



The Titanic Has Sailed

By Michael Lewitt, Editor, The Credit Strategist
July 12, 2011

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This essay is excerpted from the most recent version of *The Credit Strategist* (formerly the HCM Market Letter). To subscribe directly to this publication, please go [here](#). The Credit Strategist is on Twitter - @credstrategist

“Some things fade and wane, states disintegrate, assembly lines shorten their runs and interact with lines in other countries. This is what desire seems to demand. A method of production that will custom-cater to cultural and personal needs, not to cold war ideologies of massive uniformity. And the system pretends to go along, to become more supple and resourceful, less dependent on rigid categories. But even as desire tends to specialize, going silky and intimate, the force of converging markets produces an instantaneous capital that shoots across horizons at the speed of light, making for a certain furtive sameness, a planning away of particulars that affects everything from architecture to leisure time to the way people eat and dream.”

Don DeLillo, *Underworld* (1997)¹

Don DeLillo’s *Underworld* is one of the great novels of the late 20th century. This complex work weaves several different themes into a portrait of a Cold War world ruled by capital. But capital in DeLillo’s world is viewed as waste, excess, garbage, a conceit that comes brilliantly to life in the final chapter (appropriately entitled “Das Kapital”) in which the protagonist, Nick Shay, visits a new type of business: using underground nuclear explosions to destroy vast amounts of garbage. Nick, who is in the waste disposal business, describes the business proposition as follows:

“[The] trading company is called Tchaika and they want to invite our participation in a business scheme. We are flying to a remote site in Kazakhstan to witness an underground nuclear explosion. This is the commodity that Tchaika trades in. They

¹ Don DeLillo, *Underworld* (New York: Scribner, 1997), pp. 785-86.



sell nuclear explosions for ready cash. They want us to supply the most dangerous waste we can find and they will destroy it for us. Depending on degree of danger, they will charge their customers – the corporation or government or municipality – between three hundred dollars and twelve hundred dollars per kilo. Tchaika is connected to the commonwealth arms complex, to bomb-design laboratories and the shipping industry. They will pick up waste anywhere in the world, ship it to Kazakhstan, put it in the ground and vaporize it. We will get a broker's fee.”²

This business is described as “[t]he fusion of two streams of history, weapons and waste.”³ DeLillo is telling us that nuclear weapons are as much a form of capital as the garbage they vaporize. This is a fairly radical notion of capital, which has traditionally been considered confined to money-based objects and commodities. Garbage and nuclear weapons are not usually equated with the idea of capital. But in today's global economy, all types of tangible and intangible objects can be commoditized (and commodities are one of the forms in which capital appears). Global capitalism, then, is a larger process that sweeps up all objects in its wake and renders them tradable commodities. In *Underworld*, DeLillo shows himself to be a profound reader of the modern economy.

Greece – From tragedy to farce

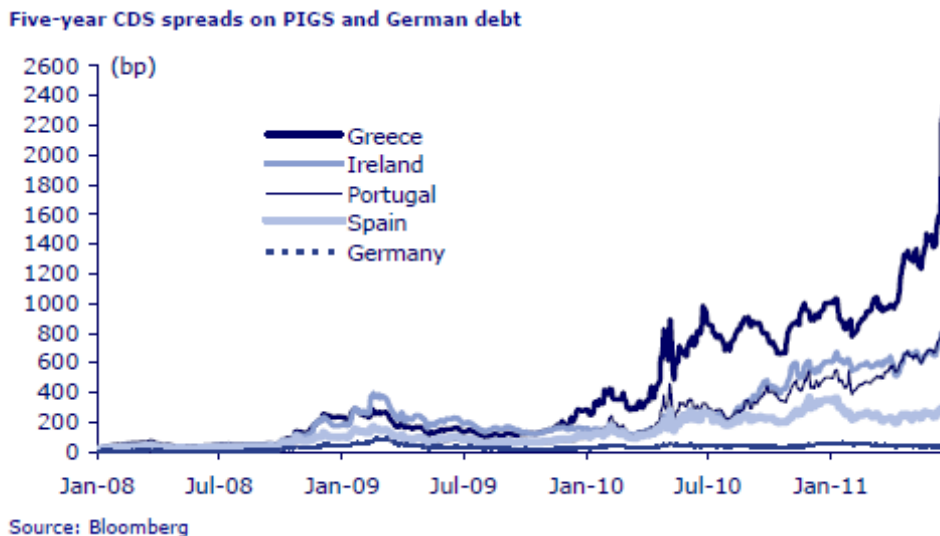
Now that the Greek parliament has passed an austerity plan that will not work, the European Union can try to pretend that its Southern flank isn't coming apart at the seams. Greece is insolvent. The only question now is whether the country will be driven into economic collapse by the austerity plan that it just passed –which is unachievable – or by a genuine default. In particular, it will be very difficult for Greece to sell the required €50 billion of state-owned assets that the plan requires.

