



MUSINGS FROM THE PANTHEON

JANUARY 19, 2009

THOUGHTS ON THE ECONOMY AND MARKETS. NOT HYPE, JUST INSIGHT.

FORGET THE JONESES

I entitled December's 2007 Musings, "The Ticking Time Bomb." And the first highlight read, "Increased debt fueled a mighty tailwind for economic growth this decade. Starting in 2008, debt will move to a strong headwind for the economy." Unfortunately for all of us, this musing proved far too prescient. I even opened with a quote from Charles Dickens's *David Copperfield*, "Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pound ought and six, result misery." And today many people find themselves in miserable circumstances because of debt. People simply forgot that asset prices rise and fall, while debts always must be paid for 100 cents on the dollar.

Last year, I envisioned we would reach a "tipping point", or "Minsky moment" that would compel government intervention. And I steadfastly believed that government intervention would prevent the vicious debt deflationary cycle (or as the Federal Reserve likes to call it "an adverse negative feedback loop") from unfolding. Now I am less certain. While the Fed and government intervention proved far from perfect, it did avert a much worse economic calamity. But I now fear a lasting change in consumer psychology took hold last quarter. We went from the 1970's era of "keeping up with Joneses" to the 2000's era of "let's one-up the Joneses". Then last quarter we began the era of "forget the Joneses". And consumer's cut spending sharply, with retail sales falling 9.8% year-over-year in December. I had hoped that after the shell shock of October and December that Christmas sales

would show improvement. But instead, consumer retrenchment intensified. Now Keynes' "paradox of thrift" permeates our economy. As everyone starts to save at the same time, it may be good for us individually but it's dismal for the economy.

Our economy became addicted to easy credit. And as we began to realize that we might not get our next "fix", the economy went into withdrawal. The Federal Reserve prevented a heart attack last year. Now it aims to get us back on the drug as soon as possible. The Fed desperately wants to prevent deleveraging on a large-scale. So as the shadow banking system implodes and banks dramatically tighten credit, the Fed believes it must step into the maelstrom. With investors seeking safety above all else, government yields fell precipitously. At the same time, corporate and consumer costs to borrow rose dramatically. Last month, junk bonds yielded 20%. Not many corporations survive in a deflationary environment borrowing at 20%. The Fed realizes this and thus plans to substitute its balance sheet for the shadow banking system and shore up the traditional banking system with future taxpayer "gifts", or as it calls them, capital infusions. To get credit flowing back at better yields, the Fed proposes buying debt in the market at much higher prices. This past week, mortgage rates fell below 5% because the Fed bought massive amounts of mortgages to drive rates down. Next on the list are corporates. Again, the Fed will simply buy massive amounts of corporate bonds to drive rates down. And where does the Fed get these vast sums of money to replace the free market?

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First, it creates money out of thin air by turning on its printing press. Second, with governments yielding less than 2½% even out 30 years, the Fed sees an arbitrage opportunity. Treasury can borrow at 2½% to purchase assets yielding anywhere from 4½% to 20%. By their reasoning, if they get mortgages back to 4½%, a new refinancing wave will be created. With plunging energy prices, a refinancing boom helps improve consumer cash flows. And lower mortgages improve housing affordability and hopefully housing prices. The same reasoning holds for corporate debt. In its grand scheme, once markets stabilize the Fed gradually stops buying and starts selling securities in the ensuing “normal” market environment. As the Guinness boys say on their commercial, “Brilliant! Simply Brilliant!”

I sincerely hope for all that Bernanke’s master plan works. But given the recent track record of government initiatives, I remain skeptical. I believe the changing social psychology toward thrift trumps massive government intervention. The Fed’s actions and fiscal stimulus will help an ailing economy, but the recession will prove deeper and longer than many investors expect. China and the Fed got us hooked on easy money, but now its addicts are going to rehab. Sure some will jump at another fix, but most will slowly quit. I expect after people refinance their house, the few that can in this environment, much of the increased cash flow will go into savings. With the massive loss of wealth last year, consumers need to repair their balance sheets. I recently saw an editorial comic. Bernie Madoff sits in a police chair with a bright light in his face. The cop asks him, “All right Madoff! Where did you get the idea of paying early investors with money from late investors?” Bernie replies, “From the Social Security System.” And as citizens begin to ponder retirements, they begin to realize the US government mortgaged their future. And they also realize the government’s

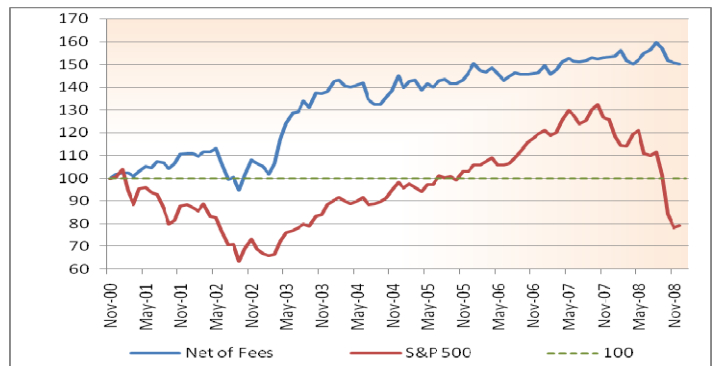
wherewithal to keep its promised obligations quickly squanders with ever increasing debt. And thus the need to save grows. Bernanke and Greenspan believed central banks could not identify bubbles. They also believed central banks could easily “mop up” after a bubble. The early recession this decade only emboldened their view. But I bet if you ask them, “Do you wish you took the punch bowl away before the party got started,” they would say yes. Or in Bernanke’s case, I am sure he would have at least intensified regulation of all financial markets!



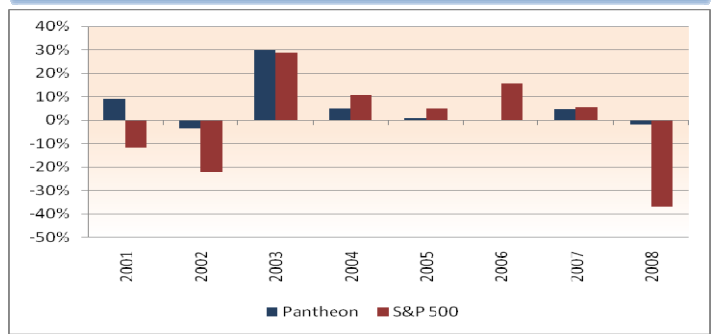
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Time Period	Pantheon Net	S&P 500	Difference
Inception	50.3%	-20.7%	71.0%
7 Year	41.0%	8.3%	32.7%
5 Year	8.7%	-5.8%	14.5%
4 Year	3.5%	-16.5%	20.0%
3 Year	2.6%	-23.0%	25.6%
2 Year	2.6%	-32.6%	35.2%
1 Year	-1.9%	-37.4%	35.5%



Year	Pantheon Net	S&P 500	Difference
2001	9.0%	-11.9%	20.9%
2002	-3.9%	-22.1%	18.3%
2003	29.7%	28.6%	1.1%
2004	5.0%	10.8%	-5.8%
2005	.9%	4.9%	-4.0%
2006	.0%	15.8%	-15.8%
2007	4.7%	5.5%	-.8%
2008	-1.9%	-37.0%	35.0%



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