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Blind Faith

> "We live in a technological golden age but in a monetary and fiscal dark age. While physicists discover the so-called God particle, governments print and borrow by the trillions. Science and technology may hurtle forward, but money and banking race backward.
>
> Jim Grant[1]

> "The further we dug into the way TARP was being administered, the more obvious it became that Treasury applied a consistent double standard…When providing the largest financial institutions with bailout money, Treasury made almost no effort to hold them accountable, and the bounteous terms delivered by the government seemed to border on being corrupt. For those institutions, no effort was spared, with government officials often defending their generosity by kneeling at the altar of the 'sanctity of contracts.' Meanwhile, an entire different set of rules applied for homeowners and businesses that were most assuredly small enough to fail."
>
> Neil Barofsky, Bailout (2012)[2]

> Difficile est saturam non scriber.[3]
>
> Juvenal

The logic of the financial markets can only be understood as anti-logic. The worse the economy does, the higher the stock market moves on hopes that the Federal Reserve will institute another round of stimulus. The S&P 500 is up 10% for the year while the tech-heavy Nasdaq is enjoying a 13.5% rise despite the high-profile collapse of the social media sector. U.S. investors are hoping and praying that Ben Bernanke and his colleagues will come to their rescue with another round of quantitative easing this week. Their European cousins are holding their breath that Mario Draghi will batter the Bundesbank into agreeing to his plans to repurchase Spanish and Italian bonds and embark on further monetization adventures. The Federal Reserve will announce the results of its meeting on Wednesday, August 1 and the ECB will follow on Thursday, August 2, shortly after this is published.[4] We would respectfully advise those anticipating any substantial announcements from these meetings to prepare for disappointment. To the extent they have further cards to play, these central banks are facing political and practical obstacles that will render it very difficult for them to deliver anything more than anodyne words and actions as summer moves into the always dangerous August holiday season. IPhones (we used to say Blackberries) should be kept on alert at the beach through Labor Day.

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[1] *Grant's Interest Rate Observer*, July 27, 2012, p. 1.

[2] Neil Barofsky, Bailout: An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street (New York: Free Press, 2012).

[3] It is hard not to write satire.

[4] The Bank of England also meets on Thursday. No disrespect intended for our British friends, but the impact of any BOE action is likely to be marginal at best.

United States

The second quarter U.S. GDP print of 1.5% seemed too high, and we expect it to be revised downward in the coming months. Unfortunately, for those hoping for QE3, it may have been just high enough to keep the Federal Reserve from acting before the election. Coupled with the Dow Jones Industrial Average hitting 13,000 again and the S&P 500 approaching 1400, 1.5% growth probably doesn't scream out for urgent Fed action. The stock market may have performed its own intervention, which could then cause it to sell off again in disappointment when the Fed fails to act. If it sells off, hopes for Fed intervention will then start up again. Such a dynamic describes just how nutty stock market psychology has become. In the meantime, the U.S. economy is barely growing, unemployment remains stubbornly high, the presidential candidates continue to talk about nothing, and the rest of us are left banging our heads against the wall wondering how this country is going to get back on a more productive and constructive track. This is how even the allegedly sane are rendered crazy.

I am seeing irrefutable evidence in the dozens of companies that I follow across a wide spectrum of industries that the U.S. economy is slowing. From the manufacturing to the retail and service sectors, corporations are seeing lower demand. They know consumers are worried. The University of Michigan consumer sentiment reading hit 72.3 in July, and the key "expectations" index dropped for the second month in a row to 65.6, the lowest reading of the year. In response, businesses are themselves contributing to slower demand. They are not hiring and are spending very cautiously. They are concerned about the future direction of tax, healthcare and regulatory policy. They do not know what their healthcare and other costs are going to be, although they have every reason to believe they are going to be higher in the future. They are worried about the fiscal cliff, on which they don't expect to see any action until after the Presidential election, as well as about the outcome of the election itself. Until there is greater clarity on these and other issues, the economy is likely to be stuck in stall speed. In the long run, however, there is little that either Presidential candidate will be able to do to alter the nation's inexorably negative budgetary, fiscal and monetary trends without radical policy reforms. And neither man has shown any sign of being capability of bringing forth any type of policy proposals that qualify as radical. That would require courage, and courage is in short supply in our political and business circles these days.

The problem is that the longer this slow growth goes on, the more difficult it will be for the economy to emerge from what has been a prolonged period of stasis. Another bout of quantitative easing is unlikely to have much of an effect in view of the fact that interest rates already are at microscopic levels. Economic activity is not being held up by the level of interest rates, it is being delayed by a profound lack of confidence in the future. Faced with the prospect of re-electing a president who believes that the government should be the primary driver of economic growth, or a private equity executive who appears to be too timid to shake anybody up (except the Brits apparently), the natural result is that economic actors lose their motivation to act first and wait for the government to lead. This may not be the intention of Mr. Obama and the Democrats, but it is the necessary consequence of their ideology. It is toxic for the country and for the economy.

The U.S. is in the midst of one of the most interesting earnings seasons in recent memory. More companies are beating on the earnings line than on the revenue line, something we saw in 2009 as the

economy entered the balance sheet recession that it is still experiencing.[5] But there have been a string of high profile earnings misses as well – MCD, AAPL, SBUX, DOW, AMZN, BSX, UPS. While individual companies are punished when they miss earnings, the overall market seems to shrug off the news. Third quarter earnings are unlikely to be as easy to ignore if economic growth stays on its current course.

Corporations will soon benefitting from a new gift from Congress and the Obama administration. The bill that the president signed on July 6 extending low interest rates on student loans also allows corporations to lower their pension contributions.[6] This is being done while S&P 500 companies have a collective pension deficit of $355 billion as of the end of June 2012. The rationale is that corporations need relief in tough times. But if corporate earnings are so great, why do corporations need relief? Corporations should be using their strong corporate profits to bolster their pension funds and protect their employees. This is another example of policy encouraging precisely the wrong behavior at the wrong time. Corporate earnings will soon look better than they should, but investors should not be fooled. Those pension shortfalls are going to have to be filled in the future.

Europe[7]

The European economy is deteriorating by the day. The UK is back in recession after experiencing 2Q12 GDP of -0.7%, the third consecutive quarter of negative growth. This was the biggest drop in GDP since early 2009. Industrial output was down -1.3% while construction plunged -5.2%. Hopefully the Olympics can cheer up our British friends.

