

Balestra Capital

Balestra Bulletin

November 30, 2009

The Balestra Bulletin is sent periodically to clients, friends, and other interested parties. It presents this writer's views on subjects that may be of interest to investors. Limited space and time do not permit a detailed exposition of the ideas, subjects and musings in print. Readers are welcome to contact us, however, for an in-depth discussion.

The panicky risk-averse investors of early 2009 have been lowering their standards in recent months and enthusiastically embracing risk in their efforts to catch up with the soaring financial markets. There are reasons for this extraordinary turnabout that have a certain logic and history. For one, anxiety among investment managers has rapidly shifted from panic over losses to fear of falling behind their performance benchmarks. Those investment managers who lost only 20% or 30% last year were given grudging respect for having “outperformed” the market; but everyone in this business knows that, while most investors will accept losing money along with everyone else, they will not for long tolerate lagging behind a rising market. Add to that the fears of institutional fund managers that those who lag behind the stampeding herd will be cut down by the pension fund consultants, even if the herd is heading over a cliff, and you have a rationale for this over-extended rally. Indeed, as this year’s rally raged on, even those managers who remain bearish have been forced to take on greater risk than they deem prudent in order to placate their clients’ demands.

Two other factors that have driven markets higher recently are momentum and, believe it or not, excess liquidity. After so much wealth destruction over the past two years, enough liquidity to drive this level of speculation would seem to be in short supply. But with interest rates at generational lows there has been ample opportunity to leverage securities and commodities markets into record-breaking rallies, especially with declining trading volumes as selling has slowed. And, as always, the rapid rise in securities prices has attracted the momentum traders like flies to honey.

Central bankers have slashed interest rates and poured money into their banking systems in a necessary and, thus far, successful effort to save the global financial system. They have been notably unsuccessful, however, in moving much of the stimulus into the real economy to create

jobs and private sector growth. The obvious exception is China where the state-owned banks do as they are told—and they were told to lend. China's GDP figures show a remarkable pick-up in the economy, with unprecedented increases in capital spending. Chinese stimulus money is going primarily into two areas: infrastructure projects (airports, highways, port facilities, etc.) and manufacturing companies for expanding production. This investment tsunami has not only buoyed China's economy, but also boosted major imports from suppliers in other Asian countries, such as Korea, Singapore, and Taiwan, along with raw materials from countries such as Brazil and Australia. Given the huge global output gap and the continuing rapid expansion of Chinese manufacturing capacity, one has to wonder who is going to buy all of this extra output. With the renminbi linked to the depreciating U.S. dollar, Chinese manufacturers will be fiercely competing with every manufacturer in the world on the basis of quantity and price.

It is also likely that a significant portion of the Chinese stimulus money has been leaking from the government/bank/corporate pipeline into speculative investing in equities, real estate, and commodities. The positive effect on stock and real estate prices is mostly domestic. However, the impact on global commodity prices is a different matter. Copper is a good example. When the commodities bubble burst last year copper bottomed at 2809.50/mt on December 24th. Since then it has risen more than 130% in a global economy that is projected by the World Bank to contract by -2.9% in 2009. Most of the other industrial metals appear to be similarly overvalued, with prices considerably higher than levels that would be expected under current supply/demand considerations. This situation appears to be remarkably similar to what happened in Japan during the late 1980s. Japanese corporations had easy access to credit at a time when stock market and real estate prices were soaring. Many of those companies found it more profitable to put borrowed money into equities and real estate than into expanding their own businesses. The negative effects of the crash that followed are still apparent 20 years later.

