

Should you Trust them?

Marc Faber

My very good friend Fred Sheehan, a book author, economist and market historian recently wrote a report entitled “Anatomy of the Bubble” in which he quoted the views, among others, of some senior economic policy members in 2007 – dead ahead of one of the most serious financial crisis in history (Frederick J. Sheehan (Fsheehan@AuContrarian.com; www.AuContrarian.com). For a good laugh if you did not believe these policy markers and to feel sorry if you trusted them, I reprint some of the quotes below.

“We have not seen major spillovers from housing onto other sectors of the economy.”

Ben Bernanke, June 21, 2007 – Federal Reserve Chairman

“I take comfort from the underlying economic strength.... Listen, I’ve been watching markets for a long time. It’s my job to be vigilant, so I’m watching these markets carefully.”

Henry Paulson, July 31, 2007 - Secretary of the Treasury

“Treasury Secretary Henry Paulson said on Wednesday the repricing of credit risk was hitting financial markets, but subprime mortgage fallout remained largely contained due to the strongest global economy in decades.”

Henry Paulson, August 1, 2007 - Secretary of the Treasury

“To begin with, the bursting of asset price bubbles often does not lead to financial instability.... There are even stronger reasons to believe that a bursting of a bubble in house prices is unlikely to produce financial instability.... Declines in home prices are far less likely to cause losses to financial institutions....”

Frederic Mishkin, January 2007 - Federal Reserve Governor

Fred then followed up with another – as he puts it – quotable buffoon:

Jack Welch - Interviewed January 19, 2007

Q: What do you think of analysts who predict we'll be in recession in six months?

A: They should find another line of work.

Q: Do you think sentiment is too bullish?

A: I'm not here as a market timer. I'm here to tell you this economy's in one helluva good shape.

September 25, 2008

NEW YORK (Reuters) - Former General Electric Chairman and Chief Executive Officer Jack Welch said the U.S. economy faces a deep downturn in coming quarters, and he supports a proposed \$700 billion government rescue package for the financial sector.

"I now believe we are in for one hell of a deep downturn," Welch told the World Business Forum in New York on Wednesday, adding that the first quarter of 2009 will likely be "brutal."

Now, I do not wish to be unfair to our brilliant economic policy makers and business leaders, after all I also made many bad calls in my life as an investment advisor. But I find it rather amusing that the very people who brought about the current financial mess or were major contributors to the problems we are faced with today (Hank Paulson as a CEO of Goldman Sachs and Jack Welch overseeing GE Capital) should now be in charge of bailing out the system. Not to mention Ben Bernanke, who significantly aggravated the crisis with his abstruse monetary philosophy and theories! Mr. Bernanke became Fed governor in 2002 and under his influence the Fed fund rate was cut to 1% and left there until June 2004 although the US economic recovery had begun in November 2001. By focusing almost entirely on "core inflation" he failed to observe the increase in commodity prices and the enormous growth in credit, which led to the housing bubble, and was accompanied by a huge expansion of leverage among financial institutions. Incidentally, excessive credit growth between 1921 and 1929 was also largely responsible for the depression of the 1930s and not, as Bernanke thinks,

policy errors at the time by the Fed. Then, after having raised the Fed funds rate in baby steps between June 2004 and August 2006, he slashed the rate from 5¼% to 2% between September 2007 and January 2008. The result was that commodity prices took off (oil rose from \$75 before the rate cuts to close to \$150 per barrel), the US dollar weakened further and most importantly his rate cuts sent the wrong message to leveraged financial institutions because it gave them a false sense of security. Had the Fed funds rate at the time not been cut, financial institutions would have begun immediately to deleverage. But by cutting rates further not only was leverage actually encouraged but it also fostered another huge increase in the volume of outstanding Credit Default Swaps (CDS) to currently approximately \$62 trillion (compared to just \$1 trillion in sub-prime mortgages). The CDS market is, I may add, a far more powerful time bomb than the sub-prime mortgage market and is likely to explode at some point (that's why AIG had to be bailed out). Ben Stein writing for the New York Times echoes a similar view. According to Stein, "what I hear from my betters in the world of finance, the most serious problems are not with the bundles of subprime mortgages themselves — a large but not lethal quantum as far as I can tell — but with derivatives contracts tied to subprime and other dicey debt. These contracts are superficially an attempt to "insure" against risks of default, hence the name 'credit-default swaps.' In fact, they are an immense wager — which anyone with lots of money or borrowing ability can enter — about how mortgage-backed bonds, leveraged loan bonds, student loan bonds, credit card bonds and the like will perform."

