

Basic Points

Capitalism Faces Its Greatest Challenge

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Basic Points

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Capitalism Faces Its Greatest Challenge

Overview



The global financial crisis that began on Wall Street could mark the end of the Reagan-Thatcher era in which capitalist economic principles gained acceptance across most of the world.

Wall Street's excesses and blunders sent the US and much of the world into recession. The worst month for US stocks in decades amid panic about a 1929-style collapse also proved to be the crucial factor in turning an electorally decisive 6% of undecided American voters into enthusiastic Democratic voters, electing a President and Congress determined to change the consensus on the respective roles of capitalist principles and government in the economy. Although Barack Obama's long campaign promising change had been imprecise about just what that change would be, after the TARP (Troubled Asset Relief Programme) congressional vote fiasco, most voters became convinced it would start with a return to pre-Reagan principles about the respective powers and privileges of government and the markets.

Somewhere, Milton Friedman is musing at the dramatic vindication of one of his core principles: the main problem with socialism is socialism; the main problem with capitalism is capitalists.

The tragedy is that it was one, numerically small, group of misbehaving capitalists that delivered this challenge to Adam Smith-style concepts of economic freedom as the most effective—and ultimately fairest—economic system.

This month we look at the investment implications of the possible repeal of a political and economic philosophy which undergirded 26 years of global growth—economically and in stock market valuations. We are leaving our cautious Asset Mix recommendations largely unchanged, while looking for the confirmation that the third Mama Bear stock market* in 35 years is ending. We have slightly boosted our recommended exposure to Emerging Markets, with the caveat that investors exclude Eastern Europe and Russia. Those economies share terrible demographics and dubious economic policies.

* A Mama Bear Market is the most vicious bear market—1929, 1973, 1981, as discussed in our book *The New Reality of Wall Street*, (2003).

Recommended Asset Allocation

Recommended Asset Allocation (for U.S. Pension Funds)		
	Allocations	Change
US Equities	20	unch
Foreign Equities		
European Equities	6	unch
Japanese and Korean Equities	1	-2
Canadian and Australian Equities	7	unch
Emerging Markets	12	+2
Bonds		
US Bonds	8	unch
Canadian Bonds	5	unch
International Bonds	11	unch
Long-Term Inflation Hedged Bonds	10	unch
Cash	20	unch

Bond Durations		
	Years	Change
US	4.00	unch
Canada	4.25	unch
International	3.75	unch

Global Exposure to Commodity Stocks		
		Change
Agriculture	35%	unch
Energy	28%	unch
Precious Metals	28%	unch
Base Metals & Steel	9%	unch

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

Capitalism Faces Its Greatest Challenge

The word “capitalism” was actually Karl Marx’s term for an industrial economy based on privately-owned enterprises that began in England and was analyzed so brilliantly by Adam Smith in his seminal work published in 1776. Marx made organized labor the ruling class in the dictatorship of the proletariat that would control economic and political development, and displace what he saw as rule by the capitalists who owned the means of production.

The emergence of publicly-traded joint stock companies as the ownership vehicle of free enterprise-oriented societies changed this boss/worker relationship as the core of economic activity. James Burnham, the intellectual leader of the Trotskyite branch of Communism, broke with his comrades when he published *The Managerial Revolution* in 1941, in which he said that ownership of large enterprises was largely separated from management of these firms: the true ruling class was executives, managers and bureaucrats. His insight has been validated: pension, endowment and mutual funds own a far larger share of American and European industries than the top executives of most large companies, let alone the ownership by public market investors.

The British Empire really came into being after Smith’s death “through an oversight in the Foreign Office,” as historians later quipped. But, like its later European imitators, its driving forces were (1) a drive to control commodities as the feedstock for growth of British industry, and (2) to create controlled markets for output from those factories.

America was the first real experiment in free enterprise and democracy based on individual liberties and opportunities, and America is centered on the individual like no other civilization.

Most authors, pundits and politicians chose to use Marx’s term—not “free enterprise”—to describe economies in which private equity ownership was the core of both economies and societies where government was the rule-maker, and shared in profits and earnings—generated primarily by the collective, competing activities of investors, entrepreneurs, privately-owned businesses and publicly-traded corporations.

America was the first real experiment in free enterprise and democracy based on individual liberties and opportunities.



A hinge of history has turned...

What we identify as the core concept of the Reagan-Thatcher “revolution” was that greater economic growth and prosperity were achieved by relying primarily on individuals—and not on government programs, or on Gosplans, or on tripartite systems with powers shared between governments, leaders of big businesses and unions. Smith believed in economic development generated primarily by the liberating and progressive forces unleashed through free trade and drastic reduction in government controls (through licensing, state-granted monopolies and state intervention into economic activity). The triumph of those ideals in our time was particularly manifested in the progressive breakdown worldwide of tariffs and trade constraints through successive agreements on global trade—GATT and WTO.

The continuum of societies moving from reliance primarily on government to reliance on the private sector as the engine of growth has been the story of history’s greatest sustained global progress during the period from 1982 until this year. The most spectacular example was, of course, China, which, under Deng Xiaoping, unleashed the energy, savings, and risk-taking of its citizens to achieve the most impressive growth of an emerging economy in history.

As this pattern became established, nations that engaged in major economic interventions, bailouts and protectionism were soundly lectured—by the US, the IMF and other internationally-important theorists—about the unwisdom of state support for losers. Among those who were soundly lectured were the governments in Japan during the 1990s. “Let your bad banks fail!” was the virtually-unanimous demand from the piously capitalistic centers of power and influence.

Then, suddenly, across most of the major economies in the “capitalist” world came the greatest flood of bailouts in history. From the city where Alan Greenspan had lectured backsliders abroad has come more than a trillion dollars in support of investment banks, commercial banks and AIG. Next in line come the now-diminutive Big Three automakers and various states and municipalities.

A hinge of history has turned, slamming the door on Reagan-Thatcherism.

What swung it was an amazingly-fast sea-change of opinion among central bankers about the primary risk to their economies—from inflation to deflation.

Basic Points

What may help keep the door shut on Reaganism is that the percentage of Americans of voting age who pay income taxes has fallen to just over 50%. One effect of Barack Obama's proposed tax changes, some analysts suggest, could drive that rate down to the tipping point where the majority of voters pay no taxes. Historically, societies in which most adults pay no taxes have tended to succumb to bread and circus demagogy, as politicians compete with each other to offer bigger "soak the rich" handouts to voters who know they won't have to pick up any part of the tab.

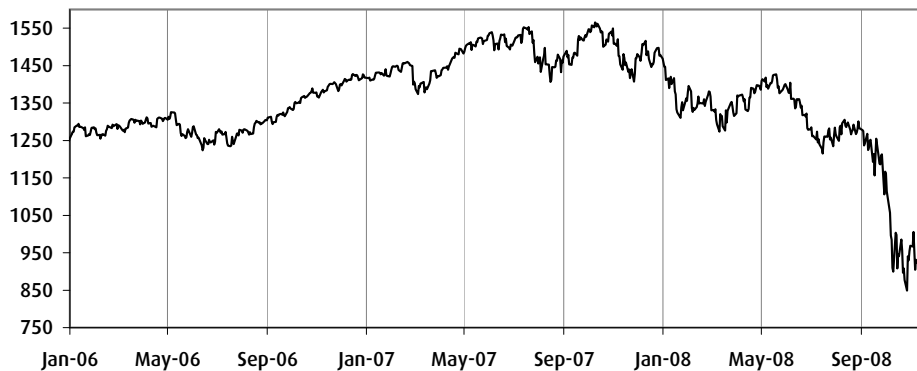
And free market economics move from endangered species to extinction.

Historically, societies in which most adults pay no taxes have tended to succumb to bread and circus demagogy...

I Hallowe'en-Style Horrors Come Early

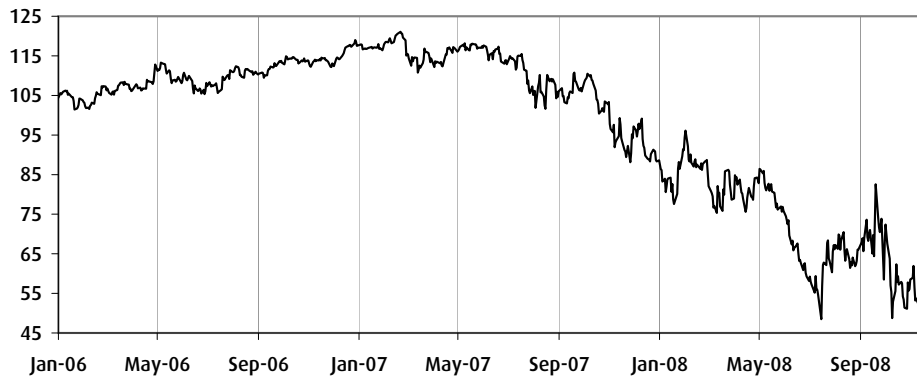
S&P 500

January 1, 2006 to November 13, 2008



Bank Stock Index (BKX)

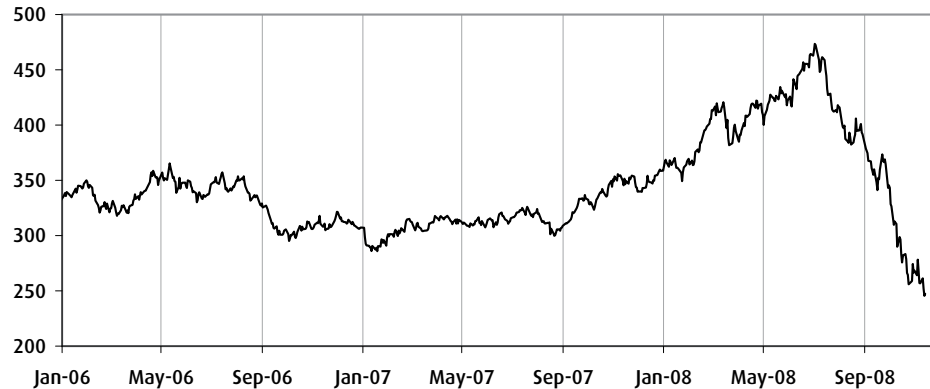
January 1, 2006 to November 13, 2008





...central bankers across the world, in a neck-snapping switch of frights, swung to face *deflation* terror.

