

The Absolute Return Letter

May 2009

The \$33,000,000,000,000 Question

“Never in the history of the world has there been a situation so bad that the government can’t make it worse”.

-Unknown

Is the crisis really over?

Commercial paper spreads have come down dramatically. Libor rates are (hmm - almost) back to normal. Even high yield spreads are narrowing. It certainly appears as if the credit crisis is well and truly over or, at the very least, the light which most of us think we can see at the end of the tunnel is no longer that of an oncoming freight train.

No wonder equities are currently enjoying one of their best spells ever. And while equities continue to go up and up, most of us are left scratching our heads. Is this the real thing or will it go down in history as ‘just’ another bear market rally? Not so long ago, the entire financial system stared Armageddon in the face. Now, only a few months later, equity markets behave as if all the worries of yesterday have been washed away. How is that possible?

The great bank illusion

The current bull market began in earnest in the second week of March, but what really got everyone going were the surprisingly good Q1 US bank earnings which were reported during the first half of April. Most commentators interpreted the numbers as the clearest piece of evidence yet that we are now firmly on the road to recovery.

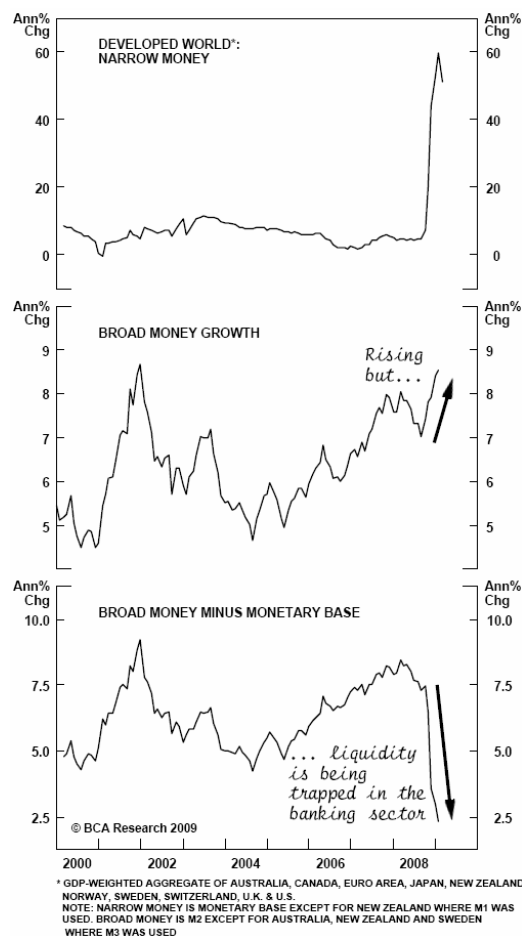
Of course US banks made good money in Q1. The environment created for them is the equivalent of the US government reducing the cost of goods to zero for its embattled car manufacturers and then going on to buy – courtesy of the US tax payer - a couple of million cars that nobody really needs. Even Detroit would make money given those conditions!

Liquidity is trapped

The problem for the rest of us is that the banks are not sharing the candy they have been handed. Much of the liquidity created by the central banks remains trapped in the financial sector (see chart 1). Quite simply, the multiplier is not doing its job, as many banks prefer to hoard cash rather than increase lending at this juncture.

This is both good and bad news at the same time. Good because it implies that we probably do not have to worry too much about the inflationary effect of the aggressive monetary easing currently taking place; bad because it means that the economy is not going to kick back to life as quickly as everyone would like – and expect.

Chart 1: Liquidity Remains Trapped in the Banking Sector



Source: BCA Research

Meanwhile investors are growing cautiously optimistic about the GDP outlook for the second half of the year with many now forecasting modest growth – at least in the United States. Only a fool would suggest that GDP would shrink by 5-10% per quarter in perpetuity, as has been the case over the past two quarters. The economic slowdown is now decelerating and, as I pointed out last month, there are good reasons why we may see a temporary lift in economic activity later this year, but it will almost certainly prove transitory.

