

Basic Points

The ObamaMama Bear Market?

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The ObamaMama Bear Market?

OVERVIEW

We're back.

When you last heard from us (Nov. 24th), we were joining in the celebrations for the election of a popular and charming new President. He appeared to have the powerful connection with voters and the clout with Congress to implement a recovery program that the markets would respect, thereby averting a really hideous recession.

In that issue (*Capitalism Faces Its Greatest Challenge*), we said the stock market was engulfed in what we called a Mama Bear Market—the third such cataclysm of our time. Mama Bear Markets plunge 40% or more, and inflict such economic and social damage that they transform political structures, as despairing investors and voters seek radically new alternatives.

The current Mama Bear arrived just in time to help elect Barack Obama, who had been trailing in the polls behind McCain until Lehman's bankruptcy turned the rather ordinary Papa Bear into a Hot Mama. We thought it would soon bottom out as investors began anticipating the recovery program. Sadly, it was transformed into the ObamaMama Bear Market, driven by two increasingly bad news stories for investors—the economy and the Obama “stimulus program” which became the misleading labeling for a multi-trillion dollar collection of almost everything Democrats had long desired. As Rahm Emanuel said, “You never want a serious crisis to go to waste...This crisis provides the opportunity for us to do things that you could not do before.”

Result: Day after day, as Obama and his team members told us more about their plans for the *America of the next decade*, based on a vast expansion of the powers and costs of government *now*, the stock market plunge continued.

At the time of the first rally since the ObamaMama Bear began, we re-enter the picture.

After such a long silence, we felt obligated to give our patient clients a two-part issue. In part one, we discuss “The Obama Revolution” and the problems it creates for investors. In part two, we discuss the kinds of cooling that have led to the current crisis and how investors should respond. We also update our commentary on another kind of cooling—the global climate condition that dare not speak its name.

“You never want a serious crisis to go to waste.”

**Who lost?
Investors.**

Given our strongly-expressed enthusiasm for Mr. Obama—in *Basic Points*, BMO Capital Markets’ *Red Book*, Conference Calls and media interviews, we are embarrassed to have to admit that the many investors who have been relentlessly selling shares in recent weeks based on their negative appraisal of his plans, people and programs have apparently made the correct call. This most eloquent, charismatic and coolest of modern Presidential candidates has not lived up to his “moderate” advance billing, nor have his multi-trillion dollar “recovery” programs been focused on near-term job creation and tax reductions, as we—and the Street—had expected.

How could we have been so naïve? Nancy Pelosi put us in our place, responding to a question about why the “stimulus” bill was so heavily dedicated to hugely expensive long-term government programs, “We won the election. We wrote the bill.”

Indeed they did. Who lost? Investors.

The ObamaMama Bear Market?

“Lord Ronald flung himself upon his horse and rode madly off in all directions.”

These classic words of Stephen Leacock came to us when we read President Obama’s bold proclamation on February 21:

“We cannot successfully address any of our problems without addressing all of them.”

This was his justification for the massive, transformational “stimulus” bill that sent the stock market plunging to new lows.

Obama’s popularity with the voters at large remains stratospheric, based on his near-magic ability to wow audiences and calm a majority of voters simultaneously.

However, it seems that the only rescuer who still has credibility with most investors is Ben Bernanke, and, as he proved last week, he can still unleash a splendid Dow rally by telling what he’s doing, why it’s going to work, and why the recession should end later this year.

Mr. Bernanke continues to display the integrity and professionalism we have so greatly admired. His ingenuity, creativity and sense of history could well prove effective enough to offset the damage inflicted on the American economy by the mislabeled “stimulus” program excreted by the House Democrats, so there’s still hope for the financially audacious.

Robert Reich, Clinton’s Labor Secretary, and one of the nation’s smartest liberals, summed up the new reality with his characteristic clarity: “Obama has repealed the Reagan Revolution.”

Problem: the Reagan Revolution was the best thing that has happened to equity investors since World War II.

The 1973-74 Mama Bear market and the ensuing stagflationary recession ended Republican rule in Washington, electing Jimmy Carter. He proved so ineffectual that Reagan was able to restore Republican power in 1980. The most important result of the fallout from the 1973-74 Mama Bear turned out to be the sustained stagflationary misery in Britain that paved the way for Margaret Thatcher’s victory in 1979 and the subsequent destruction of Labourite socialism. Her triumph was the turning point: thereafter, the world began swinging toward free markets, a process that became a rush when she and Reagan got their dearest wish—Cold War victory without firing a shot.

“Obama has repealed the Reagan Revolution.”

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...an appropriate stimulus package: it would be “timely, targeted and temporary.”

In the US, the 1981-82 Mama Bear market, the product of 18% interest rates, nearly killed the Reagan Recovery. Fortunately, Paul Volcker finally started cutting rates in August 1982, and the Reagan Revolution followed.

Mr. Obama has been denying that he has revolutionary intent, claiming that he’s just fulfilling his election pledges. The spending emphasis is directed toward three over-arching goals—fighting global warming, improvement of public education, and achieving a form of universal health care. Although each of these goals offers attractions, what most investors had expected was that Mr. Obama would take some months—or even years—to craft the requisite legislative changes and submit them to Congress, within evolving budget constraints—after first dealing with the financial and economic forest fire that threatened to spread out of control.

The brilliant Larry Summers had, on several occasions during the election campaign and after he became Economic Advisor to Obama, summed up an appropriate stimulus package: it would be “timely, targeted and temporary.” Investors assumed that meant Obama’s plan would focus on near-term job creation, with heavy emphasis on “shovel-ready” infrastructure programs that would, like Eisenhower’s Interstate Highway Program, stimulate the economy and open new areas for economic development.

What we got does in fact include money for roads, bridges and other job-creators—roughly 5% of the total.

As for the rest, Nancy Pelosi and her House colleagues gave the nation an encyclopedia-sized monstrosity with spending programs budgeted at nearly \$800 billion. No Republicans voted for it, their resistance stiffened by rebellion from Republican and moderate voters expressing horror at “runaway spending.”

According to various nonpartisan analysts, \$290 billion or more of the spending will not come before 2011. So much for the savior’s stimulus now.

What stunned many observers who had awaited this initiative so eagerly was that, in the guise of temporary stimulus, the President was launching a revolution—Change We Could Fear—that would permanently alter the respective shares of GDP between the private sector and Washington. What is the model for this new America? It’s beginning to look a lot like Belgium.

In comparing this multi-trillion gallimaufry of expenditures and regulations to reshape the American economy with Larry Summers’ previous promise that the stimulus program would be “targeted and temporary,” we thought of Dick Cheney’s and Donald Rumsfeld’s promise to a wary America, based on the CIA’s “slam dunk” assessment of Saddam’s WMD, that the war would be short and successful.

(In Feb. 2003, Donald Rumsfeld spoke to American troops, said, “It could last six days, six weeks. I doubt six months.” That war is turning out “better than anyone expected,” in *Obama’s* words, but most Americans still doubt it was worth the costs. Obama’s planned reshaping of America won’t cost hundreds of lives, but its financial and economic costs could make the financial and economic costs of the Iraq misadventure look almost trivial in comparison. (In retrospect, as a wise and loyal Democrat said to us, “Obama’s big mistake was letting Nancy Pelosi write the spending bills.”)

“Obama’s big mistake was letting Nancy Pelosi write the spending bills.”

The President, a born-again anti-earmarker, had also guaranteed that the stimulus bill would fulfill his McCain-induced election pledge to eliminate earmarks, and for that we joined in the praise.

Then, a week later, Ms. Pelosi sent up an omnibus spending bill of roughly equal scale, raising the total commitments toward the \$2 trillion mark. This one was filled with a near-record array of earmarks. In other words, the pet political projects that were verboten for the so-called stimulus package only had to wait a few days for enactment.

What are the spending priorities for Obama’s first term that will doubtless become part of Congressional baselines for built-in spending increases thereafter?

Well, there’s hundreds of billions for global warming. We address our doubts about that later (please see page 28). And there are huge sums for health care. Just maybe, Obama will be able to rein in the trial lawyers and find a way to lower the litigation risks and costs that are the biggest reason why this country spends such egregious amounts on health care compared to the rest of the world. Since the trial bar is one of his biggest backers, it will be interesting to see whether he’s prepared to push for real reform.

Which brings us to the billions headed for public schools, including more than \$500 million for Detroit schools. That system sends 5% of its students to university. Its finances are famously foul: more than \$50 million spent last year just disappeared.

That blank-check approach to Detroit doesn’t apply to D.C.. There, the Democrats actually found a Bush-era program they could cut—permanently—saving us taxpayers \$14 million. Which grotesque wasteful program is that?

It is the \$7,500 per capita voucher program for 1,700 D.C. students—overwhelmingly African-American—allowing them to attend private schools in the region. Competition for placements in this program is intense, because the students perform far above those in the rest of the D.C. system, which is generally conceded to be one of the worst anywhere.

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Would President Obama or any other leading Democratic politician or lobbyist send his children to D.C.'s public schools? Of course not.

Would President Obama or any other leading Democratic politician or lobbyist send his children to D.C.'s public schools? Of course not. (Two African-American beneficiaries of this special program are attending the Sidwell School—along with the Obama children. But not for long.)

So why were Democrats so eager to save \$14 million on an education program whose students and parents praise it to the skies?

Because the Teachers' Union, one of the party's biggest backers, opposes it.

So Congress allocates hundreds of billions for public schools, regardless of performance, and cancels a few bucks of funding for a program that really works.

Despite such a miserable start, all may not be lost. Obama's Secretary of Education, Arne Duncan, comes from the Chicago Public School system, and he has an impressive record of reform. The Chicago Teachers Union displayed a willingness to work together with him in improving a really sad situation. If the locals of the union nationwide could show similar cooperation—and if, somehow, Washington can help achieve progress across thousands of school districts sending in something more valuable than money, then maybe there'll be more change than just strangling a successful experiment that benefited a few hundred kinds. We'll give Obama the benefit of the doubt on this one—and cross our fingers. (Maybe Mr. Duncan could bring a few Chicago teachers to Washington to help the process along.)

