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'Tears to my eyes'

The gold items weighed in at 11 pounds, the silver ones at 5.5, but it wasn't the weight of the treasure that weakened the knees of British archaeologists who studied it last week. It was the craftsmanship of the seventh-century artisans that led the scholars to judge the trove of battlefield leavings to be perhaps the greatest British archaeological discovery in modern times. A 55-year-old hobbyist, Terry Herbert, chanced upon the site this summer, his metal detector paying for itself over and over in one glorious instant. Under his feet lay buried 1,500 separate artifacts: dagger hilts, Christian crosses, helmet cheekpieces and other items of booty scooped up by the victors in the smoking ruins of some long-ago battle. "My first view of the hoard brought tears to my eyes," one of the staring 21st-century authorities, Deb Klemperer, was quoted as saying in *The New York Times*.

Bankers and investors should have bawled the harder, for the exhumation of so much sterile wealth was as financially tragic as it was aesthetically sublime. What if, a modern professor of finance might wonder, these ancient warriors had put their money out at interest rather than literally burying it? The question is especially timely now that gold is making another run at the $1,000-an-ounce mark. Where can the investor with an archaeological-length time horizon turn for a decent return?

The rub about gold, Andrew Hall, one of the speakers at the *Grant's* Conference mused, is that, unlike oil, for instance, it's never used up. A particle of the golden bangle you wear just might have adorned one of the seventh-century Mercian kings who delighted in slaughtering the subjects of other Mercian kings and then, in a kind of medieval end-zone dance, burying the wealth of the vanquished deep in a Staffordshire hole.

"Gold has two interesting properties," observes Roy W. Jastram in his 1977 book "The Golden Constant." "It is cherished and it is indestructible. It is never cast away and it never diminishes, except by outright loss. It can be melted down, but it never changes its chemistry or weight in the process." Then, too, Jastram finds, "Its price has been remarkably similar for centuries at a time. Its purchasing power in the middle of the twentieth century was very nearly the same as in the midst of the seventeenth century."

Jastram is silent on the seventh century, the era in which a warrior king unintentionally set about to bring tears to the eyes of the unborn Ms. Klemperer. However, let us say that an ounce of gold bought the same proverbial "good man's suit" in 650 A.D. as it does today. Maybe it bought a suit of armor. Jastram constructed a price index for gold for which the beginning year was 1343 and the end point was 1976. Colleague Tim Hlavacek has updated the index to incorporate today's spot gold price.

Let's see, Hlavacek reasons: 11 pounds of gold works out to 160.416 troy ounces. Times the current gold price, the trove would be worth $159,020 in bullion value alone. Never mind, for now, the archaeological value. Divide that $159,020 by Jastram's (updated) multiplier to find the value of those ounces in the money of the year 1343. The answer: $569. Now imagine that that $569 in gold value was converted into the currency of the day and invested in King Wulfhere's perpetual 2s. After 666 years, the ever-so-patient investor would be sitting on $304 million.

At press time, no reliable price data for the years 650 to 1343 had presented themselves. But let us assume that Jastram's index number behaved over that span as it did between 1343 and the present. In that case, Hlavacek continues, the value of the artifacts at the time the vanquished surrendered them in the middle of the seventh century would have been $2.0347. And it is here that we come face to face with human tragedy. If those two little dollars (and change) had been invested, and continuously reinvested, in 2% consols in the year 650, they would be worth $991 billion today. At 2.5%, they would be worth $762 trillion; at 3%, $568 quadrillion, or maybe just enough to pay for the Obama administration's projected health-care initiative.

The pity is that the man with the metal detector will realize nothing like his fair share of $568 quadrillion.

(Continued on page 2)

"Went online this morning. Checked my account. Down to my last $5 million."

(Continued from page 1)

News stories quote British authorities speculating that the trove might fetch £1 million, or $1.6 million, in auctions that evidently will be closed to all bidders but British museums.

The truth about the long term, then, is that it consists of a sequence of short terms and these short terms are full of the episodes we call history: war, peace, pestilence, progress, revolution, invention, discovery, depression, enterprise, bankruptcy, birth, death, taxes and such. Kingdoms rise and fall, debts are incurred and repaid, or—as often as not—not repaid, or repaid in money unrecognizable to the poor creditor. Interest runs for years at a time, but rarely even for decades, politics or central banks intervening to disrupt the piling up of what would otherwise be wealth too vast to be stored on the planet Earth. Through it all, just as Hall and Jastram have separately noted, gold endures, holding its value but returning no income. Well, you can't have everything.

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Title holder

Concerning house prices, *Grant's* is willing to bet that either the bulls or the bears are going to be right. As to affordability, however, there's no need to climb so far out on a limb. Thanks to low interest rates, falling prices and government giveaways, owning a house today is a more attractive proposition than it's been for many a moon.

All of which is preface to a bullish update on Fidelity National Financial (FNF on the Big Board). Fidelity, we are about to contend all over again, is ideally positioned to benefit from rising real estate transaction volumes, whatever the source of the lift. As to whom they should thank for their coming good fortune—the government? Adam Smith?—the company and its investors will be purely indifferent.

Fidelity, last featured here on January 9, is predominantly a title insurer. Title insurance protects property owners and lenders from losses stemming from confusion over who owns what. The four largest title insurers (Fidelity, First American Corp., Stewart Information Services and Old Republic International) constitute a tight little oligopoly, together controlling 92% of the market. Fidelity has 46%.

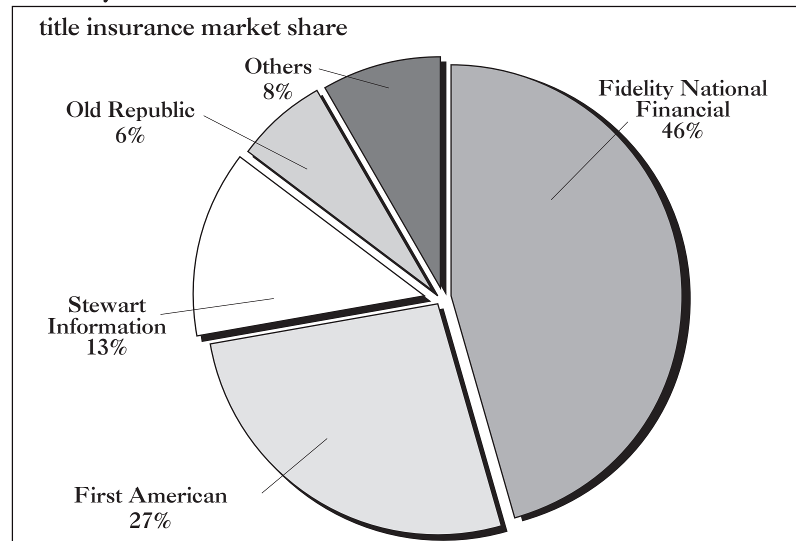
In the manner of Henry Singleton, the legendary buy-low, sell-high CEO of Teledyne Inc., Fidelity capitalized on the market turmoil last fall when it acquired LandAmerica's title insurance businesses (the third-largest at the time) out of bankruptcy. It paid $235 million in cash, stock and the assumption of debt. "The market approved," said colleague Dan Gertner (himself an owner of FNF, let the record show), "and expanded FNF's price-to-book ratio to 1.8 by mid-April from 1.2 at the time of the transaction. In response to this vote of confidence, Fidelity issued 18.2 million shares of stock for total proceeds of $331 million. The proceeds were used to reduce borrowings, repurchase debt and infuse capital into the acquired title insurance business. Again in the vein of enlightened opportunism, management repurchased $47 million of stock in May and June when it briefly traded below book value."

