

The IMF Report Shows More Pain Ahead

April 25, 2009

Dear Client,

The IMF released its Global Financial Stability Report this week. And it's projecting total losses from the global financial crisis to reach \$4.1 TRILLION. That's *four* times the amount projected in last year's report.

Meanwhile, the only indicator improving across the globe seems to be tied to confidence. Stock values have climbed, and with it, so has confidence. Misguided confidence. Clearly, my job has gotten harder as I have had to explain to clients that RISK is more prevalent now than it has been. Because the hard data, the real underpinnings of global economies, are going the opposite direction. And the IMF agrees:

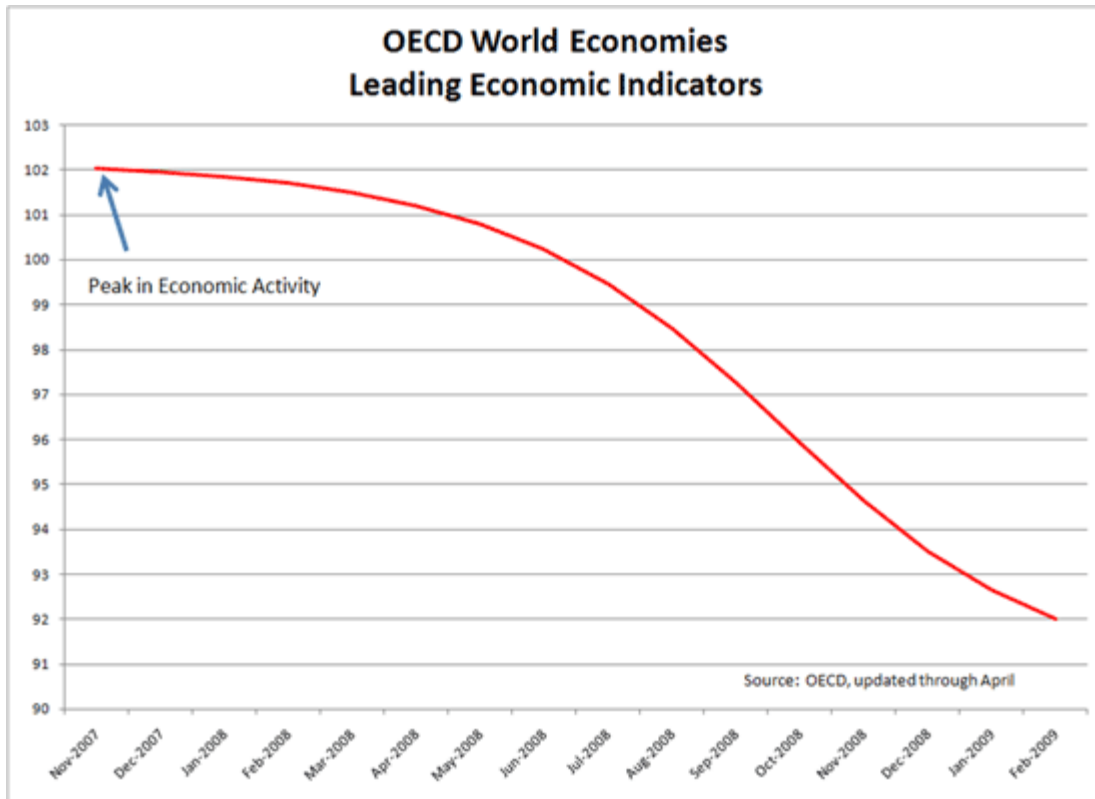
"The global financial system remains under severe stress as the crisis broadens to include households, corporations, and the banking sectors in both advanced and emerging market countries. Shrinking economic activity has put further pressure on banks' balance sheets as asset values continue to degrade, threatening their capital adequacy and further discouraging fresh lending. Thus, credit growth is slowing, and even turning negative, adding even more downward pressure on economic activity."—IMF, April 2009

Major Structural Problems Still Exist ...