The President dismisses critics of his spending programs, saying there won't be scary deficits because he has found \$2 trillions in savings on wasteful expenditures. His budget director (whose explanation was published—if at all—on Page 16 of all those pro-Obama newspapers) says more than half the savings come because this Administration won't continue the Surge in Iraq until 2019. It would have cost \$1.2 trillion, using the peak costs, to extend that until 2019, and *this* government won't let it happen. This is truly sophisticated bookkeeping. Why stop there? How about costing out Obama's campaign proposals over ten years, and, by *not* implementing those programs, we'd save \$10 trillion, and can thereby wipe out the national debt?

Why isn't the Obama team coming forward with financial rescue programs the market can believe in? One obvious reason is that Tim Geithner, who is Rescuer in Chief, doesn't have the staff to do the incredibly complex work of analysis and program design.

The top 16 Treasury positions requiring Congressional approval, who report to Mr. Geithner, remain unfilled. Not because recalcitrant Republicans are tying them up in committee: they hadn't been named and scheduled for hearings (as of late last week).

When unemployment keeps soaring, banks keep failing, and stocks remain in a major bear market, is this the time to be concentrating on universal health care, fighting global warming, and spending vastly more money on public schools?

We concur in the Congressional Budget Office's appraisal that even if the Pelosi-Obama programs pleasantly surprise us by helping to pull the US out of recession, they virtually ensure that the nation's longer-term economic and financial prospects will be bleaker than if the stimulus had not passed, *so we have less confidence in US equities as an asset class.*

The long Reagan boom that came after the last Mama Bear market so energized the markets and the economy that the S&P trebled in five years, and laid the foundations for 900% returns over fifteen years. We shall not see its like again. The entrepreneurial spirit Reagan praised and unleashed with tax cuts and deregulation (*but not of banking—that came under Clinton with the repeal of Glass-Steagall and the explosion of derivatives, particularly CDOs and Collateralized Debt Swaps*) is now the object of Obama obloquy, and Obama's program of huge tax boosts, denial of secret ballots in union organizational efforts, and massive costs to fight global warming argue for, not a Thatcherite, but at best a Belgian economic recovery.

Sic transit stimulus.

Vivat ursus.

[Because we are now licensed with the SEC, we have to declare any possible biases in our commentary. We therefore admit to the resentment we felt when our tobacconist advised us this week of the increase in federal taxes at month-end—*eighty cents more per cigar from an already high base!* This could possibly have influenced our attitude.]

**...not a Thatcherite,
but at best a Belgian
economic recovery.**

Why couldn't those past cycles be prologues for another housing boom?

Strategies For Coping With Cooling

1. Demographic Cooling

An oft-told story that originated in *The Economist* tells of the meeting of the endowment committee at an unnamed Oxford college. The fellows had managed the fund for centuries.

Finally, during the 1980s, a lecturer in Economics became a fellow. He was appalled to learn that the entire endowment was invested in real estate. He advised the Chair that he was going to propose a new investment policy based on equities.

At the next meeting, he came armed with charts showing rates of return of all asset classes over varying time periods extending back to 1945. Equities came out clearly on top.

When the presentation ended, he preened himself, and awaited questions. The Chairman, an historian, thanked him for his “most interesting presentation.”

He went on, “The College’s trust funds have given acceptable returns over a time period that includes the Hundred Years War, the Black Death, The Wars of the Roses, the Civil War, the Wars of the Spanish Succession, the Seven-Years War, the American Revolutionary War, the Napoleonic War, the various Depressions of the 19th Century, World War I, the Great Depression, World War II, and the period of troublesome inflation in the last decade. We shall be most interested if you can supply evidence of satisfactory performance of your asset class over a relevant time horizon.”

The core investment consensus—that OECD nations such as the US, Ireland, Britain and Spain could have sustained economic recoveries led by a house price boom of the kind that had occurred in earlier cycles—was actually a mania: it was based on a denial of basic, observable, everyday reality.

Why couldn't those past cycles be prologues for another housing boom?

After all, residential real estate has been a reliable long-term asset class. Apart from catastrophes such as Bubonic Plague and the Thirty Years' War, populations have tended, through history, to grow faster from generation to generation than the supply of well-located housing land. The long-term trend in growth of wealth from the Industrial Revolution, progress in medicine, sanitation, and public health, and sustained improvements in food production reinforced that trend in recent centuries.

No more.

When the overwhelming majority of families in the OECD nations collectively and simultaneously chose to cease reproducing themselves in the early 1970s, and stuck to that resolution, they repealed the most basic of long-term investment concepts. Demographers and social scientists can debate the reasons behind this momentous behavior shift—or even whether it is a good thing. We merely note the obvious, that financial prognosticators have not: people changed 35 years ago—apparently permanently—and the world changed—apparently permanently.

After the Baby Boom came, *in the twinkling of an historical eyelash*, the Baby Bust.

The industrial world—in the most momentous behavior shift in recorded history—simultaneously switched its collective priority from reproducing itself to a program that, if projected forward through centuries on a Global Excel Program, leads to extinction. Japan was in the vanguard of this historically unique transformation, but Europe and North America quickly caught on. (Japan now predicts its population will halve within 70 years.)

What began during the early 1970s was an OECD-wide collapse in the fertility rate from roughly 2.4 - 2.5 babies per female to 1.4 babies. Since 2.1 is required to maintain population levels, the three decades of fertility below 1.6 have, slowly but inexorably, transformed population profiles—***and the housing markets.***

Japan has been *the* clear, pure exemplar of this commitment to demographic deflation, because of the nation's resistance to immigration.

In Europe, the impact was for some years masked by large-scale immigration from the Southern shores of the Mediterranean.

Canada's population deterioration was also masked for many years by immigration—from Southern and Eastern Asia in British Columbia, and from Asia and the Arab world in Quebec and Ontario.

The US is the only major industrial economy to have apparently evaded sustained ageing and population collapse...but just barely. Its fertility rate remains close to replacement level. However, this is solely because of the decades of heavy inflow of Latin-American immigrants, whose age is below the average of the rest of the population, and, crucially, whose fertility rates far exceed those of "whites" (other than Mormons and Orthodox Jews).

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...this was the worst time—in recorded history—to debase, debauch and complicate mortgages.

Why is demographic deflation so crucial to investors?

Because investors, governments, realtors and homebuilders relied in this cycle as in all previous cycles on historical data for home absorption rates, and on the record of reliable secular increases in home prices to justify a multi-trillion bet on exotic mortgage products. It turned out that this was the worst time—in recorded history—to debase, debauch and complicate mortgages.

When Barney Frank and his Clintonista cronies at Fannie Mae and Freddie Mac (Fan & Fred) changed the rules on Fan & Fred lending early in this decade, and increased the pressures on other lenders to lend “more generously” to the poor, they set the stage for a mortgage crisis of record proportions. Every attempt Congressional Republicans, Bush and Alan Greenspan, made to increase the regulation and tighten the lending restrictions on Fan & Fred was blocked by Congressional Democrats. Even when Fannie was found to have grotesquely over-reported its profits, thereby triggering huge bonuses to such people as CEO Franklin Raines (Clinton’s Budget Director), and Jamie Gorelick (Clinton’s Deputy Attorney-General), Frank was successful in blocking all Congressional investigations. Days before Fan & Fred finally went down in 2008, he insisted both those companies were well-financed and posed no threats to the taxpayers.

Rep. Frank couldn’t have protected Fan & Fred for so many years and expanded their powers without powerful allies on Wall Street among the companies creating mortgage-backed CDOs in which Fan & Fred were big participants.

Result: powerful Congresspersons and powerful Wall Street leaders together spawned a greater economic disaster for the US than the Korean, Vietnam, Iraq and Afghan wars combined.

What none of these serial destroyers of the housing market noticed was that the reason they had to keep debasing the lending criteria in order to expand the supply of qualified homebuyers, was the supply of qualified homebuyers was so far below historical trends.

Historically, each new generation was substantially larger than its predecessor. However, since 1971, across the OECD, each new generation is roughly 60% the size of its predecessor. The supply of babies who would eventually qualify as financially credible first-time home-buyers is in steady, permanent decline.

What about immigration? Wouldn’t that offset the OECD birth dearth?

The answer is yes, for those immigrants who quickly qualify for jobs and demonstrate (or exceed) the character, quality, and credit-worthiness of the rest of the population. They become prime candidates for conventional mortgages. However, they have to be allowed to stay here in order to buy a house. That isn't easy. The same Congress that was forcing Fan, Fred and the bankers to lend to poor Latinos and African-Americans has restricted the supply of visas and green cards for highly-qualified immigrants to the pitiful level of 85,000.

According to an op-ed article in *The Wall Street Journal* by Richard LeFrak and Gary Shilling, "Last year 163,000 petitions were filed in the first five days after applications were accepted. The Ewing Marion Kauffman Foundation estimates that as of Sept. 30th, 2006, 500,040 residents of the US and 59,915 individuals living abroad were waiting for employment-based visas. These people tend to be highly productive. In 2006, foreign nationals resident in the US were listed as inventors on 25.6% of the patent applications filed in the US, up from 7.6% in 1998...in the fall of 2007, 241,095 non-US citizens were enrolled in graduate programs. Some 55% were in engineering and the biological and physical sciences, compared with only 16% of US citizens."

However, the financial and social integration performance of immigrants has varied widely across the OECD in recent decades. For example, a distressingly high percentage of the residents of those *Banlieux* of Paris that have been the scenes of major riots are, unfortunately, permanently unemployed people whom the state must maintain.

In contrast with the disappointing experience in recent years of many European nations with many of their Third World immigrants, the Latinos in America have historically had a far better record of employment and integration into American society. They are used to traveling to where the jobs are, and they usually seek to put down roots, have children, and share in "The American Dream."

Sadly, in this cycle, California—the destination for so many Latinos—became the scene of mortgage abuse and folly on truly historic scale. Entire housing projects were built and sold to Latinos who had scant or zero evidence of employment income, and who could not comprehend the terms in the newfangled mortgages they were given. Default rates in some of these communities now exceed 40%, and new slums are born as buildings fall into disrepair, driving down home values for those who are struggling to keep up their payments.

...Latinos in America have historically had a far better record of employment and integration into American society.

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It's later than you think!

There can be no recurrence of the kind of housing boom experienced during the 1950s and 1960s—or of the underlying strength in housing demand that held up during the tough recessions of the 1970s. The painful equity bear markets of that era were not mimicked in the mortgage markets.

