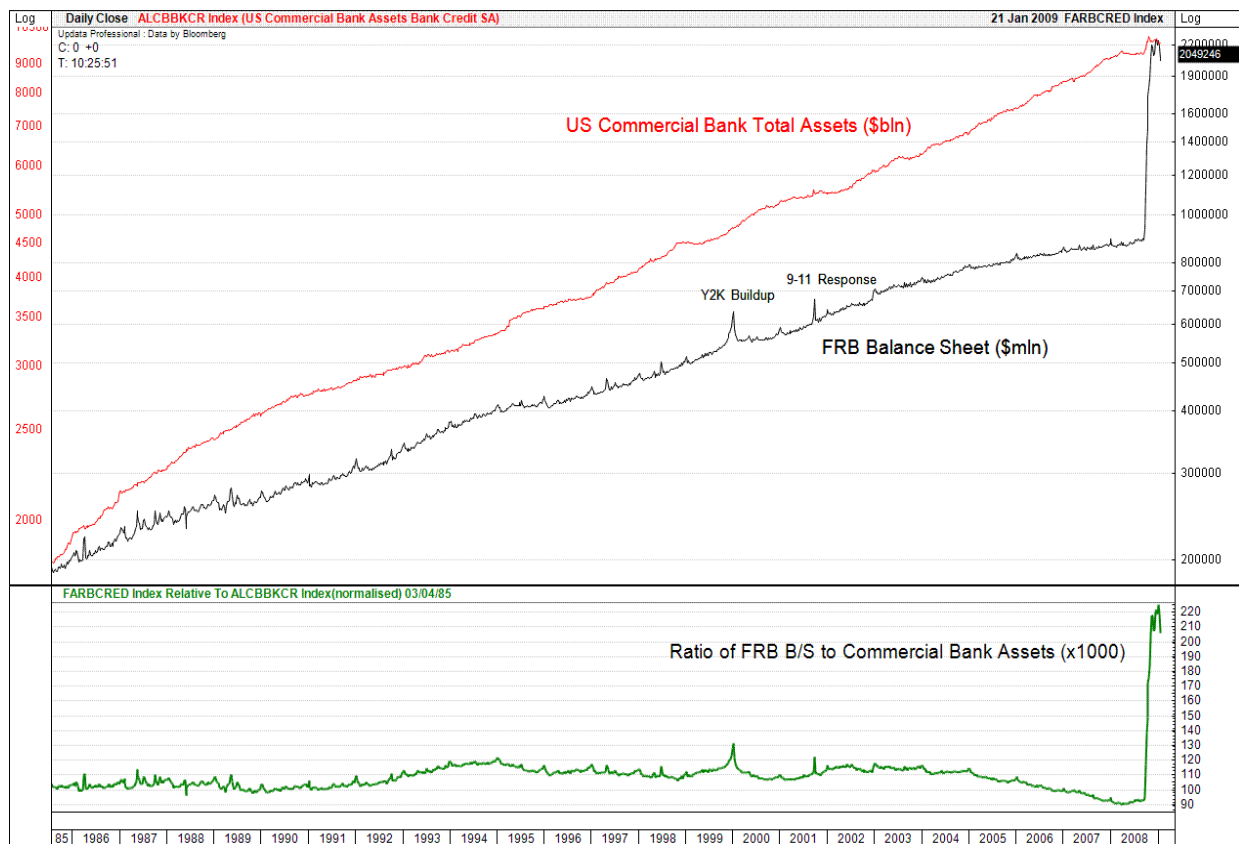
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## 2009 Outlook - The Metamorphosis

February 2009

We use this particular title in reference to the great changes that have characterized the past year and to the classic exposition of ancient mythology attributed to Ovid. Kafka's similarly named work might provide a reasonably apt metaphor, but we will leave this to the reader's imagination. The mythological reference seemed appropriate, as bear markets have a tendency to reveal the fanciful nature of widely accepted beliefs that underpinned the preceding bull market. This most recent sequence is no exception.



**US Commercial Bank Assets vs. Total Federal Reserve Bank Credit 1985-2009**

Chart 1.

*From 1985 to September 2008 the commercial bank sector increased its balance sheet over six fold to just under \$10 Trln. Over the same period the FRB increased its own balance sheet by approximately four fold to \$900 bln. This meant that on the eve of the Lehman crisis the FRB's balance sheet was a mere 9% of the total of the commercial banks, a record low that reflected the tight quantitative monetary policy that was followed in the first 18 months of this crisis. What happened next is without precedent. Recognizing the gravity of the situation the FRB more than doubled its balance sheet in a few short weeks, taking its size up to over \$2 Trillion, or approximately 21% of the commercial banking sector's total assets.*

We, Michael Aronstein and Michael Shaoul, certify that the views expressed in this research report accurately reflect our personal views about the subject security(s) and issuer(s) and that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this research report.

Important disclaimer appears at the end of this report on page 17

The circumstances leading to the events of 2008 are, by now, quite familiar to most investors. The Federal Reserve Board began the sequence with overly tight monetary conditions just at the time that the technology and growth stock mania of the late 20<sup>th</sup> century was exhausting itself. The subsequent downturn surprised policy makers, who responded with a 180 degree shift in policy to a point of extreme and inappropriate ease.

Short term interest rates of around 1% underpinned an extraordinarily steep yield curve, allowing leveraged speculation to emerge as the new national pastime. The objects of that leverage were many and far flung, with the main ones being real estate and genetically altered securities of all sorts. These asset categories lent themselves to the easiest, quickest and most extensive application of leverage. After about three years of hypertrophic demand, supply responses across nearly every asset type, from luxury hotels and golf communities to modern art and credit derivatives were sufficient to slow and then reverse prices. Thus began the journey down asset deflation lane, now entering year three.

The sheer intensity of turbulence in the capital markets and parts of the real economy makes it difficult to keep events within any sort of stable perspective. Without that ability, it is nearly impossible to avoid responding to every new data surprise and market shock. These short term responses are a recipe for disastrous investment results.

If we step back from the immediate news flow, it is possible to characterize the events of the past few years in a more general and less volatile context. In many ways, the disturbances in the global economy over the past five years are similar in form to what occurred in the early to mid 1970s. At that time the economy (particularly in the U.S.) operated under the implicit assumption that cheap, abundant oil was a permanent input feature. The first oil shock in 1973 undermined every enterprise that had been built around the cheap oil hypothesis and set off a long period of substandard global growth. It might be argued that the secular decline of U.S. manufacturing, especially the automobile industry, was set in motion after one of their core strategic assumptions (perpetually cheap energy) was proven wrong. Thirty five years later, they continue to drag an outdated business model right to the verge of bankruptcy court.

