



The Wages of Denial

By Michael Lewitt, Editor, The Credit Strategist
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“To view...fund managers as immoral was a gross simplification of the world. And what was there to replace capitalism, anyway? Communism? Theocracy? Most of the Third World had already suffered nearly terminal bouts of idealism. It was the Communists, after all, who had littered the world with cheap AK-47s in order to ‘liberate’ the masses. But the only lasting effect was that every wall between Cairo and the Philippines had at least one bullet hole in it. But nothing changed. Nothing changed because these alternate belief systems flew in the face of human nature. Of even common sense. Anyone who has ever tried to share pizza with roommates knows that Communism cannot ever work. If Lenin and Marx had just shared an apartment, perhaps a hundred million lives might have been spared and put to productive use making sneakers and office furniture.”

Daniel Suarez, Daemon (2009)

There is a famous story attributed to the great British playwright George Bernard Shaw that in many respects describes what is happening in Europe today. Shaw was speaking with a woman at a party (apparently he attended a lot of parties) and told her that anybody would agree to do anything for money if the price was high enough. The woman disagreed, so Shaw asked her if she would sleep with him for £1 million. She said, “Well, I might for £1 million.” Shaw then asked, “Would you sleep with me for ten shillings?” The woman answered: “Certainly not! What do you take me for?” And Shaw replied, “We’ve already established what you are, Madame, now we are merely haggling over the price!”

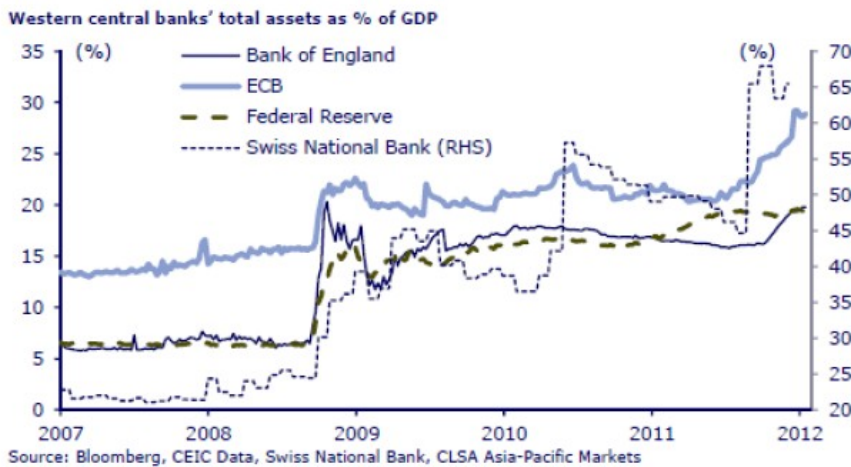
Europe is little different than a woman who is willing to sleep with a man for £1 million but not for 10p. She knows what she is but wants to haggle over the price. In the case of Europe, she is insolvent, and hopelessly so. Her procurer – in this case the European Central Bank (ECB) – can front her some money for a while, but in the end she is either going to have to repay him or suffer a very rough consequence. In the meantime, however,

she can continue to entertain her customers, in this case those willing to extend her credit in one form or another. Sooner rather than later, however, these creditors are going to grow tired of her tricks and turn their attention otherwise. At that point, she will be left to deal with the ECB because nobody else will have her.

The world eases

Over the past several months, the developed world's central banks have shifted toward a decided easing mode through quantitative easing. The Federal Reserve adopted Operation Twist, the Bank of England engaged in a new round of bond purchases, and the ECB has been purchasing the bonds of its weak sisters and launched its LTRO program in December (another tranche is due this month). Even China, which has less room to ease given rapid credit expansion over the last three years, has loosened the monetary reins recently as well. Figure 1 below shows the increasingly dominant role played by these central banks (and the Swiss National Bank) in their respective economies. Central bank balance sheets are swelling to record levels as unsustainable private sector debt burdens are being shifted to the public sector.

