View from the Mast

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Mixed Messages & Fear of Poole

As markets seized up over the past six weeks and fear of an apocalypse rode the waves, I have to admit that I rather enjoyed the spectacle. I don't want to overstate the case, but there were actual moments when financial players as diverse as hedge fund quants, private equity honchos, and other similar vermin showed behavior verging on actual humility. It helped, of course, that from my perspective, there was no real risk of a doomsday outcome. So it was a little like watching a horror film — scary, but ultimately you can reassure yourself that despite the bloodshed you're doing nothing more dangerous than sitting in a movie seat.

I didn't begin to feel ethically concerned, however, until I began to closely watch William Poole, the Federal Reserve Governor based out of St. Louis. He too was obviously enjoying events, crowing that the people losing money were people that deserved to and that only a "calamity" in markets would justify the Fed cutting interest rates. He usually managed the patented Dick Cheney "Lord of Darkness" anti-smile while speaking. I began to get nasty images of him sitting home at night in a dark study, drinking a scotch and listening to tapes of hedge fund managers and bank risk officers screaming in terror. It was creepy, and I hereby renounce any initial pleasure I took in events.

Uhhh, or at least 50% of the pleasure, no, 30% . . .

A Passing Event Meets a Real Long-Term Issue

Financial storms always appear somewhat bizarre in retrospect if they pass by without inflicting serious damage, and the "subprime" crisis is no exception. No one can look at the historical figures for the category and be surprised by the blowup. The fact that almost 14% of such loans are delinquent sounds horrifying, except for the fact that in the previous peak of defaults (2002-3) the delinquency rate reached 15% according to the Mortgage Bankers Association.

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Rating agencies such as Moodys and Standard & Poors can watch the originators of Asset-Backed Commercial Paper and CDOs (collateralized debt obligations) mix in some auto loans, credit card debt, and lottery tickets and claim the composite bucket of phlegm is more creditworthy than 95% of the composite parts. But it's hard to claim that the delinquency rate can't rise to 14% when five years ago it topped 15%.

And, clearly, some bad assumptions went into credit ratings on Asset-Backed Commercial Paper. I recently looked at a five-month-old prospectus for a CDO, something which I had never read before. After four hours, I was

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1/13th of the way through it, and estimated that due diligence on the entire piece, assuming no more than a three page summary for each component part of the investment, would take me *seven months*. Something tells me that S&P didn't assign someone to that kind of detailed work, the CDO is full of the commercial equivalent of dung and the rating (AA) is meaningless.

Why did people buy this paper? After all, house price increases in the United States showed a sharp drop off by 2Q, and equity withdrawal (which was important for the volume of quality credit card, auto loan, and similar debt) plummeted a year ago to under 1.5% of total consumption. For hedge funds focused on credit markets, the answer is fairly simple. You are being hired to provide an above-market return with as close to zero volatility as possible. As bankers discovered centuries ago, you can do this by mismatching the duration of your assets and liabilities. You borrow cheaply short-term and invest the money in higher return long-term assets. If the spread between, for example, 60-day commercial paper and paper based on 30-year mortgages shrinks you simply offset that by leveraging up 10 or 15 times. Unfortunately, bankers discovered this trick right before they discovered "unforeseen events" which led to the discovery of "bank runs" and being chased through the streets with sharp sticks. (A practice we might consider bringing back).

For foreign investors (who by most estimates absorbed well over 50% of the real dreck from 2005-2007) the calculation was somewhat different. They clearly didn't understand that the Greenspan-Goldman notion that dividing up debt into ever tinier and more complicated pieces to "spread the risk" actually meant that it was again time to croak foreigners, who had more money to invest than places locally to absorb it. Since the first spade of dirt was turned at the Erie Canal in 1817, to the Japanese being sold a 40-story building in Los Angeles in the 1990s that was constructed almost entirely out of asbestos, this has been a recurring theme in American finance.

