

It's all about liquidity

The history of markets has taught us that trauma conditions which are bad enough to earn a "crisis" label share a simple characteristic:

Financial assets trade routinely and at orderly prices... until they suddenly don't.

Debt = risk; risk requires management

Despite the glibness in public media on the subject, **"leverage" is not an appropriate synonym for debt.** Debt earns the leverage moniker when the debtor has reasonably predictable cash resources that will be adequate to service the scheduled repayment. Any other debt situation is an albatross, floating on the least reliable of all debt-service tools....*hope*. In business, the disease we call Debt-Service Hope Syndrome is typically accompanied by a seriously corrupt canker: accounting tricks. To be sure, the tricks begin as legal-but-obtuse "techniques", eventually evolving into nothing more than corporate cancer. Governments' accounting tricks are usually less crafty and their impact is spread smoothly over taxpayers, sort of like a rancid peanut butter sandwich. There is only one financial stress more fatal than debt overload.... an off-balance-sheet boatload of it.

We have waited almost two years to see the Examiner's report on the collapse of Lehman Brothers. And now we know that Lehman's management will likely burn in a specially built level of Dante's *Inferno* designed for creative bookkeepers. They will take their fiery seats alongside managements from Enron, Worldcom, Fannie Mae and Freddie Mac. But, they should reserve prominent space for the all-time recordholders: the unintended tag-team made up of (1) credit ratings issuers, notably Moody's, which amp-ed up the volume of high-profit fees generated from issuing AAA, AA and A-ratings on complex packages of formerly BBB-rated sub-prime mortgage debt that had been re-segmented by Wall Streeters, specifically to obtain those ratings and, (2) managers of worldwide giant insurer AIG; they failed (overlooked?) risk management of London-based subsidiary AIGFD, as it risked and lost far more capital than existed in all of AIG. AIGFD underwrote many \$billions of credit default insurance coverage with shrewd buyers who made naked wagers that at least 7% of sub-prime proportions, US government gnomes... apparently goaded by their friends at kingpin broker, Goldman Sachs, decided that US taxpayers must quickly (1) take over AIG, to the tune of about *\$180 billion*, and (2) payoff AIG-insured wagers against sub-prime mortgage backed bonds...*in full*... \$62 billion worth! Salt in the proverbial wound: The government not only kept AIG's damage-causing employees on payroll, they (we) paid them bonuses... extra compensation for continuing to rent us

their prime smarts. The reason given: these people were alleged to be the only ones with sufficient knowledge of the messy details to keep the wheels spinning, so that newly taxpayer-owned AIG might have a fighting chance for survival and eventual repayment.

Back to Lehman. It is trite, but apt to describe creative accounting as "juggling". A professional juggler, after all, has the skill and, yes, the bravado to believe every day that he will avoid dropping his tumbling pins. But jugglers are not magicians. Nothing disappears. Everything they toss comes back. As it is for the rest of us, but especially for a juggler, timing is everything. So it was with Lehman Brothers.... big time. Near the end of every calendar quarter, Lehman temporarily tossed its accounting balls into a borrowing arrangement known as a repurchase agreement (repo). Repo transactions raise needed cash, for a *temporary period*, via a "sale" of assets; the seller (borrower) must agree to repurchase those assets, typically after a few days, at a pre-determined price that includes interest to compensate the temporary cash provider.

As had been the root problem at failed Street-brother, Bear Stearns, dark clouds gathered over Lehman's repo-ed assets. Those assets were mostly mortgage-backed securities that became illiquid and their stated value was declining because: (a) a housing price/debt bubble increasingly hung over US real estate markets and, (b) bonds, backed by euphemistically named sub-prime mortgages, comprised much of Lehman's repo trades; they were rapidly turning into impossible-to-value, toxic assets, despite their AA or even AAA ratings. Eventually, Lehman's voracious quarter-end appetite for cash to dress up its balance sheet grew to \$50 billion! The sub-prime-collateralized repo trades, coupled with Lehman's accounting for them as robustly valued asset sales rather than borrowings. A fed-up Fed refused a bailout. Thus, 158-year old Lehman fell to its financial knees, bankruptcy and liquidation in September 2008. Post mortem: Lehman's increasingly giant repo trades were surely debt, but never "leverage".

