



INVESTMENT OUTLOOK

Due to my travels in the last few weeks, this is an abbreviated report.

ECONOMIC OUTLOOK

The stock markets, as pointed out by many economists and pundits, seem to be telling us that the worst is behind us and that recovery is not far off. When one looks more closely, one sees that this optimism is mostly based on somewhat improving sentiments rather than grounded in facts. Public confidence in the Obama administration remains high thanks to President Obama's very skillful public relations maneuvers. Though the reality of his economic program really only differs in size and focus from that of the previous administration. Q1 bank earnings have come in strongly, and bank nationalization fears have subsided. The leading indicator is less pessimistic than originally feared, and then there is the hope of the massive stimulus package in the pipeline. Let's examine these factors and try to separate facts from fiction.

Bank Earnings

Wells Fargo has revealed precious little about how it earned their reported 3 billion in profits, while Goldman Sachs attributed their 1.8 billion Q1 profits to proprietary trading in currencies and fixed income securities. Little was mentioned about a technical maneuver by GS due to their change into a bank holding company. As such, GS's accounting year changed from the previous November fiscal year end to coincide with the calendar year end of December. Normalized quarterly profits would look very different had the 1.3 billion losses piled into the month of December had been taken into account.

More importantly, just as the Bank of Japan had done for nearly two decades after the Japanese financial crisis erupted in the early 1990s, the US Federal Reserve has created an environment to enable the banks to make risk free profits. It has provided the banks with lots of cheap funds through its various emergency lending facilities as well as quantitative easing. It has permitted the banks to park vast sums of unmarketable securities on its books - nearly worthless securities created by the misjudgment and avarice of bankers. In return, the Fed has provided these institutions with cheap funds that they may use in any number of ways to generate profits. The banks can borrow short and invest risk-free (since the Fed made its intentions clear about purchasing long duration treasuries) in long term treasuries; they can also use the cheap funds to speculate in higher risk investments, such as commodities and currencies, for their proprietary accounts; or they can lend at healthy spreads on credit cards, auto loans and even mortgages. It takes good banking skills and hard work to borrow at true market rates and lend profitably. It is a no brainer to make money if the banks simply follow the Fed's dictates. It looks likely that bank earnings can be supported this way for another quarter or so until loan losses start piling up.

Bank shares are also supported by large open short interests. Capitulation of the shorts may be a theme for some time. For example, there simply is no Citigroup stock to be borrowed at the moment — too many funds are long preferred stocks (shortly to be converted into common stock at \$3.25 minus a 5% discount) and short the common stocks as a risk arbitrage.

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The relaxation of mark to market accounting rule has allowed banks to report higher profits by assuming that the securities on their books are worth more than anyone is willing to pay for them. Nonetheless, the change cannot manipulate the market into pricing these securities at higher levels than what they are worth. The ABX Index of AAA-rated securities backed by subprime collateral issued in 2007 is trading at a very depressed 25 cents to the dollar.

Economic Indicators

In the best of times, various economic indicators can cobble together an economic picture that is close to reality. In times of cyclical or secular changes, these time series are highly volatile and do not provide a very accurate reading on the economy. While leading economic indicators seem to be in the process of bottoming, industrial production and retail sales remain weak, and employment continues to deteriorate. I have my reservations as to whether the fiscal stimulus package can make up for the loss in private consumption. The relatively benign base economic model of the non-partisan Congressional Budget Office (CBO), which most law makers rely on to evaluate the economy and budget plans, calls for a multiplier effect of three dollars of new output for every two dollars of new public spending. With consumers propensity to save rising noticeably, the estimated multiplier may well turn out to be too optimistic.

In reality, the mood in Main Street is pretty downbeat at the moment. Large scale layoffs continue to be announced and many small businesses have closed shop. More than one quarter of all homes have negative equities, and in many areas home value have dropped below replacement costs, making maintenance and improvements nonsensical. This could turn large areas into slums. Unemployment continues its steep ascent and people are genuinely worried about what lies ahead. As pointed out by an astute social commentator, *“only four industries seem to have escaped the downturn unscathed. Sales of junk food, alcohol, and guns are way up; and, as was the case during the Great Depression, Hollywood movies are raking it in. This says volumes about the mass mood.”*

While most are giving Obama the benefit of the doubt, people seem genuinely spooked by the possibility that everybody in charge of everything is a fraud or a crook. After all, every financial crisis has its representative criminals, selected for their most outlandish roles in systemic abuses perpetrated by many, if not all. They are the scapegoats to quell public anger and to distract the public away from the real issue of rampant systemic abuse. The S&L crisis had Michael Milken. The dotcom bust had Bernie Ebbers of Worldcom, Enron had Ken Lay and Jeff Skilling. And now the world's largest real estate and banking crisis has, fittingly, arguably the best ponzi con artist Bernie Madoff.

President Obama's "Ersatz Capitalism"

Much hinges on President Obama's economic program. So far there is no explicit statement of the thinking behind the program, but the ideologies of his core economic team members are well known. His core economic team - the chair of the National Economic Council, Lawrence Summers; the CEA chair, Christina Romer; the budget director, Peter Orszag; and the Treasury Secretary Timothy Geithner, share the same background and creed and have all been active in public services and previous administrations. Thus, deficiencies of their program cannot be blamed on incompetence but rather the limitations of their ideas and beliefs. This is why they are following the same prescription that has not worked previously. The two-prong approach of fiscal stimulus and restoring the health of banks and credit markets differ only in emphasis and size from that of George Bush's administration.