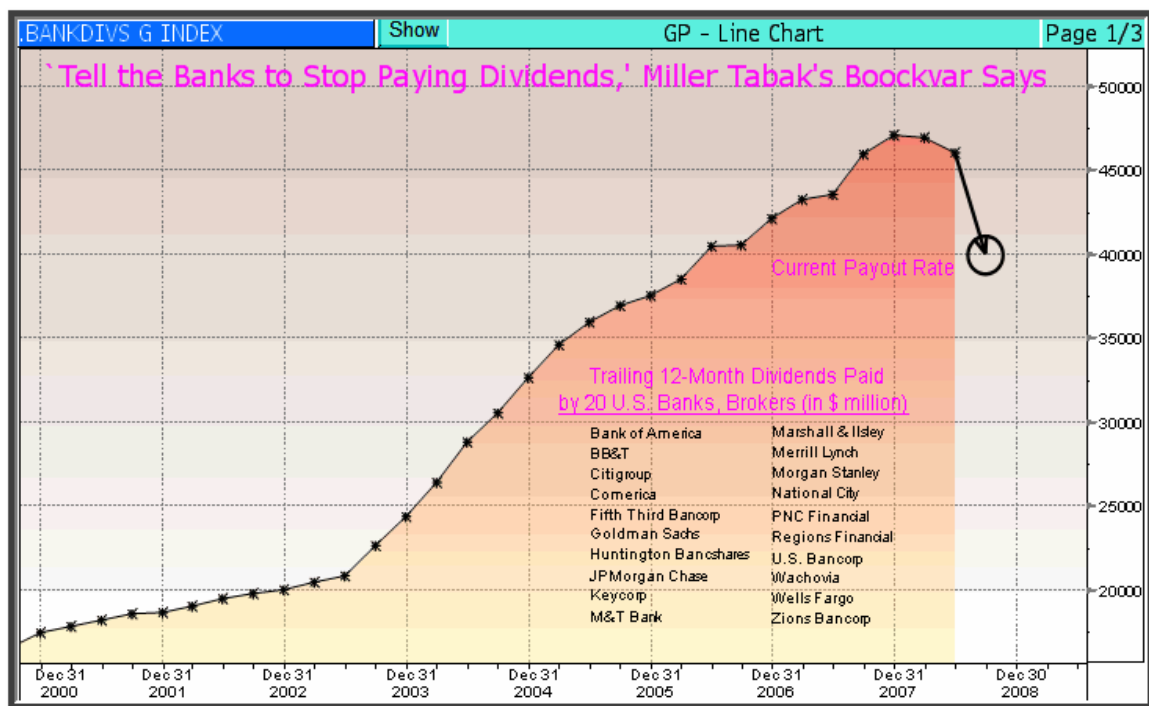
I should add that, unlike what Mr. Paulson says, falling house prices are not the problem. It is the huge leverage that is the problem. If your house is 100% self-financed (no mortgage outstanding) a rise or a decline in the value of your house has no direct economic or financial impact. In short, my view is that the bail-out plan is not addressing the cause of the problem, which is excessive leverage. Moreover, it is unlikely to help struggling homeowners but is designed to encourage even more speculation by financial companies. Peter Boockvar of Millar Tabak is furthermore concerned that it will lead to further bailouts (pboockvar@millertabak.com).

According to him, **"the Paulson bailout plan is a government bailout of the previously failed government bailout which was a bailout of the previously failed government bailout etc... Each bailout had its own unintended consequences which the next bailout tried to address. Greenspan bailed out the economy after the stock market bubble popped with 1% interest rates which sowed the seeds for the**

credit bubble. In order to bail us out, Bernanke slashed interest rates to 2% and a dramatic rise in commodity prices ensued. When that bailout didn't work, he instituted a bailout of the investment banks with the initiation of the TSLF and PDCF credit facilities for investment banks. That slowed down the deleveraging process as it gave the investment banks a false sense of security. I highlight Dick Fuld's comments soon after it began where he said it takes the liquidity issue off the table. The lack of dramatic deleveraging brought us to last week's panic in GS and MS, a failed LEH and a shotgun wedding for MER which led us to the Paulson bailout. The unintended consequence of this bailout will be a much lower US\$ and selloff in the US bond market which will leave us with higher interest rates and higher mortgage rates throw's the intentions of the Paulson plan out the window. Who will bailout this bailout"?

One solution Boockvar proposes would be for banks to cut their dividends in order to strengthen their capital (see Figure 1)

Figure 1: Banks should cut their Dividends!



Source: Peter Boockvar, Miller Tabak & Co. LLC

According to Boockvar, “here's a plan for Washington DC, tell the banks to stop paying dividends to their shareholders. I went back and looked at just 20 of the top banks, including GS, MS and MER and saw that they are paying out \$40 Billion per year out in dividends. The lending rule of thumb is \$1 of capital can service \$10 of lending. That is \$400 Billion in lending capacity that can get freed up. That is more than half of the Paulson bailout plan and it costs the taxpayer ZERO.”

Equally critical of the bailout plan is Professor Nouriel Roubini who correctly forecasted the current crisis. In a recent report he writes that the bailout plan “**is Rather a Disgrace and Rip-Off Benefitting only the Shareholders and Unsecured Creditors of Banks.**” Professor Roubini then discusses a recent IMF study:

“A recent IMF study of 42 systemic banking crises across the world provides evidence on how different crises were resolved. First of all only in 32 of the 42 cases there was government financial intervention of any sort; in 10 cases systemic banking crises were resolved without any government financial intervention. Of the 32 cases where the government recapitalized the banking system only seven included a program of purchase of bad assets/loans (like the one proposed by the US Treasury). In 25 other cases there was no government purchase of such toxic assets. In 6 cases the government purchased preferred shares; in 4 cases the government purchased common shares; in 11 cases the government purchased subordinated debt; in 12 cases the government injected cash in the banks; in 2 cases credit was extended to the banks; and in 3 cases the government assumed bank liabilities. Even in cases where bad assets were purchased – as in Chile – dividends were suspended and all profits and recoveries had to be used to repurchase the bad assets. Of course in most cases multiple forms of government recapitalization of banks were used.

