*"The basic prescription for preventing deflation is straightforward, at least in principle: Use monetary and fiscal policy as needed to support aggregate spending, in a manner as nearly consistent as possible with full utilization of economic resources and low and stable inflation. In other words, the best way to get out of trouble is not to get into it in the first place."* – Ben Bernanke

## {The Growing Bailout}

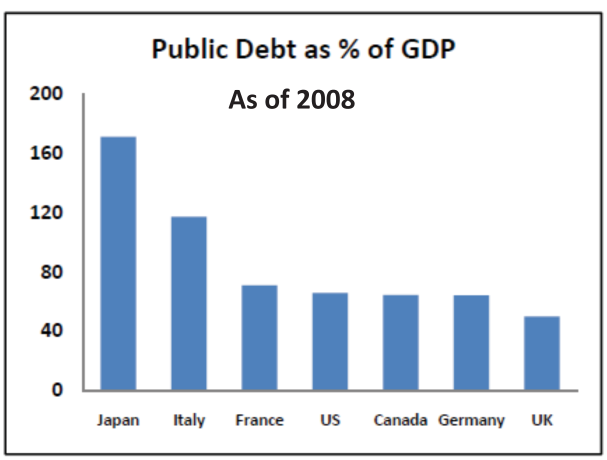
As the government bailout grows in size and shape, there are a variety of potential risks. The risks generally depend on one's perspective. From the perspective of the financial sector, the most talked about risk has been that of increased regulation and oversight, and the dangers associated with allowing the government to take a larger role in the markets. For taxpayers, the risk has been that of increased taxation down the road, not to mention the fear that government allocated funds could be allocated improperly or given to corrupt or irresponsible individuals. For investors, the greatest risk is the possibility that the bailout might not work – that even with the government's support, markets might remain stagnant.

Some of those risks are exaggerated, and some are real. All of them appear every day on the front pages of newspapers and on TV. It doesn't help that the government's bailout – from the Bear Stearns rescue to the TALF – evolves every day. In the following pages we intend to neatly summarize the multiple bailout programs, present some of the risks and opportunities that we perceive to be most relevant, and provide some examples from abroad and from history that help explain the situation we find ourselves in today.

## {Japan}

In order to assess what some of the outcomes of the bailout might be, many have turned to Japan's experience in the 1990s to learn what happens when the forces of a declining market, falling prices, near-zero interest rates, and heavy government spending converge.

Japan's banking crisis began in 1990, when the country's real estate bubble began to burst and many of its banks began to experience problems similar to those faced by US banks today: investments in debt and mortgages that were particularly hard to value destabilized the financial system. Over the next few years, the bank problems in Japan continued to worsen and assets remained hard to value, but the government acted slowly to respond to the crisis,




*Source: Outpost Investment Group; data as of 2008*

**Programs**

The government's intervention in the markets over the past year has evolved from ad-hoc crisis management (the Bear Stearns rescue, the seizure of IndyMac), to the expansion of insurance programs (widened FDIC coverage), to programs meant to allay further pain in the financial markets (TARP and TALF). The government's actions so far have been the product of varying levels of planning, urgency, and transparency, and have resulted in limited verifiable success – beyond preventing an all-out collapse of global trade. As the Treasury continues to print money and the government pledges more money to more financial institutions, there are a handful of programs that have so far formed the brunt of the cost, and the risk.

*Fannie Mae/Freddie Mac*

Takeover: Sept. 8, 2008; Amount committed/spent: $400 billion/$14 billion

The takeover of Fannie Mae and Freddie Mac came after it became clear that the pair of home mortgage insurers had not held enough capital to cover the mortgages they had helped securitize and insure. The government moved the companies into a conservatorship and backed the two firms' loans.

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waiting until 1998 to pump public funds into banks. The government was also slow to force banks to write-down their troubled assets. What resulted was a long and painful period of slow growth known as Japan's "lost decade".

