The Great Unwinding of Economic and Financial Excesses

“Most of the greatest evils that man has inflicted upon man have come through people feeling quite certain about something which, in fact, was false.”

Bertrand Russell

INTRODUCTION

Although I don’t always agree with the views of columnist Thomas Friedman, I couldn’t agree more with his criticism of US energy policies. In a recent article entitled “The energy to be serious”, he takes Hillary Clinton and John McCain to task for their suggestion that the federal excise tax on gasoline be suspended this summer (International Herald Tribune, May 3, 2008). According to Friedman,

It is great to see that we Americans finally have some national unity on energy policy. Unfortunately, the unifying idea is so ridiculous, so unworthy of the people aspiring to lead the United States, it takes your breath away.

Hillary Clinton has decided to line up with John McCain in pushing to suspend the federal excise tax on gasoline, 18.4 cents a gallon, for this summer's travel season. This is not an energy policy. This is money laundering: We Americans borrow money from China and ship it to Saudi Arabia and take a little cut for ourselves as it goes through our gas tanks. What a way to build a country.

When the summer is over, we will have increased our debt to China, increased our transfer of wealth to Saudi Arabia and increased our contribution to global warming for our kids to inherit.

No, no, no, we’ll just get the money by taxing Big Oil, says Clinton. Even if we could do that, what a terrible way to spend precious tax dollars — burning it up on the way to the beach rather than on innovation.

The McCain–Clinton gas holiday proposal is a perfect example of what energy expert Peter Schwartz of Global Business Network describes as the true American energy policy today: “Maximize demand, minimize supply and buy the rest from people who hate us the most.” … Few people know it, but for almost a year now, Congress has been bickering over whether and how to renew the investment tax credit to stimulate investment in solar energy and the production tax credit to encourage investment in wind energy. The bickering has been so poisonous that when Congress passed the 2007 energy bill last December, it failed to extend any stimulus for wind and solar energy production. Oil and gas kept their credits, but those for wind and solar have been left to expire this December… These credits are critical because they ensure that if oil prices slip back down again — which often happens — investments in wind and solar would still be profitable. That's how you launch a new energy technology and help it achieve scale, so it can compete without subsidies… It is so alarming, says Rhone Resch, the president of the Solar Energy Industries Association, that the U.S. has reached a point “where the priorities of Congress could become so distorted by politics” that it would turn its back on the next great global industry — clean power — “but that's exactly what is happening.”… While all the presidential candidates were railing about lost manufacturing jobs in Ohio, no one noticed that America's premier solar company, First Solar, from Toledo, Ohio, was opening its newest factory in the former East Germany — 540 high-paying engineering jobs — because Germany has created a booming solar market and America has not. [Germany and Japan have, respectively, 20- and 12-year solar incentive programs in place — ed. note.] In 1997, said Resch, America was the leader in solar energy technology, with 40% of global solar production. “Last year we were less than 8% and even most of that was manufacturing for overseas markets.”

The McCain–Clinton proposal is a reminder to me that the biggest energy crisis we have in our country today is the energy to be serious — the energy to do big things in a sustained, focused and intelligent way. We are in the midst of a national political brownout.

At about the same time, John Gapper, writing for the Financial Times, lamented the poor state of US infrastructure in an article entitled
“On the pot-holed highway to hell”:

If anyone doubts the problems of US infrastructure, I suggest he or she take a flight to John F. Kennedy airport (braving the landing delay), ride a taxi on the pot-holed and congested Brooklyn–Queens Expressway and try to make a mobile phone call en route. That should settle it, particularly for those who have experienced smooth flights, train rides and road travel, and speedy communications networks in, say, Beijing, Paris, or Abu Dhabi recently. The gulf in public and private infrastructure is, to put it mildly, alarming for US competitiveness… Faced with the emptying of the Highway Trust Fund, established in 1956 as the US entered a period of growth and prosperity, Mrs Clinton suggested cutting its source of funds (which she claimed could be made up by a tax on oil companies)… At times I wonder whether the world’s biggest economy has the will to solve its challenges or will end up wandering self indulgently into the minor economic leagues. I expect it will get serious when the crisis is too blatant to ignore, but it has not done so yet.

