

Late, Shamed, and Still Confused

Yes, yes, I confess I skipped writing the last issue. I followed my normal procedure and gathered official predictions by prognosticators about 2008. Since I didn't agree with the Bears (it's 1929 and start looking for thick trees on the south side of mountains because they have edible moss) or the Bulls (who had a belief that growth would come from healthy emerging markets, even during a U.S. recession) in what was termed a "decoupling," I ended up with of note of such an uncertain hedged outlook that it gave me the flu. I decoupled from publishing. I did enjoy the unrelenting attacks on Greenspan during January, but even his timorous defense ("I did not make a mistake. Please do not burn down my house") was not enough to get a firm, vigorous line of commentary established. Arguably, wimpiness is still possible here on the last, grim day of February, but uncertainty is going to extreme ends.

The Financial Morons Are Who We're Listening to?

One of the strange aspects of the February market was the volatility caused by individual brokerage firms and banks publishing estimates calling for additional multi-billion dollar write-offs at *other* financial firms. UBS of Switzerland, Goldman, Citigroup, ING, etc., all got hit (and took the markets with them for a day or two) but the calling-out was a touch bizarre. Since none of the yellers or wounded showed any ability over the past five years to identify a bad piece of financial paper, how do they recognize them now? How does the immensely wounded Citigroup call another bank to be hiding write-offs? Isn't that a bit like the Crips street gangs in L.A. attacking gangs for gun wounds and beatings in South L.A.?

But at least with the fourth quarter and yearly reporting season over for most public companies, at least the panic's scope is shrinking. The Great Fear remains financials and panic about non-financials, at least that which remains, is beginning to look increasingly silly. One, both results and forecasts are at least mildly positive. And some general conclusions are worth examining. In the U.S., one indication of risk was attenuated by the conclusion that net cash on corporate books at year end was over \$1.55 Trillion. That is clearly far more cash than is required for R&D, maintenance, or any other theoretical need for cash to fund operations. It's hard to have a financial panic among the well capitalized. It obviously would be painful for a continuing and increasing bank panic, but it would not take the main economic players to the wall, even in a recession. You can come to the same conclusions (a little more closely) in Japan and in Europe, where free cash flow in the fourth quarter was a larger amount than corporate use for cash inputs.



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An aspect of how this is affecting corporate management suites was clear in the conference calls that followed earning releases in all three regions. While it was hardly exuberant, there were little or no changes in outlook for sales or profit margins in the current environment, or under expected future conditions. In the last Bear Market, it was extremely unnerving that companies created a mutual policy of refusing to make comments about future prospects. The level of uncertainty that caused, when even insiders refused to comment, was terrifying. That is not the problem we face at the moment. I would give the modesty and confidence of current corporate commentary as a strong reason to avoid panic.

I also think that modesty, an under-rated corporate virtue, is making a strong comeback. I visited a German property developer 14 months ago. Despite trying and studying the accounts for hours, I had to admit that I didn't understand why the company could vastly increase capitalized profits every time a fraction of capital changed national borders. I was told, "if you understood finance, I would waste another 45 minutes talking to you. Since you obviously don't, this conversation is over." So, it was satisfying to have him have to proclaim, three months later, that his books were cooked and watch the stock fall 45%. I don't think wild finance works in Germany in the future.

There is, however, another issue that will matter. A year ago, after dropping \$1700 to attend a German conference, I had to listen for an hour to the chairman of Deutsche Post talk about the sacredness of the place of the manager, how every dime belonged to shareholders and that bearing in mind honesty was the heart of his task. That, and as it turned out, how much money he could sneak over the border to cheat the government out of 1.5 million Euros in clearly owed personal taxes. I think for the time he took of mine at the conference, he owes me \$275. Something tells me I'm not going to get it or an apology from insanely arrogant German property managers. But it is a problem.

Germans have adopted extremely tough cuts in the social safety net and wage restrictions for five years — and the country has been rewarded by rising exports and a strong economy. The reaction to the tax scandal was a title wave, with the press focusing on the lack of honesty and fairness and the particular scum like life of business types. The movement was radically, politically to the left and stunning in its anger. Since trust is the anecdote to panic, I don't expect the Bear Market to end first in Germany.

But, if no Justified Real Economy Panic, Why Aren't You a Raving Bull?

