Weekly Market Comment

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Penny Wise and Euro Foolish

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Among the effects of the recent and now renewed credit strains in the global economy is that investors have lost touch with relative magnitudes. For example, a billion dollars effectively represents about $3.20 for every adult and child in the U.S., while a trillion dollars represents about $3,200 dollars per person. From our standpoint, among the most important research coordination that government provides comes from the National Institutes of Health (NIH), which funds basic medical research in cancer, diabetes, multiple sclerosis, Alzheimer's, autism, and other conditions, and where the total annual budget is about $31 billion annually (roughly $100 per American). Add in just over $7 billion in research through the National Science Foundation, and about $120 per citizen a year is spent by the government on essential medical and non-military scientific research through these agencies. These figures pale in comparison to the amounts that are increasingly demanded in order to make bondholders whole on their voluntary, bad investments. The Federal Reserve provided an amount equal to the entire NIH budget simply to backstop the rescue of Bear Stearns, which allowed Bear Stearns bondholders to receive 100 cents on the dollar, plus interest. In return, the Fed got questionable assets that it pouched into a shell company called "Maiden Lane," which were later reported to have "underperformed."

Incomprehensibly large bailout figures now get tossed around unexamined in the wake of the 2008-2009 crisis (blessed, of course, by Wall Street), while funding toward NIH, NSF and other essential purposes has been increasingly squeezed. At the urging of Treasury Secretary Timothy Geithner, Europe has been encouraged to follow the "big bazooka" approach to the banking system. That global fiscal policy is forced into austere spending cuts for research, education, and social services as a result of financial recklessness, but we've become conditioned not to blink, much less wince, at gargantuan bailout figures to defend the bloated financial institutions that made bad investments at 20- 30- and 40-to-1 leverage, is Timothy Geithner's triumph and humanity's collective loss.

The most depressing display of math-illiteracy by investors last week was the excitement over a report suggesting that France and Germany had agreed to a 2 *trillion* euro bailout package for Europe, which triggered a "risk-on" tone for the rest of the week, even after the report was retracted as inaccurate. It was almost beyond belief that investors took that report seriously, but people have become so tolerant of unbelievably large figures that virtually any bailout number can now be tossed out without triggering the least bit of scrutiny. Notably, 2 trillion euros is *more than the GDP of France*, and is half the GDP of Germany and France combined. Moreover, Europe has just gone through a tooth-pulling process just to approve 440 billion euros for the European Financial Stability Fund (EFSF) from all EU members combined.

So barring new dedicated funds from Germany and France, which had zero chance of being forthcoming, the only way you could morph 440 billion euros into 2 trillion euros was for each of those 2 trillion euros to *really* be only 22 euro cents of protection. In other words, you could only say that the EFSF would "protect" 2 trillion euros in European debt by limiting the protection to about 20% of face value, without using any of the funds to recapitalize banks or deal with much deeper probable losses on Greek debt (50-60%). Those losses alone will gulp down a large chunk of the EFSF (not to mention post-default needs to stabilize Greece over the longer-term, which the Troika estimates at another 450 billion euros).

Last week, the yield on one-year Greek debt closed at 183%, a new record, and up from 169% the prior week. Yet on Friday, the market rallied on hopes of a comprehensive "solution" to the European debt crisis, and took heart that part of an 8 billion euro hold-over loan to Greece was approved. The 1-year Greek yield pushed 3 percentage points higher. As I've noted before, this limited amount of immediate relief is needed to buy time preparatory to a default. A clean solution to the European debt problem does not exist. The road ahead will likely be tortuous.

The way that Europe can be expected to deal with this is as follows. First, European banks will not have their losses limited to the optimistic but unrealistic 21% haircut that they were hoping to sustain. In order to avoid the European Financial Stability Fund from being swallowed whole by a Greek default, leaving next-to-nothing to prevent broader contagion, the probable Greek default will be around 50%-60%. Note that Greek obligations of all maturities, including 1-year notes, are trading at prices about 40 or below, so a 50% haircut would actually be an upgrade. Given the likely time needed to sustainably narrow Greek deficits, a default of that size is also the only way that another later crisis would be prevented (at least for a decade, and hopefully much longer).

Gradually, but eventually, European leaders are beginning to recognize that you can't solve a sovereign debt crisis by expanding the quantity of sovereign debt, when even the strongest countries are already bloated with it. You can't get "Out" by walking through yet another door marked "In." The markets aren't quite to that realization, hoping for some easy "final" resolution that will simply make the problem go away, but that dawn will come.

The Troika report released over the weekend notes that "the situation in Greece has taken a turn for the worse ... Deeper PSI [private sector involvement - i.e. loss-taking], which is now being contemplated, also has a vital role in establishing the sustainability of Greece's debt*. To assess the potential magnitude of improvements in the debt trajectory, and potential implications for official financing, illustrative scenarios can be considered using discount bonds with an assumed yield of 6 percent and no collateral. The results show that debt can be brought to just above 120 percent of GDP by end-2020 if 50 percent discounts are applied... *Footnote: The ECB does not agree with the inclusion of the illustrative scenarios concerning a deeper PSI in this report."

