Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

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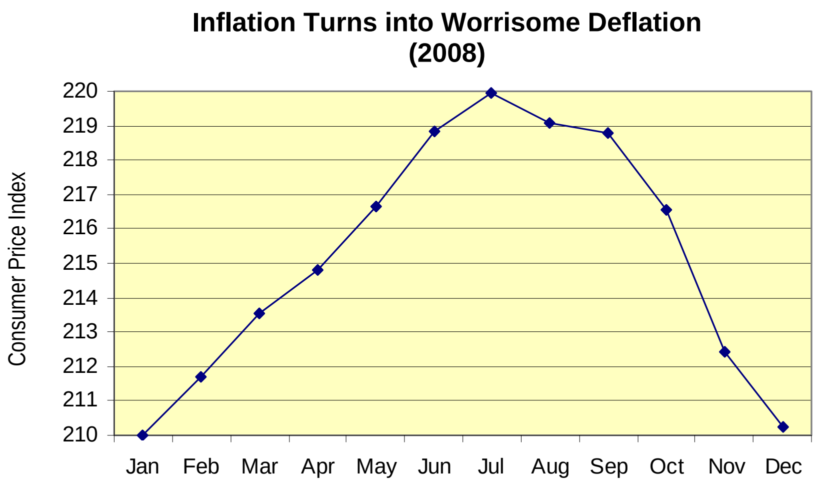
The U.S. in the Grip of a Deflationary Cycle

> Let us suppose now that one day a helicopter flies over this community and drops an additional $1,000 in bills from the sky, which is, of course, hastily collected by members of the community.
>
> Milton Friedman, *The Optimum Quantity of Money*, 1969

In 2008, U.S. investors experienced the second worst U.S. stock market returns since 1825. The S&P 500 Index's decline of 37.0% in 2008 was exceeded only by the market's 43.1% negative return in 1931 in the midst of the Depression. Returns in U.S. high yield bonds of -26.2% were the worst ever recorded. Are we out of the woods? Not yet! In 2009, we are confronted by the prospect of a frightening global deflationary spiral. The chart below shows the peaking of the U.S. Consumer Price Index (all items) last summer and its subsequent plunge:



Source: StockVal

Deflation in economic terms is a persistent decrease in the general price level of goods and services. In other words, it is a negative inflation rate, resulting in an increase in the real value of money. The last time deflation occurred in the U.S. was during the Depression. The table below shows the drop in the Consumer Price Index and the cumulative deflationary impact:

Year	Consumer Price Index	% Change From Previous Year	Cumulative Deflation
1929	17.2	0.59%	+.6%
1930	16.1	-6.40%	-5.9%
1931	14.6	-9.32%	-14.6%
1932	13.1	-10.27%	-23.4%

During this previous period of deflation, the actions of the U.S. government caused severe damage to the economy. The Federal Reserve allowed the money supply to contract by one-third. The Hoover administration raised taxes on high income earners to 60%, while the protective tariffs of the Smoot-Hawley Act helped to strangle world trade. These actions, combined with the stock market crash of 1929 and the subsequent credit contraction, caused GDP in the U.S. to drop by 25%. In this deflationary spiral, prices dropped by almost one-quarter as can be seen by the table on the previous page. The damage to the stock market was enormous; the Dow Jones Industrial Average dropped 89.2% over the next four years.

How Did We Get Here?

In previous investment commentaries, we have written about the origins of the bear market and the Panic of 2008 so we will not repeat them. The salient factor is that the events in September turned a gathering storm in the credit markets caused by the U.S. housing boom, mortgage debacle, and excessive systematic leverage into a Panic – something not seen in this country since the Depression. In medical terms, the events of September caused the U.S. financial system to go into cardiac arrest. The Panic had an immediate effect on both businesses and consumers. Consumers stopped buying, and with sales falling off a cliff, businesses stopped investing. This collapse in economic activity will probably cause the largest sudden decline in economic activity since World War II. The economic downturn affected all regions of the country simultaneously, and became global in nature. Even the global engines of economic growth – China, India and Brazil – were negatively affected within weeks. In previous recessions, some regions of the U.S. were unaffected by the economic downturn. Some sectors of the economy escaped most of the damage. Not this time! Almost all sectors of the economy – other than government – have been affected by the downturn. For the stock market to advance, this economic collapse must be reversed.

