Fanning the Financial Crisis' Fire

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Treasury Secretary Henry (Hank) Paulson recently expressed the opinion that the financial markets are emerging from the credit crisis and that "the worst is behind us." He also opined that "there is no doubt that things feel better today, by a lot, than they did in March." Hank, who in the first place never saw the onset of the crisis, also expressed the view that the Fed's decision to bail out Bear Stearns and to provide liquidity to other investment banks (read "also bail out") is "an inflection point" in the crisis. The stock market seems, however, to have a different view (see Figure 1).

Figure 1: Philadelphia Bank Index approaching new Lows!

Source: www.decisionpoint.com

I may add that in confetti which are printed with better quality paper (Euros) the performance of the Philadelphia Bank Index is far worse (see Figure 2)

Figure 2: Philadelphia Bank Index in Euros, 1996 - 2008

But it is not only the stock market which disagrees with Mr. Paulson's cheerful view. Other dissenters of Mr. Paulson's optimism are well informed financial analysts such as RBC Capital's Gerard Cassidy whose proprietary "Texas Ratio," which is calculated by dividing total Non Performing Assets (NPA – including 90+ days past due loans) by tangible capital plus allowance for loan losses, in effect measures credit problems to capital. According to Cassidy, who created the Texas Ratio from his experience with Texas banks in the 1980s and Northeast banks in the 1990s, "when the ratio exceeded 100% in the late 1980s - early 1990s, it was a solid indicator for potential bank failure." His view can be summarized as follows:

"We continue to believe the biggest issue confronting the banking industry over the next 12-18 months will be credit deterioration. Residential mortgage delinquencies are at record levels, home equity loan defaults are steadily rising and residential construction and land loan nonperforming assets are skyrocketing for lenders with excess exposure to the weakest housing markets in the US. The 'Next Shoes to Drop' for credit in conjunction with the slower economy will be in the commercial and industrial (C&I) and commercial real estate loan areas….The companies with ratios in excess of 100% combined with a [sic] nonperforming asset ratios greater 10% have a higher probability of failure….Today, the huge amount of capital raised by banks has enabled companies to keep their Texas Ratios lower than what normally has been the case in prior credit cycles…..We continue to believe that we are in the '3rd or 4th inning' of this down leg in this credit cycle. Therefore, investors should expect to see higher Texas Ratios and more bank failures before we reach the final inning of the game. **Currently, we are forecasting an estimated 150 bank failures over the next 2-3 years. Bank stock prices will likely suffer as the game plays out over the next 12 months and investors should remain underweight in bank stocks at this time"…..** (emphasis added).