It's not terribly surprising that the first financial institutions to go to the wall in this credit correction were leveraged hedge funds (Bear Stearns) and German state banks (IKB, Sachsen). Germany, per capita, has almost four times as many financial institutions as any other developed country, and well over half of these have no idea what to do with their capital. I met the management of IKB seven months ago, and what surprises me about their plunging into leveraged finance in America is that they simply seemed too dumb to take such a risk. I honestly left the bank thinking that on my last backpacking trip I had sat on smarter stumps. But if you can't make money in your core business, then I guess you can be sold damn near anything.

Reasons to Be Cheerful (Sorry)

But as much as events have perked up what is normally a slow summer, it's still worth searching for context. Let's start with beginning points and probable outcomes. First, U.S. household assets at June-end stood at just over $60 Trillion. $27.5 Trillion of that was in totally liquid holdings (cash, money market funds, mutual funds, etc.). Total household debt was $13 Trillion — 21.6% of assets. The rise in liquid net worth year over year was $700 Billion — a serious level of savings, and a better measure than the increasingly bizarre "savings rate" calculated by the government.

Corporations world-wide are similarly flush. Crunching together reports from the Fed, the European Central Bank, the Bank of Japan, and the Bureau of Economic Analysis, it appears that the interest cover ratio (pre-tax earnings to debt service costs) are at an all time high of close to six times. In the U.S., free cash flow at corporations after all expenses and capital spending is almost 3% of G.N.P. We lack timely figures for Europe and Japan, but my sense from discussions with managements suggests that similar figures apply.

There seems to be a background situation whereby a total freeze in access to credit would not exactly destroy the real economy. The economy could coast for at least a short while using purely liquid reserves as long as the most basic paper (trade finance, letters of credit, etc.) could be issued. The financial industry would be incinerated, and a huge amount of unnecessary pain would be inflicted, so steps to avoid such an eventuality make sense, but it is hardly a nuclear emergency. Balance sheets suggest that clearing prices could be established in time and the system would right itself fairly easily without huge central bank or government interventions.

Which Brings Us Back to the Real Problem We Can't Solve

> "Over the past decade a combination of diverse forces has created a significant increase in the global supply of saving — a global saving glut — which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today."
>
> Ben Bernanke, March 10, 2005

The aggravating part of the above quote is that Fed Chairman Bernanke clearly saw the making of a crisis over two years ago and did little to avert it. But let's take a brief look at the "combination of diverse forces."

One of the causes of the current situation is a hangover of the Asia Crisis of 1997, in which countries with low foreign reserves and companies with dollar-denominated debt were completely trashed by the financial and currency markets, and much of Asia suffered devaluations and a savage recession. This led (in societies that are instinctively mercantilist to begin with) to a determination to stockpile foreign reserves and maintain financial surpluses at the national level.

China, which was not particularly affected by the 1997 crisis, also increased the savings glut by maintaining a relatively low level of consumption to GNP. To its credit the central government has tried to reverse this and promote consumption, but has been stymied by the perceived need of Chinese to stockpile cash to meet the cost of corruption and bribes in everything from health care to the education system. The result? Over a Trillion in reserves. The Japanese have close to one year's GNP in cash and sight deposits. And the price of oil at $75 is sending cascades of cash into countries that must invest it abroad due to limited abilities to absorb the cash locally.

So Bernanke's "savings glut" is real and growing. What was the U.S. response? To become the crazed consumer of last resort. When the glut began in earnest, the response by the U.S., aggravated by the tech-bust and the tragedy of 9/11, was to become a huge dis-saver. The swing from a Federal surplus to deficit between the first quarter of 2000 and the third quarter of 2003 was *over 7% of GNP* — an incredible figure.

Why was this necessary? It's really fairly simple. If the U.S., because of excessive consumption, is going to run a large trade deficit, it's current account deficit, if largely funded by foreigners (which it is) must mean that some groups in the U.S. must be serious users of cash. The U.S. government, whatever one thinks of the fairness of the distribution of the Bush tax cuts, was probably correct in the aftermath of both a terrorist attack and a bear market to go heavily into deficit in order to avoid a serious recession.

