FINANCIAL ADVANTAGE, Inc.®

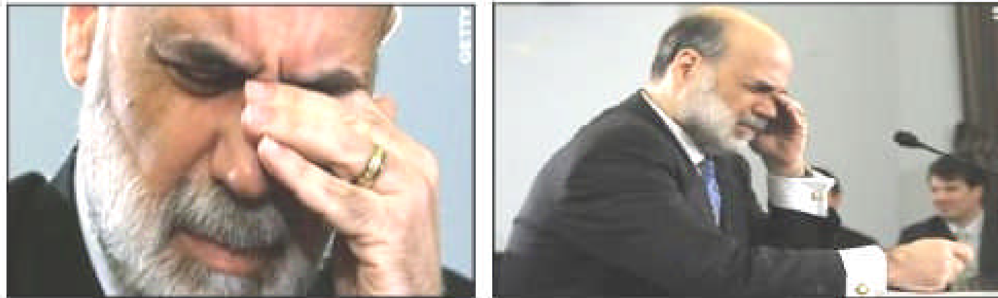
for a better life®

The *Blue Sheets®*

Our quarterly commentary on the global economy and securities markets

Winter 2007-2008

"I'm from the Government, and I'm here to help you."



Federal Reserve Bank Chairman Ben Bernanke

In Ben we trust?

In the wee hours of Tuesday morning January 22, traders woke from a three-day holiday weekend to resume their chores on the floors of America's exchanges; as they dressed for their commute, most were stunned to see on CNBC's "Squawk Box" or on their home Bloomberg monitors that foreign stock markets had plunged 5% the previous day! Dow Jones morning futures indicated a similar opening in New York, causing hundreds of viewers to cut themselves shaving! What markets did not yet know is that the Fed had held an emergency conference call the night before (no doubt spurred by the activity abroad) and was about to announce early Tuesday an off-meeting cut in the overnight rate of 3/4% to 3.5%.

Did the Fed have negative data the rest of us did not? Is the economy shakier than the consensus believes and are we in desperate need of cheap credit to stimulate demand or keep banks open?

Pictures of the Fed Chairman (above) during subsequent congressional testimony do not inspire confidence that this august body really knows what the economy needs. Or worse, perhaps they actually understand the problem but realize it is beyond their ability to fix?

The *Blue Sheets*®

Our quarterly commentary on the global economy and securities markets

Winter 2007-2008

Will Fed rate cuts help?

Now, almost a month later, pretty much everyone realizes that our current financial uncertainties stem at least in part from a surge in payment defaults on certain kinds of home mortgages widely referred to as the "sub-prime mess". Without getting too technical, this means that home mortgage defaults have risen sharply and it's feared that bad debt write-offs may so diminish banks' capital (as well as that of Wall Street's non-bank lenders) that they may be constrained from making ordinary, everyday loans to businesses and consumers. In short, a credit contraction could usher in a recession.

A recession precipitated by a credit crunch is exactly what the central bank and congress hope to head off by slashing short-term rates and passing out $165 billion (of borrowed money, we might add) to the citizenry in a "stimulus package". As of this writing over-night rates have been cut again, to 3.0%, and markets are expecting another cut to 2.5%! (Let's keep in mind that the 12 months CPI rate of inflation is 4%; 10-year Treasuries trade at 3.7% which foots to a *negative real interest rate*… a patently untenable situation. A handy rule of thumb: whatever cannot continue, will not! Lenders will not always accept an interest rate lower than the rate of inflation, so either inflation will come down (more on that later in this issue) or interest rates will rise… *or both*.

Will artificially low Fed funds rates and dropping checks from government helicopters across the fruited plain really restore the patient to health? We don't think so. If they do succeed in postponing an economic adjustment, it could only make for a more painful contraction later. That's because they are not addressing the real problem.

Whatever Mr. Bernanke and Congress do next, a core question remains: "Will cutting short-term interest rates eliminate the potential difficulty of reduced credit availability? The answer is NO! Fed cuts have already caused mortgage rates to retreat below 6%, yet refinancing activity is not rising, nor are home sales. And surveys reveal that 85% of banks have recently *raised* their credit standards, making loans harder to obtain irrespective of the interest rate. Why? The problem is not the *cost* of loans. There is no interest rate, not even 0%, that will solve the basic problem. The problem is too much debt, especially bad debt, and it is the result of a generation of indiscriminate lending.

