
MARKET FLASH

FOR THE CLIENTS OF THE ALDER FINANCIAL GROUP, INC.

ISSUED FEBRUARY 18, 2009

Testing New Lows

As I sit here and write, the major stock market averages are nearing the lows set back in November. There is no mistake as to what is driving this latest down move. For several weeks the markets have been deluged with bad news and uncertainty.

Among those concerning topics are the massive stimulus bill, the second half of the TARP program, unemployment data, near-term deflation, long-term inflation, constrained lending, foreclosures and more. With each new headline there follows some quick analysis in the media. The problem with most news outlets is that each topic is only afforded five minutes or a couple of columns of coverage. It's important to realize that most of the concepts that are driving the negative market sentiment right now are very complex issues that are well above the head of most reporters and surely take longer to explain than five minutes. In many cases these media reports are highly political publications ripe with misinformation.

In our effort to keep our clients informed, we wanted to take this opportunity to cut through the clutter and share with you our thoughts on the three most important components of the recovery efforts.

The Stimulus Bill

The federal government has just enacted the largest spending bill in the history of the nation. In addition, governments around the world are enacting their own stimulus programs. Ultimately, the goal of any stimulus plan is to fill the void in GDP left by the reduced spending by businesses and individuals. There are numerous problems with these programs.

First, it's difficult to gauge the appropriate size for a spending package. In theory the level of government interaction should be just enough to offset the private sector shortfall. This is about impossible to measure. You'll hear a lot of debate about whether or not the plan is too big or too small.

Another issue is that all spending is not alike. Ideally, you would want to inject money in a way that would encourage job creation in the private sector. This

is the action that will have a lasting effect. Transfer of payments, where the government simply takes money from one entity and gives it to another, is not helpful in creating sustainable GDP.

The stimulus bill wasn't written by economists, but instead was written by politicians. As such, there is a lot of wasted money being thrown around. The wasted money, which I estimate to be about two thirds of the package, may have a simulative effect in the short term but once those monies are gone the hole in the GDP will reappear. This is one of the lessons from the New Deal era. Temporary spending will only postpone the inevitable.

Hopefully, the economy will show signs of recovery before much of the money is spent in 2011. We then would have the chance to withdraw that portion. Either way, any benefit from this bill won't likely be felt until late this year or early next year.

TARP II

The markets are looking for immediate help, and we believe the second half of the bank bailout is where it will come from. The current downdraft in the stock market can be traced back to the latest round of TARP planning, or lack thereof. There has been such an absence of guidance as to how the remaining funds will be used that banks and investors have been left paralyzed.

It is important to understand that this legislation and funding is separate from the stimulus bill. The first round of TARP financing was originally meant to buy troubled debt. As we have written many times in the past year, there is a lot of sound reasoning behind this idea. Removing this debt from the balance sheets of financial institutions and creating an active market in these securities would help the overall markets considerably.

For various reasons, the first round of TARP money (\$350billion) was instead directly injected into banks via the purchase of preferred stock of those banks. This action was not necessarily gratuitous but it was not in keeping with the original proposal made to Congress.

Since then questions have been raised about the effectiveness of the first half of TARP funding and what

the new administration plans to do next. So far only goals have been announced. We have yet to be shown a plan.

There has been such uncertainty that no one even knows what to call the program anymore. The latest version is the Term Asset Backed Securities Loan Facility (TALF). This name implies that the Treasury Department is refocusing its efforts on jumpstarting the market in asset back securities including those backed by student loans, mortgages, and credit cards.

We believe that of all the recovery plans floating around, this one stands the best chance of really making a difference. For one thing it is the least politically influenced. It is also being crafted by economists in consultation with the private sector.

Hopefully a definitive plan will be announced within weeks. Assuming the market likes what it hears, we would expect a strong short-term rally in equities once a plan is put in place.

Housing Foreclosure Bailout

Dealing with the rising housing foreclosures has also become a hot potato. The debate crosses philosophical, economic, and political lines. Our guess is this aspect of the stimulus debate will ultimately have the least amount of influence on a recovery.

Foreclosures may be on the rise, but still 93% of mortgages are just fine. With nine out of ten people acting responsibly, it's hard to imagine a bailout of those who are in over their heads to get much political traction. Our guess is that any legislation in this area will be limited in scope.

It is estimated that there are an annual 2 million new homes needed in this country due to demographics. Housing is the one area that will fix itself given time. As prices come down demand will rise. We're already seeing this in some areas of the country that have experienced the biggest declines in prices.

We don't agree that everyone who is "upside down" on their mortgage will just walk away from their home. Developers and speculators would be far more likely to default, but they represent a relatively small percentage of property owners.

In Conclusion

Last year we summarized the economic environment as one in which the entire globe was deleveraging. Nothing has changed from then. Virtually every development we're experiencing today can be attributed to a world downsizing. Individuals and businesses are reducing their debt, spending less, and saving more.

The short-term result is a swift contraction in GDP, and the fallout will be fewer items manufactured and bought. Demand for long-term assets will be temporarily depressed as assets backed by debt are unloaded.

These effects are unavoidable. The government's job should be to help ease these effects, but they cannot make them go away. We pray that the government's activities don't saddle the economy for years to come with the unintended consequences of spending billions of dollars.

We are far less concerned with the Federal Reserve's activities. While they have greatly expended their balance sheet, the Fed's actions are far more short-term in nature and can be easily removed as economic conditions improve.

Contrary to the terminology loosely thrown around in the media, the Fed is not spending billions of dollars. They are, in fact, investing billions of dollars or guaranteeing billions of dollars in securities. They are also being paid dividends and interest on those monies. The Fed has openly said that it expects to earn money on its investments. Today Bank of America made a \$402 million dividend payment to the government on their TARP preferred shares.

I find it amusing and a little disingenuous to hear politicians talk of "investing" in education, job training, and the like when they are really spending money. But when the government does actually invest in something such as TARP assets, it is referred to as spending.

Unlike TARP, the stimulus bill is plain and simple spending. The only hope to get something in return on those dollars is if the spending spurs developments that will increase future tax revenue. We'll see.

The media and the government tell us that the American people are causing this "meltdown" by reducing their debt, saving more, spending less, and accumulating cash. Is this really a bad thing? As a nation we are acting more fiscally responsible. We haven't done that in a long time and it's a shock to the system. You have to wonder if the solution is for the government to then fill the void by acting irresponsibly.

Yes, this shift towards saving more and spending less has caused short-term economic pain. Let's try to minimize the current pain while the country goes through rehab, but let's also hope this responsibility trend continues. We'll be much healthier in the long run.