

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

February 13, 2009

*This is the ELF Capital Management, LLC Market Letter for the month ended January 2009. If you do not wish to be included in our circulation, please reply indicating your desire to be removed and we will be happy to oblige. Alternatively, any of your friends or colleagues may receive this on a regular basis by entering their email address on our list-server via this [link](#). Feel free to forward this to any of your friends! Thanks for your interest and we hope you enjoy the letter.*

## **Will Obama's \$800 Billion Plan Stimulate US?**

There has been much media coverage about President Obama's push to get an \$800 billion stimulus plan passed through the Congress. If he can pull it off, what might this mean for the economy? And what might it mean for the markets? How can we tell if such a plan will be effective in turning around this economy?

I don't know about you, but I have mixed feelings about whether the stimulus plan working its way through Congress will offer any near term benefits. At the same time, what will be its cost in the future? The whole thing reminds me about Shakespeare's Merchant of Venice. Classified as a comedy, this play is about a romantic fellow, Bassanio, who borrows money so that he can win the hand of a wealthy heiress – Portia. However, the play also has a dark side to it. One of the most notable and recognized characters in this story is Shylock, a money lender who seeks to extract a pound of flesh in return for making the loan. While the outcome of the play can be thought to have ended on a positive note, Shylock paid a big price for his misguided intentions.

With the stimulus plan, however, misguided intentions may not help save the economy and we may wind up paying a big price for its efforts. If you have a good handle on the current direction of the US Government's policy efforts, then you are one smart cookie! I say this because you have to be able to pull together many small puzzle pieces and read between the lines to understand what is going on. With dialogue in the media appealing to emotions and serving special interests, it can seem very challenging to understand how it will all turn out. Unless, of course, you understand how the pieces fit together.

I could go into a long and drawn out story to discuss how we got into this financial crisis, but that would only divert attention from this important topic. Despite the cause, we all recognize that we are in a downturn and jobs are rapidly disappearing. Here are some economic formulas that have been useful in helping me piece this "puzzle" together:

$$\mathbf{GDP = AD; GDP = M \times V; \text{ and } GDP = C + I + G + (X - M)}$$

Now, I apologize for giving you a bunch of economic formulas that seem hard to relate to. However, these formulas provide a foundation for understanding the issues; and, what might be important to see in an economic stimulus plan and what might not.

To begin, let's tackle GDP. To keep it simple, think of GDP (Gross Domestic Product) as a measure of the amount of business activity that takes place within a country each year. Last year, the US generated approximately \$14 trillion in business activity. Next, what does **GDP = AD** mean? AD, in this equation, is Aggregate Demand. Think of AD as a measure of those people who spent the \$14 trillion last year to purchase goods and

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

February 13, 2009

services. Now, consider that the economy is suffering because the average person is afraid or uncertain about their ability to spend. AD is shrinking.

Next, we'll look at **GDP = M x V**. This formula introduces the relationship of money, banking and lending to business activity. In this equation, M represents the supply of money in circulation and in demand deposits. While, V (velocity) represents how many times the money supply changes hands. Actually, this concept of velocity is often taken for granted; except when faced with an economic downturn like we are in now. In the current economy, V is shrinking. If you've followed this so far, you might begin to think that one answer to our problems is to simply increase the money supply? Here's the rub. Increasing the money supply is not so simple.

There are only three ways that I can think of to increase the money supply in the US: we can earn it, print it or borrow it.

If we undertake to increase the US money supply by "earning it", we will have to begin exporting more US goods and services to non-US customers. At the same time, we need to curb our appetite for foreign goods and services. As we have been the largest consumers to the world, this would be the hardest of our alternatives. We buy non-US goods and services because we either don't produce enough of our own (oil) or we can't offer the most attractive price. And, protectionism ("Buy American") will only serve to make our purchases more expensive. Can you think of having to pay higher prices right now? No! The safer approach is to become more competitive through creating new technologies or innovations that people in other nations want. We might also consider investing in the development of our own natural resources while we work towards reducing our dependency on foreign oil. This will take some time.

When I mention "Printing money", I am talking about the US Government actually creating new dollars and putting them into circulation – literally, just rolling them off the printing press. One could argue that the Federal Reserve Bank is doing this right now – the media is referring to it as quantitative easing. World history tends to show that this process has led countries into hyper-inflation. Perhaps, because central bankers may have been lax to sufficiently reduce the money supply when velocity began to pick up. Also, printing money cedes more control to a government and takes away from a free market system. There is also the concern that printing currency will devalue (lower) the value of the US Dollar against other currencies and raise the prices we pay for non-US goods and services.

As for "borrowing", right now economic pressures are forcing our banking system to deleverage (reduce) loan balances – mostly those originated in 2007 and before. The lack of investor interest in securitized debt has left banks holding more loans than they can safely manage. Ordinarily, the banking system serves to expand the money supply through lending. However, now the banks need to de-lever in order to survive and de-levering contracts the supply. And, the problem gets worse when borrowers default on these loans. While this is going on, the US Government is pushing the banking community to de-lever slower to reduce the resulting contraction in the money supply.