Reducing Fed rates will not fix the problem because high interest rates were never the problem in the first place… low interest rates (like teaser rates on ARMs and 2% Yen loans to finance the purchase of US securities) and inattention to default risk are what created the problem! Our current credit turmoil is a natural result of too much borrowing for the wrong reasons by folks who were likely to have a problem meeting their obligations! We think that an environment of easy credit for many years, facilitated by the Federal Reserve, by rating agencies and by too-cute financial engineering, has resulted in an economy growing faster than its savings rate could support, and that a recession and some damping of "animal spirits" is what the economy needs. Yet Mr. Bernanke and his free-spending accomplices in the Congress and White House are bent on "stimulating the economy" and preventing a much-needed period of financial sobriety from settling over the country so we can all put our affairs back in balance.

The *Blue Sheets*®

Our quarterly commentary on the global economy and securities markets

Winter 2007-2008

Prior Period Mid-Cycle Economic Slowdown Comparisons			
Indicator/Data Point	YE 1984	YE 1994	Latest Data
JuMacro And Household Leverage Characteristics			
Credit Market Debt As % Of GDP	184%	238%	338%
Mortgage Debt As % Of GDP	30.9%	43.8%	73.7%
Total Household Debt As % Of GDP	48.4%	62.7%	95.6%
Household Liabilities As % Of Disposable Personal Income	69.3%	91.9%	136.5%
Yr/Yr Growth In Consumer Credit	18.4%	15.2%	4.8%
Personal Savings Rate	11.0%	5.3%	>1%
Macro Economic Stats			
Yr/Yr Durable Goods New Orders	NA	12.0%	(8.4)%
Yr/Yr Payroll Employment Growth	4.2%	3.4%	1.2%
M2 Yr/Yr Growth	8.6%	5.4%	12.2%
Yr/Yr Industrial Production	3.1%	6.4%	1.9%
CEO Business Confidence Index	60	53	44
Yr/Yr Change In Disposable Personal Income	10.5%	3.4%	6.2%
A/T Corporate Profits As % Of GDP	5.7%	6.1%	9.2%
Housing Data			
Months Supply Of Residential Real Estate For Sale	7.3mos.	6.6mos.	10+ mos.
Yr/Yr Median Home Price Change	5.8%	4.4%	Negative
NAHB Survey Level	50	43	18

The preceding table (highlights are ours) was presented on one of our favorite economic websites, www.ContraryInvestor.com (a very valuable, modestly-priced subscription); it shows just how leveraged our economy has become during a generation of easy borrowing, supported in its latest phase by an extraordinary explosion of home prices. These days Mr. Market gets excited when it appears that a nearby Fed meeting will see another cut in overnight rates to help prevent a recession, probably because this strategy worked in 1984 and 1994. Could it be that debt is now so large, especially in the face of slowing jobs growth and shrinking home prices, that the Fed may not be able to pull off a rescue this time around? We think the numbers suggest that could be the case.

Will we have a recession?

In a word, *probably*. We may already be in one.

Ordinarily we lean toward agnosticism concerning the state of the business cycle. We think James Grant (Grant's Interest Rate Observer) has it basically right when he says, "It is usually wise to give economic prophecy a wide berth." Nonetheless, we voice our opinion on the recession question this time around because we think that years of aggressive lending and borrowing will transform the pedestrian recession from a pause that refreshes into a dangerous variable. Since we are concerned with preserving our clients' capital, we need to pay attention to dangerous variables.

For over twenty years the U.S. economy was flying high with an easy-credit tailwind that allowed it to cruise faster than the twin engines of savings and productivity could sustain without a favorable borrowing climate. The economy, especially the credit sector, is clearly overheated and needs to come in for maintenance and to let its engines cool.

But the Federal Reserve Bank is afraid to let it slow down, and for understandable reasons. They're concerned that the present illiquidity in many areas of the credit market (CDOs, asset-backed and mortgage-backed securities, structured products, leveraged loans, insured bonds, and auction rate securities to name a few) might curtail even routine debt rollovers and could precipitate a system-wide financial meltdown replete with deflation. Recall how these very same fears were extant when Bernanke was first being considered as the successor to Greenspan in mid-2005. Yes, deflation risk is the same bogeyman the Fed was fighting with 1% fed funds in 2003-2004, and they did succeed that time in stimulating loans and economic activity, setting the stage for levitating home prices and indiscriminate lending, the inevitable nasty consequences of which we are now reaping.

