DEFLATION NOW, INFLATION LATER
WEB BUZZ 2009.01.26

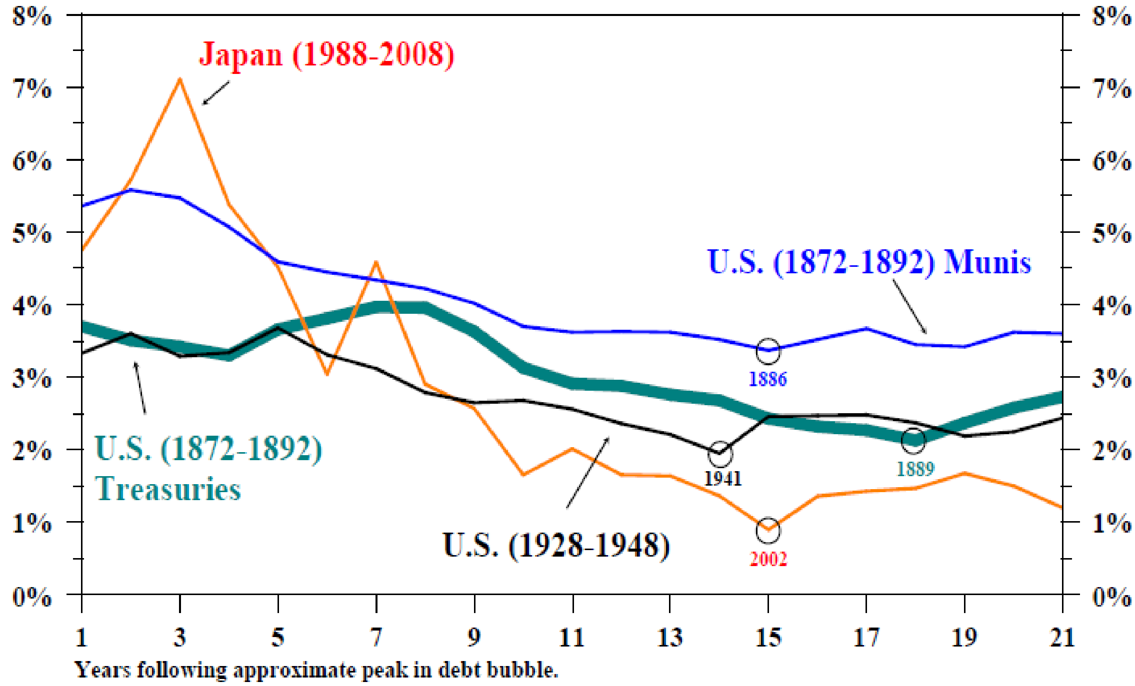
We are experiencing a strong counter-move in the 30-year government bond. This is what we thought might happen when we took profits last month. We are watching for a buying point to re-establish our investment position. The market is torn between deflation and inflation. Our position is that deflation is set in stone for the next several years, which should result in lower long-term interest rates. We also believe that inflation is probably our longer-term problem; therefore, market timing has become critical. The Federal Reserve and Congress are doing their darndest to re-inflate–we just don't believe this can take place under the present economic and financial conditions.

The rating companies (can we believe them anymore?) say there are eleven AAA sovereign credits in the marketplace, of which the U.S. is one. Just a week ago or so, Standard and Poor reiterated that the U.S. remains at AAA rating; however, many market participants looking at the upcoming deficits that need to be funded are concerned that this rating may not last. If so, then higher rates should certainly follow. The U.S. represents 20% of the world economy and 35% of the global bond market. While the current state of the U.S. economy is no picnic, we are still relatively much better off than the rest of the world.

Note the chart below concerning the history of long-term interest rates during debt deflation.

Long Term Interest Rates during Debt Deflations

annual average



Sources: Board of Governors of the Federal Reserve System, History of Interest Rates; Homer & Sylla, N.S. Balke & R.J. Gordon, C.D. Romer. Japan Securities Dealers Association. Munis listed to augment thin treasury market in the 1872-1892 time period.

Adapted from Hoisington's 4Q08 Quarterly Review and Outlook