

Custom Strategies

Investment Consulting

THE NEW ROAD

October 2009

Background

The past two years have witnessed the unfolding of surreal, unimaginable events within the global financial system. Permanent alterations to the architecture of markets and the relationships of their participants erupted violently and comprehensively. The transformation began in mid-2007 as the real estate bubble in the U.S., precipitated by an explosion of credit creation and abandonment of respect for risk, reached its zenith and began to crash. Events that followed were terrifying as the downward spiral swept across the globe with great speed and intensity, decimating prices and destroying wealth. The policy responses were often uncertain, frequently confusing, and of uncertain legal standing.

Government actions amounted to little more than financial triage, designed to stop the bleeding and prop up failing institutions and structures, as opposed to the more productive long-term goal of working toward correcting vast structural imbalances and re-imposing market discipline. While some stability has been restored to the markets, they remain fragile and vulnerable to shocks. The financial system will gradually stabilize, although immediate prospects for robust growth within developed economies appear questionable. The U.S. will continue to be plagued with real estate problems; commercial loans are becoming increasingly problematic and residential home prices are likely to decline even further when many adjustable rate mortgages reset at higher interest rates, forcing more foreclosures. As a result, banks will continue to be burdened by significant loan losses into 2010.

Despite uncertainty as to how things will develop within the financial markets and economies of the world, it is abundantly clear that substantial change has occurred and that much of the new order will prove permanent. Decoding the altered alignment of business, financial and geopolitical forces will be imperative for all investors and citizens. Secular transformation has begun and will pose great challenges as well as provide significant opportunities.

PUBLIC TAKEOVER OF PRIVATE SECTOR DEBT

Due to political pressure it is unlikely the Federal Reserve will be able to withdraw liquidity in the amount needed, or without negative consequences.

The most important development of the past two decades has been profligate spending by both the private and public sectors, and the consequent borrowing required to support that spending. The problem has been compounding for a long time, and the ultimate consequences are likely to range from uncomfortable to dire. Consumption was encouraged by many governments, particularly the

U.S.; central banks elected to inflate economies by keeping interest rates abnormally low and by resorting to deficit spending in response to every challenge to economic growth. Lenders were consequently flush with funds and willing to lower loan standards with scant concern for risk. We have witnessed the employment of previously unimaginable actions in order to keep the financial system from falling into a more severe downturn. The creation of new lending facilities such as the Troubled Asset Relief Program (TARP), and the Term Asset-Backed Securities Loan Facility (TALF) pumped massive government funds into financial entities of all kinds. Although the cyclical downturn has been cushioned, these programs, along with the takeover of a large part of the automobile industry, and the Federal Reserve's printing of huge amounts of money by purchasing so much of Treasury debt issuance, will come at a cost. In effect, all that has transpired is that private debt has been transferred to and guaranteed by government entities.



Source: Exhibit by TCW Research from Federal Reserve, Commerce Department and New Davis Research.

As highlighted on the chart above, credit market debt in the U.S. had grown to 375% of GDP by the end of the first quarter of 2009. The national debt, passing \$11 trillion, grew so high that another digit was added to the national debt clock in New York. The average maturity of outstanding government debt is the lowest on record, with 40% needing to be refinanced over the next twelve months. Interest payments on U.S. debt are currently about \$1 billion daily. Debt accrual of this magnitude cannot be sustained forever and deleveraging must occur throughout the system. Debt obligations can only be satisfied in three ways: They can be paid off, reneged or, in the case of central banks, reduced to more manageable levels in nominal terms by permitting inflation to rise. The choice of inflation is generally preferred by governments until investors impose discipline by refusing to purchase more debt unless much higher interest rates are provided.

Commercial bank reserves have climbed to dangerous levels in response to the massive increase in the Federal Reserve Board's balance sheet and quantitative easing policies. Reserves have soared as increasingly copious amounts of funds have been transferred from the Federal Reserve to a banking system that is rightfully dubious of lending into an uncertain financial landscape. The vast growth in excess liquidity is well illustrated by a look at history. From 1951 to 2007, bank reserves grew by 1.45% per annum to \$40 billion. That \$40 billion rocketed to an astonishing \$903 billion in May, 2009 and is now in excess of \$1 trillion. It strains credulity to suppose that the Federal Reserve will be able to: 1) overcome the political drumbeat to keep the money flowing; 2) successfully engineer a controlled plan to sop up this vast money pool; or 3) withdraw the stimulus needed to return unemployment to pre-crisis levels.