We think the best case one can hope for over the next five or ten years, and perhaps the one Bernanke and Co. are hoping to underwrite, is for the U.S. to grow slowly, say at 1% or 2% in real terms; let lenders cull all the doubtful credits from their balance sheets, let price adjustments clear the housing inventory and let consumer spending subside from its lofty 70% share of GDP toward its long-run norm in the low 60%s.

If we don't have a gradual adjustment we'll get a sudden one, and it won't be pretty. We agree with the growing number of economists who think we may have already entered a recessionary environment in the United States. Clearly the Federal Reserve Bank is worried about where that could take us; that is why they have abandoned their itty bitty quarter point cuts and plunged into aggressive rate-slashing that seems almost desperate.

Can low rates forestall an economic contraction one more time? The Fed thinks so; at least that is their public position. Their latest forecast is for first half GDP to gain ground at a sluggish 1.3% -

2.0% pace but to be noticeably more robust in the second half of the year when the IRS' $165 billion "stimulus package" supposedly kicks in. Bernanke's second half 2008 reacceleration forecast is widely believed and, we think, reflected in the stock market. We think such optimism is wishful thinking. Fifty percent of banks are already *tightening* their mortgage standards, and over 40% are being more cautious about small business loans and over 80% are stingier in commercial real estate deals. Spreads on real estate loans have widened from 50 basis points to 200 in the last 6 weeks! Even more worrisome, it appears that the investors do not yet really know just how much "toxic waste" is yet hidden on banks' and investment banks' balance sheets, and even more mysteriously in their "off-balance sheet" assets.

Every week more ridiculous loans come to light. One glaring example: about *a week after reporting their 2007 financial results*, presumably having scrubbed their asset portfolio at year end, Credit Suisse, the second largest bank in Switzerland, announced it was taking an additional $2.5 billion write-down of assets related to the U.S. housing market!

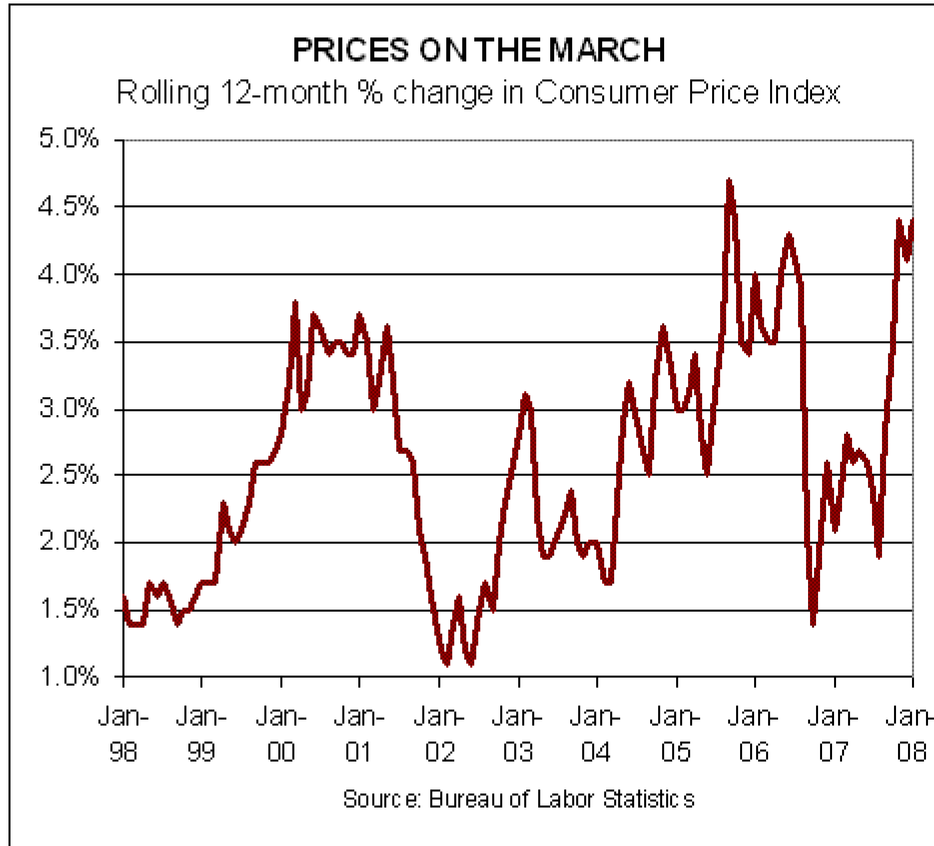
> *So the credit outlook remains murky, economic growth has already slowed to 0.6% in 4Q07, unemployment claims are up, employment actually fell in January for the first time since the last recession, leading indicators have declined for four straight months, consumer confidence crashed in the latest survey, housing remains mired in excess inventory and prices of homes are widely expected to fall further, perhaps a lot further.*