As a true long-term investor, Balestra has remained steadfast in its negative stance on all markets except precious metals and high-grade bonds. Over the past few months (after the rally was well established) we have heard many economists and Wall Street analysts explain that economic data and market cycles over the past 60 years clearly show that the recession is over and that both the global economy and investment markets will continue to rise. They are looking at the wrong 60 years. As we discussed in our February 25, 2009 Bulletin, 60 years ago after ten years of depression; five years of a world war; and another five years of recovery, which included a mild post-war recession, the United States was primed to enter a golden age of long-term growth and prosperity, when a confluence of major economic, social, and demographic factors reinforced each other in a virtuous upward spiral to produce a nearly continuous period of growth and prosperity. The major factors were:

- pent-up savings and consumer demand
- careful consumer spending and cautious use of credit
- the baby boom, which itself fostered the greatest increase in consumption ever
- cheap and abundant domestic energy sources

- women entering the labor force in large numbers, now accounting for half of all workers
- burgeoning international trade surplus
- low interest rates in the 50s and 60s, and especially since 2001
- steadily increasing easy credit until last year
- the primacy of the U.S. dollar during most of this period.

Over the past 60 years, and especially since about 1996, we have shifted to an economy in which major negative conditions have been pushing the United States along with the rest of the world into a self-reinforcing downward spiral. These factors include the following:

- extensive wealth destruction
- high and rising unemployment and underemployment of nearly 18% in the U.S.
- a record decline in housing prices, likely beginning another leg down, along with collapsing commercial real estate valuations
- over-leveraged consumers now increasingly squeezed by job losses, falling home prices, and heavy debt payments - with rising food and energy prices further limiting discretionary spending
- a continuing decline in credit, with consumer borrowing having collapsed into negative territory
- a declining U.S. dollar with an increasing shift to other currencies for international trade.

We are no longer in a golden age. We are in trouble. The correction of economic and social distortions that have built up over the past twenty years is underway. It is creating serious ongoing economic and social problems, and despite the reassurances of central bankers and investment pundits, there is no easy way to deal with it. The Fed's standard remedy for treating recessions by lowering interest rates and boosting liquidity has been seriously abused since 1982. The normal clearing function of recessions was aborted by an over-reactive monetary intervention in every case, while fiscal irresponsibility at all levels of government mounted unimpeded, and regulators were curtailed, reviled, or fired. These policies are not a template for remediation. As we wrote in a recent *Balestra Bulletin*: for policymakers to expect the most over-borrowed and over-spent consumers in the world to borrow and spend more in order to carry us out of this recession is foolishness. So we suggest that the experts change their playbook and look for guidance at the U.S. from the late 1920s through the 1930s, or more recently, Japan's ongoing tortuous financial struggle, which has its roots in the excesses of the 1980s.

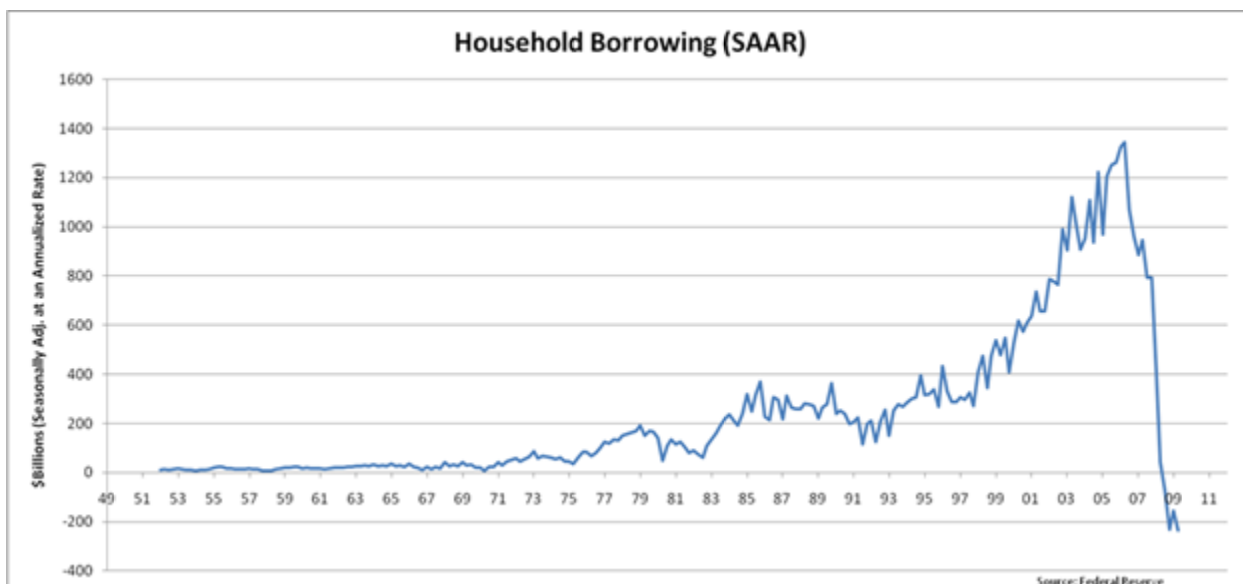
“The great tragedy of Science – the slaying of a beautiful hypothesis by an ugly fact.”