In a recent interview in Barron's William Black, the Deputy Director of the Former Savings and Loans Insurance Corp. during the S&L crisis bluntly pointed out *“we have failed bankers giving advice to failed regulators on how to deal with failed assets. How can it result in anything but failure?”*

The thinking behind Geithner's banking strategy seems to be that credit can be made to 'flow' again if there is enough injection from the top, and if the problem of toxic assets can be managed. There are a few fallacies in this thinking. First of all, credit is not a flow that can be forced downstream from the top. Credit is a contract; its creation requires not only willing lenders but willing and worthy borrowers. Secure and stable incomes, as well as stable and rising asset prices are critical conditions for a worthy borrower. And a willing and worthy borrower is motivated by the animal spirit of profit opportunities. In an economic slump such opportunities are scarce. There are likely many willing borrowers out there. But more likely than not these are the same credit unworthy borrowers that got the banks into trouble in the first place. Not only are rational people not borrowing, strapped and afraid, they want to be in cash. This creates the so called 'liquidity trap'. Under such conditions, normal estimates of multipliers may turn out to be too optimistic. When multipliers drop, fiscal spending packages would need to be even larger in order to fill in the gap in total demand.

Secondly, the current banking plan would prolong the state of denial. It involves government guarantees of bad assets, keeping current management in place and attempting to attract new private capital. The idea is that one can fix the banks from the top down, by reestablishing artificial markets for their bad assets. Delay is not innocuous. When a bank's insolvency is ignored, the incentives for normal prudent banking collapse. Management has nothing to lose. It may take big new risks, in volatile markets like commodities, in the hope of salvation before the regulators close in. Or it may loot the institutions through unjustified bonuses, dividends, and options. It will never fully disclose the extent of insolvency on its own.

The most likely scenario is a combination of looting, fraud, and a renewed speculation in volatile commodity markets. Ultimately the losses fall on the public anyway, since deposits are largely insured. Nobel economic Laureate Joseph Stiglitz critiqued in an article titled Obama's Ersatz Capitalism that the Obama plan in dealing with America's ailing banks is a “win-win-lose proposal : the banks win, investors (bond) win – and tax payers lose.”

There is little chance that the banks will simply resume normal long-term lending. To whom would they lend? For what? Against what collateral? And if banks are recapitalized without changing their management, why should we expect them to change the behavior that caused the insolvency in the first place?

World Economy

While the BRIC stock markets rebounded strongly in the first quarter, and hopes are up that these large and fast growing emerging economies will be able to pull the rest of the world out of the current slump, a central issue driving global deflation has largely been overlooked. With the US households and banks effectively bankrupt, global imbalances can no longer be recycled as previously. The US has lost much of its capacity to absorb and recycle foreign trade surpluses, which in turn underpinned the dollar hegemony. The broken credit machine that produced the world's credit supply cannot be reassembled when so many borrowers and intermediaries are insolvent.



Leaders attending the Group of 20 second Summit on Financial Markets and the World Economy in London on April 2 continued the tradition of superficial posturing for political theater without addressing some pressing global economic issues. The issues of global exchange rate mechanism and the US dollar's sole reserve currency status, as well as the terms of global trade were largely unaddressed. The overriding focus among developed countries in saving their decrepit financial institutions without addressing the structural damage these institutions have done to global credit and trade flow, could ultimately threaten dollar's reserve status. The umbilical cord that tied global trade and capital flow to the US dollar is ruptured, and global trade and capital cannot flow normally again without this fundamental issue being addressed.

The current US policy ignores the possibility that changes in foreign creditors' sentiment might eventually force its hand on the dollar. The extreme monetary easing and a massive fiscal stimulus being implemented amounts to fighting deflation by inducing inflation through destabilizing the monetary standard. While Bernanke seems confident that when the time comes, the Fed will be able to shrink the size of the Fed's balance sheet and reduce the monetary base with ease, thereby easily containing inflation. The reality is that no one controls perception and sentiment, which greatly affects the velocity of money. With the current policy, the extreme outcomes of hyper-inflation and global depression are still very much in the cards.

INVESTMENT OUTLOOK

For reasons well known to readers of this report, we believe substantial downside risks remain embedded in the global economy. Chief among our concerns is the unaddressed issue of necessary global exchange rate evolution now that the dollar centric credit machine is broken. Not addressing this issue only increases the likelihood of uncontrollable developments. This has been the main reason behind our thinking on gold – it is the only money that is no one else's liability, and its quantity cannot be humanly manipulated. Though short term central bank intervention can distort the market, history is littered with failed interventions of this sort. This seemingly stubborn position on gold has not been easy and my resolve is frequently tested. Volatilities are extremely high and mark to market losses can be substantial at times, forcing constant reevaluation of the reasoning behind this position.

Logic and reason drive long term market trends while emotions drive short term market movements. It has been a dizzying experience riding the emotional roller coaster of the market while trying to hold on to some firm ground. In the end, I am always compelled to return to logic and reason for my decisions.

"Security... it's simply the recognition that changes will take place and the knowledge that you're willing to deal with whatever happens."

- Harry Browne
American Libertarian Writer