IMPACT OF GLOBALIZATION ON DEMAND

**Two billion people in China and India is a meaningful event.
It means greater demand for commodities and steadily rising prices.**

While credit market disruptions have been a primary focus for market participants in recent years, ongoing globalization and the intertwining of financial markets have brought about tremendous change. This is obviously not a new phenomenon, but the complex ramifications are broad and will become increasingly significant over the long run.

Beginning in 1978 with the opening of China, the world has been riding a tectonic shift of immense importance which is reshaping global economies. We have communicated for some time that important shifts were occurring in response to globalization. The long anticipated emergence of Asia onto the world stage has ushered in a number of profound changes including the increase in demand for commodities, altering international trade patterns, and greatly influencing financial relationships as huge stores of sovereign wealth and liquidity have been built.

While the effect of increased sourcing of manufactured products to less developed economies is substantial, perhaps the most significant element of this change is the emergence of a prodigious number of new consumers, all desirous of attaining the pleasures, convenience, and comfort afforded more economically developed societies. The increased, and ever growing, purchasing power of more than two billion persons is a stunning addition to the total number of world consumers. The result is a sizeable increase in economic activity, which is currently manifesting itself in the demand for all categories of commodities. This phenomenon is very visible in the markets for crude oil where prices have experienced violent fluctuations within a broad uptrend, as well as industrial metals such as copper, lead, zinc, and precious metals, that have also experienced wide price swings while generally trending upward.

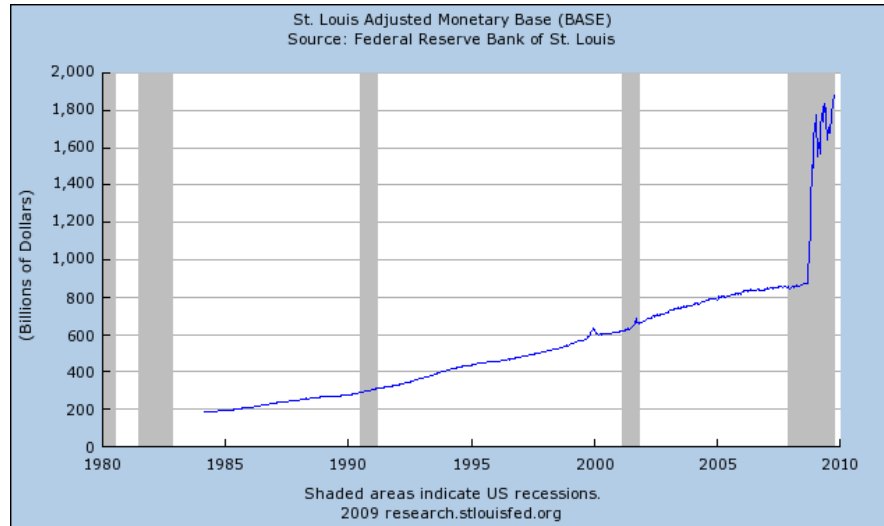
Commodity cycles are very long in duration and upward price pressure is building in many of these markets due to an extended period of underinvestment due to decades of poor return on investment in the oil, natural gas, metals and mining industries. The severe problems afflicting the world of finance have contributed to the looming shortages as sources of financing for development of new projects dried up as credit became constrained. While emerging market demand will continue strong, accelerating demand will occur as the recession gradually fades and economies, particularly developed markets, reload for growth.

It is sobering to note the large percentage increases in the consumption of a number of commodities that are going into new markets. In addition to oil and metals, the demand for agricultural commodities is rising as greater prosperity promotes changes in diets. Increased affluence always results in the greater consumption of protein. This higher demand for beef, pork, and poultry products will impact grain consumption because it takes between two to seven pounds of grain to produce one pound of meat. Some offset may result from more subdued growth in developed markets but net demand is headed up, barring a severe and long-lasting recession/depression, something we think is of very low probability.

VALUE OF THE DOLLAR

A declining dollar means higher inflation as the U.S. is a net importer of goods that become more expensive in dollar terms.