Thomas H. Huxley

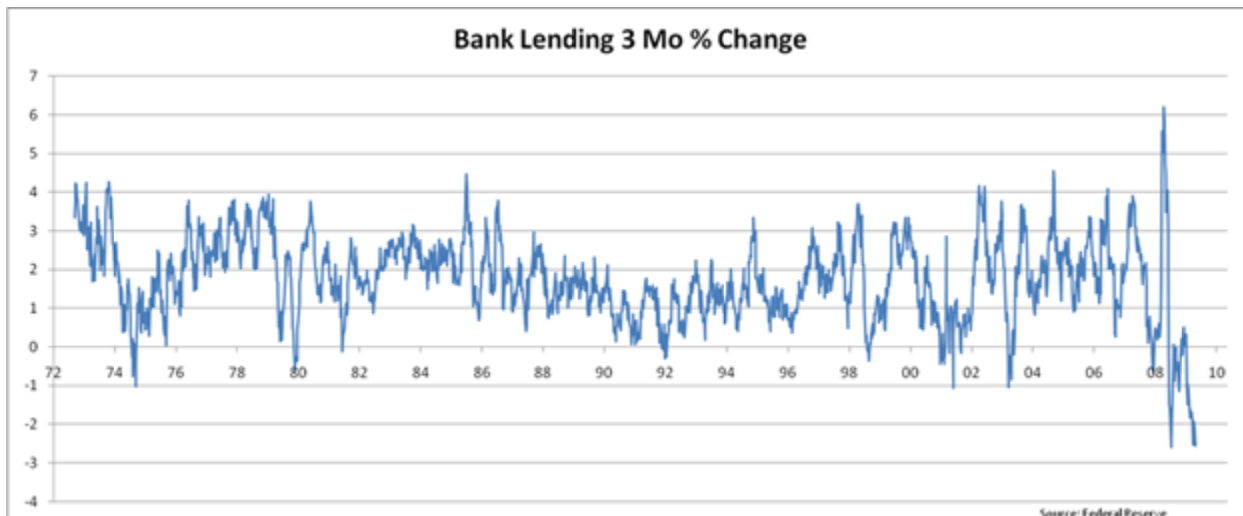
Over the past year central bankers rose to the occasion and saved the global financial system from total collapse. However, their options for halting an ongoing economic decline, much less re-igniting growth, remain severely limited. In fact their current efforts may actually cause worse and longer-lasting harm than letting the recession run its course. There is no doubt that central bankers and governments have the power to create enough currency to turn deflation into inflation, a la programs like “cash for clunkers”, tax credits for loosely defined first-time homebuyers, or even dropping dollars from helicopters. Unfortunately the stimulus has been stopping when the programs stop paying out. The Fed’s continuing programs to bolster the banking system are not doing much better. The banks, still heavily overleveraged, are hoarding cash in an attempt to rebuild their balance sheets; the money is not getting to the real economy. The paradigm for recovery from every recession of the past 60 years will not work this time without massive money printing. Yes, for reluctant consumers there is indeed a tipping point beyond which putting the government’s money in their hands will conquer their current fears of homelessness and hunger and get them to go out and buy new cars and bigger television sets. But the “ugly fact” here is that this policy almost guarantees out-of-control inflation.

