



MUSINGS FROM THE PANTHEON

DECEMBER 16, 2008

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

UNCLE SAM PLAYS SANTA

While the children dream of Santa and his sled, leveraged investors dream of Uncle Ben and his helicopter.

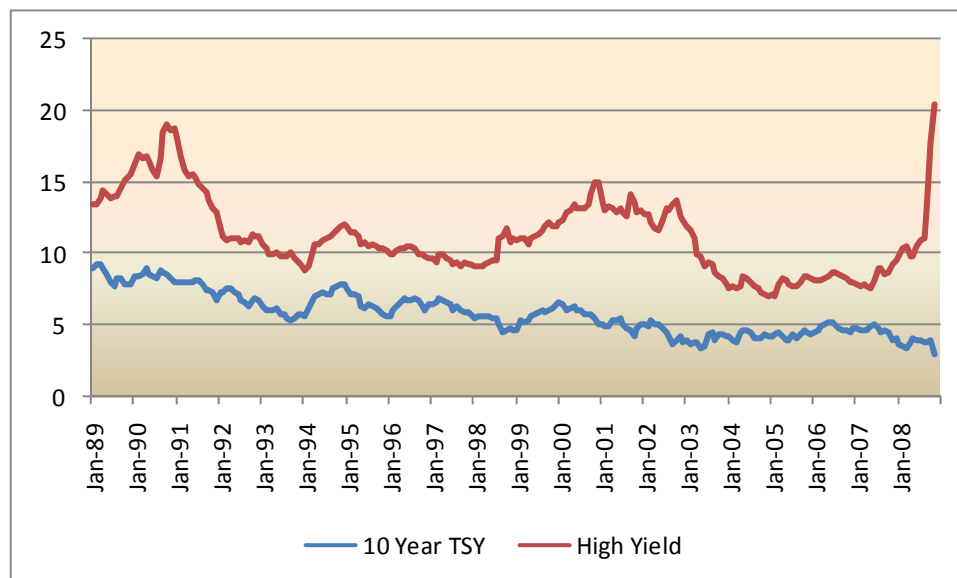
Since late in 2006, I wrote extensively that the United States risked an avalanche as the mountains of debt created over the last three decades neared unstable proportions. Our leaders preached national security since 9/11, but few said anything about economic security. And today we witness the enormous financial stress afflicting our economy for failed and negligent economic stewardship. From the Bush-Cheney belief of “deficits don’t matter” to the Greenspan-Bernanke policy of ignoring bubbles to the Frank-Schumer FNMA and FHLMC love fest, we now inherit an economy on the verge of depression. To make matters worse, we are beholden to China, Russia and the Middle East to fund our massive and growing deficits. Fortunately for us, relations remain symbiotic as they need us as much as we need them.

The stock market rallied from its lows over the past few weeks. And many pundits called the bottom. I remain hopeful but unconvinced. First, I believe consumers entered a period of shock in November. Everyone around the world watched markets implode, glued to the financial news. Few ventured out to shop or dine. As a result, retail commerce virtually shut down. But by Thanksgiving, consumers began adapting to the new world. Black Friday deals, never imagined in good times, enticed consumers to stores. And moods improved while retailers breathed a sigh of relief. Stock markets cheered the worst belonged to yesterday.

But now I fear that November’s consumer malaise has spread to the corporate world. CEO’s realize this recession will prove neither short

nor shallow. For while their equity share prices improves modestly, their cost of debt remains in the stratosphere. The Federal Reserve’s massive intervention into commercial paper markets allowed companies to again issue

High Yield Bonds Now Above 20%



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short-term debt, although at still wide spreads to treasuries. But as the Financial Times noted, "And while it is helpful that US companies can now roll over their short-term commercial paper, refinancing longer-term debt is still crippling expensive. Last week, Altria, the US tobacco company, issued bonds at 600 basis points over Treasuries, for a yield of almost 10 percent. Yet this is a company with no net debt and the abnormally stable cash flow that comes from having addicted customers." Over fifty percent of US corporate debt rates below investment grade. According to Merrill Lynch's High-Yield Corporate Bond Index, junk bonds on average now yield above 20%! I bet if I told you on January 1, 2007 that high-yield debt would yield 20% by December, the vast majority would have guessed inflation was the culprit. But that's the kicker, paying 20% for debt in a deflationary environment shocks any CEO. Perhaps that explains why no new junk bonds came to market in November or December. But can any company prudently commit to long-term capital outlays funded by rolling over short-term commercial paper?

The result, capital outlays get slashed. And even more ominous, payrolls get slashed. In the last three months, payrolls declined by over 1.25 million. The number of people working part-time for economic reasons increased over 50% in

2008 to 7.5 million. Recent data signals layoffs quickened in December. So a vicious cycle unfolds. Companies lay off workers who reduce consumption which prompts more layoffs and a self-reinforcing downward cycle follows. So how can you stop the negative feedback loop?