Governments everywhere are committed to keeping economies moving. The likely cost will be devaluation of many currencies including the U.S. dollar although nominal price stability will provide the illusion that wealth has not been compromised. The inflationary and expansionist monetary policies of the U.S. are beginning to have an increasing impact on the value of the dollar, the world's reserve currency. Astronomical budget deficits have created a mountain of debt and the outlook for immensely increased obligations in the coming years is frightening. Whereas a billion dollars here and billion there was once considered real money, we have now added three



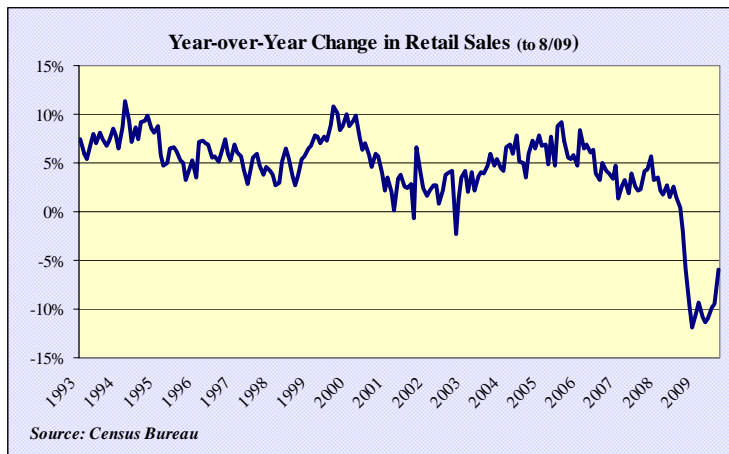
zeros. The nearly two trillion dollar budget deficit anticipated in 2010 is accepted with equanimity by our officials and many financial market observers. It is very worrisome to contemplate deficits of this magnitude for years to come, placed on top of an existing \$11 trillion debt. This is further exacerbated when considering the anticipated future obligations of Social Security and Medicare which currently stand at an estimated \$55 trillion dollars. Meeting these combined government obligations by an economy with a current GDP of \$14 trillion is impossible, at least in current dollars. Large foreign buyers of our debt, such as the Chinese, are concerned about the outlook for the dollar and the future value of their sizeable investment. China is the largest holder of U.S. securities (\$800 billion as of July 2009), followed by Japan. The Chinese recently voiced their concern when they asked the U.S. to issue Treasury Inflation Protected Securities as opposed to straight Treasury bonds. While the reserve status of the dollar is not currently challenged, a severe decline seems likely over future years.

Deflation/Recession Argument

Deflation is here now. Inflation is on the horizon.

The engine driving both the U.S. and World economies for sixty years has been the U.S. Consumer – consumer spending recently made up about 70% of U.S. GDP. Now, the government is urging banks to lend to consumers whose spending was not based on real wage increases but on debt. In October 2008, consumer spending experienced its first drop since 1991 and its sharpest drop since the second quarter of 1980. As indicated on the nearby chart, after a steep decline, there was a bump up in consumer spending in October, attributable to the “cash for clunkers” program. Most

experts think that the program simply provided a temporary boost to purchases. Consumer spending has subsequently tailed off as unemployment has risen and individuals with liquid assets are saving in an effort to rebuild the value of their real estate and retirement portfolios such as 401(k)s.



State and local governments were beneficiaries of the wealth created from the debt balloon, reaping higher property and sales taxes. Now, unemployment is becoming a concern and may negatively impact state revenues as property values plummet and the consumer reduces spending. According to the most commonly used indicator, unemployment is approaching 10%. Alternative measures, however, point

to a more problematic condition. The Federal Reserve's U6 indicator, which additionally measures workers marginally attached and, part time workers who desire to work full time, indicates the current unemployment rate is closer to 17%. As a result, states are facing increasing challenges in financing their operations. The dire financial conditions of many states are offsetting some of the impact of the Federal stimulus package. Virtually all states are cutting back services, laying off workers and, in some cases, raising taxes. California's huge budget gap has received the most attention, but most of the industrial states have similar issues.

With consumers saving more and spending less, and unemployment at historically high levels, many wonder how inflation can be rekindled. The most commonly accepted and publicized measure of inflation is the Core Consumer Price Index (CPI) that focuses on approximating a cost-of-living index, as opposed to a general price index. As long as rents remain low (the CPI uses rental rates instead of home prices in its real estate calculations) and the employment picture is not improving, it is unlikely the Federal Reserve Board will raise interest rates. Hence, deflation is viewed as the probable scenario as negative demand should lead to lower prices. We agree that an increase in the Core CPI is not an issue over the short term, but the index is cyclical in nature. Our argument for inflation centers on 1) increased demand for commodities, and 2) the tendency for governments to repay debt by deflating their currency, as other alternatives are too expensive and stifle nominal growth. We anticipate that near-term higher demand will come not from the U.S. but from regions of the world that are solvent and growing. Real demand growth in developing economies is underway. We believe that global growth will evolve and provide the basis for continued strong development in consumption and that the fundamentals currently in place will cause higher prices long before they are reflected in the CPI.