No wonder the fear of a deflationary recession has re-emerged. One can read into the latest minutes of Fed meetings that they believe a possible deflationary spiral is more frightening than rising inflation; so they have chosen to ignore the inflationary consequences of their interest rate decisions and fight deflation with the only tools available to them, monetary policy and bank regulation. Perhaps that is the best they can do. We are concerned that it may not be enough. Whether future CPI reports will reveal inflationary or deflationary trends remains a critical uncertainty. Either is dangerous but they have different implications for portfolio construction.

Deflation? Inflation?

The January '08 inflation numbers were not encouraging; + 4.3% year-over year for the latest 12 months; that's up from a 4.1% pace in December. Core inflation (which excludes food and energy because they tend to be volatile in both directions) came in at + 2.5%, well above the Fed's target of 2% or less. Nevertheless, the Fed remained officially optimistic with a 2008 forecast of 2.0-2.2% core inflation (which is up from their earlier projection of 1.7-1.9%. Is this realistic?

Following is a chart of the trailing 12 month CPI rate of inflation the past 10 years. You can see that the latest pace is higher than at any time in the decade except a brief spike to 4.7% in mid-2005 when oil had popped 100% in two years.



The Fed's January forecast is for end demand in to get stronger in the second half of this year but for inflation to decrease; this is not, as John Mauldin points out, intellectually consistent as recessions are generally a deflationary force. However, he suggests, it just may be politically impossible for the Fed to actually forecast a recession. Let's look at some of the forces for inflation and some for deflation to see if we can get a sense for the likely direction ahead.

The *Blue Sheets*®

Our quarterly commentary on the global economy and securities markets

Winter 2007-2008

Inflationary forces

- **Demand-driven price increases.** Big ticket items (houses and cars) are in oversupply and are not pushing up inflation. Fed rate cuts and the Government "stimulus package" are aimed at boosting demand, but if these prove ineffective, as we believe they will, the clear consequence of a credit contraction will be reduced demand, which *is* ***not inflationary***.
- **Cost-driven price increases.** Because of recent huge increases in the cost of energy and raw materials (largely driven by emerging market demand) a broad range of goods and services providers are boosting prices to maintain profit margins. Rising interest rates are also increasing costs for leveraged businesses. When costs are rising for domestic businesses, that is ***inflationary***.
- **Import price inflation**. This is a new one. China, which has been exporting deflation to the US for years, is now experiencing rapid inflation of its own which is starting to be passed through in our cost of imports… going from a deflationary force to an inflationary one is a ***highly inflationary*** switcheroo.
- **Currency depreciation.** A sharp decline in the dollar exchange rate versus the Chinese yuan, Japanese yen and euro in the past year is ***inflationary.***
- **Monetary policy.** Most economists currently agree that inflation is first and last a monetary phenomenon and that domestic consumer price increases are merely a symptom of loose policy. The 1900 US dollar was worth 7 cents in 2007 according to one calculation; devaluation seems almost inevitable. A free-spending government (anyone watch the political debates lately?) and its handmaiden, a central bank unfettered by a gold standard, will surely continue to fund its irresponsibly-undertaken future obligations with the cruelest tax of all, inflation. And that will be true in spades when that central bank is purposely juicing consumer demand and bailing out improvident lending institutions. Policy is ***Very inflationary***.