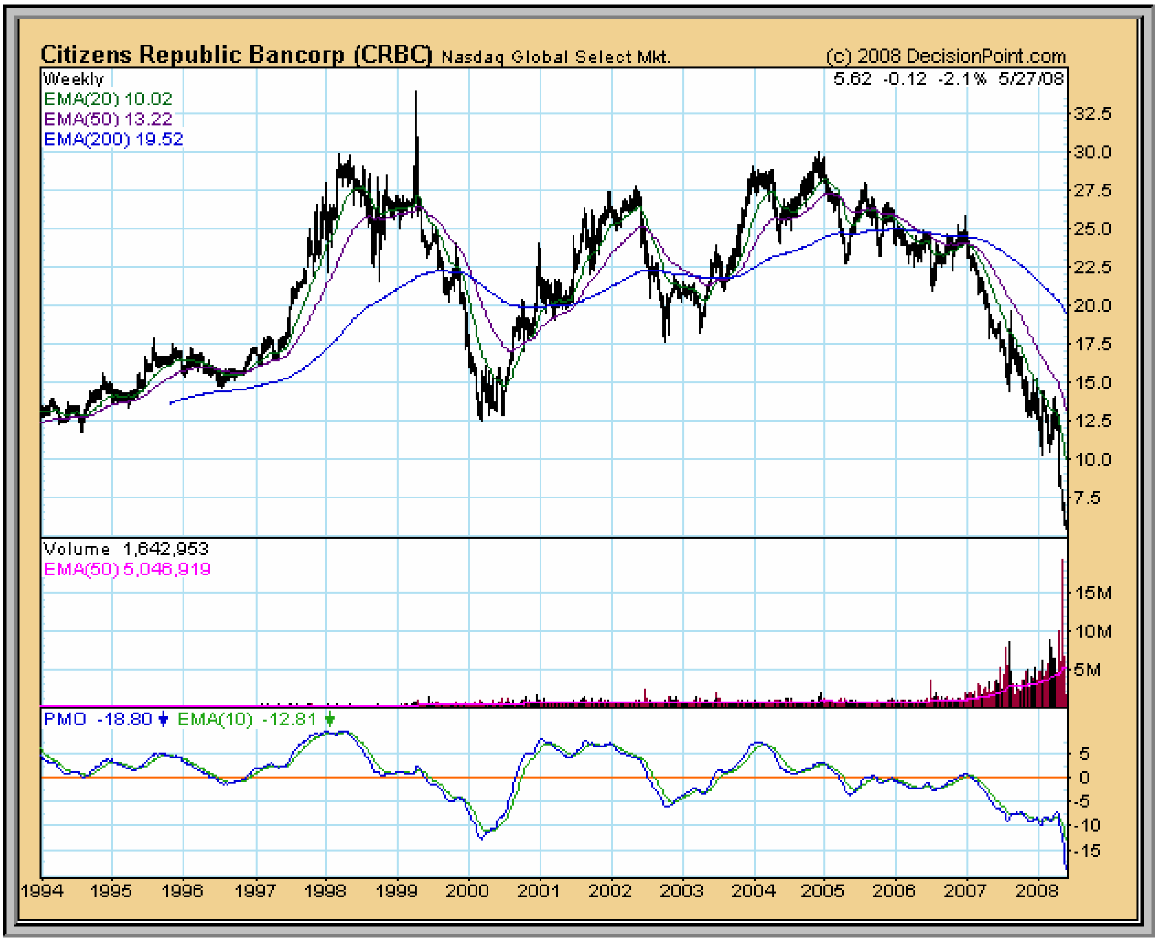
Mr. Cassidy might have added that investors should remain "underweight financial stocks" altogether because it is not only banks, which are over-leveraged and suffering from bad loans, but also investment banks, consumer loan companies and insurance companies (see Figure 3).

Figure 3: AIG, 1994 -2008: Still plenty of Downside Risk!

Source: www.decisionpoint.com

Please note that at the end of May, American International Group made a new 9-year low! Also, according to Cassidy, the ten banks with the worst "Texas Ratio" are in order: National City Corp (NCC), First BanCorp (FBP), Citizens Republic Bancorp (CRBC), UCBH Holdings (UCBH), First Horizon National Corp (FHN), Popular, Inc (BPOP), Fifth Third Banc (FITB), Colonial BancGroup (CNB), SunTrust Banks (STI), Wachovia Corp (WB). And while some of these banks have recently totally collapsed (Citizen Republic Bancorp - see Figure 4) others like SunTrust (STI) have held up relatively well.

Figure 4: Citizen Republic: Another Dissenter of Mr. Paulson's View!



Source: www.decisionpoint.com

Among the largest banks with the worst "Texas Ratio", Wells Fargo (WFC) ranks 25, Bank of America (BAC) 27, Citigroup (C) 30, Bank of New York Mellon (BK) 35 and JP Morgan Chase (JPM) 38. Needless to say, the large money center banks have also a huge exposure to the derivatives market, which aside from construction and commercial real estate loans could also blow up at any time. Probably the derivatives market has already blown up. But following the US government's good example at hiding horrible economic statistics (inflation, employment, etc.) and ratings agencies' fraud (Moody's – see Figure 5) at still assigning AAA ratings to credit insurance companies and falsely rating (caused by a computer error of course….) "Constant Proportion Debt Obligations" (CPDOs), financial institutions have wished the problem under the carpet as well (this is done by shifting level One assets into Level Three assets) – at least for the present.

Figure 5: Moody's, 2000 – 2008: Who Would Trust Them Now?