The wrong horse to ride

Who's Too Big to Fail? General Motors is a puppy, compared to the banks; only three of them now comprise over 40% of all US commercial bank assets. Why? During the 1990s, the biggest banks began paying executive bonuses in the form of stock options which logically had the effect of rapidly turning the banks into growth companies. They were no longer banks now; they were *Financial Institutions*. Lending was still important, but it was an old boys' game. New-Age managers took on high-risk securities businesses which shrank the relative size of their capital base, but also drove soaring stock option values... Leverage, you might conclude. We think not.

Debtor-Nations Club

In 1985, the US flipped from its long-held status as a creditor-nation to that of a net debtor. In March 2010, the Congressional Budget Office (CBO) published its annual 10-year costing-out of the President's proposed budget. [The CBO's denominator for budget numbers is % of GDP (which avoids the need to separately forecast and measure the impact of future inflation).] Some facts:

1. Annual budget US deficits are large: almost 10% of GDP last year; it will be over 10% this year [Greece's deficit was about 11% of GDP last year] and, even 5 years hence, the US forecast shows a 4.5% deficit; traditionally it has been about 2-3%. Realistic forecast? Robust federal revenue growth (58% by 2014) and an anemic, forecasted spending growth (only 12%) seem unrealistic on their collective face.
2. Despite the optimism in 1. above, total (recognized) US Treasury debt was traditionally about 40% of GDP; it has already jumped to 63% this year and is projected (optimistically, we think) to reach 90% of GDP by 2020. [Greece's debt was recently about 110% of its GDP.]
3. Federal health insurance programs:
 - a. Despite claims to the contrary by its supporters, the 2010 federal health care legislation is so new, so un-interpreted and un-implemented that its impact on federal deficits is highly uncertain. But, if long histories of government operations are meaningful, place your bets on an outcome of under-estimated costs.
 - b. Medicare is already a fiscal nightmare which, it is claimed, the 2010 health care legislation will alleviate, in part.
 - c. Medicaid (indigent medical care insurance that is 60-80% funded by each state). Please see the "Much ado" section below.

Fed chair Bernanke testifies repeatedly that budget and debt numbers are "unsustainable". But, he also says that unsustainable conditions tend not to be sustained. Meaning: Something's gotta give, and it will. Bernanke believes that institutional drive for survival, together with human genius has, and will produce practical solutions to emerging problems. He insists that we need a political [read: tax increase] solution. Some options:

1. This year (7 years earlier than recently projected), **pay-as-you-go Social Security retirement benefits have turned into a net federal cash drain.**

Current retirement benefit payouts now outstrip FICA tax collections from the entire US workforce. And this shortfall will simply grow, quickly, which is especially bad news for all Congress-people in both political parties. For the past 40 years, net Social Security cash inflows have significantly window-dressed federal budget deficits. That's over and done. [See also our still current, 2005 white paper on the subject at www.fiduciaryvest.com/research_whitepapers.html]. As it did at President Carter's request, Congress must now move soon to recognize the fact that life expectancy is, and has been increasing dramatically. Needed: a benefit age roll-back for those who are now below, say, age 50. But, this time, make it a permanent fix, by **linking future retirement ages to periodic mortality studies**. Hard fact: This legislation will be a long term fix that is way too late to help the Treasury pay the next 15-20 years' burden of Baby Boomers' burgeoning benefits.