This is the one crucial reason why this economic crisis is worse than the downturns of 1974 and 1981.

During those earlier severe recessions, house prices did not collapse, because there was pent-up demand from new labor force entrants and other first-time home buyers—including those funded by parents wearied of living with their grown-up progeny).

Perhaps the USA is closer to following the Japanese experience than the planners believe. For years, Japan has produced more morticians than obstetricians. We were therefore interested to see in *Investors Business Daily's* list of relative performance of 197 stock groups traded on US markets that a group moving up strongly in recent weeks is Funeral Providers.

It's later than you think!

2. Financial Sector Freeze-Ups

The 2000-2002 bear market was caused by the Triple Waterfall Crash of technology stocks. The ensuing recession wiped out the small surpluses of the late Clinton years and handed Bush a huge deficit at a time Americans' personal investment holdings had taken terrible, and—it would later appear—unrecoverable losses.

One unforeseen effect of the tech collapse was a conviction among a generation of new investment enthusiasts that stocks couldn't deliver them the luxurious retirements the promoters had promised. What remained was the one asset class that had never failed: houses. So millions of aging Boomers bet their diminished wads on bigger homes than they needed, second homes, and a new craze—flipping. Pension funds managed by that generation of investors plunged into Collateralized Real Estate CDOs, as condos, shopping centers and office towers became the latest sure thing.

This bear market was primarily caused by the collapse of a relative handful of grossly-mismanaged investment banks (and commercial banks such as Bank of America that, after the repeal of Glass-Steagall had covertly become wannabe investment banks). Although they were overextended on other derivatives and structured products, what pushed them to the brink—and created a global crisis—was their exposure to unsound mortgage products.

As we wrote in our last issue, the greed, deception and mismanagement of a few hundred morally-bankrupt people on Wall Street and in the City of London, fostered by powerful Congressional barons, has proved to be the greatest challenge to capitalism as an ethical and reliable system in modern times—if not since Adam Smith’s era.

We predicted that the political convulsions from this totally unnecessary financial collapse would threaten the survival of free markets and limited government.

Everything that has occurred since we wrote those doleful words has confirmed our view that the Thatcher-Reagan era of limited government, free trade, and strong economic growth is ending.

Our last remaining hope is that Reagan and Thatcher’s clear-eyed campaign to strengthen the West’s defenses against its enemies—which led to Cold War victory—will somehow endure the revolution now sweeping Washington amid public revulsion against shameless capitalists. Iran is only months away from having nuclear weapons to tip its fast-growing armory of missiles. Pakistan’s creator of nuclear bombs is now at liberty. North Korea continues to make advanced weapons and wild threats. The US is the only major Western nation not to have experienced a terrorist attack since 9/11. The Bush Administration routinely claimed that its pervasive surveillance systems, and keeping the extra-baddies in Guantanamo were major factors in keeping us safe.

The Hard Left has been screaming for years that Bush and Cheney were greater threats to America than Islamic terrorists (although they eschew the use of that term, as Obama has chosen to ban the use of the term “enemy combatants”).

In the years ahead we shall doubtless learn whose geopolitical appraisals were accurate.

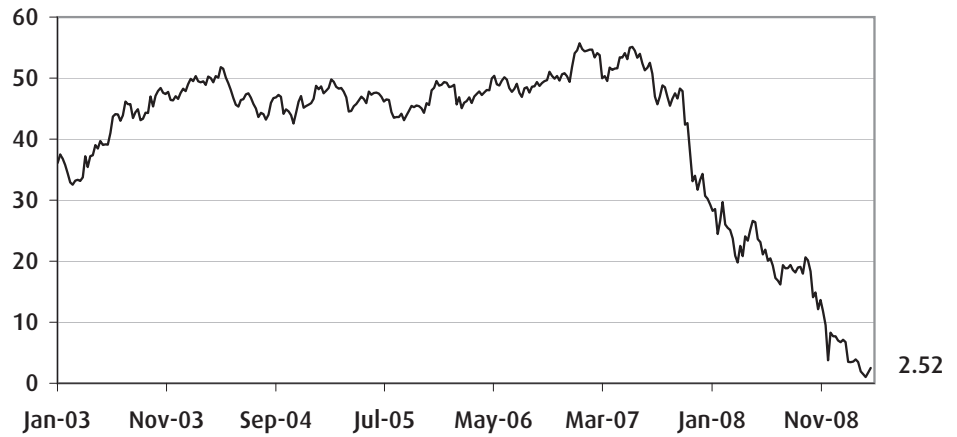
The Hard Left has been screaming for years that Bush and Cheney were greater threats to America than Islamic terrorists...

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The Survivors

Citigroup Inc. (C)

January 1, 2003 to March 16, 2009



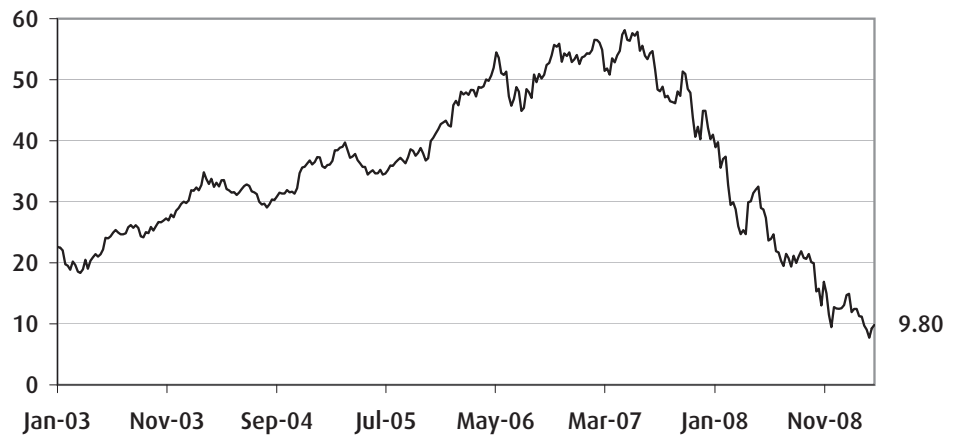
Bank of America Corp. (BAC)

January 1, 2003 to March 16, 2009



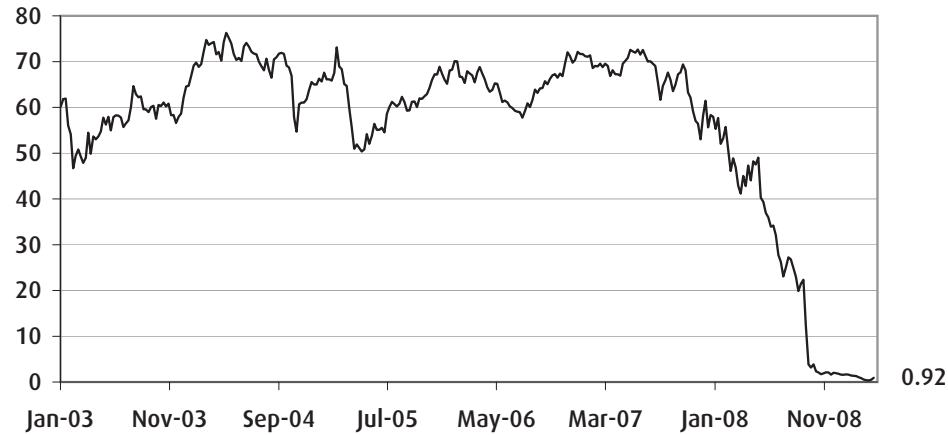
UBS AG (UBS)

January 1, 2003 to March 16, 2009



American International Group, Inc. (AIG)

January 1, 2003 to March 16, 2009



**Citigroup...now trades
at what might be
termed the “CEO/PE”
of 76 times.**

The Royal Bank of Scotland Group PLC (RBS)

October 1, 2007 to March 16, 2009



These are among the *survivors* of the worst collapse of financial stocks since the Depression. They would, until quite recently, have been considered blue chips appropriate for “widows and orphans.” Their market capitalizations have plummeted, despite receiving hundreds of billions in bailouts. According to reports in *The New York Times*, Vikram Pandit received \$216 million to become Citicorp’s CEO. If that number remains accurate, then Citigroup, after its impressive bounce to \$2.75 from its low of \$1 now trades at what might be termed the “CEO/PE” of 76 times—and roughly 108 times what Robert Rubin was paid in the past few years for advisory services, including his sought-after advice to the Board to increase the bank’s exposure to CDOs near the peak of the mania.

The ObamaMama Bear Market?

We see no sound reason for taxpayers to prop up the most unsound Wall Street banks, apart from systemic risk...

We see no sound reason for taxpayers to prop up the most unsound Wall Street banks, apart from systemic risk, which can be managed by guaranteeing counterparties on their exposure. Their diseases are incurable, but the Fed and the Treasury should seek to quarantine them to ensure that they do not transmit those lethal germs to other institutions. That seems to be the rationale behind the decision to pump more than \$150 billion into AIG. Moreover, we believe the regulators should be applying strong pressure to all institutions to reduce exposure to the kinds of complex derivatives that are this decade's "weapons of mass financial destruction," as Warren Buffett correctly prophesied. We believe that the acid test for investment in shares of any financial institution is whether it has scaled back or shut down operations that top management has demonstrated it cannot effectively supervise. If the CEO and CFO can't analyze the products the institution has been buying and trading, then they are in no position to reassure shareholders that the era of disastrous mistakes has ended.

A major issue in this decade has been the spread of Enron-style balance sheet practices across the banking system. Enron, it will be recalled, was a utility that used advanced technology and an incentive-based compensation system to become a trading powerhouse. Roughly a year before it blew up, Enron was the subject of a long analysis in *The Economist*, that described it as one of the companies that define the future, (while expressing a scintilla of doubt that the bosses might be afflicted with hubris). Enron was named "America's Most Innovative Company" by *Fortune* for five straight years from 1996-2000. Nine years ago, in a glowing story, *Fortune* characterized Enron as the Elvis that broke up a country-club dance with a Guy Lombardo band. "What exactly does Enron do?" it asked. "We try to look at markets that don't exist and dream about them existing" was the answer from its head of bandwidth trading. It quoted Enron's #2, Jeff Skilling "Can't wait for Enron's new office tower"... "I'll be able to go down a flight of stairs and shoot spitballs at the trader." (Fortune favors the Knave?)