**RJ CRB Futures Index
January 1, 2006 to November 13, 2008**



As of July 11th, the world's central bankers were focused on inflation and/or stagflation. Soaring commodity prices and rising rates of PPI and CPI at a time of a desiccating dollar were threatening a revival of the horrors of the 1970s—the nightmare decade for Basel members.

Then came the dramatic announcements of July 13th—the Midnight Massacre—that pledged the US government to backing Fannie Mae and Freddie Mac (F&F), thereby triggering roaring bull markets in bank stocks and the dollar, and a violent bear commodity market. As one rescue and bailout followed another across the US, Europe and then the world, what the Deputy-Governor of the Bank of England would call “possibly the worst financial crisis in history” hammered stock markets across the globe. The worst panic since 1973–74 slashed equity valuations to levels that would have delighted Benjamin Graham.

Suddenly, central bankers across the world, in a neck-snapping switch of frights, swung to face *deflation* terror. Nothing concentrates the mind of a central banker so wonderfully as the knowledge that his country's banking system will be hung out to dry within a month....

...unless he and his colleagues reflate successfully.

This stock market plunge has been a Mama Bear, which means that it ends the long bull market that began August 13, 1982.

Basic Points

It may also have ended the era of growing dependence on free market mechanisms and freer trade that began with the elections of Margaret Thatcher (1979) and Ronald Reagan (1980). The wrongs of a relatively few bankers and their co-conspirator politicians have plunged the entire world into a needless financial crisis, and inflicted serious damage on the wealth and savings of most of the world's population. *(A recent Barron's cartoon shows a man facing the scythe-carrying figure of Death. The specter says, "I'm not coming for you; I'm coming for your 401(k).")*

Among the victims of collateral damage from the September collapse of Lehman and the US stock market was the McCain campaign. Americans watched in horror as banks, insurance companies and S&Ls vaporized, and stocks plunged day after day. Barack Obama remained Presidential and cool, calmly reminding them that this crisis was the latest consequence of Bush economics, and that McCain—as recently as the day Lehman collapsed—had said the US economy was basically sound. The fortnight of statistical ties in the polls swung to an Obama six-point lead which he never relinquished. Voters instinctively came to believe Democratic rhetoric that Wall Street was a Republican preserve, and punished McCain and many other Republican candidates accordingly. (The reality, of course, is more complicated: Wall Street, like the rest of America, is well-populated with Democrats.)

The Katrina-style carnage invoked unprecedented rescue operations led by central banks and governments.

Amid that carnage was an historic collapse in the prices of commodities and shares of commodity producers, turning food and fuel inflation into food and fuel deflation. To the central bankers, this sudden switch freed them to employ outright reflation on majestic scale.

As inflation fears vanished, policymakers no longer worried that money on deposit with banks could be quietly losing its value: now the worry was that the nation was noisily losing its banks.

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Central bankers are much like the rest of us, except that they have so much more money to worry about.

II A Central Banker's View of Inflation History From 1944 to 2006

Central bankers are much like the rest of us, except that they have so much more money to worry about.

Since the meeting at Bretton Woods in July 1944, the dollar has been the official store of value. Gold's role has been marginalized. For many years, the US held most of the world's official gold, and it was illegal for Americans to hold gold except for jewelry or industrial uses. After the war, London became the recognized bullion trading center, and the price rarely moved more than pennies above the officially-fixed value of \$35 an ounce. Only central banks could exchange their gold holdings for dollars at the recognized price, and the US willingly supplied their requests.

The postwar generation of central bankers, economists and policymakers tacitly or openly endorsed Keynes' view that gold was a "barbarous relic." The Depression had not only devastated economies and lives, but had demonstrated the need for monetary stimulus beyond the constraints imposed by supplies of a scarce metal.

Nevertheless, the outbreak of serious inflation after the expiration of wartime price controls reminded the world that monetary and fiscal policies needed to focus on price stability. President Eisenhower spoke to such concerns when he claimed that having a little bit of inflation was like being a little bit pregnant.

That kind of purism did not commend itself to a new generation of economists. They were far more concerned about job-creation and economic growth, and downgraded inflation risks.

The pre-eminent liberal academic economist of the postwar era was Paul Samuelson, author of *Economics*, the most widely-used economics textbook since 1948. His book went through many editions. Some conservatives found it amusing to compare his comments on inflation and monetary policy in succeeding editions. In his first edition, he stated that the Fed need not raise interest rates if inflation did not exceed 3%. In each subsequent edition, the text was identical—he just kept boosting the rate of acceptable inflation by a quarter-point.

By 1962, Washington had become deeply concerned about the persistence of large current account deficits and large outflows of gold. President Kennedy gained Congressional approval for his Interest Equalization Tax that imposed a heavy tax on Americans who invested in *any* foreign assets. Pan Am, one of

Basic Points

the nation's two flagship international carriers, ran full-page advertisements urging Americans to slow down the gold drain by flying with them, rather than with foreign carriers.

The leading foreign critic of American monetary policies was Charles de Gaulle, whose monetary advisor was the dogmatic Jacques Rueff. France kept building its foreign exchange reserves with "the enduring value of gold" by exchanging its dollars (earned mostly from American tourists and wine-drinkers) for the Fed's dwindling supply of gold.

But de Gaulle proved to be right, because monetary, fiscal, welfare, and labor policies in the US, and across the industrial world fed inflationary pressures. With US gold reserves flowing abroad at increasing speed, Nixon closed the gold window in August 1971. Then, in an election-driven change of trade policies, he laid the groundwork for the US Dept. of Agriculture's (USDA) massive, subsidized sales of wheat to the USSR. Before it was halted, the US had shipped 25% of its wheat crop to the Soviets. Unknown to the USDA, Russia and Ukraine had suffered terrible crop failures. This proved to be "The Great Grain Robbery." Wheat prices doubled, driving other grain prices higher. The giant El Niño wiped out the anchovy harvest, unleashing food inflation across the world. The misery spread from foods to fuels with the Yom Kippur War, and the trebling of oil prices. Inflation surged, driven by aggressively expansionary monetary prices. Commodity inflation was transmitted into Western economies through soaring wage rates. Despite recessions and wage-price controls, powerful public sector unions were able to win outsized gains, and their successes in winning COLA contracts (Cost of Living Allowances) spread into major private sector contracts—and pension fund provisions, and became codified standard practices.

The Republican-led Congress finally eliminated the ban on Americans' holdings of gold in 1974, and the gold futures markets quickly developed. Its powerful performance became a highly-publicized statement that inflation was continuing to spin out of control. (President Ford's inflation-fighting strategy—Whip Inflation Now (WIN) Buttons—proved, unsurprisingly, inadequate to the task.) Under his successor, Jimmy Carter, inflation exploded. By the end of a miserable decade, precious metals had become the only major asset class to deliver double-digit returns. Treasury yields skyrocketed. (We marketed the pension fund management products of Mutual Life of Canada in those years by telling pension conference attendees, "The proper holding period for long-term bonds in this inflationary environment is the amount of time you hold a hand grenade after you've pulled the pin.")

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The economic history of those two decades can justly be called a Golden Era for central banking.

In the middle of this disastrous decade, the Nobel Committee finally got around to recognizing the work of the Great Dissenter from mainstream economics—Milton Friedman. He said that inflation was “always and everywhere a monetary phenomenon.” He decreed that central bankers should not try to engage in stop-go monetarism by following pricing signals, but should aim at steadying economies through consistent monetary policies that promoted growth without stimulating inflation. He also advocated a return to economic liberalism, with a reduced role for government and greater reliance on private initiative.

His ideas got their real test under Ronald Reagan and Margaret Thatcher, for whom he was the economic pole star. They owed their election victories to voters’ increasing fears that inflation was destroying the economy and their futures.

Jimmy Carter’s disappointing Presidency ended in stagflationary recession, with fed funds rates above 20%.