Source: www.decisionpoint.com

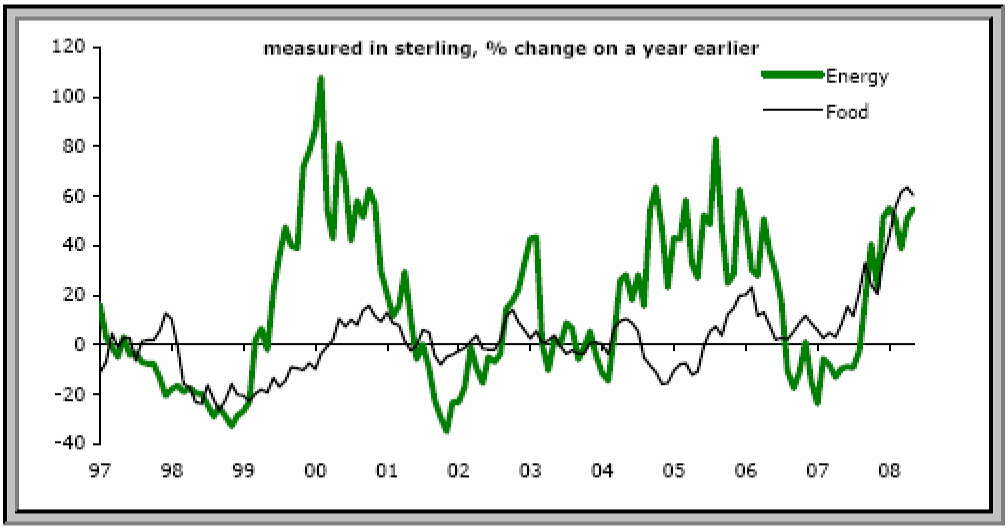
Two observations: I have been working in the financial sector since 1970 but I have never seen before (not even at Drexel Burnham in the late 1980s) the kind of extremely questionable practices, cover-ups, fraudulent behavior (at least in the eyes of someone with just minimal morals), and lack of transparency (coming so shortly after Enron blew up) by financial firms, the government and its agencies. In fact, if I weren't an incorrigible optimist who believes that what hasn't killed me yet (motorcycles, drinking and smoking heavily and ….) makes me stronger I would fall into a deep depression at the sight of the current financial environment and the government's lies! As an example, how do you reconcile the GDP growth and Bureau of Labor Statistics' employment numbers (heavily doctored by Birth/Death adjustments) with the Help-Wanted Advertising Index, which is at a 50-years low? (See Figure 6)

Figure 6: Help-Wanted Advertising Index: No Expansion Here!

Source: Conference Board, Merrill Lynch

Also, governments (not just in the US) want you to believe that the villains of today's financial mess are the hedge funds and the speculators (who drive up the price of oil). But when Peter Fisher of money manager Blackrock recently asked the rhetorical question at a luncheon for bankers, “What is the difference between a hedge fund and a bank,” someone from the audience immediately shouted, “banks are more highly leveraged!” Moreover, in a free market economy and under a capitalistic system there are always speculators. However, and this should be understood very clearly, when the Fed keeps interest rates below the rate of inflation (the true one) it encourages wild speculation and leverage even among decent and conservative people because they see the purchasing power of their accumulated savings, which they invested in bank deposits, rapidly lose their value. Thankfully, the investment community is gradually waking up to this fact. According to a recent report by Morgan Stanley, “the global weighted average inflation rate will be 5.4 per cent this year, while the global money market interest rate is currently only 4.3 per cent. This means that global short-term real interest rates are negative – at a time when inflation is rapidly accelerating. As monetary policy has been excessively accommodating for more than a decade, inflationary pressures have built up in the global economy. This was concealed initially by a series of asset price bubbles. But when too much money finally stopped chasing too many assets, it started chasing too many goods.” Moreover, if the UK with a strong currency (until recently) had annual price increases for food and energy of over 50% over the last twelve months one can imagine by how much these prices went up in the US with a weak currency! (See Figure 7)

Figure 7: UK: Raw Food and Energy Prices, 1997 – 2008



Source: Dominic White, ABN – AMRO

Bill Gross of PIMCO's fame also takes the government to task for understating inflation in his June comments. He concludes that "the correct measure of inflation matters in a number of areas, not the least of which are social security payments and wage bargaining adjustments. **There is no doubt that an artificially low number favors government and corporations as opposed to ordinary citizens.** But the number is also critical in any estimation of bond yields, stock prices, and commercial real estate cap rates. If core inflation were really 3% instead of 2%, then nominal bond yields might logically be 1% higher than they are today, because bond investors would require more compensation" (emphasis added).