The US government has responded much more aggressively to the current crisis, in part to head off the possibility of a long period of weak growth. Federal Reserve Chairman Bernanke wrote at the beginning of this decade that he found it unlikely that the United States could suffer through a decade of deflation and contraction as Japan did in the 1990s ("Deflation: Making Sure It Doesn't Happen Here", 2002). He wrote that essentially two factors caused Japan's extended slump that did not appear to be present in the United States in 2002: deep-seated financial problems in the private sector, and a discordant political system that was not effective enough to stimulate the economy through monetary and fiscal policy.

Things have changed considerably since then, and some have argued that the Federal Reserve helped cause the current crisis by, out of a fear of deflation, keeping interest rates low for too long and creating "asset bubbles". Apparently Bernanke has not forgotten the comparison to Japan; the pace at which he and Treasury Secretary Paulson started taking over financial institutions, forcing mergers, and delivering capital injections into the financial system in 2008 was the product of their determination that the U.S. would not wind up like Japan.

Twenty years later, Japan has improved and repaired its banking system, and the financial crisis in the West has not hit Japan as hard as many of its neighbors. But the problems of the 90s still linger. The country's public debt to GDP ratio is one of the highest in the world – leftover from the numerous bank bailouts that were necessary there – and the lack of a strong economic recovery has made the debt harder to pay off. But much as a Japan-like deflation in the US is a risk, there also exists a real risk of outsized inflation.

{Inflation: Albatrosses and Red Herrings}

The present government bailout is huge in size and scope, larger by far than the aid amount used in resolving the savings and loan crisis in the 1980s, and it only appears that the bailout will grow. At the time of this writing, the government (in the form of the Treasury, the Federal Reserve, the FDIC, and other programs) has lent and spent at least $2 trillion in bailout money, and it has committed an estimated $6 trillion more. The current total bailout amount of $8 trillion is about two-thirds the total value of all

*American International Group (AIG)*
Bailout: Sept. 16, 2008; Amount committed/spent: ~$180 billion/$80 billion
Only days after the bankruptcy of Lehman Brothers, the government stepped in to save American International Group (AIG), the largest insurance company in the U.S., after the firm began to report huge losses in early 2008. The losses, the result of the firm's significant vulnerability to weakness in the mortgage market, swiftly weakened the insurance firm, and made government intervention seem necessary. It was thought that to let AIG fail, as the government had done with Lehman Brothers only a few days earlier, would have set off a chain of events that could have wrought unprecedented pain in the financial markets. On March 2, 2009, the government committed an additional $30 billion to AIG to avoid a credit rating downgrade.

*FDIC Insurance*
Introduction: October 3, 2008; Amount committed/spent: Over $1.2 trillion/At least $250 billion
The Federal Deposit Insurance Corporation (FDIC) increased federal deposit insurance coverage from $100,000 to $250,000 per depositor, effective until December 31, 2009. At the time, it was estimated that the move raised the amount of deposits insured by the FDIC to about $5 trillion. The FDIC has also introduced two other programs to insure bank debt (that program is scheduled to run through June 2009), and non-interest-bearing deposit accounts.

*Troubled Assets Relief Program (TARP)*
Introduced: October 3, 2008; Amount committed/spent: $700 billion/about $350 billion
The TARP was introduced as a plan to buy up hard-to-value assets such as mortgage-backed securities from banks, to end the long series of write-downs of the assets and bank losses. However, the TARP quickly turned into a program to directly prop up banks by buying non-voting shares in the banks. Nearly $100 billion of the TARP went into two of the nation's largest banks, Citigroup and Bank of America, and at least $25 billion went to the automakers G.M. and Chrysler, while the remaining amount went to hundreds of banks, and to funding for programs to help homeowners and to help fund the TALF program. About $200 billion of the TARP remained to be committed as of March.

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existing home mortgages in the United States. The implications for the value of the dollar and price growth could be substantial.