Figure 1
Central banks rule



In the short term, central bank easing is producing improved funding conditions in the private markets. Weak European sovereigns such as Italy and Spain have thus far been able to fund themselves at lower rates. European banks are also seeing improved spreads although their access to capital markets remains limited. The covered bond market has been relatively hospitable to the strongest European banks, a promising sign. Important indicators such as the Euribor-OIS spread have rallied for four consecutive weeks and aggregate bank spreads have also tightened by almost 100 basis points. For the moment, the financial system has backed away from the precipice. While all of these are promising signs, they will go for naught if they are not accompanied by meaningful reform of the labor



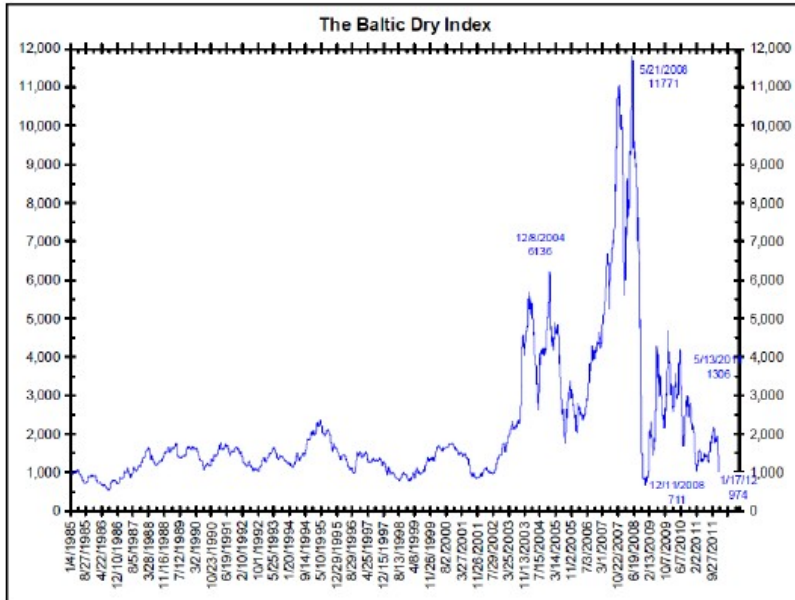
markets in southern Europe and other pro-growth changes throughout the European Union. But they are certainly better than the situation that we were facing at the end of the year.

Despite these Herculean easing measures, global growth remains below potential. One worrying sign is a sharp drop in the Baltic Dry Index (see Figure 2 on the next page). This index fell below 1000 for the first time since January 2009 on signs that Chinese demand for iron-ore cargoes is slowing. Thus far in 2012, this index is down 44 percent, led by weaker Chinese demand for iron ore. The Baltic Dry Index has often been a good indicator of a coming slowdown in economic activity. It suggests that the world's central banks will have to keep their pedals to the metal in order to sustain global growth in the year ahead. It also suggests that organic growth remains extremely weak as the world continues to fight its way out of the debt crisis. It is far too soon to break out the champagne glasses, although one might have thought differently had one a strong enough stomach to watch the coverage from Davos.

Europe

The self-congratulatory tone of Davos was particularly frustrating to watch this year. For those of us who stopped being fooled a long time ago, it was galling to sit and watch Jean-Claude Trichet and Mario Draghi congratulate themselves for delaying the day of European reckoning for a year or so. What these men need to be doing is convincing southern European leaders to impose meaningful labor and other reforms to render their economies competitive. Then again, these leaders are the descendants of the generations that stumbled into two world wars, the Holocaust, and countless other smaller disasters along the way, so perhaps we should not expect more of them. But since we are the ones who will be living with the consequences of their errors, it is our duty to speak out in order to try to produce a better outcome.