Needless to say that it is only a matter of time until bond yields will increase (see Figure 8).

Figure 8: Higher Bond Yields Likely but Wait to Short Bonds until 30-Year Yields break out convincingly above 4.8%!

Source: www.decisionpoint.com

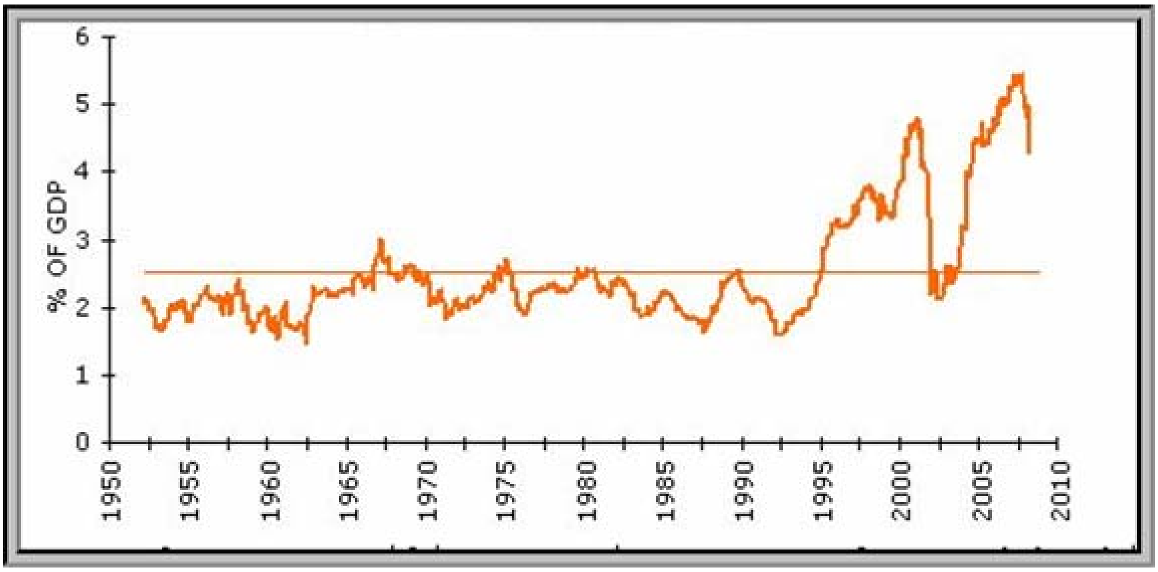
So, we can see that the Fed's con game of keeping interest rates artificially low has several undesirable effects. As Bill Gross explains, it shifts wealth and income from "ordinary citizens" to the government and to corporations (in particular to the financial sector and speculators, I might add), it leads to asset inflation and consumer price increases, which when understated badly distort real GDP growth figures. In addition, for Mr. Greenspan to argue in the Financial Times that, "the Fed is blameless on the property bubble" is nothing else than another Big Lie. As Andrew Smithers pointed out, "the argument of Alan Greenspan's article (April 7 in the FT) resembles an errant fire brigade excusing itself for failing to attend, let alone extinguish a fire, on the grounds that it did not start it and, despite being the monopoly supplier of paraffin to the neighborhood, was in no way responsible. But as the articles on the same page by Clive Crook and Wolfgang Münchau show, the damage done by the Federal Reserve in ignoring asset prices, unless they were falling, has been made clear by the current financial crisis". Unfortunately for the Fed, the crisis is now also spreading to the real economy with great intensity (see Figure 9).

Figure 9: GE: The entire Advance since 2005 has been given back!

