



Perspective on the Latest Market Events

Message from Bob Browne, Chief Investment Officer

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Duality in the Financial Markets

One of the more interesting dimensions of investing is the need to understand the duality of economic and market variables. Sometimes a market factor may act like a significant independent variable, performing as a clear determinant of other economic and market variables. At other times, the same factor may act like a dependent variable, where it seems to react simply to other factors. This shifting role as both an independent and dependent variable creates difficulties not only for econometricians who try to explain the economy and markets with mathematical models, but also for investors who try to benefit from understanding the interplay of multiple variables. The cold reality, however, is that this duality and changing role of key variables create inherent instability. Market participants themselves contribute to this instability by reacting inconsistently to these variables as they often lose sight of the duality. This is the basic idea behind investor George Soros' theory of "reflexivity," which he explains in his book, *"The Alchemy of Finance."* It is admittedly a tough read sometimes but remains essential reading for serious investors.

This last week the market started to pay a lot of attention to two variables – interest rates and oil – which are two of the best examples of this duality. Interest rates for the last year mostly have been reacting to other financial variables. As the financial crisis deepened and the real economy slowed dramatically, U.S. treasury rates dropped sharply. For short maturities, this drop was largely determined by the Federal Reserve moving the Fed Funds rate to zero. Longer term rates were affected by the flight to quality and lack of demand for just about every other type of asset. As the U.S. government began to focus its efforts on keeping mortgage rates low and did everything it could to equalize the credit risk of mortgage debt with that of the U.S. government, investors began to oblige. "Follow the government" became a common war cry among fixed-income investors. Thirty-year mortgage rates followed suit, and the government's efforts to stabilize the housing market via low-cost financing were well received by investors, at least until this past week. And then duality struck.

When the financial crisis shifted into fourth gear after the collapse of Lehman Brothers, U.S. government yields were very much a dependent variable. Government rates were reacting to everything else. They were dependent on other independent variables: credit market chaos; rapidly declining economic growth; falling equities, etc. As the government's intervention began to gain traction, it started to achieve its goal, and interest rates moved into their independent variable phase. Low interest rates in short maturities gave companies reasonable absolute cost of financing even if their corporate spreads to treasuries were wide; low long-term mortgage rates allowed current home owners an opportunity to refinance and offered new buyers affordable mortgages the first time around. Throughout the economy, decision-makers and market variables reacted to the very favorable generosity of one independent variable: interest rates.



It is interesting that even when the 10-year rate dropped to 2.50% in March, we knew then as much about the impacts of quantitative easing and the growing fiscal imbalances as we did this past week, when the 10-year U.S. yield broke through 3.50% and 30-year mortgage rates went back to 5%. Sometimes it takes a while for things to sink in. Interest rates are quickly going through the dependent/independent variable phase. It is a fast-moving cycle these days. Right now, rates are reacting to a combination of long-term concerns about the size of the government balance sheet and short-term relief that we did not fall into the abyss and may actually survive the aftermath of the great financial implosion. We need to watch rates carefully as they once again become an independent variable, and the overall cost of money becomes the dominant factor in the markets. It does not seem we are there yet. To be honest, 5% funding for a 30-year mortgage on an asset leveraged five-to-one and with a pre-payment option seems pretty reasonable to me. Remember, this is 30-year funding at a time when developed governments around the world are growing their fiscal deficits like mad despite declining worker populations and huge unfunded future obligations, such as social security and Medicare. Oil and gold markets are telling you the long-term risk is inflation and dollar depreciation, not deflation and dollar appreciation.

Let's talk about the oil markets. Oil is the new reserve currency of the world, in case you haven't noticed yet. Gold has often been the more popular of the two. It has a long, reliable history, is more portable and is much easier on the eyes than oil. Gold likely will always play an essential role in a diversified portfolio, and our initial recommended allocation during the first quarter is starting to bear fruit. But oil is a productive asset that everyone needs and wants but very few produce. And the places where oil is produced are either geographically or politically challenging, to say the least. Watch oil. Let's not forget it was not just Lehman Brothers which almost drove us to financial Armageddon. Oil priced at \$140 per barrel last summer did not help the cause.

Like interest rates, oil has quickly gone through its duality phase. It plummeted in the wake of more powerful independent market forces: a dramatic contraction of industrialized country oil consumption and deleveraging of commodity hedge funds. As oil stabilized in the \$45- to \$55-per-barrel range, it started to become a beneficial independent variable as dollars stopped leaving the consumer's pocket. It is now reacting yet again to other, more-powerful independent factors, but this time they are "good" guys: financial market stabilization, growing demand from China and the gradual return of commodity hedge funds. As oil starts to approach the \$80 range, however, its duality phase may shift its role to detrimental independent factor, and it likely will begin to negatively affect other assets. It may start to drain money from U.S. consumers' pockets at a time when they are still struggling to repair their household balance sheets. In addition, it likely will once again put more petro dollars into the pockets of oil-producing countries. It's likely these countries will not be as keen on purchasing U.S. treasuries this time around. Other strategic commodities and emerging-market equities are the more likely beneficiaries. Sovereign wealth funds with long-term horizons will likely ask themselves the following question: would I rather own a barrel of oil during the next 30 years or a financial obligation of the U.S. government?

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