Europe's July flash manufacturing PMI was down to 44.1 from 45.1 in June. Germany's flash manufacturing PMI came in at 43.3, down sharply from 45.0 in June, and France's was down to 43.5 from 45.2 in June. France's economy is beginning to be taken down the socialist path by its new president, who has proposed policies in its first budget such as imposing a new wealth tax on those with more than €800,000 of assets, lowering the retirement age to 60, raising the minimum wage, announcing plans to hire an additional 150,000 public sector workers, repealing a law that limited employer contributions to social security plans, and other anti-growth measures. The thing Hollande's government has not proposed is any meaningful reduction in public spending. Look for French bond spreads to widen as M. Hollande dismantles Sarkozy-era pro-growth reforms which, while imperfect, were far more constructive than the retrograde policies being imposed today. France seems intent on joining its weaker southern cousins, whose rigid labor and spendthrift fiscal policies have delivered them to the brink of insolvency. Investors should be shorting French sovereign credit based on these retrograde policies.

Europe has hit many inflection points over the past two years, but its current situation is as close to a breaking point as we have seen since the 2008 financial crisis. Last week, Spanish 10-year bond

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[5] In a balance sheet recession, consumers and businesses limit their spending in order to strengthen their balance sheets. While this is rational behavior for the individual economic actors, their collective behavior leads to slower economic growth. John Maynard Keynes called this the "paradox of thrift."

[6] This is accomplished by allowing corporations to assume that their pension assets are earning a return based on interest rates over the past 25 years rather than over just the last two years when interest rates have been so low. Since this calculation will pretend that they are earning more on these assets, corporations can then contribute less to their plans. Who says Congress can't get creative when it wants to accomplish something?

[7] For readers interested in a detailed history of European Union since the financial crisis as well as excellent background history particularly on Germany's relationship with the European Central Bank, I strongly recommend a new book Saving Europe: How National Politics Nearly Destroyed the Euro by Carlo Bastasin (Brookings Institution Press: Washington, D.C., 2012).

yields definitively breached the 7% level that is generally considered to separate the solvent from the insolvent. Equally if not more troubling was the fact that 5-year yields and 10-year yields inverted, with investors demanding higher yields for the shorter maturity paper. Such an inversion generally implies that investors are expecting an imminent default. Rates only moved back down after ECB President Mario Monti muttered some brave words about doing whatever is necessary to rescue the euro without providing any roadmap for how he might accomplish that (more on this below).

Spain's yield curve remains flat and elevated, and it won't take much for it to return to unsustainable levels (if it is not already at such levels). Having already been abandoned by the interbank market, Spain has now been virtually deserted by the bond market. Regardless of the fact that Madrid has promised more austerity measures, time has run out. Moreover, Bridgewater Associates recently suggested that Spanish banks are running out of collateral that they could pledge to the ECB for further loans. According to Bridgewater, Spain's banks may be down to their last €300 billion of collateral. Moreover, this collateral is not evenly spread among the banks but is likely concentrated in stronger institutions like Banco Santander and BBVA, leaving weaker institutions almost tapped out. This leaves Spain, its banks, and the ECB to manage a precarious balancing act to prevent a collapse of the banking system.

Italy is not far behind Spain. And it is no longer a question of Italy's credit quality or economic reforms. It is a matter of market psychology, and market participants are going to be extremely reluctant to fund Italy at any reasonable rate if Spain is in default. Italy's 10-year borrowing rates reached the 6.5% range last week and were heading steadily toward 7% before Mr. Monti began filibustering. Italy is considered by many to constitute the Maginot Line for the European Union beyond which the union is unlikely to survive. I would argue that Spain actually constitutes that line since a Spanish default in my mind will render an Italian default a near certainty.

There are now two possible scenarios that are likely to play out. The first – and most likely scenario – is that the European Central Bank (ECB) will step in with some type of massive bailout plan for Spain and Italy. The second is that Spain experiences a free-fall default that leads to Italy following and a global economic cataclysm. A third scenario – one that is no longer tenable - is one that global economic leaders have been hoping for but doing little to bring about – buying time for weak European economies to grow their economies to a point where they can generate sufficient income to service and ultimately repay their debts. That train has left that station. Spain is hopelessly insolvent and cannot hope to service its debt without restructuring it and inflicting massive losses on its creditors.

As noted above, on July 26, ECB President Mario Draghi started huffing and puffing and boasted that his central bank would do whatever is necessary to preserve the euro. Upon hearing this news, global equity markets rallied. Mr. Draghi provided no specifics concerning how the ECB would rescue the euro, but the markets were all too desperate to believe him. In the background, there was talk of the possibility of granting the European Stability Mechanism (ESM) (which won't be in place until mid-September at the earliest) a banking license and other such dramatic measures, but these were merely conjectures. In truth, the only tools available to the ECB are various types of debt monetization or socialization schemes, none of which will remedy or even address the underlying causes of Europe's economic malaise. The market rally places a great deal of confidence in the ability of central banks to come to the rescue of the global economy again. We do not share that optimism. In 2008, the balance sheets of the world's largest central banks (the ECB, Federal Reserve, Bank of Japan and Bank of England) were approximately $3.5

trillion in size; today, they are about $9.0 trillion in size and growing (although the Federal Reserve's balance sheet has actually shrunk slightly since the middle of last year). Some may believe that there are no limits to what central banks can do; history and common sense suggest otherwise.

Der Speigel, Germany's leading weekly newsmagazine, said the following about Mr. Draghi's outburst (thanks to Art Cashin for this):

> "[E]xperts at the central banks of the euro zone's 17 member states had no idea what to do with the news. Draghi's remark was not the result of any resolutions, and even members of the ECB Governing Council admitted that they had heard nothing of such plans until then…
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> "Now Draghi is apparently prepared to lend a hand to the hapless politicians. Under his plan, which essentially creates a new form of cooperation between governments and monetary watchdogs, both of Europe's bailout funds – the temporary European Financial Stability Facility (EFSF) and the permanent European Stability Mechanism (ESM) – and the ECB will intervene jointly in the bond markets in the future to bring bond yields down.
>
> "What sounds like a great success is actually a sign of weakness. If the ECB starts buying up the government bonds of highly indebted countries again, it won't just be yielding to the pressure of European politicians. It will also be resorting to a tool that, in the most recent past, has primarily produced one outcome: discord within the ranks of the ECB. As Germany's central bank, the Bundesbank, noted last week, Draghi's proposal is a 'problematic' instrument."

