

# INSIGHTS ON FRONT STREET



BY JASON P. TANK, CFA  
FRONT STREET INVESTMENT MANAGEMENT LLC

## TIGHTROPES AND TRIPWIRES

FEBRUARY 2009

As we watch the unfolding of "the financial crisis", we're beginning to see our government as a tightrope walker. The balancing act is quite astounding to watch. Despite their overt shift toward socialistic intervention, one can't help but see the discomfort in their eyes while they do it. Nonetheless, they forge ahead with no politically palatable alternatives in sight beyond spending money.

Their discomfort comes from their underlying belief - and ours too - that free markets naturally and ruthlessly find equilibrium. Willing buyers and sellers agree on a clearing price. Unfortunately, our politicians, our banks and many investors are totally afraid of discovering the clearing price. Their current efforts are to prop up asset prices everywhere.

The government actions being taken are not easy nor are they free of risk. We know this because if there were a simple and comprehensive solution, these issues would have ended many, many months ago.

We're concerned that their delicate tightrope act could lead directly to a tripwire. You see, our government has no money!

The trillions of dollars being thrown at this crisis don't really exist. If investors, private or otherwise, stepped back from lending to our government at attractive enough rates, then the Federal Reserve said they'll just print it.

Counter-intuitively, and perhaps only for the time being, their hints at just printing it is actually holding interest rates down. This short-term trade - largely based on the existence of a greater fool - cannot last indefinitely.

Yes, the Federal Reserve can just print dollars at will. They do this on a small scale all the time; that is what

monetary policy is all about. But, today, they are doing it on an unbelievably huge scale.

At the height of the recent credit freeze, the Fed mostly printed dollars in order to lend it out against qualified collateral. As is their formal role, they were and are acting as the "lender of last resort" because the usual private lenders have been debilitated - both financially and emotionally.

But, as of late, the Fed decided to just go ahead and print hundreds of billions of dollars to help push down mortgage rates. The only problem is it hasn't stopped the drop in housing prices yet.

The latest iteration of financial institution bailouts - to be announced tomorrow - is going to involve the use of newly-printed Federal Reserve cash. We should all get ready for a plan that "leverages up" the dwindling and controversial TARP money with hundreds of billions of dollars of Federal Reserve cash to buy or wrap guarantees around perhaps a trillion dollars of troubled assets that are currently sitting on banks' balance sheets.

The purpose of this plan - beyond trying to create some clarity for future bank investors - is to effectively socialize the losses and fold (or is it, obscure?) them into our government's financial house of mirrors.

This plan, like those before it, will likely just relieve the banks of the bad loans with the hope they will in turn lend more to borrowers. Judging from the stock prices of many banks, using the word, hope, might be a nice way of putting it. Current shareholders fear that taking more bailout money will be like putting a gun to their own head.

But even with this forced quid pro quo, will borrowers who are already leveraged up - with shrinking to non-existent home equity - be able or willing to go out and borrow even more? US consumer debt levels have now fallen in four of the last five months. Demand for loans is down despite abnormally low interest rates. This is a hopeful long-term - yet ominous short-term - economic sign. Debt is the root of the problem and able consumers are taking matters into their own hands. We'd like to know how any plan will turn that dynamic around?

What goes unsaid is that we have no other method of propping up asset prices. Without stabilized asset prices, we'll probably see more contraction of consumer credit, more jobs losses and a large wave of debt restructurings/bankruptcies. Eventually, this leads to higher savings rates and less consumer spending. Higher savings rates might bring on more bankruptcies and debt restructurings and the cycle becomes self-reinforcing in a vicious way. It probably already is.

But, being optimistic, a clearing price is always found and when things reach a bottom, we'd begin to see an authentic recovery. However, our politicians - and likely society as a whole - really don't want to see it all unfold quite like that. At worst, they'd much rather engineer a slow hiss rather than a pop, as we wrote last April 2008.

With all these plans, it is important to remember that the US Treasury has to somehow come up with all this money. In total, we are talking \$2-3 trillion of additional government borrowing on top of the \$10 trillion the federal government already owes.

And so the tripwire is this. At some point, spending money we don't actually have (and therefore, having to resort to printing money) would probably lead our creditors to demand higher interest rates. We truly can't afford that outcome, especially now.

For this reason, we think we see the fear in the eyes of those who are supposed to be in charge. Faux confidence seems to be everywhere these days. The current selling point of this stimulus and coming financial bailout plan is that we have no other choice. The main talking point is that government is now the only viable solution.

Granted, today investors are still clamoring to own Treasury debt at ultra low interest rates. But, remember, back in December, the Federal Reserve hinted strongly that they would consider buying US Treasury securities themselves if it would help matters. It is little wonder then that investors rushed in to buy ahead of the Federal Reserve. Unfortunately, instead of just doing it already, in January the Fed said they were now "prepared" to buy Treasuries.

With no imminent Fed purchases on the horizon, investors have begun to get weak knees and government interest rates have gone up.

It looks as if the Fed is getting cold feet because it is big deal when a central bank starts buying its own government's debt. If the Fed resorts to buying US Treasury debt, it's equivalent to our government lending to itself. Once they cross that line, the "full faith and credit" promise might be considerably damaged. No faith, no buyers and no more artificially low interest rates and then...the tripwire gets tripped.

Before breaking into a cold sweat, our view is that they aren't oblivious to this risk. They know there is a tripwire. It's just that nobody knows where it is. For this reason, we sincerely hope they'll stop well short of it.

So, as things stand today, our belief is that our policymakers would rather preside over a long drawn-out slowdown than to see us reach the end of this thing more quickly.

Socially speaking, that is clearly a preferable public policy.

Economically speaking, this clearly doesn't reward the prepared.

But, practically speaking, we know that "the best laid plans of mice and men often go astray".

Because of this truth, we feel we have very few choices other than to continue managing portfolios very, very cautiously.

This requires us to push our ego and our capitalist sense of greed way off to the side. That is the way of socialism and perhaps we should all get used to it. At least for now!

