



Polite Terms for Impolite Policies

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"This program [of buying mortgages] is intended to support the mortgage and housing markets and foster improved conditions in financial markets more generally." Federal Reserve Bank of New York (January 2009)

"...PIMCO and others sold them those mortgages and bought — you guessed it — Treasuries with the proceeds." Bill Gross, PIMCO (January 2010)

Whenever the conventional and familiar term for some thing begins to carry a *supposedly* negative connotation, it is convenient for someone to proffer a new and, shall we say, more digestible term. In 1966 the familiar term "conquer" was recast as "pacification," referring to our mission in Vietnam. "French Fries" became "Freedom Fries." "Christmas trees" are "holiday trees." "Public Option" became "Government-Run" (or vice-versa?). The political right and left engage equally in this practice.

"Handicapped" became "disabled," which is now supposed to be "physically challenged." I sometimes find myself using terms that I consider neutral and acceptable, only to have my more modern acquaintances (and my wife) look at me in horror and offer me immediate corrections.

I caught myself using a new and easily digestible term the other day and it struck me how the term has become so widespread and so ... unobjectionable.

If I told you that the government (under both the late-Bush and early-Obama eras) was paying for its deficits by "printing money," you'd probably squirm and furrow your brow and perhaps even pound the table over it. We all know that printing money to pay the national bills is a bad, bad thing. We know this so well that our reaction is instinctive and visceral — we don't like it. Reagan didn't do it; Bush The First didn't do it. Heck, even Clinton didn't do it.

However, what if I instead told you that the government was paying its bill just fine, using the old-fashioned method of mostly taxes, plus some

borrowing. While you might not like the borrowing, at least you understand it. After all — it's how most households in America have been paying their bills for the past 20 years. (The government must have learned how to do this from *someone*.)

So, the government is paying its bills just fine. Oh, and one other thing...the Fed is carrying on a program of quantitative easing, to "foster improved conditions in financial markets."

Well, at least they're not "printing money!"

My friends and countrymen, I've got news for you. The fancy city folk might call it quantitative easing, but out here in the sticks we call it *printing money*.

How nicely that term rolls off the tongue — Quantitative Easing. It's "easier" — that must be good, right? Easing credit conditions; easing the way back to economic recovery. Anything that we're "easing" must be a good thing in times like these. Because if times are *hard*, we need them to be *easier*.

And, it's *quantitative!* That must be a good thing, right? Smart people running computer programs and whatnot. It all seems so scientific!

But it's not. It is what I said it is — printing money.

For all practical purposes, the world has been off the gold standard for nearly a century now. Like anyone at the controls of a powerful thing, governments have, from time to time, abused the power they hold. In the 20th century, pre-war

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Polite Terms for Impolite Policies

(Continued from page 1)

Germany, Argentina (twice) and late-80's Mexico managed to create money far faster than their economies were actually growing and suffered hyperinflation and currency collapse.

Understand that in the post-hard-currency (metal money) world, central banks have to print *some* amount of money. If the real output of an economy grows by 3%, in an ideal world the central bank will grow the money supply by exactly 3%. The idea here is that the quantity of money in circulation exactly keeps up with the increase in total commerce and exchange. If the money supply doesn't grow, we end up with chronically declining prices. That might seem OK when you're buying groceries every week, but it will destroy capital investment. People like to forget that deflation not only grinds down prices — it also grinds down incomes and asset values.

Banks don't lend against assets that will decline in value over time. Metal-money advocates (and Peter Schiff) have conveniently skipped over a close study of the 1820-1900 period when America was both growing rapidly and on a true gold standard. It was not a pretty sight as farmers and small businesses found themselves attempting to repay bank loans from ever-declining incomes. The only winners were the big banks and "robber barons" of the day.

Conventional money creation happens when a government borrows money from (or sells bonds to — same thing) its central bank. The central bank accepts government bonds, and hands over bank notes. You have a bank note in your pocket right now. It says "Federal Reserve Note" right on it. That's what money is — a note issued by the central bank.

