



Moving West, Away From Microsoft

We are finally giving in and moving, bowing to Bill Gates' apparent desire to lease all office space in Western Washington. His recent decision to build and lease 1.5 million square feet of space in Bellevue, Washington has taken rents to insane levels, so it's on to Seattle. I would utter a curse on MSN, but it's redundant. The space we're giving up used to be Microsoft's legal affairs office — and given their antitrust record, taking the space back should be curse enough.

Most of the move has been uneventful, but it was a little disturbing to go through my office and find a box with gifts given to me by companies after paying them a visit abroad. Sorting through it, it's clear that there are very strict rules on such gifts — they must be worthless and ugly and less than \$6 in value. It says something, though I'm not sure what, that Remy Cointreau gave me a coaster but no Cognac, and that Henkel, the German household products company, gave me a toilet bowl cleaning product involving dancing bear cubs that the company CFO suggested might be amusing for children to watch after taking the tank lid off and flushing.

Not that I haven't sinned myself in the gift giving arena. Before my first visit to Japan in 1988, I needed a gift to give in return and the only thing the company I was working for at the time had with a logo on it (required) was baseball bats. Truly you have not walked the Bureaucratic Wall of Pain until you try to import 50 baseball bats into Japan via airport customs. It also created a huge etiquette problem. Do you give the bat at the beginning, which is unbelievably bad manners, or do you break management's concentration by forcing them to wonder for an hour or two why you've brought a lethal weapon to the meeting?

The worst meeting gift episode was in Australia. The young man that tried to give me a sample of the company's liquid soap probably didn't realize that it was under serious pressure and should have had a tube on the top, so he skipped a few steps and shot several ounces of soap into my eyes at 50 M.P.H., utterly blinding me. Realizing that he was going to be kidded about this by his workmates until he died, he left the building. I just softly mourned that I didn't have a baseball bat when it actually would have come in handy.

OK, everything in the trash . . .

Taking Out the Trash in the Markets

I'm writing this after a clearly awful week for the financial markets, when the sub-prime issue, which seemed to be under control after the last two

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Fed cuts in interest rates, came back to life, ending the careers of the CEOs of Merrill Lynch and Citigroup. The process of valuation is obviously in complete shambles. If you take so-called “super senior” CDO paper, which has the same ratings and the same components, UBS wrote its value down by 8%, Citigroup by 19% and Merrill by 41%. So obviously, no one has a clue as to the value of what they own. Fed Chairman Bernanke raised his estimate of the losses on securitized paper from \$50-\$100 Billion to “around \$150 Billion.” Moodys, one of the rating agencies that abetted the creation of the problem in the first place, came up with an estimate of \$225 Billion in losses, and began de-rating paper left and right.

Big numbers, but time to panic? I still don’t think so. It’s still a context issue. To put the losses in perspective, according to the Bank of International Settlements (BIS) the paid up capital of American and European banks is slightly over \$2 Trillion. So a \$225 Billion hit is a severe blow to earnings but not to the financial system as a whole. Skip the bank run. Sit down and have a quiet cup of coffee. And worry about a real problem — the long-term decline of securitization.

Why You won’t Like a World with Less Credit

The current problem in financial markets is blamed on “sub-prime” mortgages, but sub-prime-backed CDO instruments are merely the vehicle for exposing a key bit of illogic in the system. Securitization is simply a way to massively increase the ability of banks to increase credit without having to adhere to limits that arise from keeping the debt on their own books. The illogic comes from the fact that lenders who are able to shift loans off their books have virtually no incentive to make sure loans they make are of decent quality — or of any quality at all, for that matter.

This is not exactly news and was well understood by the 1930s, when the Glass-Steagall Act specifically forbid most types of securitization as a way to protect the post-Depression banking system. Reading the Congressional testimony from the hearings in the early 1980s that led to the ban being reversed, the main rationale appears to be that we are a lot smarter now than people used to be and many of us have access to computers. Uh oh . . .

With the notable exception of Japan, securitization over the last two decades has massively increased the availability of credit and raised the percentage of GNP tied to consumption. As the value of assets increased due to oversupply of credit, high consumption made economic sense at the household level as long as the value of assets (such as houses) rose at least as

fast as debt — which they have constantly for quite some time. But it made our economies absurdly dependant on rises in asset values.

Consumption, in a less credit crazed environment, historically rose in line with actual income. But for over a decade in the United States, consumption has risen almost $\frac{1}{2}$ of 1% a year faster than income. The pattern of running up credit card debt for everything from vacations to flat screen TVs and then paying off the balance with home equity borrowing is so entrenched we barely even notice it any longer.

Declining home prices, sub-prime or not, have killed, or is killing, this process. Consumption will have to converge with income growth and consumption will decline sharply. There is enough economic growth outside the consumption matrix to possibly avoid a recession but psychologically it's sure going to feel like one. And if the base level of housing prices is the value of a house compared to its rental value (P/RV) then prices will fall in real terms by well over 28% — which will feel like about 19 recessions.

The Decoupling Myth Meets the Numbers

One silver lining that the market appears to be betting on is that emerging markets will “decouple” from a U.S. slowdown. A number of emerging markets such as Hong Kong/China and Brazil have bounced 30% or more from their August lows. This is an attractive thought, but unfortunately is completely insane.

Like most bubble theses, there is a kernel of logic. Emerging markets have far less short-term debt in foreign currencies than in earlier crisis periods, far more foreign currency reserves, and particularly in China, a fast growing level of consumption that is adding significantly to GNP growth. But the argument is basically circular.

Markets such as Brazil and Russia are growing because of the insatiable demand for commodities from China. Smaller Asian countries, which are now basically component makers for the Chinese juggernaut, are growing because of the 10% plus growth in China's economy. China is growing . . . uh oh . . .