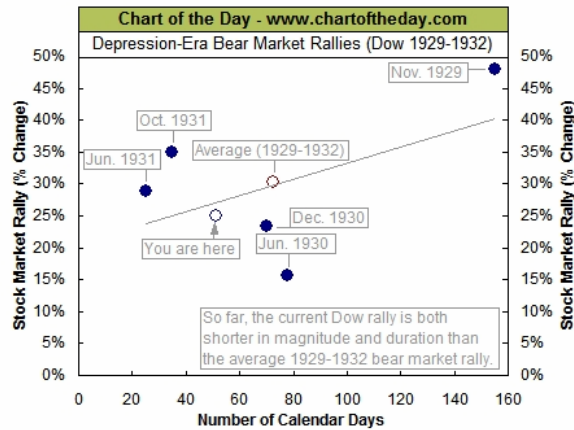
We are still in a bear market

The dangerous conclusion to draw from the experience of the past few weeks is that all is now well and dandy and it is time to load up on stocks again. I cannot emphasize it strongly enough: The bull market of March-April 2009 is almost certainly a bear market rally but, as one of my partners pointed out the other day, NYSE saw four 20%+ rallies between 1929 and 1932 (see chart 2). Bear market rallies can be extremely powerful and hence deceiving.

The problems are *not* over yet. Not by a long stretch. It will take longer than 18 months to unwind the excesses of the past 25 years. Analysts at Morgan Stanley reckon that the 15 largest banks which between them have shrunk their balance sheets by about \$3,600 billion so far in this

crisis, will shed another \$2,000 billion in 2009¹. If you do not share my pessimism, please take a quick look at chart 3 below. The US financial sector debt load (as a % of GDP) is now 117%. In the early days of the great bull market in 1982, the same number was 22%. Households are not much better off with total household debt now at 96% of GDP vs. 47% in 1982.

Chart 2: The Current Bull Market in a Historic Perspective



Source: www.tradersnarrative.com

Further write-offs to come

The IMF reckons that both European and US banks - but in particular the European ones - are well behind the curve in terms of recognising their credit crunch related losses. According to the IMF, there is at least another \$1,500 billion to come. So when the US banks reported surprisingly good numbers for Q1 it was certainly not because the economy had suddenly and miraculously revived itself, but because some of the oldest tricks in the book were used to gloss over much bigger problems².

Chart 3: Debt and Other Key Data for the US Economy

Data Point	1Q 1982	Now
Credit Market Data		
Credit Market Debt As % Of GDP	172%	370%
Federal Debt As % Of GDP	27	45
Household Debt As % Of GDP	47	96
Financial Sector Debt As % Of GDP	22	117
Federal Deficit As % Of GDP	3.2	14.3
Household Character		
Household Debt Service Ratio	10.7%	13.9%
Mortgage Debt As % Of GDP	31	73
Mortgage Debt As % Of Disposable Personal Income	43	98
Household Liquidity As % Of Liabilities	145	81
Equities As % Of Household Net Worth	8.1	17.0

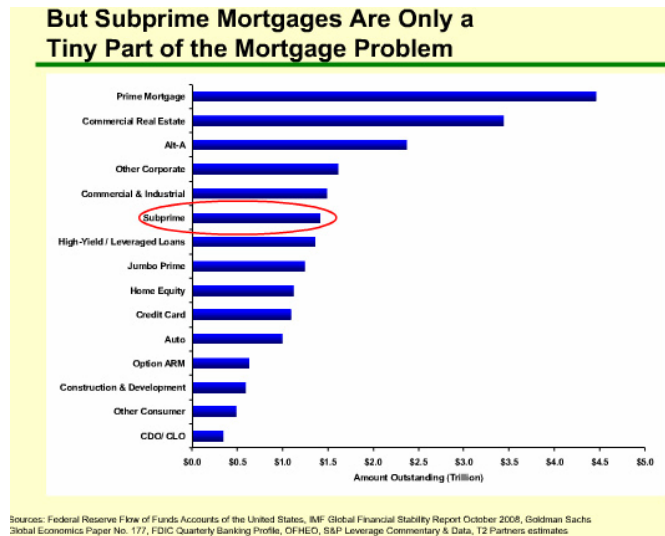
Source: www.contraryinvestor.com

¹ "Doomsday is on hold but banks will still feel further pain", *The Financial Times*, 30th April, 2009.

² In particular one US accounting rule change (FASB rule 160) explains a large part of Q1 profits.

As the recession bites into the lives of ordinary people, banks will face losses not only on sub-prime mortgages but on all loan products. As you can see from chart 4, sub-prime is indeed a small fraction of the total loan book for the US banking sector.

