Boom and Bust

By Michael Lewitt, Editor, The HCM Market Letter
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"It is perfectly true, as philosophers say, that life must be understood backwards. But they forgot the other proposition, that it must be lived forwards."

Soren Kierkegaard[1]

It is now abundantly clear that the United States economy – and therefore the entire global economy – is trapped in a cycle of boom and bust as a result of fiscal and monetary policies from which there is no easy escape. Years of lax monetary policy have created global imbalances that led to a series of ever-expanding bubbles that culminated in the 2008 financial crisis, which was centered in the mortgage market but leaked into virtually all other financial assets. This was merely the largest of a sequence of bubbles reaching back to the early 1980s' oil patch bust, morphing successively into the junk bond/S&L/real estate bust of the late 1980s, the Mexican crisis of 1994, the Asian crisis of 1997, the Long Term Capital Asset Management/Russian default of 1998, the Internet bubble of 1998-2001, the corporate credit crisis of 2001-2002, and finally the housing bust that began in 2006 and continues today. In each and every case, the same steps were taken by central banks to address the crisis: easing monetary conditions rather than purging the underlying imbalances. As a result, the imbalances have simply grown more pronounced with each bubble until the global financial system has been distorted beyond any reasonable chance to achieve equilibrium. As we speak, a new bubble is forming in fixed income assets, whose prices are rising as a result of sustained zero percent interest rates whose end is nowhere in sight.

[1] *Soren Kierkegaard's Journals and Papers*, tr. Howard V. Hong and Edna K. Hong (Bloomington: Indiana University Press, 1967-1978), 7 vols, 1:450, quoted in Philip Weinstein, *Becoming Faulkner* (New York: Oxford University Press, 2009), 91.

The other dynamic at work in the United States is a collapse of government balance sheets at the local, state and federal level. Every form of government is running unsustainable deficits with little prospect for improvement as tax rolls shrink with the permanent diminution in the work force, for even if unemployment drops it will still take years to recover the more than 7 million jobs that were lost over the past two years. The deterioration in government finances will create an enormous drag on the economy as the United States tries to sustain growth above 3 percent for any prolonged period of time. While many corporations – particularly those at the upper tiers of the credit spectrum that have not been poisoned by private equity transactions - have been strengthening their balance sheets and improving their cost structures, they will still struggle to produce sustained revenue growth if the economy suffers from the drag of broken government balance sheets. As for those highly leveraged companies that allowed themselves to be taken private during the private equity boom of the mid-2000s, serious problems lie ahead. Even if they are able to repay their debt, their competitive positions will have been badly eroded by the diversion of most of the cash flows to debt service rather than productive uses such as plant expansion, research and development, and new product development. The curse of private equity will doom them to slow motion decline for years to come.

Kierkegaard's curse

One explanation for why we find ourselves trapped in a cycle of boom and bust may well be philosophical. The quote from the 19th century Swedish philosopher Soren Kierkegaard (1813-55) with which this newsletter begins speaks to a basic discontinuity in individual human consciousness: individuals live life forward but are only really capable of understanding it – or reflecting on it is - retrospectively.[2] It also explains why it is so difficult for human beings to accurately comprehend the true economic conditions in which they are living; they are trapped inside their own individual consciousnesses and cannot view the present from an outside or objective perspective. It is impossible to both live and think our experience simultaneously.[3] As a result, we live life in all of its messy complication and are left to clean up the mess afterwards. That is the fate of living inside an individual consciousness.

But society is not trapped in a single consciousness; society is a collective consciousness. As such, it need not be confined by the limitations from which individuals suffer. A collective consciousness has the ability to reflect on its

[2] This is an extremely important insight that reinforces my belief in the importance of reading not just economics and finance materials but philosophy, psychology, history and literature in order to gain a better understanding of financial markets.