The numbers are fairly stark. If consumption had grown in the United States in line with income of the past decade, the total level of consumption would have been almost \$900 Billion less than the actual figure. If we assume the Commerce Department is correct and that for every \$1 in increased consumption approximately 61 cents went to China, then some 80% of GNP growth in China has been due directly to over-consumption by Americans.



For emerging markets generally, the improvement in financial flows have been impacted enormously from the sweat and effort of emigrants remitting money back home. In each of the last 10 years, remittances by emigrants have exceeded the total amount of foreign direct investment plus the total level of all foreign aid. The level currently, according to the IMF, exceeds \$300 Billion per year. But in even a mild global slowdown that number would slow significantly. “Decoupling” has no economic basis of any kind — it’s not economics, it’s mysticism with a side helping of rice.

China: The Good, Bad, and the Frankly Awful

Having just spent two weeks in the interior of China, it’s hard to be as unabashedly positive on the near term as the markets appear to be. Interviewing 27 managements in Changsha, Chongqing, and Beijing I’m fairly convinced that the rarest object on earth is a Chinese business person with an actual business plan. “We will produce more and more” gets to be a fairly tiring mantra after the 16th reiteration.

The problem is essentially the same for every rapidly growing economy since the United States in the late 19th century. With a savings rate of 42% and a consequent wall of money seeking investment opportunities, every profitable enterprise with decent margins soon faces a new competitor. Every foreign exporter to China soon faces a home grown competitor. For example, I saw two companies that make concrete pumps for construction. They have gone from 0% of the Chinese market in 2000 to a current level of 67% — and a third Chinese company has started production. You can only wipe out the foreign producers once. And then what happens when demand falls?

The irony of the Chinese position is that when they plead, for example, that thin margins make it impossible to accept price increases for coal for steel plants or against a sharp revaluation of the Chinese currency on the same grounds, the entire world assumes that they are lying. They’re not. Especially if one assumes, as was stated fairly baldly by an economist at the People’s Bank of China, that 71% of Chinese corporate earnings are being derived by putting corporate cash into the Chinese bull market. I’ve lived through this before — it was called Japan before the crash.

The correction won’t be orderly for the same reason that China is having immense difficulty getting a handle on companies exporting dangerous chemicals being substituted in everything from toys to toothpaste — there are over 5,000 chemical plants operating on negligible margins and a grand

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total of 15 government inspectors *for the entire country*. The substitution of toxic chemicals is not happening because the Chinese like poisoning people — it's because the tiny savings in production costs are a matter of survival for the companies involved.

This doesn't have to end in disaster, but China does have to reduce its economic growth rate sharply to allow a saner operating environment to emerge. The main difference between 1988 in Japan and China at the moment is that the Chinese officials do not, as the Japanese did, lecture you on why they are a superior nation and people and perhaps in the future we can eke out a miserable living by selling them food. The Chinese style tends towards paranoia — they take nothing for granted and seem to individually memorize risks identified by others. And they do what they say. Lack of consumption was identified by the leadership as a problem two years and almost *400 million* credit cards ago and consumption may be growing even faster than the official statistical rate of 19%. But they are not likely to decouple from a U.S. slowdown.

Ummm . . . So Why are You Bullish?

My argument is fairly simple — that the markets are currently looking for salvation in areas such as emerging markets and commodities, and that the thought process behind such optimism is, to put it kindly, fairly superficial. On the other hand, the nature of the problem is unlikely to be resolved in a crunch as opposed to a long rebalancing over a reasonable span of time, and valuations have already priced such a scenario into account.

Take the time factor. The U.S. housing situation, even if we take an ultimate “crash” scenario as the most likely outcome (which I don't), the decline will happen over many years. House prices are notoriously “sticky” on the downside and the decline in real value is much more likely to come from house prices rising less than inflation over a long period of time than a selling panic. Only a severe recession accompanied by large job losses would lead to a crunch scenario and there is absolutely no sign of such an event in recent numbers. A cascading plunge in the dollar is similarly unlikely. The central banks of China and other large holders of dollars may grumble about a continuing slow decline but absolutely no one that I can see has an interest in accelerating the process. Coordinated intervention to prop up the dollar would be far more likely.

It doesn't take a lot of valuation work to understand why, despite the turmoil, developed country markets are still up for the year. Going back 20

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years and taking the forward P/E ratio for the upcoming 12 months the average P/E for the entire world is 19% below the historical average. This is within a range of 13% below historical value for the U.S. to 27% below for Europe. Since banks account for a healthy amount of every index (as much as 22% for Europe) it's not like the sub-prime problem is being glossed over — excluding financials the markets may be as much as 31% below historical norms in terms of valuation. The solvency ratio for corporations (equity to debt) is at 30-year highs — most companies have no reason to access capital markets for the foreseeable future. It's hard to have a financial crisis if the main productive entities don't require financing.

So Who Wins in the Creditless World?

If I'm fairly correct on the "non-crisis" scenario then market calls for the near future are fairly simple. Assume a somewhat harsh downturn in global growth (from 5% to 2 %?) that includes China, and through China other emerging markets and commodities. (Oil might well be the exception for reasons that are too complex to go into here). Assume that the world can't avoid some fairly major infrastructure spending: energy, energy transmission, power generation, alternative energy, transportation. Basic medical spending will rise everywhere, partly for demographic reasons, partly as world wealth rises. Environmental products, especially those focused on autos, will face decades of rising demand: diesel, fuel injection systems, particulate filters, etc. The internal combustion engine of today wastes more fuel than it uses to power the engine — that will stop. Water systems will require capital for decades. Growth, predictability, and a defensible technological niche are the components of a great investment from this seemingly rocky place. More or less, everything else is a bank stock waiting to happen.