The core input assumption that has been undermined in this cycle is not unlimited access to inexpensive energy, but abundant and under priced credit. The plethora of liquid savings (particularly in Asia) combined with the Fed's extreme suppression of short term interest rates in the early years of this decade created compelling incentives to structure business models that would take advantage of access to leverage on extraordinarily favorable terms. The entire financial infrastructure that is now unraveling had, at the core of its assumptions, an implicit dependence in unlimited access to cheap credit. The level of belief became so outrageous as to provoke seeming serious public discussions about a leveraged buyout of General Electric. This would have involved hundreds of billions of borrowed dollars concentrated in one deal. And yet few commentators were willing to dismiss the ideal out of hand. The old saying that there is not a bell that rings at market tops is true. There is not a bell, there are hundreds.

We are in the process of passing from an environment of bargain priced credit to one in which lenders are going to be adequately compensated for the apparent risks that they are willing to assume. The fact that few are currently willing to assume any risk is another aspect of the story. Returns that have been produced at the expense of overly credulous and under compensated lenders will no longer be available. Wall Street will undergo changes more dramatic than those that occurred after fixed commissions were abolished. Credit dependency has become a structural weakness that will hinder the results of many large financial institutions for years to come.

### The Mythology

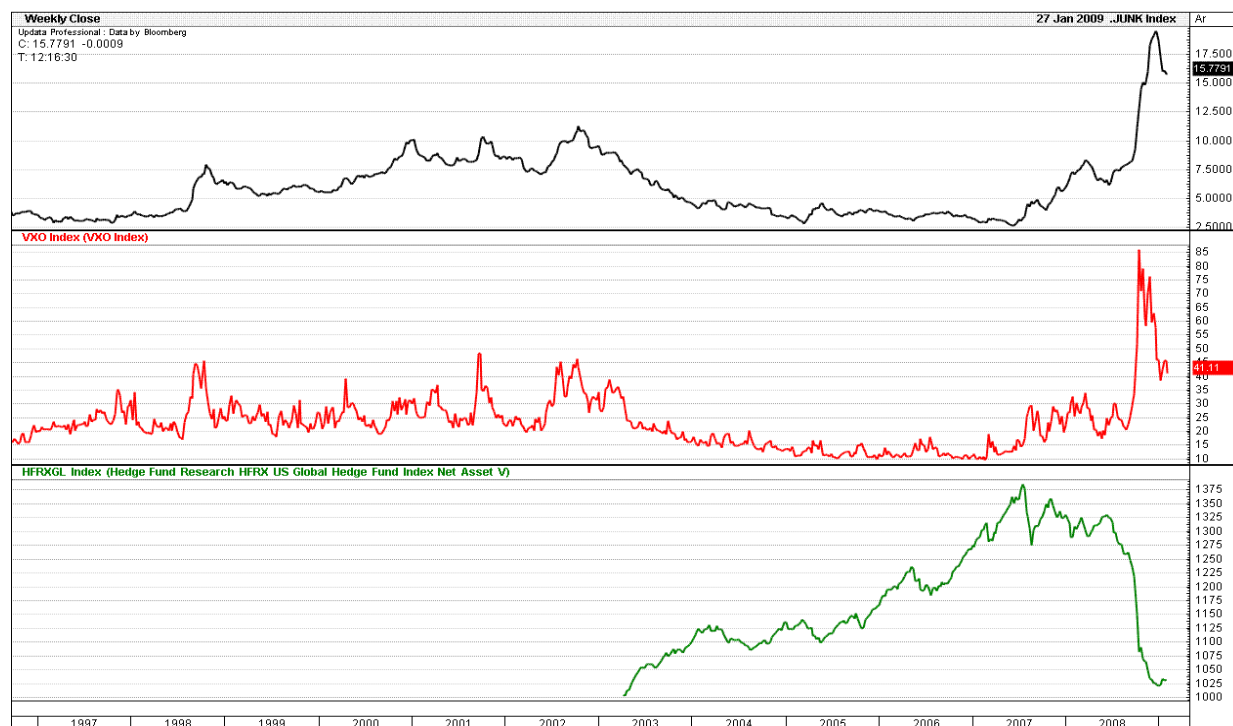
Every great excess is built around a mythological core that seems to justify extraordinary valuations and behaviors. A good deal of it originates and is propagated within academic circles, where a veneer of intellectual respectability is applied. This past cycle has been no different.

Chief among the deceptions was the designation of statistical variability of returns as an adequate measure of investment risk. We and others have written for years about the inherent flaws of this approach, which fails to take into account the unique circumstances attending every new cycle of excess. Histories of price fluctuations, credit performance and market correlations provide insight into the past, but are of little use in understanding the present, and even less so as concerns the future.

Complex statistical analysis has arisen as a popular tool as a consequence of the widespread availability of computing power and ever more detailed records of market minutia. None of what passes for risk management now would have been possible in the days of paper tickers or blackboard quotations, and yet good investors were perfectly capable of limiting their exposures to potentially disastrous outcomes even in those primitive days.

The confusion of volatility with risk of loss gave rise to an extensive array of new marketing and investment approaches that have characterized this cycle and its demise. Managers found that by presenting the illusion of higher returns without higher risk, they were able to attract untold sums in short order. The return sans risk illusion was accomplished in one basic fashion. In essence, it involved the creation of an insurance- like return stream, where small flows of premium were constantly received, against the small probability of an insurable event (the financial equivalent of a hurricane or earthquake) that would warrant the payout of a large part of the accumulated premiums. Real insurance companies do this all the time as a legitimate and important business. The problems with the modern investment version were twofold. The practitioners never suggested the possibility of the unusual but highly expensive event of loss, nor did they reserve against it. All of the premiums they received were booked as profit.

Most “stable return” or “low volatility” investment strategies while not explicitly run on the insurance company model, shared the same essential risk and return characteristics. The most straightforward comparison exists with option writing strategies, which involve the receipt of premium against the chance of an unusual market displacement that would require a large payout on the part of the option writer. The key to the marketing appeal of such strategies lies in the fact that if the insurable event is rare enough (a hundred year flood) it will appear to uninformed investors that the strategy offers nothing but steady, excess return. Because all propositions that promise to pay against the occurrence of an unusual event are, by definition, usually receiving a stream of premium payment, it is very easy to show large interval of time, often many years, during which a pure statistical analysis based on historical data will show no risk of loss. This, in essence was the marketing mechanism behind a great proportion of the strategies that rose to prominence during the first two thirds of this decade. 2008 was the insurable event that was never supposed to occur. In fact, the financial markets’ volatility during October was, according to statistical analyses of historical precedent, so improbable that the known universe has not been in existence long enough for there to be a meaningful chance of occurrence. So much for modern risk management.