A Deflationary Cycle

A deflationary spiral is characterized by the following symptoms: collapse of an asset bubble (housing), unwinding of excessive leverage, write-offs of high levels of bank loans, distressed selling of stocks and bonds, commodity prices drop, pullback by consumers, falling business sales, drop in business investments, rising unemployment, plummeting consumer and business confidence, decreasing velocity of money, falling prices, failing banks, prices continue to fall, GDP drops, consumer demand continues to drop, an excess in manufacturing capacity appears, falling tax revenues. During the Depression, the U.S. economy experienced this cycle, described by Yale professor Irving Fisher as a debt deflation cycle. Japan experienced the same deflationary cycle during the "lost decade" of the 1990s when GDP growth was anemic.

Monetary Steps to Counter Deflation

In order to counter the current deflationary spiral, the Federal Reserve Bank and the U.S. Treasury have employed massive monetary firepower. First, the Federal Reserve has brought short-term interest rates to nearly zero to assist debtors and help the banking system create enough net interest income to offset mounting credit write-offs. Secondly, the Federal Reserve acted decisively to prevent a run on money market mutual funds and banks by guaranteeing deposits in money funds and upping the FDIC guarantee of bank deposits to $250,000. As the commercial paper market froze with institutional investors unwilling to roll over outstanding commercial paper, the Federal Reserve bought massive amounts of commercial paper ($270 billion thus far) to keep corporations solvent and the commercial paper market functioning. Believing that a broken financial system would cause massive economic damage, the U.S. Treasury used the first tranche of TARP funds to increase the capital of dozens of the largest U.S. banks in order to have the necessary capital to absorb the credit write-offs and to prevent runs on the banks. Federal Reserve Bank Chairman Ben Bernanke has recently said that the Federal Reserve still has ample tools to fight deflation including controlling long-term interest rates of U.S. Treasury bonds (as was done in the 1940s). Ultimately, however, Chairman Bernanke, like his predecessor Alan Greenspan, is of the "monetarist school," agreeing with Milton Friedman, who wrote that inflation (and deflation) is "always and everywhere a monetary phenomenon." In 2002, when the U.S. economy was emerging from a recession with a whiff of deflation in the air, Ben Bernanke implied that deflation could always be avoided by printing more money. This was when he quoted Friedman's famous line about using a "helicopter drop" of money to defeat deflation (see page 1).

Fiscal Steps to Counter Deflation

In his great biography of John Maynard Keynes, Robert Skidelsky writes that Keynes believed that it was the "duty of governments to keep economic life up to the mark – at or near its best possibilities, when there is a reasonably full and efficient use of actual and potential resources." Keynes understood the part that uncertainty plays in preventing economies from performing at anywhere near their potential, "except at moments of excitement." Keynes believed that it was up to governments to provide a milieu which removed much of the uncertainty in the free market system. The Keynesian approach is widespread government spending to provide the demand which the consumer is not in a position to provide. Government spending can take the form of infrastructure projects, public works projects, grants to the states, etc.

Keynes's views have become broadly accepted by democratic capitalist governments. Most governments, including the U.S., have already enacted fiscal steps to counter the economic downturn. In mid-2008, the Bush administration signed legislation which provided for $140 billion in fiscal stimulus, consisting largely of sending checks of up to $600 to lower and middle class citizens, many of whom had paid no income tax at all. The supply side approach which gained credence in the stagflation of the 1970s and early 1980s is that fiscal stimulus can best create economic growth by using incentives for people to produce goods and services by lowering marginal tax rates. By lowering tax rates, small business owners and corporations will be induced to invest capital and hire more employees so that superior economic growth is achieved. Currently the Obama administration and Congress are drawing up plans for an $800+ billion fiscal stimulus package. Early drafts of the bill reveal enormous government spending on a range of programs and projects combined with some reduction in taxes for lower income earners and businesses which invest or hire additional employees. A growing number of critics of the fiscal stimulus bill point to the failure of FDR's government spending to provide economic growth. From 1933 until 1941 when the U.S. entered WWII, unemployment reached as high as 25% and never dropped below 14%. As the Obama administration takes over the White House with large Democratic majorities in both houses of Congress, the challenge will be to ameliorate the situation, yet to observe Hippocrates' admonition to physicians: Do no harm to the patient!