In 2008 and 2009, our central bank — the Fed — and our government engaged in a more subtle slight-of-hand. Rather than spook the financial markets by selling Treasury bonds directly to the Fed — or borrowing from the Fed — for new dollar bills, the government instead sold the bonds directly to the public. In normal situations, a government selling bonds to the public does not increase the money supply. The government sells bonds, and investors buy them with *pre-existing* money.

This time around, the Fed and government cooperated on a neat trick. Just about the time the government started selling \$1.5 trillion or so in new bonds, the Fed reached out into the open marketplace and bought

itself a similar amount of mortgage bonds. What did they buy them with? Newly issued Federal Reserve Notes, or money. That money ended up out in the economy at the same time that the Treasury conveniently needed a similar amount to pay its bills (and to make sure all our Wall Street friends could keep up the payments on the second and third homes).

The Fed, the Treasury, and all of their apologists and advisors call this "quantitative easing," to make sure that you don't really understand what happened.

The net here was new money creation of well over \$1 trillion. One final catch — the Fed has managed, so far, to convince banks to voluntarily keep about that amount on deposit at the Fed. As we wrote in our last newsletter, the banks can withdraw that cash at any time. Actual money supply "out in the wild" has only increased about 5% in the past year. But, if we add in the money that the big banks are *entitled* to withdraw from the Fed at any time — money supply has more than doubled.

In 2009, the Treasury was able to find ready buyers for over a trillion dollars in bonds mainly because the Fed was buying a like amount of mortgages at the same time. The biggest investment question for 2010 is — can they pull the same trick twice? If the housing market is still in the tank by late March, I suspect the Fed will announce that it is extending its buying of mortgages. I also suspect that the bond market will throw up when it hears the news. If the Fed doesn't keep buying mortgages, rates will surely begin to rise. Either way, it's not good news for interest-rate sensitive assets (stocks, long bonds, REITs).

Fool me once, shame on me. Fool me twice, and I'm gonna drive interest rates through the roof.

Our main investment theme going into 2010 is to avoid big bets and avoid interest rate risk. The level of uncertainty right now is as high as it has ever been. Every core asset class is priced at its upper range of reasonableness and there are no "fat pitches" at the moment (see the page to the right).

The biggest risk investors face right now is staring at them from the bathroom mirror. If you try too hard to make a big, winning bet, or if you buy into one or another extreme scenario, you are risking everything on a number of unlikely outcomes. Our approach is to overweight short-term bonds, underweight everything else, and wait for an opportunity.

Rick Ashburn, CFA, Chief Investment Officer

"The biggest risk investors face right now is staring at them from the bathroom mirror."

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Major Asset Classes

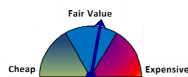
Valuation

Domestic Large Cap Stocks



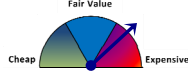
S&P500 fair value = approx. 950 at *full earnings recovery* — which has nearly occurred already; asset class moderately overvalued.

Foreign Developed Stocks



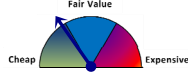
Valuation very similar to domestic market. Slightly cheaper, but earnings recovery has been slower.

Government Bonds



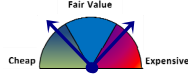
Treasury bonds are expensive relative to long-term economic growth prospects. Significant risk of price declines. See *Economic Factors* below for our thoughts on maturities.

Corporate Bonds



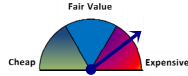
Yield spreads are still above average, and properly compensate us for default risks. We are overweight short-term corporates.

Municipal Bonds



Split decision: Short-term bonds are too expensive (low yielding); long bonds are cheap relative to taxable bonds. But — we don't like long bonds right now ("long" = 7+ years).

Real Estate Inv. Trusts (REITs)



REITs have run far past fair value. The commercial property market remains under stress. We're tempted to short REITs.

Economic Factors

Headwind or Tailwind?