Default, however, may come much sooner than people thought (or hoped). On July 4, Standard & Poor's warned that the plan to have banks roll over their Greek debt into new bonds would constitute a “selective default.” This comes after Fitch, the third-largest rating agency, took a similar position. Moody's Investors Service is the last holdout. Thus far, the European Central Bank (ECB) has stated that it will no longer accept Greek debt as collateral if the country defaults. Faced with the reality of staring over the cliff, however, the ECB is likely to change its position and continue to accept toxic Greek paper. Holding more than €80 billion of Greek debt already, and cognizant of the billions more held by Europe's banks, the ECB will back off its tough love stance and do the expedient thing. Now that the Titanic has not only sailed but hit the iceberg, the authorities will do everything within their power to keep it afloat.

² Ibid, 788.

³ Ibid, 791.

Figure 1
PIGS Get Fatter



Of course, Greece has already effectively defaulted by making it clear that it cannot meet its July debt repayment. The world, however, is desperate to delay the day of reckoning and is using the technical definition of default as a pretext for ignoring reality. As *The Credit Strategist* has noted before, a Greek default could trigger a number of problems in the global markets. First, it would make it more difficult for French and German banks to meet new higher capital requirements if they are forced to start realizing losses on their Greek holdings. Second, a default could constitute a “credit event” in the credit default swaps written on Greek debt. If a “credit event” is triggered, financial institutions (which include U.S. banks to the tune of about \$34 billion) who wrote insurance on the debt of Greece would be required to make large payouts to their counterparties. Even after the netting of contracts, this would result in a meaningful hit to bank earnings. European politicians and regulators are hoping that the credit agencies’ actions will not in fact constitute a “credit event,” but in the opaque world of credit derivatives nobody can be certain. Many contracts governing credit default swaps and other complex instruments are bespoke, which means that there is no way to determine the actual damage a default would cause. At the very least, S&P’s action accelerates the ultimate default of Greece. How much longer the world will be willing to play along with the Greek farce remains to be seen.

It is time for European leaders to start forcing private lenders – including banks – to take the losses they deserve for making ill-advised purchases of Greek debt. This doesn’t mean that these losses must be realized all at once, but the principle of private sector responsibility must be established. That would reverse the deeply embedded inclination to rescue banks at the expense of taxpayers. Taxpayers, however, are starting to catch on to



the regime of socialism for the rich, capitalism for the poor and are taking to the streets to express their displeasure. Europe's history is filled with examples of political instability arising from economic dislocations. European leaders are well aware of this history, which is one reason why they are doing everything possible to avoid an outright default of Greek debt.

The pain in Spain

As noted above, the deal reached to defer Greece's ultimate default will do little but defer Greece's ultimate default. A Greek default, as damaging as it would be, would pale in comparison to what would happen if Spain proved to be unable to meet its obligations. The size of Spain's economy is so large that it would break the €440 billion European Financial Stability Facility (the "Facility"). By the way, readers should understand that the Facility does not consist of €440 billion of cash sitting in a bank account waiting for additional countries to default. All of the commitments to the Facility are IOUs that actually have to be funded by the European states. Obviously were Spain to run into serious trouble, it would not be able to make its contribution. Spain's commitment to the fund is €52.3 billion, or 11 percent of the total.