The Economist turned out to be right about Enron's strategies being the wave of the future. Bank CEOs who lusted to attain the prestige and bonuses earned by the stars at Goldman and Morgan Stanley eagerly took advantage of the repeal of Glass-Steagall to transform (or transmogrify) their sound, stable (read: "boring") banks into slick, leading-edge, computer-model-driven powerhouses. Alan Greenspan, who always struggled to escape from the shadow of the magisterial Volcker, became an enthusiastic drummer for this "innovation." He claimed that expanding productivity across the financial system would fight inflation—thereby helping to justify his continuation of Depression-era fed funds rates long after the 2001 recession had ended—and long after it was apparent that America was in the grip of the second great Greenspan bubble—the housing bubble.

Greenspan was merely egotistical and delusional—not dishonest. He never changed Fed reporting rules to cover up dodgy risk management. So it is unfair of Congressional barons and *The Wall Street Journal* to lump him in with the long list of leading bankers when blame for the financial crisis and the recession is being allotted. What Jimmy Cayne did to Bear Stearns, Stan O’Neal did to Merrill Lynch and Richard Fuld did to Lehman was contemptible. What Greenspan did to the global financial system was merely inexcusable.

Banks that had prospered under Volcker’s wise Basel Accord rules which limited the banks’ leverage to 12x tangible equity got approval to bypass the rules by setting up Enronesque off-balance sheet entities that bought longer-duration and riskier assets. They financed them with short-term borrowings at low rates because the banks were seen to be sponsoring these backyard lot operations. This sexy success strategy was, therefore based on three principles:

1. Hide what you’re doing by moving it off the balance sheet.
2. Borrow short, at advantageous rates because investors understand these SIVS or conduits are bank-sponsored.
3. Lend long in complex CDOs and other assets that ordinary mortals don’t understand.

The widespread resort to this slippery practice was one major contributor to the current financial crisis. The sudden collapse of Enron should have been the warning sign to bank regulators that Wall Street’s basic business model was seriously bad.

Then those Enronesque ghost entities began to get into trouble and were exposed—one by one—to the light of day. It turned out that many major banks were far less liquid, far less solvent, and had far greater mismatches between their borrowings and their investments than the airbrushed portraits they had presented which made them look so effective by Basel standards.

The banks moved away from Volcker’s Basel Accords by agreeing among themselves to create a new rules model—Basel II. According to this “modernized” model, banks were allowed to rate their financial strength according to their own risk models—not according to the independent, tried and true Basel I standards.

Then they embarked on (1) the greatest collective debauchery of banking principles in the history of international banking, and (2) paying bank executives the largest bonuses in the history of international banking.

The sudden collapse of Enron should have been the warning sign to bank regulators that Wall Street's basic business model was seriously bad.

The ObamaMama Bear Market?

The national recovery will not, in general, be driven by the banks that debased their business models after Glass-Steagall's repeal.

The Basel II rules let the banks lever up far past Basel I if the banks could (1) show that their own risk models had worked well for years, and (2) that investments remained governed by the rating agencies' appraisals; in particular, as they expanded their leverage, they had to ensure that their commitment to AAA-rated investments remained intact.

It must have sounded plausible to the brandy and cigars set in Basel. However, as Goldman's Lloyd Blankfein noted in the *Financial Times* recently, "Too many financial institutions and investors simply outsourced their risk management. Rather than undertake their own analysis, they relied on the rating agencies to do the essential work of risk analysis for them... In January 2008, there were 12 Triple A-rated companies in the world. At the same time there were 64,000 structured finance instruments, such as collateralized debt obligations, rated triple A."

Henry Paulson and Ben Bernanke tried to stop the bleeding in the banking system. What President Obama and his tarnished tax-collector-in chief Tim Geithner, are now trying to do is (1) to stop the drag on the economy from sick, moribund banks preoccupied with their hundreds of billions in smelly, decaying paper, and (2) to restore the banking system to its historic role as partner in economic progress.

Now, Geithner and his associates need to adopt tough-minded triage. Which banks, if their most problematic paper is somehow transferred to a poisonous waste dump, can be vigorous participants in the economy—making loans and deals, and not just trips to Washington by ostentatiously inexpensive transportation?

Citibank, for example, may not be part of the solution to the global financial problem. If it could somehow revert to its John Reed days as THE model of a consumer bank, it would have a role and a reason for investors to own it. Since Sandy Weill fired Reed and tried to make it a bigger and better Goldman, it has lost its right to respect—or, for that matter, survival. It may live on as an undead creature, but it doesn't deserve any new injections of Geithner's limited supply of costly intravenous fluids. It has managed, because of historic pre-eminence and political connections, to garner a large proportion of Washington's sympathy and money. It deserves neither.

The national recovery will not, in general, be driven by the banks that debased their business models after Glass-Steagall's repeal. The economy will find its footing with reliance on banks that supply loans to customers with whom they have face-to-face relationships, letters of credit, inventory factoring and the other, socially-necessary basic businesses of banking. *Those products and services are the only justifications for bailing out banks.* There is no justification whatever for rescuing banks which devote their capital to complex debt products that they trade with other banks and hedge funds—any more than taxpayers should finance bookies who backed Pittsburgh and lost heavily when Arizona covered the spread.

Bank of America could prove the exception to this generalization. It has proven that it can both fail to manage its balance sheet, and flail like some dinosaur stuck in a primeval tar pit, but—as the #1 holder of deposits, #1 mortgage lender and, perhaps, #1 stockbroker, it deserves to survive. Investors seem to have decided that, at its current price, it’s a long-term call option on the possibility that it will once again be a superb consumer bank.

We now know that the top managements of many of the Wall Street banks either didn’t know the risks they were assuming—or they were fraudsters. Their activities and creations serve no crucial social or economic purpose—so the taxpayers shouldn’t have to pay a dime to maintain the lifestyles of the once-rich and always-irresponsible.

The Merrill Lynch story is particularly sad. Once the greatest brokerage firm America had ever known, under the leadership (if that is the correct word) of Stanley O’Neal, it became one of the biggest packagers and investors in dubious and outright terrible mortgages. John Thain tried to save it from collapse, but had to sell to Bank of America. Then, despite operating losses of \$41.2 billion, he acquiesced in a bonus program that aroused widespread rage. Nearly \$4 billion was paid out in hours. While those bonuses were being rushed out, Ken Lewis was demanding an extra payment from Washington to complete the buyout he wishes he had never made.

But Merrill’s bonus problems now seem modest, in the light of this week’s revelations from AIG, whose bonuses went to the very groups in Connecticut and London that blew more than \$100 billion of AIG’s money.

That shocker comes at a bad time for Mr. Geithner. Doubtless, many taxpayers filing their returns within the next four weeks will feel some of bitterness at sending money to the Treasury now that it’s headed by the Secretary who only paid up his multi-year arrears in taxes for Social Security and Medicare when Obama appointed him, and who was in on all the bailouts from the beginning—including AIG, the current poster boy for Wall Street infamies.

Apart from the bosses, the mathematics Ph.Ds who created the CDOs and other dangerous products should have the same job outlook as nuclear bomb builders after a nuclear weapons ban is imposed: they aren’t needed and if they stick around they can only cause trouble. Warren Buffett, who has long characterized their output as “Instruments of mass financial destruction,” warns in his annual letter, “Beware of geeks bearing formulas.” In lieu of severance, perhaps the Department of Education could take them on its payroll and send them to teach math in inner city schools. Not only would this please the remaining Mao fans in the universities, but for the first time in their working lives they would be doing good for the community.

**The Merrill Lynch story
is particularly sad.**

The ObamaMama Bear Market?

Adam Smith warned of the perils of a society where businessmen made too much money from trading...

Adam Smith warned of the perils of a society where businessmen made too much money from trading—as opposed to creating real industrial and commercial progress. Even in nightmares, he could not have imagined such cupidity and stupidity.

It's too late to avert the Wall Street implosion. It's not too late to ensure that no more taxpayer money goes to continuing the process.

James Baker, Reagan's Treasury Secretary who knew a thing or two about bailouts, writing in the *Financial Times*, says, "We should divide the banks into three groups: the healthy, the hopeless and the needy. Leave the healthy alone and quickly close the hopeless. The needy should be reorganized and recapitalized, preferably through private investment or debt-to-equity swaps, but, if necessary, through public funds. It is time for triage."

"All depositors of recapitalized banks should be fully guaranteed...But bank boards of directors and senior management should be replaced, and unfortunately shareholders will lose their investment...This is not a call for nationalization but rather for a temporary injection of public funds to clear up problem banks...To avoid bank runs and contain market disruption, the Treasury should announce its decisions at one time."

Mr. Baker's counsel derives, in part, from his experience with the collapse of the Continental Illinois, whose office (or tombstone) can be seen from our window. Paul Volcker instantly paid off all the Continental's Eurodollar liabilities out of the FDIC Fund, which was clearly illegal, but it prevented a financial collapse. That experience led to Mr. Volcker's great work in setting up the Basel Accords.

Mr. Volcker has a suggestion that we readily endorse. Speaking at NYU, he suggested a two-tier financial system. "Commercial banks would provide customers with depository services and access to credit and would be highly regulated, while securities firms would have the freedom to take on more risk and practice trading," he said.

That's fine with us, as long as:

1. The securities firms commit to refunding every dime of the taxpayers' money they now hold—and more speedily than Mr. Geithner paid his taxes, and
2. If one of them gets into such trouble that it has to run to Washington for a bailout, the top management would have unlimited personal liability, if it turned out that, *after 2008*, the firm had taken on new exposure to derivatives or

counterparty risks that subsequently impaired its stated capital position *and were not immediately disclosed in subsequent reports*. Any firm that practiced Enron-style accounting and has survived through emergency aid from Washington should be, for at least five years, treated with the kind of caution and doubt that the health care system would allot to a doctor judicially cited for malpractice resulting in serious injuries and/or deaths.