[3] While this is completely off topic, this raises the interesting question of whether schizophrenia, which is a version of split consciousness, is at least partially a result of the inability to reconcile living and thinking in the present.

present circumstances from the outside because some members can stand outside, as it were, and regard the present from a distance. Yet for reasons that deserve serious study, the U.S. political system has been acting in a manner more consistent with an individual consciousness than a collective consciousness. The two-party democratic system cannot overcome this condition, perhaps because the parties are bound together by the same system of laws and that system's underlying assumptions. Clearly there is some inherent characteristic of the system that prevents decision-making from improving over time, and attributing this failure to "politics" or "human nature" begs the question of identifying that characteristic. Kierkegaard may be pointing us in the right direction in terms of answering the question.

In terms of the economic history of the past thirty years, the United States has been moving forward with extremely short-sighted policies that have favored speculation over production, debt over equity, and short-term thinking over long-term planning. These policies have been responses to current conditions rather than proactive programs for the future. There has been no ability to take advantage of the collective consciousness's ability to look both forward and backward. Instead, the system has plunged forward without the ability to temper the forces that are consistently increasing systemic imbalances.

Virtually all of the talk we hear about reform from our leaders is meaningless because none of it addresses the embedded characteristics of human consciousness described above. In a practical sense, we are running out of time. We can learn from our mistakes and stop repeating them, or we can continue down our current path until we have destroyed the economy and with it our society. It is no exaggeration to say that we are well on our way on that path to destruction. We need look no further than out neighbor to the south, Haiti, to see what happens when a country is unable to establish the economic and social institutions and structures to deal with calamity, whether it is manmade or an act of God. The United States will undoubtedly face many natural disasters in the future, more Katrinas, California earthquakes and the like. But this country is also facing a disaster of equal magnitude that is completely manmade in the shambles that is being made of our economy. Until we recognize why we are doing that, we have little hope of changing course and avoiding a terrible fate. We must start taking advantage of the fact that society, unlike the individual, is a collective consciousness that does not have to be trapped by the curse of living forward but understanding our lives retrospectively. Right now, we are squandering that opportunity, and it is a crying shame.

The economy

The report that the U.S. economy grew by 5.7 percent in the fourth quarter of 2009 may be the type of news that can break the spell of negativity that began pressuring the stock and credit markets in mid-January. It certainly speaks to the type of growth that one has come to expect upon the emergence from a recession of the severity of the most recent one. Third quarter 2009 GDP growth of 2.2 percent was a worrisome sign that the economy was not responding to traditional fiscal and monetary cures. *HCM still expects the S&P 500 to rally to the 1200-1250 range and for corporate credit spreads to tighten further, but our long-term prognosis would best be described as somewhere between "grave" and "terminal."*

Despite the more positive news concerning the fourth quarter, however, caution rather than exuberance remains the appropriate reaction. First, as David Rosenberg points out, the GDP gain was dominated by an enormous inventory adjustment. Absent this adjustment, GDP would have grown at only 2.2 percent. Mr. Rosenberg also points out that domestic demand growth actually declined from 2.3 percent in the third quarter to 1.7 percent in the fourth quarter, suggesting that the domestic economy is still suffering from what was not a garden-variety recession but a depression dynamic characterized by debt destruction and deflationary forces. *HCM* would merely add that while the fourth quarter GDP figure was the type of number that we have been taught to expect based on prior historical experience with U.S. recessions, it seems inconsistent with underlying economic conditions such as the condition of the housing and job markets. We would not be surprised to see significant revisions downward of this initial figure.

The ability of the U.S. economy to sustain economic growth will come down to the question of whether what it was experiencing was an ordinary recession or a depression dynamic characterized by massive debt destruction. *HCM* remains of the view that there was nothing ordinary about the recession and that it was a culmination of thirty years of noxious fiscal, monetary and regulatory policies that were based on two flawed assumptions. The first assumption was that markets are efficient, and the second was that investors are rational. Neither bears any resemblance to reality although both assumptions continue to govern much of the thinking of those in charge of the nation's institutional capital. Unfortunately, little or nothing has changed to alter the policies that consign the economy to a continued boom-bust dynamic. For this reason, *HCM* continues to believe that the financial markets will experience extreme turbulence later this year or in 2011. The underlying dynamics – particularly the growing debt burden of the economy – are just too strong for markets to ignore indefinitely.