But government purchase of bad assets was the exception rather than the rule. It was used only in Mexico, Japan, Bolivia, Czech Republic, Jamaica, Malaysia, and Paraguay. Even in six of these seven cases where the recapitalization of banks occurred via the government purchase of bad assets such recapitalization was a combination of purchase of bad assets together with other forms of recapitalization (such as government purchase of preferred shares or subordinated debt). In the Scandinavian banking crises (Sweden, Norway, Finland) that are a model of how a banking crisis should be resolved there was not government purchase of bad assets; most of the recapitalization occurred through various injections of public capital in the banking system.

Purchase of toxic assets instead – in most cases in which it was used – made the fiscal cost of the crisis much higher and expensive (as in Japan and Mexico).

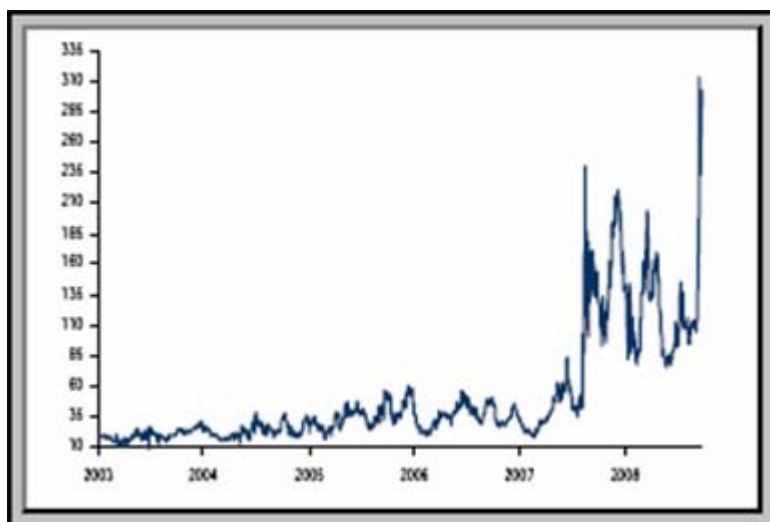
Thus the claim by the Fed and Treasury that spending \$700 billion of public money is the best way to recapitalize banks has absolutely no factual basis or justification. This way of recapitalizing financial institutions is a total rip-off that will mostly benefit – at a huge expense for the US taxpayer - the common and preferred shareholders and even unsecured creditors of the banks. Even the late addition of some warrants that the government will get in exchange of this massive injection of public money is only a cosmetic fig leaf of dubious value as the form and size of such warrants is totally vague and fuzzy.

So this rescue plan is a huge and massive bailout of the shareholders and the unsecured creditors of the financial firms (not just banks but also other non bank financial institutions); with \$700 billion of taxpayer money the pockets of reckless bankers and investors have been made fatter under the fake argument that bailing out Wall Street was necessary to rescue Main Street from a severe recession. Instead, the restoration of the financial health of distressed financial firms could have been achieved with a cheaper and better use of public money.

Indeed, the plan also does not address the need to recapitalize those financial institutions that are badly undercapitalized: this could have been achieved by using some of the \$700 billion to inject public funds in ways other and more effective than a purchase of toxic assets: via public injections of preferred shares into these firms; via required matching injections of Tier 1 capital by current shareholders to make sure that such shareholders take first tier loss in the presence of public recapitalization; via suspension of dividends payments; via a conversion of some of the unsecured debt into equity (a debt for equity swap). All these actions would have implied a much lower fiscal costs for the government as they would have forced the shareholders and creditors of the banks to contribute to the recapitalization of the banks. So less than \$700 billion of public money could have been spent if the private shareholders and creditors had been forced to contribute to the recapitalization; and whatever the size of the public contribution were to be its distribution between purchases of bad assets and more efficient and fair forms of recapitalization (preferred shares, common shares, sub debt) should have been different.”

In my humble opinion the bailout plan is badly flawed. But what else would you expect from the people Fred Sheehan quoted above! The plan is poorly designed because it fails to address how the excessive leverage in the system can be reduced at a measured pace and it also prevents the market from clearing at prices which would induce the private sector (private equity firms, sovereign and hedge funds) to recapitalize the financial sector. Also, compared to total credit market debt of \$51 trillion, a CDS market of \$ 62 trillion and a global derivatives market of notional \$1,400 trillion, a bailout with just \$700 billion is really just a drop in the bucket. Finally, I very much doubt that the bailout plan does anything to resolve the stress in money and the interbank markets (see Figure 2).

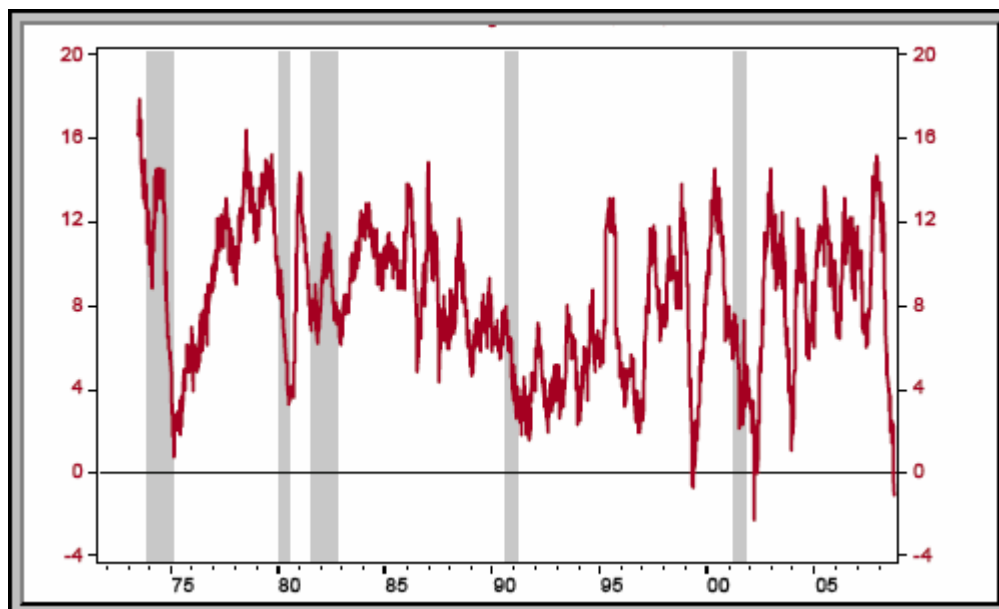
Figure 2: Ted Spread (basis points)



Source: David Rosenberg, Merrill Lynch

David Rosenberg observed that “the spread between 3-month Treasuries and Eurodollars, the so-called TED spread, is the widest in history going back to the mid 1970s, telling us that banks are not lending to each other. We had news of a large commercial bank failure, and equity stake holders are growing increasingly concerned about several other large deposit taking institutions. Make no mistake, the financial sector is in the midst of a massive deleveraging cycle, and that means it is only a matter of time before the capital market screws – from lines of credit to car loans – are turned even tighter for consumers and nonfinancial businesses” (see Figure 3).

Figure 3: Bank Credit is Contracting! Bank Credit: All Commercial Banks, 26-week percent change (SA. Billion Dollars)

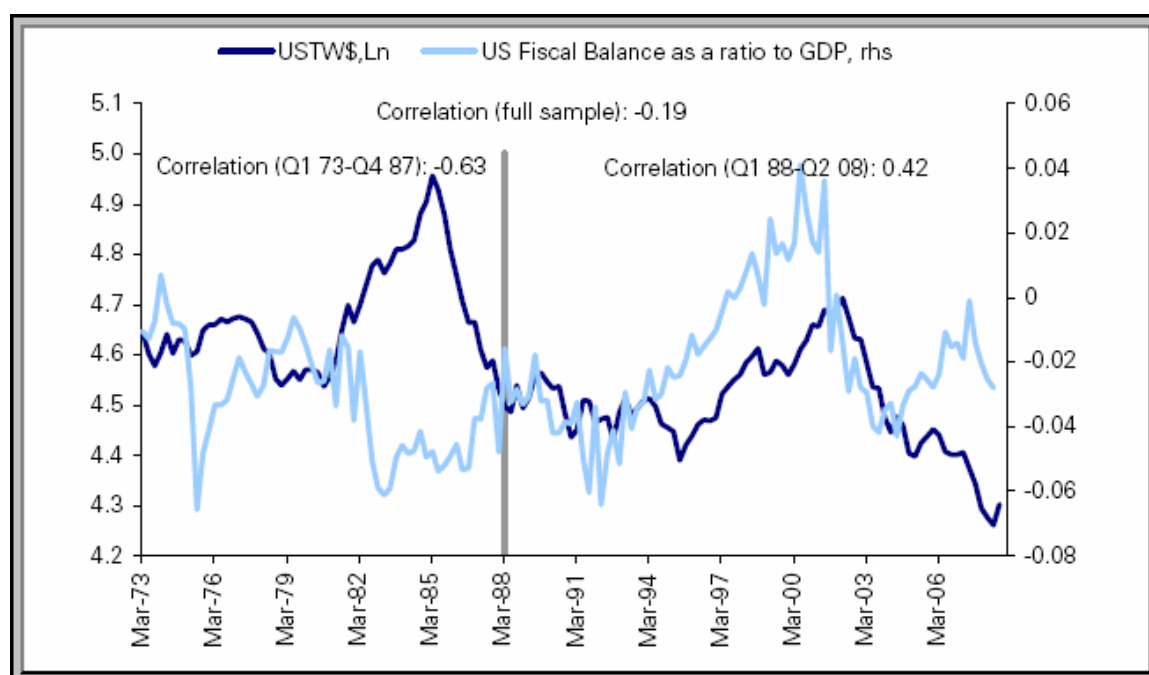


Source: David Rosenberg, Merrill Lynch

But enough academic talk! More important for us are the investment implications of the bailout plan (no matter how poorly designed) and the increasingly poor economic conditions around the world. Recently, a reader of this comment (I read all emails I receive), suggested that there is no logic in my call for a stronger US dollar. I think I have tried to demonstrate in earlier reports that in an environment of a relative shrinking global liquidity (declining US current account deficit) the US dollar should strengthen. However, I should also like to point out that in the world of investments logic should be used only very carefully. For instance, there is no logic in my mind why the Nikkei rose in 1989 to 39,000, why Hong Kong property prices continued to rise into 1997, why the NASDAQ rose above 5,000 in March 2000 and why the recent Damien Hirst sale was such a success. In fact, I need to admit that thinking logically cost me a fortune in 1999 because I had shorted high tech stocks already in 1998! Also, if you try to understand women logically you will never understand them – now I know that I shall again receive hundreds of emails about not being “politically correct” but trust me; I love them and I speak from some modest experience. I also have to admit that men are no better. As Charles McKay already observed at the beginning of the 19th century, “Men, it has been well said, think in herds;

it will be seen that they go mad in herds while they recover their senses slowly and one by one.” Markets can simply move in a direction that seems illogical to us. Take as an example the correlation between US fiscal imbalances and the US dollar. According to Deutsche Bank, there have been two regimes of correlation between US fiscal balance and the dollar: negative -0.63 during 1973-1988 and positive $+0.42$ since 1988, thereby supporting both views that larger deficits can result in a weaker or a stronger dollar (see Figure 4)

Figure 4: Correlation between US Fiscal Balance and USD, 1973 - 2008



Source: Deutsche Bank

Similarly, the US current account deficit exploded between 1981 and 1986 and the US dollar strengthened while after 1986 the current account deficit shrank and the dollar weakened. I suppose that market movements depend largely on the starting point of a market. In 1979, the USD was grossly undervalued and oversold and in 1985 it was grossly overvalued and overbought. Other important factors are of course interest rate differentials, which worked in favor of the USD between 1979 and 1985. But what I want to emphasize is that whereas in the very long run markets are probably rational and their movements logical, in the short to intermediate term they can be irrational and illogical. Personally, I did not understand why the Baltic Dry Index managed to make a new high in

May 2007, when a global economic slowdown was already evident. More rational was the performance of shipping stocks, which failed to confirm the new high in the Baltic Dry Index (see Figure 5 and Figure 6)

Figure 5: Baltic Dry Index, 2003 - 2008

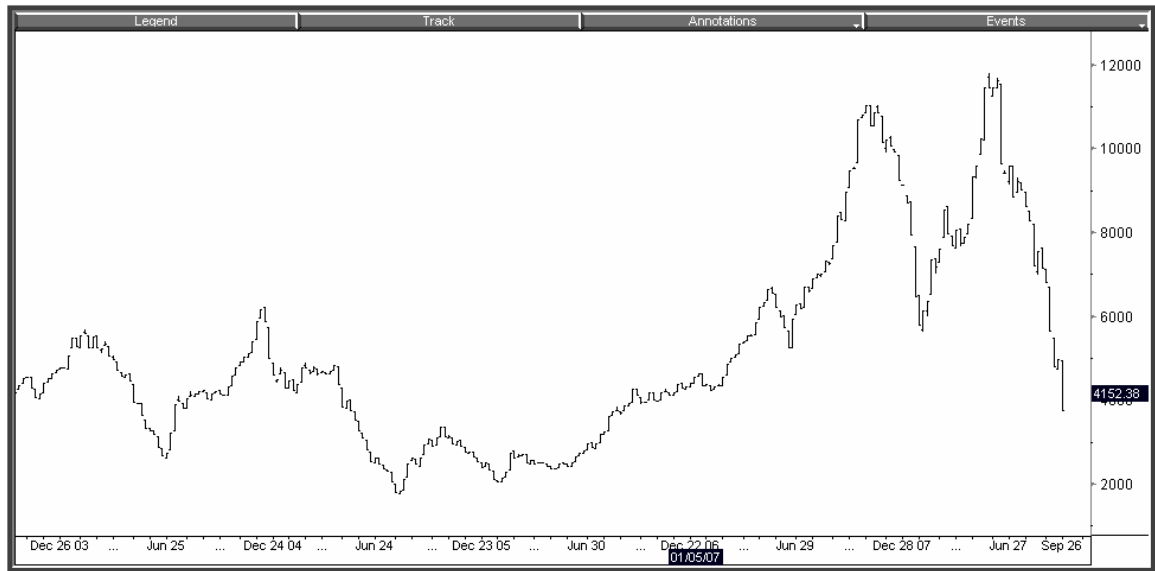
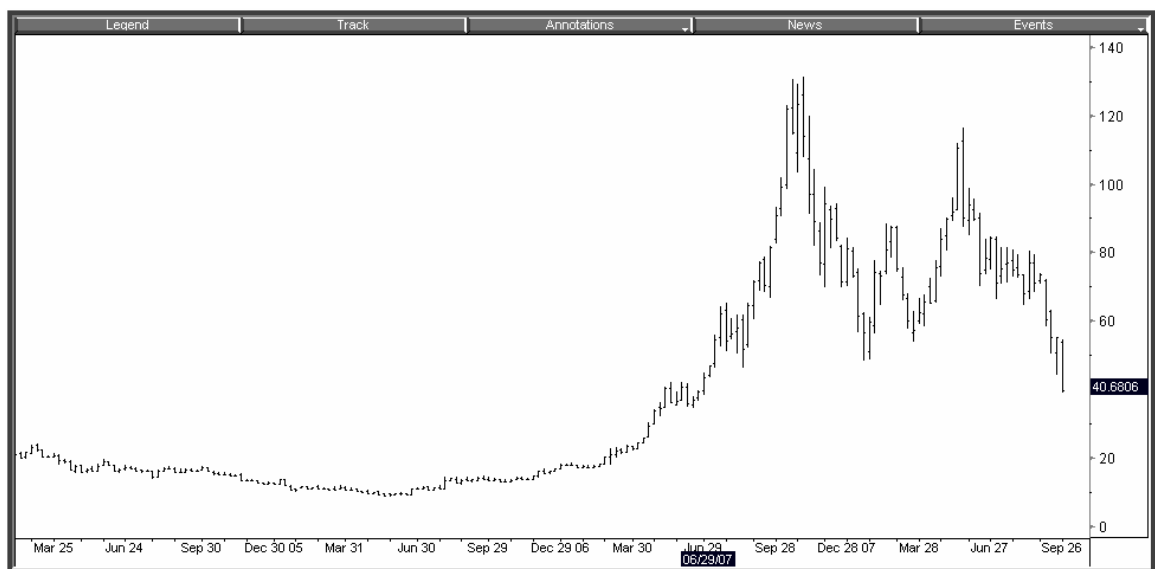


Figure 6: DryShips, 2004 - 2008

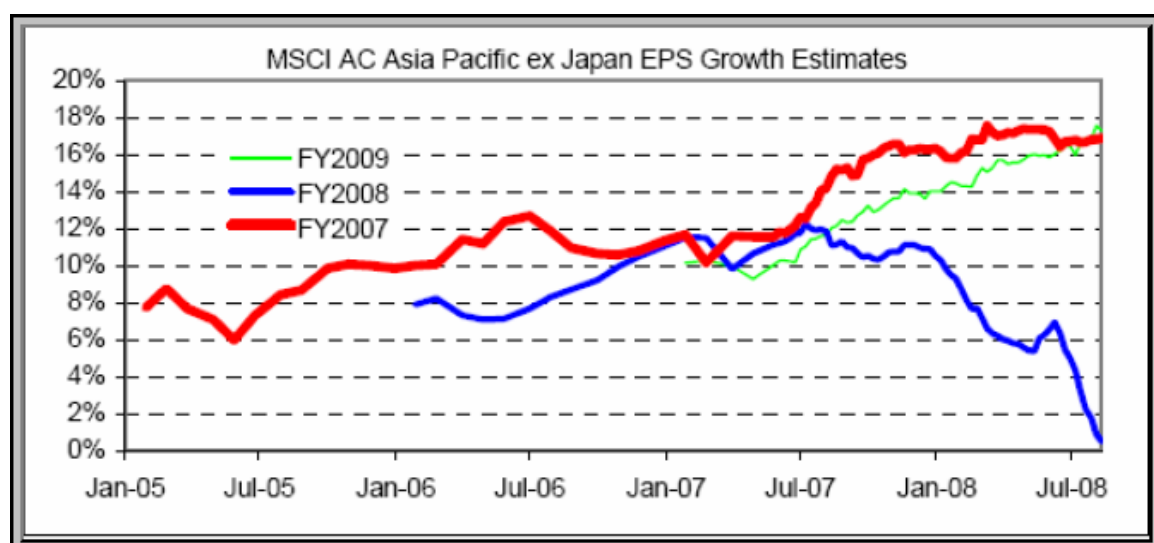


Source: Bloomberg

As an aside, I think investors should pay close attention to the reaction of markets to news. If the news is very good and a market or a stock fails to make a new high some caution is in order. Conversely, if the news is very bad and a market or stock fails to make a new low it might be a sign that the bad news has already been discounted by the market.

But getting back to the US dollar, one reason it may perform relatively well is that although the financial news coming out of the US is horrible, financial conditions in Europe could be even worse. According to Daniel Gross, director of the Centre for European Policy Studies in Brussels, **“the crucial problem on this side of the Atlantic is that the largest European banks have become not only too big to fail, but also too big to be saved.** For example, the total liabilities of Deutsche Bank (leverage ratio over 50!) amount to about €2,000bn (more than Fannie Mae) or more than 80 per cent of the gross domestic product of Germany. This is simply too much for the Bundesbank or even the German state, given that the German budget is bound by the rules of the European Union’s stability pact and the German government cannot order (unlike the US Treasury) its central bank to issue more currency. Similarly, the total liabilities of Barclays of around £1,300bn (leverage ratio 60!) are roughly equivalent to the GDP of the UK. **Fortis Bank has a leverage ratio of “only” 33, but its liabilities are three times the GDP of its home country of Belgium”** (emphasis added). In addition, I am not sure investors fully appreciate that earnings in emerging economies could be decimated next year (see Figure 7)

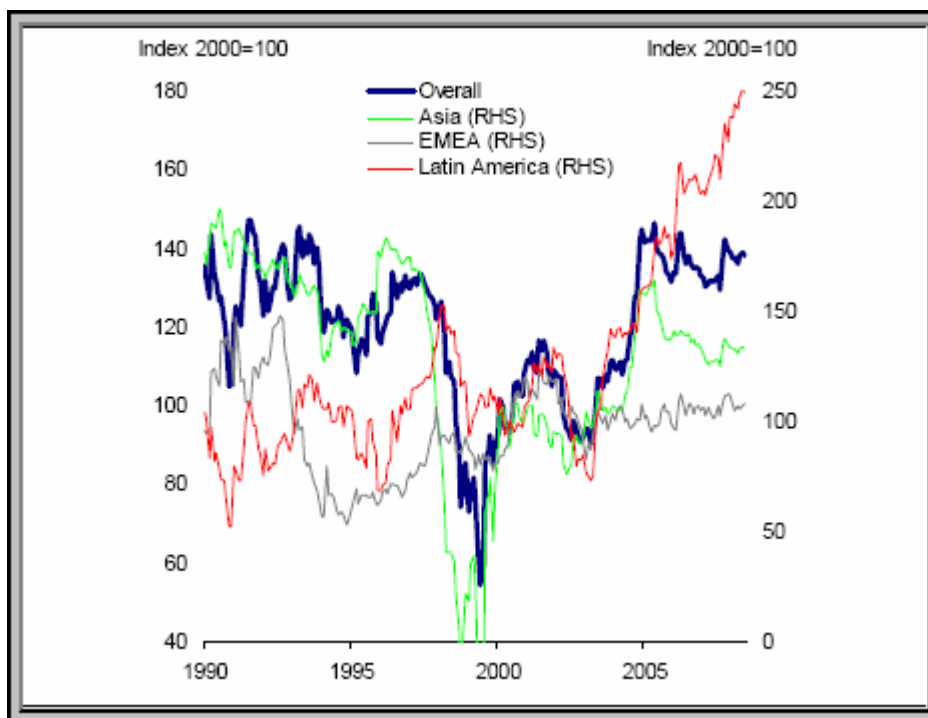
Figure 7: Asian EPS Growth Estimates for 2009 Seem far too High!



Source: Malcolm Wood, Morgan Stanley

I should add that earnings in Latin America are way above the trend-line of the last 20 years and vulnerable to significant downward adjustments (see Figure 8).

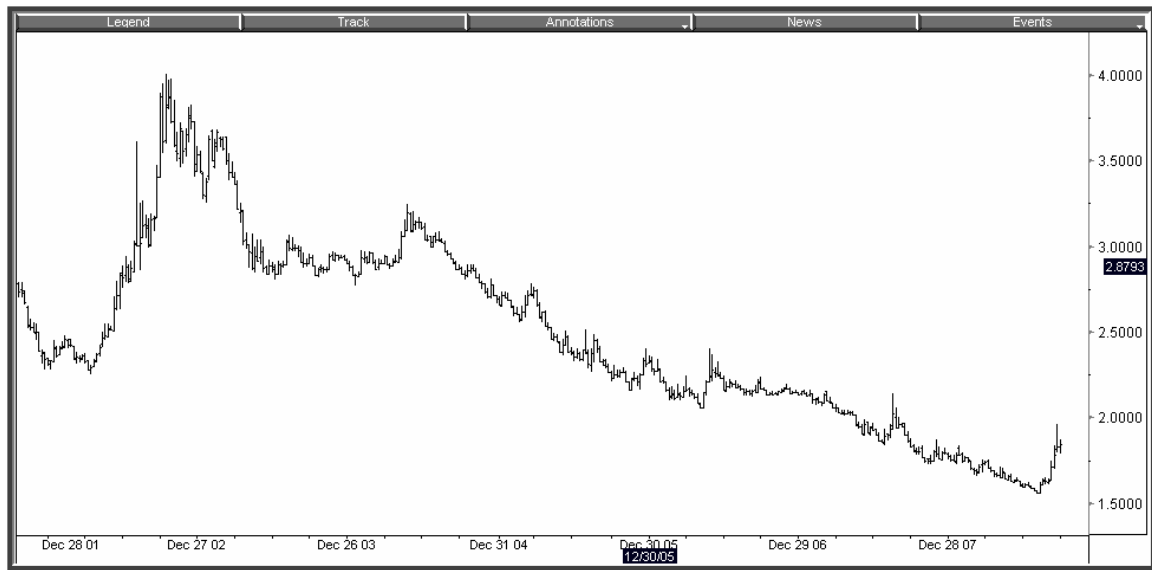
Figure 8: Emerging Markets Earnings-to-GDP Ratios



Source: Jonathan Anderson, UBS

So, whereas we are all aware of the problems in the US, emerging market investors who were dreaming of the decoupling theme could be in for some rude surprises (a friend of mine, Jim Walker, a top economist in Asia, thinks that in 2009 economic growth in Asia could decline to just 2%). Obviously, disappointing growth, which also seems to be indicated by the collapse in the Baltic Dry Index, would also weigh in on emerging market currencies (see Figure 9).

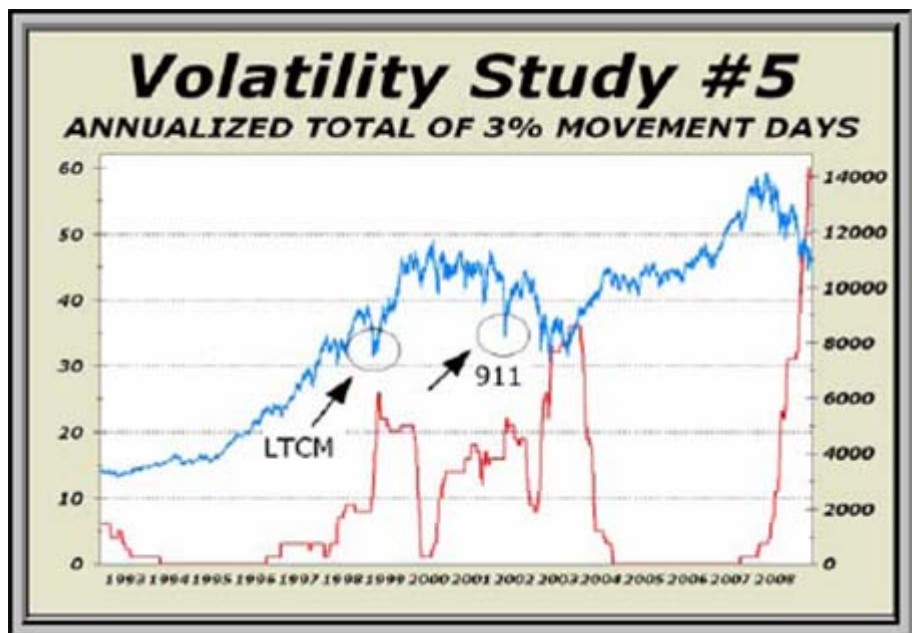
Figure 9: Brazilian Real, 2001 – 2008: a Weakening Trend?



Source: Bloomberg

Concerning the US stock market we note that there are several indicators, which suggest that a bottom should be reached shortly or has already been reached. New yearly lows exceed new highs by a wide margin, volume has picked up and volatility is extremely high (see Figure 10)

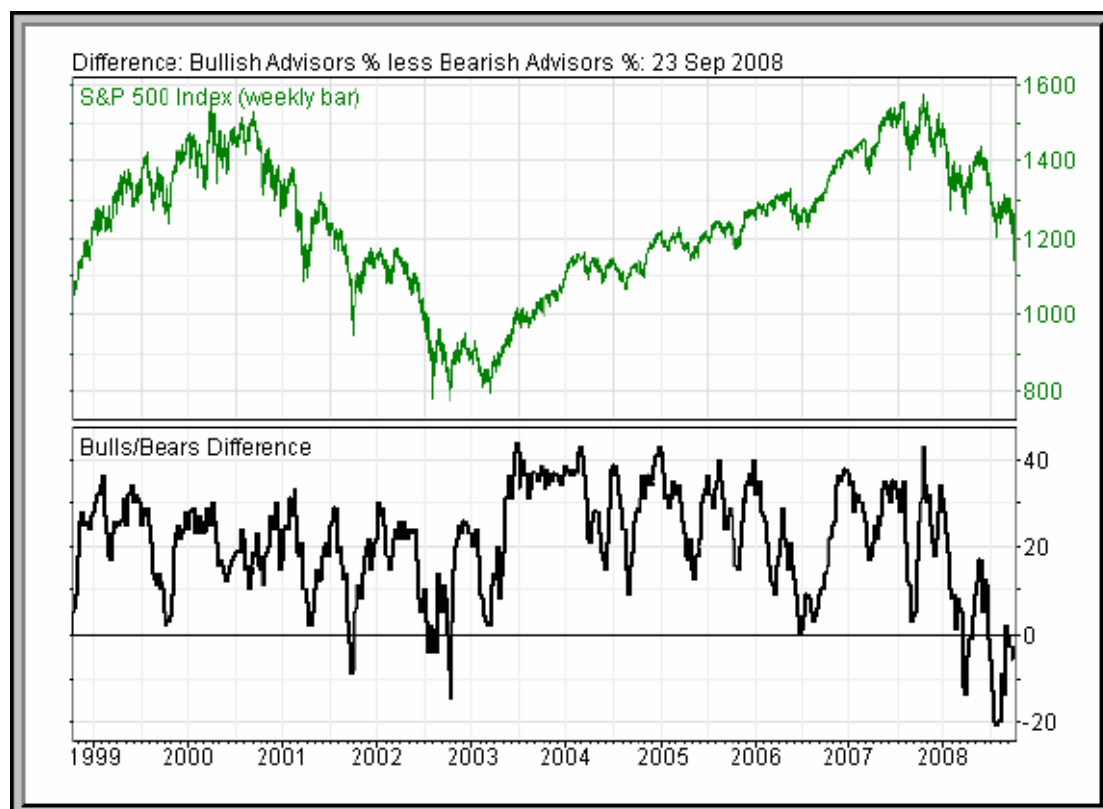
Figure 10: Extremely High Volatility occurs near Market Lows



Source: Alan M. Newman, Crosscurrents (alan@cross-currents.net)

In addition, sentiment is now extremely bearish (see Figure 11). I should add that the same way in a bull market sentiment can remain positive for a long time, in bear markets sentiment can stay negative for an extended period of time (please note how bullish sentiment remained extremely high in 2004 as the bull market was unfolding)

Figure 11: Bearish Investment Advisors at Levels Associated with Stock Market Lows.



Mike Burke, www.investorsintelligence.com

Lastly, as I indicated in earlier reports, a precondition for a low was the breakdown of until recently strong stocks such as Apple, Research in Motion, Amazon.com as well as of cyclical stocks such as steels, shipping and iron ore companies. So, whereas I find it hard to make a case for a strong bull market (new highs are almost out of the question) I could easily envision a powerful bear market rally beginning in October, which could propel the S&P 500 up between 10% and 15% and the extremely over-sold emerging markets by 20% or so.

As always, I continue to recommend investors to accumulate physical gold.