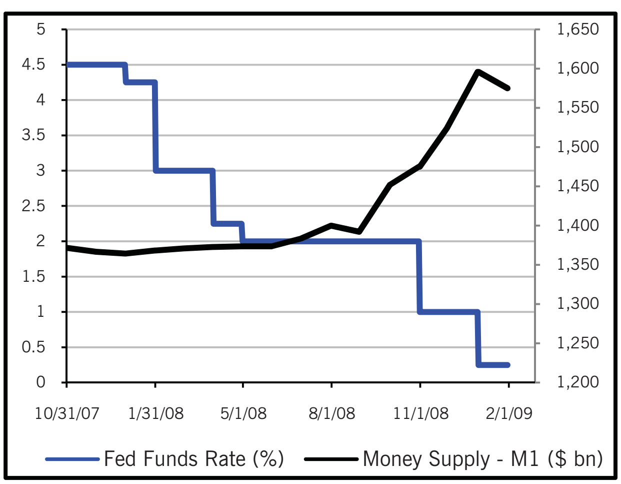
For instance, the growth of the monetary base of the United States, when viewed over the past 50 years, is relatively L-shaped: the last year has seen a much greater rise than over any other recent period. In addition, the Federal Reserve has rapidly lowered the Fed Funds Rate, to its present level of 0.25%. Short-term Treasury rates consequently dropped to near-zero. The intention of the government is to use essentially every fiscal tool at its disposal to prevent deflation. With interest rates near zero, however, virtually the only way the Treasury could compel increased lending would be to pay investors to take more money (which it will emulate through programs like the TALF, which attempts to create incentives for borrowing money and buying troubled assets).

The government's efforts will almost surely help combat deflation, both during the current crisis and when the crisis has finally passed. The drastic use of fiscal policy and aggressive spending, however, will create the risk that when the crisis is over and money begins to be quickly spent and lent again, above-target inflation could take hold. We will address the differences between the risks of high inflation and modest deflation below; in the meantime there are a few other potential speed bumps to the bailout that are worth addressing.

## {Taxation}

Another major risk of the bailout is that it will result in increased taxation on wealthier individuals, on capital gains, and on the gains of alternative investment vehicles such as hedge funds and private equity partnerships. Unlike inflation, the risk of taxation is not really at question: President Obama's newly introduced budget plan made clear that he intends to raise taxes on the wealthy, although many of those tax increases may come by way of allowing President Bush's tax cuts to expire in 2010. It appears unlikely that major tax increases will take place until the economy has found surer footing.

One of the tax issues for large investors will be newly proposed tax rules regarding hedge funds and private




*Term Asset-Backed Securities Loan Facility (TALF)*
Introduced: Originally announced in 2008, expanded February 10, 2009; Amount committed/spent: $1 trillion/$0
The TALF, which was announced and was to be funded in conjunction with the TARP, is intended to increase lending to businesses and consumers by providing loans and accepting as collateral generally high-quality loans such as auto, credit card, and student loans. The program may also accept assets such as mortgage-backed securities as collateral. The goal of the TALF is to expand the liquidity the government has been injecting into markets from banks to the broader market, in order to lower the cost of lending. The TALF, when it was first conceived, was meant to cost $200 billion, but that estimate was raised to up to $1 trillion in February 2009; the details of the TALF were being released and lending under the program was getting underway as of March.

*Public-Private Investment Fund*
Introduced: February 10, 2009; Amount committed/spent: Up to $1 trillion/$0
The fund, which has yet to be described in detail, would provide financing to private investors to help purchase bad assets from banks. The fund, as it has been described so far, would function like a "bad bank", and would seek to aggregate the worst of the assets held by banks so that they could resume lending. Details on the fund were not yet released, and the fund had not begun spending money as of March.