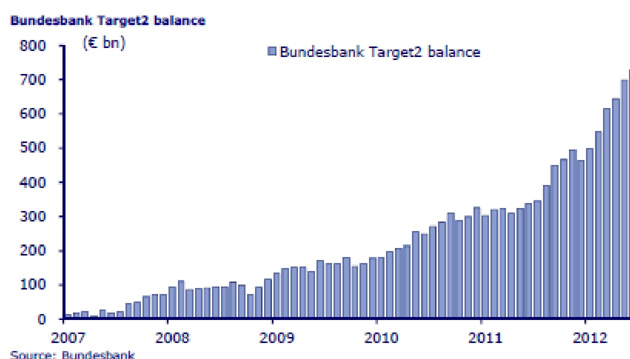
Despite Mr. Monti's words, the ECB does not act with a free hand. It is ultimately answerable to Germany, and Germany is ultimately answerable to the German Constitutional Court (more than to the Bundesbank). I am attaching the English version of an article that appeared in the July 22 issue of *El Mundo* entitled "The Karlsruhe Ascendancy" that discusses the very real limits that exist on Chancellor Merkel's and the entire German Parliament's actions under the Maastricht Treaty. These limitations are set by Germany's Constitutional Court, which is the most highly respected institution in Germany (even more respected than the Bundesbank). In a series of rulings dating back to the late 1990s, the Constitutional Court established the conditions that Germany must follow in order for its participation in the European Union to conform to Germany's 1949 Constitution.[8] As explained in my *El Mundo* article, these conditions placed major roadblocks in the way of European fiscal integration. There are two broad principles that the Court requires to be followed. The first is that the very existence of the European Union must contribute to the stability of the euro currency. If actions taken to preserve the union do not contribute to such stability, the Constitutional Court can compel Germany to withdraw from the union. The second is that Germany may not cede control of its economy in any way. This ruling effectively nullifies the possibility of a true economic and political union unless other countries hand over their fiscal governance to Germany.

Both of these principles are going to be very difficult to fulfill. With respect to the stability of the currency, perhaps the most effective step Europe could take to make its economies more competitive

[8] In one of these rulings, known as the *Karlsruhe-Lissabon-Urteil* (1999), the Constitutional Court had its *Marbury v Madison* moment and declared its right to be the final arbiter of Germany's participation under the Maastricht Treaty.

would be to radically cheapen the Euro.[9] While a managed depreciation of the currency might accord with the notion of stability, an unmanaged collapse of the currency arguably would not. Thus far the decline in the value of the euro has been orderly, but there is no assurance that the markets will continue to cooperate. With respect to the question of German control of its own economy, it is legitimate to question how Germany can truly retain such control when it is being asked to transfer an enormous percentage of its GDP to weaker European states. Germany has already transferred something on the order of 2/3s of its annual GDP to support its weaker European cousins. Many observers argue that Germany has received enormous economic benefits from the formation of the EU. But that argument prompts two responses. First, many of those benefits may in fact be illusory if one takes into account the hundreds of billions of euros of bad loans that the country's banks are now holding (German banks' total exposure to PIIGS totaled $537 billion at the end of March according to the Bank of International Settlements), plus the more than €700 billion of Target2 liabilities that are unlikely to be repaid in full.

Figure 1
<u>Target2: Not Getting Smaller</u>



Second, Germany is now faced with the choice of giving back many of those benefits through the transfer of hundreds of billions of Euros to the EU's insolvent states or bailing its banks out of the losses that an outright Spanish or Italian default will trigger. In other words, the benefits that the euro delivered to Germany are now going to have to be repaid with a usurious rate of interest.[10]

Germany is truly on the horns of a dilemma, and both horns are jabbing it in the behind. Germany really can neither afford for the EU to stay intact nor for it to come apart. Either scenario is going to cost it hundreds of billions if not a trillion euros or more. What investors need to understand, however, is that the decision is not in the hands of the country's politicians; it rests in the hands of eight red-robed judges in the tranquil town of Karlsruhe in Southwestern Germany, far away from politics in Berlin or business in Frankfort. And it is not these judges' concern what happens to the EU, or to Spain, or Italy, or the rest of the world economy. Their job is to insure that the sanctity of Germany's post-war Constitution is preserved. In the wake of the Second World War, Germany was a ruined and demoralized land. It had committed crimes against humanity and had to come to terms with its own guilt while trying to earn its way back into the community of nations. The Constitutional Court became the guardian of the

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[9] Harvard Professor (and former Reagan advisor) Martin Feldstein recommended just such a step in a recent *Financial Times* opinion piece. Of course, the ECB's monetization policies have been going a long way to accomplishing this, just not quickly enough.

[10] See "Investment Recommendations: Currencies" below for our recommendation to short German CDS resulting from this analysis.

country's sense of justice and morality. It was the source of moral and legal authority then, and remains in that position to this day. The Court has set out the ground rules for Germany's participation in the EU. The union was designed to limit German hegemony but remains tethered to German economic power.[11] Investors need to understand that this power lies in Karlsruhe. There is only so much Germany can do, and it is not going to be enough.

Aurora

The Aurora shooting was the result of two modern policy regimes: gun control (or the lack thereof), and ecommerce. The murderer was able to purchase military weapons over the Internet without being subjected to any background check. It was harder for the killer to get a driver's license than for him to assemble the arsenal that he used to murder 12 innocent people and wound another 58. New York Mayor Michael Bloomberg appropriately called for Barack Obama and Mitt Romney to disclose their positions on the rights of civilians to own assault weapons, and thus far only Mr. Obama has gingerly broached the possibility of limiting that right. In fact, no such right exists, as the former Constitutional law professor should know. The Second Amendment does not provide an absolute right to own any kind of weapon, as even Supreme Court Justice Antonin Scalia conceded in a recent interview. It was intended to protect the arming of militias, not to allow individuals to arm themselves with weapons that the Founding Fathers could not even imagine. There is an enormous difference between a handgun, which the Second Amendment may protect, and an automatic weapon with a 100-round clip. Such a weapon of war only serves one purpose – to kill as many people as possible in as short a time period as possible. There is no Second Amendment right for civilians to own such weapons and they must be outlawed immediately.