Fidelity's chief executive officer, Alan L. Stinson, held forth at an investor conference last month about the recent corporate upsizing: "[W]e did the [LandAmerica] acquisition in late December of 2008," he said, "but on a pro forma basis, the two companies combined would have had a 46% market share. In Q1 and Q2 of this year, the statistics prepared by the American Land Title Association show that we continue at 46%. So, frankly, I was a little surprised. I thought we couldn't help but lose a little market share in an integration of that size but we did not.... When we took over the two underwriters that we acquired, they were running at a pretax loss of about $20 million a month, and by March we had them profitable, and for Q2 of this year, their margins were comparable to Fidelity's. We took $250 million of cost out of LandAmerica, and by our standards, the transaction is integrated. We're done."

Fidelity has not only retained its market share, as Stinson noted, but it has also gained pricing power: "The industry has become more or less an oligopoly and that has helped us, by and large, on the pricing front. We were able this year to increase prices in 22 states. We have 13 other states pending. The biggest of those was a price increase in California, where we got a rate increase of 10%, effective March 1, and our principal competitor followed suit with a very similar increase. So we're seeing some rationality in pricing, and I think you would expect that as the industry consolidates and becomes a bit more mature in its philosophies." The price increases are just now benefiting Fidelity's top line, Stinson wound up. And he added: "We're probably in the best rate environment and best regulatory environment we've been in for a long time."

Another positive attribute, albeit a speculative one, is that Fidelity might be over-reserved. The balance sheet shows $2.74 billion of reserves for future losses. In the 2008 third quarter, management was laying aside 8.5% of revenues for that contingency. It

Fidelity dominates



source: American Land Title Association

reduced that number to 7.5% in the second quarter of this year. Analysts speculate about a redundancy as great as $1 billion. "I think it's a little early to make that call," Stinson told his audience. "But the trends are all going in the right direction and we look at it every month. I don't see anything that tells me we've got some problem ahead of us. So I suspect at some point, we'll probably be talking about the high-class problem of releasing reserves, but I think it's rather ironic that we're already thinking about that one year after we were thinking the opposite. So I see a lot of improvement both in that part of our business and the profitability and everything else. The whole confidence level in the economy seems to be improving, the way I look at it. But anyway, the reserves—we're not going to see any surprises and probably the opposite."

"Despite all of the positives—high market share, pricing power, positive regulatory environment and potential for releasing of reserves—Fidelity is attractively valued," Gertner points out. "It is trading at 1.1 times book, 12 times 2010 estimated earnings and yields 3.9%. Stinson envisions a couple of possibilities for his newfound oligopolistic bounty: 'So we either pay it out in dividends or we buy back stock, and we've cut the dividend rate over the last year or so by 50%. Knowing the way our board thinks, I could see that as a definite possibility of looking at increasing the dividend. We also are buyers of our stock at book value or below it. I believe book is $13.50. So we've been out of the market for a little while, but we do have an appetite for the stock at the right price. So I would say it'll be a sort of a balancing act between those two factors.' Either sounds appealing."

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We got 'E'

"I spend four months a year living in Europe supervising our European operations," Howard Marks, chairman of Oaktree Capital Management, remarked at the end of his talk at the *Grant's* Conference last week. "As I've gone around Europe for the last several years, I have been describing the typical American to my European friends this way: has $1,000 in the bank, owes $10,000 on the credit card, makes $20,000 after taxes and spends $22,000. I have always been curious about how that was going to end, and I still don't know that it will be a happy ending. But, as I say, consumers have surprised with their behavior and may continue to do so and pull us out of this strongly."

Debt was on Marks's mind, as it seemed to be on the mind of everyone who walked through the doors of the Plaza Hotel. The past several decades have been marked by a willingness to borrow. Indeed, as Marks pointed out, by a general "willingness"—for instance, a willingness to seek higher returns, to employ exotic investment strategies and to believe that financial models and financial theory open the door to the vault of wealth. And if that weren't enough, the past decade brought a still higher stage of willingness, e.g., to "forgo liquidity," to "rely on history to quantify the riskiness of prospective investments" and to "make increasing use of leverage, often on the basis of undependable capital."

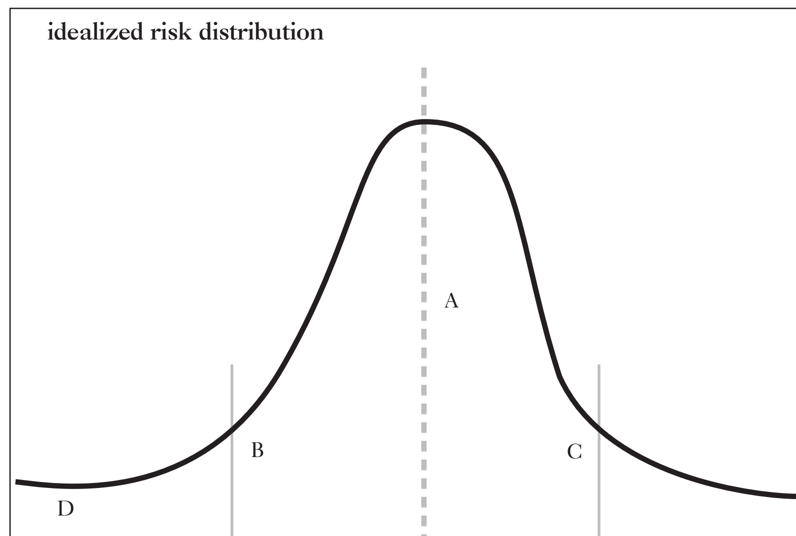
Everyone knows that leverage magnifies gains and losses alike, Marks noted. But because nobody enters into an investment to lose money, "leverage is essentially always viewed as enhancing returns." There is, however, he added, a special kind of risk inherent in leverage for which there is no compensating upside, "and that is the risk of ruin."

Before the sky fell in 2008, ruin, to many, was what happened to historical figures in long-ago panics. Modern methods of portfolio management and central banking, they believed, had reduced the probability of disaster to the vanishing point. But Alan Greenspan was not, in fact, the Jonas Salk of ruin; the risk remained, germinating in the very structures and ideas that seemed to obviate it. So the question presents itself: How to invest with the knowledge that financial oblivion is a not impossible outcome?

"The ability of one's portfolio to survive in a hostile environment is a function of the margin of safety you build in," Marks said. "Buffett constantly talks about the margin of safety, margin for error, and this is clearly the key for the conservative investor. The safety of your portfolio, the ability to weather that bad day, is directly proportional to the amount of margin for error. When we plan on our margin for error, we must project what the future will look like. Most of us have little choice but to project a future that looks like the past. So we create a distribution of past events and we extrapolate it into the future."

Here, Marks showed a typical bell-shaped curve. "We say that 'A' may be the mean, median or mode," he said, pointing to the line that bisects the hump. "'A' happened most in the past, and we figure that 'A' will probably happen in the future. We know that other things can happen. It can be as bad as 'B,'" he said, pointing to a spot on the left slope of the bell, "or

Where's 'E'?



source: Oaktree Capital Management

as good as 'C,'" a spot on the right slope of the bell, "within the band of two standard deviations, which covers almost all contingencies. So we must allow for the possibility of 'B' or 'C.' Now, we know that 'D' happened once in the past. It is in the left edge of the negative tail. We are not going to plan for 'D.' We can't plan for these worst-case events, because if we did, we would never be able to move forward. So we will probably ignore 'D' in our planning. And the problem is that, last year, we got 'E.'"