Consumer, investor and business confidence certainly have a powerful role in an economic recovery. ***But confidence alone can't overpower the major structural problems still overhanging the global economy.*** The longer the structural problems exist, the faster confidence retreats. And the sharper the unsubstantiated rally in investor confidence, the sharper the next leg down in global asset values will be.

The Organization for Economic Cooperation and Development's (OECD) latest report on world leading economic indicators shows that the growth cycle experienced another consecutive downtick. That's the ***twenty-first consecutive month*** that leading economic indicators for world economies have declined since peaking in November of 2007.

And the OECD's indicators continue to see world economies in a strong downtrend as shown in the chart below.



Both the IMF and the OECD expect economic growth for 2009 to be deeply negative, and the 2010 forecast is for roughly flat growth. That might be the least rosy projection for 2010. But based on the expert community's track record during this crisis, I'd prefer to be on the other side of the bet that 2010 will bring recovery.

Remember ... the official record on identifying the magnitude of problems, the reach of those problems and projecting recovery has been littered with underestimations, miss-steps, flawed theories, and empty optimism.

And now, the IMF is taking a hard line on the severity of the damage — the most aggressive public projection. Four times more aggressive to be exact.

If the IMF is right, we are nowhere near the bottom of this economic downturn. And there will be significantly more pain to be felt in the financial sector.

With that, there's one region in the world that looks particularly vulnerable to negative surprises as the financial-led economic crisis extends and deepens ...

Europe Is Up to Its Eyeballs in Problems

Of the \$4.1 trillion in potential global write-downs, Europe (excluding the UK) is expected to suffer the largest share. The IMF projects Europe to get whacked with \$1.1 trillion (or 39 percent of the total) of new losses. The U.S. is thought to be on the hook for another \$1.05 trillion (37 percent).

Western European banks have dangerously high credit exposure to their neighboring emerging market economies.

Then there was more bad news out of Europe this week: Deflation.

And it's widespread ...

- Ø Spain, the fifth largest economy in the European Union, reported a fall in consumer prices for the first time in 50 years.
- Ø The UK reported the first annual fall in retail prices since 1960.
- Ø Ireland experienced its first drop in consumer prices since joining the Euro in 1999.
- Ø Germany's wholesale prices dropped the most in 22 years.
- Ø And Switzerland is so concerned about deflation that its central bank has intervened in the currency markets to weaken its own currency and has begun buying up its own debt to increase the supply of Swiss francs.

So inverse currency ETFs are worth watching.

But deflation is not a problem confined to Europe. Deflation is a global problem ...

Broad commodity prices are down 54 percent since July of last year. U.S. consumer prices declined year over year for the first time since 1955. The Baltic Dry Index (the cost of shipping raw materials around the world) has lost a colossal 84 percent of its value in less than a year. And producer prices, wholesale prices ... all have trended lower and have now hit sub-zero levels in most major countries.

Fortune Magazine's fortune 500 companies report came out last week. It reported that corporate profits in 2007 were 645 billion and in its latest report for 2008, profits were a mere 99 billion. That is an 85% drop in profits in one year for our fortune 500 companies.

Fortunately for the U.S ...

Fed Chairman Ben Bernanke is well studied on historical episodes of deflation and has taken out the entire toolbox to fight off a destructive downward spiral in prices. In fact, he wrote a speech on it. And it was before he ever walked the halls as the Fed Chairman.

In 2002, then Fed Governor Bernanke addressed the National Economists Club with his speech, *Deflation: Making Sure "It" Doesn't Happen Here*. And his 2002 speech reads like the Fed's playbook for the current recession.

Back then, Bernanke pointed to the dangers of deflation taking a foothold on an economy. He spoke about the destructive effects deflation has on outstanding debt.

We can see this by looking at the Great Depression when the United States experienced three consecutive years of falling prices to the tune of roughly 10 percent a year. Consider what that means for someone who borrows money at 5 percent interest. It's like they actually took out a loan at 15 percent interest!

This ever-increasing real value of debt makes debt prohibitively unaffordable and puts the brakes on any new demand for debt. This creates a vicious cycle that further weakens consumption and feeds into a spiral of more deflation and more contraction in the economy.