**Credit Spreads, Volatility & Hedge Fund Returns**

Chart 2.

The above chart shows the CS High Yield II index (spread to 5 year T-Note) in black, the VXO index in red and the HFR Global Hedge Fund Return Index in green. As the chart clearly demonstrates the 2003-2007 “golden age” for the hedge fund industry coincided with a rapid compression of both credit spreads and volatility, followed by a prolonged period of unusually low readings in both areas. This produced a “virtuous” circle of return generation, capital raising and further compression which in turn both enhanced returns and concentrated strategies on a range of investments that had the characteristics of being of long credit and/or short volatility. When both credit spreads and volatility finally started to rise in early 2007 the effect was immediately apparent in hedge fund returns and quickly developed into a “vicious” circle that culminated in the ugly blow out of spreads and volatility in late 2008.

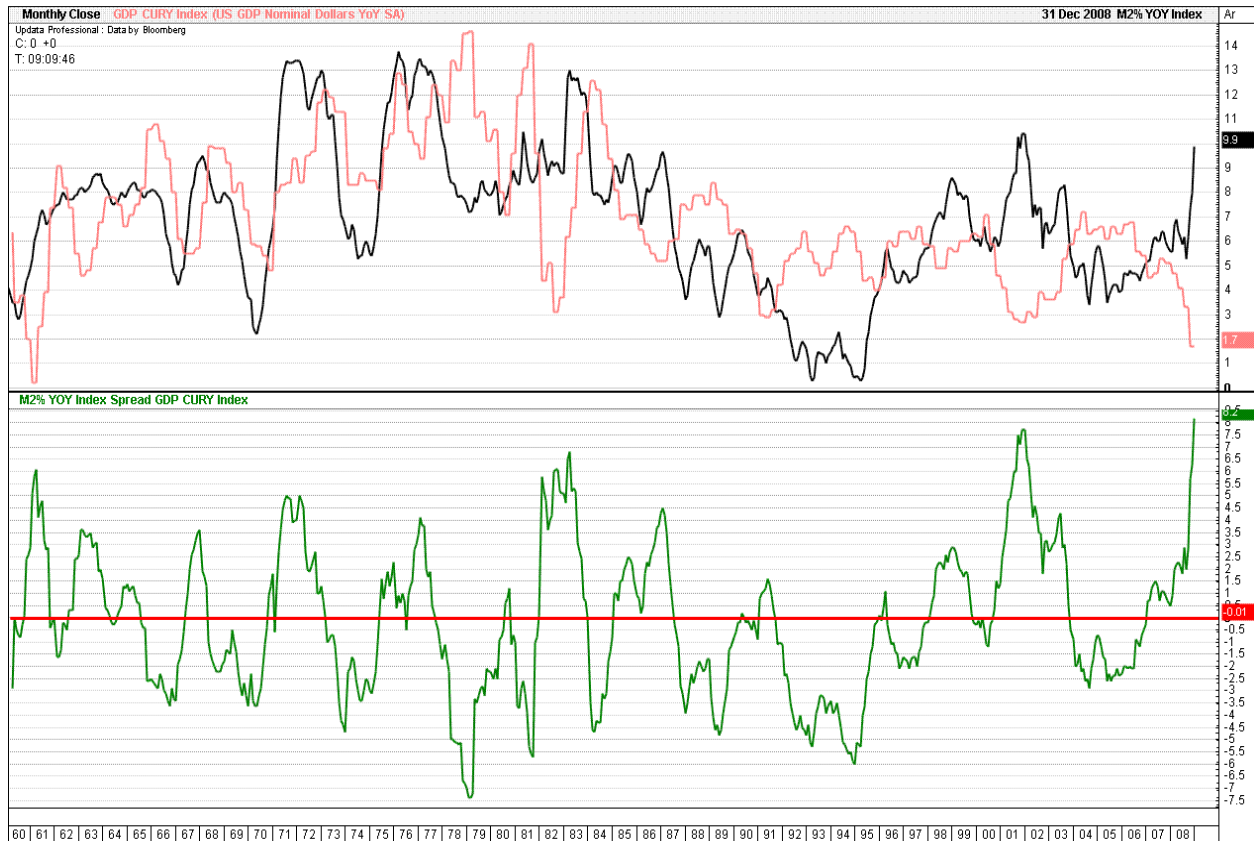
The direct sale of option premium is the simplest investment analog to the payoff structure of an insurance business, but there are many other important strategies that share similar return and risk characteristics. The general principal behind each of these is the acceptance of a steady, incremental return premium against the presumably small chance of some disruptive event. Over the past several years, much of the incremental growth of the hedge fund business was based on the illusion of excess return without additional risk that can be created by these types of strategies.

Insurance like structures with the potential to create nearly unlimited loss in the event of unusual market displacements were spread around the globe like a mutant influenza virus. Structured products with these characteristics were sold as currency hedges to foreign corporations, interest rate hedges to municipalities, fixed income and equity substitutes to clients of private banks and commodity hedges to producers, consumers and speculators. In each case, history provided a comforting picture of stability and normalcy.

The financial market effects were equally illusory. The widespread sales of credit insurance (CDS) and other insurance like products drove down premiums across all markets. Currency, interest rate, credit and equity volatility reached historic lows during 2007. The compression of spreads and volatility was taken as a sign that risks across all financial markets were actually diminishing as risk management techniques became ever more sophisticated. The Fed joined the intellectual bandwagon with carefully telegraphed, perfectly regular policy moves, in the mistaken belief that markets would become more predictable if monetary policy appeared to be.

The entire enterprise ignored the primary rule of risk management i.e., *the more people engaged in an investment activity, the more likely that a small disturbance in results will be amplified by a coordinated rush for the exits*. In other words, popularity is the precursor of calamity.