As of August 12, 1982, the Dow-Jones Industrials Index adjusted for inflation—the “Constant Dollar Dow”—was back to October 1929 levels.

A day later, Fed Chairman Paul Volcker, a Democratic appointee whom Reagan solidly backed even as the nation buckled under 20% interest rates into the worst recession since the Depression, declared victory over inflation and cut the fed funds rate, launching the greatest bond and equity bull markets of all time.

What followed was a 24-year decline in inflation and interest rates. The US experienced two brief recessions, but Britain and Canada experienced only one. The economic history of those two decades can justly be called a Golden Era for central banking. The best-known banker of the era—Alan Greenspan—was the subject of adoring books, and was even knighted by the Queen.

Ironically, after these years of narrowing standard deviations for the economy, and falling inflation, and the greatest growth in global equity prices in history, when the recently-retired and suddenly-rich Greenspan published his autobiography, he titled it *The Age of Turbulence*. This was the equivalent of Louis XVI publishing his autobiography in 1787 and calling it *The Age When Monarchy Proved The Philosophes Wrong*.

The good times for the Basel brandy-and-cigars club were not to last.

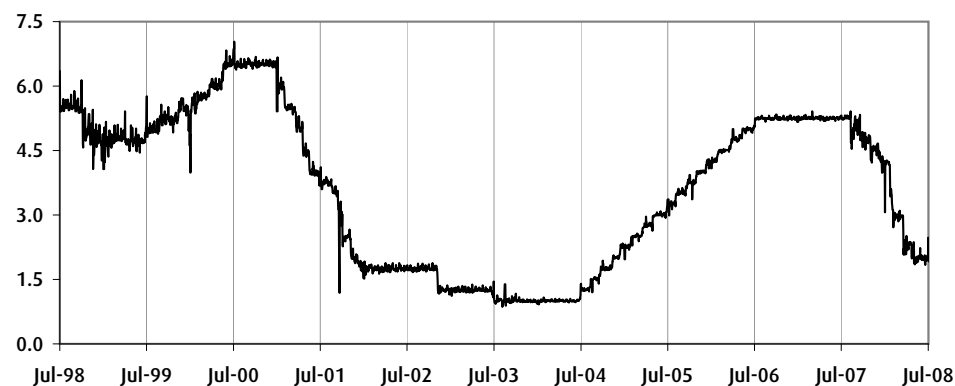
Basic Points

Greenspan swung from restraint to rapid monetary expansion after the collapse of Long-Term Capital Management, a company whose bosses included two Nobel Laureates. Result: Nasdaq leapt to a Triple Waterfall peak of 5200, followed by collapse, triggering devastation for 401(k)s of gullible Baby Boomers who believed Wall Street's shameless sales pitches—and a recession that began just as George W. Bush was entering the White House. In retrospect, both Bushes can, with some justification, blame Greenspan for misconceived monetary policies that mortally wounded their Presidencies. Having helped drive the US into an unnecessary recession, Greenspan sought to undo the damage by holding the fed funds rate at a surreal 1% long into the recovery. That misconceived monetarism turned the housing recovery into a boom, and then a mania, and, on Ben Bernanke's watch, into the worst housing bust since the Depression. It also spawned hundreds of *nouveaux-riches* in the la-la leveraged lands of hedge funds and private equity firms, and created jobs on Wall Street for a horde of mathematics and physics PhDs. What happened on the Street was the capitalist version of what had happened in Pakistan, where the top scientists were recruited to build nuclear bombs, not to create an industrial economy that could compete with India. The Street, following that model, put a significant percentage of America's inadequate pool of mathematics and physics PhDs to work devising structures that would eventually destroy American banks in sequential explosions. The airborne pollution from those explosions weakened and destroyed financial institutions and stock markets across the world.

Nothing became Greenspan in his career as the timing of his leaving it.

Nothing became Greenspan in his career as the timing of his leaving it. He exited the Fed just as commodity inflation pressures were starting to build, the housing bubble he had inflated was about to burst, and the consequences of his failure to go to the mat against Fannie and Freddie and their Congressional shills were about to challenge the survival of the American banking system.

Fed Funds Rates
July 1, 1998 to July 1, 2008

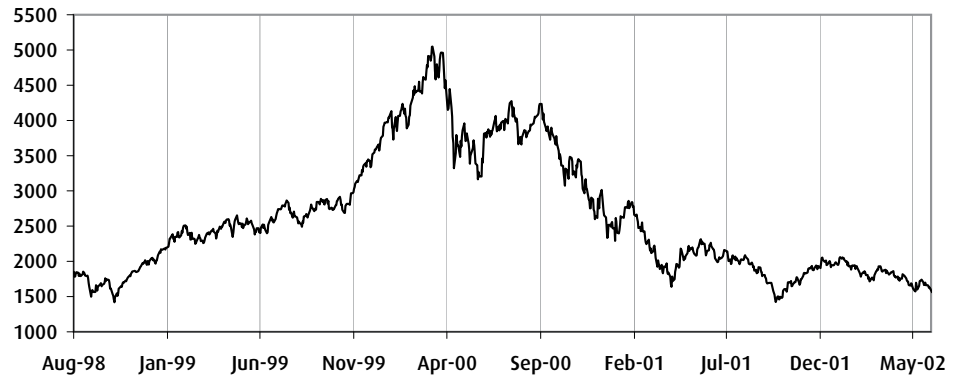


Source: The Federal Reserve Board (<http://www.federalreserve.gov/>)

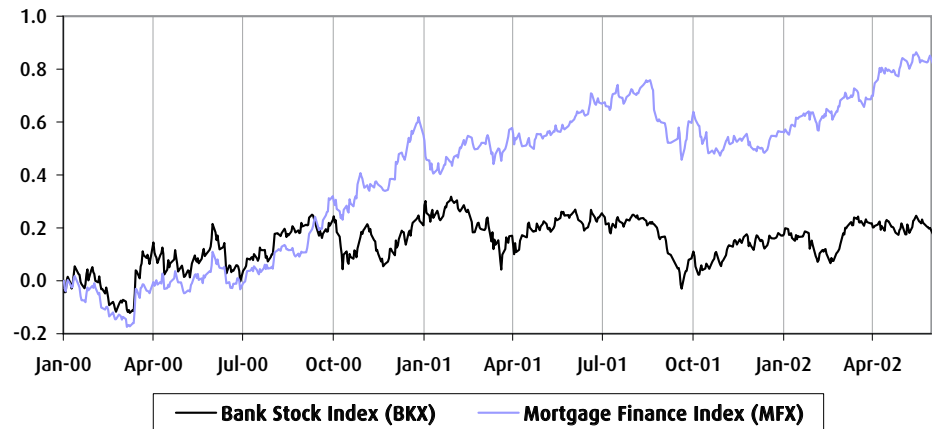


**...in each case,
extremely loose
monetary policies
turned a bull market
into a bubble...**

**Nasdaq
August 1, 1998 to June 1, 2002**



**Bank Stock Index (BKX) vs. Mortgage Finance Index (MFX)
January 1, 2000 to June 1, 2002**



The housing and tech bubbles had certain common characteristics:

- in each case, Wall Street was one of the guilty parties: with tech, the co-conspirator was Silicon Valley; with housing, the co-conspirators were Fannie & Freddie, their Congressional front-men and the sleaziest of the mortgage originators, including Countrywide, New Century Financial and other now-defunct entities;
- in each case, extremely loose monetary policies turned a bull market into a bubble;
- in each case, the asset class had particular appeal to relatively-untrained Baby Boomer investors as a “can’t miss” investment;

Basic Points

- in each case, America led the way to boom and to disaster, with other OECD nations following; Germany was the most conspicuous imitator of American tech folly; Britain, Spain, Ireland and Hungary have, to date, been the most conspicuous imitators of American housing folly. (Could Canada be next?)

What Kind of Bear?

When it became apparent a year ago that a bear market had arrived, the next challenge was to predict its severity. (The bear market was confirmed when the S&P reached a new high in October despite a major breakdown in financial stocks. That kind of divergence has always been a signal that the bulls are on their way to the abattoir.) Would this be a Papa Bear Market, a cyclical bear whose arrival announces a coming recession? Or would it be a Mama Bear, a devastating collapse that would end an entire major economic era?

Just as hikers and campers are warned that the most dangerous beast to encounter on the trail is a Mama Bear with cubs, so investors have learned that bear markets have differing severity.

Until August we had assumed this was “merely a Papa,” which implied a downside for the S&P in the 25% range, and a mild recession. As the dimensions of the global financial crisis unfolded, smashing financial markets across the world and sending one economy after another into recession, we realized this was a Big Mama.

We had worked and survived (barely) through the two earlier Mama eras—the stagflationary collapse of 1973–74 in which the Dow’s P/E briefly broke below six, and the 1980–82 agony driven by the brutal—but necessary—monetarist policies of the early Thatcher and Reagan years. When the fed funds rate was more than twice the average Return on Equity of US corporations, and when stocks as an asset class were at 52-year lows, the trumpeted “cult of equity” of the Bernie Cornfeld bubble years seemed to have as little practical justification as beliefs in witches or extra-terrestrial invasions.