Inflation. Here's the thing: An official, permanent and immutable fact of the post-industrialized world is that money supplies will everywhere and always grow faster than real output. It's the whole point of having paper money — to provide a bulwark against deflation. The trick is to manage one's paper money growth so that it's just a teensy bit faster than real growth. Say, 1-3% or so. We think inflationary pressures are quite low at the moment. Industrial capacity use is at its lowest in over 40 years. Does anybody think the average salaryman can walk in and demand a raise right now? While the Fed has doubled the size of its balance sheet since August 2008, that has yet to result in an unusual rise in the actual money supply (barely 5% growth in the last year). In the near term, we do not worry about a sharp spike in consumer prices. Too many people out of work; neither companies nor workers have any pricing power. *However*, as the recovery takes hold (and it hasn't yet), watch for the Fed to move aggressively to pull money out of the system and stem potential inflation. As a football coach once said of the forward pass, three things can happen and two of them are bad.

- ◆ Fed moves too quick; interest rates spike; economy falls back into the basement.
- ◆ Fed moves too slow; asset bubbles and inflation ensue; bubbles pop; economy falls back into the basement.
- ◆ Fed gets it just right. Goldilocks. Everybody is happy. But...

...if we're lucky and the Fed pulls off a miracle Hail-Mary pass, we still expect that inflation will move inexorably up to the highest limits of the public's willingness to tolerate. We worry that will set us up for a multi-decade grind of 4-5% inflation, which will relentlessly suck the value out of our savings. All this adds up to a headwind that the economy (and our portfolios) will have to overcome. *(And, for the record, we think the second of the three outcomes listed above is the most likely. Check back next January to see if we were right.)*



Bond Interest Rates. As noted below under Yield Curve Shape, longer-dated bonds are paying attractive interest rates relative to shorter bonds. It's tempting to move out there and make 5% instead of 2%. However, supply factors — such as a looming 2010 Treasury borrowing of \$1.5 trillion+plus — do not bode well for the interest rates on long bonds. We have already moved our clients into shorter maturities, bringing our average maturity down around 2 years. Even without inflation, long bond rates are in trouble. As is the usual plan in such an environment, we have to be patient and earn measly short-term interest rates and then pounce when long bond rates are high enough to compensate us for our long-term inflation outlook (as discussed just above).



Corporate Earnings. Earnings recovery has been nothing short of stunning. So stunning, in fact, that we have pretty much recovered back to pre-crash earnings numbers for the non-financial companies in the S&P500. The catch is that we thought those earlier high earnings levels were too far above trend and were unsustainable. We were right back then, and we are again of the opinion today that profit margins will suffer pressure as the recovery unfolds. Even as earnings have risen, top-line revenues are still falling.



Real Estate. The housing market is a basket case. There are million or two foreclosures yet to happen. This is the driving story of consumer consumption, and could be for another decade. The commercial property market is also in a tailspin, characterized by a huge overhang of underwater "zombie properties" that aren't generating enough cash to pay the mortgage, yet have not been written down and re-offered at a new and proper cost basis. While this hurts banks and real estate investors, it is ultimately an economic good as plentiful and cheap office space is available to growing companies. So, we call this one a split — housing is a headwind; commercial property will turn into a tailwind sooner or later.



Yield Curve Shape. The shape of the yield curve is defined by how much rates rise as we move from short-term rates (*e.g.*, money markets) out to longer term rates such as 5- and 10-year bonds. We lamented the flatness of the yield curve back in early 2007, arguing that a flat yield curve is a precursor to economic slowdown (hardly anyone believed us!). Now we have a steep yield curve again — the essential ingredient to productive business investment and a growing economy. An upward-sloping yield curve is the mother's milk of capitalism.



Hold On to Optimism

Andy Hempeck

Bubbles, Doom and Gloom can generate a lot of headlines, but as an investment manager we try to remove the sensationalism (in up markets and down markets) and look at the facts with a unemotional eye. According to the headlines, the “Great Recession” is over and we can all breathe a sigh of relief.

Maybe we can, but we believe the patient still needs to be monitored closely. Emergency room physicians focus on saving their patients’ most critical systems. That is what the federal government has done over the last year. It is hard to say at this point if the patient can be taken off life support or has developed an addiction to the morphine that Dr. Uncle Sam has been pumping into the veins of the financial system. A look at U.S. history tells us we are a resilient nation and we have the genes to bounce back.

Whether the U.S. economy is addicted to the Fed stimulus or not, The U.S. is still a powerful economic engine. Although the death of our manufacturing prowess has been much talked about, U.S. companies make more locomotives and produce more steel than ever and have been able to accomplish this more efficiently than any time in history. We produce more

GDP per barrel of oil than any economy on earth. Efficiency is not sexy, but can help catapult us forward.