Another broad array of myths arose around the principle of diversification. This valuable portfolio concept became confused with and eventually defined by various measures of statistical correlation. This simply proved to be another of the fallacies underlying modern, quantitative financial techniques, where series of numbers are manipulated toward conclusions without a basic understanding of the processes that have generated them. Finance is not physics. Assets and strategies that were assumed to be unrelated because they had been in past cycles now proved highly correlated as a result of common ownership, financing sources or inclusion in broad indices or widely held portfolio structures. These new sources of correlation did not generally exist in prior cycles and hence the statistical evidence of history pointed toward none of the recent dangers. The efficient frontier proved to be a long, deep precipice.



M2 Growth YOY% (black) with Nominal GDP (red) 1959-2008

Chart 3.

*While the extent to which interest rates have been lowered by the FRB is widely understood, the quantitative aspect of the current stimulus is far less commonly recognized. The above chart shows the growth rates of the overall US economy (nominal GDP) together with the growth of broad money supply (M2). The spread between these two measures is shown in green on the lower panel. When this spread is negative, economic activity is growing faster than money and monetary conditions can be said to be tightening. The opposite is true of a positive spread and as the above chart shows, we have never had a greater positive difference between M2 growth (9.9%) and Nominal GDP (1.8%) than was recorded at the end of December 2008. This massive easing only began in earnest during the 4<sup>th</sup> quarter and therefore has not yet had time to have a significant effect.*

Underlying the entire investment Pantheon was an enormous, global financing mechanism that presumed normalcy across all asset categories at all times. Almost no margin for error was allowed. The combination of widespread portfolio structures that were meant to take advantage of low volatility and normal relationships within and across all markets combined with the widespread use of leverage rates well in excess of 90% provided a perfect mix for the transmission of acute distress across the entire landscape of global finance. In essence, the fourth quarter of 2008 provided a textbook example of an old fashioned panic and crash. The unique aspect of this one was the speed of propagation across nearly every asset class and every corner of the global financial system.

The scope of the dislocations unfolding in the past year is such that it almost demands some broad, abstract characterization in order to begin any analysis or possible response. This is what seemed most lacking in governmental efforts to cushion the effects. Initial responses were episodic and without any thematic cohesion or understanding of the fundamental, as opposed to local, causes. This lack of broad perspective also accounts for the dismal investment performance of many renowned value managers. Because their skills generally consisted in a thorough understanding of the values inherent in the assets and operations of individual companies, the abrupt change in macroeconomic conditions, which altered the metrics of all security valuations, was overlooked or dismissed. Because most value approaches assume a gradual reversion to normalcy, dramatic shifts in the nature of normalcy have the ability to invalidate historic standards of value. Bottom up expertise is fine unless the top down forces are overwhelming.

In the aftermath of Lehman's failure, world markets underwent a colossal, synchronous margin call. A good amount of the call was unmet by additional provision of capital, and so there were widespread sell-outs into markets that had ceased to function with any semblance of normal liquidity. The price declines were breathtaking. There was little performance differentiation among large cap equities, corporate bonds, commodities, emerging market securities, credit default swaps or other OTC derivative markets. Where markets completely froze, the rush for liquidity simply intensified in those that were still functioning.

At the heart of the issue was the matter of funding. Financial assets that were carried on credit were forced onto markets when the funding was withdrawn. This created a spiral of lower valuations, diminished bank capital and further contraction of credit. In some ways, this was a financial analogue to the inventory cycles that shaped the economy in the past. In those cases, producers would accumulate large stocks of raw materials or intermediate goods when it appeared that good times would go on forever. The Federal Reserve would tighten credit and most of the funding for inventories, which were largely carried with short term bank loans, would evaporate. Companies would be forced to liquidate into the void of a credit starved marketplace. Prices would collapse and real commercial distress would ensue.



**Cash & Treasury Holdings as Percentage of Commercial Bank Balance Sheet 1985-2009**

Chart 4.

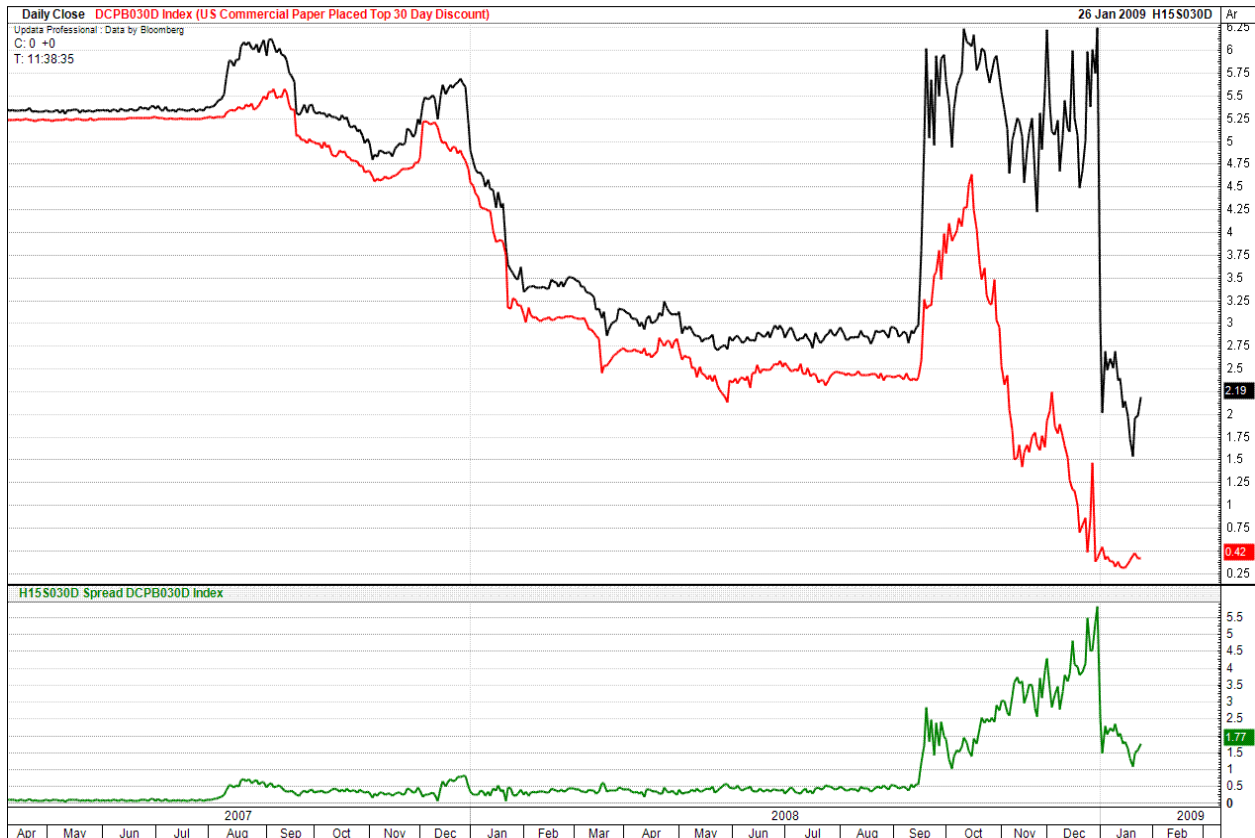
*The above chart shows the radical change in the composition of bank balance sheets over the last 2 decades. Not only did the size of balance sheets balloon over this period (see fig 1) but the proportion of cash and Treasuries held fell from a high of 31% in 1992 to a remarkably low 14% by September 2008. Post-Lehman we have witnessed one of the great “repair jobs” in the history of modern finance as cash and Treasuries have risen to account for a historically average 23% of bank balance sheets, an increase of almost \$900 bln. A very significant portion of this repair has been provided by the expansion of the FRB balance sheet and to a lesser extent the TARP capital injections.*

