



Economic Debate Gets Harsh

Now that we are approximately four years into the argument between economists and market players over the fragility (or not) of the prolonged growth in world economic output, you can discern a definite fraying of tempers. The U.S. recovery has now survived, in rough order, a humongous current account deficit, a huge spike in energy prices, the collapse of home equity withdrawal, and the sharp and rude end of housing price increases and rampant property speculation. Each of these was supposed to have seriously dented the U.S. economy, leaving us to a grim near-term future of living in our cars and dumpster-diving for food.

The opposite camp, which is where I tend to fall, is that while there are potential risks to a prolonged period of low interest rates, they are manageable and rather insignificant in the context of the greatest period of sustained global growth in decades. This camp would also argue that potential inflation is at least somewhat higher than the market expects, and that rising interest rates over the next several years are probably the true threat to financial markets.

This camp is now fighting the hysteria over subprime mortgages tanking and wiping out the occasional hedge fund. Good, clean academic fun, of course, but I was startled to receive an e-mail from someone I've known for quite a while, in response to a blurb I put up saying essentially that "this too shall pass." He informed me that I "was potentially a human Saudi Arabia, if they ever discover a commercial use for drool." And this is a man I once bought a consolatory beer for in Cleveland after a panel discussion because he was extremely upset that one of his footnotes was criticized as being "over-broad."

I think gun fire is next . . .

Subprime Debt, Bear Stearns, and the Endgame for Liquidity

The end of June was, of course, dominated by the public offering of shares in Blackstone, the private equity group, and the hammering of two hedge funds sponsored by Bear Stearns which were focused on subprime mortgage debt. There were certainly oddities in both situations, but neither was worth anywhere near the attention that was focused on them.

There was much commentary, most of it fairly nasty, that Blackstone was being incredibly hypocritical in going public. After all, the company managers had just spent years saying that companies were better off being out of the scrutiny of being public and should be taken private, preferably by Blackstone. I think the contradiction is fairly easy to resolve. Being a public company, as Blackstone has pointed out, does involve things like treating all shareholders equally and granting them a say, however tiny their economic involvement, in how the company is managed.

Blackstone did not contradict this stance — they simply sold shares to the public that basically give shareholders the same rights as prisoners of war in the Aztec Empire.

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Shareholders can say anything they want, but basically the managers of Blackstone retain the right to rip your beating heart out of your chest and throw it down the stairway.

How could the managers of Blackstone, criticizing the public market years ago, ever have predicted that it would be possible to do a multi-billion dollar IPO on such terms? The question, of course, is why did anybody buy it after reading the prospectus?

The Bear Stearns subprime hedge fund fiasco had similar oddments. Two funds began hemorrhaging cash after high leverage combined with losses sustained by overinvestment in the riskier types of subprime debt created liquidity problems. Merrill Lynch, which had lent almost a billion dollars to the funds, threatened to auction off the collateral they possessed which secured the loans. Huge pressure was applied on all parties to avoid the auction, and it was more or less avoided when Bear put up \$1.6 Billion to liquefy at least one of the funds.

The oddity, of course, is why the auction was considered to be so threatening. The Wall Street argument is that many debt pools tied to subprime mortgages are illiquid and thus an auction would create prices for other owners of similar debt much lower than where they are currently being assessed. This, it was said, would cause other funds to mark their value to the new prices and cause a chain reaction of write downs leading to more selling which would lead to more write downs, etc.

I have to admit, that even for an optimist such as myself, these explanations seem to waft from the fetid forest of utter bogusness. The debt held by Merrill was less than ¼ of 1% of similar debt outstanding. If the orderly auction of the debt would only happen at much lower prices, isn't it reasonable to assume that the real value of the debt is much lower than it is being held on the books of hedge funds and other financial institutions? Of course, we can trust the valuations of those holding the debt since *in every case* managers are compensated directly on the higher prices being sustained. So I'm sure they're being scrupulously honest and above-board.

The Monthly Disaster Fear: Is Subprime A Looming Pit?

Sitting here and fingering an inch thick pile of panic-inducing brokerage pieces on mounting losses in subprime mortgage debt, I'm struggling primarily not to laugh. My favorite pieces include works entitled "The End of Money?" and one describing the current situation as being similar but greater in magnitude than the Savings & Loan crisis of the late 1980s.

Are losses piling up? Yes. Is it a threat to the financial system? Please. First, the S&L crisis did lead to a seizing up of the financial system and a serious risk of a credit disruption — which is why the government spent hundreds of billions on a bailout. But the big "problem" today is an absolute wall of global liquidity. A massive write down in the subprime area extended over a year or so is a rounding error, not the beginning of a credit seize-up.