Of the many acts of moral cowardice that Congress has committed, allowing the ban on these weapons to lapse in 2004 is one of the most unforgiveable. Allowing such weapons to be sold over the Internet along with SWAT gear must rank among the most anti-human laws currently on the books in this country. It is time for politicians and those who elect them to stand up to the tyranny of the gun lobby. We may never be able to understand the madness of a man who walks into a movie theatre with intending to murder dozens of people, but the madness of a legal regime that arms him is so evidently a self-inflicted wound that one has to wonder why it needs to be explained at all. Consistency may the hobgoblin of little minds, as Emerson taught us, but the inconsistencies that lead far too often to mass murder in America are going to be the epitaphs of a dead civilization if we render them intellectually and morally coherent in a hurry. Americans should not have to worry that when they leave their homes to go to the mall or the movies that they will be murdered by home-grown gun-wielding madmen.

The Presidential Election

My political views are hardly a secret, but I do strain for some objectivity in writing about the election. As I wrote on Twitter several months ago, an election between a community organizer and a

[11] Like many religious converts, who are even more punctilious about observance than non-converts, Germany has been far more conscientious about creating a pro-growth capitalist economy than the other countries in Europe on whom it inflicted so much death and destruction during the Second World War. It would be a grave error (one too often committed by market strategists) to ignore the psychological dimensions of this historical background and relationships among the EU members in trying to determine the likely course of events in this crisis. The Eurocrisis requires a much broader, more historically informed and psychologically subtle analysis than what Wall Street and the media has provided.

private equity guy was obviously designed to torment me, and it is certainly succeeding. I have not donated a dollar to any political candidate during this election cycle due to my profound disgust with the political process. I also want to be free to speak my mind without being compromised by any affiliation. Both parties have been equally corrupt, incompetent and devoid of ideas, and I want to be free to say so.

One would think that I would be enjoying the attacks on private equity in view of my well-known criticisms of that industry, but I take little pleasure in politically-motivated attacks that are based on ignorance and distort the facts. Private equity firms charge egregiously high fees and pay ridiculously low tax rate on his earnings. They should not be publicly held, and anybody who invests in their stocks does so at their own risk and is likely to lose money. In certain periods, such as the years leading up to the 2008 financial crisis, they invested recklessly in transactions that did not contribute to the productive capacity of the economy. But those are problems that could be largely remedied by sensible changes in tax policy. At some point, institutions and their consultants will figure out that the industry's risk-adjusted returns are mediocre at best (with some rare exceptions) and do not merit the large asset allocations or undeserved fees that have been extracted over the years. But the industry is also doing some constructive things, such as investing in energy projects (and in some cases coming to the rescue of struggling energy companies and their local communities, as in the case of KKR's capital injection in Petroplus Holding AG's refinery in Coryton, England and Carlyle Group's purchase of Sunoco Inc.'s Philadelphia refinery). Private equity has the potential to play a far more constructive role in the economy than it did in the 2000s. Productive investments can be as profitable as speculative ones.

A Truly Terrible Book

While on the subject of private equity, I have to take a moment to pan a book written by Edward Conant the former head of Bain Capital, LLC's New York office: Unintended Consequences: Why Everything You've Been Told About the Economy is Wrong. In the book, which is largely incoherent, Mr. Conard attempts to rationalize virtually all of the wrong-headed policies that led to the precarious financial condition that the U.S. finds itself in today. His self-satisfaction drips off every page, and he clearly believes he is making intellectually clever arguments that challenge consensus thinking. Unfortunately, one need only to look at economic data and what has happened to the U.S. economy to realize that his arguments are unsupportable. And that would have been the case even had a decent editor shaped the prose into something readable.

If the substance of his book weren't sufficiently deficient, Mr. Conant makes certain assertions toward the end that are both unsupportable and offensive. He asserts – backed up by absolutely no factual evidence (because none exists) – that liberal arts majors are solipsistic and irresponsible, and are therefore responsible for what ails our economy. He writes: "Many liberal-arts [sic] majors choose selfish solipsism over the burdens of shouldering the risk and responsibility critical to increasing economic growth. They study literature and art history rather than computer programming and engineering." He asserts that these students have "recognize[d] that working hard won't make them happy." (262) Continuing, he spouts: "Art history and Elizabethan poetry don't employ workers; the arduous and tedious application of business sciences such as computer programming and accounting does." (276). In view of the fact that it was ethically vacuous business majors who led the financial system to the abyss, Mr. Conard must have been inhabiting a parallel universe over the past decade. Moreover, his belief that computer programming and accounting are sciences speaks to a narrowness of thought and misunderstanding of these disciplines that explains all we need to know about Mr. Conant's qualifications

to contribute to a meaningful discussion of the issues that deserve our attention. I strongly advise everyone to spend their time more wisely than I did and pass on reading this garbled and uninformed book.

Investment Recommendations

I recently wrote a short piece for the Cumberland Advisors web site (www.cumber.com) entitled "The Pension Dilemma" in which I highlighted the challenges facing not only pension funds but all investors in today's zero interest rate environment. It is attached to the end of this letter. Conventional wisdom holds that investors should avoid bonds and favor stocks in such an environment. Yet bonds have outperformed stocks, as our friend David Rosenberg loves to point out. Many equity managers – including equity-oriented hedge fund managers – have disappointed their investors in both 2011 and 2012. Nonetheless, savvy stock picks can still produce excellent returns. We have attached a new schedule that we intend to update on a monthly basis tracking our stock recommendations so readers can more easily keep track of how we are doing. We reiterate our strong advice that this is no environment for leverage. We also repeat our view that shorting stocks is for professional traders.

Finally, we want to make clear that the odds of a systemic crisis are currently uncomfortably high. The most likely cause of such an event would be a free-fall Spanish default that would trigger a European banking crisis that would then spread to the U.S. and cause global financial markets to sell-off at least as sharply as they did in 2008. As expressed above, I am not as sanguine as others that central bankers will be capable of doing what is necessary to prevent such an outcome. Accordingly, all of the recommendations that follow are predicated on the assumption that such a crisis does not occur. For those who believe that a crisis will occur – or who alternatively want to invest 50% of their assets on the basis that one will occur – we recommend a mixture of cash, short-term Treasuries and gold. We recently read a report by Jan Loeys and Nikoloes Panigirtzoglou of J.P. Morgan Chase that recommended that investors should stay short cash and that cash is the one asset investors should underweight.[12] That strikes me as among the worst advice an investor could possibly be given, and perfectly consistent with the type of advice that I would expect an institution like JPM to give its clients.