We admit that a little inflation in the U.S. would not be a bad thing right now. In fact, along with pushing the value of the U.S. dollar lower, it appears to be current government policy. Unfortunately it likely entails more “ugly facts” such as foreign governments’ refusal to continue to finance our “borrow and consume” habit precipitating a currency crisis and rising trade barriers; a rapidly rising cost of living index coupled with falling household buying power; and hyperinflation - the worst of all possible outcomes. Nevertheless the Fed and the U.S. Treasury continue to push money into the financial system like French farmers feeding geese to make *foie gras*. Obviously some of the money is stimulating consumption. The important questions are: how much and for how long? Based on the actual data so far -- not nearly enough to stimulate growth and recovery.

At this point American consumers are just plain scared. The rate of job loss has been slowing (from disastrous to merely terrible), but new job growth is anemic. Actually the job loss rate is unimportant when it is more or less matched by the rate of jobs created, but today the disparity is huge, with six job seekers for every new job. Household wealth has evaporated, while household debt is at record levels. Consumption, which accounts for approximately 70% of GDP, is slowing dramatically and is likely to decline in percentage terms to levels not seen since the 1930s. The clearest indicator of this startling shift is seen in the change in household borrowing in dollar terms. After rising for 57 years (since the Federal Reserve began tracking the data) to \$1.3 trillion per year in 2006, it has fallen vertically to negative over the past year.



Credit creation in general has also plummeted, as the banks continue to focus on rebuilding their capital and repairing their balance sheets. In a still slowing economy loan demand by qualified borrowers has dried up, while needy borrowers are denied loans. We should add here that the rally in securities markets has provided a partial offset by enabling many corporations to issue bonds over the past few months. But small businesses, normally the wellspring of new jobs creation in previous recoveries, are starved of capital. In fact loan standards are much more stringent today than just 18 months ago—the opposite of what is necessary to stimulate the economy. We wonder what mechanism the bulls think will drive growth in the absence of any significant credit expansion.



“Oh that is nice work if you can get it. And you can get it - if you try.”

George Gershwin

So where is all of this supposed financial stimulus going? As mentioned above, banks are hoarding most of it and making easy profits by borrowing money from the Fed at near zero cost, and then lending it back to the federal government by buying Treasury bonds at rates ranging from 2% to 4%, depending on the bonds duration. Simultaneously borrowing and lending to the government with a fat interest rate spread is indeed “nice work”. With short-term interest rates at record lows hedge funds and other such investors are also doing nicely with the carry trade by leveraging up on cheap credit. Therefore, with relatively little of the stimulus money going into the real economy and with high quality bonds producing record-low returns, much of the stimulus money has been flowing to higher-yielding and higher-risk securities.

This search for returns has already started a new asset-price boom - an echo bubble – in stock and commodities markets, setting the stage for the next bust when the relevant financial data disappoints. The Fed’s current stimulus program is helping to push securities higher, but is not producing much benefit for the economy. China’s stimulus program has been successful in turbo-charging its economy because it created so much more liquidity relative to the U.S. and because it could force its banks to lend the money, primarily to operating companies and individuals. However, its program has also generated a classic asset-price bubble, and rising prices especially for commodities, will further constrict consumption by households in increasingly straightened circumstances.

We were happy to jump in and buy equities when the rally started in March. Why not! The S&P was down by 50%, central bankers were ensuring that the financial system would hold together, and we knew that the end of the credit freeze would allow goods to flow again, which in turn would enable a shift from disastrous to merely terrible economic performance. We bought stocks to hedge against possible losses in our holdings of credit default swaps, put options, and other negatively oriented securities because we thought it unlikely that a rally would mark the end of either the recession or the bear market. We have sold almost all of the equities over the course of the rally; in retrospect, some of them too soon. However, we have not changed our minds.