Finally, we wish to comment on one of those innovations so praised by Alan Greenspan that should have been strangled at birth—Collateralized Debt Swaps. The taxpayers are on the hook at AIG, once known as the world’s biggest insurance company, for more than \$150 billion. Why? Because under “Hank” Greenberg, the company became one of the world’s biggest players in a new line of insurance—insuring against debt defaults. By issuing these contracts on humungous scale, AIG was choosing to participate in the large-scale violation of one of the most sacred principles of insurance—insurable interest. In the early years of life insurance, companies allowed applicants to take out life insurance on almost anybody. When they found out that they were paying extraordinarily heavily on policies in which the policyholder was unrelated to the deceased, a principle, codified into law, emerged: you had to be a close relative or business associate of the person whose life was insured.

The CDSes swiftly became toys of hedge funds and other players who wanted to place bets on how the market’s perception of corporate risk changed from day-to-day. The supply of these speculative vehicles frequently exceeded the total amount of underlying debt by more than 1,000%. Result: the historic day-to-day pricing of risk by bond investors who hold real stakes in corporate debt was supplanted by heavily-levered speculators. AIG’s actuaries had no real expertise in pricing corporate debt, and, as it turned out, even less expertise in pricing CDOs. They simply bet their company.

The creation and metastasizing of Collateralized Debt Swaps proved to be the financial equivalent of what happened when the Sorcerer’s Apprentice got hold of the master’s book of spells—and chaos ensued. The Risk Management Committees of the institutions who bet their banks on these new instruments met Oscar Wilde’s definition of a committee: “A collection of incompetents meeting to do the unnecessary.”

The defense offered by the Street for this disaster is the equivalent of the old story of a defense offered to a charge of drunk driving: “I didn’t know I was loaded.”

Collateralized Debt Swaps proved to be the financial equivalent of what happened when the Sorcerer’s Apprentice got hold of the master’s book of spells...

The ObamaMama Bear Market?

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3. The Equity Bear and the Restatement of the National Balance Sheet

Commentators have been making a great deal of the fact that last year was the worst for the S&P since 1931.

This grim statistic is supportive of the widely-noised idea that this downturn is the worst since the Depression. For weeks after the election, President Obama missed no opportunity to remind audiences of that comparison. (He switched from talk of Depression and disaster to optimism when the “stimulus” bill reached the Hill.)

As this is written, the returns on the S&P for the past 10.25 years are well below those achieved in the ten years after September 1929. But we aren’t suffering 25% unemployment, GDP hasn’t fallen by a third, and more than 85% of mortgagors are meeting their mortgage obligations.

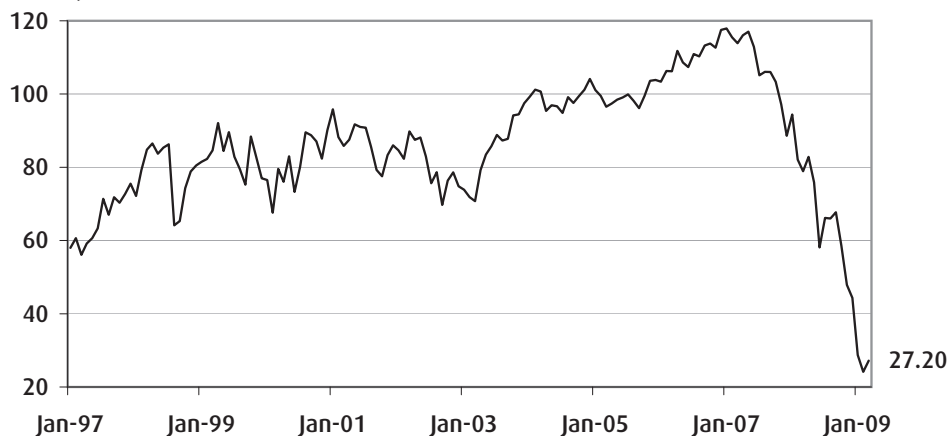
S&P 500

January 1, 1997 to March 16, 2009



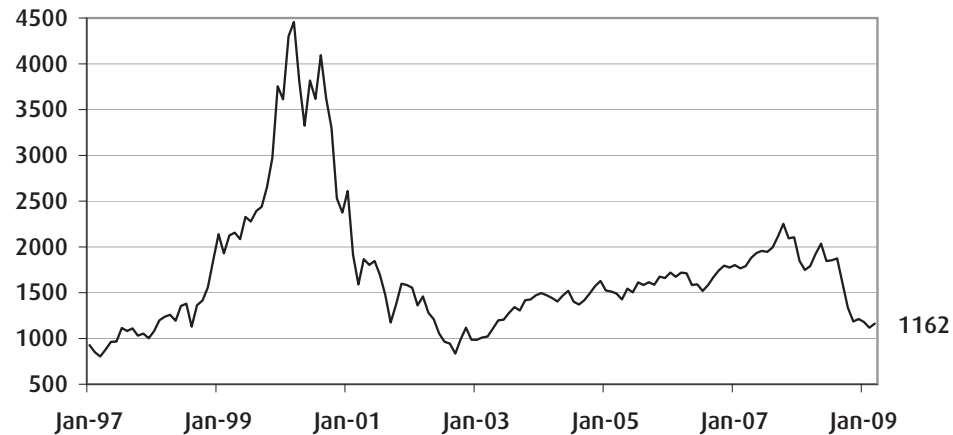
Philadelphia KBW Bank Index (BKX)

January 1, 1997 to March 16, 2009



Nasdaq 100 Index

January 1, 1997 to March 16, 2009



**Where are the snow
jobs of yesteryear?**

Peter Bernstein, writing in the *Financial Times*, cites Ibbotson data showing that long Treasuries have outperformed the S&P 500 on a total return basis over five, ten, and 25-year periods, “and by substantial amounts.”

As we wrote in our book, “If Treasuries outperform stocks, then capitalism is dead.”

The entire capital market pricing theory and the theoretical economic basis of capitalism—that equities and other risk assets must outperform government bonds—are not just challenged—they are apparently obsolete—like the belief that alligators were facing extinction.

Larry Summers summed up equity performance with an even more doleful metric last week, saying that the US stock market, adjusted for inflation, was back to where it was during Lyndon Johnson’s Administration. That’s 35 years of zero real return. What about those books like *Stocks for the Long Run* that enriched the drumbeaters? Where are the snow jobs of yesteryear?

Mr. Summers didn’t point out that gold has gone from \$35 an ounce to \$900 since LBJ introduced The Great Society.

The ObamaMama Bear Market?

**...“another day older
and deeper in debt.”**

The equity bear market is doubtless the concern of most of this journal’s readers. Of course, there’s that other bear market—the housing market. Depending on which set of statistics you believe, and where you live, house prices have fallen 20% or more. Nevertheless, by one of the most critical of housing tests, US housing affordability is at its most favorable level in a decade. For those who can buy homes with conventional mortgages, the housing bubble has burst—and they have an opportunity to buy on the best terms since the early Clinton years.

Add up the assets, and all the debts—mortgage, home equity, credit card, auto loan—and it becomes clear that the typical middle-class American has been losing ground at a horrifying rate.

The hallmark of deflations is that the value of debt rises remorselessly in relation to the value of total underlying equity. Corporate and household balance sheets weaken, and bankruptcies and foreclosures climb.

Ned Davis recently published a chart showing total US household debt relative to GDP over the past eighty years. As recently as 1998, debt stood at roughly 240% of GDP. It’s been setting new records by the year, and now stands at 359.2% of GDP.

In other words, during the decade that US stocks delivered the worst total return to investors since the Depression, the debt/GDP ratio deteriorated by almost 50%. Therefore, Americans were trying to make up for the inadequate returns on their savings through greater borrowing... “another day older and deeper in debt.”

Americans have, for at least a decade, been displaying the symptoms of severe debt deflation without recognizing them... and the national debt, which isn’t included in the Davis calculation, is scheduled to leap by roughly 25% in this fiscal year and next.

We suspect that same ratio analysis would show that Japan and most nations in the European Union have also been displaying the symptoms of debt deflation, and maybe only the Japanese recognize their predicament—because they’ve been in this Slough of Despond for most of the time since 1989.

However, we are also certain that China, India and Brazil—and many other smaller Emerging Markets—have experienced diametrically-opposed economic and financial performance in the past decade.

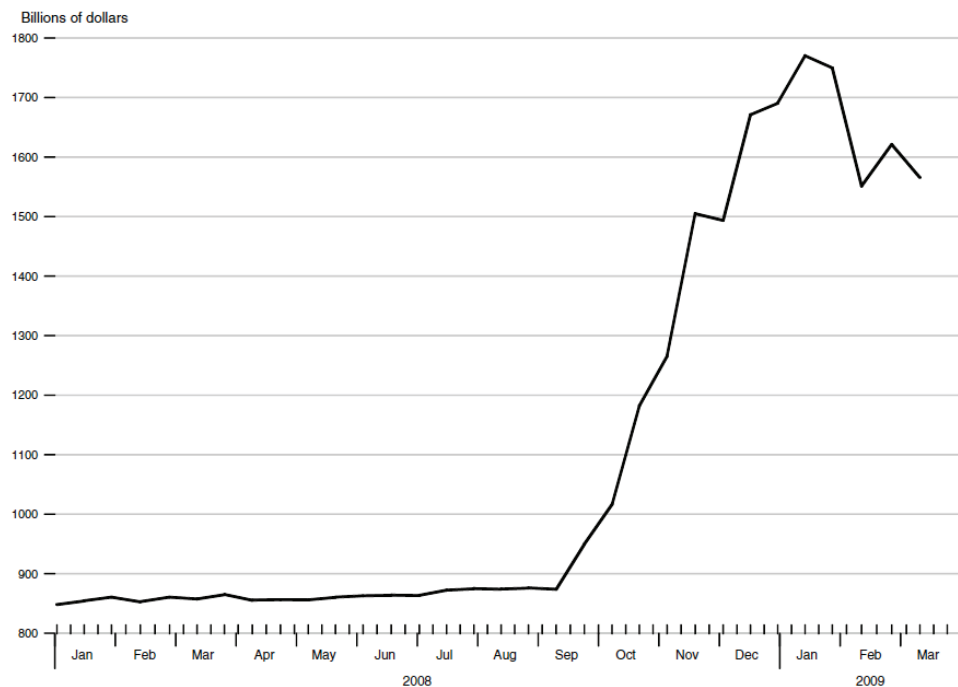
If we were in fact experiencing something approximating debt deflation before the economy drove over a cliff last year, then it is surely important to inject some inflation into the system *now*. Since roughly 50% of inflation is psychologically-based, it actually helps if critics scream that the nation faces runaway inflation because of bailouts, stimulus packages, and the dramatic restructuring of the Fed's balance sheet:

...it is surely important to inject some inflation into the system *now*.