Equities

The performance of the S&P 500 (up about 10% year-to-date) has been nothing less than heroic in view of what is going on in the world. The U.S. economy is slowly measurably, Treasury bonds are sending off deflationary signals, and the earnings season has been disappointing (particularly on the revenue line). With that preface…

- Despite their almost constitutional compulsion to disgrace themselves in one way or another, we continue to view the large banks as attractive investments: JPM, BAC, C, and WFC. We also like the regional bank ETF (CKE) and the large bank ETF (KBWB). We have changed our view on both MS and GS based on the fact that their recent disappointing earnings result demonstrate that their business models can no longer produce the types of earnings or returns on equities that would justify significantly higher stock prices in the foreseeable future. MS is now trading at something like 1/3 of book value of $30.74/share, which in part reflects a justifiable lack of

[12] Global Research, Economic Data Watch, July 20, 2012.

confidence in the firm's current and past management.[13] GS is trading at about 70% of book value of $134.48/share, which is also a very sharp discount although I will leave it to others to debate whether it is a justifiable one or not. The fact that GS's proprietary trading revenues have virtually disappeared, which was clearly the intent of legislators, speaks to a generational shift on Wall Street that is still being played out. I continue to recommend AIG. The regional banks are also still attractive: PNC, USB, BOH, KEY.

- The publicly-traded private equity firms remain conflict-ridden companies that grossly overpay their executives at the expense of their shareholders. These stocks should be avoided at all costs: APO, BX, CG, and FIG. KKR is the only stock we would consider owning since it is managed by a much higher quality group of executives although the company suffers from the same conflict of interest and executive compensation issues.

- CHK is now trading at a discount of more than 70% to its tangible book value and remains a buy. Three other companies that are trading at sharp discounts to their tangible book value are RIG (48% discount), CPN (54% discount) and MGM (72%). All are interesting long-term investments.

- We are changing our recommendation on GM to a sell. There are two serious problems with GM as a business right now. First, it is not going to make money in Europe for the foreseeable future. Second, it is becoming increasingly dependent on subprime lending to simulate its North American car business. Since its purchase of Americredit in late 2010, loans to customers with the worst FICO scores (below 540) have increased from 79% to more than $2.3 billion. Those with the second worst FICO scores (540-599) rose 28% to $4.3 billion. In contrast, borrowers with the highest FICO scores (660+) dropped 42% to $676 million. This sounds suspiciously like a replay of GMAC and is a troubling sign. While the stock is trading below $20/share and is cheap by all traditional measures of valuation, there is little reason to believe that anything specific to its business will improve in the foreseeable future. The U.S. economy is weak, consumers are cautious, the European economy is getting worse, and the company is seeking out the least creditworthy consumers to whom to sell its product. Based on these facts, we would now avoid the stock.

- One of our short names that has worked our particularly well is CRM (Chipotle). On July 20, 2012, it finally started giving up the ghost and traded down 21.51% ($86.88 - that is not a misprint) to $316.98. Restaurant stocks should not trade like Internet stocks of the late 1990s. Now we see why.

- FB remains a short. One of the most insightful observations I have heard about FB is that it is a desktop-oriented company rather than a mobile telephone-oriented application, and for that reason will be challenged going forward. My target price is still $15/share, which I will still consider too high.

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[13] Am I the only one to wonder whether there is any cultural significance to the fact that in the movie version of Andrew Ross Sorkin's bestseller Too Big To Fail, Morgan Stanley's John Mack was played by the actor who played the obsessive-compulsive detective Adrian Monk on the television series of that name while Lloyd Blankfein was played by the actor who plays the dissolute talent agent Charlie Runkle on Californication?

Fixed Income

High Yield Credit

As described in the attached short essay I wrote for Cumberland Advisors, high yield bonds remain fairly valued and remain among the best ways to earn risk-adjusted yields in today's zero interest rate world. That said, high yield bonds have rallied and spreads have tightened to the low 600s. Nonetheless, high yield bonds still offer on average 7% in a zero interest rate world. With defaults still below 3%, a skilled manager can deliver attractive risk adjusted returns.

Certain sectors, like homebuilders, are starting to trade at ridiculously tight spreads and should be avoided at all costs. For example, DR Horton bonds are trading at a yield of 3.33% and Toll Brothers bonds are trading at 3.79% (the average yield on the Bank of America/Merrill Lynch BBB Index is 3.72%). It is laughable that homebuilder bonds are trading like investment grade bonds. I made the mistake of covering my shorts in homebuilder bonds the last time they traded at investment grade spreads in 2007; I am not going to make that mistake again. The housing market may be recovering, but it is a long way from investment grade. This type of trading activity is typical of the stupidity that so often shows up in the high yield bond market. If your bond manager is holding homebuilder bonds yielding less than 4%, you should fire him immediately.

As for some ways to earn yield income, I recommend the following:

- The following fixed income ETFs offer attractive risk adjusted yields with modest upside potential and reasonable downside protection: BAB; BKLN and PSK.
- KFN just announced a very strong quarter and a 17% increase in its quarterly dividend to $0.21/share. TFG1 just announced a $0.01 increase in its quarterly dividend to $0.115/share. While this is a step in the right direction, it is still stingy and far below what the company is capable of paying. Accordingly, I am changing my buy recommendation to neutral on TFG1. Investors would do much better in the long-run to sell TFG1 and buy KFN despite TFG1's bigger discount to book value. While TFG1 remains extremely undervalued and a good way to gain exposure to the bank loan market, its management has yet to learn how to treat shareholders properly. TFG1's dividend is far too low compared to its cash generation and profitability while its management compensation is egregiously excessive. KFN is far better managed and far more focused on returning capital to shareholders. I plan to move my funds out of TFG1 and into KFN; I am tired of doing business with people I don't trust and don't respect, and I don't trust or respect TFG1's management.
- I would recommend that investors avoid the two popular high yield ETFs – JNK and HYG. I believe these products are structurally flawed. Investors would be much better served by investing with a skilled high yield manager.

