

GLOBAL MARKETS

The Paulson initiative

INVESTMENT CONCLUSION

In the past week the US and the global financial system has been yanked back from the brink of collapse by a raft of policy initiatives, culminating in the US Treasury plan to buy up to \$700bn worth of mortgages. The long-term impact on the economy of many of these measures is at best doubtful. But the impact on markets is not. Risk assets will continue to rally.

The Big'un (see our report, *The coming big'un*, 17 July 2008, where we increased our equity weightings on expectation of a big rally) is now upon us. Believe it or not, the US equity market closed on Friday almost exactly where it was in July! We got rid of our short credit positions and long volatility (VIX) positions last week (see our report, *Meltdown*, 18 September 2008) and increased our holdings of US yield steepeners. We now reluctantly need to do even more.

We're increasing equity weighting further from neutral to overweight at the expense of US bonds and global cash. We do not expect to hold this position for longer than a month or two while the current rally lasts. The rally will be like food and sex — better in the anticipation than in the realisation of the economic act to follow.

The principles of restructuring

We are not positive about all the policy actions taken to pull the world back from the abyss. In the forest of 'saviour' measures being thrown up around us we have some very simple criteria (see our report, *A short history of the Sovietisation of the American Tractor*, 20 May 2008) to judge the quality of the timber:

First, any action that socialises credit or risk or provides free bailouts to creditors and, particularly, to bankers is bad.

21 September 2008

This memorandum is based upon information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell or a solicitation of an offer to buy or sell the securities mentioned herein. It is provided solely for the information of professional investors who are expected to make their own investment decisions without undue reliance on this memorandum. Independent Strategy Limited has no obligation to notify investors when opinions or information in this report change and may disseminate differing views from time to time pertinent to the specific requirements of investors. Independent Strategy Limited is authorised and regulated by the Financial Services Authority in the UK. Save for any liability or obligations under the Financial Services and Markets Act 2000, Independent Strategy Limited accepts no liability whatsoever for any direct or consequential loss arising from any use of this memorandum and its contents. It may not be circulated to or used by private investors for any purpose whatsoever, or reproduced, sold, distributed or published by any recipient for any purpose without the written consent of Independent Strategy Limited.

Second, any measure that moves us towards classic restructuring is good. Classic restructuring means that central banks provide limitless liquidity to keep the system afloat, theoretically (according the Bagehot principle) at punitive rates; although the Scandinavians were successful at making limitless liquidity available to the banking system for free in their recurrent bank restructurings.

Third, under classic restructuring, government, using a special agency, obliges (by independent audit) banks to recognise and write down their bad loans and attached assets to market or 'fair' value and to register the corresponding hit to their capital. Banks that are thus made insolvent are nationalised and then either recapitalised and sold off or liquidated. The nationalised bank management is fired and nationalised shareholders lose their investment, but the debts of the banks are guaranteed by the state.

We have been teased by some clients as wearing hair shirts as principles. Indeed, we are morally outraged by the arrogance, greed, incompetence and stupidity of bankers. But however satisfying their come-uppance might be, this is not why we apply such principles in policies to deal with the credit crisis. It is because any course other than classic restructuring results in a dysfunctional capital allocation that is against the interest of all investors. That is not to say that markets that are suffering from a dearth of liquidity won't boom when any measure, good or bad, acts to increase liquidity. Such relief rallies are finite, however.

Classic restructuring or 'soft option'?

Since the credit crisis began, the US has almost invariably travelled the wrong road and is now the most socialised democratic economy in the world. The vast majority of credit is now either directly lent by government or by institutions that would not be able to lend were it not for intervention of the state or central bank. Much credit risk has also been socialised by government guarantee.

The reasons this needs to be reversed are two-fold. First, market capitalism cannot function without pricing risk. Second, uncleansed loans and assets on banks balance sheets and in the economy (remember all those 'walking-dead' zombie corporations that blighted the Japanese economy for a decade?) prevent the efficient allocation of capital.

The most recent crop of policy initiatives is not promising. Government guarantees (\$50bn from the Exchange Stabilization Fund) for money market funds that have wilfully and stupidly invested in illiquid assets is

simply the transfer of risk to the state and a free lunch for ignorant investors and incompetent managers.

Fed lending (limitless amounts at the discount rate for 270 days) to banks in order for them to buy asset-backed commercial paper as well as GSE agency debt is more of the same. The nationalisation of the bankrupt GSEs, Fannie Mae and Freddie Mac, necessary though this may have been, should be followed by a shrinkage or elimination of their role. Instead, they are being required under the latest Paulson initiative to play an even bigger role in providing 'soft option' mortgages by increasing their purchases of mortgage-backed securities.

The one measure that made complete sense last week was coordinated intervention by major central banks to inject \$180bn worth of liquidity to financial markets at the nadir of the crisis. That is exactly what central banks should do in such a crisis. But 'restoring liquidity' or 'normalising credit conditions' is also the justification given by the US government for most of the policy measures discussed above. It doesn't wash!