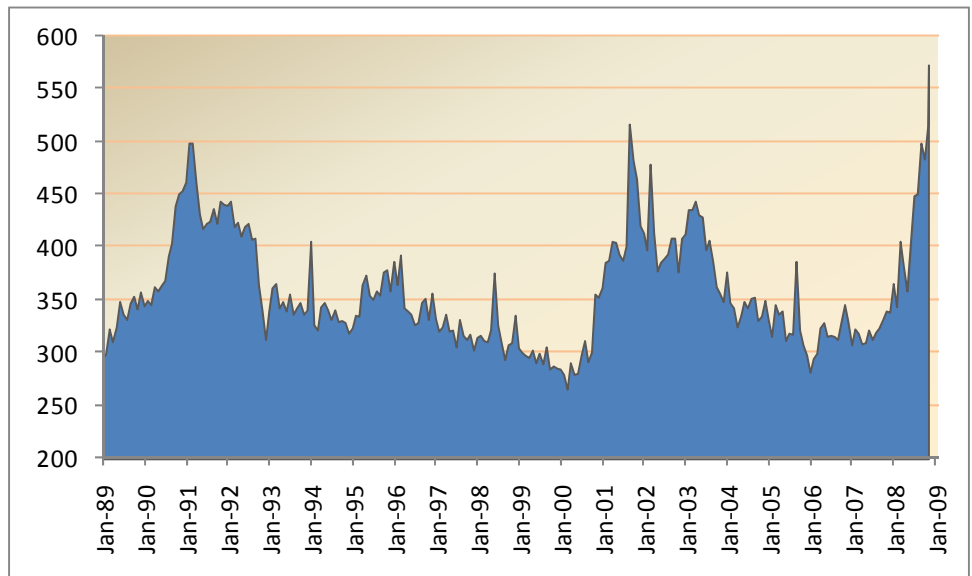
The only hope rests with massive government intervention. And that's what we are getting.

The press continues to report about the \$700 billion bailout. While that number belongs to the Congressional bailout, we surpassed \$700 billion long ago. Since August, the Fed created \$1.4 trillion out of thin air, accepting questionable assets as collateral. In addition, the government guaranteed trillions of assets, from money market funds to commercial paper to mortgages: all to thaw credit's freeze. And in some markets, the government's efforts helped ease conditions. But no market for credit currently acts anywhere near normal. And while the government's motives remain good, all these programs carry the enormous risk of "unintended consequences." Why should only banks receive government bail-

Sir, Christmas is when kids tell Santa what they want, and adults pay for it. Deficits are when governments tell adults what they want, and their kids pay for it."

*Mr. Mark Bogard,
December 2008
Financial Times*

Unemployment Claims Surge



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Risk is a Four-Letter Word! T-Bills Yield 0%



outs? Why not include automobile companies? And then why not give to biotechnology? So the first unintended outcome lets everyone blame their woes on the financial environment, never on management, and fly to

Washington hat-in-hand. Another, the Federal Reserve publicly discusses buying mortgages to bring rates down to 4.5% to help housing prices and let homeowners refinance. But now anyone about to buy a home waits, opting to hold off for lower rates, and further depressing housing. And with demand for investment banking falling off a cliff, wouldn't fewer competitors help survivors earn satisfactory returns? But no, the government bails out the weak with the strong, driving profits to zero for all. I don't know the future, but I do know without greater transparency, Washington's effort to stem the downward cycle will not be driven by free, or even "on-probation", markets.

Last year I wrote that for my grandmother, after living through the Great Depression, debt was a four-letter word. William McChesney Martin, Jr. served the longest term as Federal Reserve Chairman, from 1951 to 1970. When asked about his central banking philosophy, he famously quipped, "to take away the punch bowl as the party gets going." Compare this philosophy to current Chairman Bernanke's in

2002, "Understandably, as a society, we would like to find ways to mitigate the potential instabilities associated with asset-price booms and busts. Monetary policy is not a useful tool for achieving this objective, however. Even putting aside the great difficulty of identifying bubbles in asset prices, monetary policy cannot be directed finely enough to guide asset prices without risking severe collateral damage to the economy." So perhaps living through a Great Depression alters your view of bubbles built on an ocean of debt. And now Bernanke realizes he needs to stem the stampede from risk. For today, risk is a four-letter word. When the Federal Reserve must guarantee money market funds, "Houston, we have a problem." A year ago, I thought government could prevent a stampede from occurring. But today's lack of transparency, failure to remove problem assets from the financial system, and global scale of the crisis concerns me. And while bear markets' rally, I take my cues from the bond market for now. And corporate yields still signal more pain.

Before ending on another sour note, the best-

"The total return loss for the ten years ended November 20th, 2008, matches the worst 10-year performance in U.S. stock market history (1929 to 1939)." *Mr. Steve Leuthold, December 2008*



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case made that we reached a bottom in stocks comes from Steve Leuthold. He reports that, "The total return loss for the ten years ended November 20th, 2008, matches the worst 10-year performance in U.S. stock market history (1929 to 1939)." Perhaps, but I am willing to wager that pent-up demand for goods was a little better in 1939 after 10 years in depression than today. I don't think Sears reported record profits in 1938 like Best Buy did last year.

Our hopes rest with Mr. Bernanke and President-Elect Obama. Bernanke must somehow rekindle investors' risk appetite, from banks to hedge funds to senior citizens. This task

proves more difficult each day. But he does have a printing press and a helicopter that lifted off weeks ago. While the children dream of Santa and his sled, leveraged investors dream of Uncle Ben and his helicopter. Obama needs to invest in infrastructure and create the most jobs for each taxpayer dollar spent. Infrastructure spending is desperately needed in the U.S. But I read a wonderful quote from a Mr. Mark Bogard in the Financial Times, "Sir, Christmas is when kids tell Santa what they want, and adults pay for it. Deficits are when governments tell adults what they want, and their kids pay for it." I fear for my children's future, but pray the mother-of-all bailouts works.

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Pantheon Investments, LLC.©



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