Municipals/Investment Grade Credit/Government Bonds/Cash

Municipal and investment grade bonds obviously offer only marginal yields above Treasuries in today's market. Nonetheless, as long as the direction of interest rates continues to be downward, they

should continue to provide respectable real returns. Government bonds should be avoided at all costs unless one believes that a systemic crisis is highly likely. In that case, short-term Treasuries will be a good place to hide out. Just to illustrate the treacherous math of government bonds, if interest rates were to increase over the next 12 months from today's 1.5% to 2.5%, the 10-year Treasury bill would lose about 8 points in value, or the equivalent of 5.33 years of interest. That is why it is so tempting to short Treasuries. Unfortunately, that trade has competed with shorting Japanese Government Bonds (JGBs) for the title of widow maker over the past couple of years. But just because shorting Treasuries has not worked out is no reason to run out and start buying them. I continue to believe that the best place to park cash in the absence of a systemic crisis remains bank loan proxies such as BKLN or prime rate mutual funds which should produce a return of at least 4%. These investments do not have interest rate risk and the credit risk that they do pose is currently not a problem.

Currencies/Sovereign Credit

The Japanese Yen still acts like a safe haven currency, which alone suggests the sad state in which the global economy finds itself. At about 78 (to the USD), the Yen has resisted the best efforts of the Bank of Japan to weaken it. As noted above, 10-year JGBs are now trading at 0.78%, which leaves them a whopping 0.30% higher than Switzerland's 0.48% 10-year rates (Switzerland's yield curve is trading in negative territory almost all the way up to 10 years). Kyle Bass, whose press agent was working overtime getting him on television promoting the short JGB trade when they were trading closer to 1.0%, must be tearing his hair out. One glimmer of hope with respect to Mr. Bass's trade appeared last week when Japan's public pension fund, the world's largest, announced that it has been selling JGBs: "Payouts are getting bigger than insurance revenue, so we need to sell Japanese government bonds to raise cash." This fund is one of the largest buyers of Japanese debt, holding 71.3 trillion yen, or 63% of its assets, in JGBs as of March according to *Zerohedge*. Will this be the beginning of the end of Japan's ability to finance itself? Let us put it this way: if we were to hold our breath, we would tell our family to start planning our funeral.

Figure 2
German CDS: Going Wider

As noted above, one of the most effective measures that Europe could take to render its economy more competitive would be to reduce the value of the euro as quickly as possible. A sharp drop in the value of the euro is a question of when, not if. It was therefore somewhat humorous to watch the television characters on CNBC treat a recommendation to short the euro at its recent ***Seeking Alpha Conference*** as some kind of revelation. I have been recommending that trade for longer than I can

remember. I obviously need a better press agent (no thanks). In any case, as I have written repeatedly, the euro is a short against virtually every currency on the planet. It will eventually reach parity with the USD, at which point the two can fade into oblivion together (the USD has been weaker against a number of currencies lately although its relationship with the euro gets all the attention). When the ECB and whatever other international organizations it can drag along initiate their next monetization scheme, it will initiate the next phase in the destruction of the euro as a fiat currency. That day is not far off.

Germany has thus far – and with good reason - served as a safe haven for investors fleeing other European sovereigns. But as noted above, Germany is facing enormous bills whether the EU stays intact or not. Moody's has lowered the outlook on Germany's Aaa-rated government bonds from stable to negative, citing "rising contingent liabilities that the German government will assume as a result of European policymakers' reactive and gradualist policy response, which comes on top of a marked deterioration in the country's own debt levels relative to pre-crisis levels." For that reason, we continue to recommend (for our institutional and more sophisticated readers) that they buy German CDS. We see no way that Germany's fiscal condition is going to do anything other than deteriorate in the foreseeable future. Accordingly, we believe that concerns over Germany's rising debt level as well as the fact that its economy will not do well while the rest of Europe is in the doldrums should override safe haven concerns and lead its CDS levels to widen.

Michael E. Lewitt

2012 Equity Recommendations

Stock	1/3/2012	2/1/2012	3/1/2012	4/2/2012	5/2/2012	6/1/2012	7/2/2012	7/30/2012	Gain/Loss (%)
Long									
JPM	34.98	37.6	40.37	46.13	43.2	31.93	36.28	36.14	3.32%
BAC	5.8	7.36	8.12	9.68	8.16	7.02	8.05	7.28	25.52%
C	28.33	31.60	34.13	36.87	32.70	25.39	27.46	27.14	-4.20%
MS	16.08	19.39	19.19	19.81	16.95	12.73	14.94	13.51	-15.98%
GS	95.36	113.45	121.13	124.90	113.77	92.64	97.13	100.88	5.79%
WFC	28.43	29.89	31.54	34.51	33.57	30.16	33.55	33.96	19.45%
USB	27.58	28.56	29.71	31.71	32.04	29.60	32.44	33.75	22.37%
BBT	25.86	27.95	29.22	31.34	32.19	28.35	31.11	31.71	22.62%
KRE	25.00	26.29	27.00	28.67	28.14	25.38	27.59	27.04	8.16%
PNC	59.03	59.86	60.29	64.72	66.73	58.07	61.49	59.82	1.34%
BBT	25.86	27.95	29.22	31.34	32.19	28.35	31.11	31.71	22.62%
KEY	7.77	7.85	8.09	8.48	8.02	7.14	7.72	8.06	3.73%
CFR	53.99	56.63	56.95	58.66	59.20	55.05	57.76	55.47	2.74%
BOH	45.08	46.52	46.38	48.22	49.31	44.69	46.11	46.86	3.95%
KFN	8.74	8.93	9.47	9.25	9.22	8.08	8.87	9.21	5.38%
TFG1	6.55	6.44	6.98	7.10	7.88	7.15	7.40	7.37	12.52%
BKLN	23.93	24.42	24.50	24.60	24.64	23.75	24.42	24.54	2.55%
DOW	29.79	33.94	34.10	34.97	33.35	30.36	31.51	28.84	-3.19%
GM	21.05	24.37	26.47	26.76	22.93	22.01	19.57	19.36	-8.03%
PSK	42.48	44.40	45.32	44.92	45.15	44.62	45.41	45.81	7.84%
CHK	23.60	20.97	24.93	23.31	16.74	15.58	18.73	18.70	-20.76%
NLY	16.07	16.89	16.50	15.87	16.29	16.33	16.95	17.36	8.03%