In the current cycle, inventory excesses and inflation were generally concentrated in financial assets and property. Banks balance sheets exploded with excessive securities’ financing rather than commercial and industrial lending. The Fed’s own balance sheet, which represents the primary source of funding for the financial system, failed to keep pace. Market participants were forced to rely on private, short term financing for a record stock of exotic, illiquid and recently conceived securities. As the adjacent chart shows, the Fed’s provision of liquidity through its balance sheet activities showed no meaningful expansion until crisis had reached full force. Even after the Bear Stearns failure, the expansion of Fed lending in response to that crisis was rapidly allowed to dissipate, leading to the re-emergence of the same acute funding issues in the weeks before the Lehman debacle.

Following the October crash, the Fed threw caution to the wind as far as its own balance sheet was concerned. The historic expansion of their funding activities is well documented, and from our perspective, crucial in setting the stage for more normal markets.

Both the Fed and the U.S. Treasury were slow to recognize the essential nature of this particular crisis. In fact, the latter may still be at a loss if their continuing erratic and piecemeal approaches are any indication. The practical failure of the first TARP initiative could have been avoided if emphasis was placed on stopping the spiral of forced liquidation rather than removing certain “bad” assets from the banking system. Simply by funding those assets within the institutions where they resided would have preempted any need to continue selling into non-existent markets. By providing term funding within any institution that requested it, the entire issue of valuation and moral hazard could have been avoided. The troubled institutions would not have been rid of their mistakes, but would have had the leeway to hold them apart for some number of years and absorb the losses in an orderly fashion. This would have prevented the wholesale dumping of good assets and the consequent impairment of institutions that had not been playing in traffic. The collapse in high grade corporate bond prices (since reversed) that briefly threatened the solvency of the entire insurance industry might have been avoided.

The ongoing conceptual failures at Treasury have not extended to the Federal Reserve. Their willingness to provide funding support across a wide expanse of capital markets has reversed many of the pressures in the more fundamental elements of credit. Recall that it has been less than three months since a wholesale run on money market funds seemed to be unfolding, with the attendant failure of the commercial paper market. Since the Fed began its funding efforts in earnest, high grade CP (which they have purchased directly) has fallen to historic low yields, while second tier paper, which continued under pressure throughout 2008, has lately seen yields cut nearly in half.



**30 Day CP rates Tier 1 (red) and Tier 2 (black)**

Chart 5.

*Thus far one of the greatest “non-traditional” policy successes has been the FRB Commercial Paper Funding Facility (CPFF). Introduced in late October at which time the commercial paper market had frozen to a halt. This facility allowed the FRB to purchase Tier 1 paper of maturity up to 90 days. As the chart shows Tier 1 yields responded immediately and the FRB was able to bring yields sharply lower over the next 6 weeks. Tier 2 issuers, however, felt no relief and the FRB came under great pressure to extend its facility to lower quality credits, but refused to do so. Right at the end of 2008 Tier 2 rates finally collapsed and while they remain high relative to Tier 1 (see spread in green) the funding costs for Tier 2 issuers in nominal terms is a mere 2.20%.*

Other signs of restoration within the credit and money markets abound. Libor and swap spreads have retreated to near normal levels. Nominal short term rates of all sorts are at or near historic lows. High grade corporate bonds have rallied strongly, and issuance among investment grade companies is beginning to run at a record pace. Credit, while being rationed by a crippled banking system, is available through the capital markets for high quality borrowers. Borrowing for speculative investment activities, including LBOs, activist hedge fund forays and credit dependent relative value or arbitrage strategies is nearly impossible. Similar distinctions exist in mortgage markets.

Large, high valuation commercial projects cannot be financed or refinanced under any terms. The equity value in most large commercial property ventures that have financing based upon either a rise in rental rates or an appreciation of the property has probably vanished. Jumbo mortgages are difficult to obtain for all but the most creditworthy, and even they are paying well above conforming levels. The direct support of the conforming mortgage markets by the Fed is bringing nominal rates down to levels where large increases in refinancing activity have begun. Rates are now at levels where we expect to see a significant pick up in housing activity within the conforming price limits at or near current price levels. Prices and activity at the luxury end have much farther to fall.

## 2009

The turmoil in capital markets that characterized 2008 is rapidly emerging in the global economy. There, the economic mythology that suggested the invulnerability of developing market economies to financial and asset price disruptions in the U.S., Europe and Japan has suffered the intrusion of reality. Global demand, trade and investment have collapsed. Commodity prices have followed, thus undermining the main economic drivers of emerging market economies. Adding fuel to the fire is a gradual realization that many of the speculative underpinnings of credit mania in developed world financial and property markets were transmitted and perfectly replicated in developing markets. A good deal of their apparent prosperity seems to have derived from hedge funds, proprietary trading, currency speculation and luxury property development. Some of these activities were legitimate adjunct to local development, but many are turning out to be no more than secondary extensions of the excesses in the developed nations. They have proven about as uncorrelated as Nasdaq and NYSE stocks.