Companies founded in our country are still pushing the boundaries and producing preeminent manufacturing techniques we cannot even see. Companies like Genentech (recently bought by Roche) produce medical solutions which are changing how we live. Monsanto is helping to produce more and grow crops faster than ever. Chevron is finding ways to utilize and harness energy in ways we have only begun to see.

All these advances will not happen overnight and will not cause the stock market to proceed on an ever increasing chart in the direction to the upper right hand corner of your statement, but they are reasons to remain optimistic all be it cautious. It will take time to determine if the patient can indeed be taken off life support. When first removed from the life support system the patient does not walk out the door and immediately run a marathon. The patient will need to rehabilitate slowly. Hopefully our friends at the US Treasury and Fed realize this.

Many opportunities are still ahead for investors and our country, but don’t get caught up in the latest headlines — try to remain unemotional about investing.

Further Thoughts on Inflation

Lenore Hawkins

Starting with the collapse of Lehman Brothers in September of 2008, the Federal Reserve more than doubled its balance sheet in only three months by financing its credit extensions using the electronic equivalent of printing money. At the beginning of September 2008 the Fed had \$894 billion in assets, by December 17th that number rose to \$2.24 trillion and now stands at \$2.17 trillion. This unprecedented expansion resulted in an increase in the reserves credited to banks and a corresponding increase in the Fed’s assets. To create most of these reserves the Fed purchased mortgage securities from the banks for 100% of the original loan amount by giving the banks credit for those mortgages in their reserve accounts as part of the bank bailouts.

Typically in the U.S. we see a 10x multiple on reserves, meaning for every \$1 increase in reserves, we expect to see a \$10 increase in bank lending, much of which ends up as new money creation. That has not yet occurred because, for an increase in reserve funds to make their way into the economy, lenders need to be willing to lend against their reserves and borrowers need to be willing to borrow. With unemployment continuing at high levels, households shifting from consumption to savings, and paying down debts, the demand for consumer loans is lacking. With corporations cautious about future expansions, commercial lending demands are also lower. Once demand for loans increases and banks are more confident in their own balance sheets, we could see significant increase in the money supply, which means inflation. The Fed claims to be

watching for indications of this and have stated that they are willing to respond quickly by raising rates. An increase in the rate the Fed pays banks decreases the supply of money in the economy because banks are more willing to leave money in their reserves, earning interest from the Fed, rather than lending it out.

Now back to the Federal Reserve’s balance sheet. The loans the Fed “bought” from the banks are expected to be worth less than the original loan amount. Nearly 10.7 million households, or about 23% of U.S. homeowners, owe more on their mortgages than the properties are worth. In addition, the states with the highest rate of underwater mortgages are, and most likely not coincidentally, non-recourse mortgage states, meaning borrowers are not held personally liable for more than the home’s value at the time that the loan is foreclosed. It is also highly unlikely that the Federal government will go after individual homeowners to recoup losses on underwater loans.

This calls into question the quality of the assets owned by the Federal Reserve, which is of great concern to holders of U.S. debt. As we’ve seen the quality of sovereign debt globally come into question, the interest rate at which the United States is able to issue debt could rise if the perceived quality of our debt is lowered. With 71% of the marketable debt held by the public due by 2014 AND 40% of individual income tax receipts already going to pay the interest on existing debt, an increase in interest rates on U.S. debt could harm the economy, which puts the Fed in between a rock and a hard place when it comes to raising rates.

2009 Calendar Year Index Returns

Large-Cap U.S. Stocks	26.49%	REITs	29.58%
Small-Cap U.S. Stocks	36.12%	High-Yield Bonds	39.09%
Foreign Stocks (Developed)	28.17%	High-Grade Bonds	17.73%
Emerging Market Stocks	76.04%	Inflation	+1.84%

(year-over-year November 30)

Wherever possible, we use the returns on Vanguard Index Funds as the benchmark figures for various asset classes.

Readers wishing to review the actual performance record of a composite of our client portfolios should call or email us at info@creeksidepartners.com