U.S. Federal Reserve Adjusted Monetary Base

January 2007 to March 2009

Averages of Daily Figures, Seasonally Adjusted



Adjusted Monetary Base

To the average of two maintenance periods ending:	Compounded annual rates of change, average of two maintenance periods ending:							
	03/12/08	06/04/08	08/13/08	09/10/08	10/08/08	11/05/08	12/17/08	01/14/09
08/13/08	4.4							
09/10/08	3.7	5.9						
10/08/08	26.4	46.5	114.0					
11/05/08	71.8	129.2	328.5	785.3				
12/17/08	121.3	209.3	454.6	803.8	1088.0			
01/14/09	128.8	210.6	401.8	617.4	716.5	506.4		
02/11/09	102.9	155.8	256.1	348.3	346.6	203.9	31.5	
03/11/09	85.5	122.4	182.9	231.7	213.1	114.4	3.0	-41.5

Source: Federal Reserve Bank of St. Louis; US Financial Data; March 13, 2009

The ObamaMama Bear Market?

We'd like to think that we don't scream, but we have for a year been discussing the strong likelihood that once the economy stops imploding, inflation pressures could be sudden—and dramatic. There are enough similarities between this cycle and the 1970s that the troubles of that era are instructive.

Consider:

...gold is fulfilling its classic function...

1. As of December 6, 1974, with the US and Europe in deep recession, the Dow-Jones Industrials were trading at a six multiple and had erased all the gains of the mutual fund-Cornfeld boom. Nixon had tried to crush inflation three years earlier with wage and price controls, but inflation pressures held up, and the Yom Kippur War and the trebling of oil prices and runaway food inflation set the stage for recession with inflation, which peaked at 14%, before Paul Volcker hammered it down with interest rates reaching 20%. Gold ran in six years from \$38 to \$825.
2. As of August 12, 1982, the Constant Dollar Dow-Jones Industrial Index was back to October 1929 levels. The next day, Volcker finally cut the fed funds rate, and the greatest bond and stock rally in history began.
3. Both then and now, the trebling of oil prices was a big factor in triggering recessions. (One big—and reassuring— difference: oil prices this time have plummeted, and, by some calculations, the stimulus to consumers and industries from this plunge exceeds all the monetary and fiscal stimulus pumped in across the OECD.)
4. Gold bugs are once again running advertisements in newspapers and TV telling investors that gold is the surest investment—and gold prices have been climbing once again. And, once again, many desperate holders of gold jewelry are rushing to sell to raise cash. For them, gold is fulfilling its classic function: no matter how grim the financial markets may be, there is always a ready market for gold at a good price. While Citigroup's stock was plunging 90%, gold's price was climbing by a third.
5. Equity bear markets are once again so powerful that they wipe out all the excess returns that made equities a respected investment asset class.

One of the base-case arguments for equities has been that holders of high-quality dividend-paying stocks can count on income to ride out the worst of a bear market.

Not this time. Such stalwarts as major banks, General Electric and Dow Chemical have eliminated their dividends or cut them to an unpretty penny-a-share.

What has happened to stockholders has also happened to investors in bank deposits, money funds and short-duration bond funds: they are collateral victims in the struggle to save the bad banks. Each time Bernanke slashes interest rates, and each time the Street cheers, the incomes of millions of investors—including millions of retirees—shrinks further.

In other words, members of the middle class who actually lived by Benjamin Franklin's maxims of the rewards of thrift and savings are losing heavily on the value of their equity portfolios, and losing heavily on their investment income. Overstressed mortgagors who get to refinance at lower rates, and banks that misbehaved on majestic scale are the winners.

Maybe, as we hear from some elderly people, the system is rigged against them and capitalism can no longer claim to be an essentially moral ideal.

When one can't trust anything else—banks, money market funds, or politicians—that leaves only gold—the only asset that is no one's liability.

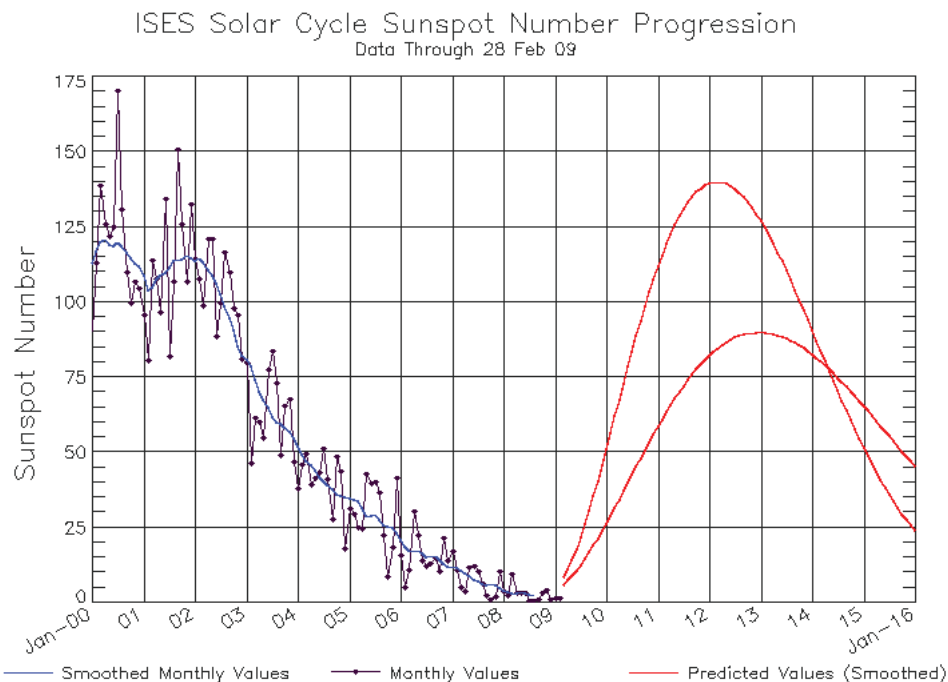
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...the most-respected measures of global climate show a strong cooling trend in this decade...

4. Global Climate Cooling?

Since we last published, the sunspots have been scarce and small, and the most-respected measures of global climate show a strong cooling trend in this decade.

Solar Cycle 23 and 24



Updated 2009 Mar 2

NOAA/SWPC Boulder, CO USA

Source: NOAA Spaceweather Prediction Center: Solar Cycle Progression. <http://www.swpc.noaa.gov/SolarCycle/index.html>

(The projections for future sunspot activity are from the two best-known sunspot research centres. For two years, they have been moving them forward as the sunspots disappoint the astronomers by failing to return.)

As clients know, we use our study of history to compare popular views about economics, finance, geopolitics with evidence of what has happened in previous eras.

As all scientific studies have shown, since the early 19th Century, the world has warmed up. Previously, the world went through roughly two centuries of serious global cooling. Whether by coincidence or not, sunspot activity during those centuries was extremely low.

Outside the Tropics, the world was cold. Example: Scotland suffered six straight crop failures during the 1690s because of late Springs and early frosts. Some historians believe this was the major reason why the Scots gave up their dreams of independence and joined England. There were skating parties on the Thames each winter. Polar ice caps expanded dramatically.

Then, in the early 19th Century, the sunspots returned. The pattern: ten years of sunspot activity, a year of rest, then a new cycle.

The last sunspot cycle ended on schedule in 2006. Also on schedule, there was minimal or no sunspot activity in 2007. Not to worry, said the global warmists: they'll be back next year.

They didn't come back in 2008. They haven't returned so far this year. In retrospect, the record-breaking day-long super-spectacular series of 174 sunspot explosions on Bastille Day in July 2001 was the equivalent of Gandalf's fireworks display for Bilbo Baggins's 111th birthday, which ended Bilbo's ownership of the Ring. Astronomers still speak with awe of the sunspots that day. Satellite and radio communications across the world were devastated, and the Aurora Borealis was seen as far south as Texas. Almost immediately, sunspot activity began to dwindle, and then the spots completely disappeared in 2007. Periods of high sunspot activity didn't reach the levels seen in the 1980s and 1990s. Minimums were lower. Then the sunspots virtually disappeared.

They haven't come back, which means we are experiencing the longest sunspot drought in more than two centuries. As NASA notes, solar wind activity is at a fifty-year low. As other astronomers have noted, that decline in solar wind could be the factor that has dramatically reduced the depth of our atmosphere. Earth has had, for most of the time that we could measure such things, 400 miles of atmosphere between ground level and the Absolute Zero temperatures of outer space. We're down to 250 miles.

As the science writer of the *Telegraph* put it, we are 150 miles closer to outer space than we were at the dawn of the Space Age.

As clients are well aware, we are influenced by the work of astronomers dating back to the Astronomer Royal, William Herschel, who two centuries ago demonstrated a correlation between the price of corn (wheat), and changes in sunspot activity. So we have watched with growing interest as astronomers report surprise at the failure of the sunspots to return.

**...we are 150 miles
closer to outer space
than we were at the
dawn of the Space Age.**

The ObamaMama Bear Market?

...they had managed to miss 193,000 square miles of sea ice, an area 18% larger than California.

The Victorian scientists would have swiftly said that the two cold winters we have been experiencing were inevitable, given the collapse in sunspot activity. There hasn't been such sustained spotlessness on the sun for so long that it seems that the global warmists came to believe that those earlier Minimums were freakish occurrences.

Historians learn to take history as it is reported, and not to impose their own prejudices on it. We believe it highly likely that the temperate zones of the world—where most people and most grains come from—will experience notably cooler weather this year, which could imperil key crops.

Last year, according to some preliminary climatological surveys, the world temperature fell one degree Fahrenheit, the biggest one-drop for which we have authoritative records apart from the short-term cooling after Mount Pinatubo erupted in 1991.

That temperature decline seems to have continued through winter, which has been severe in many regions. It is, as of now, the 10th coldest in Chicago's history. Snow has been reported as far south as Malibu. The Pacific Northwest—including Seattle, Vancouver and Victoria—has suffered the kind of snow and ice storms that more resemble New England than the balmy Pacific Coast. London had one of its biggest snowstorms in decades. Louisiana had a severe snowstorm in December that closed the major bridge across the Mississippi, backing up traffic for miles in either direction.