Perhaps this is a bit unfair. Some leaders have recognized the problem for economic development, as well as for safety. They include Arnold Schwarzenegger and Ed Rendell, governors of California and Pennsylvania, and Mayor Michael Bloomberg of New York. The trio have allied to press for the states and Washington to act.

Gapper then quoted Ed Rendell, incidentally one of Mrs. Clinton’s biggest supporters, who supported her initiative to suspend the “gas tax” and increase taxes on oil companies (a really bad idea, since higher oil company taxes will curtail exploration). “Dams are in a horrible condition … we have no real rail transport, unlike most nations in the world… Summer delays make flying in America a disaster,” Rendell said. According to Gapper,

…there are lots of ways in which infrastructure inadequacy matters to the US but I would focus on two.

First it imposes a drag on economic growth. The private infrastructure is poor enough — broadband speed lags behind other countries and mobile coverage is spotty. But much of the public infrastructure is unfit, a fact that was becoming clear even before Hurricane Katrina flooded New Orleans and a Minneapolis bridge collapsed during rush hour last year.

Second, it presents an awful image of the US to investors and other visitors. The state of transport and communication infrastructure is a symbol of a nation’s economic development and the US is starting to look like a third world country. In fact, scratch that. Many developing countries look and feel better.

Of course they are in a different phase of development. The US invested 10% of its federal non-military budget in infrastructure in the 1950s and 1960s as it built the interstate highway system — at the time, the envy of the world. While the US investment has fallen to less than 1% of gross domestic product, China has been matching its double-digit postwar record… Americans may not like the sound of that, but they cannot expect the US to maintain the economic dynamism of the late 20th century in the 21st unless they buckle down. Sooner or later, wishful thinking is going to crash into financial reality.

In a column for the New York Times, Thomas Friedman noted that Americans really “want to do nation-building” — not in Iraq and Afghanistan, but in America. According to Friedman,

We are not as powerful as we used to be because over the past three decades, the Asian values of our parents’ generation — work hard, study, save, invest, live within your means — have given way to subprime values: “You can have the American dream — a house — with no money down and no payments for two years.” … A few weeks ago, my wife and I flew from New York’s Kennedy Airport to Singapore. In J.F.K.’s waiting lounge we could barely find a place to sit. Eighteen hours later, we landed at Singapore’s ultramodern airport, with free Internet portals and children’s play zones throughout. We felt, as we have before, like we had just flown from the Flintstones to the Jetsons. If all Americans could compare Berlin’s luxurious central train station today with the grimy, decrepit Penn Station in New York City, they would swear we were the ones who lost World War II.

How could this be? We are a great power. How could we be borrowing money from Singapore? Maybe it’s because Singapore is investing billions of dollars, from its own savings, into infrastructure and scientific research to attract the world’s best talent — including Americans… And us? Harvard’s president, Drew Faust, just told a Senate hearing that cutbacks in government research funds were resulting in “downsized labs, layoffs of post docs, slipping morale and more conservative science that shies away from the big research questions.” Today, she added, “China, India, Singapore … have adopted biomedical research and the building of biotechnology clusters as national goals. Suddenly, those who train in America have significant options elsewhere.”

I have quoted Friedman and Gapper extensively for several reasons. I have been accused of being anti-American, and therefore I wanted to show our readers that there is an increasing body of Americans who are very concerned about their country’s misguided fiscal and
monetary policies, which are designed to boost consumption not only of oil, but of everything else as well, at the expense of capital investments, and research and development spending, which are badly needed if the US wants to regain its competitiveness. As Mark Gongloff noted in a column for the Wall Street Journal,

…what the U.S. really needs, if it seeks a real fix to its energy-consumption problem, is less demand, not more. Mr. Market says there’s a simple way to do that. Jack up the gas tax. Don’t lower it. Economists call it a Pigovian Tax”, in honor of the English economist Arthur Pigou, who early in the 20th century examined economic activity that hurts innocent bystanders. To stop behavior that’s not in the public good, you tax it more, not less.

Of course, a higher tax would hurt working-class Americans who rely on their cars, though other taxes, like the federal payroll taxes or state sales taxes on food, could be lowered to offset it.

