CUBICASSET MANAGEMENT, LLC

2009 4th Quarter Stock Market Commentary

BEN BERNANKE, HOMEOPATH

"The problem with socialism is that eventually
you run out of other people's money."
- Margaret Thatcher

The patient's face is pale and waxy and her body has an emaciated appearance. Her face and hair are oily, while her lips and corners of the mouth are dry and cracked. She is weak, both in body and mind, and is absentminded and forgetful. The mucous from bodily discharges has the constituency of egg whites. The patient is thirsty for cold drinks even though she is constantly chilly. She is sensitive to light touch and pressure and has frequent cold sores on the lips or mouth. Mentally she is depressed, easily startled and irritable. She dwells on past occurrences, is fearful of crowds, and speaks of an impending calamity. Symptoms are generally worse in the morning, and frequently dissipate from bathing in cold water.

The cure for this constellation of symptoms? According to the Encyclopedia of Alternative Medicine, she should be prescribed natrum muriaticum. Never heard of it? It's more commonly called salt water. This is one of literally thousands of homeopathic remedies, probably the longest running junk science in history. It dates back to Samuel Hahneman in the late 1700s, who observed that eating cinchona bark produced symptoms similar to those of malaria. He reasoned that the bark might then serve as a cure, arguing that "like cures like," a principle he named the Law of Similars. To figure out which remedy works for which symptoms, the practitioner does a "proving", giving the substance to healthy people and seeing what symptoms they exhibit over the next few days (whether caused by the substance or not). Then, if someone exhibits those symptoms, they are given a highly diluted mixture of that substance. As far back as 1842 the Supreme Court Justice Oliver Wendell Holmes wrote *Homeopathy and its Kindred Delusions*, recognizing the specious nature of homeopathic claims. But somehow its nonsensical allure persists.

Currently, the United States is still exhibiting numerous symptoms of economic illness: high unemployment, underutilized manufacturing capacity, declining housing prices and scarce credit. These were precipitated by the bursting of the housing bubble, which in turn arose when the Federal Reserve kept interest rates far too low for far too long in the aftermath of the September 11 attack. Ben Bernanke's solution is simple. Drive interest rates to near zero and keep them there for the foreseeable future. The International Monetary Fund has cited a risk that surging Hong Kong asset prices are being driven by a flood of capital. The World Bank has issued a warning of looming asset bubbles in equity markets across Asia and in real estate in China, Hong Kong, Singapore and Vietnam. During President Obama's trip to China last fall China's top bank regulator said that a weak dollar and low U.S. interest rates had led to "massive speculation" that was inflating asset bubbles around the world. Everyone

seems to see the problem re-developing, except American economic policy makers. The situation calls to mind a quip by Albert Einstein that "the definition of insanity is to do the same thing over and over and expect different results."

Evidence of the danger is mounting. Consider first the commodities markets. The most obvious warning sign is coming from the soaring price of gold, which has reached an all time record high in excess of $1,100/ounce. (See the chart below.) Soaring demand from emerging markets may be forecasting inflation, or it may simply be providing a safe haven from the declining dollar. Policy makers

point out that gold's value is derived from psychological factors, rather than industrial demand. More troubling is the stubbornly high price of oil, which has climbed 60% from its March low. This is despite the fact that worldwide oil consumption dropped in 2009. Even the price of gasoline is rising, in defiance of the usual seasonal drop in demand after the summer driving season, and in the face of declining refinery capacity utilization.

There is an old adage (usually attributed to Mark Twain) that to a man with a hammer, everything looks like a nail. To a real estate developer, financer or speculator, every real estate debacle looks like the next great opportunity, and cheap money makes the lure irresistible. J.P. Morgan recently reported that in the Southern California and Phoenix, Arizona markets, competition is intense for developable parcels of land. The brokerage characterized the market as "frothy" and "frenzied." The Federal Housing Authority, which seems to have forgotten the pain that was caused by low down payment mortgages, has lowered the down payment required to qualify for an FHA loan to 3.5%. This means that for a buyer of the median priced home, $177,900, the required down payment is $6,226, less than the value of the government's home buyer credit of $8,000. Robert Toll, the chief executive officer of home-builder Toll Brothers, has warned that the FHA's reckless lending may precipitate another crisis in the lending industry. In Hong Kong, mortgages are available at a 2.05% annual rate, and money is pouring in. Donald Tsang, the city's chief executive, says "The relatively small number of units completed and the record prices attained in certain transactions this year have caused concern about the supply of flats, difficulty in purchasing a home and the possibility of a property bubble." One apartment sold for the equivalent of $56.7 million (those are U.S., not Hong Kong, dollars), the highest price per square foot ever paid in any city in the world.