Chart 4: The Mix of the US Loan Book

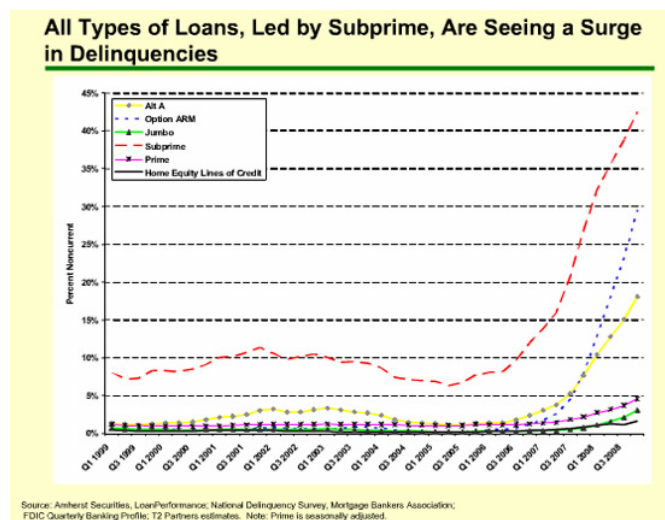


Source: <http://www.urbandigs.com/>

Delinquencies are on the rise

And that is precisely what is beginning to happen as illustrated in chart 5. Delinquencies are now on the rise on all mortgage products; however, whereas sub-prime started to deteriorate as early as 2007, it is only recently that delinquencies related to Alt-A and adjustable rate mortgages have taken off, and prime and jumbo loans are only now starting to suffer.

Chart 5: Delinquencies on US Mortgage Products



Source: <http://www.urbandigs.com/>

These are all temporary problems, though, however bad they may appear. By far my biggest concern at the moment is the enormity of the debt problem facing most OECD countries. In the March issue of the

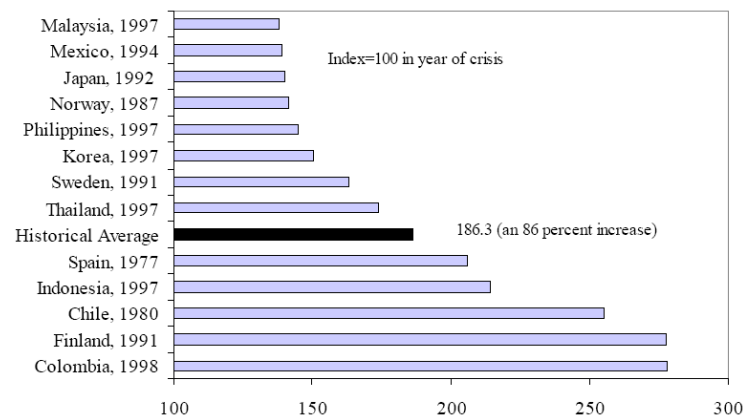
Absolute Return Letter I referred to an important study conducted by Carmen Reinhart and Kenneth Rogoff back in December of last year³ which I would like to re-visit (see chart 6).

Banking crises run and run

Reinhart and Rogoff studied every banking crisis of the past generation and made some startling observations. One in particular caught my attention. It has to do with the subsequent rise in government debt which, according to Reinhart and Rogoff, has been “... a defining characteristic of the aftermath of banking crises for over a century”. According to the authors, governments inevitably underestimate the ultimate cost of a banking crisis, because the indirect costs (such as falling tax revenue in subsequent years) end up much higher than predicted.

The IMF estimates that the cost of the current crisis to the United States will eventually reach 34% of GDP or close to \$5 trillion. However, the Obama administration, through its various implicit and explicit guarantees, is already using a number close to \$9 trillion⁴. And Reinhart and Rogoff’s historical average of 86% of GDP implies an ultimate cost of over \$12 trillion!

Chart 6: Increase in Public Debt in the 3 Years Following a Banking Crisis (inflation adjusted)



Source: Reinhart & Rogoff

The IMF is too optimistic

I have a lot of respect for all the good work being produced by the people at the IMF; however, they are sometimes too politically correct for my taste; maybe too afraid of stepping on someone’s toes. So when they go public, as they did recently, with an estimate of how much the current crisis would ultimately cost, their projection will more than likely prove hopelessly inadequate.

The true cost is important, because it has to be financed through new bond issuance, and it is my thesis that the sheer size of this tsunami will eventually overwhelm the world’s bond markets. As you can see from chart 7, using the official IMF estimates, the twelve most industrialised of the world’s G20 countries (in my book known as the Dirty Dozen) will have to issue about \$10 trillion worth of new bonds to cover the cost of the current crisis.

³ “The Aftermath of Financial Crisis”, Carmen Reinhart & Kenneth Rogoff, December 2009.