By mid-October this year, the S&P was down from its October 2007 high by almost exactly the percentage it had fallen in those earlier Big Mama eras—in roughly half the time. Could this mean the 2008 Mama would prove to a reincarnation of the 1929 Grizzly that ravaged markets for a decade, smashing equity prices by 90%?

The 1929 model of Mama was a product of deflation; both modern Mamas have been products of inflation—one as inflation was soaring, and one as it was peaking in advance of a two-decade collapse.

...Britain, Spain, Ireland and Hungary have, to date, been the most conspicuous imitators of American housing folly. (Could Canada be next?)



Today's Mama Bear bared her fangs at a time US CPI had reached a 15-year high of 5.4%...

The Seventies model was driven by the fallout from the Keynesian and Phillips Curve-inspired inflationary policies of central bankers at a time of serious inflationary pressures created by food and fuel inflation, and by the ability of powerful unions to extract real wage gains during the worst recession of the postwar era. It was also driven by demographic pressure, as millions of job-seeking Baby Boomers left schools and universities at a time the economy was already in contraction from inflation shock. Unemployment rates climbed to peaks that triggered social disruption and drove governments from power.

The Eighties model was driven by the *disinflationary* policies of Friedmanesque central Bankers. The cure nearly killed the patient, but it worked—beyond the wildest dreams of investors whose nights had previously been dominated by nightmares.

Most of our clients came into the investment and financial industries after both of the bookend Mama Bears of the stagflation era had disappeared into history.

None has seen the deflationary Crash of 1929 that began with mild inflation and was driven by disastrous monetary, fiscal and trade policies. Nevertheless, its atavistic power to evoke fear in the consciousness of central bankers, investors and voters continues.

Today's Mama Bear bared her fangs at a time US CPI had reached a 15-year high of 5.4%: uncomfortable, but at a level that could be relatively painlessly constrained by moderate tightening, such as the ECB was employing—while the Fed was still in easing mode.

But the deflationary impact of the housing and banking busts and the collapse of bank stocks have meant that the Fed—and all other central banks—have had no choice but to throw inflation fears to the wind.

Basic Points

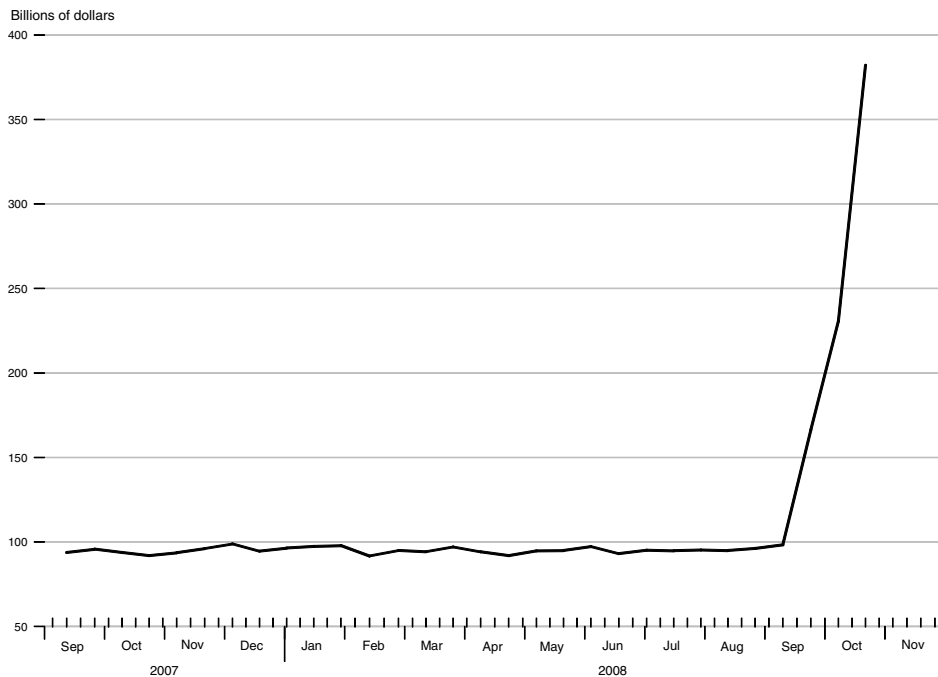
III Bernanke, Paulson, Brown and Darling Take Charge

Bernanke's response has been not only unprecedented, but truly astonishing. His tribute to Milton Friedman on the great man's 90th birthday included a promise that the Fed would not make the mistake it had made in 1930. He noted Friedman's observation that deflation was always easier to defeat than inflation: it simply involved pumping money into the economy. Friedman even joked that the Fed could scatter money from airplanes.

Bernanke has taken off to The Wild Blue Yonder...

Bernanke has taken off to The Wild Blue Yonder:

US Adjusted Reserves November 6, 2008



To the average of two maintenance periods ending:	Compounded annual rates of change, average of two maintenance periods ending:							
	10/24/07	01/16/08	03/26/08	04/23/08	05/21/08	06/18/08	07/30/08	08/27/08
03/26/08	7.2							
04/23/08	0.4	-14.0						
05/21/08	3.8	-5.9	-5.1					
06/18/08	3.9	-4.1	-1.9	16.2				
07/30/08	3.1	-3.5	-1.8	8.2	1.0			
08/27/08	3.5	-2.2	-0.1	8.1	2.8	2.0		
09/24/08	46.8	56.9	91.5	130.0	161.7	239.8	760.5	
10/22/08	230.2	347.0	653.3	985.7	1499.8	2831.6	15896.2	195067.7

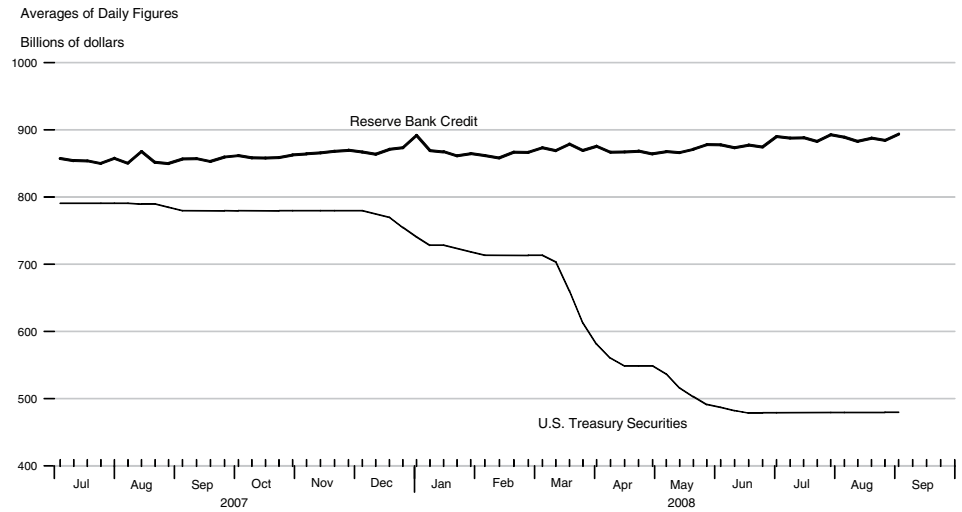
Source: Federal Reserve Bank of St. Louis; US Financial Data; November 7, 2008



...banks that had believed in their own risk models with the fatal fanaticism of those medieval alchemists who had willingly accepted the risk of the death penalty...

This latest response to the economic crisis came after the Fed's initial program of large-scale swaps of Treasuries for illiquid and dubious paper was threatening to erase the basic firepower of the world's major central bank.

Reserve Bank Credit and Federal Reserve Holdings of U.S. Treasury Securities September 4, 2008



Source: Federal Reserve Bank of St. Louis; US Financial Data; September 5, 2008

Crisis-driven monetary explosions come when central bankers decide that the risk of deflation is so great that they can afford to shelve their basic fears of inflation. "We can deal with the inflation risk later," they say to themselves, fingers crossed.

Bernanke is ably assisted in this almost Weimaresque operation by the once-cautious Treasury Secretary, Henry Paulson, whose bailout of the morally and financially-challenged F&F has, in effect, boosted the national debt by nearly 40%. That was for openers. He followed that with TARP, which gained grudging Congressional approval after two dramatic votes in the House. TARP was to commit the Treasury to buying up to \$750 Billion of illiquid, dubious and downright putrid "investments" from banks that had believed in their own risk models with the fatal fanaticism of those medieval alchemists who had willingly accepted the risk of the death penalty to convince rulers to try their potions.

Basic Points

Mr. Paulson wisely changed his TARP acquisitions program to follow the shrewd strategy unveiled by British Prime Minister Gordon Brown and his Chancellor, Alistair Darling. The British rescue operations start from the premise that the banking system is over-levered and incapable of raising new equity. Solution: inject new equity massively. That relieves the banks of struggling to raise cash through fire sales of opaque assets for whatever bids are available, driving down valuations across the system—even for banks that had seemed adequately capitalized. Rather than creating some massive dumping ground for assets that will be big liabilities for future regimes, Darling and Paulson beef up bank balance sheets, using the “magic” of the leverage principles of the Basel Accords to get banks back on their feet.