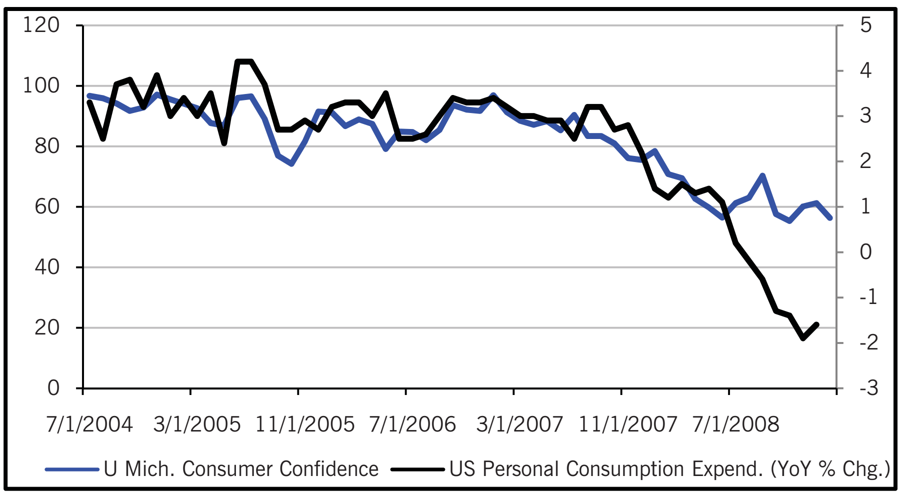
*Commercial Paper/Money Markets*
Introduced: October 7, 2008; Amount committed/spent: Up to $2 trillion/$250 billion
The Federal Reserve announced this program in October, to provide stability to the commercial paper market, which had been beaten down as investors moved from commercial paper – previously viewed as a safe and liquid place to temporarily put money – to Treasuries. Commercial paper is sold by companies to help finance their day-to-day operations, and it is not backed by collateral. Similarly, after the Treasury guaranteed money market accounts, the Fed moved in to buy the assets of some money market funds when the illiquidity of their holdings caused them to "break the buck", or to allow their share price to fall below $1.

equity partnerships. The budget proposal plans to increase taxation of carried interest for general partners (the "owners" of a hedge fund). Currently those dollars are taxed at capital gains rates, but the proposal intends to tax them as income, which would substantially raise taxation on general partners (from around 15% for long-terms gains to as high as 39%). Hedge funds and private equity vehicles would probably try to pass some of those tax costs to limited partners as fees, which could drag on performance. But the tax changes do not appear set to become law until 2011, which should allay most investors' fears about increased taxation in the near term.

### {Bank Incentives and Financial Earnings}

Another risk of the government's bailout efforts is that the financial system could emerge damaged (as did Japan's) and unable to make a strong recovery for a long period. Many have objected to the government's decision to prop-up the banks and auto companies, claiming that aiding failing industries only perpetuates failed strategies and rewards the people who caused the mess in the first place. This is a concern, as the economy's ability to recover will depend to a large extent on the health of financial institutions. As the term "zombie banks" bubbles to the surface of the American psyche, however, it has become clear that the government will go to nearly any lengths to save the country's biggest banks from failing.

The willingness to provide limitless capital to financial institutions removes the ceiling for government spending and only increases the associated monetary and tax risks. It also provides little resolution to what has been called bankers' "free option" – reaping the benefits of booms, but not paying the costs of busts. But the fallout thus far has already changed the playing field and effectively eliminated some of the financial system's worst offenders. As early as September, the last two stand-alone investment banks (the less regulated and more risk-prone cousins of commercial banks), Morgan Stanley and Goldman Sachs, announced that they would become bank holding companies, which are subject to more regulation and operate under stricter rules. (Lehman Brothers was another of the last of the investment banks, before it filed for bankruptcy on September 15.) The government's decision to continue to prop up the other major players, such as Bank of America, Citigroup and AIG, has so far been consonant with Chairman Bernanke's commitment to throwing everything but the kitchen sink at the problem. Investors who are sensitive to the risks surrounding that approach – inflation vs. deflation, attendant interest rate risks, and taxation – will benefit.