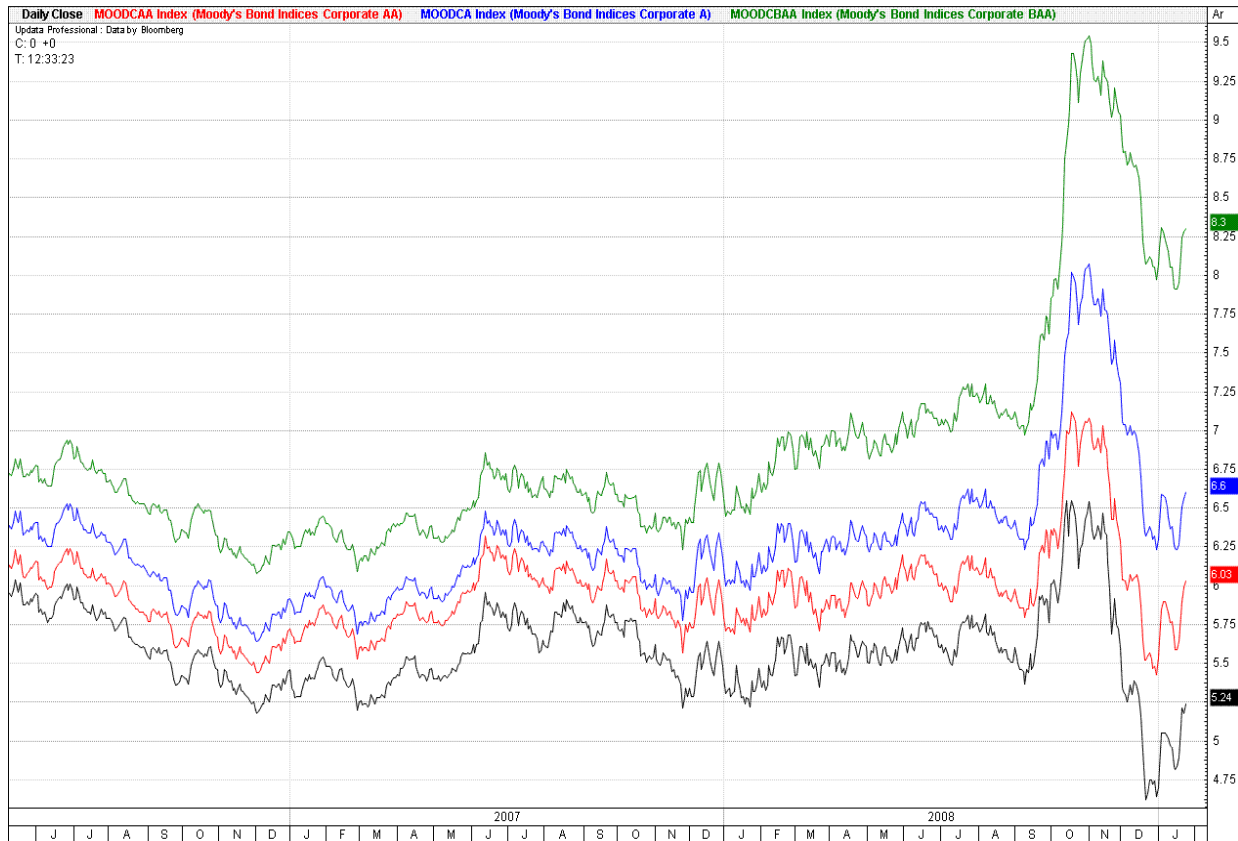
The founts of speculative wealth that shaped the last cycle and much of contemporary culture have run dry. All followed the general form of utilizing unlimited, cheap credit to create and amplify investment returns. The business models behind the large, integrated investment and commercial banks have failed. Like the railroads of the late 19<sup>th</sup> century or the automobile manufacturers that proliferated during the 1920s, most of these institutions will cease to exist in anything near their present forms, and will spend years in the repair shed. The same fate awaits much of the “alternative” investment universe, where thousands of private management firms will disappear.

In the wake of these changes at the core of our financial system, there will be a long period in which the relative fortunes of various business and professional sectors will realign. The oft heard complaint about “income inequality” will gradually lose its rhetorical cache, as it becomes clear in hindsight that the late lamented inflation of capital assets was the primary driver of the disparities. Owners of capital assets and those who move them around and finance their movement naturally benefit disproportionately during a cycle in which real prices of those assets are dramatically inflated. Now that that cycle has ended and reversed, its negative effects will fall more heavily on owners of capital assets, also known as rich people. The wealth envy that has driven a good deal of harmful political and legislative initiative should begin to lose some potency. At least one can hope.

We have witnessed a deflationary cataclysm within the global balance sheet. Because all of our economic measurement systems concentrate on analysis of national income statements (GDP), changes in the valuation of existing wealth are largely overlooked. This has confounded policy makers, who do not seem to have a page in their operations manual that deals with generalized price changes across the balance sheet that are not clearly manifest in CPI reports. The oft heard protests of central bankers that they are not in business to address what they term “asset bubbles” seems a basic evasion of their role in regulating the extent of credit expansions regardless of the consequences of those expansions. Credit excess drives all generalized price expansions, whether the object of the excess is consumer goods or capital assets. If a central bank is unwilling to address a situation where credit grows at a far greater rate than the expansion of real output, it hardly has any excuse to exist.

With the collapse of asset prices across a wide section of the economy, we have gone from a funding crisis to one that involves longer term financing and solvency. The Fed’s actions to expand their balance sheet and provide funding support for a large segment of the money and credit markets has reduced the threat of another acute phase of forced liquidation. The tension in the system is no longer concentrated in the interplay between security owners and their margin clerks, but between commercial debtors and creditors. We have entered the workout phase of a gigantic Chapter 11 filing, during which those who owe and those who are owed will have to sit down and work out some settlement that takes into account the new, lower levels of value that have arisen in a world where financing can no longer assume asset appreciation. In some instances, e.g. the automobile industry, the process will be public, political and highly complex. In others, it will be as simple as a commercial mortgage holder taking possession of a property and accepting the operating cash flows in lieu of the previous owner’s mortgage payments. In almost every instance, there will be some loss of nominal value for all parties concerned.