The University of Illinois Climate Research Centre, which researches ice caps and sea ice in the polar regions (“The Chryosphere”), has for years been reporting on the shrinkage of sea ice. When they took their annual year-end portraits of the poles, they were amazed: In just four months, the sea ice had expanded dramatically, and the total ice was now back to the average level of the past thirty years.

But, (you may say), I've read the reports on the Arctic ice cap shrinkage and I know that we face a crisis. One of the best-known reports is published by the US National Snow and Ice Data Center, whose work was influential in the move to declare polar bears an endangered species. The Institute kept reporting this year that the ice was still disappearing, and its reports kept getting printed.

The Page 16 story came in mid-February when the Institute had to confess that “sensor problems” had given some misleading readings. In fact, they had managed to miss 193,000 square miles of sea ice, an area 18% larger than California.

Our take on all this is that the global warmists have such control over the universities, politics and media, that discussion of the possibility of a new period of global cooling is treated as something between hysteria and voodoo. Therefore, farmers and agricultural planners are making no provision for the *possibility* that this growing season could be far more challenging than last year. And, based on the historical evidence, cooling is cumulative: if the spots don't return, next year is likely to be more problematic for farmers than this year.

'Twas ever thus. Our knowledge of sunspots dates back to Galileo and the records of sunspots have been kept since his time. He wasn't permitted by the Elites of his time to say publicly that the earth revolved around the sun. The Vatican no longer claims that kind of authority, but the Scientific Left (if that is not an oxymoron) does.

One of Galileo's contemporaries, Montaigne, expressed his exasperation about the way science was treated. "We parrot whatever opinions are commonly held, accepting them as truths, with all the paraphernalia of supporting arguments and proofs, as though they were something firm and solid... Thus the world is pickled in stupidity and brimming over with lies." That could describe today's situation whenever the subject of global warming is discussed publicly.

This could be the ultimate Page 16 story.

On the other hand, it may be, as Henry Ford so vociferously maintained, that "History is bunk."

"Thus the world is pickled in stupidity and brimming over with lies."

The ObamaMama Bear Market?

INVESTMENT ENVIRONMENT

Although this recession is still not quite as severe as the recessions of 1974 and 1981, it has produced the most serious financial crisis since the Depression because of the grotesque gambling orgies in Fan & Fred, Wall Street, The City, and Switzerland.

We started writing about the CDO excesses 23 months ago (*Don't Ask; Don't Tell; It's Subprime Time!*). We followed up in June with a paper on the towering derivatives (*Babel in Bond-Land*), and in August, (*Fall Came Early*). In December we published *Double, Double, Greed and Trouble, CDOs and Housing Bubble*, and reduced our recommended equity exposure proclaiming the onset of a financially-driven bear market.

So why didn't we see the coming Crash?

Frankly, because until The Midnight Massacre of July 13th, our indicators only suggested a Papa Bear Market that would leave most of the global economy intact and produce only a minor Largo movement in the Great Commodity Sonata.

As scornful as we were of Wall Street and its "Jurassic Park Avenue" creations, we underestimated just how gigantic was the supply of truly rotten stuff. We made the mistake of thinking that the top managements on Wall Street (if not at Fan & Fred) were fundamentally smart and would make reasonable efforts to be realistic in their public statements about their risk exposures.

In a way, we were like Greenspan, who professed himself as "shocked" that all those glitterati would inflict such horrendous damage on their companies.

Then, everything unraveled so fast that we were looking for a bottom within weeks. We also figured that an Obama election would be a national tonic and that the new brain trust would arrest the panic and restore confidence.

The Dow has leapt 14% since March 9. Does that mean, as so many are now saying, (and as we theorized at the time) that the market bottomed in November?

We'd love to believe that the market anticipated all the bad news back then, but we suspect that it got the economic news right but the political news wrong. We fear that, once this rally, (which is doubtless heavily driven by short-covering) falters, investors will once again focus on the longer-term damage for the US economy from the trillions being committed for global warming and public schools, and the enduring effects from the wipeout of trillions of wealth in stocks and pension funds.

If as the grisliest of bears growl, a global Depression looms, then why are raw materials stocks outpacing other equities?

The ObamaMama Bear Market?

So why didn't we see the coming Crash?

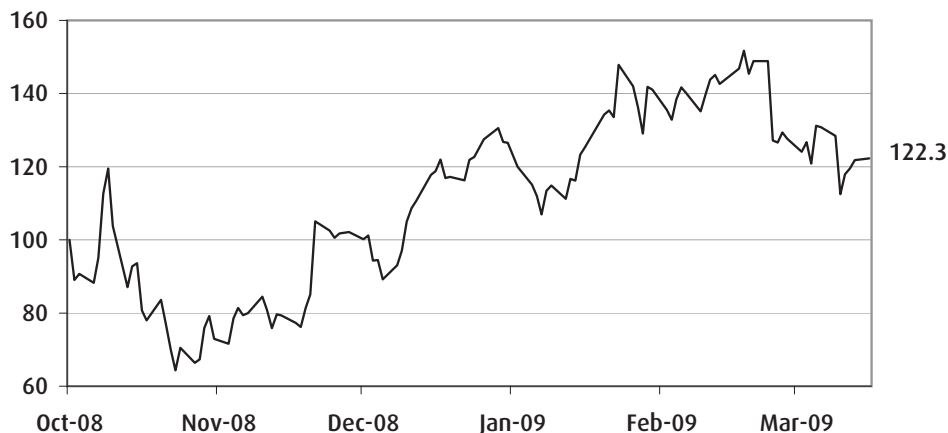
There has been one relatively sustained beam of optimism during the weeks when the S&P was declining almost daily: commodity stocks.

The commodity stocks did in fact bottom-out on relative strength quickly, and outperformed from November until the broad market began rallying again last week.

Some market forecasters have been noting that, even when the S&P was falling, and major US banks were struggling to stay alive, the commodity stocks were quietly outperforming. This implies that there is light at the end of the tunnel. If as the grisliest of bears growl, a global Depression looms, then why are raw materials stocks outpacing other equities? The only commodity producers which delivered good returns to investors during the Depression were gold mines. (Admittedly, it should be different this time: China is stockpiling metals and oil, thereby providing, in effect, a form of safety net for producers.)

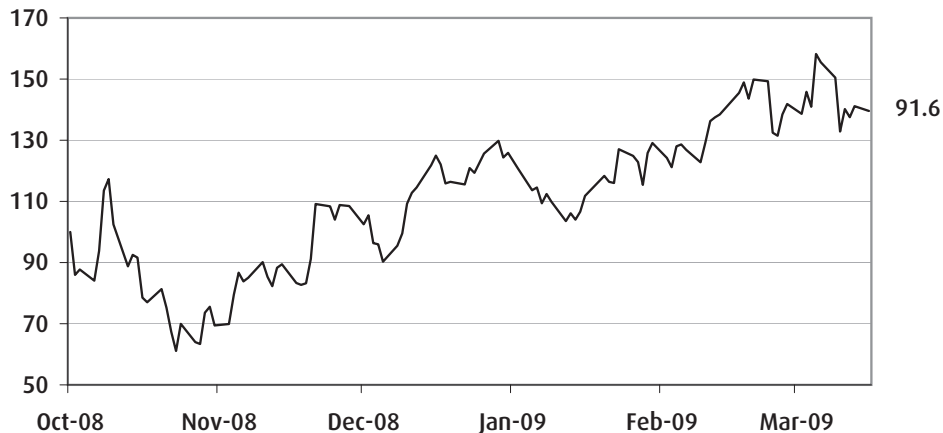
Barrick Gold Relative to S&P 500

October 1, 2008 to March 16, 2009



Goldcorp Inc. (GG) Relative to S&P 500

October 1, 2008 to March 16, 2009



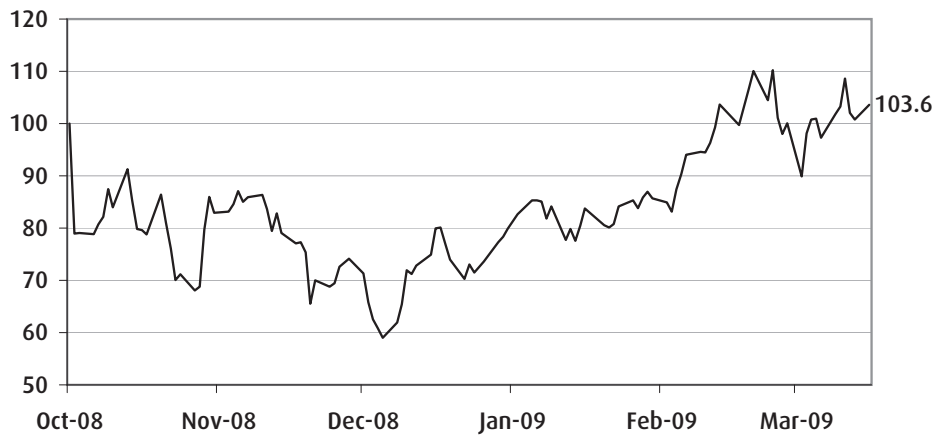
Potash Corp. of Saskatchewan Inc. (POT) Relative to S&P 500