The Obama budget

Based on initial media reports, President Obama's first budget makes for extremely grim reading. The document's projected $1.6 trillion deficit (that's trillion with a "t") is even worse than we expected. Frankly, it is impossible to consider this budget proposal a serious basis on which to govern this country's economic affairs. First and foremost, it refuses to address any of the structural problems that are certain to render the United States a Banana Republic unless they are addressed. It is a virtual certainty that the final budget will not resemble what has been proposed, but knowing the ways of Washington it is also a certainty that whatever emerges from the bowels of our government will be no less destructive of the economic health of this nation than this first shot across the bow by an already discredited Democratic administration.

For those of our readers keeping track, it should be pointed out that with the pending increase in the national debt ceiling and the *de facto* nationalization of Fannie Mae and Freddie Mac, the national debt is already approaching $18 trillion, which means that $20 trillion is a chip shot by 2012. Perhaps, deep in his heart of hearts, our President is coming to realize that financial discipline and stability are lost causes and that he might as well work for passage of as many of his political priorities as he can squeeze into his first term. *All HCM can say with certainty is that this budget proposal in a case study of how to bankrupt a nation.*

It is only fair to point out that Mr. Obama did not cause this problem (except to the extent of his participation in the overall failure of government as a member of the U.S Senate). He inherited trillion dollar deficits from his predecessor, who waited until near the end of his term to use his veto pen and presided over a historic and perhaps irreversible (not unavoidable – irreversible) decline in the U.S. balance sheet. But Obama wanted the job and is now the man at the helm and has to do more than produce a budget like the one he just released. This budget suggests a couple of things. First, it is a vivid illustration of the fact that "we're in a lot worse shape than advertised," as former U.S. comptroller David Walker told *The Wall Street Journal*. Mr. Walker is also the head of the Peter G. Peterson Foundation, a think tank focused on debt reduction (at least some of the proceeds of the IPO of The Blackstone Group are being used for something worthwhile). Second, the budget suggests that that the administration's economic team still doesn't appreciate the urgency of the situation nor the effect that such a dire budget plan is going to have on the confidence of consumers, investors, and other economic actors who are charged with making day-to-day economic decisions under what is turning out to be a mushroom cloud of debt.

The markets did not react negatively to the release of this budget, but they should have; they were more focused on the better-than-expected fourth quarter 2009 GDP release. But the fact that they rallied on the day that the budget was released is a truly dire signal of how deeply in denial the stewards of the nation's (and the world's) capital remain about the unfolding financial collapse. The American people are beginning to catch on, however, and politicians are becoming properly concerned about where their next free lunch is going to come from. Because it is abundantly clear that we are running out of free lunches.

The Boston Tea Massacre

In last month's issue of this publication, we wrote: "*Political instability is being severely underpriced by the financial markets.*" [italics in original][4] Little did we expect an upheaval in U.S. politics to come so soon (we were targeting the November mid-term elections). The voters of Massachusetts, however, were given an opportunity to take the political temperature of the nation on January 19, however, and reported a fever of distrust and anger at the ways of Washington under one party Democratic rule. *HCM* views the election of Republican Scott Brown to fill the late Ted Kennedy's Senate seat as less a rejection of President Obama and his agenda (although it is surely that) than as a repudiation of the unseemly, tone-deaf ascendancy of Nancy Pelosi and Harry Reid. The pending healthcare legislation was likely the straw that broke the camel's back in the eyes of the voters, who even in a strong labor state like Massachusetts could not avoid viewing the deal cut with unions to exempt them from the Cadillac tax as little more than an unprincipled political bribe.[5] Following the earlier payoff to Nebraska Senator Ben Nelson, the union deal was too much for any principled voter to accept. In the end, voters are not idiots although they often seem to elect them. And it does not take a nuclear physicist to look around and see that just as George W. Bush ran as a moderate and ruled like a far right Conservative, Barack Obama has pulled the same trick from the opposite end of the political spectrum and run for President like a moderate and ruled (largely by leaving the details of legislation to Congress) from the far left. Even worse, these leftist tendencies have accomplished little, particularly in the realm of financial reform, where his economic team headed by Lawrence Summers and Timothy Geithner continues to lead him down the garden path. The latest blunder, the proposed tax on banks, is a case in point.

