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JOHN MAULDIN'S THOUGHTS FROM THE FRONTLINE

WHEN THE FED STOPS THE MUSIC

In this week's *Thoughts from the Frontline* John Mauldin takes a look at the repercussions in the economy once the Fed stops with quantitative easing in March, by estimating the effect on GDP. In addition, currencies are analysed, with a focus on the US dollar and the notion that if it is believed that the USD will weaken, then relative to what will it weaken. This week's letter ends with an explanation of the effect deleveraging is having on the recovery from the recession.

Enjoy the read.

Last week we delved into the uncertainties that face us and that make forecasting for 2010 problematical. Will the government actually increase taxes as much as they say, with unemployment still likely to be at 10%? Or will cooler heads prevail? Would such an increase cause a recession? Will the markets anticipate the effects of such a major increase in advance? How will the mortgage market react when the Fed stops buying mortgage securities at the end of March? There are so many things in the air, and today we explore more of them, as I continue (perhaps foolishly) to try and peer into what is a very cloudy crystal ball.

Your Help Is Needed

But first, and far more important, is the tragedy that is unfolding in Haiti. Long-time readers know that several times a year I mention in this letter my very good friend Walt Ratterman, who volunteers his time going all over the world to install solar-power systems for hospitals and clinics, along with other relief efforts. My readers have been very generous over the years to Knightsbridge and their relief efforts. Walt and other members of Knightsbridge literally go into places where if they were caught by the government they would simply be shot (as in Burma). In Afghanistan, before our troops went in, the Taliban put a very hefty price on his head as he brought food and medicine to the northern tribes. Pakistan, Sudan, Darfur, Sri Lanka after the tsunami, in rebel-held territory, to bring medicine when no one else could get through - the hell-holes of the world. He and I talk frequently about the wisdom of taking such risks, and he cheerfully replies that someone has to. There are people dying.

When we talked just a few weeks ago he mentioned he was going to Haiti. At least, I said, that was one place where no one would be shooting at him. He had been there several times. And then we find a different type of uncertainty rearing its head. After all the places he had been where the danger was fellow human beings, this occasion found him in the courtyard of the Hotel Montana, minutes before the earthquake hit. There were teams on the ground the next morning, specifically looking for him, but as of Friday evening he has not been found. We are hopeful, because they are still finding survivors at the hotel.

His friends from Knightsbridge will be going there to assist in the recovery. Medical teams from Knightsbridge are going in early next week, and another experienced team will follow later in the week. These are people who know what to do and how to get it done.

A few of you who have done this type of work may want to contact Ed Artis (see below) to see if you can be of service (especially medical). As I have often written, these are the good guys. They pay their own way and have no office overhead. It is a total volunteer effort. But they do need money for medicines, supplies, etc., and transport to get them there.

What follows is a brief message from Ed, along with a way to send them money. And if you are not comfortable sending money to this rather small but extremely effective outfit, then donate to your favorite charity. This is a real disaster and they need our help. Also, I am including a picture of Walt, and all our prayers go out to his brave family. We are still hoping we find Walt. The world needs every Walt Ratterman it has. And your donation will make sure the work of this brave humanitarian goes on. And now from Ed:

John,

Tax deductions for donations via checks are thru Steps for Recovery ... as are those which are immediate online thru the Paypal icon on the website **www.kbi.org** We are going to have one, possibly two flights going in ... one led by Dr. Jim Laws and the other by me... Jim is in Florida tomorrow, staging the first one... I will follow and do likewise with the second one within the next week...

I will be the point of contact for this action as I have very good communications and will be in constant contact with the Team and updating the Blog from the field daily...

Banking of donations by check will be handled by Mike Carlin while I am away... Online donations are immediate and I can handle them via the net with tax documents to follow...