Some of the deflationist's concerns are centered on the output gap, where production is now low due to high unemployment and excess industrial capacity. Long periods of unemployment tend to make workers less efficient and skills become outdated. The same phenomenon of inactivity applies to machinery that becomes obsolescent as capital spending on new technologies and efficiencies is reduced during periods of low productivity.

Summary

Adherents to the Austrian school of economics, with its emphasis on monetary theory, would conclude that inflation is inevitable. We agree but readily admit that the timing is uncertain. The excess liquidity in the system will eventually seek a higher rate of return as current low yields translate into negative real returns after adjusting for inflation.

The primary arguments against the inflationary outcome focus on high unemployment, low consumer spending (the so-called output gap) and, most importantly, faith that the Federal Reserve will be able to accurately manipulate monetary policy in terms of timing interest rate increases and reign in the money supply. We remain skeptical that the solutions to previously inconceivable financial distress and unusual circumstances can somehow be resolved without the unwelcome consequences of inflation and a weak dollar. The world is hooked on the elixir of printed money and a sudden burst of financial discipline is implausible. If the current incipient signs of recovery fade and stocks begin to slide, the trumpets of a call to action will be loudly sounded; more stimuli would follow, more loan guarantees would evolve, and more questions about the viability of fiat currencies would follow.

Current economic conditions and the response by governments to the balance sheet crisis are unlike anything we have witnessed in the past. There are no existing models to measure the long-term impact of shuffling vast debt from the private sector to the public sector. The implications appear clear and investors should take steps to ensure portfolios are properly structured for the inevitable.

Portfolio Strategies for “The New Road” Ahead

The world has been riding a tectonic shift of immense importance which is reshaping global economies. Substantial change has occurred and much of the new order will prove permanent. In light of the deleveraging and re-regulation that has occurred over the past two years, investors should re-assess their portfolio policies and allocations to adjust investments for the “New Road” ahead. Most portfolios are “under-hedged” to inflation and should be moving toward a meaningful exposure to inflation sensitive assets. Portfolios are more prepared for deflation through fixed income and other yield oriented assets. Our view is that the following asset classes and types of investments should represent a meaningful exposure within a diversified portfolio.

Hard Assets and Natural Resources

Own what people need, not what they want:

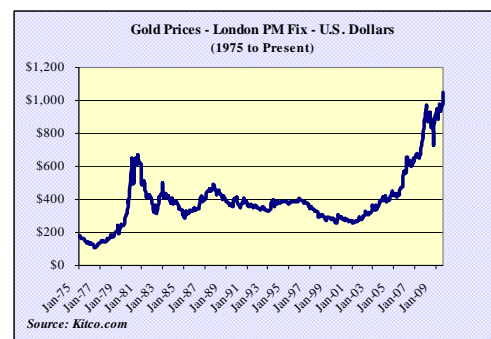
The metals and mining industry has not had sufficient new investment for 20-30 years. For the most part, developing nations avoided investments in toxic financial assets and, as a result, their balance sheets have remained relatively strong. They are spending their reserves on infrastructure, which leads to end-product demand. The Chinese are buying natural resource companies around the world. Competition for all types of resources will likely increase and this will ultimately lead to higher prices as demand collides with supply. Geopolitical accommodations may become unglued.

The demand for food will increase as the world’s emerging market populations improve their diets and consume more products that use larger amounts of natural resources. Agricultural products of all types will benefit, as will the production of clean drinking water which is a scarce commodity in some parts of the world.

Gold

Protect against inflation:

The price of gold peaked at \$1,030 in October 2008 during the Bear Stearns meltdown, and then plummeted to \$712.50 before rebounding to over \$1,000 in 2009. Gold is a safe-haven against inflation. If the government avoids deflation, which we suspect will be the long-term case, inflation and a declining dollar are unavoidable and gold will prove to have been a good insurance policy.



International Equities and Non-Dollar Denominated Bonds

Protect against a decline in the dollar:

The U.S. government has borrowed trillions of dollars that it may not be able to pay back without deflating the value of the dollar. One way to protect assets against a declining dollar is to purchase non-U.S. investments that will rise as the dollar falls. Investments would include equities and non-dollar denominated bonds.

What to avoid:

Long-Term U.S. Treasury bonds are risky. At a 4.22% yield and 17 year duration, a \$1 million investment in a 30-year Treasury bond would decline \$170,000 if interest rates were to rise by one percentage point to 5.22%. If interest rates were to rise by three percentage points to 7.22%, you would lose \$510,000, or half your investment. Long-term, interest rates are more likely to rise than decline and there are many less volatile places to stash deflation oriented, income producing assets.