Gongloff then explained that Harvard economist Gregory Mankiw, President Bush’s former chief economic adviser, has proposed increasing the “gas tax” by ten cents a year for ten years in order to give the economy time to adjust. According to Professor Mankiw, who belongs to the Pigou Club, a pro-“gas tax” group, higher gasoline taxes “should lower world oil prices”, as higher prices would curtail demand considerably.

Despite my usual serious reservations about increasing taxes in order to curb demand, I would support higher gasoline taxes in the US (or tax incentives for energy-saving engines and heavy penalties for gas-guzzling vehicles) because its implementation would be simple and the revenues obtained from higher gas taxes could be used to improve the entire transportation infrastructure. In particular, a better public transportation system would improve the energy efficiency of the country and lessen its addiction to imported oil. It should also be noted that the US has one of the lowest gasoline taxes in the world (see Figure 1).

In addition, opinion leaders are increasingly sceptical about the lies dished out by the government. Thomas Friedman opines that Americans “need a president who is tough enough to tell the truth to the American people. Any one of the candidates can answer the Red Phone at 3 a.m. in the White House bedroom. I’m voting for the one who can talk straight to the American people on national TV — at 8 p.m. — from the White House East Room.” And Gongloff concludes that, although higher gas taxes would have all sorts of desirable effects, unfortunately, increasing them “doesn’t win elections. And the only market that matters now is the one for votes.”

At the same time, investors and strategists are becoming more and more sceptical about the economic statistics published by the various agencies. The employment, inflation, and GDP growth figures are highly suspect. According to Martin Feldstein, a former chief economic adviser to President Reagan and now a Harvard economist, “misleading growth statistics give false comfort” because “monthly data since January indicate that economic activity and GDP have been declining since the start of the year” (Financial Times, May 7, 2008). Feldstein opines that …although the tax rebates now underway may provide some temporary help, the combination of falling real incomes, declining household wealth and a dramatic drop in consumer confidence suggests further falls in consumer spending and GDP. But the most serious risk is that the rapid fall in house prices — down 12% in the past year and falling at a 25% rate in the past three months — will raise the number of negative equity mortgages, leading to widespread defaults and foreclosures. Because US mortgages are “no-recourse” loans (lenders have no recourse to the house’s owner beyond the value of the house) individuals with negative equity have an incentive to default. There are now an estimated 8 million negative-equity mortgages — more than 15% of all outstanding mortgages. Defaults are rising and foreclosures are now at twice the rate of a year ago. A downward spiral in house prices would cause a fall in household wealth and in the capital of financial institutions, potentially resulting in a deeper and longer recession than any seen in the past several decades.

According to Feldstein, the government should intervene to “prevent positive-equity mortgages from becoming negative-equity mortgages”. In other words, Feldstein

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**Figure 1** Average Gasoline Taxes per Gallon, March 2008

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<tr>
<th>Country</th>
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<td>Germany</td>
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<td>UK</td>
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<td>France</td>
<td>$4.83</td>
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<td>Japan</td>
<td>$2.29</td>
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<td>Canada</td>
<td>$1.19</td>
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<td>US</td>
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Sources: International Energy Agency and The Wall Street Journal
proposes that the government should support the real estate market “by providing low-interest loans with full recourse that would allow any homeowner to pay down a significant fraction of his mortgage. Homeowners would be in effect giving up the potential to default on their mortgage loans in exchange for lower interest costs.”

There are, however, some problems with Feldstein’s proposal. For one, it is likely that the majority of homeowners who are burdened with the estimated 8 million negative-equity mortgages (I have seen figures which suggest that there are 15 million negative-equity mortgages outstanding) also have negative-equity car loans and large credit card debts — in short, they have no equity to start with. So, in these cases, “full recourse” loans wouldn’t serve their purpose and would instead amount to a market-distorting direct government subsidy of imprudent borrowers at the expense of taxpayers. Second, I wonder how Mr. Feldstein would propose supporting the market for unsold condos. In buildings with five to nine units — like a large number of garden apartment buildings — the condominium vacancy rate is at an unprecedented 15.2%. That is up from 12.2% at the end of 2007; whereas prior to 2006, it never exceeded 10%. (For rental units, the vacancy rate is even higher. According to Floyd Norris, chief financial correspondent with the New York Times, 25.2% — one in four — of the housing units built since 2000 are vacant.)

