



GLOBAL FINANCIAL MARKETS PERSPECTIVE  
SECOND QUARTER 2009

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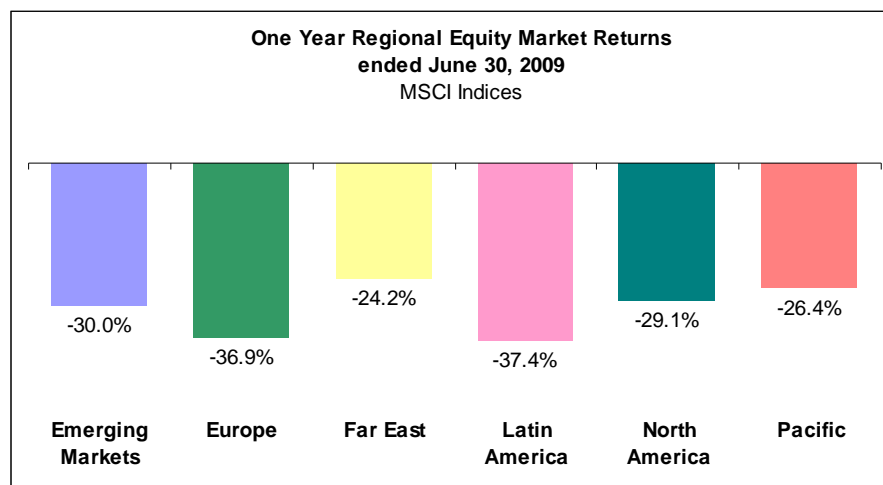
## On the Rocky Road to Recovery

### INTRODUCTION

Over the past two years, the lessons learned from the 1930s were not enough to identify and resolve the shenanigans engaged in by global financial institutions. Investors placed bets that the future was going to be like the past. The big bets became even bigger. Leverage became the name of the game. Real estate investors were the most euphoric believing that home values would NEVER go down (how could they?) Compounding the developing bubble were government agencies that encouraged people with low incomes to invest in the American Dream of owning their own home. This wave of “must own a home” regardless of ability to make mortgage payments spread globally and infected otherwise normally functioning real estate markets. Moreover, these banks and finance companies took huge investment bets and, in turn, bundled mortgages into multi-billion dollar securities that commanded Triple A ratings backed by insurance companies. Brokerage firms leveraged 50 to 1 (or more) in order to produce extraordinary profits. These “innovations” in mortgage finance were more destructive than constructive and did the most for crooks who took full advantage of both novice and “professional” investors. These so-called financial market gurus, who swindled billions out of unsuspecting investors, were successful simply because soaring financial markets hid their fraudulent activities. When all of these travesties are bundled together, a financial market collapse of historic proportions is the result.

Conduct unbecoming a financial professional was overlooked by politicians, regulators and investors. Bernard Madoff, the head Ponzi schemer of this generation, received a prison sentence of 150 years for stealing billions of investor’s dollars. Alan Stanford, another purported thief of billions of dollars is awaiting trial. His game was issuing “safe” high-yielding CDs by his bank in the Bahamas. An early speculator was the Amaranth fund - a multi-strategy hedge fund managed by Amaranth Advisors who had US\$9 billion in assets under management. In September 2006, the fund collapsed after losing roughly US\$6 billion on natural gas futures. The failure was one of the largest known hedge fund collapses in history. Many more of these swindlers have been exposed in recent months and they will likely spend meaningful time in jail. Yet, given all of the bad things that have happened over the past two years, we have survived. Now is time to improve the policing of our global financial system and to remind people that sometimes it just can be too good to be true.

During the second quarter, the government's growing commitment to stability was reflected in the "green shoots" of a global economic recovery. As risk appetites returned, equity and commodity prices rose, credit spreads narrowed and money markets re-liquified. World equities rose a robust 21%. However, global equity markets remained in the red over the past year despite their gains so far in 2009 as can be seen in the chart below. Meanwhile, sovereign bonds and the U.S. dollar performed poorly.



The last two years do not reflect a crisis of capitalism but rather a crisis in the governance of capitalism. While not fans of regulation, we are in favor of a major revamp of the laws governing financial markets similar to the 1930s when the Securities and Exchange Commission overhauled the industry's regulatory structure. The determination to "clean up" the financial system is a global commitment with competent experts from the public and private sector coming together to regain control of a precarious financial system and a debt-dependent global economy. Even Pope Benedict XVI condemned the "grave deviations and failures" of capitalism exposed by the financial crisis and issued a strong call for a "true world political authority" to oversee a return to ethics in the global economy. The body politic must get governance right this time.

#### THE SHAPE OF THE RECOVERY

The good news is that history usually repeats itself and we see some early indications that the worst is behind us. The bad news is that the road to recovery could be rocky. The ravaged housing market, collapsing state and local government revenues, and continued increases in unemployment will be challenges for the Obama Administration. In retrospect, the fiscal policies of both Bush and Obama can be credited with keeping the U.S. economy from slipping into a depression. With the help of the Federal Reserve and the Treasury department, the federal government acted aggressively to stretch a safety net under the economy until the normal business cycle begins to reassert itself.

The lessons from the Great Depression are too stark to ignore. We are not making the same mistakes even though there is a chorus of Hoover-like politicians who are opting for less, not more, government spending. The mantra of higher taxes on the rich was a mistake made in the 1930s -- a mistake we shouldn't make again.

