

By Michael E. Lewitt

## The Illusion of Calm?

Don't be fooled. There are tidal waves building out there—and our so-called leaders are doing little to stop them

**T**he financial markets enter 2010 on a much calmer note than they entered 2009, when the worst effects of the financial crisis were still being felt. By mid-December 2009, the S&P 500 rallied from its March 2009 low of 666 to nearly 1,100, the Dow Jones Industrial Average was perched above the 10,000 mark, and credit markets were functioning again (with the exception of securitization markets, which remained dead in the water). The recession appeared to have ended sometime during the summer of 2009, and third quarter GDP growth was a positive 2.8 percent. Fourth quarter growth was expected to be positive as well. Overall, investors were breathing a well-earned sigh of relief.

Perhaps they should save their breath and their capital until:

- (1) there are genuine signs that the economy can grow without massive government support; and
- (2) their political and business leaders engage in some genuine financial reform instead of a series of politically expedient compromises and show trials that leave the system as unstable as ever.

Financial markets are studies in relativity. Once investors were convinced that Armageddon was no longer at hand, they began to act as though the global economy would heal and that the sins of the past could be forgotten. That is a big mistake. As I argue in my forthcoming book, *The Death of Capital* (Wiley, Spring 2010), the steps taken by governments around the world to stabilize

their financial systems will only lead to greater instability in the future. Sovereign balance sheets are saddled with trillions of dollars of additional debt just as they are facing rising costs to deal with issues such as aging populations, healthcare reform, hunger, infrastructure repair, climate change and energy challenges. A stable global financial system is an absolute necessity if these challenges are going to be met. Unfortunately, a stable financial system is precisely what we don't have. Instead, the system is suffering from profound imbalances that cannot be papered over by stock market gains. The world remains highly vulnerable to another crisis unless appropriate reforms are instituted to promote financial stability. More than one year after the bankruptcy of Lehman Brothers and the near extinction of Western finance, there are scant signs of progress on this front.

A year ago, I argued that the United States needed to adopt two types of reforms: economic and regulatory.<sup>1</sup>

On the economic front, the government had to commit funds and ideas to productive activities and away from the types of speculative activities that brought the most powerful economy in the world to its knees. Rebuilding America's transportation and energy infrastructure, for example, should be priorities, including an expansion of the use of nuclear power. Other areas that deserve funding include education, technology and green industrial projects such as the design and manufacture of more energy efficient vehicles.

On the regulatory front, reform was needed in the areas of banks' capital adequacy, executive compensation, hedge fund and private equity fund regulation, derivatives regulation, the ban of off-balance sheet vehicles, and reinstatement of the downtick rule on short sales of stock.

It is fair to say that both areas of reform have seen



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limited progress. The most important reforms have been diverted by multimillion dollar lobbying efforts by the financial industry itself. In particular, the failure to take steps to adequately regulate credit derivatives has left the financial system vulnerable to potentially fatal instability in the future.

Despite all the talk about having learned our lessons from the 2008 financial crisis, we have done little to put these lessons into practice.

### Economic Stability

In the near-term (that is to say, the first half of 2010), the economy is likely to experience relative stability. Economic growth will likely remain positive throughout this period, with GDP growing around 3 percent. After mid-2010, growth is likely to decline to the 2 percent level and remain at a relatively depressed level for an extended period of time.

A couple of things should be said about these predictions. First, I am speaking of headline numbers, which are notoriously inaccurate and misleading. The 2.8 percent GDP growth that was reported in the third quarter of 2009 (it was originally reported as 3.5 percent growth but was revised downward in late November), for example, was largely attributable to contributions from the “Cash for Clunkers” program and other one-time government stimuli that tell us little about sustainable future growth. Moreover, there are statistical anomalies in the figures that suggest that growth has been significantly overstated by as much as 1.5 to 2.0 percent for a prolonged period of time.<sup>2</sup>

The sad truth is that GDP growth in the United States away from government stimulus is extremely anemic and is likely to remain that way for a prolonged period of time. The real challenge is identifying sources of possible future growth. The most likely candidate is exports to Asia, a region that is showing strong signs of growth (although much of it is attributable to stimulus-induced spending in China, which may not be sustainable). Traditionalists argue that the average post-World War II recovery has lasted 45 months. Assuming that the U.S. recession ended sometime in the summer of 2009, they contend that we are in the very early stages in the recovery from a longer-than-average 17-month recession.