Finally, I very much side with Mrs. Moneypenny who, in a witty Financial Times column dated May 3, 2008, argued that the UK government should not intervene in the housing market, because falling home prices “might be painful for some but what about the benefit for many others? What nurses and teachers and first-time buyers need is for prices to come down.” According to Mrs. Moneypenny, it is not an acceptable excuse from investors that they had not read the disclaimers. “I suspect that borrowers of 110% mortgages are in many cases young and naïve and, in their enthusiasm to buy property, had not read the disclaimers. That’s not an acceptable excuse either. Husbands should carry disclaimers. Your marriage may be at risk if you insist on rationing golf, or some such incomprehensible activity.”

Mrs. Moneypenny then explained that a friend of hers wanted to leave her husband because she found him irritating and because he hardly ever had sex with her. However, “if irritation with one’s husband and a lack of sex were reason enough to walk out, the divorce rate would go through the roof,” she wrote. She told her friend to “hang in there”, because if she went back to the open market and found another husband, how would she know that he would be less irritating and would want to have more sex? “[M]arriage is frequently embarked upon when you are young and naïve and don’t weigh the risks,” she wrote. “But there is no regulator or government that will save you from the pain if it goes wrong. And neither should there be. Any more than for people who take out 110% mortgages.”

Well put! Governments and their agencies around the world — not just in the US — have created asset bubbles by keeping interest rates artificially low and through lax regulatory oversight, which has encouraged the purchase of all sorts of assets with high leverage. These governments should not now compound their earlier mistakes by supporting asset markets with even lower interest rates and fiscal measures in order to prevent the market mechanism from clearing properly at the lower prices. After all, and as Mrs. Moneypenny suggests, there is usually no — or little — mention in the discussions of markets that “inflated asset markets” are making it expensive and difficult for first-time buyers to acquire assets without high leverage. In this respect, I should like to point out that throughout the 1970s and even most of the 1980s, less than 30 hours of work (total private hourly earnings of production workers) were required to buy one S&P 500. Now, however, despite some decline in this number from its peak in 2000, it requires 78 hours of work to buy one S&P 500 (see Figure 2). I suppose that, over time, the S&P 500 and other asset markets will adjust to the downside and again become more affordable, or that hourly earnings will increase significantly (inflation).

I would also like to make the point that if the government and its
agencies support the equity and residential property markets, a case could be made for it also to support, in future, the prices of commodities, commercial properties, and art and collectibles. In fact, I am concerned that investors haven’t paid sufficient attention to the problems that could arise should these markets decline meaningfully.

ARE DECLINING COMMERCIAL PROPERTY PRICES THE NEXT SHOE TO DROP?

It has been my view that, whereas the Fed increased the Fed fund rate between June 2004 and August 2006 from 1% to 5.25%, no tightening of monetary conditions occurred because lending standards were eased and leverage increased in all asset markets. Conversely, although the Fed has cut the Fed fund rate aggressively since September 2007, from 5.25% to 2%, the impact of the interest rate cuts was limited because they were accompanied by tighter lending standards. In other words, whereas the Fed has been easing, the private sector has been tightening considerably. About a third of the 56 banks surveyed by the Fed in April reported tighter credit standards for credit card loans, up from just 10% in January. (Some 44% of the banks, up from 30% in January, tightened credit standards for other consumer loans.) More than 60% of the banks tightened standards on prime mortgages, up from a little over 50% in January and only 15% a year ago. But it would seem that lending standards were particularly tightened for commercial real estate loans, where 80% of the surveyed banks reported tightened standards (the highest since the Fed introduced the survey in 1990). Tighter lending standards could, as Richard Berner of Morgan Stanley suggests, claim the recession’s next victim — commercial construction and, in my opinion, declining commercial property prices. Berner notes that, although non-residential construction starts tumbled in January by 13% from a year ago, according to Reed Construction Data, the downturn in traditional commercial construction should be mild because “the overall growth in supply for much of this expansion has been modest by historical standards [see Figure 3]. The ‘capital discipline’ theme that governed corporate spending in this expansion partly extended to construction as well. For example, commercial construction excluding healthcare facilities rose by only 3.9% annualized over the past five years.”