That footnote is interesting - it's not that the ECB disputed the deeper loss-taking scenarios - it just didn't want to include them in the report.

My guess is that European leaders will force a bank recapitalization within days - probably 100 billion euros, preferably 200 billion, but the larger number is doubtful because at present market values, European banks would have to sell new shares in nearly the same quantity as their current outstanding float in order to acquire the new capital. Yet Stratfor correctly notes that even in the event of a 200 billion recapitalization, a 50% haircut on Greek debt "would absorb more than half of that 200 billion euros. A mere 8 percent haircut on Italian debt would absorb the remainder." So a good chunk of the present EFSF could end up recapitalizing banks, especially if too little is raised from private investors. This would leave little ammunition against any further strains, should they develop.

Of course, Europe wouldn't need to blow all of these public resources or impose depression on Greek citizens if bank stockholders and bondholders were required to absorb the losses that result from the mind-boggling leverage taken by European banks. It's that *leverage* (born of inadequate capital requirements and regulation), not simply bad investments or even Greek default per se, that is at the core of the crisis.

The bottom line is a) European leaders will likely initiate a forced bank recapitalization within days; b) Greece will default, but the new hold-over funding may give the country a few more months; c) the EFSF will not be "leveraged" by the European Central Bank; d) banks are likely to take haircuts of not 21%, but closer to 50% or more on Greek debt; e) much of the EFSF will go toward covering post-default capital shortfalls in the European banking system following writedowns of Greek debt; f) the rest will most probably be used to provide "first loss" coverage of perhaps 10% on other European debt, which may be sufficient to limit contagion provided that implied default probabilities on Italian and Spanish debt don't breach that level and the global economy stabilizes; g) uncertainty following a Greek default is likely to create significant financial strains, even in the absence of a recession; h) all bets for stability are off if the global economy deteriorates markedly from here, which is unfortunately what we continue to expect.

Shenanigans

On the subject of bank capital, I can't stress enough that the proper approach is for government to restrict even temporary, fully-collateralized assistance only to those institutions that are clearly solvent, and to promptly restructure the other institutions. What the global economy needs most is *not* bank bailouts, but to establish and enforce a legal and regulatory structure that allows the *streamlined bankruptcy of insolvent institutions* (Title II of Dodd-Frank addresses this with a more comprehensive policy than existed in 2008, but it doesn't read as a "clean" solution in my view - putting too many cooks in the kitchen - particularly the Fed and the Treasury).

Again, again, again, the "failure" of a financial institution only means that the institution fails to pay off *its own* bondholders. Depositors typically lose nothing. For example, "saving" Bear Stearns meant primarily that Bear Stearns' bondholders would be made whole. Saving Dexia a few weeks ago meant the same thing for Dexia's bondholders. The key is not to prevent "failure," but to prevent *disorderly* failure and piecemeal liquidation. Washington Mutual was a seamless, and therefore nearly unmemorable "failure." Lehman was disorderly and jarring. The difference was that there was a legal and regulatory structure to quickly cut away stockholder and bondholder liabilities in the Washington Mutual instance (which was handled by the FDIC), while there was no similar way to restructure non-bank financials like Lehman in 2008.

From my perspective, weak regulation of bank leverage, inadequate capital requirements, and the need for prompt, streamlined restructuring for insolvent banks are among the most urgent problems that the global economy faces. Consider this. The Financial Times reported on Friday that in 2008, Dexia lent 1.5 billion euros of its capital to two institutional investors, who used the cash to buy newly issued shares in ... wait for it ... Dexia. Remember that as a bank, Dexia operated at leverage of about 50 times its tangible shareholder equity (see last week's comment). So Dexia's maneuver made it possible to meet regulatory capital standards and take on a huge amount of additional leverage, without actually raising any bona-fide capital. As FT noted, "The unorthodox funding move, which roused Belgian regulators' concern at the time, amounted to Dexia borrowing money from itself to finance a capital increase. This is illegal in most jurisdictions and is now banned in the European Union, but did not break Belgium's existing laws."

On a similarly outrageous note, Bloomberg reported last week that " Bank of America , hit by a credit downgrade last month, has moved derivatives from its Merrill Lynch unit to a subsidiary flush with insured deposits... The Federal Reserve and the Federal Deposit Insurance Corp. disagree over the transfers, which are being requested by the counterparties. The Fed has signaled that it favors moving the derivatives to give relief to the bank holding company, while the FDIC is objecting. The bank doesn't believe regulatory approval is needed." Well, other than that it goes against Section 23A of the Federal Reserve Act , but then, the Fed can make an exemption whether the FDIC likes it or not . And that's what we've come to - government of the banks, by the banks, and for the banks (because banks are people too) .