This is a shrewd strategy that should work.

How Did All Those Banks Get Into Trouble at Once?

The financial catastrophe was rooted in three kinds of terrible decisions driven by greed:

First, the banks levered themselves up to—and beyond—the hilt. American banks generally stuck to permitted Basel I leverage levels: teens. Many European banks, which were enthusiastic buyers of Wall Street’s most highly-perfumed paper, followed the more-agreeable rules of Basel II, which gave them room to lever up forty or more times—as long as their Value At Risk (VAR) models showed that their assets were near-zero risk. That they rushed to shed the wise controls of Paul Volcker’s handiwork in Basel I and switch to the kinds of models that had destroyed Long-Term Capital Management shocked Paul Volcker, and also led to the publication of the great business book of our time, *The Black Swan* by Nassim Taleb. That book was published nearly a year before the banking crisis reached Page One. Fortunately, the Canadian banks generally stayed within Basel I ground rules.

Second, the bankers used Babelesque Towering leverage to load up with paper on and off their balance sheets, with complex products that soon could be sold, if at all, only at huge discounts to the model-based valuations the banks were employing. The off-balance sheet entities were, as Paul Volcker has noted, the financial industry’s imitations of Enron’s innovations.

**...using the “magic”
of the leverage
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their feet.**



In other words, this decade's CEOs bet their banks on the programs that had, in the previous decade, produced celebrated collapses—Long-Term Capital and Enron...

Third, after the repeal of Glass-Steagall, many of the biggest banks, led by Citigroup, rushed to take on the trappings, glamour and revenues of investment banks. They abandoned their historic practices for home mortgage origination and investing; they dashed madly into the large-scale creation of Collateralized Debt Obligations, in which each instrument shared in vast numbers of underlying credits of varying risks. Gone was the day when they made loans to borrowers they knew, sending some of the conventional mortgages to F&F and holding the rest on their balance sheets. They also jumped into the Leveraged Buyout business, helping to inflate the second bubble of this decade. Their eagerness to compete with investment banks meant that the discipline that had once characterized most LBO lending—including strict covenants on debt levels for borrowers—vanished.

What could have motivated this sudden willingness, across the system, to scrap the basic bankerly principles of prudence?

Answer: the huge fees paid by Wall Street's new stars—the Private Equity acquirers. That was why Chuck Prince gleefully talked about why Citigroup was “still dancing” in July 2007: his bank was still trying to catch up to Goldman, Morgan Stanley and Bear Stearns in the investment banking sweepstakes. In the early years of this decade, finding buyers to absorb the new LBO loans was not difficult. But as the takeover mania grew, the business risk levels of the acquired companies climbed, and the covenants dwindled away like Cheshire Cats. The big bankers could only grin—and bury these junk debts on their balance sheets. Then they stopped grinning and, too late, began to face grim reality.

In other words, this decade's CEOs bet their banks on the programs that had, in the previous decade, produced celebrated collapses—Long-Term Capital and Enron—and on attempting to become leaders in a hotly-competitive business dominated by longstanding investment banks. For displaying such brilliance, the bosses got compensation packages that began to approach those of prominent hedge fund and private equity stars.

What only a few captious observers noticed was that the big banks, which were now talking routinely of such corporate attitudinal shifts as developing “entrepreneurial cultures,” had privileges—including access to the Fed that were based on banks' indispensable economic functions. The Fed was there to ensure they had the liquidity for the basic businesses of banking, such as lending for day-to-day business transactions, guarantees on international trade, small business financing, and consumer loans. As the banks' on-and-off balance sheet risks soared from their investment banking gambles, what was unfolding was an unprecedented level of societal risk.

Basic Points

The banks were growing by privatizing investment banking rewards and socializing the banks' new kinds of risks.

The economy had been put to a new—gigantic—kind of risk game: "Heads", the banks' top officers and, maybe, the stockholders would win; "Tails", taxpayers would lose: big time.

In other words, what this ghastly cultural and ethical degradation of business models and practices involved was a stealthy shedding of basic capitalist morality. Since Adam Smith's time, free market economies had been based on the simple principle that risks and rewards were two sides of the same coin—not an equation in which the risk side was charged to the coin of the realm should the business enterprise be so mismanaged that it had to be bailed out by taxpayers.

These days, as one wealthy banker and investment banker after another rushes to Bernanke and Paulson for bailouts, what many—if not most—of them have been checking at the door is a capitalist conscience.

Consider Stanley O'Neal, who brought down Merrill Lynch and forced it into emergency borrowing at the Fed, and eventual takeover by Bank of America. He had had the presence of mind to negotiate an appropriate going-away present if he were shown the door, so he departed with something like \$139 million—roughly \$1 million for each half-billion blown during his reign. It is a sign of the times that he isn't living in anonymous disgrace: he was swiftly given a high-profile directorship in a non-financial corporation.

The big banks that are costing the taxpayers so heavily were not brought to the edge of collapse because of losses from the basic businesses of banking—looking after the day-to-day needs of businesses, municipalities and consumers.

They have failed through creation and/or purchase of investment banking-created instruments they didn't understand, guaranteeing financing for corporate takeovers, changing their home mortgage practices to include large-scale commitments to subprime mortgages, and to home equity and condo lending at escalated percentages of purchase prices of bubble-escalated valuations. When experienced commercial and retail bankers turned themselves into new-age investment and merchant bankers, it was the financial equivalent of thousands of imitators of Dr. Frankenstein simultaneously following the same toxic formula. Predictable result: The City of London would join Wall Street on the list of the most dangerous locales for investors.

The big banks that are costing the taxpayers so heavily were not brought to the edge of collapse because of losses from the basic businesses of banking...



The Depression killed hundreds of banks... [but] they did not fail through reckless betting of their balance sheets on new business models they didn't really understand.

The Depression killed hundreds of banks. But most of them went broke honestly—because their *basic banking businesses could not survive a collapse in GDP*. They did not fail through reckless betting of their balance sheets on new business models they didn't really understand.

As far back as July 2007, as the subprime problem was becoming a crisis, investment banks had begun justifying horrendous losses in supposedly low-risk mortgage funds by claiming they had been hit by “26th Standard Deviation Events.” We remarked at the time, that we, unschooled in such statistical data, inquired what that meant. We learned it should only occur once every 100,000 years. Our suggestion to the scholarly statisticians managing those funds was that they improve the quality of their data by recruiting anthropologists and experts in pre-history, to give them data on such risks as large-scale attacks by saber-toothed tigers, so they could more accurately appraise the risks of investing in products created by Countrywide and New Century Financial—and of relying on F&F's financial strength to take perfumed paper off their hands at par value.

In the current bank-spawned crisis, Page One stories since mid-September have been proclaiming that across America, as weakened banks were being rescued by the week, the taxpayers faced many billions of dollars in O'Neal-style guaranteed payouts for top executives. Doubtless, the need to look after these claims helped stimulate the beggars' rush to Washington.

Congress demanded controls on payouts to bad bosses, but Paulson was somewhat disinclined to put restrictions on the application of the funds he was injecting. McCain backed Paulson's requests for a “quick, clean deal.”

No wonder Barack Obama struck political gold when he summed up the difference between his program and McCain's: he was for the middle class, but McCain was for the CEOs.

Now that the recession is taking hold, and investment banking activity has shrunk from tsunami levels to Saharan shallows, investors can expect that commercial banks will be asking for bailouts because of losses now looming in *conventional lending*. American Express is reconstituting itself as a bank so it can join the queue at the Fed. Many of the banks that will ask for help deserve it, and they will use the funds Washington supplies to continue supporting viable businesses and consumers. Others will be seeking rescue from ill-considered construction loans for condo and office tower deals booked at bubble peaks.

Basic Points

As might be expected from such defilers of capitalist morality, the Wall Street banks that have drained hundreds of billions from the taxpayer-created pools, are not showing eagerness to help unfreeze the arteries of the basic economy. They are hoarding Washington's cash to rebuild their debauched balance sheets and prop up stock prices they can no longer support by large-scale buybacks. Result: the commercial paper market is thawing too slowly, and interbank lending remains subdued.

**“Takes one to know one”
may be the new mantra
of banking.**

That banks, which were so eager to shovel out trillions on dubious credits to back investment banking operations, are so dubious about lending to each other to stop the economy from falling deeper into recession probably reflects both their own cash concerns and their recognition that the borrowing banks may have been no less stupid in their lending practices. “Takes one to know one” may be the new mantra of banking.

Paul Volcker notes that bank capital problems have occurred in all earlier cycles. He quotes Walter Wriston, CEO of National City Bank in the 1970s, who said that he didn't really need capital, it was just there to satisfy “fogeys on the board.” Perhaps the current boards of directors are short on fogeys.

The efforts of leading central banks to save their banking systems aren't limited to bailouts and special lending facilities. Not only has Bernanke been forced to drive the fed funds rate back to the Greenspan level of 1%, but last week the more-cautious European Central Bank cut its rate by 1% to 3.25%, and the Bank of England slashed its by an impressive (or depressing) 1.5% to 3%.