Source: www.decisionpoint.com

There used to be a saying that when GM makes a new low (as it just did) or a new high the stock market would confirm the move: in other words, the market would subsequently make a new low or a new high. The goldilocks crowd then dismissed this "rule" as irrelevant because they argued that GM was an old economy dinosaur and not representative of the new innovation and service driven economy. But when a broad based industrial and technology driven conglomerate such as GE makes a new low (below the January and March 2008 lows) I suppose that investors should realize that we are no longer only dealing with a financial crisis but also with a serious economic downturn, which is spreading around the world. In time, this should depress corporate earnings everywhere since they still remain far above the trend (see Figure 10).

Figure 10: S&P 500 profits as a Percent of GDP: Far Above the Trend!



Source: Gerard Minack, Morgan Stanley

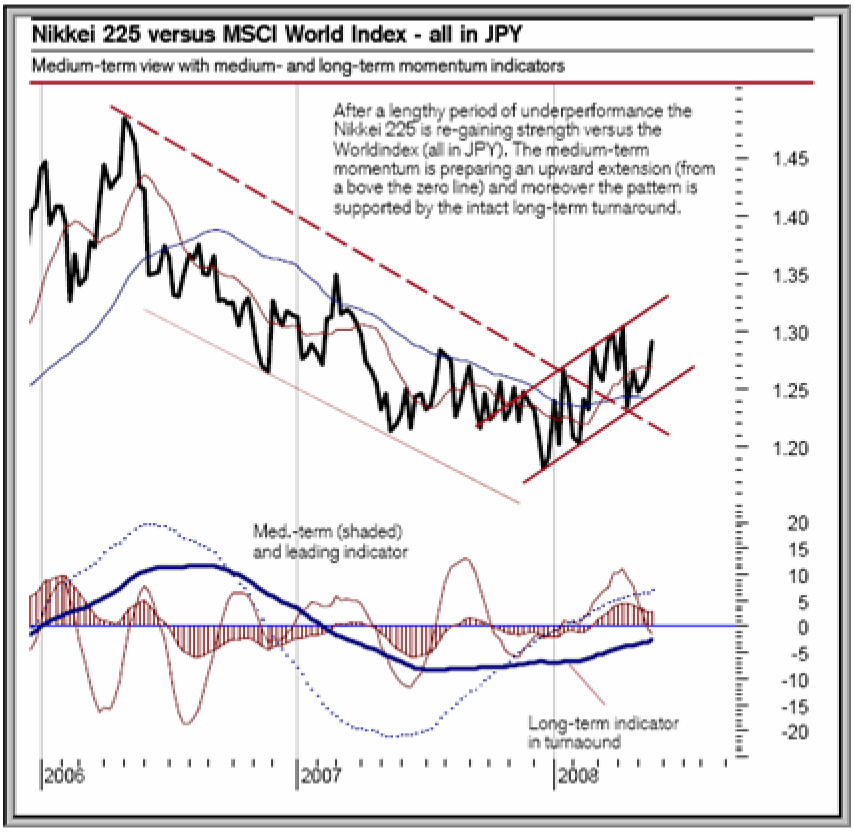
Given that the financial crisis is far from over, that corporate profits will unlikely rebound strongly for the foreseeable future and that the outlook for inflation is unfavorable (higher interest rates), we remain extremely defensive.

As outlined in last month's report, I believe the US dollar and US equities will outperform the rest of the world. **For now, I recommend a long US dollar position against the Euro with tight stops.** US equities are unlikely to move up strongly but should decline less than foreign equities (in particular emerging stock markets). In my opinion, the S&P 500 will not make new lows for now, rally from about June 15th to the middle of July and then decline meaningfully in the fall.

The inflation figures published by the BLS are a total fraud. **Bonds should move lower (higher interest rates), which should support the US dollar.**

Now that everybody is predicting higher oil prices and further increases in commodity prices a contrarian view is appropriate. The global economy is decelerating rapidly, oil demand is finally contracting. **Lower oil and industrial commodity prices should follow.** Prime beneficiaries from lower oil prices will be airlines (AMR, Lufthansa, Thai International, Singapore Air, etc.) and Japanese equities, which have begun to outperform the rest of the world (see Figure 11)