Deflationary forces

- **Promotional price decreases.** When manufacturers (and some service providers) need to counter weak demand trends they often do so by cutting prices. This is a temporary force because ultimately providers need to show a profit, but we'll call it a ***mildly deflationary*** force.
- **Productivity gains.** Rising output per hour of work is a pretty consistent phenomenon in a free enterprise economy with good access to technological advances. It makes possible a rising standard of living (higher real wages) for the workforce without necessarily contributing to price increases for consumer goods and services. Productivity gains have slowed the last few years and real wages have stagnated. If a credit contraction reduces capacity utilization and increases unemployment, productivity may flatten and lose its deflationary punch. Looking at the flip side, this would be a ***mildly inflationary*** turn of events.
- **Cost decrease pass-through**. Outsourcing to lower-cost parts of the world, a deflationary force, will continue but a) it may be slowing and b) its power is neutralized when those regions begin to experience rising costs themselves as seems to be the case in China. ***Neutral.***

- **Credit contraction resulting in reduced end demand for goods and services.** This could overwhelm some of the inflationary forces if, in fact, the Federal Reserve Bank and IRS largess fail to stimulate consumer demand and businesses shrink spending in response. Since corporations have been enjoying record profit margins the past few years, they would seem to be in a position to cut prices in an effort to gain share of a shrinking or stagnant market. There is not much evidence of this except in the very cyclical housing and auto industries, but it is a wild card. Our current appraisal is that this is ***not a significant factor***, but bears watching.

  On balance inflationary forces seem to us to have the upper hand.

Fairy tale wisdom?

It was easy for us to take the long-running "Goldilocks" economy for granted; full employment, robust GDP growth, only barely interrupted by shallow recessions, and low inflation besides. As our heroine declared when she tried out baby bear's sleeping accommodations… *it was just right*! Until the rightful owners returned home, of course.

Just as economic growth was hyped by our spending the portion of our incomes that we used to save and by borrowing more on top of that, at the same time we were able to import deflation from Asia and Eastern Europe. Just right! But it appears more and more as though we may be losing both the credit-cycle growth stimulus and the Asian deflation at the same time! Could the bears be coming home? Will they be as understanding as Goldilocks' bear buddies?

There is a popular nonsense song from the original soundtrack of Disney's Cinderella that goes like this: "Salagadoola mechika boola, bibbity bobbity boo. Put 'em together and what have you got? Bibbity Bobbity Boo."

The music emanating from the Central Bank makes about the same amount of sense; cheap credit to stimulate an economy already struggling under a too-heavy debt burden and a zero savings rate. We think the weight of evidence suggests that a long overdue correction in a generation-long credit cycle is underway and that any demand growth that comes from increasing population (about 1% a year) and productivity growth (1-2%) may be neutralized by credit-related consumption cutbacks and a gradually rising savings rate.

At the same time, inflationary forces are clearly extant. Very slow growth and rising inflation; put 'em together and what have you got? Stagity-Flagity STAGFLATON! As more experienced investors will recall, that was the popular description of the 1970s economic environment of very slow real growth and rising inflation. Inflation probably will not reach the double-digit disaster that the Fed Chairman Volker had to manhandle with crushing interest rates back then; for one thing we are not seeing wage inflation pass through, perhaps because of globalization of the workforce. But there will be upward pressure on interest rates, and spreads over the risk-free rate will widen.

Mainstream economic forecasts call for a growth slowdown to something like 1.8% to 2% in the first half of 2008, and picking up steam thereafter (as the IRS stimulation checks start to boost consumer spending, so the official story goes). We think that slow growth is the best case scenario; but for it to effect a gradual de-leveraging of the economy, growth will have to remains slow for a period of 5 or even 10 years. And we think that near-term economic risks are to the downside.

The *Blue Sheets*®

Our quarterly commentary on the global economy and securities markets

Winter 2007-2008

In China we trust?

Whatever you think of Jim Cramer (host of CNBC's Mad Money) most agree he is one entertaining guy. But don't let his on-screen shenanigans fool you; he has been around the capital markets a long time and he can be very insightful. In late January he was ranting on air, I mean RANTING about the pathetic paper tigers our leading financial institutions have become. "Merrill Lynch and Citigroup are BANKRUPT," he shouted and waved two thumbs down for emphasis, "They had to be bailed out by Chinese Communists and state sponsors of terrorism!" Pretty sobering thought, it seemed to us. Any validity?

Of course, what Cramer was talking about in provocative language designed to shock viewers and boost ratings is the enormous write-offs Citi and Merrill took in the third and fourth quarters; amounts that literally wiped out the last five years of profits, shriveled the equity on these behemoths' balance sheets and forced them to turn to Arabian princes and Pacific Rim sovereign funds for financial resuscitation.

