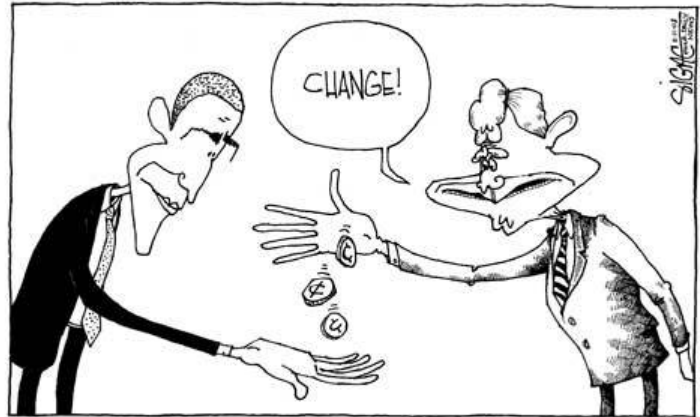


During the 2008 Presidential campaign, the word "change" was used more than probably any other, including even "maverick" (*see End Note*). Some people consider change a refreshing new beginning, but for others it is terrifying. Woodrow Wilson, our 28th U.S. President, once said, "*If you want to make enemies, try to change something.*" As the president who oversaw such major legislation as the creation of the Federal Reserve System, the Federal Trade Commission, the Clayton Antitrust Act, the first progressive federal income tax, and national suffrage for women, Wilson spoke from experience. President-Elect Obama has a no-less daunting task ahead. He was swept into office by a wave of Americans looking for a light at the end of the tunnel of the current economic crisis. Now that "*change has come to America*¹," the focus has turned toward what is actually going to be done to make it happen. His 8 million-plus popular vote victory and increased Democratic majorities in both houses of Congress give his administration a powerful tailwind for reform. His newly-appointed Chief of Staff, Rahm Emanuel, recently outlined the agenda in terms of four priorities:

1. Financial-regulatory reform,
2. Tax reform,
3. Health care reform,
4. Energy policy reform

President-Elect Obama reiterated during both a press conference and television interview in the last several days that his intention as president will be to make revitalizing the economy his first priority. Below, we examine



Source: *The Boston Globe*

the policy options available to address the economic downturn, how they have been tackled in the past, what we think could happen this time, and how these policy changes may affect the markets in the months and years ahead.

"We need not fear the expression of ideas - we do need to fear their suppression."

- *Harry S. Truman (1945 - 1953)*

The President-Elect has promised a departure from governing by strict party lines, and since the election has continued to stress a post-partisan approach. His comments have indicated that his administration will try to solve the country's financial problems in part by taking the best ideas from our nation's history, regardless of whether they are from the F.D.R. or Reagan eras. In fact, Obama said he has been reading about the Great Depression and President Franklin D. Roosevelt's first 100 days in office, and he hopes his team could emulate that administration's confidence and willingness to experiment. He also stated that no two time periods are exactly alike, and therefore he has no intention of

¹ A partial quotation from Senator Obama's election-night victory speech in Grant Park, Chicago, IL, Nov. 4, 2008.

just recreating the solutions used during the 1930's. Today's economy is more global, more modern than the one of nearly 80 years ago; information is transmitted more rapidly, and the tools we have at our disposal are more advanced and time-tested. History does, however, provide an important guide. We can learn from what has been done, and how these tools may or may not work during the current period.

"Whoever controls the volume of money in any country is absolute master of all industry and commerce."

- James Garfield (1881)

Over the past several decades, the pace of economic growth in the U.S. has been managed largely through monetary policy actions. This type of policy is executed by the Federal Reserve using three main tools:

1. Open market operations are the primary method for implementing monetary policy. Since the 1980's, the objective of open market operations has been to achieve a specific fed funds rate target, which is set by the Federal Reserve's Federal Open Market Committee (FOMC). This is the rate charged for overnight lending of Federal Reserve deposits between institutions. The Fed manipulates this rate through the purchase and sale of federally-issued securities like U.S. Treasuries. They sell securities on the open market to decrease the money supply and slow economic activity, while the Fed buys Treasuries to put more funds into circulation and promote growth.
2. The discount rate, set by the Fed's Board of Governors², is the interest rate that commercial banks and other depository institutions pay when they borrow from regional Federal Reserve Banks. This discount window, as it is called, serves as the "lender of last resort" for commercial banks, assuring them access to liquidity.
3. Reserve requirements, also set by the Board of Governors, dictate the amount of deposits an institution must hold in Federal Reserve Banks relative to liabilities.