2. We might see Congress turn toward a European-style **Value Added Tax (VAT)**. Presumably, this tax, imposed at each level of the country's production of goods and services would involve a trade-off pact with voters, by eliminating much of the current income tax system. If a VAT is added, we're willing to bet that taxes won't be scrapped on "high" incomes... thresholded by the President as "a quarter of a million dollars" (political-speak for \$250,000). P.S. Don't look for this figure to be inflation-indexed.
3. In our view, despite Mr. Bernanke's public testimony, the most likely bet for **significant abatement of federal debt/deficits is via inflation**. This will be the most efficient solution, because the relatively independent Federal Reserve Board and Bank would be the natural party-in-charge of it. Some considerations:
 - The Fed's official mission statement is to manage (smooth) the nation's economic growth, using money supply and interest rates as tools. This puts it in a natural driver's seat for something like a controlled-burn in a managed forest.... destroy the underbrush, but save the trees and improve their future growth.
 - The Fed has the tools: it is the only entity that can legally print US Dollars; there is no Constitutional or legislative cap on that money printing activity.
 - The Fed would also have the beneficial angle that it can remove solution-implementation from the hands of Congressional bickering. In fact, because there are no elegant solutions being proposed, the Fed is surely spending most of its time planning the details of its money printing option and has likely been doing so, behind several layers of closed doors, for months.
 - There is a "model" of sorts for this process: the 1970s and early 80s. No doubt the Fed would use the worst of those 35-year-old scenarios as studies in avoidance-planning, to help it develop a smoother path.

- The Fed works actively with its worldwide counterparts. Managed inflation in the US will no doubt be coordinated with other central banks, which is not to say it will look elegant.
- An inflation-based Fed strategy will have an obviously unfavorable impact on debt investors, other than those holding Treasury Inflation Protected Securities (TIPS). But, as things stand now, the Fed has found the need to engineer a severe penalty on conventional savings; savers now face a zero yield and, after inflation, a negative return, while sophisticated investors earn a spread between borrowing free money in the US and investing it elsewhere in bonds that have a real yield.

Next Chapter: State and local government fiscal crisis?

Recent surveys indicate that 48 states face significant or severe overall current budget deficits this year. *Forty-eight.*

For some reason, the muni bond market has been relatively stable and orderly, perhaps propped up by money-spewing pipelines connected directly to the US Congress's "stimulus" pumps. The [un-countable] "jobs-saved" category that the Obama Administration deems among stimulus's success is mostly found among state and local government bureaus. And that fact unfortunately forms **this year's version of last year's cities and states budget crises**: How do we avoid closing libraries and schools and laying off fire and police personnel? The 2010 answer-back from cities and states is: We can't. Perhaps the bigger question: Can the California legislature scrimp and tax enough to avoid default? If not, who will save them?... *Uno who.*

Much ado about a lot (of money)

Medicaid is a huge and growing cost for the states, over which their legislatures have little control. It will be interesting to see how the 2010 health care legislation plays out with respect to this segment of the nation's health care cost. If it is true that there are some 40+ million uninsured, legally resident US population and, if it is also true that around 30 million of them will become insured, then it logically follows that: (1) the volume of non-paying, indigent patients who presently flood the nation's hospital emergency rooms will be sharply curtailed and (2) Medicaid costs *should* therefore decline significantly. Catch: **the legislation requires everyone to purchase health insurance, so perhaps 10 to 20 million people may not be able to afford the premiums.** Their insurance premia will have to be paid by someone... not the doctors/hospitals.... *Uno who.*

The net result is likely to be that, because of universal insurance coverage, the providers will actually collect more revenue than now, but the offset is that, absent fundamental changes, the premium costs of the nation's insurance will rise significantly. Under current US custom, insured patients are hardly involved in the economics of their health care costs, so they and the providers naturally tend to over-utilize the most costly elements in the delivery system. If that tradition continues (i.e., nothing is added to the federal legislation to alter this course), then the 30 million newly insureds will likely begin to over-utilize the system too. A basic formula for measuring the impact (health care or any other) is: **Change in Cost = Change in [Supply x Demand]**. So, assuming the supply-side does not quickly expand (i.e., a throngs of college kids soon decide to become doctors and an explosion of hospital construction), then the *presumed* hike in Demand will drive significantly higher medical cost. Indeed, we simply must devise solutions for such a demand/cost explosion; they are likely to be dramatic.