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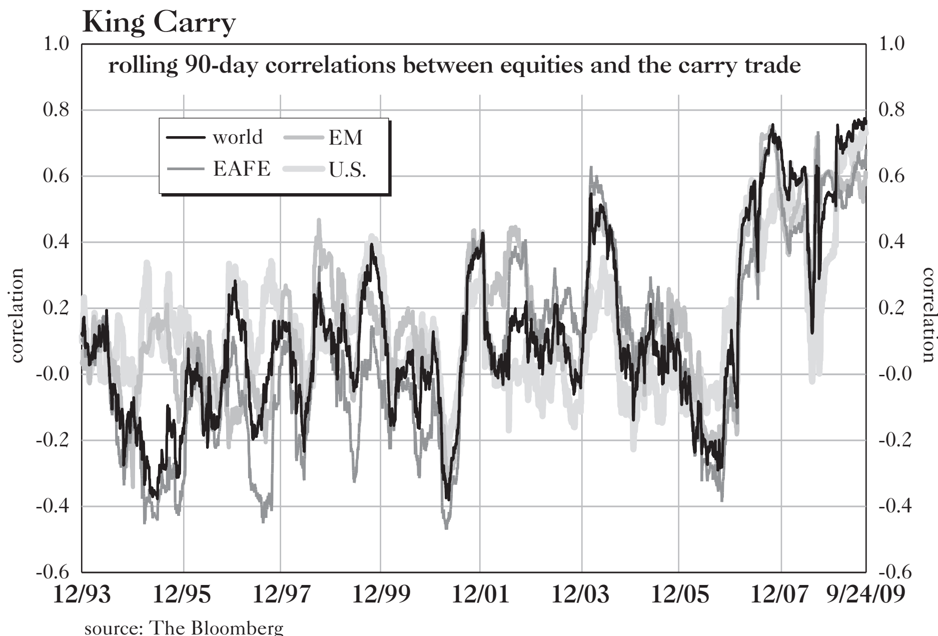
Requiem for a decade

Bubble has chased bubble since the tech-stock levitation of the late 1990s, observed James A. Bianco, founder and president of Bianco Research, Barrington, Ill. There might be no great harm in that, he said, if there had been something to show for all the money printing—say, buoyant asset prices or a sturdy labor market. Nothing of the kind, however.

"The S&P 500 is largely at the same level as it was in January 1998," Bianco noted. "Another way of looking at expressing that is to look at the 10-year total return of the S&P: It is negative as of the end of August on a 10-year basis. The last time we saw that was in the 1930s."

The U.S. economy, too, is creating unwanted comparisons with the decade of Hoover and Roosevelt. "We have had virtually no job growth in the past 10 years," Bianco continued. "This is the first decade since the 1930s where we have had no job growth for 10 years. This is going to be the first time since the Great Depression (other than the nine-month recovery in 1981) that we will have destroyed all of the jobs created in the previous advance. If we lose another 300,000 jobs over the next couple of months, all the jobs created between November 2001 and December 2007 will have been erased by this recession."

It's easy to assert that world markets have become addicted to "carry"—to a positive gap between the cost of margin debt, on the one hand, and the yield on the assets that such borrowings finance, on the other. And Bianco did so assert, while adding some statistical evidence in support of the assertion. Observe, he said, Deutsche Bank's "G-10 Currency Future Harvest" index, which replicates the carry strategy of borrowing in low-yield futures and lending in high-yield futures ("low" and "high" being relative terms). Now, then, Bianco went on, if you map the correlation between the carry index and various world equity indices, you find that "the relationships are 70% to 80%, the highest. . .in 16 years. In other words, markets are becoming more correlated, markets are moving up and down [together]. The big key driver of all these markets seems to be the ability to either get or deny carry."



So what appeared to Alan Greenspan a decade ago as an age of unexampled productivity growth and material progress has rather resembled a bubble. "There has been no job growth in this period," Bianco concluded. "There has been no appreciation in the stock market during this period. What we have had is a boom, we have had a bust, we have had cheap money and a boom and a bust and even cheaper money. And it appears that we are trying to start another boom again."

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Bullish on a building

"I have three points to make," announced Jerry O'Connor, progenitor of O'Connor Capital Partners, longtime investors in commercial real estate. "The deluge of real estate debt defaults and restructurings is now in full swing. Well-chosen real estate is now a better value than stocks and bonds. Sourcing compelling real estate deals is a very difficult strategy to implement."

Difficult but not impossible, as O'Connor was able to demonstrate in describing a recent investment of his own. Worldwide Plaza, a 47-story office tower at 825 Eighth Ave. and 50th St. in Manhattan, changed hands for $2.1 billion in the top-making 2007 Equity Office Property/Blackstone transaction. The investor group in which O'Connor participated recently paid $600 million. "The point," he said, was price. "So the valuation was $1,100 a foot," O'Connor went on, "we bought it for $318 a foot. The net operating income was $58 million, now it's $37 million. Our cost of finance—and we borrowed from Deutsche Bank, which wrote down their debt—is 4%. We are paying 300 basis points, or 350 basis points, over. We have a half-occupied building, and we have a $16 million cash flow on $130 million of equity invested. It's OK."

By the sound of him, however, O'Connor is doing more worrying than investing. "Rents are declining," he said. "They are declining across the board. In resi, in retail, in office. The most extreme decline has been in office. Office rents in New York are down one-third to one-half. Very importantly, the market hasn't cleared.

There is so much stuff that is stuck in the system, and we don't know how this is going to come out. EOP/Blackstone is the cancer that keeps on giving, almost every year. . . . The cap rate when they sold was 3½%, and these guys laid it off at 3¼% or whatever. Three-month [financing] was then 6½%, 7%. So you borrowed . . . assuming that rents would double, and rents are down by one-third, so everyone is upside down."

Banks have their own troubles, O'Connor continued. "Point No. 1 is that for all FDIC-insured banks, construction-and-development loans are 40% of equity capital. Add nonfarm nonresidential and you are at 114%. If you look at the money-center banks and you look at tangible common equity—not Tier 1 capital, but hard equity—and you say, 'What are commercial real estate loans as a percentage of hard equity?' It's 118% for J.P. Morgan, 366% for Wells Fargo. So a lot of pain is going to come, and yet people haven't acted. Banks aren't selling. Banks are holding. Banks are hoarding, and the government is their ally in this. . . ."

A seasoned developer of shopping malls, O'Connor said he was bearish on them—"very." But he emphasized not so much his conviction as his lack of it. "I have never been so unsure of the road ahead or so concerned by the trends in government spending and controls," he confessed. All the more reason, he concluded, to insist on a margin of safety—as his fellow investors and he did in the their purchase of Worldwide Plaza. "We assumed," O'Connor wound up, "the rent rates would be 50% of what we achieved with the [renewal of the lease of Cravath, Swaine & Moore], and we assumed it would take us 3½ years to lease it up. Margin of safety, low price per pound, you ought to be OK."

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'I have doubts'

John Paulson owns dollars, billions of them, but that doesn't mean he trusts them. In fact, the president of Paulson & Co. advised the *Grant's* audience, once the Fed began directly buying Treasurys and mortgages (the program started in March), "I lost faith in the dollar as a reserve currency for my assets."