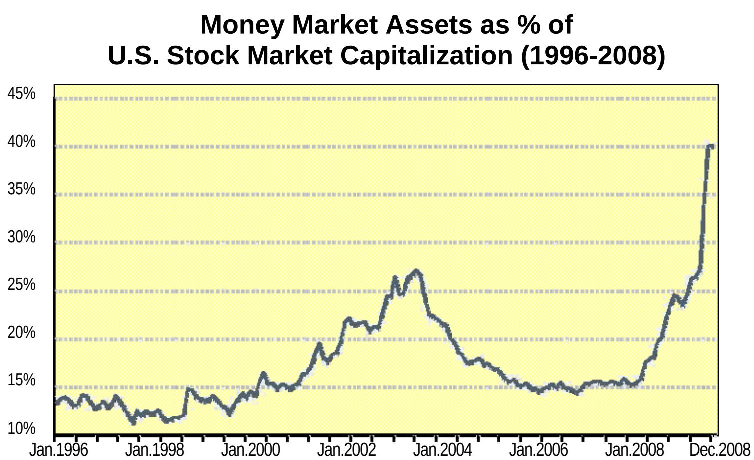
2009 Investment Outlook

There is a formidable list of problems which the U.S. economy has to overcome if the stock market is to turn in a positive year in 2009. The main challenge is to stop the deflationary cycle with its falling housing prices, foreclosures, lower corporate profits, higher unemployment, and beleaguered banking system. The good news is that the U.S. has faced economic distress before and has survived it using both monetary and fiscal means.

At BFS, we believe that the aggressive monetary and fiscal steps that are being taken by the U.S. government will successfully halt the deflationary cycle in 2009. While deflation may continue for the first part of the year, there is a good chance that the CPI will end flat for 2009. It is likely that the recession will continue until the end of 2009 or early 2010, and it is probable that U.S. unemployment (a lagging economic indicator) will not peak until it reaches 8%+ in 2010. One of the real dangers to the economy is that the government will do too much and overreach itself, causing high inflation in the years to come. The Treasury and Federal Reserve have already injected $2.5 trillion of liquidity into the U.S. financial system with another $5 trillion in guarantees and commitments (to be used if necessary). They will need to withdraw this money from the economy quickly, as well as raise interest rates while unemployment is still high, if we are to avoid an asset bubble, commodity dislocations and inflation such as that experienced when the Federal Reserve kept the Fed Funds rate at below 2% from 2002-2004 long after the recession was over.

Reasons Why the Stock Market May Surprise in 2009 on the Upside

In the near term, there is risk that the stock market re-tests the low of 741 which the S&P 500 reached on November 20, 2008. This would be a 12-15% pullback from its current level. The reason for this potential sell-off is that U.S. GDP during the 4th quarter 2008 probably declined 5% or more, and it is possible that the first quarter 2009 GDP may be nearly as bad. However, as the year progresses, monetary and fiscal stimulus should cause housing prices in most sectors of the country to bottom, and by mid-year, the banks will have written off 75% or more of their problem loans. The huge drop in energy prices will also have the effect of a welcome tax cut for consumers. Finally, the stock market usually rallies 3-6 months before a recession ends. One reason for optimism in this regard is the enormous amount of money market assets on the sidelines waiting for the right moment to re-enter the stock market as shown below:



Source: Fidelity Investments

Another reason for a positive prognosis is the inexpensive valuations of quality growth stocks. Many of the best companies are selling at valuations not seen in 25 years. With bond and money market yields at low levels, the 2.55% dividend yield on the Russell 3000 Index is higher than the yield on a 10-Year U.S. Treasury Note. This has not happened since the 1950s, and it should cause money to flow into stocks as the year progresses. Finally, despair and pessimism about the economy and the stock market abound, and corporate results will often exceed such low expectations. Accordingly, we urge investors to stay in the game. We believe that the deflationary cycle will be broken this year and that well chosen stocks will surprise on the upside. While not minimizing the challenges ahead, we at BFS believe that quality stocks purchased at good prices in this bear market will prove to be great bargains in the years to come.