It is in this process that adherence to free market principles by the incoming administration will be crucial. The genius of free markets lies in their freedom to adjust to change in a way that continually clears the slate of harmful rigidities. When demand for a good or service diminishes, the price will fall until demand is restored. Markets that are burdened with oversupply will fall to a clearing level, at which the excess is taken up and normal production can resume. When businesses become less profitable, compensation of employees with those businesses must fall to levels that allow the restoration of profitability. Absent that, the businesses will fail. All aspects of a free market system must be sufficiently elastic so that the inevitable fluctuations can be smoothly adjusted to. The ability of prices to adjust easily is the central requisite for a properly functioning market economy. The difficult fact for many people with a more interventionist bent to accept is that there is no such thing as a “proper” price level that can be divined by some group of assiduous politicians or their well credentialed retainers. The markets let you know when a price has reached a level at which some restorative or restrictive response is forthcoming. Prices can only be characterized by the human responses that they provoke. Two dollars per gallon was always believed to be a high price for gasoline, but in the recent cycle it didn’t seem to stop people from purchasing gigantic, powerful vehicles or driving them as far as always. Four dollars proved the real breaking point, but that was only apparent after the market took prices there.



Moody's Corporate Bond Indexes - AAA (black) AA (red) A (blue) BAA (green)

Chart 6.

*We spent a great deal of time following the Investment Grade credit indexes in November and December since we argued that a recovery in this asset class was a necessary precursor to any recovery in equities and other risk assets. As the above chart shows nominal yields subsequently fell sharply and, even more importantly, issuance soared. While spreads to Treasuries may remain abnormally high (particularly for A and BAA grade bonds) nominal yields are now (with the exception of BAA) at or below their pre-crisis levels. Even BAA grade bonds' yields at around 8.20% are only slightly above their 20 year average of 7.94%. The availability of abundant corporate credit at a reasonable price via the bond market is a crucial factor in deciding the fate of the economy the months ahead.*

With the perilous state of finance and global confidence, any policies that inhibit the process of adjustment within capital markets and the real economy will be detrimental to prospects for recovery. To the extent that these policies tend toward those espoused by the left wing of the Democratic Party, there is the potential for a longer, more serious period of depressed activity. We would be particularly alarmed by any moves to raise taxes, limit or alter the terms of international trade or compel unionization among more private sector workers.

To the extent that markets are allowed to adjust to the new environment, recovery in the U.S. housing sector should begin during the next two quarters, as both prices and mortgage rates reach levels that provoke more normal demand and construction. Stabilization in housing activity (not a resumption of price appreciation) will be a precursor of a more general restoration of demand and should provide some valuation metrics and liquidity within mortgage derivative markets. As with other areas of the economy, it is important that government allows house values to find levels at which there is a natural demand. Efforts to artificially maintain previously inflated prices will only postpone real recovery.

Any stabilization and recovery in the real economy depends upon the restoration of normalcy in credit and money markets. The long term impairment of the banking system precludes a major role for bank lending as a counterweight to the economic malaise. Capital markets will be called upon as a primary source of financing. In this context, the restorative trends underway within these markets are heartening. It was not long ago that the morning financial news was headed by the latest Libor fix. At this writing three month dollar Libor has fallen from its October high of 4.80% to an historic low of 1.08%. Similar declines in rates for prime and second grade commercial paper are evident. Mortgage spreads have contracted, and investment grade bond yields are well below their average long term yields, having come down substantially since October. Issuance of investment grade debt is accelerating to record levels in the U.S. and Europe.



**30 Year Fixed GSE Conforming Mortgage Rate 1998-2008**

Chart 7.

*Our feeling is that across fixed income markets far too much attention is being spent on spreads, which are abnormally wide and exhibit the fact that significant stress remains in the system, rather than rates, which are abnormally low and thus potentially stimulative for economic activity. The current 30 year mortgage rate is a good example of this since its current yield of 5.30% is extremely low historically and certainly is moderate enough to enhance the affordability of the housing stock. Clearly a lower yield would further increase the affordability of housing but this should not disguise the fact that interest rates are already at a level where they are capable of stimulating marginal demand for both new mortgages and refinancing.*

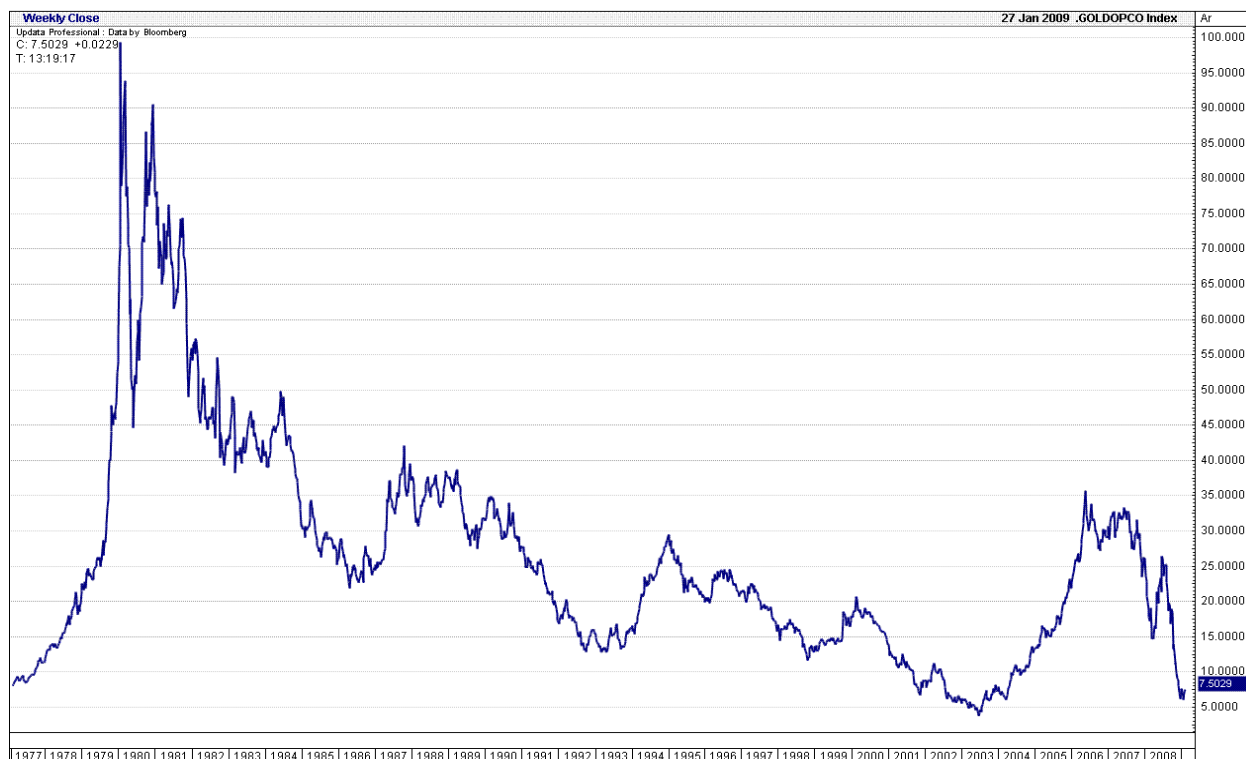
Three years ago we explained our concerns about property and mortgage markets by noting that in a heavily indebted economy, seemingly benign changes in interest rates will have disproportionately severe effects on overall activity. At the time, people argued that interest rates, despite having risen substantially from their 2003 lows, were still well within normal ranges. The idea that a 5% federal funds rate could precipitate a secular collapse of residential real estate was regarded as absurd. We are currently holding out a similar but functionally obverse proposition, namely, that the very degree of indebtedness within our economy makes it extremely responsive to the palliative effects of lower interest rates. As credit markets continue to heal, the benefits of lower rates will be transmitted through an expanding section of borrowers. Already, the automatic resets of corporate loans in relation to Libor is reducing rates for a large number of borrowers, as is the boom in mortgage refinancing with 30 year rates below 5%. As the effects of the Fed's actions continue to expand from their initial orbit, increasing rewards for some greater degree of risk assumption should be at hand.

