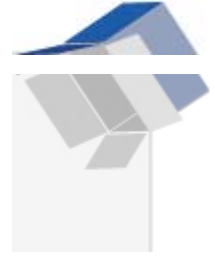


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## Why The Worst Will Soon Be Over

from Bedlam Asset Management



### ***"I've seen an elephant fly", weather forecasts, and why the worst will soon be over***

*It is almost sad for us that the worst of the world's largest ever bank crisis is just about to or may even have passed its peak. It was fun not to hold any and be thought a crazy, even though if any bank director was asked the right questions, it was clear the system had to fall over. Now that it has, we move on (but still hold no financials). There are other aspects we'll miss too. The impotence of Politicians revealed -- no power to affect the direction of the business cycle, and even less understanding of the economies over which they portentously believed themselves in charge. Who will forget the British Chancellor's vacant stare whenever asked a simple financial question, even as his eyebrows squirmed like caterpillars in their death throes thus betraying his ignorance?*

*Then there's the regulators, so far behind the curve it's embarrassing. No wonder in recent speeches PM Brown announced that he and the Treasury would sort out the banks, even though the role is split between the FSA and the Bank of England. We won't miss the shocks after combing through the balance sheets of Bradford and Bingley, Anglo-Irish, Northern Rock, RBS, Soc Gen and UBS to discover how weak and sloppy were their business models; and we look forward to illogical panic reactions ending. For in the midst of the largest financial fire in history, more effort has been expended on arguing who is to blame, rather than trying to find the extinguishers. Happy, happy days. Farewell.*

*If you do not weep uncontrollably whilst watching Dumbo (the movie, not the people above), then you have no soul. The climax of the story is that without his white feather he could not fly, and was but a terrified and rather badly drawn pachyderm at the top of the high dive. With a little persuasion however, he realised the lack of his comfort blanket did not preclude him from his destiny, so off he flew. The multiple financial implosions of September and early October reduced governments, central banks and regulators into a Dumboesque, catatonic inertia. Fortunately, the panic in all markets has made them realise that they did have sufficient powers: if not to fly, then at least to prevent an immediate Depression. Thus for the first time this century, there is good clarity on the*

*medium term future, both for the global economy and stock markets. This is one of a steep recession, followed by several years of a mild and stuttering recovery. Surprisingly, this is a good result.*

### **The eye of the storm has just passed over**

As long ago as 1999, a long and thoughtful front page article in the New York Times highlighted the dangers of the world's two largest mortgage underwriters, Fannie Mae and Freddie Mac. They had just been blessed by the regulators, Congress and President Clinton to tear up the risk book: to offer large and easy mortgage terms to those Americans who could never realistically hope to own a home. This relaxation of prudent lending rules was soon widely imitated, particularly in economies with a property owning mentality. The consequence was a global economic growth chimera, accelerated by the reduction of the dead hand of bureaucracy in third world countries such as China and India. This allowed them to achieve far better growth rates.

From 1999 onwards the hurricane started to build, moving ever closer to the world's financial system, obvious even to the man in the street. Yet the near-term gains were so beneficial to individuals and government budgets that every Finance Minister threw prudence down the well. Chancellors even became popular. Bizarrely, the only people who did not recognise the inevitable were the regulators, senior bankers and fund managers. In 2007, the storm ripped into the banks. There was a brief calm as the eye came overhead, within which complete regulatory and political paralysis developed, even as institution after institution imploded. Now the eye is passing; we're back into the other side of the storm. Initially the winds will be extreme, but each crisis will be a little less than the one before. It is the best possible outcome, for the alternative was an immediate vertical drop into a deep economic Depression. This would have made the 1930s look a picnic. The 'positive' alternative may not seem that glamorous as many small countries are already in recession and the major ones will follow before the end of this year. Yet this recession will be a 45 degree slope, not a 90 degree fall. This is because the correct response is now in train. It means that as early as 2010, a stuttering recovery could commence.

### **The British solution goes global?**

It is a great surprise that three small islands off North Western Europe have been the cause, and the cure, of the crisis. It was Ireland's emergency guarantee of all deposits which set off the nuclear reaction: risible, because its blanket nature covering all deposits for its six banks worked out at \$576bn, nearly three times gross domestic product,

