



11th May 2009

A bull market that few are buying

“We refused to touch credit default swaps. It would be like buying insurance on the Titanic from someone on the Titanic.”

- Nassim Taleb.

It's not just what you know, it's who you know. And it's not just who you know, it's who you pay off. As the Center for Public Integrity reports (as cited in last week's Financial Times), the largest US originators of subprime mortgages spent roughly \$370 million on lobbying and campaign donations in Washington during the past decade in attempts to stave off tighter regulation of their industry. The study

“shows that most of the top 25 originators, most of which are now bankrupt, were either owned or heavily financed by the nation's largest banks, including Citigroup, Goldman Sachs, Wells Fargo, JP Morgan and Bank of America,”

who collectively originated \$1 trillion in subprime mortgages (almost three quarters of the total) between 2005-2007. That \$370 million was money well spent though, given that it was followed, in turn, as the mortgage market imploded, by \$700 billion – so far – in troubled asset relief funds – otherwise known as taxpayers' money. Who said crime doesn't pay? That's a return on capital some 1,891 times bigger than the original “investment”. Now **that's** leverage. Strangely enough, US politicians have been largely silent about their own complicity in the theft of the century.

GMO's Jeremy Grantham is a little more willing to discuss this obviously uncomfortable truth, and he does so in his latest, excellent quarterly letter. He also touches on the grotesque issues of moral hazard, not to say outright social bias, raised by the partisan attitude of the US administration, and others, toward the (previously deep-pocketed) banking sector:

“If a government invests directly, drawing employment from a large pool of the unemployed, and only invests in projects with a high societal return on investment such as hiring workers with well-stocked tool belts to install insulation, or repair bridges and transmission lines.. it seems nearly certain that such a government will never have to regret it. Keeping banks, bankers or even auto workers in business seems, in comparison, far more questionable. So questionable in fact that it must be justified by politics, not economics. We should particularly not allow ourselves to be intimidated by the financial mafia into believing that all of the failing financial companies – or very nearly all – had to be defended at all costs. To take the equivalent dough that was spent on propping up, say, Goldman or related entities like AIG (that were necessary to Goldman's well being), as well as the many other incompetent banks and spending it instead on really useful, high return infrastructure and energy conservation and oil and coal replacement projects would seem

like a real bargain for society. Yes, we would certainly have had a very painful temporary economic hit from financial and other bankruptcies if we had decided to let them go, but given the proven resilience of economies, it would still have seemed a better long-term bet. But, as I said, this is all just speculative theory and I don't have to deal with Congress."

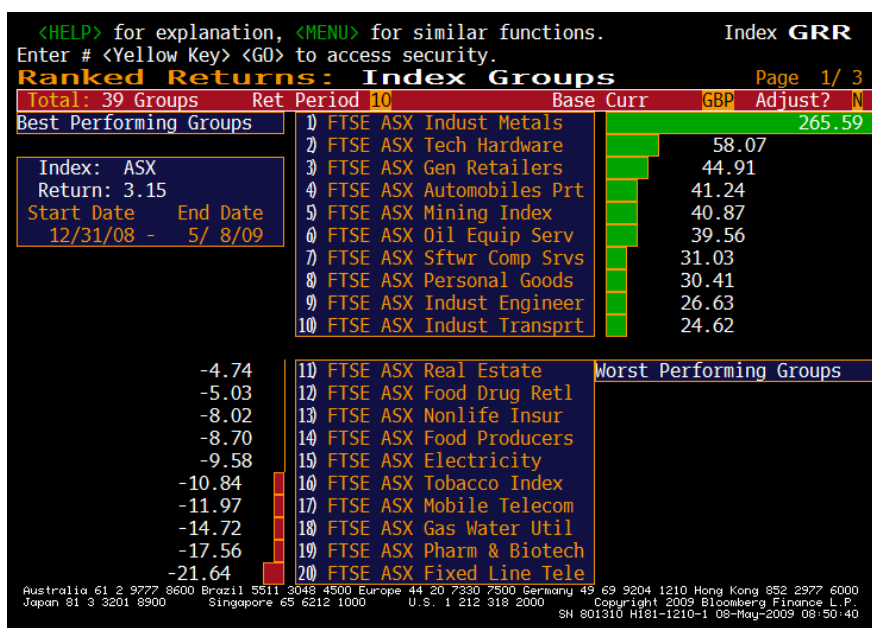
That last observation may not be strictly accurate, inasmuch as all of us working in finance are now braced for more intrusive and poorly thought-out regulation thanks to our cousins in the banks.

To add insult to taxpayer injury, Bloomberg was quick to report that Goldman Sachs was judged to have sufficient capital after the widely leaked Geithner banking stress tests. In practically the same breath, the news service reported that Goldman reaped more than \$100 million in trading revenue on a record 34 separate days during the first quarter of 2009. The previous peak was 28 days during Q1 2008. Will US taxpayers be getting back their rightful share of those proceeds, one wonders. But in any case, US banks making good money during the first quarter does not exactly require superhuman ability. As Niels Jensen of Absolute Return Partners points out,

"Of course US banks made good money in Q1. The environment created for them is the equivalent of the US government reducing the cost of goods to zero for its embattled car manufacturers and then going on to buy – courtesy of the US tax payer – a couple of million cars that nobody really needs. Even Detroit would make money given those conditions !"