Remember what a fuss the U.S. put up two years ago when a Dubai firm wanted to buy an English port management company that operated several US port facilities? Now suddenly we're welcoming direct investment in US banks, brokers and insurance companies from just about anyplace that has liquidity… including the Middle east and Communist China. On Friday February 22, the stock market was down about 1% a half hour before the close. Suddenly, trading switched to the upside and in that last 30 minutes the Dow closed up 1.5% from the day's lows! The reason, you ask? Rumors that a group of big banks was planning to bail out capital-starved bond insurer Ambac. Nobody thought to ask what that might do to the banks' own precarious credit ratings… until Monday when Fitch let it be known that it could hurt them! "Like two drunks holding each other up," one commentator observed. Yet S&P confirmed Ambac's AAA rating Monday afternoon. Stay tuned!

Is this credit turmoil a financial crisis for America or just a bump in the road? Do Middle East and Asian investors, whether sovereign or individual, see an opportunity that domestic investors are missing? Or are they possibly making imprudent investments here? What are the longer-term implications for the US economy? For stock and bond markets? For national policy? Congress is already worried about the sovereign funds' activity; is protectionism around the corner? None of us knows the answers to these questions, of course, but if we are right that the US economy has enjoyed an easy-credit tailwind for over 20 years, and now the de-leveraging part of the cycle is turning credit access into a headwind, growth will be more labored and erratic, perhaps for many years.

What does all this mean for investment returns?

As one TV wag commented, de-leveraging is hell. That may be a little melodramatic, but de-leveraging could at least mean years of slow growth in the economy and a low return investment climate punctuated by dramatic volatility in securities markets. It could mean a continuation of the P/E contraction for stocks that began in 2000 (one of FAI's five long-term investment themes). We anticipate that in a de-leveraging environment corporate profits as a percentage of GDP may begin this year the process of reverting to their lower long-term mean, disappointing consensus earnings expectations. And we have a conviction that bond yields are likely to be rising to levels that more properly reflect credit risks and inflation risk.

The *Blue Sheets*®

Our quarterly commentary on the global economy and securities markets

Winter 2007-2008

Valuation

Price/Earnings ratios for broad market indexes reflect two things… prevailing interest rates and the consensus outlook for profits growth. Higher interest rates produce lower P/E ratios. A perception that profits growth will slow or even be negative typically has the same effect, lower P/E ratios. Our outlook, as explained above, is for both a rise in interest rates and a more sober consensus earnings outlook for companies doing most of their business in the U.S.

John Hussman (www.hussmanfunds.com) points out that "secular bear markets" (usually lasting 15 years or longer, punctuated by strong upswings and downturns) tend to consist of three multi-year down cycles, each ending in a lower valuation as measured by the P/E ratio. A falling P/E overwhelms the positive impact of rising earnings. Buying stocks when the market's P/E is high, especially when the ratio is calculated on peak earnings, as is the case today, portends years of investment returns no better than can be had in Treasury Bills. John contends, and we concur, that a secular bear market began in 2000. Stock returns since early1998 have averaged no better than T-Bill returns, and this secular bear could continue another 5 years or more and still be nothing special in the history of secular bear markets.

Wall Street, keen to market the next great scheme as they did mortgage pools and other now-tarnished inventions, will tell anyone who will listen that stock valuations are low. In fact, except for the runaway dot.com era sporting a fantastic 34 P/E on the S&P 500, today's multiple of 19X on trailing GAAP earnings is high. When you also consider that this is on profits that are 40-50% above their long-term average as a % of GDP, the valuation is very high. When you further consider that bear markets typically end with P/Es well below their 13X to 14X long-term average, a significant risk is apparent.

Managing perpetual uncertainty

But the future is always uncertain. Change is always in the air, and it creates new uncertainties and differences of opinion about the best way to be invested. Some change is important and some is not. At FAI, we make an effort to distinguish change that is random or of only shallow, fleeting consequence from change that is pervasive and has actionable, longer-term implications for investment returns. We try to ignore the transient stuff and adapt clients' portfolios to the more lasting influences that we see and understand. That's the purpose of our five long-term investment themes, three of which we touched on in the Autumn 2007 issue of the Blue Sheets. We intended to devote this Winter issue to the remaining two themes, Emerging markets and Aging population, but deepening credit market concerns pre-empted that plan. Watch for our Spring issue!

For the Investment Committee:
J. Michael Martin, J.D., CFP
February 25, 2008

DJIA 12,570

S&P 500 1,371

NASDAQ 2,327

30-yr Treasury 4.66%