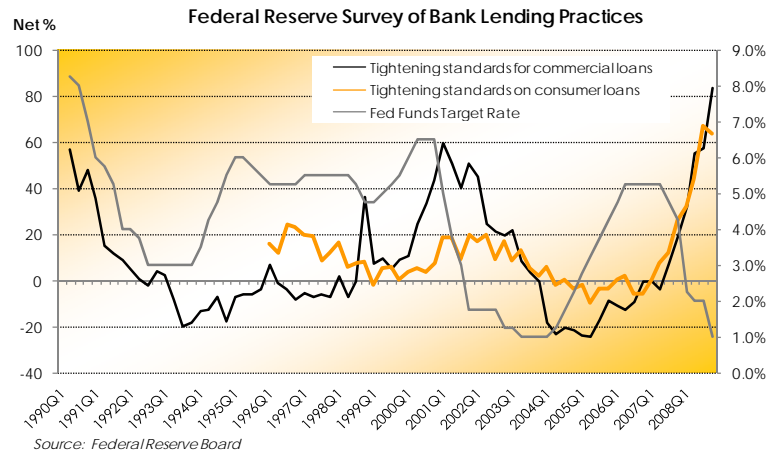
This is how it works in practical terms. When the economy slows and unemployment creeps up, the FOMC lowers the fed funds target rate, reducing the cost of lending between banks, and in turn lowering the cost of borrowing for businesses and consumers. Since money is now available more "cheaply", economic activity picks up as businesses expand and individuals spend. The reverse happens when activity overheats and higher interest rates serve as a wet blanket to an inflationary economy. It does take time for these changes to feed through the system, however, and there is normally a lag of about 12 to 18 months between policy changes and practical results.

In our view, the Fed's ability to immediately stimulate growth by lowering interest rates is limited at this point. First of all, short-term interest rates are already very low; the fed funds target rate is now set at 1%. Second, policy makers have already pursued an aggressive easing campaign, bringing the target rate down 350 basis points in the last 12 months. Regardless, any changes made now will take several quarters to be felt in the real

² The Board of Governors of the Federal Reserve System is a seven-member subset of the 12-member FOMC.

economy. Third, and most importantly, banks are reeling from the impact of deleveraging and writing down losses from toxic mortgage-related assets. They are taking advantage of the lower costs of borrowing and their access to the Fed's "lender of last resort" discount window, but hoarding these funds to shore up their balance sheets. As a result, the benefits of easy monetary policy are not being passed along to businesses and consumers, who are still experiencing very tight lending conditions.

This can be seen from the divergence in the direction of the fed funds target rate and bank lending conditions data in the chart to the right. Furthermore, despite the deflationary headwinds of a global economic slowdown, extreme and prolonged monetary easing could set the stage for inflationary pressures down the road if the recession is not as severe as many expect.



"The main thing is never quit, never quit, never quit."

- William Jefferson Clinton (1993 – 2001)

If easier monetary policy is not a viable option to stimulate growth at this point, then what is the alternative? The President-Elect addressed this concern when asked during his interview on "60 Minutes" last Sunday if there would be a point when asking the Treasury Department to print more money would not be an option. He expressed his belief that there now seems to be a consensus among both conservative- and liberal-leaning economists that the nation has little choice but to boost government spending. *"We have to do whatever it takes to get this economy moving again,"* he said, *"we're gonna have to spend money now to stimulate the economy... We shouldn't worry about the deficit next year or even the year after... Short term, the most important thing is that we avoid a deepening recession."*

In this regard, the next President is taking a page from the playbook of F.D.R. During the days of recession and high unemployment in the 1930's, we saw the birth of Keynesian economics, which emphasized countercyclical fiscal policy. This theory encouraged deficit spending during times of recession and high unemployment, and higher taxes and reduced government outlays during boom times. Keynes famously argued that governments should address problems in the short run rather than wait for market forces to do it in the long run, because *"in the long run, we are all dead."* Obama echoed this philosophy in his comments above.

"Never spend your money before you have earned it."

- *Thomas Jefferson (1801 – 1809)*

Fiscal policy generally can influence the economy through changes in taxation or government spending. In theory, consumer spending can be increased by reducing taxes or handing out stimulus checks, as was done earlier this year. At this point, however, consumers are deleveraging their personal balance sheets just as banks and businesses are doing. It is likely that another stimulus check would go toward paying down debt and not new purchases to fuel business activity. We believe that a more effective way to boost the economy would be through direct government spending on infrastructure and public works; this is a view that is gaining traction both domestically and internationally.