Even with the markets split clearly between satisfactory economic finance and outlook and opaque financials risk, there is still an area or two to keep

me awake at night. One is the notion of emerging markets, especially Chinese growth, filling a basket that is slightly tattered in the developed world.

I tried to get on top of the magnitude and the likelihood of the issue by calling an old friend, who is an economics researcher at the People's Bank of China. His three minute horse laugh was not encouraging. Nor was the information that the Central Committee had to wait a week to get the theory because it was impossible to find an academic in China to translate and sponsor the concept. China clearly doesn't believe it, and expects to feel serious economic pressure in the face of a U.S. recession.

This is actually one of the few bits of good news I've heard from China in some time. After three decades of following emerging markets, the pattern is looking hard to break: emergence of an economy, glorious achievement, followed by insane overconfidence and treating a bad price or trend as something for the geniuses in the New Star Economy to override.

China has been doing this with price signals for some time. Drastic food price inflation has led to sloppy controls. High wage disparity between the coast and the interiors has led to massive infrastructure expenditures, based partly on a study of the U.S. interstate highway program from the 1950s. You can build a transportation system that reduces transport costs to the point where Eastern companies, faced with rising wage pressure, can move operations to the poverty-wracked center. But you can't easily do it without an increase in petroleum usage, which was massive when the interstate was constructed in the U.S.

And this is just a small flaw in the distorted price signals in the Chinese economy. For instance, people took it recently as a solid sign of qualitative consumption growth that Chinese, in surveys, began suggesting a demand for solid, "non-cheap," non-traditional cars. But how did a demand for larger, more fuel-intensive cars develop? The answer is in a vacuum. The Chinese keep the price of oil fixed at \$55 per barrel — just over half the world price. What happens in a supply decline or price surge? A deeply nailed emerging market. A U.S. recession is a similar issue, which is why the Chinese experts are not rushing to embrace decoupling. China is seeking to offset output costs that are forcing them out of markets by moving production to the cheaper center, i.e., by Chinesing the Chinese. Output (and exports) must grow at an astonishing level for the plan to work. A less-importing, lower consuming, recessionary U.S. is hardly the plan for this.

A further footnote to look at is agricultural commodity prices. Before we count on consumption from emerging markets we should look more closely at their accounts. Based on work from the Commodity Research Bloc, the 12 largest emerging markets have a CPI inflation rate that ascribes 30-40% to food. So it's hardly a surprise that spending on food is close to eliminating most

financial surpluses. The Chairman of the Canadian fertilizer producer, Potash Corporation, had a dramatic statement of where food price increases were going to end up around the world — at emerging market famines. It bears thinking about, especially if you're waiting for emerging market demand to save you.



So Is the Whole Picture Down to Recession?

So with no dramatic corporate distress, and no emerging market white knight, most of the volatility is confined to financials. And, of course, you can clearly argue that how the situation resolves itself determines the level of positive wealth effect. The reluctance to definitively call a recession is two-fold. One, Fed Chief Bernanke still seems to comfortably argue that he doesn't see a recession on the horizon. The other, of course is that being a pundit for the last several years it has been clearly driven in that the best way to look like you need to buy a clown suit is to predict the decline of the buying habits of the American consumer. But consumption, adjusted for inflation, has frozen over the past two months. So where are we?

One of the answers is not a direct one, but is more contextual. A study done two years ago had an amazing statistic. It showed that Americans in the 90th to 95th percentile of income *borrowed* in 2006 to pay for their grandiose lifestyles. In other words, an income level that was well beyond affluent did not meet lifestyle demands, which obviously were derived from the court of Louis XIV. The consumption demand was obviously absurdly high but the crawlback demand and pace is impossible to calculate. With GDP being 71% comprised of consumption, you can easily see the prospect of a 2-3% recession as a simple sign of a return to sanity.

And there is the question of how stressed the population actually is. It was surprising to me that 86% of the U.S. population due for rebates told researchers that they plan to "save" the money dispensed by the Federal Treasury. I think stress would be "buy food," or "jeans for kids." If the financial issue doesn't tumble the economy (which it doesn't appear to be doing) and cause a sharp, sustained rise in unemployment, I would be in the Bernanke non-recession camp.