UPDATED INFO VIA OUR "CURRENT MISSIONS Blog": http://currentmissions.blogspot.com/ (and info on Walt)

ONLINE DONATIONS VIA THE DONATE ICON LOCATED ON THE TOP PAGE OF OUR WEBSITE, LOCATED AT: www.kbi.org (scroll down a little)

DONATIONS SENT VIA CHECKS SHOULD BE MADE OUT TO "STEPS FOR RECOVERY"

BUT CLEARLY MARKED "FOR KNIGHTSBRIDGE / HAITI "

CHECKS SHOULD BE MAILED TO the address below as I will be in the field:

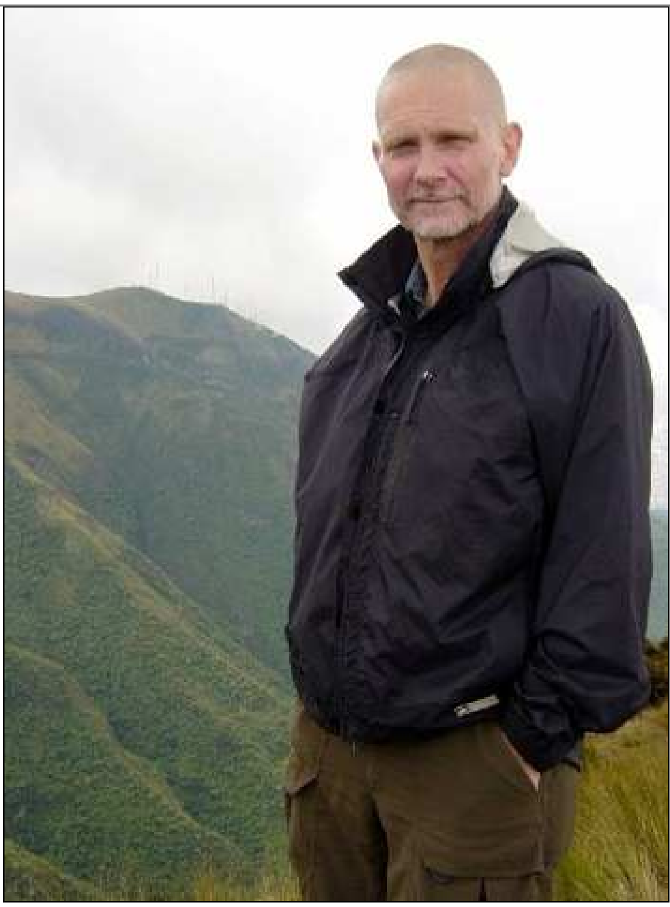
Steps For Recovery
P.O. Box 67522
Century City, CA 90067

(A California 501(c)3
Federal ID # 95.4472343)

Ed Artis - Manila

Friday January 15, 2010

knightsbrg@aol.com



Walt Ratterman

When the Fed Stops the Music

The Federal Reserve has been very clear about the fact that they intend to stop the quantitative easing program at the end of March. What that means in practice is that they are going to stop buying mortgage securities. That does two things. As Bill Gross so aptly points out, those mortgage purchases helped keep mortgage rates low. But they also financed the US government fiscal deficit, albeit indirectly. It seems that funds and banks that sold the mortgage securities turned around and bought US government debt or put the cash right back at the Fed.

Foreigners bought about $300 billion of the $1.5 trillion in new government debt. The rest came from the US, courtesy of the Fed buying mortgages. But that program stops (theoretically) at the end of March. The government still plans to run yet another $1.4-trillion-dollar deficit (give or take a few hundred billion). The question is, who will buy the debt? Foreigners will kick in another $300 billion, unless they decide to stop selling us stuff, or buy other less liquid or physical assets. So far there is no sign of that.

But as I asked last year, who is going to buy the multiple trillions in government debt that the G-7 countries want to issue? Who is going to buy another $1 trillion here in just the US? That is 7% of GDP. That means that consumers and businesses will have to save an additional 7% of GDP just to finance government debt at the federal level, not counting state and local debt. As Bill Gross concludes in his recent column (**www.pimco.com**):

"The fact is that investors, much like national citizens, need to be vigilant, and there has been a decided lack of vigilance in recent years from both camps in the U.S. While we may not have much of a vote between political parties, in the investment world we do have a choice of airlines and some of those national planes may have elevated their bond and other asset markets on the wings of central bank check writing over the past 12 months. Downdrafts and discipline lie ahead for governments and investor portfolios alike. While my own Pollyannish advocacy of 'check-free' elections may be quixotic, the shifting of private investment dollars to more fiscally responsible government bond markets may make for a very real outcome in 2010 and beyond. **Additionally, if exit strategies proceed as planned, all U.S. and U.K. asset markets may suffer from the absence of the near $2 trillion of government checks written in 2009. It seems no coincidence that stocks, high yield bonds, and other risk assets have thrived since early March, just as this 'juice' was being squeezed into financial markets.** If so, then most 'carry' trades in credit, duration, and currency space may be at risk in the first half of 2010 as the markets readjust to the absence of their 'sugar daddy.'"