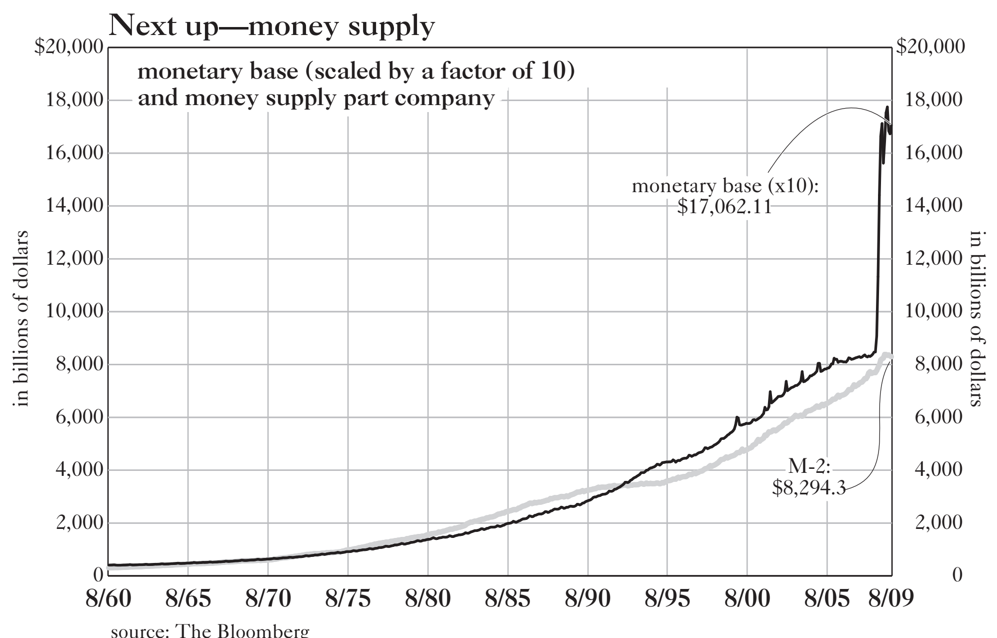
The topic of Paulson's talk—"Inflation? Gold? How much? When?"—might have seemed incongruous, the speaker acknowledged, inasmuch as the company he manages is in the event-arbitrage business, not the macro-speculation business. "So what is my interest in inflation or deflation or gold? It's primarily my interest as an investor. And having all my assets denominated in dollars." He said he never believed the Fed would go as far as it did. But when it did, he decided to seek an alternative currency in which to denominate his wealth. And that currency is the barbarous relic.

Paulson identified two basic sources of gold demand. One he called the "fear factor," a hedge against Armageddon. And as protection against the end of the world, he said he would want about $5 millions' worth—enough to tide his family over till the storm subsides. The second, and principal, source of gold demand is that for protection against debasement. "Demand for gold as an inflation hedge is, for me, 100 or 1,000 times more than that [$5 million]," he said. "It really equals what are my dollar holdings. If I'm fearful that the dollar holdings are going to decline, I'm going to lose value just holding dollars, then I'm going to want to hedge out all of my dollar exposure to something that's not going to lose its value."

Paulson displayed a graph of the vertically rising monetary base, next to which was plotted the money supply. For decades, he noted, the correlation between growth in the base and M-2 has been on the order of one to one. Lately, however, the base has climbed in splendid isolation. The question before the house was whether money-supply growth would follow the lead of the base, precipitating a new inflation as it goes.

Yes, Paulson said in reply: "The velocity of money plummeted after Lehman with the expansion of the monetary base. However, we believe that the velocity of money will pick up as the economy recovers and as banks start to use those reserves in lending."

Paulson had data. "We are starting to see lending pick up," he said. "I'm actually, probably, a good leading indicator. At the beginning of this year, we didn't have any borrowings. We had $19 billion in cash in our funds. By April, we had deployed all that cash, and now we are actively borrowing money on margin and through other facilities to increase our leverage. So we have gone from a depositor now to a borrower in the banking sector. Our prime brokers tell us that they are starting to see an increase in borrowing from other hedge funds and other investors as well. And we are also hearing that the demand for commercial loans is starting to pick up from some of the banking relationships that we have. It seems to us, with time, as the economy recovers, lending will resume, velocity picks up, and the monetary base, unless it's



source: The Bloomberg

withdrawn, will show up in the money supply and likely lead to inflation."

How could the Fed, sleepless and all knowing, permit such a failure of judgment? Has it no "exit strategy"? No, Paulson suggested, it does not have an exit strategy. It rather has a set of techniques by which it could effect an exit. But it has no coherent strategy on when to use them. "It seems to me," he said, "when they say they are not going to withdraw the stimulus until the economy shows good signs of recovery, I think what they are referring to is the unemployment rate. That's a key target for the administration. Right now, it's 9.7%. It may continue to go higher in the next couple of quarters to perhaps somewhere in the 10% range. But at any rate, it appears unlikely that they will start withdrawing stimulus until it is down to the 6.5% level. To achieve that, we would have to have fairly high economic growth. They say you need at least 3.3% economic growth to bring down the unemployment rate, because there is about 2.2% productivity growth, 1% population growth, so you have to be above that . . . 3.2% level, before the unemployment rate starts coming down. So to bring the unemployment rate down to 6.5%, you would have to have an extended period of a growth above the low 3% range, which would likely start to see those bank reserves being lent and the monetary base then come into the money supply before they would start to raise interest rates or start to withdraw the stimulus."

Asked about the downside risk in gold, Paulson mentioned price volatility. However, he added, "What I'm looking at is not where gold is going to be tomorrow, one week from now, one month from now, three months from now. What I'm looking at is where is gold going to be vis-a-vis the dollar one year from now, three years from now, five years from now. And I think, with a high probability at each of those points, gold will be higher than it is relative to the dollar today. That probability increases the further out you go, and the magnitude of that difference also increases the further out you go. So when I look at what the risk is, the risk to me is far more staying in dollars than it is in gold at this point."

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'Virtually guaranteed'

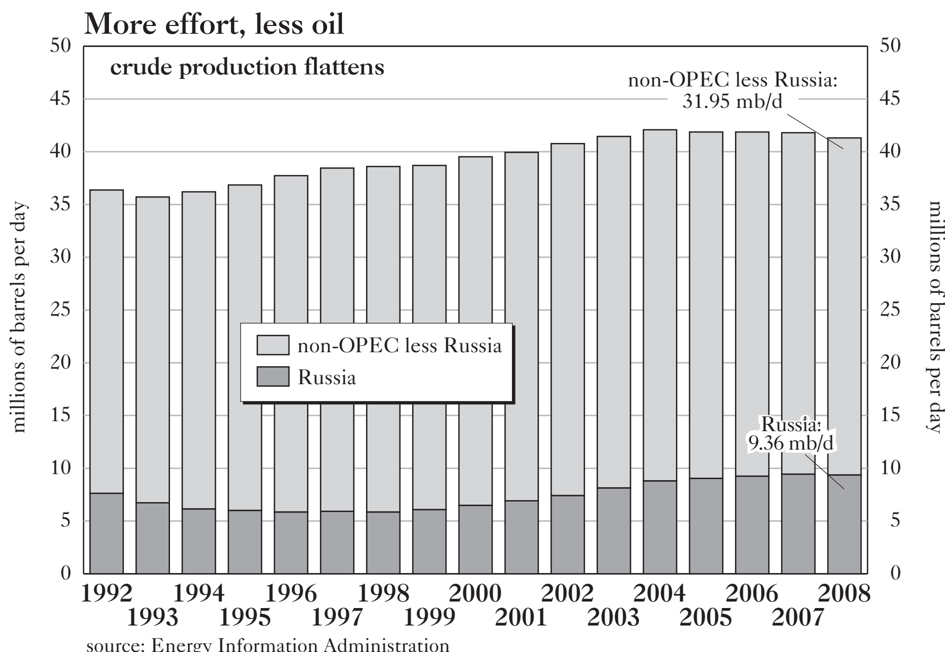
The truth about oil, said Andrew Hall, chairman and chief executive of Phibro LLC, is that production is ebbing while demand is rising. Yes, the papers are full of news of exciting new discoveries in the deep offshore fields of Mexico, Brazil and West Africa. But such sources are costly to develop, and, besides, "the rate at which they can be developed will barely offset declining production elsewhere."