Still, Berner admits that “discipline seems to have faded over the past year, when construction accelerated in virtually all categories, and with the slowdown in business activity, vacancy rates have begun to rise. There are clear pockets of excess in financial services office buildings and in retailing and lodging. A slowdown in office employment and shakeout in retail and wholesale activity may pressure rents just as lenders and investors tighten credit availability and raise its price. However, mining, power, and healthcare construction may buck the trend.”

Now, it may very well turn out that, as Berner writes, the downturn in commercial construction will be mild. What is far less certain is that the decline in commercial property prices will be mild. If capital values in the UK are any guide for the outlook of the US commercial property market, conditions are far from promising (see Figure 4). According to the latest figures from the Investment Property Databank (IPD), capital values in the UK’s commercial property market fell by 4.6% in the first quarter, taking the total return on property investments to minus 3.3% and the annualised total return for the 12 months to the end of March 2008 to minus 9.7%; according to the IPD, this was the worst annual performance since 2001, when the index was first compiled. Also, according to Strutt & Parker, one of the UK’s largest property consultants, prime UK commercial property prices in the Southeast have slumped by around 25% in the past two quarters, with yields hardening from 4.5% to 6%, an unprecedented shift in property values. (In the first quarter of 2008, Strutt & Parker saw its own revenues more than halve, which is far better than the collapse in the turnover of the UK commercial property market to just 25% of what it was in the first quarter of 2007.) Also, the British commercial property developer Hammerson warned recently that job
losses in the City were having an impact on the demand for offices in the financial district. (According to Hammerson, the office investment market in France has also shown some signs of softening.) The worsening conditions in the British commercial property market are certainly mirrored in the decline of Hammerson’s share price (see Figure 5). I might add that British residential home prices have also begun to decline, with homebuilders having performed about as badly as their American counterparts (see Figure 6).

I think that if UK commercial property prices could decline as much as they have done, the same is likely to occur in the US. As Richard Berner explains, “real outlays for office construction rose at an 18.6% annual rate over the past two years. In the fourth quarter alone, more than 19 million square feet of new office space came on the market according to Reis, Inc., the most since the fourth quarter of 2000. In 2008 Reis expects about 75 million square feet of new office space to come online in the 79 markets it tracks, up from 53 million square feet finished in 2007. Real construction spending for multi-merchandise shopping and lodging increased 10.3% and 57.7%, respectively, over the past 8 quarters.”

We can clearly see here that supplies are increasing at the very time the demand for office space is likely to decline — possibly quite considerably. According to Berner, the national office vacancy rate had already edged up to 12.6% in the fourth quarter of 2007 — the first increase in four years. He notes dryly that “vacancy rates don’t yet reflect sublease space coming available as mortgage lenders go out of business. They will soon.” Perhaps he should have added that other financial institutions could also go out of business or merge, or at the very least significantly curtail their activities, which would certainly reduce their office space requirements. In New York, where the financial sector occupies 35.6% of the approximately 391 million square feet (36 million...
square metres) of office space, both commercial and residential property prices could be rather vulnerable to a significant and long-lasting downturn in the financial sector. (The same could also be said of properties in other Western financial centres, but probably less so in Asia.) As a result, I regard the shares of property companies and REITs such as Brookfield Properties (BPO), Boston Properties (BXP), and Vornado Realty Trust (VNO) (see Figure 7) as being vulnerable to renewed price weakness.

The other sectors of the commercial property market that could weaken significantly are retail and lodging. The International Council of Shopping Centers recently increased its forecast of US store closures for 2008 to nearly 6,500, up from 5,800, which would be the highest number of such closures since 2001. Over the last six months, chains such as Starbucks, Pacific Sunwear, and Ann Taylor have announced the closure of a total of 1,000 stores, while Home Depot announced that it would abandon the opening of 50 stores this year and would close 15 poorly performing locations. Since consumer spending has risen over the last seven years from 66% to over 70% of GDP, and since the US seems to be badly oversupplied with retail stores (and restaurants), a more pronounced decline in the value of shopping centres should be expected once consumption moderates — either because the consumer is tapped out (unable to increase his borrowings against his house) or perhaps as a...
That all is not well in the vast land of shopping centres is evident from the stock performance of the highly leveraged Australian shopping centre owner Centro Properties Group, which owns 600 shopping centres in the US and 130 in Australia (see Figure 8).