The financial reform train wreck

[4] Readers should be aware of Thomas Friedman's January 31, 2010 column in *The New York Times* in which he wrote that he heard, for the first time, a significant amount of discussion about U.S. political instability at the recent gathering of political and business leaders in Davos, Switzerland. Not only were we pleased to see that *HCM* was again ahead of the curve, but also were struck by the belief that the world is coming to view the sad political spectacle of partisanship and gridlock as a source of systemic instability, not as a means of preventing the most radical parts of each party from forcing their agenda on moderates. The world still looks to the United States for leadership, particularly on economic issues, and right now all it sees is a great deal of sound and fury that is signifying nothing.

[5] This deal would have left the 92 percent of private sector workers who are not unionized paying the tax, a fact that leads one to question not only the motives but the intelligence of the Democratic leadership.

It gives *HCM* no pleasure to suggest that the President is being poorly served by his economic advisors. The President's latest proposals may be designed to appeal to populist outrage at Wall Street (which *HCM* shares), but they are poorly designed and would accomplish little to create a more stable financial system. If we were cynical, we might think that Obama was deliberately proposing these plans with the knowledge that they would cost Wall Street nothing and do nothing to promote financial stability. If we were really cynical, we might think instead that Larry Summers and Tim Geithner didn't really oppose these plans too strenuously (as the press reported) because they know perfectly well how ineffective these plans will be. With all of the gray matter in the White House, it's difficult for *HCM* to accept these proposals with a straight face.

On January 14, 2010, the President introduced a proposal to tax banks for the bailout. The proposal would levy a tax on the non-depository assets of banks with more than $50 billion of such assets. The purpose of this tax would be to recover the cost of the bailout for the American taxpayers. This proposal is inadequate from several standpoints. By only taxing the banks, it ignores the complicity of many other speculators who benefited from the reckless financial practices that led to the financial crisis, such as hedge funds and other investors who continue to speculate in naked credit default swaps and other dangerous financial instruments. It is widely known by knowledgeable market professionals that the vast majority of trading in such instruments is done for the purpose of speculation, not for the purpose of hedging underlying positions. Accordingly, this proposal gives a free pass to much of the speculative activity that comprises the most profoundly flawed practices in the system. The Tax on Speculation that was proposed in this publication recently is more precisely aimed at unproductive activities that, if permitted to fester, will continue to push the U.S. economy down the road to ruin. The tax also lets the banks off easy. The $90 billion price tag (it was initially reported to be $120 billion but quickly shrunk without explanation to the lower figure) over ten years is a drop in the bucket compared to the trillions of dollars of damage that the banks' reckless practices imposed on the American economy. Recapturing just the cost of the TARP does not go far enough to compensate society for the damage that modern financial practices have imposed. This tax does not go nearly far enough in imposing financial responsibility on these quasi-public utilities.

President Obama did not stop his financial reform revival with the ill-begotten tax on banks, however. On the day after the Massachusetts massacre, he unveiled a three part plan to limit risk-taking by banks with insured deposits. The so-called "Volcker Plan" would prevent banks from owning hedge funds, private equity funds or engaging in proprietary trading with insured deposits. No details were provided, which suggests that the plan was rushed out the door in order to burnish the President's reform credentials. The "markets," meaning Wall Street, panicked at this announcement as they feared that the game they have been running on the rest of us would be coming to an end. Unlike Meredith Whitney (fellow Brown University alum), who believes that this proposal has a high likelihood of passing in some form, *HCM* does not expect any such legislation to gain much traction in the current Congress (although we do concur with her general point that profitability at these institutions is going to come under increasing regulatory and political pressure).