Once upon a time, Hall proceeded, the view held sway that there was "an infinite amount of oil to be discovered and/or developed," and that, in any case, higher prices would elicit more drilling and, ultimately, more production. "Today, it is not so much a question of if the rate of oil supply is going to peak, but when," he said. "Also, the facts speak for themselves. Oil production in many parts of the world has already peaked and entered a terminal decline that even sustained high prices are unable to reverse."

Over-the-hill producing nations—the U.K., Mexico and Norway, among others—today generate 60% of global supply. Simply to compensate for the decline of existing production requires prodigious new E&P success—indeed, a new Saudi Arabia every two or three years. Then, too, the big exporting countries have conceived a taste for the style of living their customers enjoy. "They have young and rapidly growing populations, and for political reasons they keep fuel prices at levels substantially below global ones. Strong domestic growth in demand in these exporting countries, coupled with stagnant or declining production, means less oil available for export. Saudi Arabia and Kuwait just announced plans to add new power-generating capacity for 2012, which will burn over 500,000 barrels of oil a day—or about 5% of their combined exports. Recall that Indonesia, one of the founding members of OPEC, is now an importer of oil—its production has dropped below the level of its domestic consumption. And it was only 10 or 12 years ago that China ceased being a net exporter of oil."

All told, said Hall, "Future oil supply is going to be constrained for both geological and political reasons and will likely be costly to extract. Because of high income elasticity, demand for oil will continue to grow robustly in the developing world. Demand elasticity for oil in consumer countries is very low—at least in the short term. Supply elasticity is also low—or even negative—owing to the rent-maximizing behavior of resource owners. All these factors mean that extreme oil-price volatility with an upward bias is virtually guaranteed."

"Won't cheap natural gas make inroads on expensive oil?" a man in the audience asked. To a degree, Hall replied, but the scope for substitution of gas for oil is limited. "In most industrial usage, that substitution has already



source: Energy Information Administration

happened." Then, too, "the biggest use of oil is in the transportation sector, and substituting other forms of energy in that sector is going to be very difficult and very expensive."

Bullish on C-notes

"My name is Jeffrey," the chief investment officer of TCW Group said as he faced the *Grant's* audience. "I am a recovering inflationist. There, I said it."

Jeffrey Gundlach was the man on the rostrum, and hundred-dollar bills was the topic at hand. He was bullish on them, Gundlach said, and bullish, too, on the prospects for falling prices. It's a deflationary world, he declared.

"The great majority of investors are very, very bearish on the dollar," Gundlach went on. "Yet Lehman went bust, AIG went bust, Citigroup effectively went bust. Fannie Mae and Freddie Mac are nationalized, and with all that going on, the dollar is higher today than it was in March and June of last year. The dollar is building a base. Now, I know it's weak lately, but I'm fascinated whenever I see a consensus viewpoint like the market is going to extreme new levels—in the case of the dollar, new lows—and yet it's not happening." Then, too, Gundlach added, everyone seems to be rooting for gold to vault high over the bar of $1,000 to the ounce. Yet, neither is that happening.

No secret about the source of the deflationary undertow, Gundlach proceeded. It's the "debt bomb." He dwelt a minute on the folly of yesteryear: "What a misnomer, 'home-equity takeout.' Where's the equity there? It's just borrowing more money, as if you had a treasure chest in your basement that you found and you're taking it out. All you're doing is buying a more expensive home without moving. That's all you're doing with home-equity takeouts. But that added about 10% or so per year to GDP, that buildup in consumer debt. . . ."

If that was yesteryear, Cash for Clunkers is, approximately, today. The very success of the program, Gundlach said, shows how deeply embedded deflation is. "Because the way you sell cars is, effectively, slash the price by 20%, which is what the rebates represent, and offers of no-money-down-financing. The bad news is most of these loans in Cash for Clunkers, I think, are candidates for default."

And how might the Obama administration pay for the gifts it is so liberally bestowing on the American people? Pay-as-you-go is the plan for the moment, "but the problem will be down the line. The promises to pay that the U. S. government has taken on represent $65 trillion, pushing up to $70 trillion, against a $14 trillion economy."

Gundlach polled the crowd: "Will the government inflate, or will the government default? Who here believes that the U.S. government is going to default on its promises to pay? Anybody?" Silence.

"You're all wrong," he announced. "Let me phrase it a different way so that you [give] a different answer. Who here believes that they are not going to get Social Security? Well, that's a default because that's a promise to pay. ... They're going to say, 'I'm a taxpayer; I'm a citizen. If you're going to default on me in part, how about those Chinese? How about those OPEC guys? Why don't we factor them down, too? We're civilized people; we're not going to call it a default. We're going to call it a maturity tax. So that when we pay the Chinese their trillion dollars, we say, 'Actually, we're taxing the maturity at 50%, so you actually get $500 billion instead. You know what? We're such civilized folks, we're not even going to bother you with the paperwork. We'll handle it on our end. You send us the trillion, we'll send you back $500 billion. We'll just net you the amount.' It's time to start thinking expansively."

Closed shop

"The big picture," Paul Singer, founder and general partner of Elliott Associates, told the assembled, "is that we are in a new era of government intervention in private business and financial markets, and investors need to either steer clear or figure out how to avoid being run over."

Singer spoke from hard-won experience. Elliott, an investor in a variety of auto paper, negotiated with the administration—or, at least, was dictated to by it—in connection with the General Motors, Chrysler and Delphi proceedings. In the end, Singer related, Elliott did "pretty well" on its investments. But that was no thanks to the government's fidelity to the rule of law or to the fundamental precepts of what used to be called fair play.

Exhibit "A" was the Chrysler restructuring talks. For a time, the Chrysler auto bank-debt committee consisted of four big banks and Elliott. In response to the proposition that debt holders should be paid in full, inasmuch as the loan was secured by all the company's assets, the government bid 15 cents on the dollar. "After some back and forth," said Singer, "the government's bid for the bank debt was raised to about 29 cents, but over 60 cents was offered to the *unsecured* pension and post-retirement health-care-related claims. A few days later, it was widely reported that the government gave an ultimatum to debt holders: accept 32 cents that day, or be named and blamed by the president of the United States the next day in a press conference, following which the company would file for bankruptcy. As an additional pressure tactic, debt holders received phone calls from governors, U.S. senators, congressional representatives and union members."

Elliott, said Singer, quickly accepted this "pathetically" low 32-cent recovery, the government holding all the cards. "Most holders shrugged off our advice," he continued. "But, indeed, the next day the president held a press conference specifically to make a very strong but factually incorrect statement against the non-acquiescing creditors whom he labeled speculators, strangely saying he did not 'stand with them,' whatever that vague phrase was intended to convey. With all the power at the president's disposal, this statement was left open to all sorts of wild interpretations—perhaps by design—with extreme and unprecedented public policy implications. Words matter, especially when coming directly from the president of the United States. In fact, several of those creditors had paid 100 cents for their debt, although what they paid was irrelevant to their legal claim. It is worth noting that these creditors manage capital for hospitals, pension funds, and nonprofit endowments, and they have a fiduciary responsibility to their investors, whether the president 'stands with them' or not.

"While the president only collectively blamed the creditors who did not acquiesce," Singer went on, "the administration named them individually, and they were excoriated. Several caved quickly when they realized how unpleasant it was going to get and how little upside they had, but several pursued an ultimately futile legal objection that petered out when the judge indeed summarily approved the sale of the entire company without a bankruptcy reorganization process or vote. It was reported, we understand with some accuracy, that lenders had received threats of SEC and IRS investigations if they did not accept the government's bid, but after the president's press conference, all of the holders clammed up regarding those threats."