### {The $787 Billion Fiscal Stimulus}

Separate from but not unrelated to the bailout of the financial sector has been the government's efforts to jump-start the economy through fiscal stimulus. The first big fiscal stimulus in the present crisis took the form of rebates to taxpayers in mid-2008, when the government sent checks to most Americans after tax season wound down; that stimulus totaled about $168 billion in rebates to individuals and tax breaks for businesses. The 2008 stimulus appeared, at first, as though it may have helped give the markets and the economy some footing, as consumer expenditures appeared to find a floor in late spring and the slide of domestic markets slowed. That pause was later known as the Wile E. Coyote effect – the brief stop before the big fall. As summer became fall, markets, consumer confidence, and about every other asset value and indicator fell sharply. Amid the financial crisis, direct fiscal stimulus took a pause until early 2009 when President Obama, in his first weeks in office, pushed through the latest stimulus bill.

Called the American Recovery and Reinvestment Act of 2009, the final package includes billions of dollars in spending and tax cuts, primarily focused on extensive tax cuts for individuals, expansion of health care coverage and unemployment benefits, education, and spending on the renovation of infrastructure such as roads and bridges. At a substantial fraction of the United States' $14 trillion GDP, the stimulus plan is aggressive and intends to create new jobs in the quickest way possible – by paying workers to begin building and renovating infrastructure while helping re-train individuals in economically depressed areas. The bill is aimed at side-stepping some of the worst side-effects of a long-term recession: the risk of people becoming habitually unemployed, undereducated or disillusioned about their ability to be productive. Again, these were side-effects of the experience of Japan in the 90s; the government's aggressive stimulus is aimed at diverting the possibility of America's recession becoming habit-forming.

Several commentators have echoed the refrain that sending each American a $10,000 check – the rough equivalent of $3 trillion, or the estimated total cost to taxpayers of the bailout – would be the fastest and most complete fiscal stimulus ever practiced. This off-the-cuff reaction to the bailout ignores what would be some of its most obvious side-effects. Growth would return overnight, but so would destructive inflation; the political and social ramifications would also be hazardous. By attempting to stabilize financial markets, rather than opening the gates of the Treasury to taxpayers, the government is in the midst of an effort to hold in place the social and financial structure by which the country has historically thrived. Directing some of the government's money toward solving individuals' financial problems, while also helping banks resolve theirs, seems a fair compromise.

## {Conclusions & Outlook}

Investors are at present effectively caught in a price growth double-bind: prices and consumer spending (and therefore inflation) seem almost inevitably set to decline, due to contractions in the economy and the lengthiest recession in decades; and yet, growing government spending and the lowering of interest rates seem set to precipitate aggressive inflation. There is not overwhelming evidence, at present, to strongly favor either one of the two scenarios.

There is a lot of good reason to favor the inflation scenario, however: inflation is, in a sense, the "grease on the cogs" of the financial system. We don't build cars and planes and, most importantly, we don't build houses and take out mortgages with deflating prices in mind. The subprime mortgage debacle is a perfect example of the crises that arise when trends reverse and prices of assets suddenly fall below the level of the debt that was issued to purchase them. Equity holders lose much of the incentive to continue to pay the debt, and chaos ensues. Inflation, for all its flaws, is at least preferable to chaos, especially to a government.

It also stands to reason that President Obama's administration, which has said that it will attempt to revitalize the middle class, is more likely to favor the risk of very high inflation than the risk of moderate deflation. Inflation lessens the purchasing power of those with accumulated capital, and it increases the amount of capital available to those who do not save. High inflation – especially very high inflation, like that seen in the 70s – is not anyone's goal, but the government is likely to continue the bailout program until some form of inflation, whether it is high or not, is here.