Interestingly, upscale markets also feel the pinch. Revenues at the Wynn Las Vegas dropped in the first quarter of 2008 to $125 million from $173 million a year ago (see Figure 9), and the occupancy rate at the Venetian fell from 99% in the first quarter of 2007 to 91% in the first quarter of 2008. Of all 70 cents of every $1 of revenues in room charges, the average room rate was

result of the saving rate increasing. That all is not well in the vast land of shopping centres is evident from the stock performance of the highly leveraged Australian shopping centre owner Centro Properties Group, which owns 600 shopping centres in the US and 130 in Australia (see Figure 8).

Above we heard from Richard Berner that real construction for lodging has increased by 57% over the past eight quarters. Again, this significant increase in the lodging industry comes at a time of slowing demand. In Las Vegas, several casino operators reported that their first-quarter revenues had declined, while the number of conventions held has dropped 10.4%. (Las Vegas gambling revenues are down by 4.2% so far this year, while the occupancy rate at the Venetian fell from 99% in the first quarter of 2007 to 91% in the first quarter of 2008. Of all 70 cents of every $1 of revenues in room charges, the average room rate was

result of the saving rate increasing.
down in February by 5.1% from a year earlier. Revenues at Atlantic City’s casinos fell in 2007 for the first time since Resorts International opened its first casino there in 1978. (Privately owned Tropicana Entertainment, which operates casinos in Las Vegas and Atlantic City, has just filed for bankruptcy protection.)

What is also noteworthy regarding the lodging industry is that, although Phoenix, Arizona hosted the Super Bowl in February of this year, data from Smith Travel Research show that hotels in Phoenix experienced an 8.6% decline in occupancy in the first quarter compared with a year ago. (The average daily room rate was up 17.8% during the Super Bowl month of February, but rates fell back in March and were up just 1.3% compared with March 2007.) I would expect lodging companies such as Starwood soon to show disappointing earnings, especially given its engagement in the operation of vacation ownership resorts and the marketing and selling of vacation ownership interests in their resorts (see Figure 10). Moreover, it is very likely that construction of amusement and recreation venues, and lodging facilities, will slow considerably in the very near future (see Figures 11 and 12).

While the US commercial real estate market may not be as glutted as the residential market, the sharp decline in home prices is likely to negatively affect the commercial real estate market through a combination of tighter lending standards and declining consumption (poor retail sales) — at least in real terms. I should also like to mention that, whereas in the past residential and commercial real estate booms were usually concentrated in one region or a specific market (Texas in the early 1980s; Japan, Taiwan, and California in the late 1980s), at present there seems to be a construction boom in both commercial and residential real estate on an unprecedented global scale. And while I would expect some markets to be more resilient than others (for example, Asia, Russia, and frontier markets), the size of the current global boom would suggest that a meaningful slowdown in construction activity is likely to be just around the corner and that prices could come down practically everywhere, albeit with different intensities.
Over the last few weeks there has been a significant change in the investment environment, which could have important consequences for the near future. Suddenly, the US dollar has strengthened not only against the Euro and the Swiss Franc but also against some previously strong Asian currencies. In particular, the US dollar has been strong against the Korean Won (see Figure 13). As I have explained on numerous occasions, the US trade deficit is contracting largely because of weak domestic consumption (see Figure 14). As a result, the US current account deficit is also diminishing. Since the US current account deficit was the principal source of global excess liquidity, a relative tightening of global liquidity is now under way and is reflected by Foreign Official Dollar Reserves no longer expanding at an accelerating rate, as was the case between 1998 and 2005 (see Figure 15). In principle, when the US current account deficit no longer expands at an accelerating rate, US dollar stability or US dollar strength should be expected, while at the same time global economic growth should slow down and commodity prices should decline.