Others (including me) argue that we did not suf-

fer a garden-variety recession but a deflationary debt depression that will impose a heavy hangover on the United States for years to come. Accordingly, whether the economy continues to grow as it has in the aftermath of previous recessions, such growth will be anemic in view of the significant headwinds facing the economy: a moribund housing industry; a debilitated consumer; high debt at all levels of the economy; and increasing loss of confidence in government and business leaders. Accordingly, my outlook is extremely cautious.

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### Interest Rates

In 2010, there will be constant debate about when the Federal Reserve can begin to back away from its zero interest rate policy. The answer is likely to be “not anytime soon.” The system is too dependent on low interest rates to reflate asset values that were beaten down during the crisis. The Federal Reserve is bound to keep rates low for the foreseeable future and certainly throughout 2010. The U.S. housing market remains deeply depressed, despite the fact that the rate of decline has slowed meaningfully. Higher interest rates would be anathema to prospective homebuyers, and the authorities will do everything within their power to prevent rates from rising. Concerns about the decline of the dollar are well-placed, but a lower dollar is a boon for U.S. exports and something politicians (which include Federal Reserve Chairman Ben Bernanke) like to scream about while in the same breath pursuing policies that further trash the currency.

That does not mean that the Federal Reserve’s policy is the correct one for the long-term. There is a significant likelihood that zero interest rates are sowing the seeds of the next bubble. Low interest rates inevitably lead to speculation. The U.S. dollar has become the currency of choice for the new global “carry” trade in which speculators borrow dollars to invest in other

currencies and financial instruments. Much of the borrowed money is being invested in Asia, where asset prices are rising in countries like Singapore, Taiwan and Hong Kong. China is experiencing its own self-imposed bubble as a result of record levels of government stimulus that dwarf the size of the stimulus programs adopted by the United States and other Western nations. Asset prices in Asia—whether stocks or commodities—are reaching levels that are fundamentally incompatible with the economic fundamentals. This is also a potential danger in the U.S. markets.

## Stock Markets

The U.S. stock market staged an historic recovery over the last three quarters of 2009. Nonetheless, stock prices ran far ahead of economic fundamentals. Corporate performance was characterized by lower revenues and better-than-projected earnings, which is a dubious recipe for long-term economic growth and stock market health. Investors should pay careful attention to corporate revenues as they navigate the market in the year ahead.

Better-than-expected corporate earnings were the dominant theme and certainly suggested that the environment for equities was improving. Traditional stock market observers expect the S&P 500 to trade in the 1,100-1,200 range in 2010 based on a 15-times multiple of \$70 to \$80 earnings. This is a perfectly reasonable view on both the multiple and the earnings side. If anything, the multiple could trade higher (to the 18-to-20 times range), because money will remain cheap and fixed income will offer limited alternatives. Significant percentages of S&P 500 companies beat their earnings estimates beginning in the second quarter of 2009, although this feat was largely accomplished via cost cutting and not through revenue growth. Cost cutting was accomplished largely through job cuts, which hurt consumers and consumer spending. As of November 2009, consumer confidence remained at historically low levels, which suggest that a recovery in consumer spending is not imminent. Revenue growth is likely to remain weak in 2010, particularly for companies with limited foreign exposure, which should place a cap on earnings and stock prices.

The most attractive stocks will be those of companies that have significant foreign sales (and non-dollar sales) as well as those paying decent dividends. Growth in the emerging markets will continue to be strong, and inves-

tors would be well served by gaining exposure to these markets through mutual funds and exchange-traded funds (ETFs). The stock market will likely hit a wall when economic growth drops from the 2.8 percent rate (or higher) reached in the third quarter of 2009 to a more likely level of 2.0 percent or less. That time is most likely to be in the middle of 2010, so investors should manage their portfolios accordingly. In all cases, investors should remain focused on stocks with lower price/earnings and price/book ratios and avoid chasing growth in an economy where growth is going to be hard to come by.