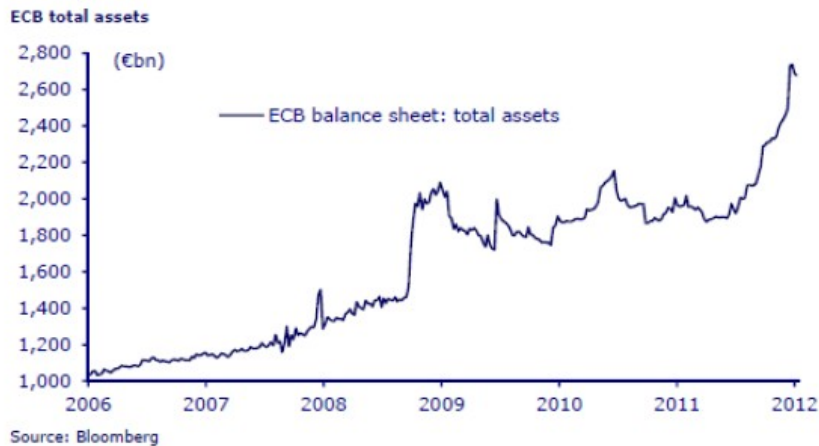
Figure 2
Baltic Dry Index Collapses



For the umpteenth time, you cannot solve a debt crisis with more debt. Figure 3 on the next page shows the results of the ECB's efforts to bail out insolvent countries and banks – it has merely shifted bad debts from the banks' balance sheets to their own. Nobody can say precisely how much of the ECB's €2.8 trillion (\$3.4 trillion) of debt will not be repaid, but the amount of bad debt is much bigger than a bread box. Despite all of the changes that we see in the world around us, the basic laws of economics have not been repealed. It would be nice to think that just because we can create derivative financial instruments out of thin air that these instruments will automatically have value, but that is simply not the case. In order to have value you must create value. And much of what the modern financial system does fails to create value. Accordingly, you cannot solve an insolvency crisis with more debt. You can only solve an insolvency crisis by taking losses on bad debts and building economies back up with pro-growth policies. And that is not being done.

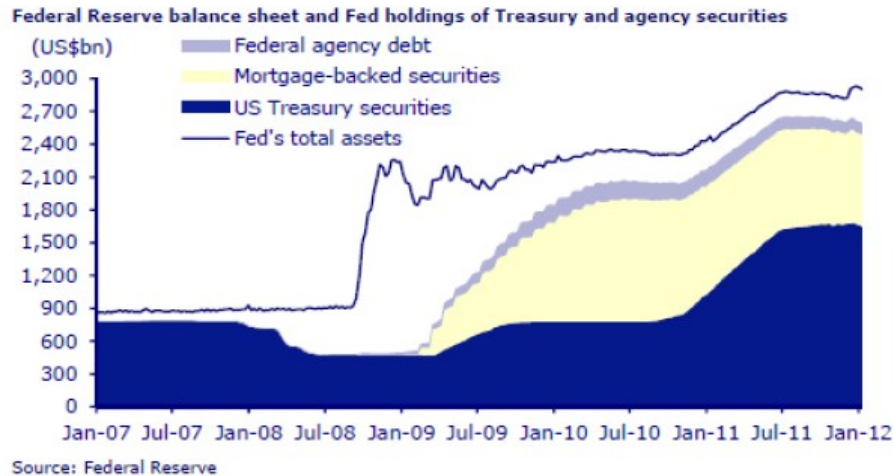
As long as you pretend that bad debts are money good, you are weighing down economies with obligations that trap them in a cycle of failure. Several of Europe's sovereigns – Greece, Portugal, Spain, and Italy for sure – are insolvent. Many of Europe's banks are insolvent in large part because they own too much of these bankrupt sovereigns' debts (and are buying more under the ill-conceived LTRO program). The world's leaders can all play pretend and let this situation fester until it can no longer be fixed – which is pretty much what they've been doing for the last decade or so – or they can start to impose the tough reforms that will give Western economies a chance to grow in the future. The choice is theirs. Thus far they are not making the right choice.

Figure 3
ECB Buys 'Til It Bursts
U.S. Monetary Policy



The Federal Reserve made it clear last week that it is not going to raise rates for almost three more years (in Fed speak, economic conditions are likely to “warrant exceptionally low levels for the federal funds rate at least through late 2014”). It did not make that judgment based on a belief that economic growth is going to accelerate in any meaningful way, or that inflation is going to become a problem within that time frame. Its judgment was based on a belief that U.S. growth will be tepid and that deflation rather than inflation is a near-term concern. GDP has averaged 1.6 percent over the past four quarters and real GDP growth has averaged 2.5 percent over the past 8 quarters. This tells us that growth has slowed down and is not expanding like in previous recoveries. This is likely due to the weight of debt suffocating all levels of the economy as well as the lack of confidence in economic and political leadership. The longer the Republican nomination circus goes on, the lower the chance that confidence will recover anytime soon. The prospect of four more years of an Obama presidency is going to depress markets (as well as this author).