The BIG QUESTION, of course, is how the US trade and current account deficits will perform in future. Will they contract because of a weak US economy and sharply rising import prices, which would curtail the demand for imported consumer goods and oil? Or will they begin to expand again because of the Fed's easy monetary policies and a further sharp increase in the price of oil? In the first case, investors should own the US dollar and, on a relative basis, US dollar assets; whereas in the second case, investors should use the current rebound in the US dollar as a selling opportunity and move funds into emerging markets and commodities.

I have to admit that I don't have a very strong conviction about either scenario, although I am leaning (based on recent economic statistics and recent market action) towards the view that the US dollar will strengthen further — at least in the intermediate term — because I expect that the trade and current account deficits will continue to improve. I should also like to explain why I don't have a particularly strong conviction. Rising oil prices curtail the demand for discretionary expenditures. So, whereas rising oil prices are by themselves bad for the US trade deficit, they are not necessarily as bad as one might expect on first sight, because the higher oil prices go, the less money the consumer has for discretionary purchases. Similarly, a meaningful decline in oil prices would lead to more discretionary expenditures and, most likely, again increase the non-oil trade deficit. Economics can be very tricky, and forecasting based on economic trends very treacherous. Equally tricky is attempting to forecast the market’s reaction to the two different scenarios outlined above. Would a sharp decline in oil prices be supportive of the US dollar, or would a strong dollar knock off oil prices and lead to additional US dollar strength? Or could an economic slump in the US lead to US dollar weakness, despite contracting trade and current account deficits? As I indicated above, I am leaning towards the view that the
new accounting rules allow for trading assets to be divided into three levels. Level One assets are the most liquid assets and therefore the easiest to price. They make up less than a quarter of most firms’ assets.

Level Two assets make up the majority of firms’ assets but rely heavily on the firms’ assumptions about things such as interest rates because they are far less liquid than Level One assets; according to regulatory filings by the five largest U.S. brokers and largest money center banks, there are more than $4 trillion in Level Two assets on their balance sheets.

Finally, Level Three assets are the least liquid of the firms’ trading assets and therefore are valued using what are called “unobservable inputs”.

Level Three assets include real estate, mortgage-backed securities, private equity investments and possibly even “undertakings of great advantage, but nobody to know what they are” (cf. South Sea Bubble).

The three magic words that make an asset a Level Three asset are “no observable inputs”. What this means is that not only are they hard to price, but nearly impossible to sell. Recently there’s been such deterioration in all types of mortgages that more and more assets are finding their way into this category. Also, this is the first time insurance companies have made the list. I think the list will continue to grow.

Ten companies now have more Level Three assets than capital. In order, they are (as a % of total shareholder equity):

1) Bear Stearns (BSC): 313.97%
2) Morgan Stanley (MS): 234.88%
3) Merrill Lynch (MER): 225.4%
4) Goldman Sachs (GS): 191.56%
5) Lehman (LEH): 171.18%
6) Fannie Mae (FNM): 161.48%
7) Northwest Air (NWA): 142.02%
8) Citigroup (C): 125.06%
9) Prudential (PRU): 119.36%
10) Hartford (HIG): 108.52%

So now we have insurance companies joining the party. Yes, the contagion is spreading and no, it’s not over. Not even close.

As Sedacca points out, another issue is “the speed at which Level Two assets are growing”.

US dollar may have some upside potential from the current level and that economic growth will disappoint and lead to lower commodity prices (including gold) in the near term. The principal reason for this view is my belief that the financial crisis has been postponed, but certainly not solved. I am grateful to my friend Bennet Sedacca, president of Atlantic Advisors LLC (bsedacca@bloomberg.net), for shedding some light on financial firms’ quality of assets, as follows:
Level Two assets, according to Bloomberg are “assets that have quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model derived valuations in which all significant inputs and significant value drivers in active markets.” This is otherwise known as “mark to model”. And without further ado, below I will rank companies by their absolute level of Level Two assets and by ratio to total shareholder equity [see Tables 1 and 2]. Now I realize that I may sound like a “scaredy cat”, but hey, in this business, discretion is the better part of value. As absolute return investors, I have to pay attention to something I think could be a problem; even if it never develops, all I have lost is opportunity, not capital.