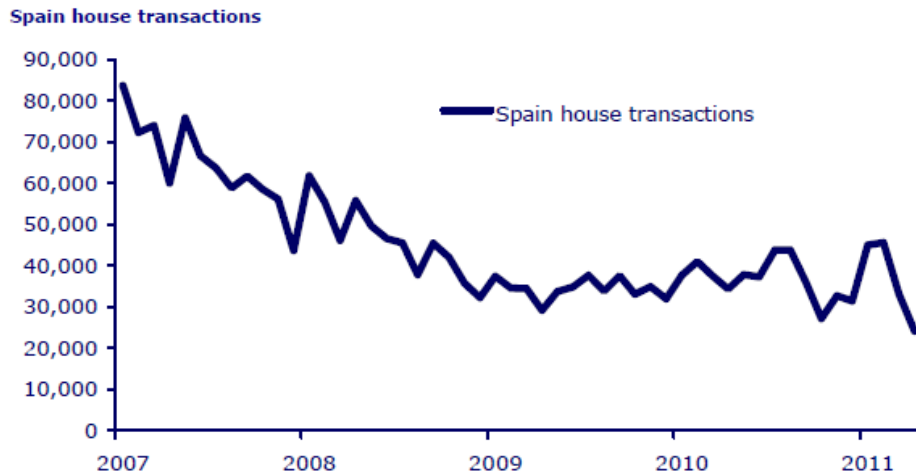
Spain's economy isn't looking very robust right now, in part due to the austerity plans that the Spanish government has attempted to put in place over the objections of that country's powerful unions.

Figure 2 below, borrowed from our friend Christopher Wood's indispensable weekly publication *GREED & fear*, shows that Spain's housing market remains very troubled. In April, the number of Spanish house transactions fell to a post-crisis low of 24,000 units. Through the end of April, house transactions were falling at an increasing rate. Spain suffered an even larger housing bubble than the U.S. and is experiencing the same kind of prolonged slump in that sector as this country.

Figure 3 below illustrates that the cost of insuring Spanish sovereign debt is again rising, which is consistent with the trading levels of its government bonds. Spanish two-year paper is now trading at record yields which are unaffordable for the country. Speculators are continuing to profit from purchasing insurance on Spanish debt. This raises once again the question of the wisdom of permitting speculation in sovereign debt. CDS markets tend to be illiquid and shallow; as a result, small transactions tend to have a disproportionate effect on prices. While there is a strong argument for permitting the trading of sovereign CDS to hedge existing positions, it is more difficult to justify mere speculation on the direction of Spanish interest rates. The reason why *The Credit Strategist* questions the advisability of naked (unhedged) sovereign CDS is that the ability of that market to move interest rates with relatively small amounts of capital adds to the financial pressure on troubled sovereigns without providing a significant social benefit in return. If CDS trading were limited to actual cash bonds and hedges on those bonds, a more accurate picture of the market's assessment of risk would be achieved. While many

argue that sovereign CDS allows the market to better price the risk of sovereign debt, *The Credit Strategist* would argue that this is only true with respect to the direction rather than the magnitude of credit quality changes.

Figure 2
And You Think U.S. Housing Is In Trouble?



Source: Bloomberg

Figure 3
Speculators Sink Spanish Debt



Source: Bloomberg



The U.S. economy

It was entirely predictable that the U.S. equity market would rally on the news that Greek would not default *this month*, but it does little to convince *The Credit Strategist* that the long-term outlook for European sovereign debt or the global economy has improved. Markets – particularly the equity markets – are trying to pretend that the global economy is experiencing a self-sustaining recovery. A hard look at the economic numbers would tell an objective observer that no such recovery is occurring. As I watch the parade of bullish portfolio managers and media pundits on CNBC, I feel as though I inhabit a different universe from these so-called experts. The impressive rally during the last week of June was clearly a combination of window dressing and a sigh of relief that Greek didn't default now. Bulls are hanging their intellectual hats on the fact that corporate earnings are still strong without acknowledging that it is likely that Corporate America has already realized most of the gains from the balance sheet recession. Earnings and margins should be strong in an environment where it costs nothing to borrow money, it is prudent to reduce headcount, and there are enough tax loopholes to drive a truck through. The more important question is what happens next, and the case for a self-sustaining recovery fueled by a profitable private sector is dubious.

In order to see genuine improvement in the long-term outlook, there would have to be real progress made with respect to reducing the U.S. deficit and adopting tax and other policies that encourage productive investment rather than speculation. The Beltway dicker over the federal debt limit is wholly predictable but depressing nonetheless. It is not being helped by the relatively disinterested approach of President Obama, who needs to step up and exert leadership without engaging in the demagoguery that too often rears its ugly head. Mr. Obama should remember that presidents are supposed to take the high road the next time he is tempted to publicly blast the Republicans.