Short

NFLX	72.24	122.97	112.75	113.97	82.23	62.95	67.85	57.75	20.06%
RIMM	15.51	16.70	13.58	14.37	12.80	10.26	7.49	7.23	53.38%
FB	NA	NA	NA	NA	NA	38.00	30.77	23.15	39.08%
SHLD	31.43	41.95	69.24	66.69	62.07	48.45	59.97	49.96	-58.96%
BX	14.64	16.64	15.73	15.86	13.25	11.88	13.33	13.96	4.64%
APO	13.05	14.68	13.96	14.40	12.65	11.36	12.73	13.34	-2.22%
FIG	3.45	3.66	3.87	3.66	3.64	3.06	3.49	3.74	-8.41%
CG	NA	NA	NA	NA	22.00	21.02	22.90	24.21	-10.05%
CRM	101.20	119.32	144.98	157.18	158.94	130.99	139.07	125.87	-24.38%
CMG	341.27	370.41	394.10	418.40	422.80	397.14	383.46	291.13	14.69%

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The Credit Strategist
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The Karlsruhe Ascendancy

Michael E. Lewitt

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By now, it has almost become a cliché to point to the lack of political union as the source of Europe's crisis. Sooner or later, a decision must be made whether European countries will be willing to surrender enough of their sovereignty to give their economic union a chance to work. The key to this question lies in Germany. Germany was the motivating force behind the formation of the European Union. Ironically enough, a plan designed to limit German hegemony remains captive to that very hegemony. All roads still lead back to Berlin.

Germany is governed by two institutions that exercise almost unquestioned influence over its economy and politics: the Bundesbank and the German Constitutional Court. The Constitutional Court sits in the town of Karlsruhe, far from Berlin, and enjoys a special respect in German society. In the aftermath of World War II and during the formation of the Federal Republic of Germany in 1949, the preservation of order and justice in a morally and physically ravaged land was incalculably important. The Constitutional Court was charged with maintaining those values and has retained that role – and the respect associated with it – through the current day. In matters as important as Germany's role in Europe and the EU, the Constitutional Court has the final word. Not Chancellor Merkel. Not the Bundesbank. As such, its rulings regarding precisely how far Germany can go in joining a political union must be clearly understood.

In two key decisions in the late 1990s, the Constitutional Court established the key principals that must be considered in handicapping the prospects for a genuine European Union and a durable solution to Europe's financial crisis. In retrospect, these rulings contain the germs of Europe's debt crisis and the obstacles to resolving it. The first ruling came in 1998, when the Constitutional Court held that the pre-condition to Germany's agreement to transfer responsibility for monetary policy to the European Central Bank under the Maastricht Treaty was that the treaty contributes to the stability of the Euro currency. If the treaty – and the economic union resulting from it - were unable to promote that currency stability, Germany could be forced to exit. And it would be the Constitutional Court that would have the right to order that exit.

In 1999, the Constitutional Court made an even more important ruling known as the Karlsruhe-Lissabon-Urteil. In this ruling, the Court effectively reserved for itself the right to determine which powers were within the boundaries of the European Union authorities and which were retained by the German state. Effectively, any rights that were not expressly granted to the EU by the German national parliament remained within the hands of Germany. In particular, the German Constitutional Court reserved for itself those areas affecting "the political formation of the economic, cultural and social circumstances of life." This covered "areas which shape the citizens' circumstances of life, in particular the private space of their own responsibility and of political and social security," as well as "the administration of criminal justice, the police monopoly, and that of the military, the use of force, the shaping of the circumstances of life by social policy and important decisions on cultural issues such as the school and education system, the provisions governing the media, and dealing with religious communities." Most important, the list of powers that cannot be ceded to the European level included

"fundamental fiscal decisions on revenue and expenditure." In that one sentence, the Constitutional Court established a nearly insurmountable roadblock to European fiscal integration.

It is in the context of these rulings by the German Constitutional Court that the prospects for the European Union must be measured. The constant struggle between Germany's demands for control over European economic policy and the individual requirements of the EU's 17 member nations will be impossible to resolve unless the standards of Germany's Constitutional Court are met. The first standard is that the European Union must contribute to the stability of the Euro. The Euro, however, is likely to depreciate much further in value against the U.S. dollar and other major currencies as part of the adjustment necessary to revive European economic growth. Whether that degree of depreciation can occur and meet the demands of currency stability remains to be seen.

The second standard is that Germany will not surrender its control over its own economy, something that may be difficult to accomplish if the country is required to transfer hundreds of billions of dollars to prop up the economies of its weaker nations. Unlike politicians, who can make a word mean practically anything, the judges on Germany's Constitutional Court are not so flexible. While they are only human and are not immune from political influences, they appear to be guided by a strict set of principles that they are unlikely to surrender. The Bundesbank may be worried about the €727 billion that it has effectively loaned to the central banks of Europe's weak sisters through the TARGET2 program (and that some believe is one factor keeping Germany in the EU), but that is not the Constitutional Court's concern. If the European Union is to survive, it is only likely to do so on Germany's terms. Until that reality is accepted by the 17 other members of the EU, progress toward a solution to the European debt crisis is only likely to come slowly and reluctantly

High Yield Bonds Are Fairly Valued

Michael E. Lewitt

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The great economic historian Charles Kindleberger described a bubble as follows:

> "What happens, basically, is that some event changes the economic outlook. New opportunities for profits are seized, and overdone, in ways so closely resembling irrationality as to constitute a mania. Once the excessive character of the upswing is realized, the financial system experiences a sort of 'distress,' in the course of which the rush to reverse the expansion process may become so precipitous as to resemble panic. In the manic phase, people of wealth or credit switch out of money or borrow to buy real or financial assets. In panic, the reverse movement takes place, from real or financial assets to money, or repayment of debt, with a crash in the prices of commodities, houses, buildings, land, stocks, bonds – in short, in whatever has been the subject of the mania." (Manias, Panics and Crashes, 1989)

In recent years, we have seen this process occur with respect to Internet stocks (late 1990s), the nation's housing stock (mid-2000s), and twice with respect to corporate credit and the high yield bond market (2001-2 and 2008).

Last weekend, we were warned that the high yield bond market is experiencing a bubble. Unfortunately, the warning was completely misplaced despite coming from a highly respected source, *MacroMavens'* Stephanie Pomboy. Ms. Pomboy argued in *Barron's* that high yield bonds meet "all the standard criteria of a bubble." I don't know which criteria she is referring to, but I would respectfully suggest that Ms. Pomboy reread her Kindleberger. The reality is that today's high yield bond market exhibits none of the characteristics of a bubble.

Investors' desperate search for yield in today's zero interest rate environment could lead them to look for yield in all the wrong places. The Federal Reserve's zero interest rate policy has now persisted for four years and there is no end in sight. Today, however, the high yield bond market is not one of the wrong places to look for yield, as it has been so many times in the past. There are several reasons why that is the case.

