

## MORAL HAZARD BE DAMNED, PART II

January 25, 2008

As the weakness of our global financial structure becomes more apparent, so do the predictable signs of panic-induced remedies being offered up by every member of our political elite. From the President to the Leader of the House, the Senate, and the Federal Reserve comes one common frightening message: “Hi, we’re from the government and we’re here to help you.”

We have addressed the effects of financial deleveraging in many previous commentaries. More specifically, we concluded in August, and again in September that the Federal Reserve would “resort to any method to stop a financial market correction.” Accordingly, Mr. Bernanke’s 75 basis point interest rate cut is consistent with that conclusion. Unfortunately, there are probably not many tricks left in his bag.

Our illustrious leaders, fearful of being accused of doing nothing in an election year, have taken a tactic from “Helicopter Ben’s” (Bernanke) writings, and are giving checks to “deserving” Americans to jump start the economy. (In previous writings, Fed. Chairman Ben Bernanke advocated dropping money out of a helicopter as a last resort to stem a panic, hence the nickname “Helicopter Ben”.)

We feel these steps will immediately help to support markets and stem the bearish sentiment. They do not, however, address the deficiencies in our financial structure. Our banks and insurers are suffering through a capital adequacy problem and as such, any meaningful solution must include capital investment incentives, such as the removal of the double tax on dividends, the tax on capital gains, and lowering the corporate tax rate to levels used by our competitors such as Canada, Russia and Germany. A realistic look at our politics, however, tells us that such a meaningful solution is out of the question; so, our course of action will be to remain in a defensive posture and wait to see whether these recent attempts to support markets and instill confidence actually work. There is an outside chance that lower interest rates will allow for the refinancing of much of this debt, thus avoiding the many delinquencies and foreclosures that may be in the making. Only time will tell.

We expect near-term market strength as bargain hunting and short covering move those sectors that fell the most in the recent 2000-point decline. Strength in financials and cyclicals is expected, but we will probably watch from the sidelines, looking for longer term trends to become more evident. We are especially interested in the direction of the dollar and dollar denominated commodities. And as always, we will be watching the primaries and the polls in order to get more insight into future tax and regulation policies. We promise to keep you informed.

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