But not to worry, Bernanke has his playbook. And in the playbook you'll find what play to run when the Fed has *already* cut short term rates down to zero — the traditional policy action to fight deflation.

In contrast to the times of the Great Depression, the dollar is no longer on the gold standard. So today, the dollar is just a piece of paper. And that means the government can print more and more and more money until the value of goods and services begins to climb against the value of a dollar.

A key point in Bernanke's paper: "Under a paper money system, a determined government can always generate higher spending and hence positive inflation."

This just out from the Associated Press

So that explains this article by the Associated Press... The Federal Reserve says the government is prepared to rescue any of the banks that underwent "stress tests" and were deemed vulnerable if the recession worsened sharply.

The Fed says the 19 companies that hold one-half of the loans in the U.S. banking system won't be allowed to fail – even if they fared poorly on the stress tests.

The tests are intended to measure whether banks have enough capital to withstand losses on mortgages and other assets if unemployment rises and home prices fall further. By Associated Press April 24, 2009.

What Are the Competitors Doing?

Today I would like to dissect a little information that came out of Caterpillar this week.

Caterpillar is frequently used as a barometer for the global economy. Not only do they make the earth movers that we use to make our roads and bridges, but they also make the engines that power big ocean freighters. They make those jumbo giant trucks that companies use to move iron ore, copper and other minerals; so it is a pretty good indicator for how the global economy is doing. Now if that is true, we really should want to pay attention to them and that is why what they had to say caught my eye.

First of all the headline news last week said that Caterpillar reported its first quarterly loss in 17 years; on the surface, that sounds pretty bad and it is because Caterpillar lost 122 million dollars or 19 cents per share. So again on the surface, not so good. The reason for the big plunge in profits is their 22% decline in sales, especially in Europe which were down by 40% and North America which were down 36%.

But the thing that really caught my eye, was that Caterpillar said that they are going to suspend activities that uses up their cash. In other words, no more stock buy backs! No more increases in their dividends! And, they said that they were cutting their expenditure budget to conserve cash as well! This is not the sign of a company that has a very optimistic outlook. Especially, after they said earlier this year that they were laying off 22,000 of their workers. So I think there is little doubt that Caterpillar is having problems.

At the same time though, if you looked a little deeper in their press release, you would have found some optimistic things about China.

Caterpillar said that some of their Chinese suppliers, who had been working 3 days a week in 2008, are now working 5 days a week, and that some are even working over-time.

This should tell us a lot.

And what it is telling me is that since China has had its own problems with their economy, they would not immediately be ramping up production unless they were very confident about their out-put.

If anyone should know this, it should be Caterpillar. Why? Because out of their 5.2 billion in sales last quarter, 2 billion came from Asia.

The reason for the growth is pretty simple.

I have talked about the 586 billion stimulus plan of China's in my earlier emails. Unlike ours, which is going into buying toxic assets of banks, thrifts and insurance companies, China is spending its 586 billion dollars on roads, highways, airports, bridges, shipping ports; things that will produce productive infrastructure as well as good jobs.

So, we want to take this positive news about Caterpillar and China's business and see how we can make some money on it. To me, the most logical thing is to take a look at *Komatsu* (KMTUY) the Japanese Caterpillar of Asia. Being there close creates cheaper shipping cost and they have a greater foothold in China as well. The Chinese have just typically done business with Komatsu Equipment more than with Caterpillar. So, if Caterpillar is doing well in Asia, then I would suspect that Komatsu is doing just great!

We will continue to watch and listen to what the American Companies are saying but I think that we should also be looking for those little nuggets of information, like the bright out-look in China from Caterpillar and see how we can apply that toward making money in some of the best Asian companies there are.

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Sources: MSN Money, Market Watch, Money & Markets, Uncommon Wisdom

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What I am showing with these two charts is the difference in the number of times each company has tested the bottom. Komatsu has tested 5 times and held. It is now on a less volatile path to its 200 day moving average. Caterpillar, has tested its most recent bottom just one time. So the odds of Cat going back down and testing its low at the \$23 dollar level is very likely and that means more risk and more volatility.