The Financial Overhang — Out There for Awhile

The experience of decent earnings and the constant appearance of financial panic appearing sporadically is causing market watchers to become restive. But the delay of an "all clear" solution seems inevitable the more you study the matter. In the period of ever-rising leverage, easy money, and assets being created that were separate from bank balance sheets, you had everyone from Bill Gross to George Soros to Warren Buffett scratching their heads as the pools grew and mutated. The reason that resolution is so slow is that players today

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are constrained to logical debt positions — and the amount possible to be purchased in a sane context is not only overwhelmed by the complexity of the instruments, but the gut-choking immensity of the size of money required to cover the sellers.

It's hard to see how this wrangle ends without a bailout. Sorry, I know several people whom the very term outrages, and even Treasury Sec. Paulson says he "doesn't want to rescue investors." But like the Savings & Loan mess of the late 1980s, it could become save or sink, especially if home prices continue their decline.

The obvious rescue is (please don't throw things in my direction!) a new version of the Resolution Trust Company of the 1990 Savings & Loan crisis. RTCII would be capitalized at \$400(?) Billion and buy under pressure paper from all holders. If we needed some form of justice and pain, we could categorize the sellers into camps, depending on how much risk they took and how much they attempted to limit it. Or, we could be generous and take back loan sleeves where there are new mortgages at the current realizable selling price. A penalty to the cautious of us who didn't go out on a limb? Well, what was the RTC? We survived it. Or the other choice — a very long wait until normalcy returns. Is that what we want?

The Pressure Rises — but "Fairness" Halts Any Momentum

The amount of discussion from the Congress to the Fed constantly crests, along with the view that any tool available to Bernanke is worthless by itself. There has also been an enormous search for those who, in the view of their opponents, do not "deserve" to benefit from any sort of bailout, especially if it's tax-supported. Wall Street is widely loathed, with money center banks close, as a victim of disdain. Even the Secretary of the Treasury has said openly that he can't imagine, or stomach, a relief act that bails out "investors." I think this reflects a loathing for individuals who bought houses in hot markets intending to flip them in the near future. But where does responsibility lie? I think the Carlyle case is interesting.

Carlyle went public (in the Netherlands) less than a year ago focusing on an area — bonds — that it has no historical record in. It then took the close to \$1 Billion it raised, and then borrowed almost 32 times the amount of equity and put the money into Fannie Mae and similar "ultrasafe" bonds — before they began to sell off, apparently collapsing the company. (I say apparently because the last gasp of the saga is not over as I write). But who is, ahem, guilty? The IPO investors following a famous name? The managers, putting a Mt. Everest of debt on a modest equity base? Bankers, lending over \$20 Billion to a famous asset manager with a business plan, after a credit crunch started,

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VIEW FROM THE MAST

THE VIEW FROM THE MAST is published periodically by *Ted Tyson, Chief Investment Officer of Mastholm Asset Management, LLC. Mastholm provides international equity investment management services to institutional investors utilizing a bottom-up, all-capitalization, growth investment approach.*

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that was basically leverage on speed? The massive decades long waterfall of housing agency debt that was extremely opaque — sellers hinted that the U.S. government backed the debt, the U.S. coyly denied that, without ever absolutely saying it. And no one knew 100%.

Everyone in the saga, including Carlyle, is smart and has sterling reputations. All of the individual pieces of the puzzle can be reduced to sane, rational behavior. Quilt? Quilt? The existence and continuity of a wall of money simply was the core first assumption of everyone involved. Crazy? Compared to what? The belief in 1991 that it made sense to give a \$1 Billion market cap to a company that sold pet goods over the Internet?

Resistance to the Treasury or the Fed taking an aggressive action based on “fairness” has at least a useful comparison. When Japan responded to a financial and property collapse in the late 1980s, (that was enormous compared to ours — some property categories managed an 89% decline) by ignoring and allowing the financial sector to avoid marking to market, the follow-up was widely known as the “lost decade” and the tepid recovery was vulnerable, as today, to a full scale re-correction. It was “fair” but an anchor on the economy that has never eased. Aggressive action is better than avoidance.

As the credit crunch sharpens, the alternative road will look clearer and better. As I’ve mentioned, the real economy is reasonably capitalized and stable. Fiscal stability, even with a Fed bailout, is fuel for enormous growth. OK, I admit that many of the players were dim, shameless greedheads. But, all in all, I want them back. Some obvious limits this time around (no off-balance sheet finance at banks for example) but I would leave the arrogance and energy — the coarseness is part of the charm that makes the system work. And let’s admit it, particularly those of us who’ve been in the markets for decades — it does work! 