In any event it is the sudden and somewhat mystifying recovery back to health by the equity markets that is leaving more than a few market-watchers and putatively professional investors scratching their heads. How can a still deteriorating macro economy, an ongoing dearth of banking credit and a dreadful global trade outlook be consistent with a sharp recovery by stocks ? There are several answers. One is that the heroic diversion of taxpayers' money toward the banking system has temporarily goosed a capital-sensitive and sentiment-sensitive stock market – this, essentially, is Grantham's view. Another is that professional investors have been sitting on the sidelines for a sufficient length of time that they are scared at the prospect of missing a suddenly fast-moving train, irrespective of where it is headed. Another is that short-covering managers have voted with their feet. Another still is that the financial crisis is nearly over and the global economy is headed for recovery. Anybody who truly believes this last scenario should be sectioned.

A rally built on sand ? Relative performance by FTSE sectors, year to date



A glance at the best and worst performing index sectors within the FTSE this year shows that the rally has explicitly favoured the most cyclical and recession-vulnerable stocks: industrial metals; retailers; automobiles and parts; industrial engineers.. But the rising tide has not lifted all boats – defensives like food producers; utilities; tobacco; pharmaceuticals and telecoms stocks have all suffered negative returns. That admittedly reflects just how bombed-out and oversold many cyclical businesses became during the first quarter, but it strongly suggests a relief rally as opposed to a sustainable one. Because as the IMF recently indicated in its World Economic Outlook, recessions triggered by financial crisis are inevitably more severe than regular business cycle recessions, and recoveries are typically slower, impeded by weak private demand and credit and a steady rise in household savings.

There is another reason to fear that the rally's foundations are less than secure, and they come in the form of the dead hand of (inconsistent) government intervention, specifically but not exclusively in the Anglo-Saxon economies. For breathtaking hypocrisy, note for example the scolding issued by President Obama to bond fund managers within the hedge fund community for opposing a government rescue that compromised their duty to their investors:

“While many stakeholders made sacrifices and worked constructively, I have to tell you some did not. In particular, a group of investment firms and hedge funds decided to hold out for the prospect of an unjustified taxpayer-funded bailout. They were hoping that everyone else would make sacrifices, and they would have to make none. Some demanded twice the return that other lenders were getting. I don't stand with them. I stand with Chrysler's employees and their families and communities.. I don't stand with those who held out when everybody else is making sacrifices..”

Evidently those hedge funds **didn't** spend enough on lobbying. As hedge fund manager Cliff Asness of AQR responded,

“Managers have a fiduciary obligation to look after their clients' money as best they can, not to support the President, nor to oppose him, nor otherwise advance their political views. Let's be clear, it is the job and obligation of all investment managers, including hedge fund managers, to get their clients the most return they can. If they give away their clients' money to share the 'sacrifice', they are stealing.”

And as Bill Gross of Pimco pointedly observed, as Adam Smith's invisible hand comes to resemble more and more the public fist of government, asset values will be negatively affected:

“First comes the haircutting and burden sharing, most recently evidenced by Chrysler and soon to be played out via the stress testing and equity dilution of government ownership of ailing banks. In those footsteps, however, will follow a slower rate of economic growth, not just in the US, but worldwide as heretofore libertarian capitalism is bridled, saddled and taught to trot instead of gallop over the investment plains.. the Obama cannon shot will have financial consequences. Do not be deceived by the euphoric sightings of “green shoots” and the claims for new bull markets in a multitude of asset classes. Stable and secure income is still the order of the day.”

So a war on terror is followed by a war on free markets, wherein those special interest groups (namely bankers) who bribe politicians most heavily get the greatest protection, while other financiers whose businesses don't involve millions of voters and who never required a penny of taxpayer support get publicly flayed. Those of us watching aghast at the incineration of the public finances in the UK at least have the grain of comfort that the current socialist administration will almost certainly be voted out of office within the next 12 months. Our friends in the US have an

altogether longer wait – and many will no doubt be regretting their support for the Big Government they have landed themselves with.

Tim Price
Director of Investment
PFP Wealth Management
11th May 2009.

Email: tim.price@pfp.co.uk

Weblog: <http://thepriceofeverything.typepad.com>

Bloomberg homepage: PFPG <GO>

Important Note:

PFP has made this document available for your general information. You are encouraged to seek advice before acting on the information, either from your usual adviser or ourselves. We have taken all reasonable steps to ensure the content is correct at the time of publication, but may have condensed the source material. Any views expressed or interpretations given are those of the author. Please note that PFP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. We have no control over the availability of linked pages. © PFP Group - no part of this document may be reproduced without the express permission of PFP. PFP Wealth Management is authorised and regulated by the Financial Services Authority, registered number 473710.

FP 1032/09/SB