Fears of inflation due to increasing government spending are misplaced since there is little chance of surging demand in the near term to create an updraft in prices. For inflation to undermine the economy there must be a surge in demand and a shortage of supply. Widespread job losses have replaced pay raises and labor shortages of the years of plenty: the property bubble has burst, global commodity prices have corrected substantially and banks have experienced a liquidity squeeze. Deflationary effects are being felt globally from China to the Middle East to Europe and to South America. Unfortunately, rising unemployment in the major industrialized economies, together with deleveraging, is expected to exert downward pressure on wage inflation over the next few years that would negatively affect consumer spending. Until the private sector digests the recent crises, the public sector will play a crucial role in turning the economy around. The analogy of a wild party and the requisite hangover is not too far off the mark.

#### THE THREAT OF BIG GOVERNMENT

Our last Financial Markets Perspective was titled: "A new World Order" and was penned as the G20 was meeting in London to solve the global financial crisis. At this writing, the G8 is meeting in L'Aquila, Italy to discuss the very same topic. (The Group of Twenty Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. The Group of Eight is a forum, created by France in 1975, for governments of eight nations of the northern hemisphere: Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States.) We believe that the shift to a new world order where emerging economies will play a larger role will take time and until the shift has occurred the G8 is the appropriate body to resolve the global economy's current predicament.

This global financial market crisis provided the temptation for the federal government to intrude into our personal freedoms. The bailout/takeover of the banking system through onerous loans that were forced on many banks combined with the bankruptcies of two out of three of the major auto companies provide an early warning signal that "Big Brother" is getting bolder in shrinking our freedoms. As part of the takeover of these industries, the politicians were quick to create a salary "czar" who determines the rationality and justification of individual executive's compensation. We are reminded of the wage and price controls instituted by President Nixon in August of 1971, a decision that contributed to a decade of high inflation and financial market malaise.

The inevitable national healthcare program that is dominating the Congress is another example of extreme intervention in the private sector. The legislation for such a proposal will face tough scrutiny in the Congress, but combined with a Democratic executive, the Congressional majority will have the power to push through such legislation. A recent article in the Wall Street Journal commented on one item in the pending healthcare legislation that raises our concerns: the idea that the government will be able to raise taxes of \$36 billion in the next ten years through penalties imposed on individuals who refuse to take free healthcare! Maybe the public should demand that the same politicians who ram through this legislation be also subject to it.

And then there is the growing threat of protectionism. The key challenge to resuming the Doha talks in November is persuading the U.S. and India to repair a rift that emerged at the global trade summit a year ago. A global trade deal could pre-empt protectionism by capping import tariffs at their current, relatively low rates, as well as dismantling barriers to trade in agriculture and industrial goods. Negotiations also keep trade ministries in touch with each other that make everybody more careful about protectionism. U.S. trade officials said President Obama would make a major trade speech at the G8 meeting, but there is no indication if that will happen.

Fears of global warming are also encouraging the government to become more active in regulating our lives. Efforts to curtail domestic production of oil and gas by the "greenies" and the potential passage of "cap and trade" legislation that will impose heavy tax penalties on companies that use carbon based fuels in production could add an enormous burden to the functioning of the U.S. economy. President Obama wants something tangible to take to the Copenhagen climate change talks in December, but the more important issue is what this exercise says about his approach to governance. The President seems to believe that the Carter and Clinton Presidencies failed by fighting too much with Democrats in Congress. So his solution is to abdicate his agenda to Congress -- first the stimulus, now cap and trade, and soon health care. We wish he had told us he was running to be Prime Minister.

## CONCLUSIONS

The recovery from these crises does not rest solely in establishing new rules and regulations. There is a very important human dimension to our problems in that poor judgment was endemic in this era of self-regulation. Greed overcame rationality and normally responsible people lost their bearings. Since the body politic renders the ultimate judgment on matters of governance in free-market systems, politicians and the business community must have the vision and the courage to look beyond their normal short-term horizons and make tough choices that could provide a longer-lasting cure for a crisis-torn world.

In the meantime, foreign equity markets continue to offer attractive investment opportunities. China and India have the largest populations in the world. Last year these two countries combined graduated 975,000 scientists and engineers while the United States graduated only 70,000. If only 20% of China's 1.3 billion population moves up to the middle class then 260 million more people will need to consume things like better food and clean water. That number is almost as big as the entire population of the United States!

China's economy has grown by roughly 10% per year for the past 30 years. A large portion of that growth has been driven by exports and this export growth is really a "technology transfer," as foreign companies share their know-how (manufacturing, warehousing, distribution, etc.), allowing China to climb the learning curve much faster than it could have on its own. Such a technology transfer causes a huge improvement in labor productivity.

More recently, however, the western world's recessions have caused China's export growth to slow. To counteract this slowdown, the Chinese government has provided stimulus of four trillion renminbi (\$580 billion). This monetary stimulus should permit China to grow at 7% - 8% per year for the next couple of years. However, by 2011 the stimulus will be gone and probably not renewed. It is also doubtful exports will reassert themselves to former levels. Therefore, the government is working toward transitioning the economy from a story of labor productivity to one of capital productivity.

This shift would have positive implications not only for China but the rest of the world. Forcing reform in the financial markets is a major thrust of that transition. Accelerating reform in the financial markets should create more "efficiency of capital." While the nascent reforms currently appear scattered, over time they should have more of an impact allowing capital productivity to replace the decline in labor productivity caused by declining exports. More and more Chinese companies have been going public and issuing bonds. Large banks have increased lending to their smaller brethren and they have created more diversified financial channels. Increased trade with Hong Kong and renewed relations with Taiwan bode well for the region as well.

On the home front we will continue to struggle with the resolution of residual problems in housing and related industries. The inexorable rise in unemployment can only be truncated with a resumption of private sector growth. In the meantime, the federal government will remain the spender of last resort to allow for a stronger recovery. Growth in corporate earnings later this year will be the key pillar of strength that will signal a recovery in the private sector. The road to that recovery will be a little rougher than in the past.

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