\$130,000 per head or \$200,000 per person in employment. Within these numbers was a sub-liability of nearly \$50,000 per head over foreign deposits, mostly British. Despite now excellent Anglo-Irish relations, if these guarantees had been called, they could never have been paid. Immediately Germany, Spain, Greece and smaller countries followed suit. Mildly anti-EU British politicians then peculiarly started to bleat about supra-national solutions - an impossible dream - and did nothing. More sensible foreign leaders reacted nationally to the inevitable consequences of their electorates seeing their local banks disappear in a puff of smoke. Fortunately, market mechanisms then kicked in. Large British deposits were being sucked out, into unreal Irish bank guarantees at an alarming rate. Meanwhile in Iceland, the third offshore island, the entire bank system finally decided to die. Although this was assured much earlier (see Pick of the Week No. 48, "Abdul and Jorvik Go Shopping"), it had staggered on for a surprisingly long time. The twin Irish/Iceland events resulted in dramatic falls in British asset prices and even worse gridlock in the lending markets. Outflows to Ireland were swiftly followed by a sudden realisation that simply idiotic deposits worth over £5bn had been placed into hopeless Icelandic-owned institutions and were about to disappear. Depositors included over 100 UK local government authorities as well as unwise financial intermediaries. Without warning and in a single bound, the British governing class leapt from narcolepsy to sprinting at gold medal speed.

The key change has been the rapid implementation of the most comprehensive bank bail out package ever seen. It should work, because it addresses the overlapping problems of too little Tier 1 capital, the fear of bank counterparty risk, the inability to roll over corporate loans and the risk of deposit flight. The result is state directed capitalism. It has lead to howls of outrage across the investment and political spectrum, from the purists who believe market forces should be allowed to work themselves out, to the mob baying for capitalist blood. The cacophony of noise and finger pointing will continue for many years, but both arguments are irrelevant. They are based on old rules. For just as in war habeas corpus and other rights are torn up, so in a financial meltdown the old rules are shredded.

The British decision has been to save the core of the national banking system and create a more realistic structure than the blanket guarantees of Ireland. The sums pledged are large enough to meet all the capital required to support the capital of each major domestic bank. The use of high yielding preference shares and permanent income bearing securities is likely to mean the government may end up owning perhaps a mere quarter of three to six banks, yet its ability to control them all, and their lending, is a certainty. This multiple approach is already being favourably viewed in other countries; it is speedy, cheaper and

turns the all-important psychology from one of utter despair to merely gloom. It is more effective, and overall less burdensome on the taxpayer than any other solution. In the UK and elsewhere, the previous drip feed of liquidity into the markets, started by Mr Paulson in the US, simply proved the law of diminishing returns. Ever larger funds had to be provided to produce ever weaker results. To be fair, the unique (so far) British solution is almost the same as Mr. Buffet's bail-out of Goldman Sachs. His very high yielding preference stock and presumably many other strings must have provided a guide.

Britain's Treasury mandarins had also dusted off and absorbed the lessons of earlier French, Swedish and Japanese models. The result is a more effective hybrid. Since President Mitterand nationalised the banks in 1980 (later part re-listed), France has had state directed capitalism dominated by three banks. Inevitably these are ponderous and suffer poor shareholder returns, but in a whacky way, the system works. In Sweden, the necessary nationalisation of anything with 'bank' on its nameplate also proved effective; although the stock market did not recover for 18 months, the economy managed weak growth in almost every quarter. Japan's Resolution Trust Corporation initially failed because the government dithered for six years after the 1990 crash, before taking any meaningful action. Subsequently, vast amounts of debt were issued to Hoover up bankrupt banks and duff corporate loans. It worked. We believe that most G7 (i.e. including America) and G20 countries will adopt Britain's hybrid ruse in the near future; if so, the storm is passing for sure.

### **Foreseeable consequences**

Some are most unpleasant. The authorities will have little control over these and it would be foolish if they seek to cover every eventuality. Staying with our three islands, one result is that Britain has probably exacerbated the Irish banking crisis; the depositors who fled there for "safety" will soon work out they are better off and better covered in government controlled banks back home. As the new UK rules bite, runs on some mutual groups such as building societies or Spain's equivalent, the Caixas are likely; in both cases their prime purpose is to take deposits to fund property purchases. Government guarantees do not and cannot extend to such groups. Banks like Santander will be forced to absorb dozens of these local mutuals, as will Commerzbank in Germany. This trend is extant already with the large banks in America. Most major industrial countries therefore will end up with a handful of large semi state banks which will dominate the domestic deposit markets.

Other casualties may include leasing companies. With no deposit base, often no overall regulator and dependence on wholesale funding, their future is not exactly bright. More casualties abound in Eastern Europe; many countries there needed to devalue even before