Come May, Singer noted, the government was feeling its oats. In Chrysler, it had flattened the opposition and rewarded its union contributors. But General Motors was a tougher nut than Chrysler. Whereas Chrysler had one class of debt held by a few dozen professionals, GM had thousands of retail bondholders, most of whom had paid par and most of whom voted. Only a small percentage of these individual creditors had accepted the government's bid, which was five cents on the dollar, compared with 66 cents for union claims.

"Until Chrysler," said Singer, "we didn't think the government would try to give a higher recovery to the unions than to similarly situated or even senior creditors, as such a result would favor the administration's political allies so blatantly. However, after Chrysler, it was less surprising to see the arrogant 'take five cents or get zero' posture of the government. Tough negotiating is normal in bankruptcy, but no other bankruptcy stakeholders have the full power of the federal government, including the investigative agencies, to reinforce their positions and threats."

In the end, Singer related, the government raised the bid to a "soft 20 cents" from a nickel. "The recovery for pari passu claims ranged from 66 cents to 100 cents, a shameful, ridiculous differential. Bondholders created a minor ruckus because of the disparity, but the deal was ramrodded through in another super-fast bankruptcy process. Since our position in GM carco debt was focused in a subsidiary we assessed to have far better recovery prospects than the parent, along with illiquid retail securities trading at dramatic discounts, we made money in GM carco debt, but not nearly as much as we made in GMAC and Chrysler finco debt, which traded up some more as the remaining approvals were received for GMAC to be a bank-holding company. . . .

"In thinking about the auto industry restructuring as a whole," Singer concluded, "the rule of law and the belief that America is a place of understandable and fair procedures and processes took a beating in the GM and Chrysler situations for no good reason of policy, and the appearance of the use of the legal system to reward political contributors did not help the image of America as a beacon of opportunity and attractiveness for investing capital. I fear the true cost of the government's foray into ends-justify-the-means restructurings has yet to be tallied and will ultimately prove to be a lingering millstone around our *stare decisis*-driven bankruptcy system (if not also the credit market for unionized companies) for years to come."

Keynes undressed

"Let's stipulate," said Hunter Lewis, author of "Where Keynes Went Wrong," "that if Keynes were here, he could make a complete fool of his critics, certainly including me. But there is something worth noting about Keynes's ideas. They had a formulaic quality. In almost every case, he delighted in taking some piece of conventional wisdom or even of common sense and turning it on its head. So, you think that prudent saving and investing is the way to wealth? On the contrary, spending is the way to wealth. But surely one must invest in order to get rich? And how can one invest without first putting aside some savings? No, no, said Keynes. Don't be a dunderhead. Where do you get the savings if not from income? And where do you get the income if not from someone's spending? So it's really spending that drives everything."

It may sound like a parlor game, Lewis allowed, "but it's a parlor game that leads directly to China's 15% of GDP stimulus program. Meanwhile, never mind that Keynes personally was not a spender, but rather a diligent saver and investor."

Yet this diligent saver advocated lots of debt—there can never be too much, he insisted—and interest rates verging on zero. "Then keep them there. In other words, credit should be completely free. For reference, see especially pages 374-77 of 'The General Theory,' Keynes did say that it would take some time to abolish interest rates. Perhaps a generation. On that schedule, we should have reached a regime of free credit by about 1966."

"When you read Keynes right through all his many volumes," Lewis continued, "this habit of taking the conventional wisdom and turning it on its head begins to seem a little too predictable. You think that high interest rates will persuade more people to save and thus increase savings? Nonsense. Low interest rates, not high rates, will increase savings."

Keynes may be dead, but his ideas go on and on. Republicans and Democrats, Tories and Laborites bow to the man whose books they haven't read. "This might be said to define an intellectual bubble," Lewis remarked, "a bubble supporting all the other bubbles. But intellectual bubbles, like others, may become largest just before they pop."

Keynes seems to have managed to implant his playful paradoxes in the minds of our 21st-century policy makers, Lewis pointed out. How to fix a debt problem? Borrow more. The solution to sky-high medical expenses? Bigger doctor bills.

"We have become so accustomed to this paradoxical language, we just take it for granted," our speaker went on. "If the Keynesian paradox of thrift and all the other Keynesian paradoxes are so widely accepted, they must surely be right. . . . But there is a problem here. Keynes did not prove his propositions. He did not even try to prove them. He claimed in a letter to the governor of the Bank of England, Montagu Norman, that his ideas were a 'mathematical certainty.' But that was just a crude bluff. There are very few chains of closely reasoned logic in Keynes, mathematical or verbal. There is almost no interest in evidence. In the whole of 'The General Theory,' there are only two pages devoted to empirical evidence. And one of the two studies cited is dismissed as 'improbable.'"

Keynes dealt in hunches, said Lewis, and so do his disciples. Ask them how much stimulus is needed, and

they say, "More than you think." Or ask how long the Treasury must keep writing these checks, and they reply, "For a year or two." "Why so non-specific?" Lewis asked—and he answered, "Because we are betting our chips on hunches."

Lewis proceeded to list the various Keynesian notions that time and scholarship have exploded. The proposition that stimulus spending would produce a gusher of tax receipts is one. The idea that economic slumps are not self-correcting is another. "It was disproven by a Keynesian disciple, Franco Modigliani, even before Keynes's death," said Lewis. "Yet President Obama still echoed it in 2009. He told us that without stimulus the economy might fall past the point of return."

But the worst of the Keynesian doctrines is the one that holds that prices, interest rates and exchange rates are there to be manipulated. Lewis observed that Washington keeps falling prey to it: "Secretary Paulson's original TARP plan didn't work because real mortgage prices had been obliterated. Geithner's follow-up plan just tried to manipulate mortgage prices further. The bottom line I am offering here is that Keynes is the emperor without any clothes. His ideas may be helping the elite get richer. They are first in line to borrow the cheap money. But these ideas are impoverishing the masses, including the people clinging to life on a dollar a day."

Bearish are the investment consequences of the Keynesian bubble, judged Lewis, the co-founder of Cambridge Associates. "Stocks seem expensive to me right now," he wound up, "but if I had to buy either stocks or cash and put it in a lockbox for 10 years, I would certainly choose the stocks."

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This Mises moment

"My proposition today," began David Stockman, Ronald Reagan's first director of the Office of Management and Budget, "is that we're in a fiscal calamity—caused by the further, and perhaps, final, triumph of politics. Admittedly, I issued this very same forecast a while back—23 years ago to be exact. But I'm not reluctant to try again. Having read *Grant's* continuously since 1988, I've learned there's no shame whatsoever in being early—even often!"

