

## TREASURY JUNK

December 30, 2009

Throughout our 30-year history, Cadinha & Co. has always made U.S. Treasury obligations our bond of choice when making fixed income investments on behalf of our clients. Admittedly, we have liked the liquidity enjoyed by Treasury securities but we were attracted by the fact that Treasury obligations carry no credit risk. The Treasury's ability to pay interest and principal was never in question. The current high level of Treasury borrowing coupled with the current and future passage of large scale entitlement programs has concerned us, but not to the extent that we doubted the ability of our government to make good on its obligations. Recently, however, the Treasury has aggressively been taking over many other "too big to fail" obligations such as Fannie Mae and Freddie Mac bonds. The FDIC, General Motors, AIG and others appear to be inline for bailouts as well.

The new healthcare legislation appears to also extend our federal credit rating to states through added Medicaid supplements. The future obligations of Social Security and healthcare in general will also become Treasury obligations under this new thinking. Our Treasury is, in effect, borrowing more money than the current deficit requires while receiving no new cash to spend. The money has been spent, but we're now adding these spent dollars to our structural deficit, requiring future taxpayer paybacks.

About a month ago, we decided that the fall in the dollar had just about run its course. The market had become one-sided and the *carry trade* (borrowing cheap dollars to invest overseas) seemed a bit "frothy". In response to this perspective, we cut back on several foreign holdings and began to add Treasury bonds. After all, weren't Treasury bonds always the same, or as good as the currency? If the dollar strengthened we could comfortably expect some money to find its way into U.S. Treasury obligations, rendering us a profit in addition to the interest return. In the event of a destabilizing global event, there has always been an immediate "flight to quality" benefiting our Treasury Markets.

We were right on our call for a strong dollar (which has increased in value by 5% over the last month). Treasury bonds, however, have declined in value over the same time, presenting us with a new risk paradigm. Recently, global economic and financial news unveiled "sovereign risk" as a new concern. The default by Dubai and the credit downgrades in Greece and Spain, coupled with increasing concern about the United Kingdom's debt has aptly punctuated this issue, but there was no "flight to quality".

The fact that investors have clearly differentiated between the dollar as a currency and Treasury obligations as a form of credit tells us that we are entering a new world of risk with regard to bond investments. It is possible that bonds fell because the well publicized bond-buying appetites of our foreign trading partners (like China) have sharply abated. Many interpret this as a loss of confidence in our ability to repay this debt, but they overlook the fact that our trade deficit has recently declined, leaving countries like China with fewer dollars to buy our Treasuries. Nevertheless, the market response tells us that sovereign credit risk is now being priced into our Treasuries. Accordingly, you can expect us to head for the exits in order to moderate this sudden increase in risk. Overall, our debt clouds continue to gather. Consider these factors: in addition to financing a projected deficit of \$1½-2 trillion next year, Uncle Sam must "roll over" \$2.5 trillion of maturing debt over the next two years. Banks worldwide have

some \$7 trillion due in the same time frame. Commercial Real Estate will need \$750 billion, and many municipalities like California and New York are approaching default within the next few months, not to mention home-owners with refinancing needs, and lenders like Fannie & Freddie putting failed mortgages back to lenders. With so much pent-up demand for money, we can expect the price of money to increase. Saying it another way--interest rates are likely to go up, pushing bond prices down.

There is one possible fix for this dilemma and that is for the Federal Reserve to print money and purchase much of this looming debt. If Mr. Bernanke answers this call, then we will likely precipitate another dollar crisis featuring a falling dollar and a lower living standard for Americans. Should this happen, the price of Treasuries may increase for a short period of time. Nevertheless, we just don't feel comfortable betting on either outcome with your assets. At best, the odds are 50/50...not a high enough probability of success.

While the credit outlook appears bleak, the outlook for corporate earnings seems quite bright over the next quarter or two. The stimulus packages, TARP, extension of unemployment benefits, cash for clunkers, and cash for caulkers all stack up as increased business for most corporations. Corporations, for the most part, have "shed" expenses so any sales increase will translate to higher profits and productivity. We are considering many investments in the equities arena, but are searching in particular for companies that are self-financing and not reliant on government spending for growth. Obviously, the new credit risk, if left unchecked, will affect the market in general, so careful selection will be an important key for the coming year.

Investors have now experienced ten years of negative stock market returns in the U.S., with the NASDAQ being the worst performer of all indexes. At Cadinha & Co., our returns over the same time frame have been positive, leaving clients in comparatively good shape and able to capitalize on any future opportunity. We have achieved this record by carefully avoiding excessive risk which brings with it the potential for large losses. We are embarking on this new year with a fair amount of optimism while maintaining our defensive mindset.

We continue to believe that we are in a lengthy deleveraging process with each asset class taking its turn at the "fire sale" auction. Accordingly, there is no single idea or allocation that will sail through this process unscathed. Patience may be the most desirable trait for one to have during this difficult period. It will take that and more to stay ahead of this game.

Wishing you a healthy, happy and prosperous New Year.

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