⁴ <http://zerohedge.blogspot.com/2009/04/bail-out-for-dummies-part-1.html>

Chart 7: The Cost of the Banking Crisis (IMF estimate)

Country	2008 GDP (\$ billion)	IMF Estimate Δ Deficit (% of GDP)	Projected Bond Issuance (\$ billion)
Australia	\$1,069	26%	\$278
Canada	\$1,564	14%	\$219
France	\$2,978	21%	\$625
Germany	\$3,818	14%	\$535
Italy	\$2,399	28%	\$672
Japan	\$4,844	28%	\$1,356
South Korea	\$858	14%	\$120
Mexico	\$1,143	6%	\$69
Spain	\$1,683	35%	\$589
Turkey	\$799	12%	\$96
UK	\$2,787	29%	\$808
US	\$14,330	34%	\$4,872
Total, G12	\$38,272	27%	\$10,239

Source: CIA World Fact Book, IMF

The final cost will be enormous However, if you (like me) believe that IMF underestimates the true cost of this crisis, Reinhart and Rogoff offer a more realistic approach (see chart 8). Using their least costly case study (Malaysia 1997) as our best case scenario, the true cost comes to \$15 trillion. If one uses the average of 86% instead, the cost jumps to a whopping \$33 trillion. I didn't even bother to produce a worst case scenario - it all got too depressing!

Chart 8: The Cost of the Banking Crisis (Reinhart & Rogoff estimates)

	Δ Deficit (% of GDP)	Projected Bond Issuance (\$ billion)
IMF Estimate	27%	\$10,239
Rogoff, Best Case	40%	\$15,309
Rogoff, Average	86%	\$33,029

Source: CIA World Fact Book, IMF, Rogoff & Reinhart

I need to put the \$33 trillion into perspective, because it is so big that it is almost incomprehensible. According to Wikipedia (see chart 9), total private wealth across the world today is about \$37 trillion *less* the losses incurred in 2007-09, so the real number is probably closer to \$30 trillion now. Total global savings (loosely adjusted for the big losses in 2008) are probably somewhere in the region of \$100 trillion. In other words, financing this crisis could absorb one-third of total global savings. No wonder Gordon Brown looks tired!

Chart 9: Global Assets under Management

Fund Type	As of End	\$ Billion
Private Wealth	2006	\$37,200
Pension Funds	2007	\$28,228
Mutual Funds	2007	\$26,200
Insurance Companies	2007	\$18,836
FX Reserves	2007	\$7,341
Sovereign Wealth Funds	2007	\$3,300

Source: http://en.wikipedia.org/wiki/Global_assets_under_management

Where do we find the money? Obviously, governments may buy a portion of these bonds themselves, but they cannot afford more than a fraction of the total unless they want to challenge Mugabe as the ultimate master of illusion. Neither should investors hold out for sovereign wealth funds to do the dirty work. As is clear from chart 9, the total amount of wealth accumulated in these funds is pocket money when compared to the projected bond issuance over the next few years.

Hence it comes down to the price at which governments can attract sufficient demand from people like you and me. One of two things may happen. *Either* this crisis will ignite such a bout of deflation that investors will happily own government bonds yielding 2-3% *or* the deflation scare goes away ultimately, the global economy recovers and bond investors demand *much* higher yields for taking sovereign risk. I am not yet sure which scenario will prevail, but I do know that both are quite bad for equities longer term. Take your profits!

Niels C. Jensen

© 2002-2009 Absolute Return Partners LLP. All rights reserved.

This material has been prepared by Absolute Return Partners LLP ("ARP"). ARP is authorised and regulated by the Financial Services Authority. It is provided for information purposes, is intended for your use only and does not constitute an invitation or offer to subscribe for or purchase any of the products or services mentioned. The information provided is not intended to provide a sufficient basis on which to make an investment decision. Information and opinions presented in this material have been obtained or derived from sources believed by ARP to be reliable, but ARP makes no representation as to their accuracy or completeness. ARP accepts no liability for any loss arising from the use of this material. The results referred to in this document are not a guide to the future performance of ARP. The value of investments can go down as well as up and the implementation of the approach described does not guarantee positive performance. Any reference to potential asset allocation and potential returns do not represent and should not be interpreted as projections.

Absolute Return Partners

Absolute Return Partners LLP is a London based private partnership. We provide independent asset management and investment advisory services globally to institutional as well as private investors, charities, foundations and trusts.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns. We use a diversified range of both traditional and alternative asset classes when creating portfolios for our clients.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Services Authority.

Visit www.arpllp.com to learn more about us.

Absolute Return Letter Contributors

Niels C. Jensen	njensen@arpllp.com	tel. +44 20 8939 2901
Jan Vilhelmsen	jvilhelmsen@arpllp.com	tel. +44 20 8939 2902
Nick Rees	nrees@arpllp.com	tel. +44 20 8939 2903
Robert Dawson	rdawson@arpllp.com	tel: +44 20 8939 2904
Tricia Ward	tward@arpllp.com	tel: +44 20 8939 2906

The ARP Structural Alpha Portfolio as at 31st March, 2009:

