Rational Investing LLC

manish.aurora@rationalinvesting.com 212 466 1119 December 2009

The New Bolshevik Revolution, and the Opportunity for a Second Act in American Life

Governor Zhou Xiaochuan of the People's Bank of China and our very own Fed Chairman Ben Bernanke have made Sir Alan of Greenspan look like a capitalist. They have printed (or guaranteed, for those inclined to split hairs) the entire loss of market capitalization around the globe in last year's meltdown. All the bulls have been made whole. Talk about the new Bolshevik Revolution, with freshly printed dollars for all, right off the collectivist presses, politely called Quantitative Easing, sort of a 'voluntary gulag' for those American taxpayers under the illusion that we live in a capitalist society.

In the meantime, with apologies to Fitzgerald, this has produced the greatest opportunity ever offered for a Second Act in American life. The day before, Mr. Dennis Gartman, a newsletter writer, was complaining on CNBC that his broker cut the margin on his short position on the morning of the crash of '87, making what would have been a great day, a wash. Well, for all the assorted journalists, quantitative analysts such as yours truly, and other ne'er-do-well bears who saw the market's decline coming in 2008 but could not duplicate Julian Robertson's execution, here is the ultimate second chance to short the market and make their fortunes, or at least cement their invitations to CNBC's shows.

Quantitative Easing, or QE to its friends, 'printing money' to its enemies, is the band-aid that has stemmed the bleeding of over-levered financial institutions worldwide and created a historic rally in stocks. We are past arguing whether the Fed should have guaranteed $20+ trillion of on and off balance sheet exposure to the financial system. The real question is whether the market's gains are sustainable. Another important question is what the accompanying rally in hard commodities - gold, oil etc. is telling us.

Few politicians or central bankers would ever be willing to discover where the market would have cleared itself without intervention last fall, though on a valuation basis, it will get there sooner rather than later. Investors are misguided in believing the Fed can (or should) fight deflation perpetually. We wrote earlier in the year that a small amount of supply driven deflation is a good and normal outcome of innovation. What matters now is whether printing money leads to new lending. The answer depends on whether the aid recipient banks' current books are real a.k.a. marked to market, and they have sufficient capital to support those marks vs. their liabilities so they can continue making fresh loans. Adequate bank capitalization is the only step that will restore growth to the economy. Otherwise, we will be stuck with entities that have become levered distressed investors pretending to be intermediaries. Distressed investing has an important role to play as privately supported risk, but without involving institutions with FDIC backing meant to supply ongoing credit to the economy.

If commercial mortgages and levered loans are trading at a discount to their marks, then cutting interest rates below equilibrium to prop prices merely creates the mirage of cheap money. In reality, a typical senior (floating rate) bank loan, by setting Fed Funds to zero to offset asset value decline, has become a zero coupon subordinate credit risk. As a result, the real expected return to existing bank balance sheets is, say 8% even if the nominal return is 3%. Banks will sit on those assets, refinancing them at face value as debt, but in reality earning equity like premiums, until borrowers are capable of paying a real coupon or the loans can sell close to their marks. That process might take a half a decade for good credits. In other instances, market prices imply assets can never see their former nominal value, and the banks need to be liquidated immediately. Their number, unfortunately, grows by the day.

In the absence of real fresh credit available at par, this economy will face demand driven deflation, and that is not curable with QE. Instead of earnings bouncing back to support current consumption levels, it is consumption that can stall. Without real loan valuations, the supply of credit in the system is fake. In macroeconomic terms, the 'velocity' of money falls, and the creation of bank reserves is not able to offset this decline sufficiently to support the economy. Also fake, then, is the market's liquidity, often measured by bid-ask spreads on trading screens, if anyone has tried to sell more than 1,000 shares of a small or mid cap stock recently. The beneficiaries are, once again, arbitrageurs pretending to be bank holding companies. The result is a financial system fast becoming Orwellian in its architecture. We, the people of the United States, are deluding ourselves into believing that everything is back to normal, while the foundations of our society need rebooting.

