

HAL'S TALK – April 16, 2009

BUBBLE ECONOMICS

At our last get together two weeks ago, I felt compelled to warn our guests to beware of premature market turn-arounds, which accompany all market bubbles. In the meantime, true to form, a number of commentators have cautiously suggested that things will improve shortly as the Dow Jones Industrials have rallied and even the S & P 500, the home of most financial stocks, is higher. Perhaps more significantly, the global consumer confidence level has risen to its highest level in 11 months.

But, the classic examples of market bubbles suggest the recovery can not take place until all the excesses have been wrung from the system.

Stock market wise, this means that selling or default by a majority of investors must have taken place. But redemptions from mutual funds, the most popular investment category are reportedly just 2%, while many hedge funds have frozen withdrawals altogether, so the typical panic phase is still ahead of us.

Even if individuals have purged their personal portfolios of so called “toxic waste”, as taxpayers, they find themselves as unwilling guarantors of trillions of dollars of unsaleable bank-owned derivatives contracts which will constitute a drag on the markets until they are written off.

All of this has taken place because two university professors, Merton and Scholes who won the Nobel Prize in Economics in 1997, has constructed a virtual market model to assist traders in assessing the comparative value of financial derivatives where no physical market existed. At that time, I wrote that they could probably earn another prize for unwinding the model before it created a major market crisis. At first its use created outsized profits for their employer, a hedge fund named Long Term Capital Management, but by 1998, the fund had lost over \$4.5 billion and had to be bailed out by Wall Street banks. But once aware of the huge commissions, other funds, including sub-prime mortgage funds jumped on the “mark to model” bandwagon, which triggered the housing bubble and subsequent crash when their virtual models failed.

Now, the Fed, the Treasury and Wall Street are attempting to pawn off the wreckage on investors and taxpayers while floating new bailouts for homeowners. Will this work?

The fact is to qualify for such benefits, homeowners must meet four tests:

1. They must not be delinquent in their current loans
2. They must have a positive equity, i.e., they must not owe more than the present value of their home
3. They must be gainfully employed
4. They must have a good credit history

But delinquencies are soaring and these people, by definition do not qualify. In addition, delinquencies beget foreclosures, which beget auctions, which beget lower home values, which beget more underwater mortgages, more delinquencies, and more unemployment, which disqualify more homeowners in a vicious cycle, necessitating more bailouts which equal more inflation and more vulnerability for more Americans.

In any case, like the fish in Blue Lakes, the risk/reward ratio of rising early to bait, no matter how tempting, is anti-survival. It follows then, that the successful enterprises will be those whose business models do not depend on early recovery, but on adapting to the stop and go economy that will attend the massive bailouts.

But I imagine that most of you did not expect a real turnaround by the end of 2009, so I probably don’t have to worry about you in this regard.

What does concern me though, is what happens to consumers – your customers – when this rally fades and confidence plunges – possibly in the fall, historically the most dangerous time for financial markets.

This is where your attention must be focused – on the second wave of the credit/housing collapse. If you are prepared for this, your business survival

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quotient will be greatly enhanced and you will by then be ready for the next challenge which promises opportunity for those who understand it and danger for those who don’t.

What is the name of this new bubble?

I call it the “Bailout Bubble” and its collapse will bring yet another bubble, more about that next time.

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