Money is becoming remarkably cheaper.

Overnight US commercial paper for well-ranked corporations has fallen to 0.5% annualized rates—or even lower. The longer the term of the paper, the higher the rate, but the short-term market for quality borrowers has improved dramatically. Only weeks ago, it was frozen.

As we survey the spreading global recession, we cannot help reflecting on another asymmetry of this process of saving banks which don't deserve to be rescued, but are deemed too economically important to be allowed to fail. The rescues involve slashing rates to borrowers—at the expense of savers. There was much Republican grumbling during the election campaign that Obama was talking too loosely about income redistribution. But what about Bernanke driving down returns on such traditional savings vehicles as savings accounts, T-Bills and money market funds?



...taxpayers have to rescue banks from collapses occasioned by excessive and misguided risk-taking, and savers are punished to produce the low interest rates those bad bankers need...

Those barely-observable borrowing rates on very short money are great news for corporate treasurers, but bad news for savers in money market funds.

During Japan's long years of economic darkness, one member of the board of the Bank of Japan—the only woman—complained bitterly about the nation's zero-interest rate policy. "You are taking money from my people—the elderly savers—to support those bad bankers whose greed and mismanagement drove the nation into this recession. Families have to be very rich to survive on interest rates of less than one-half per cent."

Every serious analyst who looks at the future of the US economy says that one of the first priorities has to be a restoration of the national saving rate. It was as much as 12% back when Volcker's tight money had the economy in recession and inflation in retreat, but it's been in the zero range in recent years. Those who sought to escape from the low interest rates available in bank deposits and money market funds have been savaged by collapsing values of virtually all risk-based assets. Now that deposit accounts are once again yielding pitiful returns, it is hard to see how the savings rate can recover—which means the US remains pathetically dependent on gigantic weekly inflows from savers abroad—mostly in the Third World. Now that banking problems and recessions are reaching those formerly robust regions of the world, the "global saving glut" Bernanke observed could become a drought.

In other words, the crisis the bankers created forces two kinds of asymmetric responses: the taxpayers have to rescue banks from collapses occasioned by excessive and misguided risk-taking, and savers are punished to produce the low interest rates those bad bankers need to rebuild their violated balance sheets. Savers, who tend to pay somewhat higher levels of tax than those with no investment income, are doubly victimized—as savers and as taxpayers. The national debt is climbing at rates only seen in major wars, so taxpayers will be paying for the misbehavior of a small number of people in Fannie, Freddie, Congress and banks—forever.

Basic Points

In concluding this part of the survey, we note that some of the biggest of the bailed-out bankers have been most vociferous in their insistence that Washington not respond with more intense regulation of their businesses. They even have the chutzpah to proclaim that increased regulation could choke off the innovation and competitiveness that make America a world leader.

What created this crisis was not a Depression that destroyed the ability of vast sectors of small and large businesses to cover their basic costs of financing inventories, receivables and short-term capital spending, and left 20% of the work force unemployed and unable to service mortgages that were less than 50% of their homes' values. In that case, bankers could justly claim that keeping them in business was just good business for the nation.

This crisis was caused by banks that didn't see enough excitement and profitability in fulfilling their historic role in the national economy—and who are unenthusiastic about fulfilling that role even when Washington bails them out.

The nation will be better off when the bankers take the investments into their equity, start the slow process of unwinding their exposure to bad assets on their balance sheets—and get back into lending to small businesses, farmers, exporters, and other credit-worthy customers.

The only people who should rejoice about the bankers' behavior are the William Ayers crowd. (Ayers dedicated a book to Sirhan Sirhan, Robert Kennedy's assassin.) The collective blunders of Wall Street, F&F and The City may well have ended the splendid period in which capitalism was given its best chance to prove that it was the worst kind of economic system—except for all others that have been tried.

This crisis was caused by banks that didn't see enough excitement and profitability in fulfilling their historic role in the national economy...



...investors' fright-flight from risk to riskless assets offsets much of that multi-trillion dollar response from central bankers across the world's economies and time zones.

Wake Me When It's Over

We were talking to the manager of a short-term fund last week, and he told us that activity in the market was reviving slowly. He had a new kind of problem: "There's a ton of money out there, but nothing to buy."

As investors in hedge funds, mutual funds and equity portfolios sell into this Mama Bear market, they aren't redeploying the hundreds of billions of dollars they are capturing into other long-duration or risky assets. Stock markets across the world have been devastated. Don't even ask about Emerging Market debt. And, as MacroMavens notes, the yield spread between investment-quality corporate bonds and Treasuries is at a record.

When the Fed more than doubled its balance sheet in six weeks, it was the equivalent of injecting adrenalin right into the heart of a cardiac patient. The economy is in the ICU at the moment, but it's getting the best—and most expensive—care.

But investors' fright-flight from risk to riskless assets offsets much of that multi-trillion dollar response from central bankers across the world's economies and time zones. Keynes called this a "liquidity trap." It occurred after the Crash of 1929 and, briefly, after the Crash of 1973–74. It did not occur in 1982, because there was so much demand for equities once rates began to fall from the 20% range. (Thirty year Treasury zeros outperformed stocks even during the Reagan rally.)

The reason money market funds are having trouble finding acceptable investments for their rapid cash buildups is that a wide range of previously-acceptable AAA-rated products have been deflowered, even if ratings services haven't yet issued downgrades. The collapse of Lehman, and the ensuing damage suffered by short-term investors worldwide, has forced fund managers to narrow their purchases to a few supposedly sure-fire asset classes and borrowers. The ratings services face massive litigation for their large-scale, promiscuous issuance of AAA ratings on subprime-based CDOs, and fund managers can no longer excuse themselves with their clients by insisting that some soured investment was AAA-rated.

Basic Points

Another area of concern—bank-sponsored SIVs—seems to be receding from the crisis headlines in the US and Europe, but fund managers generally remain unwilling to roll over their exposure to these ambiguous offerings. When the appropriately-named SIVs began to leak, shocked investors found that “bank-sponsored” often didn’t mean what they thought. “You shoulda read the fine print in the prospectus,” they were told. That’s one mistake they won’t make again, so SIVs will join Enron SPEs in the boneyard of bad confections that could be successfully hidden off balance sheets.

We are of the view that this buildup of cash that is struggling to find a place to go will ultimately be the source of funding for legitimate short-term paper issuers—and for the next equity bull market.

When cash ceases to be trash, it soon begins burning holes in its holders’ pants pockets—and that heat triggers eagerness to take risks.

When will that glorious time arrive?

When the Thirties Mama had completed her devastation, she disappeared for 39 years. The second appeared in 1972 and stayed until 1974. The Dow reached 1030 in the subsequent recovery, only to fall to 730 in August 1982, which seemed like a Mama because inflation had been in the double-digit realm for more than two years and with the Constant Dollar Dow back at 1929 levels that was probably the all-time low point for equities as an asset class in the postwar period. The Dow was at 730, fourteen years after it had first touched 1,000. (Alternatively, one could view the entire period since 1968 as one long Mama Bear interrupted with several powerful, failing rallies.)

No matter how one slices it, a 48% plunge in the Dow is a Mama Bear and nothing since 1929 has exceeded it. Since there is only a superficial comparison between the world of today and the world of 1929, we must assume that this Mama should be near the peak of her savaging.

**When cash ceases
to be trash, it soon
begins burning holes
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triggers eagerness
to take risks.**



...the spread over T-Bills reflects bankers' pricing of the risk in short-term loans to each other.

Four indicators will, collectively, signal that the Mama Bear has done her worst:

1. The TED Spread

Long time readers know how we cherish this indicator—the yield differential between the front-month 90-day T-Bill and Eurodollar contracts. It has kept its 100% accuracy rating through all the financial crises since 1974.

Why does it work?

Because the TED spread measures risk within the global banking system. Eurodollars are the primary instrument of inter-bank lending—unregulated and uninsured dollars. Therefore, the spread over T-Bills reflects bankers' pricing of the risk in short-term loans *to each other*. It *ALWAYS* spikes in advance of a financial crisis. It *ALWAYS* falls when the crisis is past.

It has become even more sensitive over the years as the banking system has become more globalized and network-driven. Serious banking problems anywhere in the system can be enough to produce a flicker—or worse. In 1984, on the day Continental Illinois went down, the Fed's onsite manager called Paul Volcker before 5 a.m. to tell him that the TED had opened at 415. That was enough to send all the Fed's emergency operations into action. They swiftly checked with the eight biggest banks and found the trouble spot—the Continental Illinois. By 11 a.m., the Fed had bailed it out, using the FDIC (Federal Deposit Insurance Corporation) Fund to pay off the Japanese banks' wholesale Eurodollar deposits that they were unwilling to roll over. (That may have been the largest-scale illegal act of a US public servant in history: the FDIC Fund had a \$100,000 limit per deposit and it was limited to domestic depositors. Sometimes, a Fed Chairman's gotta do what a Fed Chairman does.)

The TED peaked around 500 when Lehman collapsed and broke 200 last Friday. It is currently 197. We suspect that if it breaks 150 and stays there for at least a week, the *financial crisis* part of this drama, while not humdrum, will no longer command center stage.