### **Market Comment**

Monetary policy is beginning to bear fruit as credit markets continue to revert toward conditions that are more normal. The process has proceeded from the core outward, as would be expected given the hierarchies that govern the markets for money and credit. Expansion of the Federal Reserve's own balance sheet is the foundational source of credit to the entire system. In the aftermath of Lehman's failure, Federal Reserve Credit grew at a rate far beyond any precedents. The immediate effects were in the heart of the money markets, where commercial paper, repo, swap and interbank rates began to ease. These all continued to improve throughout the fourth quarter, and their progress began to spread along both risk and maturity spectra, prompting large rallies in agency debt and investment grade corporates.

Many observers, citing still elevated spreads as more decisive than the substantially lower absolute levels of rates, have downplayed improvement in the credit markets. Our view is that credit spreads are currently indicative of distortions in the rate levels of Treasury debt, where the need to unwind disastrous swap trades (involving many municipalities and public institutions) has combined with a blind panic away from the slightest degree of credit risk to push the entire government rate structure to anomalous and unsustainably low levels. As rates across the Treasury curve continue to rise, credit spreads should begin to normalize. From an economic perspective, however, we consider the absolute rather than relative interest costs to be much more important. The recent improvement in levels should provide important support to the corporate sector in coming months.

Similar signs of improvement in the commodity complex are beginning to emerge. The collapse of commodity prices in the wake of the investment mania that seized all markets in the first half of 2008 has prompted a nearly instantaneous supply response. Tight credit and price declines of more than 50% have led to wholesale project cancellations, closures and inventory reductions by consumers. Flows of speculative funds from the sector have intensified, with the effects showing in extreme distortions of futures curves in some of the markets where index speculation was most intense. The argument that speculation in commodity futures does not and cannot influence real physical prices has lost whatever bits of credibility it may have had.



**Annual Opportunity Cost of 1 oz Gold 1977-2009**

Chart 8.

*The above chart shows the annual “opportunity cost” of investing in 1 oz of gold instead of the 2 year Treasury Note from 1977-2009. Our reasoning behind looking at this relationship is that although gold can be viewed as an alternative monetary asset that has a “fundamental” value (its supply is at least not infinitely variable) it suffers the significant defect of not paying interest. This “opportunity cost” is an excellent way of judging whether gold is “cheap” or “expensive” in a given monetary environment. As the chart demonstrates while gold at its current price of \$900 is only 12% below its all time high the opportunity cost of gold is extremely low at \$7.50. We expect to see this measure rise considerably in the coming months. Since we do not believe that the yield of the 2 year T-note will rise significantly it seems far more likely that it will be higher gold prices that lead to a normalizing of this relationship.*

After initially being subject to this liquidation pressure, precious metals in recent weeks have provided a haven. Gold, which has the most direct sensitivity to overall liquidity conditions, was a stand out during the fourth quarter. It has been our experience that major trend changes in gold precede those within the general commodity complex by approximately six months. If this relationship holds, recovery in a broader array of materials’ prices should begin in this quarter. The implications for portfolio strategy are extensive and somewhat counter-intuitive.

For equity investors, the main message is that from this point forward, the market needs leadership from its more economically sensitive sectors. An environment in which the leadership is expected among traditionally defensive, non-cyclical stocks is one in which we hardly find it worthwhile to assume the risks of equity investment. A stagnant economy will provide much greater opportunity in high-grade bonds. Our more favorable attitude toward equity risk derives from an expectation of more vigorous recovery in the cyclical areas of the U.S. economy. These include materials, energy, machinery, construction and technology. Absent improvement in these, stocks overall will have a difficult time justifying the risks of any significant allocation.

We have just witnessed what might be regarded as the first postmodern bear market, during which the close integration of all corners of the investment world has compressed three years worth of liquidation into one. Declines in equity markets were not much different from those witnessed between 2000 and 2002; they were simply compressed into one third of the time with three times the attendant volatility. In addition greater use of leverage increased the “multiplier” that links the fall in equity value to the actual damage in the average portfolio. The aftermath of this process is a sense of shock that has made it nearly impossible for most participants to tolerate risk, at precisely the time that the volatile range that the equity market has settled in requires far more resolve than normal. This psychological pressure, which has settled across the entire investment realm, is now the chief impediment to recovery.

The liquidity available in equity markets should be a large part of their appeal going forward. During the height of the crisis, listed stocks were about the only asset type where immediate cash was available at prices within a few percentage points of the prior quotation. This is not the case for most of the “alternative” world, which enjoyed the greatest flows of institutional money between 2002 and 2008. The disadvantage of listed equities relates to the psychological trauma mentioned in the paragraph above. Because equities markets are about the only place where continuous and universally available price quotations occur, observers must endure a constant flow of abnormally volatile and seemingly capricious movements. For a significant number of investors, this has become a torturous prospect and they have simply sworn off.

However, the risks of equity aversion are themselves substantial. The record levels of liquidity provided by central banks are beginning to bear fruit within capital markets. In conjunction with the extraordinarily high level of passive capital locked in instruments with negligible returns, the ingredients for a long period of higher inflation are in place. Productive capital assets and some alternatives to dollar liquidity may prove to be the only media where adequate real returns on savings exist. It is time to turn off the television and summon the courage to accept some of the apparent risks against the prospect of those that are less clear but more dangerous.

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