The Republicans need to accept the reality of higher taxes, and Democrats must accept the reality of lower entitlement spending. The Republican refusal to consider any tax increases is not only unrealistic but unsupportable as long as tax breaks such as the carried interest tax for the private equity industry remain on the books. But other than eliminating egregious tax schemes like the carried interest tax, the solution is not to increase tax rates. Low tax rates should be coupled with an elimination of deductions to create a system whereby people and corporations actually pay tax commensurate with their ability to do so. In particular, it is inexcusable that in a time of war the highest earners have not been asked to contribute a greater share of their income to pay the cost of war. *The Credit Strategist* has argued in the past that taxes for people earning more than \$1,000,000 should be raised (on their income over that amount).

On the spending side, Congressman Paul Ryan's plan includes some reasonable expense cuts. Its Medicare proposals, however, need to be carefully examined because it is unclear that they will lower medical costs. In fact, Jared Bernstein, until recently Vice President Biden's chief economic advisor, argues that Mr. Ryan's plan doesn't reduce



costs but merely shifts them. According to the Congressional Budget Office, health spending on the typical beneficiary would be 40 percent higher under the Ryan plan than under the existing Medicare regime.

The debate over the debt ceiling is a study in all that is wrong in American politics. Both parties are doing little to persuade anyone of their entitlement to the leadership positions that they currently hold. First of all, the debate is about nothing since the United States has not a \$14 trillion but a \$20 trillion deficit if it is properly calculated to include the obligations of Fannie Mae and Freddie Mac (which are held in conservatorship by the U.S. government). Second, any deficit reduction plan is going to raise taxes and cut revenues. The key to any plan's ultimate success, however, is cutting the right taxes and the right spending. In order to accomplish that, certain principles will have to be followed.

The first principle requires a reform of the current tax system from one that favors debt over equity and speculation over productive investment into a regime that encourages precisely the opposite. The second principle should be that wealthy individuals and profitable corporations must contribute more revenue. But this should not be achieved solely through higher tax rates; instead, the special interest deductions that allow these parties to pay taxes at a far lower rate than the statutory rate should be eliminated. There also should be a higher tax rate on people making \$1,000,000 and over. This is the first time in American history when taxes haven't been raised during wartime, which compounds the disgrace of the wars being fought primarily by the least advantaged segments of our society while the wealthy sit home and watch. The third principle must be the acceptance of serious entitlement reform and cuts. The solution is not that difficult to describe; unfortunately until our political parties put the nation ahead of their own interests, it will be difficult to achieve.

There is a virtual certainty that a debt ceiling deal will be reached on the eve of the drop dead date, August 2. The problem is that even the most ambitious debt reduction plans leave the United States with a \$20 trillion debt burden by 2020 (including the GSEs, which are guaranteed by the government). What is needed to solve the debt problem is higher economic growth coupled with spending discipline. Higher economic growth can only be effected by policy changes that encourage investments in productive areas such as education and energy and the discouragement of unproductive uses of capital such as speculative trading of derivatives and leveraged buyouts.

More consequences of failed policy

On July 2, *The Wall Street Journal* ran a front-page article entitled "Iran Funnel New Weapons to Iraq and Afghanistan." The article describes Iranian efforts to hasten the United States withdrawal from these two countries by shipping dangerous arms to these its allies in these countries. It appears that an intense geopolitical battle in the Middle East is being fought by the U.S. on one side and Iran on the other. In view of the loss of several important (albeit corrupt) allies in the Arab Spring, this is an extremely disturbing



development. Even more disturbing is the fact that the United States appears to be both unable and unwilling to engage in the battle due to a lack of political and economic leadership. As the spokesman for the Iranian Foreign Ministry said, “[The Americans] are better off going home and sorting out their own domestic problems.” Despite the source, these words ring true; America may have been engaged in nation building abroad, but it has been engaged in nation destruction at home.

