



## Market Commentary

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## Household Credit Turns Negative

Never before has household borrowing contracted by so much in a single quarter. Today, the Federal Reserve released its third quarter Flow of Funds Report, and it showed that U.S. households contracted borrowing by \$117 billion during the quarter. Most of that came from a \$259 billion contraction in home mortgage net new borrowing. In other words, the amount of new money and credit entering into the system from the largest segment of the economy has not only stopped, but has gone into reverse. A negative number in the overall household category has never been recorded throughout the Federal Reserve's history of keeping the flow of funds data. The negative \$117 billion in net new borrowing (perhaps better called net savings) compares to the \$1.4 trillion of annualized borrowing that was occurring during the peak of the housing bubble in the second quarter of 2006.

We have spoken at length about the relationship between credit and money creation, the effect on prices, and the hard dollar environment that we believe we find ourselves in at this time. This contraction in credit can also be seen by foreigners whose net new borrowing fell by the largest amount ever -- over \$500 billion. The Federal Government, largely through the expansion of the Federal Reserve's balance sheet, provided a massive offset to credit by growing net borrowings at an annualized rate of \$2,078 billion -- a massive 39% annualized increase for the quarter.

### Why Does This Matter?

This matters because, in order for monetary policy to be successful in fighting recession, the Fed must increase the money supply by giving banks and individuals more money. They do this in a variety of ways, but the most common approach is lowering interest rates while simultaneously infusing banks' balance sheets with cash. Those dollars must then be lent out to individuals and businesses that make investments which have a multiplier effect on the economy, thus creating expenditures, revenue, jobs, and some upward pressure on prices.

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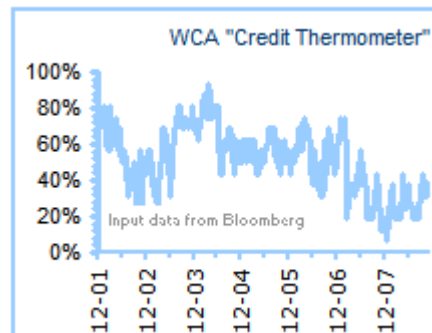
What the Flow of Funds data shows us is that the normal credit cycle (which usually troughs out at a two-thirds drop-off in net new credit) is not what is happening this cycle. The lack of willingness by banks to lend (to protect their capital position), coupled with individuals' and businesses' lack of interest in borrowing (possibly because home values remain elevated or because leverage ratios are uncomfortably high), prevent new credit and money from being created. This lack of credit creation is contributing to downward pressure on both asset prices and consumer prices and exacerbating both recovery and de-leveraging efforts.

## Government's Role

The programmatic response by government to engage in deficit-financed spending during recessions is well entrenched. Thus, we expect to see further efforts for the government to step up borrowing and spending in the absence of private-sector initiatives. The data we now have shows that government borrowing relating to the various rescue efforts is creating credit, but much of that credit is remaining within the banking system itself to replace capital that is being written off. To date, mortgage-related write-offs in the United States has exceeded \$600 billion, and globally, those write-offs are approaching \$1 Trillion, according to Bloomberg.

Overall rescue efforts, including new guarantees, credit facilities, equity purchases, and loans to financial firms, are nearing \$8 Trillion in size. Granted, one hopes that most of those guarantees (which do not include the now explicit guarantees of packaged Fannie and Freddie debt) will not require payment by the government, and not all the loans and equity injections will be without some eventual return of principal. We have seen the Federal Reserve's balance sheet swell to \$2 Trillion (from \$1 Trillion) in recent weeks, because the losses incurred by the financial system have been in excess of what the

banking system could absorb without government assistance. On balance, these efforts have not been viewed as conclusive victories, as many of the credit spreads we follow remain very elevated and are rising while full-faith-and-credit government bonds and bills are signaling that extreme stress remains despite the efforts of the Federal Reserve and Treasury. We continue to monitor for signs of credit improvement as measured by the WCA "Credit Thermometer," and while some initial improvement followed the announcement of the TARP program last fall, the trends have once again begun to gradually move in the wrong direction. This remains a troubling sign that suggests continued strain in the banking system. It is this system which remains reluctant to lend despite the government efforts to initiate a program of expansionary monetary policy.



