



EVERY MASTERPIECE

Gertrude Stein, born in Allegheny, Pennsylvania said that “Every masterpiece came into the world with a measure of ugliness in it. That ugliness is the sign of the creator's struggle to say a new thing in a new way.”

Our view is that the FED is transitioning from the era of Alan "The Maestro" Greenspan to the Bernake message of proactive policy action rather than reactive policy to excesses. The markets are volatile and attempting to interpret comments, innuendo, and meeting minutes. What strikes us is that the bond market vigilante's have taken it upon themselves to lower interest rates while the FED reiterates it's tight stance on the cost of money. In comes ugly-home flippers sleepless and hedge fund losses while cash is the highest returning risk adjusted asset.

What are the conditions?

- Clearly housing has weakened in response to interest rates and the drain on consumer pockets from high petrol prices since Katrina.
- Job growth remains strong and wage growth has been up.
- Inflation is above the FED's implicit band, with the most recent GDP deflator at 3.3%
- The soft patch (Q3'06) is behind the market. The markets are discounting to a summer growth pause while market participants were on holiday.

How bad is the housing market?

- We reported in the Spring of '05 we saw certain mortgage loan residuals with late payments of as high as 35% and 17% of them intending to declare Chapter 7,11, or 13.
- We now see *mid to low FICO score mortgagees defaulting on up to 18% of the loans*, particularly in the mid-west.
- *Residential building represents about 6% of GDP in America. In a recession building can decline by up to 40%*
- Economists estimate spending as a result of the wealth effect of home price increases to be about 5 cents on every dollar of actual appreciation. This means that *5% of \$5 trillion in home appreciation accounts for 2% of the change in GDP.*



Raison d'êtra revisited

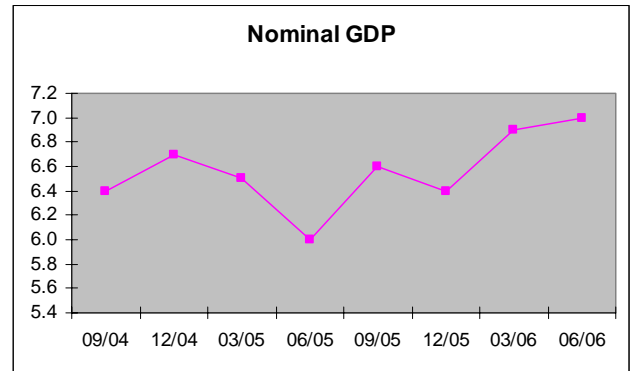
The Fed FOMC does not view their function as making home loans cheap, cars affordable, or jobs plentiful. They are singularly focused on *price stability*.

What is actually happening to the masterpiece that Greenspan painted? It was one of easy money on the belief that productivity gains and globalization of labor and manufacturing would off-set demand pull inflation (the New Economy). The reality of the post Katrina period has been one of constrained commodity availability and cost push inflation.

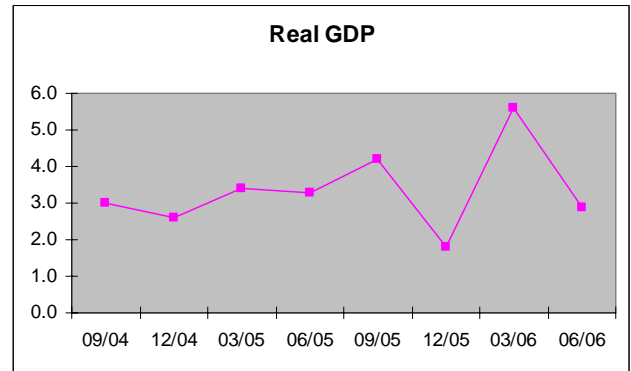
Let's look at nominal GDP in the US. which has pushed to extraordinarily high levels (Chart 1) If we look at GDP in real terms (adjusted for inflation) we see the dip in real GDP in the wake of Katrina as energy costs rose (Chart 2) ...and inflation as measured by the GDP Deflator is soaring (Chart 3)

A weak dollar is good for exports of US manufactured goods and a weak dollar raises the cost of imports. The Dollar has weakened verses the Chinese Yuan (Chart 4) and imports are unlikely to slow.