But could such a write down work its hideous way through the entire credit structure? Let's hope so. A rise in risk avoidance that increased credit spreads between government bonds and junk bonds and "covenant light" leveraged buyout debt would be a move *towards greater financial market sanity*. It could well have the impact of saving the system from what was beginning to look like truly scary levels of financial market excess. The change won't be fun for many in the financial industry, but that doesn't mean that it wouldn't be a truly good thing to have happen.

Purely as a side note, reading several prospectuses relating to packaged loans that have been sliced into several different levels of potential risk did raise one question in my mind. If everything from mortgages to leveraged buy out loans have been divided into many differing levels of risk and sold to thousands of buyers, many of whom have sub-syndicated the positions or written derivatives based on them, what happens when the credit cycle turns and some of these loans go bad? With all the people involved, where are the creditors going to meet, Giants Stadium? Add the traditional "lawyers, guns, and money" and the first big default is going to look like a bad day in Beirut. Those of us with children who are young adults should be encouraging them to go into structured finance bankruptcy law. Sure it's boring, but you're not going to have to worry about being out of work until 2085 or so.

Private Equity, Activist Investors Go East & Become Road Kill

Greater fear of risk, rising credit spreads, and higher interest rates are all making funding private equity deals a more difficult task, as is a sharp rise in the amount of debt being taken on relative to any potential scenario of future earnings. With more than \$250 Billion of such deals in the U.S. alone coming to market to be funded in the next several months it will be interesting to see if the phenomena has reached its natural limit.

One end run has been the idea of private equity and activist hedge funds moving the target to markets such as China and Japan. I've been asked several times about this idea, but always feel like I'm discussing events on a different planet. The notion that Asia is a captive beast, waiting for the cleansing wind of private equity to rescue it is bizarre in the extreme.

Take China. Since the country is closing in on the \$1 Trillion level of reserves and has a savings rate of close to 50%, the notion of bringing the country capital seems like bringing a bucket of water to the Pacific Ocean. And management skill and discipline, the other much boasted about "gift" that private equity brings? First, Chinese businesses in virtually every sector operate in an environment of constant oversupply and expansion of production and low profit margins. Surviving for a week in such an environment would make an average developed country manager's head explode. Trust me — the Chinese are excellent and disciplined beyond belief already.

As for new technical skills and specialized managerial talent, there is a growing need,



but why would Chinese enterprises seek help in such an area from foreign private equity houses? Are firms such as KKR and Blackstone known for having a lot of Mandarin-speaking talent on hand? Are managers in the West lining up for assignments in Changsha? The idea is simply goofy. China will educate and deploy the talent it needs, just as it has done for over two decades now, internally and on its own.

Japanese Management Explores the New World and Gags

The notion of public equity managers being confronted by private equity, activist funds, and institutional investors was particularly pronounced in Japan over the past several weeks. Investors sought everything from takeovers, to management changes, to financial restructurings, to dividend increases. My informal score card at the end ran: stolid, autocratic corporate managers: 27; new financial activist investors: 0.

There was some press commentary that this was an epochal setback for the Japanese market (“Why Japanese Investors Could Cool on Japanese Stocks: Hopes for Better Returns May Ebb After a Series Of Setbacks Hit Activists,” *Wall Street Journal*, 6/29/07) which seems more than a touch bizarre since no experienced Japanese hand I speak with had expected a different outcome.

Why the resistance from Japanese managers, and why did Japanese shareholders overwhelmingly back them in shareholder votes? It’s really not that complicated. Japanese companies accept shareholders and disclosure as part of being public, but at the core they do not give investors any key role or, to be honest, clearly understand what distinguishes us from pond scum. That shares rise in value is certainly nice if it happens, but it is not the point of making widgets or whatever the corporate product happens to be.

Japanese companies are overwhelmingly driven by *increased revenues* and this has been the case for all of the post-war period. Being financially aware is certainly an aspect of this, but it is hardly the key priority. The key metric is *competitiveness*.

This often leads to the misperception that Japan is immune to change, which is utterly ridiculous. But change follows events rather than being proactive, which is often the default setting for financial markets. Seventeen years ago Japan’s “Bubble Era” imploded, but the country’s politicians and businessmen took few intelligent proscription actions as long as the previously built up wealth could be used to avoid change. When that option collapsed post the Asian Crisis of 1997 and the near-implosion of the main Japanese banks in 1998, change to maintain global competitiveness reached extraordinary velocity.

One of the clearest signs of this is the destruction (in Japan) of costs seen over the last decade and a staggering increase in income inequality in what was formerly one of the most egalitarian societies on earth. In the former “lifetime-employment state” the percentage of “non-regular” workers has risen in the last ten years from 19 to 31% of the workforce. Two-thirds of “non-regular” workers are on limited contracts and receive

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no guarantee of full time hours. One result is that on a per-hour basis they earn only 40% what the regular workforce earns.