For example, bailing out money market funds may be necessary to restore liquidity in the 'frozen' wholesale markets upon which banks depend (overly because they are run by morons) for their funding. But why should the managers and owners of the toxic assets that made the markets freeze in the first place not be subject to nationalisation, dismissal and their owners to haircuts?

For a few brief moments last week when Lehman went bust and AIG was nationalised and funded at penalty interest rates, it appeared that the US administration had seen the light and the tough love of classic restructuring was going to be the new policy. Alas now, having read the latest Paulson bill, we fear we are back to training Pavlov's banker dogs to piss in the carpet of capitalism. We shall live with the stink and stain for along time.

The bank bailout

The latest Paulson initiative for the US treasury to purchase up to \$700bn worth of mortgages lacks much detail. But the runes are looking bad because of what is omitted rather than what has been committed.

Let us suppose for a second that the reason the banks can't lend is because they have so much toxic assets that they have destroyed their own capital and so must shrink their loan books and deleverage their

balance sheets. Further, let us assume that the bankers know this of themselves and of each other, which is why the banks have stopped lending to each other.

Along comes the US Treasury (Dolby surround sound of cavalry approaching) and says: “forget it guys (and gals), we’ll relieve you of those toxic assets and you’ll be right as rain”.

But the toxic assets are still toxic, right? So at what price will the US Treasury buy them? Undisclosed is the answer! In the draft Paulson bill there is no mention of the price to be paid or the process of negotiating it or to how to deal with the consequence of asset and loan writedowns within the banking system. It may emerge later. But it isn’t there now.

The success of the Resolution Trust Corporation (RTC) set up in 1989 to resolve the savings and loans (S&L) crisis was because it marked down the value of the toxic assets it took from the thrifts to market price and then sold them in the market. So the market cleared toxic assets and loans. The banks had to match the valuations of the RTC for their remaining loans and assets as well as for the ones sold to the RTC. Even the Home Owners Loan Corporation bought (with low-yielding government paper) defaulted mortgages at only 80% of appraised value of the underlying property, and that was in 1933 when 50% (not 5%) of US mortgage holders had defaulted.

In other words, the success of the RTC programme was that it surgically cleared bad assets out of the banking system by forcing writedowns on the banks and clearing the overhang of bad assets through the market in return for refinancing.

Inevitably, writing down the loans and assets of the banking system results in insolvent banks. Thus there is a need for the establishment (in the same breath as setting up the government initiative to take over the toxic assets) of a Restructuring Agency to recapitalise, dispose of or liquidate insolvent banks. There is no such provision in the Paulson initiative.

This lacuna can only mean that the price that the Treasury intends to pay for the toxic assets will not mean big write-offs for the banks, despite the provision in the legislative proposal that the Treasury would “take into consideration” protecting taxpayers in addition to promoting market stability. This is also the reason why the Treasury can either hold to maturity or sell the mortgages it acquires. It is also perhaps the reason why the initiative extends to commercial mortgages, the ones bankrupting the regional banks more than the money centre ones.

A free lunch?

The grave danger here is that this is yet another free banquet for the Wall Street *nomenklatura* provided by their brethren in the administration, styled up to be for the greater good of the people. And it will be a very big banquet indeed, one much to be celebrated by the City and the Street. At \$700bn the package is about \$200bn bigger than the (net) losses (after foreclosure and recovery) that we have anticipate for residential and commercial mortgages in the US financial sector. So bankers are going to get a lot of cash or discountable treasuries for their toxic assets.

The financing will be through issuance of treasury bonds, many of which will have to be long maturity if they are to match that of the assets being bought. Given this and the other programmes to be financed by treasuries, it is likely that the US government's borrowing requirement will rise to close to 100% of GDP next year. That is one good reason we are long yield steepeners.

On balance, the package should be positive for the dollar in the short term because it makes cyclical recovery of the US economy ahead of Europe and Japan more likely. But it also boosts the US budget deficit, the national savings deficit and the need for external financing. Markets will start worrying about this before the year end. By the same token, it is likely to result in lower gold prices (because systemic financial risk is reduced) and higher commodity and oil prices, for a while.

If this turns out to be a 'soft option' bailout, the US economy will suffer from impaired financial sector balance sheets and misallocation of capital for a very long time to come to the detriment of the performance of financial assets and the dollar. So enjoy the banquet while it lasts, which may not be very long.

Perhaps the greatest failure of the package is its vision. It seeks to prolong a credit-addicted, thriftless society whose time is over. It seeks to minimise pain where pain is inevitable if things are to change for the better in a durable manner. Wasn't it a European central bank that spoke of a "necessary recession" to correct global imbalances? At the heart of global imbalances is the US consumer, who has become addicted to credit as a material bridge between what he or she buys and earns. This package seeks to prolong that ultimately fatal addiction.