We believe that the U.S. and most other stock markets are now significantly overvalued, even if the recession is over. More importantly, we believe that the world has entered an extended period of economic, financial, and social turmoil and that the ability of governments and central bankers to deal with these problems is severely limited. The apparent solutions to some of these problems often conflict with or negate the effects of the others, thereby worsening the situation rather than helping. For example: faced with fierce competition from China, whose currency is again linked to the declining U.S. dollar, there is a real danger that politicians in countries with significant manufacturing bases will competitively devalue their currencies, raise tariffs and

institute other trade barriers – despite the lessons that should have been learned from the Great Depression. Lowering interest rates to promote growth can foster an ongoing asset price boom, which can crush discretionary consumer spending, as the rising costs of necessities, such as food and fuel, take a larger share of declining incomes. Giving cash to people to buy cars and houses prevents prices from falling to clearing levels and that can set the stage for renewed growth. The cost of expanding social programs in order to promote spending and job growth may be the debasement of the currency, which would lead to rapidly inflating consumer goods prices.

It is easy to criticize without offering a solution. Unfortunately we have not been able to devise any easy or painless way of dealing with these problems. There are choices to be made, however. We believe that the program most likely to bring the global economy back to reasonable health and growth is to maintain social spending at the humanitarian minimum, and to limit government spending to projects that will create long-term growth (education, research, infrastructure, etc.), while allowing prices to fall to affordable levels that will finally attract buyers again. Implicit in this policy is to cut all unnecessary government spending so as to restore confidence in the government's fiscal condition. Taking this path may be the least bad way to work our way back to economic health. Nevertheless, it will cause widespread economic distress and social unrest, and it will take time - perhaps several years. Continuing with current policies is likely to lead ultimately to considerably more pain over a longer period of time. Unfortunately, we think that our suggestion is not politically viable. We expect more temporary fixes, more government money spent with little or no beneficial effect, and continuing economic deterioration.

As is the case when we have been bearish in the past, we hope that we are wrong. We hope that the stock market rally is the beginning of a new bull market, that rising unemployment is indeed a lagging indicator instead of a leading one, that consumers will start to borrow and spend again, that the U.S. will export more than it imports and once again become a creditor nation.

We have reviewed most of the negative factors that are well understood by serious investors. We think it important to add here Balestra's view of the unknowns. It is of course the job of financial analysts to project outcomes based on available data. Many also try to incorporate what is not known into their deliberations, something that we have found particularly useful from time to time. We believe the current unknowns to be a major concern. For example, at the height of the financial crisis the banks were given special dispensation to mark their assets to their own financial models rather than marking them to market prices. As a result, nobody knows the true condition of banks' balance sheets; and certainly not the condition of the entire banking system. Yet this is a rather important factor in making any investment decision. When taking into account another unknown, the current values and likely courses of the commercial and residential assets held by banks, and the well-known high leverage on banks' balance sheets, we think that there is a significant probability that the U.S. banking system is seriously insolvent. We know that most banks are working to strengthen their balance sheets, but we have reasons to think that the "unknown" future prices of real estate will continue to decline over the next year or

two. On balance, as our readers have probably deduced by now, we think that the unknowns are looking pretty grim, which bolsters our caution and reluctance to jump into what looks to us like a short-lived echo bubble. An additional reason for caution lies in the fact that so many bearish investment managers have been forced into equities. This anomalous situation of fully invested bears has created the real possibility that some negative event or even a modest pullback in securities prices can precipitate a rout like the 1987 crash, as everyone heads for the exit at the same time.

Despite (or maybe because of) the fact that stock and commodities markets have been making new recovery highs in this uncertain economic environment, capital preservation has become a compelling strategy. Securities markets can go their own way for extended periods, realigning with economic reality only when they are forced to, so our crystal ball is not necessarily of much help without a clock attached. Therefore, we shall maintain our conservative portfolio positions, while we watch to see who is winning the battle between the central bankers and the recession. We are rooting for the bankers but the crystal ball says to lay odds on the recession.