A few weeks ago, China announced a domestic stimulus package totaling 4 trillion yuan, or the equivalent of US\$586 billion. The plan includes extensive infrastructure construction, aid to farmers, and a cut in export taxes. This past weekend, a statement from the Group of 20 economic summit in Washington indicated that world leaders would take further actions to stabilize the financial system, and vowed to *"use fiscal measures to stimulate domestic demand to rapid effect, as appropriate."* President-Elect Obama has indicated that his first legislative goal will be to pass an economic stimulus package that includes job creation, construction programs, a tax cut for the middle class and some first initiatives on health care reform. Beyond the fiscal impact, these initiatives could provide a once-in-a-generation opportunity to make needed repairs to our aging national infrastructure. As of today, about \$350 billion of the original \$700 billion bailout package approved by Congress still remains to fund future initiatives. Treasury Secretary Henry Paulson has indicated that he will not tap into these funds, and that he will leave them for the new administration to allocate.

"The only limit to our realization of tomorrow will be our doubts of today."

- *Franklin Delano Roosevelt (1933 – 1945)*

One argument against deficit spending is that when the government issues more debt, it competes directly with private businesses for borrowers' dollars. This phenomenon is called "crowding out" of private investment. In the economic situation we face today, however, all debt riskier than Treasuries is already having a hard time attracting lenders. While issuing more government debt likely will drive up interest rates, stagnant growth is now a greater risk. The worry of fiscal conservatives is that any new spending initiatives could increase the footprint of government for many years to come. Once an economic recovery is in place, the administration will need to take a more prudent fiscal approach to address our massive deficits.

Looking beyond the immediate crisis, reform of the financial system will surely be a top concern for the next administration. President-Elect Obama has said that he does not favor *"heavy-handed regulations that [could] crush the entrepreneurial spirit and risk taking of American capitalism,"* but that restoring *"a sense of trust, transparency, openness in our financial system"* is the priority.

"Some people call me an idealist. Well, that is the way I know am an American."

- Woodrow Wilson (1913 – 1921)

Aside from the fiscal stimulus package, the President-Elect has chosen to comment on a select few of his other priorities. It comes as no surprise that energy policy reform is a primary focus. Obama recently spoke by videoconference to a climate conference in Los Angeles, where he said that his presidency *"will mark a new chapter in America's leadership on climate change that will strengthen our security and create millions of new jobs in the process."* He reiterated his campaign vow to reduce greenhouse gas emissions 80% by 2050. His energy platform promises to help create 5 million new jobs by investing \$150 billion in new clean energy technologies over the next ten years, and in that time save more oil than we currently import from the Middle East and Venezuela combined. Ambitiously, Obama stated that his plan would put 1 million American-built hybrid cars on the road by 2015. While oil prices are now down to almost a third of the \$147/barrel mark of earlier this year, we do not expect this to sideline the new President's goals. The urgency may not be as severe with gas near \$2 per gallon, but we believe that there has been some significant movement in Americans' attitudes toward a greener way of life. We will need to know more detail about planned investments in energy-saving technologies, but it appears that the next four years could prove beneficial for the global alternative energy sector.

With the backdrop of an aging baby boomer population, health care should benefit from an Obama presidency. We believe, however, that any sweeping health care reforms will take a temporary back seat to the financial crisis. It is likely that the administration will try to include some health care initiatives on the back of more-immediate financial legislation. The health care sector is a good candidate to emerge as the new market-leading sector when we finally gain some positive footing.

"The American, by nature, is optimistic."

- John F. Kennedy (1960 – 1963)

More generally, we believe that a changing of the guard will prove a positive tailwind for confidence. After a year of painful deleveraging and financial bailouts, the importance of improving psychological confidence should not be underestimated. Until the leadership transition actually takes place, however, we expect continued volatility and directional uncertainty in the markets.

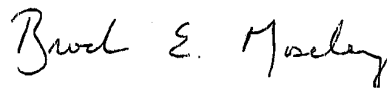
As the U.S. was the first to enter the financial crisis, we expect it to lead the rest of the world in a recovery. To date, the Fed has been more aggressive than the other central banks in easing monetary policy. Given the new Democratic administration and increased majority in Congress, we expect that a robust fiscal stimulus package will be passed in early 2009. With the likely increase in issuance of Treasury debt, and the already low level of interest rates, we believe that equities will prove a more profitable asset class than fixed income over the next several years. In the short run, however, we remain cautious on equities and continue to look for some positive developments, including:

renewed access to credit, narrowing of credit spreads, lower market volatility, some firming in consumer spending, and markets trading on earnings and growth fundamentals instead of fear.

November 19, 2008



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Chief Investment Officer

End Note:

In the 1800s, Samuel Augustus Maverick went to Texas and became known for not branding his cattle. He was more interested in keeping track of the land he owned than the livestock on it, according to one of his descendents. Unbranded cattle, then, were called "Maverick's." The name came to mean anyone who didn't bear another's brand. Source: *The New York Times*, "Who You Callin' a Maverick?," October 4, 2008.

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