This is yet another uncertainty. We simply have no idea, no relevant marker, for what happens when a country goes so cold turkey, coming off a central bank bond-buying binge. And this in the midst of a massive deleveraging and with stock market valuations basically where they were in 1987 - except there was at least large earnings growth then.

Who Wants the Old Maid?

Why, therefore, would anyone want to be long the dollar or treasuries? The dollar may be the worst currency in the world, except for all the others. What's an emerging-market central banker to do? Where do you put your reserves?

The dollar? With large fiscal deficits and low interest rates? "What are my other choices?" they must be asking themselves. The euro? Really? The euro is not a currency, it is an experiment.

Everyone knows the problems of Greece. There is no political will in the country (so far) to do what Ireland has done, and really cut their budget. I think Spain is an even bigger nightmare for the EU when compared to relatively small Greece. Italy? Belgium? Portugal? All those countries (and their voters) will be watching to see how the EU deals with Greece. The potential for volatility in the euro is just huge. I hope the euro survives. The world is better off with the euro. But there are very large pressures facing the Eurozone.

And what about the British pound? Already down 20% (a little relief for my London trip next week!), and their problems are every bit as large as those in the US. What about the yen? The government has let it be known they are not happy with the rise in the yen, and seem ready to actually do something about it.

What about the Renminbi? Oh, wait, you can't get enough of them, and the Chinese manipulate their currency. Same for most other Asian currencies.

The dollar may rise against the major currencies during the first part of the year. As I wrote weeks ago, world trade is slowly picking up. While that growth has not been very visible in the US, it is becoming evident among the emerging-market countries that were not overly leveraged when the crisis began. And trade is still in dollars.

Businesses sold their dollars during the crisis, as they did not need them for trade. But now, with trade picking up, they once again have to buy dollars. That is one reason for the recent bull market in dollars. The other is that the markets are massively short the dollar. When everyone is on the same side of a trade, that trade may have run its course, at least for a while. And that seems to be the case recently for the dollar.

So, where are the strong currencies going forward? The Canadian dollar is on its way to parity. I would want to own the Aussie, if I was a trader. Maybe the Swiss franc, although it is so high on a parity-value basis right now.

But the currency I want the most if I am a central banker is that barbaric yellow relic, gold. Just as India has recently bought 200 tons of gold, I think central banks in other emerging nations will want to buy more, too. They all have relatively little gold as a percentage of their reserves. Look for that to change.

I also like gold in terms of the euro, the pound, and the yen - more than I like it in terms of the US dollar, but even there I like gold long-term, at least until we get some fiscal sanity.

It's the Deleveraging, Stupid!

The reason this recession is different is that it is a deleveraging recession. We borrowed too much (all over the developed world) and now are having to repair our balance sheets as the assets we bought have fallen in value (housing, bonds, securities, etc.). A new and very interesting (if somewhat long) study by the McKinsey Global Institute found that periods of overleveraging are often followed by 6-7 years of slow growth as the deleveraging process plays out. No quick fixes.

Let's look at some of their main conclusions (and they have a solid ten-page executive summary, worth reading.) This analysis adds new details to the picture of how leverage grew around the world before the crisis and how the process of reducing it could unfold. MGI finds that:

- Leverage levels are still very high in some sectors of several countries - and this is a global problem, not just a US one.

- To assess the sustainability of leverage, one must take a granular view using multiple sector-specific metrics. The analysis has identified ten sectors within five economies that have a high likelihood of deleveraging.

- Empirically, a long period of deleveraging nearly always follows a major financial crisis.

- Deleveraging episodes are painful, lasting six to seven years on average and reducing the ratio of debt to GDP by 25 percent. GDP typically contracts during the first several years and then recovers.

- If history is a guide, many years of debt reduction are expected in specific sectors of some of the world's largest economies, and this process will exert a significant drag on GDP growth.