## Fixed Income

Most fixed income instruments experienced enormous rallies in 2009—courtesy of massive government support. As a result, most of these assets are currently fully or over-valued and should be approached with caution. The mortgage market remains vulnerable to weakness in housing and commercial real estate throughout the country, while high-yield bonds are trading at spreads that do not compensate investors for the equity risk that they pose. The leveraged loan market also has returned to levels that offer attractive opportunities in specific new issues and secondary loans, but overall the market is again fully priced.

The good news in the corporate credit market is that defaults should drop sharply from double-digit levels and credit downgrades also should slow significantly. The opening of the bond markets in early 2009 relieved a great deal of pressure on corporations, which are facing massive refinancing needs over the next five years. In general, most companies (with the exception of the most troubled) should be able to refinance their debts, although the cost of capital will rise. Savvy investors with sound credit skills will be able to pick and choose among many new offerings that should be priced to sell in 2010, as companies come to market to extend existing maturities or refinance maturing debt.

## Emerging Markets

Emerging markets will continue to show growth in 2010—although they risk becoming the next bubble. The blow up of Dubai in late November 2009 was a sign that some emerging markets have been built on a foundation of sand. China's Herculean government stimulus spending was massive—three to four orders

of magnitude as large as similar programs in the United States and Europe when measured as a percentage of GDP. But it was successful in raising asset prices across the board in 2009. Unfortunately, the Chinese economy was really not equipped to handle the infusion of so much capital and by mid-2009 was experiencing sequential bubbles in stocks, commodities and other asset classes.

While upward price moves in these assets may continue in 2010, they are unjustified by economic fundamentals and ultimately will have to return to earth. Evidence for this can be found every time the Chinese government announces that it may start encouraging banks to restrict lending; in an almost Pavlovian response, upon hearing such news, the Chinese stock market immediately sells off sharply. Despite propaganda about China's new capitalism, China remains largely a command economy driven today by government stimulus. Domestic demand is developing far more slowly than GDP growth suggests.

## Gold and Fiat Currencies

By late November 2009, gold had risen to more than \$1,100 an ounce and is likely to continue to rise as a result of continuing doubts about the value of fiat currencies and shortages of physical gold. As I've written many times, gold is the anti-leveraged buyout, the anti-credit default swap, the antidote to all of the speculative financial practices that led to the 2008 financial crisis. Every investor should hold a portion of his portfolio (ideally 5 to 10 percent) in the precious metal (and hold it in physical gold rather than gold stocks or the ETF).

Despite the obvious fact that fiat currencies have been terribly devalued by the massive amounts of debt that governments have printed to bail out their economies, investors should not assume that shorting these currencies or buying gold is a one-way trade. There are good reasons to believe, for example, that the U.S. dollar could stage a rally at any time. The U.S. current account deficit, which has a significant impact on the value of the dollar, has been shrinking significantly during the past two years, a fact that has gone largely unnoticed by the media and economic pundits.

Moreover, one of the best things the U.S. dollar has going for it is that it is competing with other fiat currencies like the Euro, which suffers from similar problems (that is to say, these other currencies are also backed by nothing more than faith—or lack of faith—

in the economic policies of the governments that issue them). Accordingly, any dollar decline based on loss of confidence in the dollar is likely to be both gradual and subject to reversals based on technical factors such as the shrinking current account deficit.

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It should be noted, however, that it is unlikely that the Federal Reserve or the Obama Administration will take any meaningful steps to bolster the dollar. A weak dollar remains a boon to U.S. exports, one of the few potential bright spots for the U.S. economy. Moreover, foreigners don't count in the polls, and all eyes will be on the upcoming mid-term elections in November 2010 and thereafter the 2012 presidential elections. The dollar should be considered safe from political intervention although there may be a great deal of empty jawboning about it in the months and years to come. It is a certainty that jawboning will not be accompanied by any meaningful policy changes that would actually support its value.