October 1, 2008 to March 16, 2009



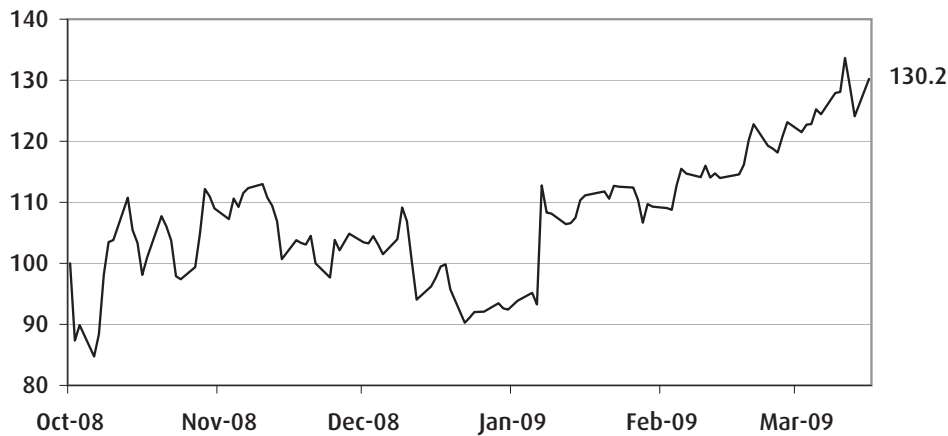
Agrium Inc. (AGU) Relative to S&P 500

October 1, 2008 to March 16, 2009



Monsanto Company (MON) Relative to S&P 500

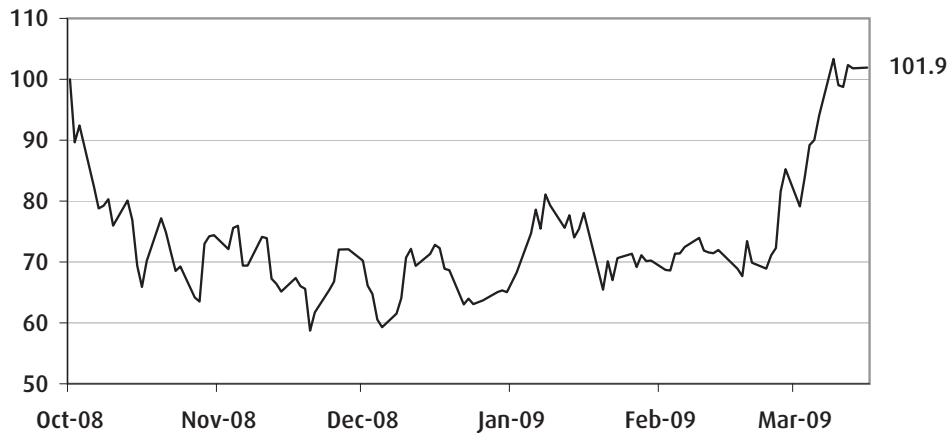
October 1, 2008 to March 16, 2009



The ObamaMama Bear Market?

Suncor (SU) Relative to S&P 500

October 1, 2008 to March 16, 2009



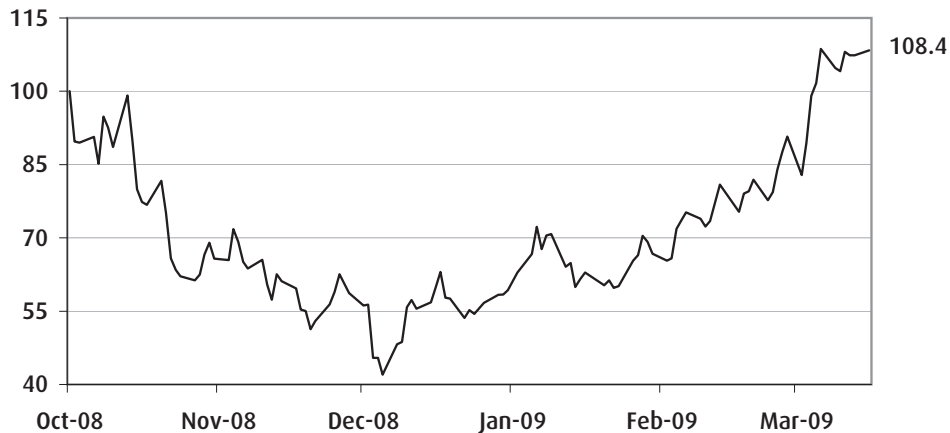
Transocean Ltd. (RIG) Relative to S&P 500

October 1, 2008 to March 16, 2009



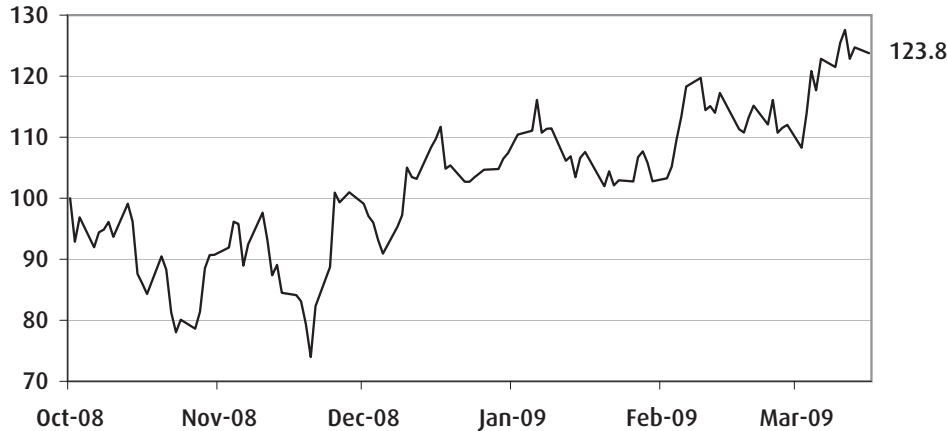
Freeport-McMoRan Copper & Gold Inc. (FCX) Relative to S&P 500

October 1, 2008 to March 16, 2009



BHP Billiton (BHP) Relative to S&P 500

October 1, 2008 to March 16, 2009



This is an ObamaMama Bear Market now... many of the rules and criteria that worked in identifying bottoms in previous Mamas may not be so relevant this time.

Indeed, a commodity stock portfolio structured according to our recommended weightings shown on page 38 should, we believe, continue to display good relative strength to the broad indices, and will likely display less daily volatility than the S&P. The gold stocks tend to go up and the other commodity stocks go down when the news is bank failures and catastrophes, or when Obama or a spokesman is talking about the Big Government American economy of the distant future; conversely, those economy-related commodity stock groups soar when investors turn optimistic about the economy—and gold stocks slump.

The overall stock market will, we believe, continue to be heavily influenced by perceptions about Obama, his people, and his programs. This is an ObamaMama Bear Market now, and it is driven by both despair and disillusionment. The despair and the disillusionment may endure until the economy recovers. Many of the rules and criteria that worked in identifying bottoms in previous Mamas may not be so relevant this time. Obama carried the investor class by a sizable majority, the only Democrat in decades to score well with that group. They have been turning on him this year with the fury of those who feel betrayed. He is, however, a very smart man who has some very smart people around him, and he has a near-unique ability to convince the average voter that he is a true leader. That he has been stumbling is clear, but he is likely to find his footing anew. US stocks could put on quite a show if the economy is seen to revive—and his programs are seen to be working. What might happen then would be called The ObamaBull Market.

**Recommended Asset Allocation
(for U.S. Pension Funds)**

	Allocations	Change
US Equities	18	-2
Foreign Equities		
European Equities	6	unch
Japanese and Korean Equities	2	+1
Canadian and Australian Equities	9	+2
Emerging Markets	11	-1
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
Precious Metals	35%	+7
Agriculture	33%	-2
Energy	22%	-6
Base Metals & Steel	10%	+1

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.

The ObamaMama Bear Market?

RECOMMENDED ASSET ALLOCATION

We have redistributed our cautious Recommended Equity Exposure modestly. We think the *downside* risk to US equities is small and that there is a good chance the November lows could hold if they are retested.

We have reduced Emerging Markets as an asset class because it includes East Europe and Russia, which will be among the most-troubled regions this year.

We retain our enthusiasm for Asian markets, particularly China and India.

We think Japan and Korea will participate in the strength in Mainland Asia later this year.

The Canadian stock market has over-reacted to the terrible political and financial news from the US. Canada's political and regulatory environments—and Canadian bank stocks—may never have looked better compared to the US. We believe Canadian equities will strongly outperform their US counterparts—in the near-term and the long-term.

We have altered the weightings of stocks within the commodity sector to reflect our view of greater equity risk, smaller economic returns, and higher ultimate inflation risk.

**...Canadian equities
will strongly outperform
their US counterparts—
in the near-term and
the long-term.**

The ObamaMama Bear Market?

INVESTMENT RECOMMENDATIONS

1. If you haven't sold your US equities in the face of all the talk about a Depression, then you shouldn't let anyone convince you now, although you may want to take advantage of this rally to lighten up on stocks that worried you most.
2. There will not be a new bull market without leadership—at least in its early stages—from the financial stocks. This is a time for stock-pickers to select survivors. There will doubtless be more nail-biting moments before anything like an “All Clear” is sounded, but commercial banks with strong deposit bases and small business franchises and haven't tried to strut like Wall Street Ramblers will surely prove worthwhile.
3. Gold has generally been strong despite all the talk of Depression and deflation, and despite the rally in the dollar. It serves two investment needs—on a day-to-day basis it provides a hedge against financial implosions and broad stock market selloffs, and on a longer-term basis it provides a hedge against the inflation that seems inevitable once the US economy begins to crawl out of the pit. It got overdone when the pessimism about runaway US government spending and excessive fed stimulus reached peaks. It remains a core holding in times when economic and financial risks remain both huge—and unknowable.
4. Since “The Midnight Massacre” of July 13th, the dollar, the yen and the Swiss franc outperformed other currencies as the currencies in which debt was denominated. Deleveraging meant that banks and other speculators were forced to sell other currencies and other kinds of assets to repay debts denominated in those currencies. The dollar now stands alone as the last currency winner from debt unwinding. The yen has now succumbed to the moribund Japanese economy. Even the mighty Swiss franc has fallen, as the Swiss Central Bank seeks to reduce the franc's value to protect watchmakers and other Swiss industries. We believe the Canadian and Australian dollars are deeply undervalued.
5. Watch the websites that update the sunspot story. If the spots don't return by mid-June, then there might well be great rallies in the grains. Buy the fertilizer, seed and farm equipment stocks.

if you don't like the management much and won't buy the stock, you shouldn't touch the debt...

The ObamaMama Bear Market?

There will not be a new bull market without leadership—at least in its early stages—from the financial stocks.

6. The publicly-traded debt of most quality companies should outperform the stocks until the crisis is resolved and/or the economy revives. Which bonds to choose? In general, if you like the company, you should, in general, be kindly disposed toward the debt. Back in our debt-management days, we learned, from some painful experience, that if you don't like the management much and won't buy the stock, you shouldn't touch the debt, regardless of what the ratings services say.
7. If the S&P breaks down heavily anew, then you may finally get the kind of buying opportunity that will later prove to have been quite wondrous. For now, continue to hold substantial cash and mid-term bonds.

THE COXE STRATEGY JOURNAL

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