The financial crisis of 2008 was the culmination of years of policy errors as described in, among other places, my book *The Death of Capital*. In the economic realm, these flawed policies favored debt over equity and speculation over productive investment. In the political/foreign policy realm, the United States supported corrupt leaders like those of Egypt and Tunisia on the premise that these men offered the greatest chance of maintaining political stability. In both cases, the result has been the build-up of destabilizing forces over long periods of time. The eruption of these forces was therefore far more severe than they would have been had change happened earlier because the underlying pressures had longer to build up.

Now the United States faces a strong threat to its national interest in the Middle East and is no longer in a position to do much about it. Not only should the wars in Iraq and Afghanistan end (the former because our work is largely done, the latter because it is unwinnable), but this country can no longer afford to pay for them. The United States is now in drastic need of nation building and the resources spent on these wars must be redirected home.

This is why it is necessary to understand the 2008 financial crisis in a broader context than the merely economic. I hear many people in the media and elsewhere complain about the fact that none of the perpetrators of the financial crisis have been thrown in jail. The insider trading convictions that are riddling Wall Street have nothing to do with the 2008 crisis and therefore offer no satisfaction to those looking for a sense of justice. The fact that many of the people responsible for the bad decisions that severely hurt the economy have instead been rewarded with great wealth is particularly galling to the average American. The point I want to raise here, however, is that the damage these individuals inflicted was far severe and wide-ranging than generally considered. Clearly they inflicted enormous financial losses on institutions and individuals. But they also damaged the economic fabric of the United States in ways that we will be uncovering for years to come. Iran’s efforts to undermine U.S. influence in the Middle East are just one example of the larger field of damage that financial actors left in their wake. The self-absorption and selfishness of the fallen CEOs and their co-conspirators inflicted an incalculable cost on the future of this country. These were not just crimes against institutions or individuals or even the financial system, but they were crimes that severely damaged this country’s standing in the world and ability to protect its vital national interests. In that context, pleas of innocence from the like of Richard Fuld, Jimmy Cayne, and Stan O’Neil – men who were paid egregious sums of money to run systemically important companies – ring



hollow. These individual placed the future of the United States at risk, and that is why they should be severely punished if it can be proven that they broke the law.

Investment recommendations

The last week of June saw the biggest rally in U.S. stocks in years. As is often the case these days, this rally appeared to be completely detached from economic fundamentals. Much of the force behind the rally was relief that Greece would not default now, although there is wide recognition that Greek will default eventually. As noted above, S&P's announcement that it will deem the current restructuring plan to be a "selective default" may hasten that day and put a damper (or an end) to the rally. There was also the usual dose of short covering to spice things up. But fundamentally we think that investors should use the recent rally to reduce risk. There are just too many macro worries to be massively long. It won't matter how "cheap" individual stocks may be if the global financial system experiences a Greek default. Everything will go down. And if Greece delays its day of reckoning, Ireland, Portugal, Spain, Italy and Belgium are on the queue. Portugal was downgraded to junk status by Moody's on July 5. The European debt crisis has destabilized the global financial system, and until it is resolved, the chances of a financial accident will remain high.

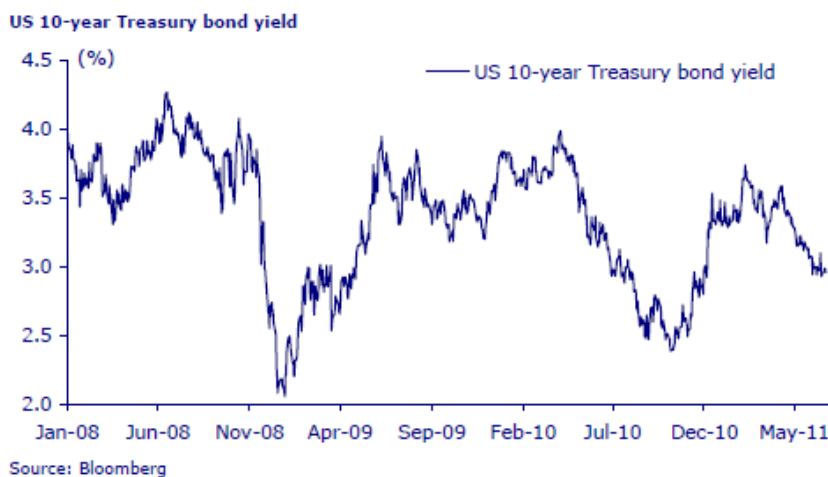
Stocks: In this type of investing environment, our views lead us to be extremely defensive. That means that equity exposure should be concentrated in deeply undervalued names. These are the types of stocks that will suffer the least if the market sells off sharply again. Some investors favor cyclical names based on their view that the U.S. economy is on the verge of a self-sustaining recovery. We do not agree with that view and would avoid economically sensitive stocks. Large capitalization dividend-paying companies in non-cyclical sectors are also decent places to hide for those who want equity exposure. We would also avoid the new flurry of high-flying Internet companies that are trading at valuations that are no less ridiculous than the ones we saw during the Internet Bubble (and we would include NetFlix Inc. in that category despite the incessant rise in its stock price). There are also a number of restaurant stocks that are trading at ridiculous valuations that should be avoided (or shorted at the appropriate time): CPTL and PNRA. Finally, Chinese stocks are proving themselves to be even more dangerous than we expected and should be approached with extreme caution.