Again, I apologize for just touching the surface on these "money supply" dynamics. One could write a book on each of these subjects to explore the nuances of each. And, at present, the challenges are many. I'm of the belief that it may be more productive for the

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

February 13, 2009

Government to place greater emphasis on the Velocity side of the equation. This type of effort might be more efficient and effective in reviving this economy. That's not to say that the Money supply should be ignored; it shouldn't. However, efforts to reverse the course of Velocity could very well improve our Money Supply challenges as well. Nevertheless, improving Velocity is a behavioral effort that requires changing the sentiment of the public from fear to optimism. How has the Government and the media been doing so far to improve sentiment? Which leads me to the next equation...

While it looks significantly more involved, **GDP = C + I + G + (X - M)** relates who is doing the spending. The equation considers Consumer, Government and business Investment spending. It also considers the impact of foreign trade (both goods and services that are eXported and iMported). When I look over the 2008 GDP numbers, it shows Consumer activity representing approximately 70% and Government spending was approximately 20%. Presently, all but Government spending is shrinking. Maybe, it has to do with the ease with which the Government can still borrow money.

If the proposed stimulus plan can trigger job creation, then the package stands a good chance "jump-starting" Velocity. I agree with President Obama's assessment that creating jobs should be a primary focus of the plan. However, I'm not as confident that Congress will wind up settling on a plan that will target allocating resources to those areas offering the greatest impact. Of course, provisions that serve to prevent an acceleration of the money supply contraction may also be needed. Yet, so called "transfer payments" would have little to no impact at all. The stimulus payment that many taxpayers got last summer has been referred to as a "transfer payment". It is believed that much of that payment went to reducing debt, rather than for spending. So, if you've followed the discussion above, the payment received last summer had little to no effect on GDP, AD or V.

At the time of this writing, details of the stimulus package remain vague. So, if you were looking for some market forecasting about the unpredictable, sorry to disappoint you. However, I did give you a framework for understanding the challenges involved and for developing your own opinion. The best outcome is one which gets the consumer spending again. And, speaking of spending...

Do you often make purchases for your home or business via the internet? If so, I want to share with you what I believe will become one of the fastest growing social shopping networks on the web today. It's called Aisle 19. Aisle 19 is a web portal that lets you shop from over 600 stores (many of which you probably already shop from); earns you cash rebates from your purchases; and alerts you to any discount offers from that vendor as well. There are no fees to join. But you have to be invited by a member – which is what I am doing now. To join Aisle 19, just click on this [LINK](#). If the link doesn't work for you, just go to my web site home page at [www.hwkfs.com](http://www.hwkfs.com), and sign up from there.

### **Current Outlook and Thoughts**

As we continue to muddle through this first quarter of 2009, my current thinking and strategy remains substantially consistent with [my 2009 predictions letter](#). Thus far, we were looking for the 4<sup>th</sup> quarter 2008 GDP to come in at -3.0 to -3.5% and we were looking for unemployment to begin accelerating in the 1<sup>st</sup> quarter of 2009. The advance GDP figures, released on January 30<sup>th</sup>, reported that GDP declined by 3.8% and unemployment

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

February 13, 2009

has accelerated. If history repeats, the rapid acceleration usually signals that unemployment should peak in the next month or two. From hereto forward, we'll have to wait and see how the US Government intervention impacts the rest of my predictions.

This month's letter is coming out later than usual and we're still waiting to see if more hedge fund redemptions hit the market like we saw in November. As most hedge funds redeem client funds at the end of every calendar quarter, upon 45 days prior notice, I expect that we could see selling come into the markets over the last two weeks of February. While we believe that most of the heavy selling already occurred last November, Bernie Madoff and others like him might cause another round of redemptions.

If you haven't heard about Madoff, he was the fellow who had a very secretive money management strategy that led his clients to believe he was earning them significant above average returns. At the end of the day, it was all a scam and his clients were bilked out of billions of dollars. He's going into the record books as perpetrating the largest Ponzi Scheme in history. Unlike Madoff's, our process of managing individual client accounts at an independent custodian broker, offers one of the most transparent and cost effective money management relationships available. And the broker, TD Ameritrade Institutional, is a large and profitable technology-based securities firm that offers clients' internet access to their account information. With us, there is no Ponzi Scheme – what you see is what you get; and, what you get, is the ability to see all of your holdings anytime.

Our client portfolios are positioned cautiously and if we see another round of hedge fund redemptions, we'll be ready to take advantage of any opportunities created. During January, we allocated approximately 35% of client assets into a handful of diversified bond funds that offer attractive yield and appreciation opportunities. And, have been maintaining cash balances between 20% to 50% through buying US equity ETF's on the dips and selling into rallies.

If the information in our articles is helpful for you and you're not a client, please look over our web site [www.hwkfs.com](http://www.hwkfs.com) to see if we can be of service.