The story is similar in Singapore. According to the Asia Times, surging demand for residential units in recent months has resulted in potential buyers queueing for hours before new house openings and many have left blank checks with their property agents to fill out to secure their spots in new

projects. Private sector developers in July launched an all-time high of 2,878 new flats and an astounding 2,767 of those units were sold out within a month. That sales figure smashed by 52% the record of 1,825 units sold set the previous month. Over 43% of the transactions that took place in July fell under the middle-to high-end tier, with prices anywhere between US$715 - $1000 per square foot. Over the summer, one Singapore condominium developer raised prices 5% the day before units went on sale. After dozens of would-be buyers lined up on a steamy night, the developer — a joint venture of Hong Leong Group and Japan's Mitsui Fudosan - held a lottery for a chance to bid on the units. Singapore home prices rose 15.8% in the third quarter, the fastest rate in 28 years.

The real estate market in India is also showing bubble characteristics. Property prices, especially in the major cities, have shot up many fold over the years and are beyond the reach of the middle class. The euphoria of the India growth story and the availability of cheap credit have propelled property prices to astronomical levels.

Emerging market equities offer yet another example of how the tsunami of liquidity created by central banks is pushing selected asset prices. Since March 9, when stock markets troughed, the principal index of the stocks of developed nations have risen 65%. But the Morgan Stanley Emerging Markets Index is up an astonishing 96%. And that is just the average performance - South Korean stocks have risen 111%, Brazil is up 134%, and India has soared 144%. Investors worldwide are tripping over each other in a mad rush to borrow dollars (since there is essentially a zero interest rate to borrow them), and reinvest the funds in other appreciating assets. This is a repeat performance of the yen "carry-trade" of 2006-7 when investors borrowed over a trillion dollars worth of yen, which, as we now, know did not have a happy ending.

But the mother of all asset bubbles is occurring in the bond market. So much money has flowed into the U.S. treasury market that long-term yields do not seem to adequately reflect the risk to principal if inflation (and subsequently interest rates) should rise. If interest rates should rise from their current low level by only 1%, there would be a loss of 8% of principal for holders of the 10-year note, and a 15% loss for holders of the 30-year long bond. There is a simple way to protect against this risk, by purchasing so-called TIPS (treasury inflation protected securities). These bonds pay a modest interest rate, but the principal value of the bond inflates regularly to adjust for changes in inflation. In a recent survey of 34 economists, every single one of them predicts that the 10-year TIPS will have a higher return, in either real (that is, inflation adjusted) or nominal (the stated interest rate) terms, than the traditional 10-year note. Moreover, the TIPS are risk-free if held to maturity, while the traditional bonds are subject to the risk of purchasing power loss through inflation. This is a very rare situation in economics, which is known as second order stochastic dominance. When it occurs, EVERY rational investor should be buying the TIPS, if they are available, rather than the 10-year note. And yet money continues to pour into the nominal notes, but from speculators, rather than investors. They are financing their purchases with near zero interest rates to pocket the coupon on the fixed-rate note, secure in the supposed belief that the Federal Reserve will be the buyer of last resort for their securities. This situation cannot have a happy ending when the Fed eventually ends its artificial support of the debt markets.

So what is Ben Bernanke thinking? Obviously, all these data points are available to the Fed, too. Publicly, the Fed Chairman has indicated that the economic recovery is still weak, and the financial system too fragile, to allow rates to rise. Mr. Bernanke obviously hopes that this

homeopathic approach, of lending at low rates to cure the problems produced by lending at low rates, will succeed. If it does, the administration plans to tackle the obesity epidemic by handing out Krispy Kreme donuts.

To most market participants, the Fed's approach seems unlikely to be successful. If short term rates were allowed to rise to 0.5%, it is hard to imagine that any borrowers would be deterred from borrowing. But speculators might be deterred from speculating, since they would then perceive the possibility of subsequent rate increases. Moreover, Chairman Bernanke has espoused the oxymoronic view that he sees no evidence of asset bubbles, and besides the Fed has no way to perceive asset bubbles as they are occurring. I suppose that it is possible that asset values are rising to reflect the likelihood of a robust global economic rebound. But a cynic might suspect a more devious motive. With the U.S. national debt at roughly $12 trillion and growing by well over $1 trillion per year, isn't it preferable for the government, which is not only the world's biggest debtor, but the only debtor that determines the interest rate it will pay on its borrowings, to pay 0% interest on new borrowings?