- Coping with pockets of deleveraging is also a challenge for business executives. The process portends a prolonged period in which credit is less available and more costly, altering the viability of some of business models and changing the attractiveness of different types of investments. In historic episodes, private investment was often quite low for the duration of deleveraging. Today, the household sectors of several countries have a high likelihood of deleveraging. If this happens, consumption growth will likely be slower than the pre-crisis trend, and spending patterns will shift. Consumer-facing businesses have already seen a shift in spending toward value-oriented goods and away from luxury goods, and this new pattern may persist while households repair their balance sheets. Business leaders will need flexibility to respond to such shifts.

You can read the whole report at their web site. The ten-page summary is also there. **http://www.mckinsey.com/mgi/publications/debt_and_deleveraging/index.asp**

The Lex column in the Financial Times this week observes, concerning the report:

"It may be economically and politically sensible for governments to spend money on making life more palatable at the height of the crisis. But the longer countries go on before paying down their debt, the more painful and drawn-out the process is likely to be. Unless, of course, government bond investors revolt and expedite the whole shebang."

And that is the crux of the matter. We have to raise $1 trillion-plus in the US from domestic sources. Great Britain has the GDP-equivalent task. So does much of Europe. Japan is simply off the radar. Japan, as I have noted, is a bug in search of a windshield.

Some time in the coming few years the bond markets of the world will be tested. Normally a deleveraging cycle would be deflationary and lower interest rates would be the outcome. But in the face of such large deficits, with no home-grown source to meet them? That worked for Japan for 20 years, as their domestic markets bought their debt. But that process is coming to an end.

James Carville once famously remarked that when he died he wanted to come back as the bond market, because that is where the real power is. And I think we will find out all too soon what the bond vigilantes have to say.

And so we have uncertainty all around us. What will our taxes look like in the US in just 12 months? Health care? Who will finance the bonds, without a credible plan to reduce the deficit? And any plan that has Nancy Pelosi as its guarantor is by definition not credible.

There is just so much that is uncertain, and all we can do is wait to see how it unfolds. My best guess is that we see a solid GDP number posted for the 4th quarter (which will get revised down over time), due mostly to stimulus and inventory rebuilding. By the middle of the year the stimulus will be far less. And while inventories are rebuilding and that is good for the GDP numbers, the sales-to-inventories number has not risen. And final demand is what drives inventory rebuilding.

The latter half of the year looks to be weaker, and then we hit what right now looks like the largest tax increase in history, much of it on the small businesses that are the drivers of job creation. The National Federation of Independent Businesses just released their latest survey. It was brutal. There is little optimism in it.

The Fed is going to stop the music in March. There will be a scramble for the chairs. This is a huge experiment with no precedent. The entire developed world is the test subject. Risk assets will be subject to uncertainty. And markets hate uncertainty.

Hopefully, we can Muddle Through this year before a relapse into recession in 2011 (because of the tax increase). I wish I could see it like Larry Kudlow, but I don't. I would be very cautious about being long the stock market. It is now a trader's market. I would not be buying long-duration bonds. It is still an absolute-return world.

London, Monaco and Zurich

It is getting time to hit the send button, and still no word about Walt. But they are still rescuing people from the hotel. Life is so uncertain. I just didn't see that one coming - which is how it is with surprises.

Next week I am off to Europe to be with Niels Jensen and my partners at Absolute Return Partners, meeting with clients, prospects, and funds. Then I have nothing scheduled until I go to the Singularity University's 9-day Executive Program from February 26 through March 6. As for how I feel about it, the fact that I would devote nine days to it basically says it all. They have a very powerful faculty brief a rather small group about how the future of a variety of technologies will impact all aspects of business and the economy. It is not cheap, at $15,000, but I think it will be worth my time. They have had more applications than they have slots, but they have said they will give my readers special preference (as far as possible). You can go to **www.singularityu.org** and click on the link to the conference to find out more. I have been told the names of some of my fellow attendees, and let me say, the list is impressive. I am really looking forward to it. Hope to see some of you there.

Again, please help if you can with Haiti. The needs will be so great. I think I need more time with my kids this weekend.

Your learning to embrace uncertainty analyst,

John Mauldin

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