That means, it will be time to start buying stocks, *if...*

Basic Points

2. The Bank Stock Index continues to outperform the S&P

Since the Midnight Massacre, the BKX has been outperforming the S&P on a relative basis, for more than the requisite six weeks.

That means, it will be time to start buying stocks, *if...*

3. The VIX Index retreats

Although the VIX leaps when there is serious trouble for stocks, it is actually a volatility index, not a measure of actual risk. It measures, for traders of S&P Futures, how wide is the price range of options on the S&P.

As long as the S&P is trading in a +30 range day after day, the stock market is still fibrillating, and the patient is not yet ready to go walking in the park with a cane. It needs to retreat from its manic zone.

That means, it will be time to start buying stocks, *if...*

4. The Yen and the US Dollar Decline

In an Orwellian paradox—Weakness is Strength—the yen and the dollar have outperformed other currencies. The yen and dollar indices are the currencies in which debt is denominated. They have been elevated sharply due to the deleveraging process; as US investors sell assets outside the US and repay debts inside the US, the dollar rises. The yen, as the instrument of the carry trade, suffers the same ignoble boost. By outperforming Eurodollars, pounds and other major currencies, they have been giving warning signals. They should revert to normalcy, and turn negative, when the distress sales of hedge fund assets and of bankrupt assets have dwindled.

When all four indicators have confirmed, it will be time to start buying stocks.

**In an Orwellian paradox—
Weakness is Strength—
the yen and the dollar
have outperformed
other currencies.**



When the wildebeest and zebra population increases by 700% near a small lake, it doesn't take a huge reduction in rainfall to produce a collapse in the herbivore population.

The Outlook for Equities in the Next Bull Market

Even before banking problems had reached crisis proportions and stocks were crashing, the equity markets had been disappointing investors. In the ten years ended June, the real return on the S&P had been near zero. That is a major correction, and could be considered a bear market.

Yet the stock market crashed *after* this long correction.

Of the asset classes to which investors have historically turned as providing inflation protection, only commodities had performed strongly in this decade. That outperformance ended with a bang in July. The third asset class—housing—was, of course, the worst.

Recently, a few organizations have begun to chart stock performance compared with long-term averages, and have begun arguing that stocks are cheap. Example: a Citigroup study cited in *The Wall Street Journal* showed global equity valuations (on a trailing P/E ratio) back to 1970. They had peaked in 2000 during the tech mania at 35, and were now at 10.3, slightly below the 11.4 average for the Seventies. The wise Steven Leuthold has been pounding the table for months about the cheapness of equities.

We suspect that pension funds will be major buyers of equities next year. They are currently unwinding their huge exposure to “alternative investments,”—mostly hedge funds and private equity. In the process they are accumulating record amounts of cash—and forcing managers to sell gigantic quantities of equities.

We doubt pension funds will be eager to rush back into investment structures in which the proprietors have 2% and 20% fee structures—or to continue paying the awesome fees paid to some private equity barons who were so conspicuous at Manhattan galas and have been such conspicuous flops in recent years. The crashes in their portfolios will doubtless put an end to their attempts to be seen as modern Medicis. Lorenzo and Cosimo had far more class—and were usually financing greater artists.

Warren Buffett has long warned of the unwisdom of paying such outsized fees to “investors’ helpers.” He predicted that at some point they would overreach in terms of what they paid for the assets they acquired, but they would already have pocketed the giant fees from the good times.

We believe that many of the best-known hedge funds—including those whom we are proud to call clients—are worth those fees—but not 8,000 of them. When the wildebeest and zebra population increases by 700% near a small lake, it doesn't take a huge reduction in rainfall to produce a collapse in the herbivore population.

Basic Points

Pension funds are going to have to move from holding cash and Treasuries, because they've committed themselves to earning 7% or more on their portfolios in their FASB statements, and Treasuries across the yield curve are earning miserable returns. Once they conclude that this Mama Bear market is ending, they will surely return to equities—and they'll probably start that process with long-only fund managers charging modest fees, while boosting their exposure to equity-oriented hedge funds which managed to avoid most of the sell-offs in the Financials.

They'll also have to buy corporate and Emerging Market debts, where spreads over Treasuries are at records. In other words, the pension industry will soon face a crisis because of drastic underfunding. The sexy and exotic asset classes that gave them double-digit returns for double-digit fees are currently giving them double-digit losses.

The reduced population of hedge funds with demonstrated commodity expertise should not only survive, but prosper. The catastrophe for their competitors whose assets were prime-brokered with Lehman has given the survivors an enormous opportunity to grow their businesses. When the global economy recovers, commodity prices will come roaring back.

In that regard, we notice that commodity futures managers tend to buy and sell commodities as a class—probably reflecting cash inflows and outflows with their clients. Result: when crude oil, (which is more than half the weight of the Goldman Sachs Index) collapsed, they sold everything else.

There are two errors in that strategy:

1. Grain prices are not historically correlated to GDP growth or contraction—as are prices for energy and metals. On a supply/demand basis, grains are now greatly underpriced—at a time that this period of global cooling is intensifying.
2. The plunge in oil prices is wondrous news for the two Asian economic heavyweights—China and India. Their economies will be stronger than other EMs—and probably stronger than bearish forecasters currently predict. So will their Current Accounts. So will their demand for non-oil commodities.

The sexy and exotic asset classes that gave them double-digit returns for double-digit fees are currently giving them double-digit losses.



We believe Obama will usher in a new Golden Age—at least for a while.

Gold During the Crisis and Beyond

Does it matter for gold investors who owns the White House?

Two Democratic Presidents were good for gold:

Roosevelt raised gold's price from \$20.67 per ounce to \$35.00, and gold mining was one of the few boom industries of the 1930s.

Jimmy Carter was the best thing that ever happened to gold. When he was elected, gold was trading near \$100 an ounce, and it soared to \$825 in 1980 as his Presidency was nearing its conclusion.

One Democrat was bad for gold. During Clinton's tenure, gold traded as low as \$300 and bottomed out at the end of his term near \$325.

As for Republicans, Reagan was extremely bad news for gold, with its price falling from the \$700 range to \$325 during his first term. Thereafter it did little, except for the runup from \$325 to \$500 at the time of the 1987 Crash, but it swiftly retraced steps and by the time he retired, was back below \$400.

George H.W. Bush's Presidency was a non-event for gold.

We believe Obama will usher in a new Golden Age—at least for a while. The global monetary stimulus, in which the Fed *quadruples its Monetary Reserves in eight weeks* and other central banks also reflate with unalloyed zeal, is laying the foundations for (1) an economic recovery, and (2) a return to inflationary pressures and enthusiasm for inflation hedges. Gold bugs, frequently strategists' pests in recent decades, should actually become good social critters—at least for a while.

In surveying gold's behavior this year, we note that it hit a new high at the time of the Bear Stearns' collapse, and was headed back to the peak as bank stocks reached new depths on August 11th. That was gold filling its role as a haven during financial crises.

But it never climbed back to those peaks during the tumultuous weeks after the Lehman collapse. Why?

Basic Points

We see several factors:

1. The daily announcements of new bailouts made speculators wary of betting on an overall collapse which would make gold the best asset of all.
2. As part of the rally after the Midnight Massacre, the dollar had its best bull market in many years. Gold fell during those weeks in its role as the counterpart to the dollar.
3. When the fear driving central bankers and investors to the edge of panic is deflation, that isn't gold-friendly mania.
4. In the early phases of the bailout, the Fed's balance sheet barely ticked higher. It only soared after Lehman's demise, which was the first time the Fed resorted to drastic monetary stimulus (as opposed to emergency lending).
5. So much investor interest in gold is channeled into the Exchange Traded Fund—GLD. As we warned the World Gold Council at the time it was considering creating that ETF, it could have the effect of making gold behave like a stock during a stock market crash—it's in investors' accounts and subject to margin calls with all other stocks.

Looking ahead, we expect the dollar bull market to end soon and the equity bear market also to end soon. By that time, students of monetarism will be worrying about the Fed's drastic rescue policies—and there should be renewed interest in gold.

Unless Milton Friedman is as obsolete as J.K. Galbraith and Samuelson, when the economic recovery arrives, gold will be in a major bull market.

It will be the time the victims of the Midnight Massacre still left standing can say, with a grin—and a metaphorical gun, "Make my day!"

Unless Milton Friedman is as obsolete as J.K. Galbraith and Samuelson, when the economic recovery arrives, gold will be in a major bull market.



[Obama] can be justly proud of his victory. But so can every American. Where else in this fractious world could this have happened?

THE OBAMA TRIUMPH

Barack Obama is already a figure on the world stage, having wowed vast crowds in a triumphal tour of Europe, including a memorable show in Berlin. (It didn't play as well at home when critics noted that he had claimed "The world rescued Berlin." It was, of course the US Army Air Force and NATO that saved Berlin, but dreamy one-worldness was more appropriate for that occasion.)