You see the same revolutionary (if depressing) change in the social statistics. I secretly admired the Japanese for refusing to throw the citizenry over the side of the ship in the post-Bubble period. As it turns out, this was a lot like rooting for the Smoot-Hawley protectionist tariffs in the U.S. in 1930, but hey, at least their hearts were in the right place, right? Well they're pretty much over that softness if recent figures are any guide.

If we define the poverty rate in a developed country as a family having less than half the median income (probably the best way to make cross-country comparisons) then the poverty rate for single mothers is over 50% and child poverty is over 14% — both very high numbers by the standard of the developed world.

So Japan has the contradictory situation of widely restored global economic competitiveness and crippling psychological depression about the economic outlook. One indication of this is that Japanese hold cash equivalent to 77% of GNP — by far the most conservative investment stance in the developed world. And you know something? They're right to be so conservative. To the large extent that economic value added in the Japanese economy is still tied to the export economy, and as countries such as China and India compete in ever more complex and sophisticated areas, the outlook for the average worker is probably fairly unexciting. But the outlook for the economy is perfectly OK because of the maniacal focus on competitiveness that drives all activity. It's the diversion of activist investing that is beside the point and will be for the foreseeable future.

Pay Your Money—Take Your Chances

So if the level of global growth is continuing for the fifth year at previously undreamed of levels and most of the “fear” factors in the financial orbit are advanced versions of “stupid pet tricks” are we totally in the clear? Probably, except for one lingering imponderable.

The mystery is that global money supply growth is barreling along in the mid-teens without causing any discernable increase in inflationary expectations. According to traditional economic theory this is completely impossible, and it's obviously keeping central bankers awake at night. What does it mean?

One obvious theory is that inflation does exist but central banks have discovered ever less honest ways to hide it. For example, one economist on the internet who performs the Herculean task of calculating the U.S. inflation rate disregarding all changes in calculation methods made by Alan Greenspan during his time at the Federal Reserve, claims that the inflation rate is over 10%. This simply doesn't feel right. One, while I defer to no one in my feeling that Greenspan is a meretricious sub-species of poisonous lizard, most of the changes he made were obviously correct and non-controversial. Two, it's not like an

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inflation rate of 10% wouldn't create an economy far different than what we are currently experiencing in our day to day lives.

The second theory is sort of the polar opposite. It holds that massive printing of money is not leading to inflation because it is merely (and temporarily) offsetting a "dark force" of deflation that is gathering force to waste the entire financial system. I guess anything is possible, but I tend to disregard theories that seem to require as a premise the actual existence of Caspar the Friendly Ghost. I'm not a big "secret, dark forces" guy.

So why are high monetary creation, sustained global growth, surging oil and commodity prices, and plunging unemployment rates and spot specialist employment shortages everywhere not turning low inflation into a bonfire?

My guess is simple extrapolation. For the past decade and more the basic premise of all economic and corporate managers everywhere has been that trade is expanding, trade barriers are dropping, and that ever increasing price-based competition is how the game works now and forevermore. This premise has been the justification for the extraordinary shift in the share of corporate profits moving from labor to capital, to the point where profits in aggregate in the OECD are now the largest share of GNP ever recorded.

What would reverse this? My guess is that with economic activity shifting to a global scale, with limited communication between economic actors across what is, after all, an entire globe, the extrapolation of ever more grinding competition has kept any particular economic actor from bucking the trend and attempting to raise either prices or wages. This ends in one of two ways.

The first way, and the worst, is a sharp rise in protectionism, which lowers global economic output, increases inflation, while not guaranteeing any real or substantial increase in the wages and working conditions of workers.

The second way is a bit mystical, I admit, but would involve, as unemployment continues to fall, spontaneous one-off wage and price increases in areas where capacity utilization is high. (This is also, by the way, why Bernanke of the Fed mentions the issue of capacity use in virtually every major address). In a tight labor market this would serve as a powerful wedge for wages to rise — the increase of wages in some sectors would put employers in other sectors at a huge disadvantage when it came to hiring the best workers. Thus a few scattered wage increases could lead over time to a more widespread increase in the labor share of income and higher inflation.

The reason that I don't toss and turn at night thinking about the issue is that the few scattered attempts that I've seen so far to implement price increases have been failures in areas as diverse as pump drives and the U.S. beer market. When I see a handful stick I'll change my mind perhaps, but I'm fairly confident onward and upward still seems the short- and medium-term course.

But just in case I'm wrong, *does* anyone know of a commercial use for drool?