One indicator of our troubles is that the TED (Treasury vs. Eurodollar interest rates) spread, usually an important short term indicator of systemic risk, is now useless as proxy for the supply of credit to the consumer or final buyers of assets, which remains severely constrained, with loan volumes down 15% and some rates past 30% p.a. The only assets not facing constraint are those where liquidity is assured – gold, copper, etc. Hence initially, it becomes possible to fight deflation by buying commodities which might merely outperform that deflation. If real estate, an important element of our consumption, falls by 40% and gold only falls by 5% from its inflated basis, many investors would rightly consider that to be a victory. But over time, commodity prices follow down those of industrial products. If that were not the case, then Japan would have been restored to growth long ago, and gold would have been hoarded by the Japanese. Instead, their consumption froze even though the typical Japanese household was far from levered, and the thought of hedging against inflation with gold does not even cross the mind of Mrs. Watanabe.

The rest of the Japanese prescription – deficit spending, massive bureaucratic intervention in the real economy, etc. has all failed outright. (Anyone recall MITI? Or its reference in the eighties to DRAM, which now goes for $10 a GB, as the new 'rice'?) The US need not bother trying again, though it seems bent on doing so. And Bernanke's prescription to the Japanese – price targeting – i.e. creating enough inflation to raise the price of benchmark goods by a certain percentage a year, might just achieve inflation worthy of the Weimar Republic instead if the Fed, er, overshoots or miscalculates changing consumer preferences. Such an outcome, combined with the current rate of deficit spending, will certainly achieve the New York Times' ambition of converting the USA into the UASS – Union of American Socialist States. But then again, when did the Fed ever err?

Why does QE hurt equities? And what is the time horizon, then of our analysis? The first answer is that as the economy slows and credit quality becomes less transparent, the cost of information rises and real economic risks get magnified. Public investors, who distrust amortizing cash flows, severely raise the market's discount rate, and this destroys the already diminished terminal value of firms. The information required to estimate terminal value at a time of low growth is very expensive. This is the greatest current flaw in prevalent US equity market valuation models – they are propagating low short term interest rates out the term and credit structure with little additional premium for an economy without growth, or at least without business incentives to grow in an age of government intervention.

The solution, therefore, is to allow all institutions that need to go bust to do so as rapidly as politically possible, and then allow remaining managements to grow their businesses again and have their equity priced accordingly. Accompanying this would be steps necessary to attract capital – the lowest marginal tax rates given a level of required taxation and limits on balance sheets of the government and guaranteed entities so that short term financing reaches private borrowers.

Until and unless we achieve this politically, the credit curve will remain quite steep, and this will hamper equity returns. The current spread between investment grade and junk bonds of almost 5%, which bond mavens find hard to explain, reflects the risks of this era quite accurately. And that spread will guide equity returns for the foreseeable future. If it widens again, equities will get trashed. If it tightens further, equities will hold up and move on from this crisis. But the surprise will be how wide spreads remain relative to the Treasury curve while the risk of error by intervening authorities does not go away.

So what explains the current rally? If there is some probability that printing money can heal the U.S. economy, and that the Nikkei's history reflects uniquely Japanese problems, then equity can trade at high multiples, and gold is a hedge against a central bank overshoot, creating oh, say, 13% inflation where they intended to create 3%. The indicators of success or failure – housing, retail sales, inflation, all pointed in the direction of turnaround recently on the back of government support, hence the rally. So where is the macro flaw in S&P 1100?

Japan's problems, while early, are not unique, and unfortunately neither is the collective wishful thinking of their bureaucrats and bankers. In macro terms, the flaw is explained by the velocity of money mentioned earlier. GDP = Price * Quantity = Money supply * Velocity, and if V's decline offsets M's rise, then the impact of QE on prices gets washed out. Given the money printed by the Fed is sitting as bank reserves guarding against discount loans inching back to par, rather than being lent out to create economic activity, this is the likely scenario.

Once the mid-term election looms, and double digit unemployment dominates the headlines, US voters will demand growth not financed by deficits. This began with the results of the Virginia and New Jersey gubernatorial elections. If the rhetoric out of the Californian contest (and, for that matter, the UK parliamentary elections) is any indicator, profligacy is going out of fashion.

During the S&L crisis, William Black, then deputy director at the former Federal Savings and Loan Insurance Corp., and others like him, forced a cleanup of balance sheets[1], and the RTC was used to sell off distressed assets. We need another Mr. Black, and another RTC, pronto, to repair corporate and national balance sheets. The Japanese chose otherwise, and the outcome is not one to look forward to. As things stand, a second leg to the bear market remains probable.

For a better understanding of how the current term structure of interest rates is impacting our equity valuations, please do not hesitate to write back or call.

1 http://online.barrons.com/article/SB123940701204709985.html