Moreover, just as with the tax on banks, the Volcker Plan misses the point, which should be to legislate the financial products that cause damage, such as naked credit default swaps. Moreover, this legislation promotes the fantasy that something can actually be done to prevent firms from growing "too big to fail" when it is virtually impossible to do so without placing limits on such products. *You could cut down to size the largest firms in the world, but if they are all still trading toxic products with each other and are thereby still interconnected, the system would still be at risk if one of them failed because the entire system would only be as strong as its weakest link. It is not a question of individual firms being "too big to fail"; products such as credit default swaps effectively turn the entire system into the equivalent of a single firm that is too big to fail!* That is why the products must be regulated. The proper approach is to significantly strengthen capital requirements AND eliminate toxic products, as I argue in my forthcoming book, The Death of Capital (publication date early May 2010). There can be little quarrel with the argument promulgated by Paul Volcker that banks should not be trading with depositors' funds, but that begs the question of the systemic risks they still pose by trading toxic products with their own capital.

Moreover, as many others have pointed out, while proprietary trading creates its share of blowups, it was not the primary cause of the financial crisis. As much money as it lost during the financial crisis, Wall Street was fairly adept at shifting the risks in its proprietary trading to its counterparties (like AIG, whose losses the government was forced to pick up, a story for another day). The major Wall Street losses were primarily attributable to bad lending decisions, which were driven by a failure to recognize the pro-cyclical monetary policies of the Federal Reserve and the boom and bust cycle in which both fiscal and monetary policy has trapped the United States and global economies. That has little to do with proprietary trading, although it does have to do with profound failures of risk management and intellect. Unfortunately, we can be assured that these mistakes will be repeated again, probably in the relatively near future, although hopefully not by readers of this publication (and my book).

Bernanke by a neck

As *HCM* wrote last month, Ben Bernanke did himself no favors by arguing in a January 3 speech that the Federal Reserve's low interest rate policy did not contribute to the financial crisis. This speech could not have instilled confidence in his already controversial stewardship of the central bank, although the Senate made the right decision by confirming him for a second term. Nonetheless, Mr. Bernanke would do well to pay heed to the obvious lesson not just of the recent crisis but of the many financial crises throughout history, virtually all of which have been aided and abetted by loose monetary policy. It was particularly depressing to see the spectacle of Harry Reid, whose political sell-by date has long since passed, effectively holding Mr. Bernanke's reappointment hostage to making monetary policy even looser than it already is. In announcing his support for Mr. Bernanke, Mr. Reid said that the Fed Chairman had promised to "redouble his efforts" to make credit available and "has assured [me] that he will soon outline plans for making that happen, and I eagerly await them." Mr. Reid must believe that the Federal Reserve could lower rates to below zero or repurchase another $1.25 trillion of mortgage securities since keeping rates at near zero for more than a year and purchasing a first $1.25 trillion batch of mortgages didn't do the trick! Mr. Reid needs to be sent home to Nevada as soon as possible before he does any further damage to this country (and he should take Nancy Pelosi with him), and *HCM* trusts that Mr. Bernanke will ignore his reckless advice (which was also given by California Senator Barbara Boxer and other clueless Democrats) and learn from the mistake he made in keeping interest rates too low during the first two years of his term.

What planet is the SEC on?

The Securities and Exchange Commission lowered itself another notch in the esteem of investors and other sentient beings last week when it voted to encourage companies to disclose the effects of climate change on their businesses. *The Wall Street Journal* put it best in scoffing at this action: "The agency that spent more than a decade ignoring evidence of Bernard Madoff's $50 billion fraud; the agency that spent even longer constructing a credit-ratings oligopoly that still threatens investors; the agency that in 2004 encouraged Wall Street firms to increase leverage and then failed to monitor them – this agency now has spare time to meditate on climate science." In addition to politicizing the climate debate, the advisory raised serious questions about the understanding of the Commissioners concerning the SEC's role in protecting investors. After all, companies are required to advise companies of ALL serious risks involved in their businesses, provided those risks are reasonably foreseeable and verifiable. Accordingly, this advisory was either unnecessary or, by specifying a so-called "new" risk that needs to be disclosed, raised a host of questions about what other types of risks companies should be warning their investors. In view of the current state of climatology, and the obvious politicization of the issue (evidence by the 3-to-2 party-line vote approving the advisory), the SEC was once again demonstrating that it spends too much time worrying about matters about which it shouldn't and too little time concerned with issues that might actually protect investors. As an example of its concern, the SEC suggested that insurers may want to consider disclosing whether severe weather or changes in sea levels might increase the risk of claims in coastal regions. While they are at it, why shouldn't they advise companies to start warning investors about the possible effects of a meteorite hitting the earth? It is probably too much to hope that any such extraterrestrial mercy killing could be arranged for an agency that is still having trouble figuring out its own mission.