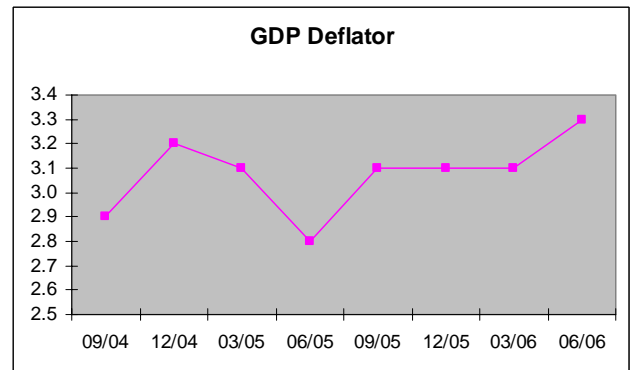
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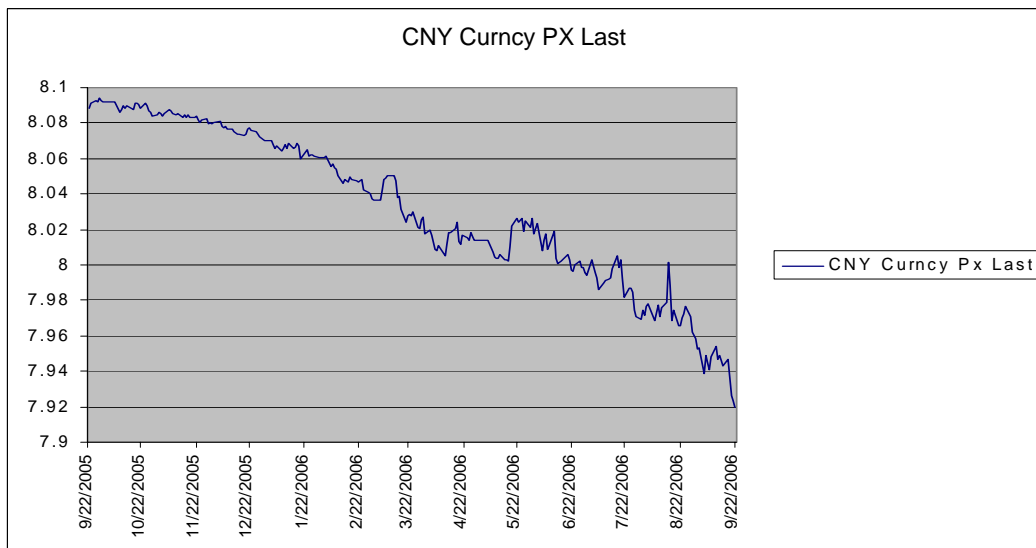
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SUMMARY

- **Bernake will create his own *Master Piece* and there will be a certain ugliness to it as he sends a new message-no more easy money.**
- **The new message is that policy will be firm to constrain monetary base growth and speculation for a longer period that the market thinks collectively.**
- The US Dollar weakness will put upward pressure on import prices and is unlikely to spur significant manufacturing growth, particularly in light of auto production cuts.
- **Monetary base growth has slowed to about 4% YOY which is less than nominal GDP- easy money is gone.**
- The slowdown in monetary base is being off-set by **a rise in the velocity of money thus reducing leverage but sustaining growth**
- Dollar weakness will raise OPEC's desire to keep oil high via production limits as it is paid for in petro-dollars (USD).
- The FED has a three position switch, it is not simply a matter of raising rates or lowering rates. **The cost of money can be held constant by the FED despite the decline in longer term interest rates.**

JKM