## What Is Needed to Create a Bullish Case?

The re-pricing of risk in financial markets has been a positive start. Credit spreads and equity risk premia are all much higher than before the process of debt-deflation began. Home prices have fallen by roughly 20%, which makes that asset more affordable than it had been. These adjustments are creating value in the marketplace for private capital and eventually could yield better returns for risk-taking investors. In the meantime, falling asset prices are making it difficult for households and financial institutions to reduce debt and balance sheet leverage.

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This phenomenon can be clearly seen by looking at the interplay of equity and debt on the U.S. household balance sheet. Because asset prices (home prices and stock market values) are falling faster than debt can be paid off, the official tally for U.S. household equity has contracted by \$7.1 trillion in the last four quarters. By comparison, the bursting of the technology stock bubble resulted in only a \$4.1 trillion loss of household equity. While debt and leverage remains the "Achilles heel" of household finances, the collective efforts to liquidate assets to pay down debt at all levels of the economy are exacerbating the leverage problem as the debt-to-equity ratio for households rises sharply from 21% of equity to 26% of equity in a little over a year. Falling employment, wage concessions, and further erosion in asset prices could make matters worse over the near term and pose additional risks to lenders and financial institutions exposed to weak creditors.

## Current Portfolio Posture

While we clearly see that markets have corrected by historic proportions, we are concerned that the monetary transmission mechanisms through which expansionary monetary policy are implemented are not functioning properly at this time. Without such tools, it is difficult to see a rapid recovery from this recession as we have seen in past cycles. The data we received today in the form of the Flow of Funds Report from the Federal Reserve serves as a sobering reminder of the challenges we face on the road to eventual recovery.

Therefore, we continue to await signs of improvement in financial market conditions before committing any additional risk capital to our tactical asset allocation portfolios. Our current portfolio continues to emphasize high grade and liquid assets, including government bonds and bills.

## Recommended Asset Allocation

	Growth	Balanced	Conservative
<b>INCOME &amp; OTHER</b>	41.0%	66.0%	91.0%
<b>DOMESTIC BONDS</b>	39.8%	64.0%	88.2%
Money Market	1.2%	2.0%	2.8%
Short-Term Treasuries	8.7%	14.0%	19.3%
Intermediate Term Treasuries	6.8%	11.0%	15.2%
Long-Term Treasuries	6.2%	10.0%	13.8%
Extended Duration (LT Strips)	6.2%	10.0%	13.8%
Investment Grade Corp Bonds	7.5%	12.0%	16.5%
High Yield Corporate Bonds	3.1%	5.0%	6.9%
<b>COMMODITIES &amp; OTHER</b>	1.2%	2.0%	2.8%
Preferred Equity	1.2%	2.0%	2.8%
<b>COMMON STOCKS</b>	59.0%	34.0%	9.0%
<b>DOMESTIC COMMON STOCKS</b>	59.0%	34.0%	9.0%
<b>U.S. SIZE &amp; STYLE</b>	59.0%	34.0%	9.0%
Large Cap Growth	17.4%	10.0%	2.6%
Large Cap Value	17.4%	10.0%	2.6%
Mid Cap Growth	6.9%	4.0%	1.1%
Mid Cap Value	6.9%	4.0%	1.1%
Small Cap Growth	5.2%	3.0%	0.8%
Small Cap Value	5.2%	3.0%	0.8%
<b>TOTAL PORTFOLIO</b>	100%	100%	100%

## Recommended Sector Allocation

	Suggested Weight	S&P 500 Weight*
<b>U.S. Equity Sectors</b>		
Energy	0%	13%
Technology	12%	17%
Materials	4%	3%
Industrials	4%	12%
Consumer Discretionary	10%	8%
Health Care	26%	12%
Utilities	13%	4%
Consumer Staples	16%	10%
Telecommunications	0%	4%
Financials	14%	18%
Total	100%	100%

\* Source: Bloomberg

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