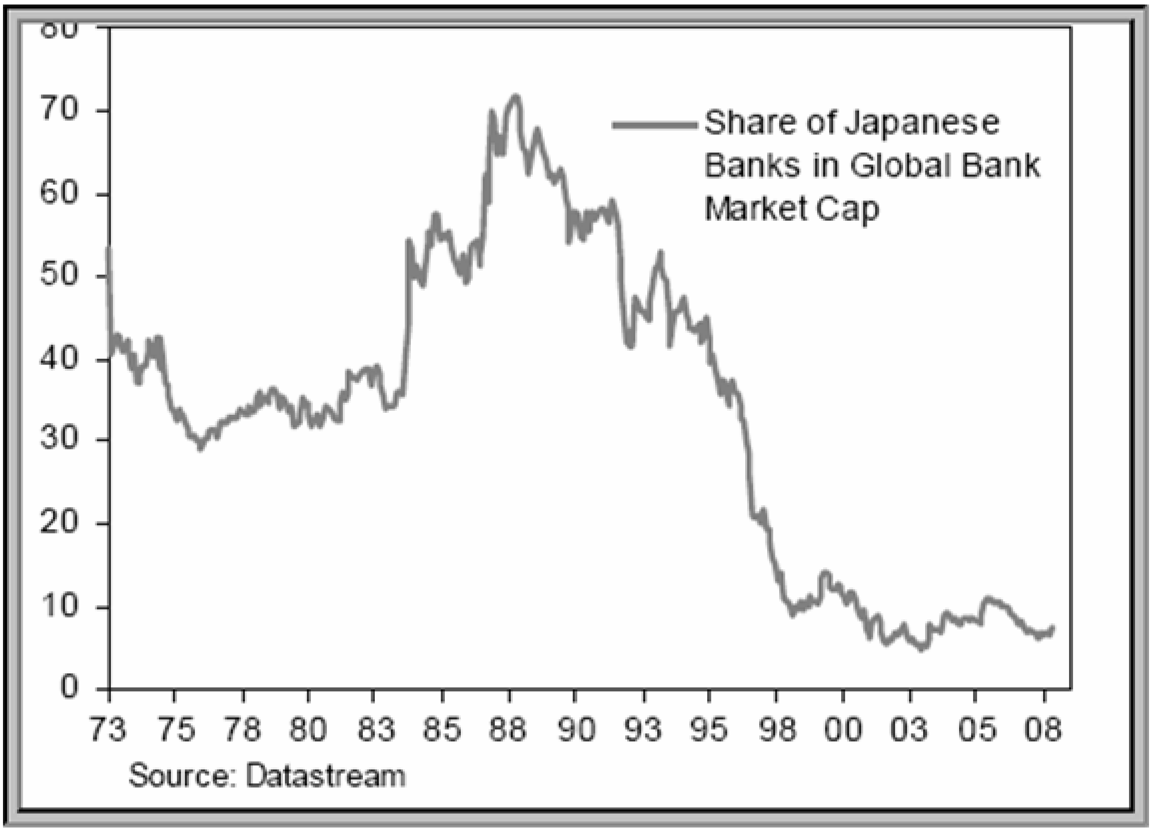
Figure 11: Japanese Equities to Outperform



Source: www.credit-suisse.com/techresearch

In particular, Japanese banks would seem to have some appeal following their relative global underperformance over the last 17 years (see Figure 12).

Figure 12: Japanese Banks: From over 70% of Global Bank Market Capitalization to less than 10%!



Source: Goldman Sachs

We are in the midst of very challenging investment times and my recommendation is to reduce positions in all asset classes on rebounds.

Gold is probably still in a long term bull market but as I outlined in last month's report we are in the midst of an environment of deleveraging, which could depress prices below $ 800.

In short, enjoy the summer and your tax rebates because the investment markets will bring lots of volatility but unlikely much joy!

"The federal government is sending each of us a $600 rebate. If we spend that money at Wal-Mart, the money goes to China. If we spend it on gasoline it goes to the Arabs. If we buy a computer it will go to India. If we purchase fruit and vegetables it will go to Mexico, Honduras and Guatemala. If we purchase a good car it will go to Germany. If we purchase useless crap it will go to Taiwan and none of it will help the American economy. The only way to keep that money here at home is to spend it on prostitutes and beer, since these are the only products still produced in US. I've been doing my part, and I thank you for your help"!

Eliot Spitzer (former Governor, New York)