the storm hit. Now devaluations are imminent. Elsewhere, several larger countries will have their own particular problems. One we fear for is Australia, ironically because of a very good policy. After Singapore and Chile, it has one of the most logical and best funded pension schemes in the world (curiously, this is a legacy of its most socialist Prime Minister, Gough Whitlam; even more curious, he was 'deposed' by the British High Commissioner and Mr Rupert Murdoch in 1975). The scheme is beautiful in its simplicity. From the first day at work, employees and employers put large percentages of salary until retirement into a personal, untouchable pension pot. Tax-free and ring-fenced, these huge flows are managed by a host of competitive and usually efficient 'Superfund' managers. Of all reasonably sized advanced countries, Australia alone has ensured that an ageing population will be able to fund itself without drawing down from the state. Yet a flaw has developed. The industry is competitive, Australians are ruggedly entrepreneurial. Personal pensions are portable at the push of a button. Recently, some Superfund valuations have been exuberant. Many have as much as a third of investments in unlisted property, private equity and other opaque vehicles. Often performance seems remarkable: to June 2008 perhaps +20% in a year, usually based on internal valuations. Yet similar investments listed on the public markets have seen large falls in value. It unlikely there's much, if any, fraud, merely denial and over-optimism. Given Australians are well-educated and financially literate, it seems only a matter of time before some awake and transfer their pensions from the optimistically priced super funds and switch to those whose prices are more realistic, and low. It is the smart thing to do. If there is one lesson from the crisis, it is 'if there can be a run, there will be one'.

Another country is Italy. It seems to think itself relatively safe. Italians (and most Europeans) have shown a hubris over financial implosions in America. It is worth recalling that in absolute terms, and pro rata to national GDPs, European institutions own more of America's misstructured and bankrupt sub-prime debt than the Americans themselves. Where is it? Too much we believe in Italy. There, opaque bank balance sheets make Japan's look as clear as glass. The industry is fractured. Like Iceland (but to a far lesser extent), there are considerable cross holdings, mystery nominee companies and asset shuffling by feisty entrepreneurs. These in turn are often highly geared, with a maze of cross-holding debt structures. When the giant hornet of the recession flies into this web, it will simply it snap.

### **Embrace the recession**

A global Depression is likely to be avoided by a whisker; a fast and vicious recession now is a certainty. Although key forecasts are being revised lower, they still lag this outlook.

The IMF's latest suggestion that China will grow next year by 9.6%, and that the volume of World trade by 4% are but two examples of excess optimism. China will enter a recession, defined as 4-6% growth. At this level, social unrest tends to accelerate. The collapse in commodity imports, from copper to steel, show a slowdown already under way. Another obvious cause is the once insatiable appetite of American consumers, to import at least five toasters and three refrigerators for each home has already ceased. As regards growth in world trade, the 4% forecast is also optimistic, given demand for bulk commodities, such as oil and iron ore, is tumbling.

Consumer incomes will be squeezed until the pips squeak, because of correct government actions to focus only on saving the major banks. National budgets are blowing up into huge deficits. The idea that America, the world's most important economy, is sure to have a budget deficit of 10% of GDP in 2008/9 is simply eye-popping, as is the 40% increase in the last six months in the public sector borrowing requirement in the UK. To finance these giant deficits, governments will have to tax more and spend less. Just as the bank rule book has been torn up, so the global abattoir is hardly large enough to slaughter the queue of sacred cows. In Britain, the burgeoning black hole in of state sector pension funds will have to be minced. Apart from the fact that many have been mismanaged for years (their leap into Icelandic deposits because they were approved by discredited rating agencies, or their belief that the higher the deposit rate, the better the bank, prove the statement), their over-generous terms are now unaffordable. Whether the government achieves this through a wholesale rise in the retirement age, increased taxation on pensions, or a cap on the payout rate like utilities to RPI minus, is a moot point. Another chopper must be taken by all governments to welfare.

Although welfare abuse is rampant across Europe, statistically it is worst in British and is both unaffordable and wasteful. As we have reported before, false unemployment statistics have dominated the last decade. Unemployment sank from well over two million to under a million. Meanwhile, those of working age but permanently incapacitated soared from under a million to well over two million. Cute trick. So Britons are the puniest people on the planet, according to officialdom. Aggressive steps will have to be taken to prune the number, if only because of the certainty that unemployment will rise, thus busting the budget even further. State directed capitalism must emerge with heavier-handed, state monitoring of its population.

Whilst liquidity and lending will gradually improve, governments will want to rebuild 'their' banks' balance sheets as fast as possible. Globally, official interest rates will be slashed; the unusually co-ordinated cuts earlier this week by six major central banks is but

the start. Lending rates however, will stay high thus increasing the margin between deposit rates and the price of loans. Fees will also soar, such as new extra charges in most economies for arranging a mortgage. Many did not exist at all even a year ago. Credit card companies will lower credit limits to individuals, irrespective of true personal wealth, as their imperative has switched from maximising profits to minimising losses. Only the best personal balance sheets will get decent-sized limits. If individuals cannot obtain credit, they are forced to save if they want to buy a new car, or a home. In the 1970s and early 1990s recessions, savings rates in advanced countries rose dramatically: in Britain from 2% to 12%, in America a slightly smaller rise. 12% again seems a good educated guess, especially as the starting point is record low savings rates (-1.1% in the UK for the first quarter). Thus the impact on retail economic activity is dire. As governments tax more and cut expenditure, and the consumer is forced to save, this is why for 2009 we pencil in at least two quarters of serious GDP contraction for the UK, US, Spain, Australia, Ireland and Italy.