Private equity

Many institutional investors are still waiting to see how their private equity investments will turn out after the debacle of 2008. In the meantime, the private equity industry is still trying to prevent itself from being taxed like ordinary Americans. The industry's lobbyists are still getting out their violins and making the same lame arguments that we have heard before, that taxing private equity profits as the ordinary income they are will stifle the economic recovery. *The Wall Street Journal* featured some of these arguments on January 7, 2010. "Private equity will endure, but the draconian tax hike, if enacted, will unquestionably slow the flow of capital to companies struggling to get back on their feet during this very fragile economic recovery," said Douglas Lowenstein, president of the Private Equity Council. Taxing carried interests as ordinary income would hurt "the competitiveness of U.S. businesses, capital formation in the United States, and ultimately job growth," Richard Baker, head of Washington, D.C.-based hedge-fund lobbying group Managed Funds Association, wrote to lawmakers. By now, these statements are little more than an embarrassment to the industry paying for them to be made. In many cases, the companies "struggling to get back on their feet" are those that either recently or at some point in the past three decades assumed too much debt through private equity deals at the peak of the market. As for harming the competitiveness of U.S. business and capital formation, private equity plays no role in those activities. Instead, it sucks the life out of companies by diverting their capital to repay their bankers while starving their businesses of funds needed for product development, R&D, and new plants and equipment. Even the private equity firms themselves can't possibly believe the nonsense spewing out from the mouths of their lobbyists.

The latest example of why private equity is bad for America is the plan by the private equity owners of HCA, Inc. to take a $1.75 billion dividend. HCA is not just any company – it is the largest operator of hospitals in America. As such, it provides a vital social function. The company was taken private in 2006 by

Kohlberg, Kravis & Roberts & Co., Bain Capital Partners and Merrill Lynch Global Private Equity and the founding Frist family in a $21.3 billion. The initial leverage (debt/EBITDA) was 6.4x and was reduced to 4.7x by 2009; after the dividend it will return to 5.0x. The last *HCM* heard, there was some kind of healthcare crisis in America, with tens of millions of people unable to obtain health insurance, the costs of care rising without a commensurate improvement in the quality of care, and President Obama was risking much of his political capital on a far-reaching reform plan. It would seem that HCA, as the nation's largest hospital operator, could probably play an important role in reforming the healthcare system so that it could provide better care to more people at affordable prices. That is clearly not the goal of KKR, Bain, and Merrill Lynch Private Equity, however; their goal is to make a profit as quickly as possible on their investment. This may be good for their investors (although few of these firms' other 2006 vintage deals are doing nearly as well as HCA), but it is not good for society and does nothing to improve the healthcare system.

There has been surprising little discussion of the wisdom of allowing firms such as HCA, which provide an important social function and are heavily depending on government funds for a significant part of their revenue, from being taken private in heavily leveraged transactions – but perhaps there should be. *HCM* is not suggesting that such transactions be the subject of legislation; our political leaders have demonstrated that they are the least fit to address issues of complexity or principle. Instead, the issue should be addressed seriously by the institutional investors who have entrusted private equity firms with billions of dollars of their beneficiaries' money. After all, these beneficiaries are the same working men and women who are being hurt by the healthcare crisis. One of the biggest failures in today's institutional investment world is the failure of its managers to connect the dots and understand the consequences that their investment decisions are having on their beneficiaries. In many cases, strategies like private equity turn out to be nothing more than cases of robbing Peter to pay Paul when the total picture of what is gained and what is lost is added up.

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Disclosure Appendix

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