Cottonfield – Market Update November 2008

It is all about the Transmission to Reflate

It has become more difficult for investors to recognize where the investment opportunities can be found in the future. Complexity, uncertainty, timing and volatility are the cause.

After Wave 1 - the bursting of the asset bubble more than one year ago - Wave 2 brought us the demise of the banking system and the near meltdown of the financial system. We have entered Wave 3, the worsening outlook for the real economies around the globe. The light at the end of the tunnel is not visible, yet.

We may very well see a Wave 4 which shall be triggered by the feedback of the economic slump back into the banking and again the financial system. Banks, having benefited from the lifesavers thrown at them by governments and central banks in Wave 2, may again have to reach for more support from equity investors of all sorts. Then only, the current uncertainties may begin to stabilize. But at that point, the impact of today's rescue actions by governments and central banks may come to the fore. Today, nobody knows what negative implications all these actions may present to us in 12 or more months from today.

To us the key question is if or how effective the bailout and support efforts are going to be transmitted into the real economies.

If the stimulus and rescue programs for banks, agencies, automobile manufacturers and for a daily growing number of other recipients, transmit into the economies in due time then the old tools of money supply and favorable lending conditions work one more time. We then see also inflation come back, possibly with a vengeance we would not like to experience. We then look at a repeat of the effects of central bank and government stimulus dating back to the early 2000.

At the other extreme, if banks and all other institutions benefiting today from the lifesavers are either not willing or able to pass the benefits of such lifesavers on to the real economies, then this deleveraging process may end up in a case of severe deflation.

We at Cottonfield cannot see the transmission mechanisms work this time around:

- Economies are not machines where a change in mechanics results in a predictable outcome.
- Economies include also psychology and moods scarred either by the past or influenced by the outlook. The scars are deep and the outlook uncertain.
- Consumers and the baby boomers got burnt: They lost money and wealth in real estate, in stock markets, in their pension plans and therefore possibly old age financing, and in other assets. Cheap credit may prove not enough restart to spending.
- The mood of the bankers must definitely have improved with all the support they got (at least the large banks). Banks as part of the oil in the economic machine, must, however, see that they survive and recover from their life threatening leverage implications. So, they will primarily pursue their survival, then to use funds and opportunities to expand their powers by buying some of the losers *(… the old song)* and only then may they think of expanding credit of all sort in size and at terms enticing borrowers.
- The mood of the politicians is to reflate by way of all kinds of bailout programs and stimulus packages. But what if stimulus packages are used to repay debt or to build up savings instead of being consumed in support of the real economies? Near-term, economies shall not benefit. Longer-term the basis for high(er) inflation is laid again.

Our assumption for now is that the transmission mechanisms for reflating are not in place.

So far few of the problems have been resolved but rather band-aids have prevented worse from happening. In the next few months, the deleveraging process shall continue. As part of this process we may not experiencing the wished for kick-start of economies but rather the onset of fundamental changes to economies, societies and political landscapes.

We expect a material global economic slowdown lasting well into 2009 if not longer due to:

- the continuing demise of the asset bubble (real estate, credit card, LBO loans, etc)
- increasing unemployment and possibly a contraction of income (wages, investment, etc.)
- the reduction of debt combined with a simultaneous increase of savings rates
- banks not passing on their newly “gained” liquidity by way of credits to the economies
- substantially more personal, corporate and governmental defaults
- significant tax hikes to finance the additional debt governments are taking on
- cuts in governmental social and welfare programs
- the full negative impact of this crisis on pension plans, life insurances, insurance companies and the investment success of social security institutions
- A new wave of energy and food price increases exacerbating today’s woes for society

The changes to **culture and societies** may include

- greed and the notion of limitless growth giving way to more modesty and a sense for collective responsibility (within communities and nations ?)
- consumers not being able to rely on old age income, taking on more personal responsibility
- the widening of the gap between rich and poor. Now, the rich are losing asset values, the poor and pensioners their shirts.
- a revolt of the poor and unemployed?

What do we expect for the **political landscape?**

- A much increased role of governments in many aspects of our lives
- hopefully, the emergence of true and less selfish leaders of a younger generation
- the creation of new and the strengthening of supranational bodies regulating financial affairs
- simultaneously a mental and practical contraction back to national borders and interests
- including an acceleration of efforts to control national assets such as natural resources
- immense economic pressures within the EU endangering the survival of the current form and structure (?)

The current discussion deflation versus inflation looks not like a matter of either or but rather a matter of sequence. Overall and of course differing in extent from country to county, we expect (deep) recessions and a deflationary (prices shrink) environment for the next 6+ months. Today’s rescue efforts, a resurfacing energy and food demand–supply dilemma and possibly other factors shall then lead us to stagflationary (poor economy, rising prices) economies before ending in an outright price inflation environment.

Future investment decisions must focus on timing and the selection of opportunities as appropriate for the outlined stages of economic development.

Cottonfield as an asset manager for Swiss domestic and international clients evaluates opportunities today for tomorrow.

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