## **Unforeseen consequences**

We did not expect that within two weeks of a financial meltdown, Russia would have achieved a key military ambition. As four Scandinavian governments dithered over supporting their fifth cousin a window opened, in through which Putin flew like Count Dracula, with a \$4bn lifeline to Iceland's government: "no strings attached". Oh yes? Russia in Europe has always been "choked". The Black Sea/Bosporus exit is tricky. Large naval vessels can leave Petersburg but the Baltic straits too, are narrow. Hence much of the fleet is in the only other port, Murmansk. Even from there, the problem has been that to get the navy into the North Atlantic, it is blocked by other straits such as the English Channel. In 2005/6, NATO schizophrenically decided to poke Russia in the eye by putting missiles along its European border, and also to close its Keflavik Airbase in Iceland (although there are still a few odd American planes there). It has handed Russia at worst a neutral sea passage, almost certainly a refuelling base/friendship zone. This makes us slightly dither about defence stocks. They look cheap but historically in recessions, governments have slashed military expenditure. The UK could cut back its still quasi-imperial ambitions and become a Belgian-type power. Even so, across all Western Europe, so antiquated are many armaments and so poorly equipped many of the troops, it may be that defence, usually the first cow to the slaughter is actually fattened up instead.

America too has usually slashed defence budgets in previous recessions, and could do so now. Any one of the 14 battle fleets has more fire power than the entire Chinese navy. The totality of America's naval firepower is nearly 60% of the entire world's navies combined;

such overwhelming superiority is unnecessary in terms economic expenditure or national security. Yet operating in two oceans, with Russia sending off a fleet to Venezuela in one (we're amazed the rust buckets got there at all) and a Chinese naval building programme which is accelerating, we suspect America's military will continue to claim its full funding. So too will NASA: rocket launches already planned from Asia will allow more communist cadres to peer down at Houston from space than ever before. This is not going to be popular.

### **This is cheerful?**

For all these imponderables and uncertainties, investors can start to do that 'light at the end of the tunnel' thing. If the hurricane had hit in 2005 or 6, the damage would have been less; but this is spilt milk, move on. The light is that correct actions are now in train. Many savers will still lose money in those weaker institutions which the governments have rightly decided to sacrifice, to preserve the core of the system. It will be unfair and unpleasant, but the right action. More important is that just as banks in each country will consolidate down to a core handful, so the same will apply in many other sectors. Consolidation is the new trend. Normally the advice would be to buy small bombed-out niche companies with good businesses, knowing that giant multi-nationals, most of whom have surprisingly strong balance sheets, will be buyers. However, the number of already wounded, as their banks reduce or refuse to roll over their loans at all, mean these multi-nationals can be very picky, and wait. Just as government-induced bank consolidation ensures their balance sheets should recover far faster than had there been no intervention, so more voluntary consolidation in other sectors will have a similar result. Consider the semi-conductor industry (if only for a moment). It is about to be obliterated. Huge over-capacity and rapidly tumbling demand. By as soon as end 2009, it is a good bet the number of manufacturers will have halved. Their profit cycle will then boom. Consolidation in pharmaceuticals has already started, one of the few sectors with very strong free cash flow and growth. In telephony, the parasitic companies are about to be sprayed with DDT. These lived off the incompetence of once state owned incumbents to move into the mobile market and almost universally, are highly borrowed, rely on ever-available bank credit and ever-rising sales. The consumer always foregoes trips to the cinema or theatre in a recession. This time he will hunker down in front of his broadband-fed, all singing and all dancing pc/TV/call-centre/work station. Only the ex-national monopolies can provide this service, the rest blow away like chaff.

Despite consensus forecasts for corporate profits in 2009 being still way too happy -- we are pencilling profits ex the banks for the MSCI World Index in 2009 of minus 9% - the

return to an almost forgotten world of national and international cartels to reboot the economic cycle may well ensure that after a steep recession, a return to mild profit growth may be none too far away. The 'death' of free markets is sad: for a while we were all rich, it was fun and you didn't have to work much either; just own a house and a lot of debt. The imminent brave new world of state directed banks and cartelisation of sectors is inherently corrupt and less efficient, but should work. It is certainly the least bad solution for us all; yet this very different and cartelised world could be rather interesting, and profitable. Although indices have every chance of a roaring bounce soon, in 2009 many will sink again. Even so, too many large company valuations are already forecasting a Depression. We think state owned banks are temporarily rather a good idea, and many company valuations look pretty interesting, especially versus bonds, property or even cash. Growing huge ears or sticking a white feather up your nose is another option, but not advised.

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John F. Mauldin

[johnmauldin@investorsinsight.com](mailto:johnmauldin@investorsinsight.com)

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