Figure 4
Fed Isn't Far Behind ECB



Interestingly enough, inflation-based securities (TIPS) rallied by a half-point after the Federal Reserve's announcement that it was targeting 2 percent inflation, suggesting that the markets see the central bank printing money around the clock until it can create the inflation that remains absent from the economic scene today. The U.S. economy remains larded with overcapacity in a number of key areas, the most troubling being housing, commercial real estate and employment. As long as these key areas remain underutilized, deflation rather than inflation will remain dominant. That does not mean that prices at the supermarket or the gas station are going to plunge – in fact, both food and gasoline prices are likely to remain high, particularly if future GDP prints are as disappointing as the ones we saw in 2011 and the Federal Reserve is tempted into another round of quantitative easing. Prior bouts of quantitative easing led to higher commodity prices, but declines in debt-swollen asset prices counteracted overall inflation trends. For the average person (now known as the “99%”) everything but housing has increased in value. The problem is that only those members of the 99% that were renting their homes/apartments benefitted from this phenomenon. Overall, most people have suffered from Federal Reserve policies, particularly savers, homeowners, and those who followed the precepts of what were considered prudent financial management.

Private equity's worst nightmare

If Stephen Schwarzman thought the Obama administration's previous attempts to repeal the carried interest tax felt like Hitler's invasion of Poland, he is likely to find the next round feeling like the U.S. attack on Hiroshima. Public opinion appears to have finally caught up to this issue with the presence of former private equity mogul Mitt Romney as the leading candidate in the Republican presidential field. The carried interest tax has always been a hot button for *The Credit Strategist* since it is both unprincipled as a matter of tax law and grossly misguided as a matter of tax policy. As a matter of tax law, it taxes labor as capital.



As a matter of tax policy, it increases the incentives for investors to use debt rather than equity and increases the amount of debt in the economy. Neither of these effects is hospitable to economic growth, particularly when the type of debt employed is non-recourse and essentially creates a heads-I-win, tails-you-lose set of incentives for private equity managers.

This one-way incentive system is exacerbated by the one-sided fee system that grossly overcompensate private equity managers with a two percent management fee regardless of the success of their efforts and additional fees for doing what they are supposed to do in the first place (like monitoring and arranging financings for their portfolio companies). Why wouldn't somebody want to become a private equity manager with this set of rules? Fortunately, it appears that this game is coming to an end, because it represents one of the most egregious examples of how the elite has rigged the game in its own favor while imposing enormous negative costs on society. The ultimate cost, of course, is paid by the institutional investors who end up paying the lion's share of whatever gains these investments generate to the managers. Private equity returns, when properly adjusted for leverage, concentration risk, liquidity and fees, are mediocre at best with few exceptions.¹ Unfortunately, large institutions in the public sector are so desperate to meet their funding goals that they have been brainwashed into believing that they must invest in a compensation scheme dressed up as an asset class. There are far better ways to generate the returns required by large public funds than private equity (stewards of those funds should feel free to call me for ideas – at the risk of sounding like Jeff Gundlach, I have been generating those returns for two decades).

This debate, while necessary, is coming at an unfortunate time because the likely nomination of Mitt Romney, a beneficiary of private equity's undeserved benefits, is also likely to leave us with four more years of Mr. Obama as our president, which means anti-growth business policies and weak foreign policy management.²

¹ I discuss exorbitant private equity fees and mediocre private equity returns at length in Chapter 5 of my book *The Death of Capital: How Creative Policy Can Restore Stability* (John Wiley & Sons: 2010). There are probably a few copies left on Amazon.

² Speaking of Mr. Obama's foreign policy, it is apparent that while Iranian sanctions are now starting to bite, this administration waited far too long to take action to prevent Iran from moving forward to gain nuclear weapons capability. Mr. Obama has also been far too passive in allowing Venezuelan President Hugo Chavez to forge alliances with Iran and China, which poses a direct threat to U.S. interests in our own hemisphere. While Mr. Chavez is unlikely to live very long, there is little assurance that his successors will follow a more constructive path. It is time for the U.S. to add a Venezuelan oil and central bank embargo to the Iranian embargoes in order to make it clear to the Venezuelan dictator that his antics have a cost. Trying to appease him is not only a sign of weakness; it is evidence of a dangerous naïveté that the U.S. cannot afford.



Investment Recommendations

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