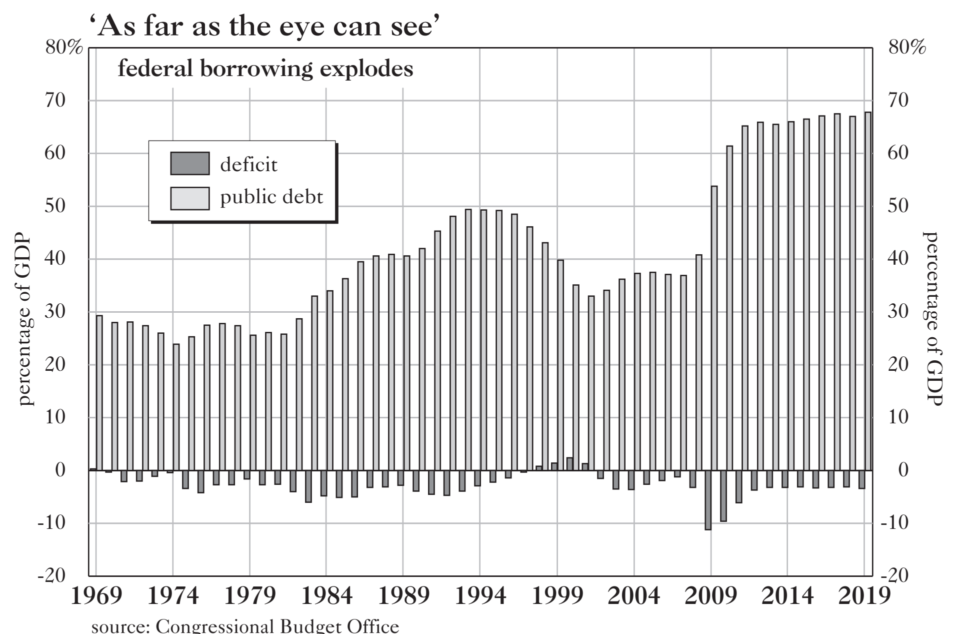
Publication of "The Triumph of Politics," Stockman's 1986 memoir, followed, rather than preceded, the author's monetary education. In that sense, said Stockman, the book, too, was slightly premature. In the day, he was alive to "statist fiscal and regulatory evils, but had only dimly grasped the Austrian masters' wisdom on money: That is, in printing money backed by nothing, central banks inherently threaten prosperity. So, today, I'll add the proposition that fiscal decay is the inevitable stepchild of the very monetary rot that the Austrians—Mises, Hayek, Rothbard—so deplored."

Untutored in money, Stockman did not immediately understand just how temporary would prove the fiscal reprieve of the late 1990s. "In fact," he said, "the fiscal equation was just then tumbling into a fatal descent. And it is here—let's pinpoint the exact date at Alan Greenspan's 'irrational exuberance' call in December 1996—where the Austrian men separate themselves from the Keynesian and Friedmanite boys. The latter continued to quibble about how to measure money, whether it was growing too fast or slow and if more or less financial regulation was needed."

There was, or should have been, no quibbling about the Great East Asian Export Machine, however, which was then cranking up to produce the Great East Asian Deflation. Nominal U.S. GDP was on the order of $10 trillion when the Maestro spoke up, Stockman observed, at which nice, round number it might have remained under a proper gold standard. The tsunami of cheap imports would have "flattened American employment, wages, incomes and prices. In so doing, it would have kept money GDP bottled up at around $10 trillion, thereby denying the next decade's debt-fueled rise in both output and prices, which took money GDP to $14 trillion." But there was no gold standard, rather a debt-inducing paper system.

"By Austrian lights, then," Stockman continued, "this $4 trillion difference represents counterfeit GDP, owing to the false conversion of unsupportable borrowings into current income—debt which is now being forcibly liquidated. This bubble-driven inflation of money GDP also caused government revenues to swell unsustainably, thereby camouflaging for more than a decade the fiscal deficit's actual, far more frightful aspect.

"There is no mystery in this contrafactual history. With money anchored to a standard, say gold, the armada of containerships steaming from the Pacific Rim into Long Beach would have brought massive trade deficits, but also would have set in motion their own correction. Taking flight in the opposite direction, gold bullion, not paper dollars, would have been on the backhaul to East Asia. In turn, an old-fashioned drain on America's gold would have



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obviated a lot of fatuous jawing about the Chinese being seven feet tall economically or excessively addicted to an alleged financial opium called 'over-saving.' Instead, without need for a single meeting of the Open Market Committee, the loss of gold would have presently caused a sharp contraction of domestic bank reserves, a shrinkage of loans by an approximate 10 times multiple thereof and a sharp rise in the rate of interest on the dollar markets."

Admittedly, such monetary rigors would have gone down hard. Enduring them, however, we Americans would have learned the truth about our place in the newly competitive world. This wisdom would have come to us 10 years before the maxing out of the national credit card in the fall of 2008. "It goes without saying," added Stockman, "that believers in the elixir of counterfeit money and credit, which is to say Keynesians, monetarists and Goldman Sachs partners, will dismiss all this as flat-earth doctrine—fossilized ideas pre-dating the discovery of government's wondrous power to manage the macro-economy. Still, a doctrine that holds up the state as an agent of economic betterment suffers from some deep flaws of its own. Decades of experience show, for example, that fiscal stimulus is an exercise by which one class and region steals from another. But the worse flaw is the hallowed central-bank doctrine that deflation is always bad. In fact, wrongheaded deflation fighting is what generated the boom of the 1920s and the subsequent bust—a scenario repeated almost exactly during the last decade."

Deflation, Stockman proceeded, is a positive benefit when technological progress delivers cheaper costs. Commodity prices may decline, but real incomes and wealth increase. East Asian exporters are the all-time champions in the cost-chopping line, he said, besting "the Internet, Wal-Mart, Henry Ford's moving assembly line, central station electric power, the railroads, canals, steam engine, spinning jenny, and, while we are at it, let's throw in the wheel, too! The Fed's strategy in the face of the Great East Asian Deflation, then, was exactly upside down. It should have raised interest rates and liquidated credit in order to encourage a deflation of domestic wages, prices and corporate cost structures which were no longer competitive or viable in the new global markets. But by keeping interest rates absurdly low on the pretext that the 'core' CPI index was, as it was pleased to say, 'well-anchored,' the Fed thwarted the fundamental economic adjustments that were vital for the American economy to regain its footings."

It follows that the panic of 2008 was no random policy error but was predestined. What made it inevitable was the Federal Reserve itself. Our central bank has always been an instrument of politics, said Stockman, i.e., the "politics of the speculative classes, whether domiciled on Wall Street, Main Street or the agrarian Plains. Let the political chatter get fevered enough about unfairly 'low' prices for goods, grains or labor and there has invariably been a new theory and willing maestro at the Fed to print up some easy credit."

Such was the story of the 1920s under Benjamin Strong, of the 1930s under Eugene Meyer and Marriner Eccles, and of the 1970s under Arthur Burns, the latter looking on in a cloud of pipe smoke as the last tenuous links between gold and the dollar were cut. President Carter named Paul A. Volcker to slay the inflation that Carter's predecessors had hatched, and Volcker did his duty. But "even Paul Volcker's disinflationary feat turned out to be a one-hit wonder," Stockman noted. By the mid-1980s, the Reaganites looked upon the extra-strong dollar and blanched. Led by the newly appointed Treasury secretary, Jim Baker, they organized a conference at the Plaza Hotel to cheapen it.

And the Bush Republicans? "Assembled in Karl Rove's political assault camp," said Stockman, was "a coalition of the neocons, the social cons, the tax cons and the just cons. None of them gave two hoots about real fiscal discipline. The neocons postured as big-time thinkers, articulating a lofty policy case for an American imperium. But unlike real imperialists, the neocons had nothing to say about the crucial issue of war finance. Indeed, since DOD couldn't seem to keep a pipeline open in the planet's second-richest oil province, the neocons could not even fall back on the imperialist's traditional gambit of looting the colonies. Obviously, the real answer was a war tax—especially since the war at issue was an elective. But that idea was anathema in Karl Rove's assault camp, so the neocons simply ignored the fiscal consequence of the multi-hundred-billion annual drain on the Treasury their policies entailed. War finance, it seems, was relegated to the GOP's all-purpose folklore—the myth that lower taxes and more growth would cover any fiscal hole.