The Bloomberg report continued, "B ank of America's holding company -- the parent of both the retail bank and the Merrill Lynch securities unit -- held almost $75 trillion of derivatives at the end of June, according to data compiled by the OCC. About $53 trillion, or 71 percent, were within Bank of America NA [the FDIC insured entity], according to the data, which represent the notional values of the trades. That compares with JPMorgan's deposit-taking entity, JPMorgan Chase Bank NA, which contained 99 percent of the New York-based firm's $79 trillion of notional derivatives."

Note that the figures are in trillions, not billions (U.S. GDP is $15 trillion). That said, the vast majority of the "notional value" of derivatives in the financial system represents multiple fully-hedged links in a long chain between final users who actually take the risk, so Bank of America's true risk is most probably a *tiny* fraction of that notional amount. Unless those derivatives include unhedged short positions in credit default swaps on Greek debt (which we can't really rule out), it's not clear that the derivatives themselves are underwater. The real problem, in my view, is that the transfer is clearly driven by the intent to get around capital adequacy regulations, and runs precisely opposite to the right way to create a good bank and a bad bank . It saddles the good bank - the taxpayer insured one - with the questionable liabilities, while "giving relief" to the holding company. This is really preposterous.

As a final note, it's worth observing that a number of banks reported positive "earnings surprises" last week. If you look at those results for any of the major banks, it is immediately clear that the bulk of the earnings were of two sources: further reductions in reserves against potential loan losses, and an accounting gain known as a "Credit Valuation Adjustment." Those two items, for example, were responsible for nearly 90% of Citigroup's reported "earnings." The Credit Valuation Adjustment (CVA) works like this: as the bond market has become more concerned about new financial strains, the bonds of U.S. banks have sold off significantly in order to reflect higher default probabilities. Under U.S. accounting rules, bank assets are no longer marked to market, but happily for the banks, the decline in the market value of their bond liabilities means that the banks could technically "buy their bonds back cheaper." So the decline in the bonds, despite being due to an increase in investor concerns about bank default, actually gets reported as an addition to earnings! Surprise, surprise.

Market Climate

As of last week, the Market Climate for stocks remained hostile, with a clearly negative expected return/risk profile. Strategic Growth and Strategic International remain tightly hedged. That said, we're beginning to see some emerging speculative elements in our analysis of market action. When there is ample negative news to smack speculators back to reality, it's difficult for speculation to get "legs," but speculation can take on a life of its own even in overvalued markets when there is a pause in flow of fresh concerns. Given our continued expectations of oncoming recession, and the likely inadequacy (from the market's perspective) of bailout provisions in Europe, my impression is that further speculation is likely to be quickly smacked, but I won't impose that impression on the objective evidence. While we would expect to retain a tight line of put option protection in any event, measurable improvement in market internals over the next few weeks would likely provoke us to accept a small positive exposure by covering some of our short index calls - at least until overvalued, overbought conditions are joined by overbullish sentiment. I doubt that we'll observe even that modest constructive shift in the data, but am keeping an open mind. More often, overbought rallies in negative Market Climates (as we observe today) simply fail.

I continue to view economic evidence as consistent with oncoming recession. While there was some enthusiasm over the pop in the Philly Fed index to 8.7%, it's useful to remember that the Philly Fed index also popped from negative levels in August 2007 to 8.6% in November 2007 (the month our Recession Warning Composite turned negative and the economy went into recession). Meanwhile, the Conference Board's index of leading indicators places nearly half of its weight on the yield curve and M2, which reduces its robustness compared with broader methods. The slight positive reading last month was driven by those monetary components. As Babson Capital has noted, the non-monetary components of the LEI have historically had a 94% correlation with the index, with much more noise from the monetary components. In fact, in recent years, the monetary components have become negatively correlated with the economic components, so that improvements in the monetary components typically occur despite true economic deterioration. For example, I suspect that last month's rise in M2 was largely due to investors switching from large money market funds (which have substantial holdings in European bank debt) and into Certificates of Deposit at U.S. banks - hardly an indication of robust economic prospects. Even the Conference Board conceded a very high probability of oncoming recession last month.

Notably, the ECRI Weekly Leading Index growth rate dropped to a fresh low of -10.1% last week, and unlike 2010, the deterioration is matched by weakness in a much broader set of evidence. Suffice it to say that leading data is *leading* data, and there is typically a gap between the point that the leading evidence turns down decisively and the point where coincident and lagging indicators confirm the deterioration. As for stocks, recession-linked bear markets don't end before the recession even begins.

In bonds, yield levels are still depressingly low, but given the likelihood of recession and further credit strains, there is some potential for a renewed flight to safety in Treasury securities. That prospect combines moderately positive return possibilities with significant risks, so the return/risk potential is fairly limited, but improves somewhat as yields rise. Accordingly, we would be inclined to move slightly out in duration on further upticks in long-term yields. Presently, Strategic Total Return continues to carry a duration of about 1.5 years, with about 18% of assets in precious metals shares, and less than 4% in utilities and foreign currencies.

Prospectuses for the Hussman Strategic Growth Fund, the Hussman Strategic Total Return Fund, and the Hussman Strategic International Equity Fund, as well as Fund reports and other information, are available by clicking "The Funds" menu button from any page of this website.