Volatility: The VIX Index, which we watch carefully, sold down to below 16 before the July 4 holiday weekend. We believe this is far too low a level for an environment filled with significant questions about the U.S. recovery as well as well-publicized European risks. Investors should go long volatility either as a hedge against long positions or as an outright trade since the current level of the VIX is inconsistent with the risks we see in the market. As noted in previous issues of this publication, investors can go long volatility not only through options on the VIX index but on the S&P 500 and small-cap stock indexes. Shorting the stock indices is usually a more efficient way to capture increasing market volatility for technical reasons.



Bonds: Bonds remain unattractive despite the recent rise in yields in corporates and mortgage bonds. High yield bonds were experiencing a significant sell-off before last week's rally as investors finally realized that they were not being compensated for the risk of owning equity securities disguised as bonds. Leverage ratios have been creeping up on leveraged buyouts and other leveraged capital structures, although they remain below pre-crisis levels. Despite the sell-off, high yield bonds are still trading at yields that are too low to justify their purchase. Investors should avoid them. The same is true for investment grade bonds that continue to offer little reward for the limited risk they pose. Subprime mortgage securities had also sold off sharply before recovering dramatically last week. We find it difficult to believe that all but the most experienced investors should venture into mortgage paper in view of the sorry state of the housing market.

Figure 4
Interest Rates Will Remain Low



Interest Rates: Despite the recent rise in the 10-year Treasury yield, interest rates will continue to stay low for the foreseeable future. The recent increase in yields is unlikely to persist in the face of European debt troubles and increasing evidence of a flaccid U.S. economic recovery. As Figure 4 illustrates, yields are significantly above their historical lows and could drop further if the U.S. economy relapses into recession. If the U.S. avoids negative growth but bumbles along at 2-3 percent growth, yields likely won't drop to below 2.5 percent but should remain in the 3 percent range. While we do not disagree with Bill Gross's view that Treasuries are going to have to find a lot of new buyers, we suspect that the old buyers (the U.S. government) will still find a way to lap up a lot of supply. We also think that U.S. banks will increase their holdings of Treasuries as they deal with higher capital requirements and remain reluctant to lend. They still need to generate yield income to eat up the losses on their bad debt holdings, which range from Greek debt to subprime loans. All of these already distressed bonds have dropped further in price recently, leaving a bigger hole in bank balance sheets (whether they want to admit it or not).



Specific Investment Recommendations: I continue to recommend KFN and TFG1 as solid defensive holdings in a difficult environment. I also believe BP remains significantly undervalued regardless of what oil prices do (and we do not see oil prices dropping below \$80/barrel for the rest of 2011). We strongly believe that European banks are in trouble and would recommend investors avoid owning them and consider shorting them. The best way to do this trade remains the old-fashioned way – rather than use the illiquid ETF SX7E, it would be better to assemble a basket of stocks of individual European banks. We also remain long-term bullish on gold; Western central banks are devoting 100 percent of their efforts to debauching their fiat currencies.

Personal announcement

I am pleased to announce that I am now working with Cruiser Capital LLC, an investment management firm managed by my friend Keith Rosenbloom. Keith is a terrific value investor with a very successful long-term track record, and I look forward to my association with him and his firm. I can be reached through this publication or at MichaelL@cruisercap.com. My phone number remains (561) 239-1510.

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July 5, 2011



Disclosure Appendix

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The Credit Strategist
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