"The tax cons, for their part, did not even think about fiscal policy; they issued papal edicts. Consequently, a kernel of truth—the notion that lower marginal tax rates are economically beneficial—became ensnared in a body of debatable doctrine, even outright claptrap. Foremost among the latter is the alleged absence of a correlation between deficits and either interest rates or real growth. Fine. If that's the test, let's abolish taxes completely and put the federal government on a regimen of 100% bond finance."

So, in the absence of a conservative fiscal opposition, anything goes: cash

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for clunkers, for Wall Street, for pig farmers. There is, of course, moralizing talk—for instance, that which deplores the blight of appropriations earmarks. "But taken together," said Stockman, "those 8,000 earmarks add up to just 15 hours of annual federal spending." The destruction of "any residual will" to control federal spending is leading us to that interesting moment when the supply of new Treasurys finally smothers the demand.

"Then," Stockman predicted, "the Big Panic will come. In the event, some will look back and wonder why we destroyed our capacity for fiscal governance in order to save the likes of AIG, Citibank and especially Goldman during the comparatively minor disorder of September 2008."

Our speaker brushed aside the near-universal contention that, absent federal intervention to support money funds, the commercial paper market and the spider's web of credit-default insurance written by AIG, the world would have come to an end. He pointed out that, 91 years before, J.P. Morgan, warming the chair later to be occupied by a succession of Fed chairmen, allowed the call-loan rate to soar to 30%. Somehow, the nation survived the Panic of 1907, even if a certain number of leveraged financiers did not. Yet "we are now supposed to believe that capitalism's very foundation had become so frail that GE could not be allowed to take the required haircut for its foolish asset/liability mismatch. Well, we shouldn't believe the financial system would have gone tilt had taxpayers not propped up GE's shares and debentures, because the claim simply isn't believable. Thus, 'systemic risk' was but a fig leaf for aggrandizement of the state, and especially its central banking branch. The resulting waste of resources and ballooning of moral hazard was palpable. But the real cost was in the final destruction of political discipline which resulted from the mad rush to TARP."

Recall, Stockman went on, the previously cited $4 trillion in "counterfeit GDP," financed by the Fed-sponsored debt inflation. It put a phony, cheerful gloss on federal receipts. "So now," he said, "with year-on-year revenues down 20%, it can be seen that even the revenue agents of the land were swimming naked. The official budget estimators assume, of course, that the Fed's reflationary hat trick will be successful, bringing with it a proportionate recoupment of receipts. But suppose this is an Austrian moment, and the deflation continues. The rub then is that government expenditure, like debt, is immune to deflation while its revenues are fully exposed.

"Specifically, about $1 trillion of Uncle Sam's current $3.6 trillion spending base is for Social Security and other transfer payments—programs that sport a COLA [cost-of-living adjustment] but not an un-COLA. Last year, at the bubble high, the federal COLA jumped by 5% atop all the prior COLAs. . . . But since these federal entitlements come with no deflation clawback, the $1 trillion transfer payment aggregate won't go down, even as the CPI falls steadily over the years ahead."

Neither will the $750 billion defense budget nor the $750 billion combined Medicare and Medicaid budgets yield any deflationary savings. Nor still will the $650 billion earmarked for domestic discretionary programs, that "vast congressional pork barrel."

"That leaves $150 billion of interest on the $8 trillion of publicly held debt," Stockman noted. "Right now, it's a bargain because one-third consists of interest-free T-bills. Unfortunately, in five years the publicly held debt outstanding is likely to swell to $15 trillion, and even in a sustained deflation, investors are wont to find a more remunerative place to park their cash. So even at a 3% blended interest rate, the math suggests $450 billion of annual federal debt service—or about three times today's level. Thus, federal spending will soon top $4 trillion—even under a prolonged deflation, and even if Washington doesn't stiff us with more stimuli."

Contrast that $4 trillion in outlays to just $2.2 trillion in run-rate receipts. Not a worry, the Keynesians and inflationists contend: "With 15 million new jobs and 5% unemployment by year five, along with wage and salary growth averaging 5.4% per year," all will be well. "But," said Stockman, "even after this minor miracle, revenue climbs back to only $3.3 trillion—still way below the spending level."

All will assuredly not be well, he insisted: "Last month, the BLS told us there were 131.2 million nonfarm jobs—nearly the same number recorded in December 2000—and that private wages and salaries have been deflating at a 4% annualized rate since spring. So, after the most fantastic economic bubble in history, what we have to show for it is zero net job growth and money wages which are visibly buckling for the first time since the 1930s.

"The bet, then, is that federal revenues will stall—as the liquidation of debt and malinvestment proceeds apace. This revenue drought, in turn, means a $2 trillion annual deficit as far as the eye can see. It might be fairly wondered whether Mr. Market's patience with the dollar and the Treasury's paper is likely to stretch nearly so far."

Or whether or not China's gargantuan vendor-financing scheme will come crashing down. Stockman, at least, did not wonder. It will, because its customers have reached the end of their borrowing tether. Besides, the Asian exporters overbuilt even as their customers overborrowed. An excess of productive capacity will bring about lower prices of the things they make in such profusion. Squeezed, the formerly invincible proprietors of the Great East Asian Export Machine will demand bigger subsidies and cheaper currencies.

"With the next Big Deflation thus looking like a sure thing," Stockman closed, "perhaps this is indeed an Austrian moment—again."

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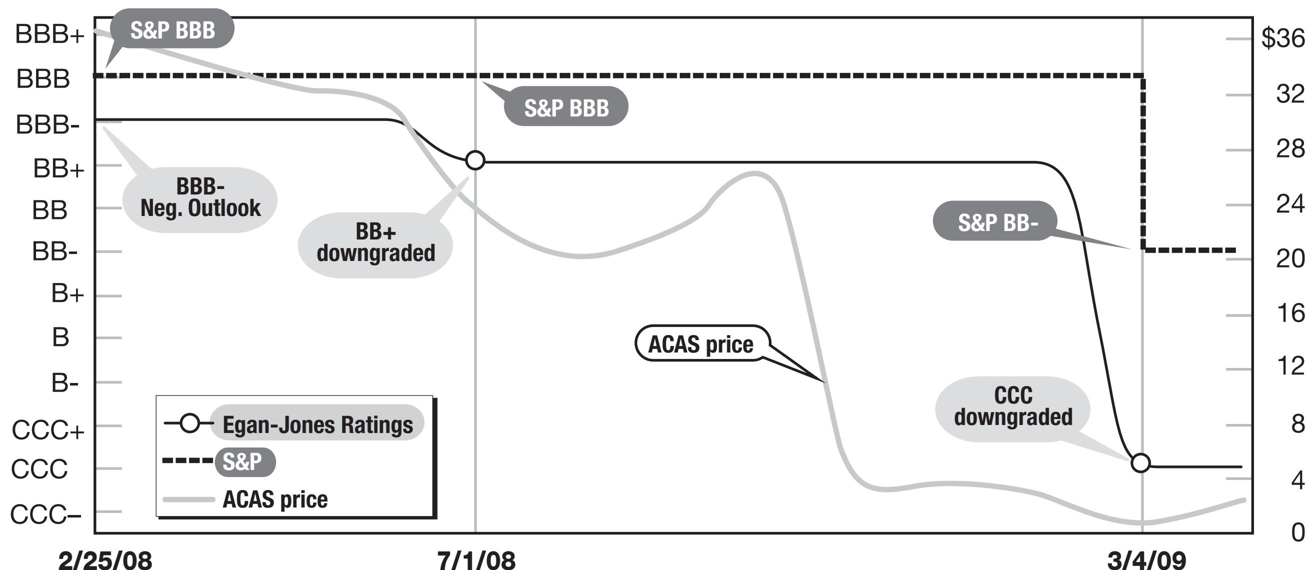

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