This, however, presented the Fed with a humongous problem which it completely fumbled. The logical response to meeting a vast negative change in government accounts is to raise interest rates as soon as possible, not to keep them at record lows for extended periods. This would have eventually constrained consumption, lowered the current account deficit, and not led to a housing and asset credit bubble of enormous magnitude. If the U.S. was to avoid an increase in interest rates it had to continue to create dis-saving in the U.S. Since the Federal deficit was already straining credibility, the maintenance of illogically low interest rates and the subsequent credit

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and housing asset bubbles were completely predictable consequences of Greenspan's and Bernanke's idiotic obsessional fear of deflation.

They aren't fatal by any means, and I'm still dubious that tighter credit restrictions resulting from the scare are necessarily a bad thing, but a series of cuts in interest rates and constant tinkering in the funding system is a potential walk in the direction of chaos. Lower rates won't revive a low-quality mortgage market facing the prospect of price declines. It won't revive home equity loans. It won't allow people who never should of owned houses or committed fraud in applications (an estimated 30% of 2006 subprime borrowers) to refinance. It will just provide succor to a financial industry that is overactive and overlarge, and which needs to shrink along with the asset bubble that created and sustained it.

A Brief Return to the Savings Glut

If the current problem is not a potential market and economy killer, there does remain one problem that Bernanke has identified but not addressed — the savings glut. There is almost no market participant that I'm aware of that doesn't recognize that the backdrop of the current situation is the "savings glut," "the money supply tsunami" or the "wall of money." We are in the peculiar situation in which profits are high in the developed world, China is booming like nobody's business, commodity producers are coining it from sharply rising prices of everything from oil to wheat, and inflation is not in sight. How could this all be possible simultaneously?

Greenspan referred to it as a "conundrum" but then he never had much of a grasp of human nature — and that's simply what is involved. In a period where global growth has just had its greatest five-year period in history, it's not surprising that earnings from most types of productive assets have soared creating a vast wave of money that needs to be reinvested. Since potential pools, such as corporations and households, are also flush with liquidity, the logical result is that *return on investments must plummet.* It's basic supply and demand. In a world where investors feel that a 6-8% nominal return on investment is a sort of sacred minimum, it's not surprising they have given a Trillion dollars to hedge funds, nor is it surprising that many such funds have bought increasingly dodgy paper and then leveraged the entire wodge to get higher returns. Private equity, which buys income producing assets financed at relatively low interest rates is far more logical because the value of the underlying asset's earnings *over time* should appreciate significantly relative to the amount of money seeking investment opportunities.

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We've been here before. In the 19th century in Britain, wealth exploded while investment opportunities in the U.K. grew at a fairly stodgy pace. This led, in its turn, to huge foreign investments, which in time increased surplus (investable) worth further. But a quick casual glance at Jane Austen or Dickens will turn up scenes where characters are thrilled to get 1.3% on safe, government paper.

The good news in the prospect of a permanent saving glut relative to investment opportunities is that it could well lead to a prolonged bull market for every type of earning generating asset, and a hyper-bull market for equities representing companies likely to grow faster than local G.N.P. and for bonds generally.

The bad news, of course, is that a world of 3% investment returns would overturn a lot of assumptions about how generous a social safety net is possible and how people can fund their ever-lengthening retirements. But the road from here to there is probably not through a mortgage-backed induced collapse of the credit markets, nor is a series of interest rate cuts in the U.S. (which we'll probably get, unfortunately) likely to have much long-term influence on the course of events.

So basically, the advice is just as boring as this: consume less, save more, don't expect the nominal investment rate to do anything in the medium term but fall, and invest in income-producing assets, particularly fast growing ones where the growth appears sustainable. I know it's boring, and much less gripping than being invested in a computer-induced CDO of mortgages given to people who've been actually convicted of theft, Burmese railroad bonds, and McDonalds promotional coupons, which S&P says will earn 13% at zero risk, but hey, I'll stick with boring — and solvent.

The View from the Mast

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