What Obama has accomplished is, quite simply, the most magnificent primary and election campaigns America has ever witnessed. He came from obscurity in a crowded field of contenders to snatch the nomination from Hillary Clinton—and nobody had ever beaten the Clintons. He then unleashed a faultless campaign against McCain based on the Internet, and on youthful enthusiasm and idealism to deliver a continuous reminder to voters of the age gap between him and McCain—and to tie McCain firmly to the discredited George Bush. Although he whipped crowds into passion, he himself displayed the reflective coolness that would make him seem Presidential. (As George Will notes, as far back as *The Federalist*, American political theorists have insisted that the prime quality needed in an effective leader is a mature temperament. That quality means more than mere experience, writers such as Madison have argued. McCain, in contrast, seemed at times too excitable and, therefore, unPresidential.)

Obama got 2.5% more of the popular vote than Gore and 4% more than Kerry—winning far more votes than anyone who ever contested the Presidency. He had the good fortune—as a contender against the ruling party—that, as of election day the S&P was having its worst year since 1937. But he capitalized on that advantage brilliantly.

He proved himself to be a Tiger Woods of politics; a handsome, athletic-looking, mixed-race man who moves with ease among races and cultures. He is widely called a "transformative" leader.

He can be justly proud of his victory. But so can every American. Where else in this fractious world could this have happened?

Basic Points

Now, he must manage the nation. He has had no experience in managing anything but his campaign, so he must demonstrate a different kind of wisdom, intuition and discipline to deal with the financial crisis and recession at home and the inevitable crises abroad.

What will this great victor on the national political battlefield do when he takes command of the nation? Are the skills needed to defeat an old warrior on the political battlefield the skills needed to be an effective President?

We could not help recalling the famous words to Hannibal from his wise Cavalry Commander Maharbal, after the huge Carthaginian triumphs at Trasimene and Cannae meant that Rome could finally be his. "No man has been blessed with all God's gifts," he told Hannibal. "You know how to gain a victory. You do not know how to use it."

He turned out to be right. Hannibal hesitated about marching into Rome, and proved unable to manage supply lines or deal with the delaying tactics of Fabius Cunctator (who gave his name to the moderate wing of British socialism) and was ultimately defeated and slain.

However, that recollection may, thankfully, be far off the mark.

We heard from a friend of Paul Volcker's that he believes Obama is a great listener who learns quickly, and should be a fine President. As clients know, we consider Mr. Volcker the greatest American non-military public servant of our generation, and his endorsement is greatly reassuring.

Moreover, Mr. Volcker is one of the luminaries listed on Obama's new Presidential website in which he lists the programs and people that will soon be in charge of the national agenda. Bloomberg's Jonathan Weil has published a scathing piece, listing the members of Obama's Economic Advisory Team, more than half of whom have been in senior management or on boards of companies which confessed to major accounting problems, including three from the F&F Board and Bob Rubin, co-head of the team that nearly brought down Citigroup. We aren't so concerned, because F&F was so stuffed with leading Democrats in executive and board positions that Obama might have been forced to go to relative unknowns—and none of his distinguished appointees has ever been accused of fraud.



[Obama's] Treasury Secretary will inherit both the mess and an alphabet soup of remedies.

The Obama election managers know that political, economic and financial conditions could hardly have been worse for McCain's candidacy, yet Obama did not achieve a Reaganesque or even Nixonian electoral college wipeout. America remains a center-right country, and Obama should not allow himself to appear like a male Pelosi. He and his advisers are said to be studying the Clinton first term, which ended with biggest Republican and Gubernatorial sweep in decades. They are determined not to make the same mistakes—and these people have shown they are excellent at avoiding mistakes.

Those investors who are panicking out of stocks on the basis that Obama will impose punitive taxes and drive the nation far to the Left are, we believe, deeply misguided.

This is a mesmerizing man who believes he has the vision to unite the country and confront its problems realistically. He could prove to be one of the great Presidents.

Challenges

Although he has promised to repeal Bush economics, he probably won't want to derail the Paulson-Bernanke rescue program. His Treasury Secretary will inherit both the mess and an alphabet soup of remedies. By late January, the stock market should have stabilized, and there should be more than a few signs of recovery.

Economic stimulus comes automatically from the federal budget process: as tax revenues fall and mandated expenditures rise, the descent of GDP slows and the economy begins to emerge from the storm cellars. Congress will doubtless pass some extra spending programs aimed at its own special concerns, but these are likely to have only marginal impact—for good or ill.

Realistically, President Obama should not allow the excitement and urgency of the recession to prevent him from organizing the blue-ribbon advisory panels to deal with the three programs that are rapidly taking charge of the federal budgeting process—Social Security, Medicare and Medicaid. Before his second term is complete, they will either be under control or will be utterly out of control. He has the kind of broad-based mandate needed to enact genuine reform. If he doesn't make great progress within the early years of his Presidency, he and the nation will both be huge losers.

Basic Points

What gives him a freer hand in tackling the nation's economic and fiscal problems is that Big Government rode to the rescue of Big Business, and that means Obama can legitimately find other new roles for governmental intervention without being denounced as a socialist who wants to destroy capitalism and initiative. Voters don't understand F&F's crucial roles in this crisis, because the Republicans did such a terrible job of explaining how leading Congressional Democrats shilled for the F&F malefactors (with the help of a handful of key Republicans). It's too late now. The public believes that this crisis is almost entirely the fault of big business, and will be open-minded—or even enthusiastic—about other forms of regulation, control or pre-emption.

Abroad, he has a chance to build closer relations with America's allies. He may also have a chance to form effective coalitions to deal with such global troublemakers as Iran, North Korea and Russia. (Russia greeted his election with a threat to point nuclear weapons at Eastern European nations who accept American anti-ballistic missile technology. The Kremlin may have already decided to test this new Democrat the way Krushchev tested Kennedy. Krushchev was so unimpressed with this "callow" young man that he immediately went ahead with building the Berlin Wall.)

The great Reagan-Thatcher bull market which, despite intervening short-term bear pullbacks, took the Dow from 750 to 14,000 ended with this Big Mama. Bigger Government is coming back. Obama is probably as credible and sophisticated as anyone in expanding government's economic role—and far less objectionable than most. Those libertarians and free enterprisers who have been working themselves into a snit at the prospect of an Obama Presidency should be fair-minded and admit that Wall Street made this swing to the Left possible—and even necessary. At the very least, the business community should show that it recognizes who caused this financial crisis and recession by ensuring that none of the Street's biggest names who leave in disgrace will, O'Neal style, receive other directorships. It might help the process of reform if they were also expelled from upscale clubs.

**Bigger Government
is coming back.**



**It will doubtless be
a long time before
Complacency returns.
But the Era of Fear will
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Conclusion

The two interlocked events—the US-created global financial crisis and the Obama election triumph—mark the end of decades that were generally favorable to business activity, profits and free trade, primarily because of a shrinking role for government in the economy. Stock prices have had a glorious run since 1982. It ended last year.

If, as we believe, the current rescue campaigns worldwide succeed, by late next year, the global commodity boom will enter its third—*Presto* or *Allegro Molto*—Movement of the Great Sonata. There will be new highs at least for gold, grains and metals, and oil prices should move back to low triple digits.

Equity prices could stage a brisk rally any time soon, but thereafter they will await positive economic news. The bank stocks appear to have double-bottomed at New York, and have outperformed the S&P since the Midnight Massacre by one of their widest margins on record.

The January 2007 issue of *Basic Points* was entitled *The Age of Complacency*. We argued that markets were far too complacent and greater volatility lay ahead. No, we certainly didn't anticipate the sustained earthquakes and hurricanes we have experienced in recent months. It will doubtless be a long time before Complacency returns.

But the Era of Fear will probably end soon.

Perhaps in time for celebrating the inauguration of a fascinating new President.

INVESTMENT RECOMMENDATIONS

1. It is definitely too late to sell stocks, and it is still too early to do more than nibble at bargains. Investors should be opportunistic buyers, because today's prices for quality stocks will look ridiculously cheap within two years—or less.
2. When the time comes to begin re-accumulating equities, buy banks and diversified financials. If there is going to be a global economic recovery, these former pariahs should perform well—under mostly new management.
3. At the same time, buy commodity-oriented stocks. They are oversold to depths we could not have imagined. When, not if, there is a global economic recovery, these stocks will once again be *the* winning asset class.
4. While you are waiting, you should be beginning to accumulate the bonds—convertible and otherwise—of quality corporations. What could be the trigger for a major equity rally would be a sharp contraction in the near-record yield spread between investment-quality corporates and Treasuries.
5. Buy Emerging Market bonds from the fundamentally sound economies, such as China, India, and Brazil. Avoid Eastern European debt.
6. Another group to be included when you are once again accumulating stocks is the leading business-oriented tech stocks. These companies will participate in a global recovery, whereas the consumer-oriented techs may have to wait quite a while.
7. This is also a good time to be looking at the railroad stocks. They benefit from lower energy costs, which may offset a significant percentage of the cutback in top-line revenues during the recession. Coming out the other side, they should be core investments.
8. Gold has been a disappointment. It has outperformed stocks since the S&P's peaks, but not enough to be profitable. As deflation fears ebb, it will once again be lustrous.

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