The most important reason is that corporate default risk today is extremely low today. It is also likely to stay that way. Thus far in 2012, the corporate default rate is below 3%, far less than the historical average of 4.6%. High yield issuers have strong cash balances, healthy working capital positions, and manageable debt amortization schedules. Prior to earlier high yield bond market collapses in 2001 and 2009, there were many warning signs that corporate defaults were going to skyrocket. The market did not disappoint. In 2001, defaults reached 10.5% and in 2009 they hit 13%, the highest corporate default rates the U.S. had seen since the Great Depression of the 1930s. Conditions today are a far cry from then.

The second reason why the high yield bond market is not in a bubble is that valuations are not unreasonable. Ms. Pomboy argues that "spreads are hovering at 2005 lows" (*Barrons'*, July 23, 2012, p.

33), but that is simply not true. In fact, spreads are much wider today than they were in 2007 (which was when spreads reached their narrowest levels rather than in 2005 as Ms. Pomboy suggested).

	5/31/2007	7/24/12	Difference
Avg. Yield-To-Worst	7.48%	7.01%	-0.47
High Yield Index Spread	238	613	+375
BB Spread	168	451	+283
B Spread	228	588	+360
CCC Spread	378	1027	+649

Based on Barclays/Lehman High Yield Index option adjusted spreads.

Ms. Pomboy is certainly correct to point out that the absolute yields on high yield bonds are uncomfortably stingy today. As hybrid securities that combine the characteristics of equity and debt, high yield bonds should offer investors an appropriately high return for taking equity risk. That risk, however, is much higher in a CCC-rated bond than a BB-rated bond. But CCC-rated bonds offer average yields of 11% today, which compares very favorably with what is on offer from many stocks today. That is certainly not the sign of a bubble. This is particularly true with respect to the CCC-rated bonds of large leveraged buyouts that date from the mid-2000s. Moreover, despite their low ratings, many of these bonds are attractive investments today for too many reasons to outline here.

The third reason that high yield bonds are not experiencing a bubble is that there are few signs that the new issue market has reached the silly season. In fact, the quality of new bond issuance is far superior today to what it was in the periods that preceded previous market crashes. The Internet Bubble of the late 1990s-early 2000s was fueled by telecommunications and Internet companies selling debt, while the Private Equity Bubble of the mid-2000s was fed by the large buyout firms. In both periods, these borrowers flooded the markets with tens of billions of dollars of highly speculative deals of dubious credit quality: bonds rated CCC+ or lower; holding company bonds; pay-in-kind or toggle notes (bonds that have the option of paying interest in cash or kind); dividend recapitalization financings; and covenant light bank loans. Most new issuance today is related to the refinancing of existing debt. Very few new LBOs are being done, and telecommunications, technology and Internet companies are financing themselves in the equity markets, where they belong.

Those familiar with my track record and writings know that I have never been an apologist for high yield bonds. In fact, I have spent much of my career warning investors about their risks. My approach to investing in this asset class is different than that of most managers based on my dour view of these securities and the private equity firms that are among their largest issuers. In both 2001 and 2007, I warned investors to exit the high yield credit market in my newsletter, ***The Credit Strategist (www.thecreditstrategist.com)***. I do not feel that way today for the reasons outlined above. There *are* significant risks facing investors today, as David Kotok has so eloquently warned in his writings on the European debt crisis. For once, however, those risks do not come from weak credit quality or overvaluation in the U.S. high yield market. Ms. Pomboy was incorrect in her assessment, and the last thing the high yield bond market needs is its own Meredith Whitney moment.

The Pension Dilemma

Michael E. Lewitt

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America's largest pension fund, the California Public Employees Retirement System (CALPERS), reported a 1% return on its investments for the 12 months that ended June 30, 2012. This disappointing return fell woefully short of the plan's target return of 7.5%. An analysis of the plan's returns by asset class showed the following:

Public Equity	-7.2%
Private Equity	-5.4%
Fixed Income	12.7%
Real Estate	15.9%
Timberland	-11.0%
Infrastructure	8.4%
Liquidity	4.6%
Inflation Assets	0.1%
Absolute Return Assets	-2.0%

While a single years' performance should not be treated as dispositive, CALPERS' experience is dispositive of a number of anomalies that arise in a zero interest rate environment.

CALPERS' performance is a case study in the challenges facing large pension fund (and all investors) in a world without yield. The fact that fixed income produced a double digit return while equities produced large losses unveils some of the fallacies that continue to govern institutional investment thinking. Conventional thinking has argued that equity is far more attractive than fixed income in an environment where bonds pay very low interest rates and stocks are trading at reasonable price/earnings multiples. Yet as CALPERS and other investors have discovered to their surprise, fixed income is producing stellar returns while public and private equity are not.

CALPERS attributed its stock market losses in part to poor manager selection, but many equity managers (including equity-oriented hedge funds) disappointed in 2011 and continue to do so in 2012. Such widespread underperformance speaks to the asset class rather than the practitioners. In contrast, 10-year Treasuries have offered increasingly low yields for the privilege of loaning money to the spendthrift U.S. government. Nonetheless, the return on these instruments (which some have described as certificates of confiscation) have been extremely high over the past two years.

CALPERS' returns do not tell us much about the risk-adjusted nature of the returns. Disappointing private equity returns are a case in point. Despite the fact that private equity lost less money than public equity, the private equity performance was arguably much worse once it was adjusted for the characteristics of private equity funds: egregiously high fees; high leverage; concentration risk; and illiquidity. And let us not forget how this asset class imploded in 2008 and is still digging out from that disaster. Institutions remain convinced that they must have large allocations to private equity. This is a result of the success of early investors in private equity such as the Yale University Endowment Fund led by David Swenson. But early investors participated in early private equity firms' monopoly profits. The industry has since become overcrowded and risk-adjusted returns are now poor. Many institutions are increasing their allocations to private equity; it is time to rethink that approach.

The men and women managing large pension funds have a difficult task. But they need to revise their thinking about asset allocation. They rely too much on consultants, who in turn rely too much on conventional thinking that has proven time and again to be misguided. Traditional notions of asset allocation continue to lead institutions into traps such as excessive allocations to private equity that lead to unacceptably low returns. It is time for a new intellectual regime that recognizes that low interest rates are here to stay but neither assure low fixed income returns nor promise high equity returns.