## Policy Vacuum

Policy is where the rubber meets the road. Current plans to reform healthcare and the financial system offer little hope that the United States will be putting its economic house in order anytime soon. And while that failure may not sink the markets in the short term, in the long term policy failures spell serious trouble. Healthcare represents an intractable problem that stubbornly resists simple or inexpensive solutions. Financial reform is a more manageable challenge but has been hijacked by special interests that are preventing meaningful reform from being implemented. A year ago, I recommended seven relatively straightforward reforms that would go a long way to stabilizing the financial system. I stand by them today:

- (1) Reform executive compensation with long-term

compensation schemes that are primarily paid in stock, not cash.

- (2) Limit financial institution leverage to 10-to-1.
- (3) Limit hedge fund leverage to 2-to-1 on stocks and 3-to-1 on debt.
- (4) Ban all off-balance sheet entities.
- (5) Require all private equity firms to register as investment advisors.
- (6) Require all hedge funds to register as investment advisors.
- (7) Reinstitute the downtick rule for short selling.

Now, I would add to this list:

- (8) Ban all naked credit default swaps.
- (9) Impose a "Tax on Speculations and Securities Trading" on the following activities: naked default swaps (if they are not banned) (1.25 percent); securities issued in leveraged buyouts and leveraged recapitalizations (0.60 percent); quantitative trading strategies (0.35 percent); equity derivatives (options and futures contracts) (0.25 percent); large block trades (0.25 percent); and all other stock, bond and bank loan trades (0.15 percent). The tax would be imposed on the face amount of the securities or instruments being traded.

These reforms would significantly reduce the chance that the financial system would experience a replay of the 2008 financial crisis. But thus far, there appears to be an agreement (and only on a limited basis) on reforming executive compensation. The other recommendations have all been sidetracked by Washington lobbying and the cowardice of our elected leaders to stand up for principles other than insuring their reelections through currying favor with special interests. This is disgraceful and is setting the table for further financial instability.

In particular, the refusal to ban naked credit default swaps leaves open the very real possibility that a group of investors can get together and mount a bear raid on an otherwise healthy financial institution, including one that is systemically important. We saw the damage such

bear raids can cause not just in the fatal cases of Bear Stearns & Co. and Lehman Brothers, but also in the near fatal cases of Goldman Sachs and Morgan Stanley. The latter two firms, which were perfectly sound, were almost forced out of business by the rising spreads on their credit default swaps at the height of the crisis.

The asymmetric incentives created by credit default swaps render them true instruments of mass financial destruction and they should only be permitted to the extent that they are true hedging instruments. As mere instruments of speculation, they introduce a degree of instability into the financial markets that we will come to regret if we don't act quickly to rein them in.

## Be Very Afraid

Markets appear stable on the surface, but serious instabilities continue to churn out of the sight of investors, policymakers and regulators. The water may stay calm for a while, but big waves are building in the open water and ultimately will come to shore.

Investors should insure that their portfolios are structured so that they can be turned into cash quickly when the seas begin to get rough. Investors should pay close attention to value measures such as price/earnings ratios and credit spreads for warning signs that these are getting extended beyond what economic fundamentals suggest make sense (and we may already be at that point in U.S. stock and credit markets as 2009 comes to a close). Investors should not wait until the last minute to reduce risk exposures.

The market recovery from post-crisis lows was not surprising, but neither would a sharp and sudden market sell-off were the economy to fail to sustain itself without government support. **IE**

## Endnotes

1. Michael E. Lewitt, "Let's Get It Right," *Trusts & Estates*, January 2009, at p. 23.
2. Goldman Sachs' economics team has questioned whether official government GDP statistics capture how poorly small business (that is to say, sole proprietorships) are doing. These businesses account for 17 percent of the U.S. economy. Goldman Sachs used data from the National Federation of Independent Business confidence survey and estimated that third quarter GDP may have been overstated by 0.5 to 1.0 percent in one scenario and as much as 1.0 to 2.0 percent in a second scenario.