I have to say that these statistics on leverage and the quality of assets held by the financial sector are frightening! I’m sure that all these firms’ employees are hyper-smart, but for my part I wouldn’t want to run a business on such a leverage, and I certainly wouldn’t sleep well at night. Still, no matter how negative I may be regarding the financial sector’s long-term outlook, I am also aware that nothing goes down in a straight line and that intermediate strong rallies (frequently of 40%) do interrupt long-term downtrends. Financial stocks became grossly oversold in March and their lows should hold — at least for a while — as investors continue to slumber in confidence and complacency (see Figures 16 and 17).

I indicated above that I am leaning towards the view that the US dollar may have some upside potential from its current level, and that economic growth will disappoint and lead to lower commodity prices in the near term. The CRB Index has been forming an ascending wedge and, whereas temporary further strength is a possibility because of the potential for additional gains in oil prices, more often than not rising wedges are followed by sharp price reversals (see Figure 18).

The question is, of course, which assets would gain the most if commodity prices — in particular, oil prices — declined. The only reason I can think of for commodity prices, including oil, declining sharply would be widespread economic weakness, not just in the US but

<table>
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<th>Table 1: Level Two Assets Ranked by Dollar Amount</th>
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<tr>
<td>1. Citigroup $1.15 trillion</td>
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<tr>
<td>2. J.P. Morgan $1.09 trillion</td>
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<tr>
<td>3. Merrill Lynch $1.02 trillion</td>
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<td>4. Bank of America $781 billion</td>
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<td>5. Goldman Sachs $620 billion</td>
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<td>6. Bear Stearns $332 billion</td>
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<td>7. Fannie Mae $321 billion</td>
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<td>8. Morgan Stanley $304 billion</td>
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<td>9. Prudential $276 billion</td>
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<td>10. Lehman $200 billion</td>
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Source: Bennet Sedacca, Atlantic Advisors, LLC

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<th>Table 2: Level Two Assets Ranked by Ratio to Total Shareholder Equity</th>
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<tr>
<td>1. Merrill Lynch 28x</td>
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<td>2. Bear Stearns 28x</td>
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<td>3. Goldman Sachs 12x</td>
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<td>4. Prudential 12x</td>
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<tr>
<td>5. Amerprise Financial 9x</td>
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<td>6. Citigroup 9x</td>
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<td>7. American Electric Power 9x</td>
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<td>8. Genworth Financial 9x</td>
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<td>9. Hartford Insurance 9x</td>
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<td>10. Lehman Brothers 9x</td>
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<td>11. Suntrust 8.7x</td>
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<td>12. J.P. Morgan 8.7x</td>
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<td>13. Anadarko Petroleum 8.7x</td>
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<tr>
<td>14. Travelers 8.5x</td>
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<td>15. Lowes Corp. 8.5x</td>
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Source: Bennet Sedacca, Atlantic Advisors, LLC

Figure 16: Citigroup, Inc. (C), 2006–2008

Source: www.decisionpoint.com
negative for the currencies of countries that have benefited from rising commodity prices (Australia, Canada, New Zealand, etc). As a result, I still maintain the view that, for the next few months, US and Japanese equities could outperform the emerging stock markets and assets in commodity-rich countries. Moreover, it is likely that weakness in oil prices, which would be brought about by lower demand (economic weakness), would also hurt the entire material and metal sector. Stocks such as US Steel (X) and Cleveland-Cliffs (CLF) seem to be in a blow-off phase. At the same time, lower oil prices could lift the prices of airline shares such as Singapore Airlines (SIA SP), AMR (AMR), Lufthansa (LHA GR), and Thai International (THAI TB). I should add that investors’ reaction to declining oil prices will be to buy equities and to assume that inflation will moderate. I am less certain that lower oil prices arising from economic weakness will be very positive for equities and will reduce inflationary pressures. Yet, as just explained, declining oil prices will be perceived as positive by the investment community. But given the already moderately overbought condition of the S&P 500, meaningful additional gains should not be expected and selling towards 1450 for the S&P 500 is still recommended.

I have maintained a relatively positive stance towards Japanese equities in recent months (see also the report by Jesper Koll of Tantallon Research in the February 2008 GBD report — jesper@trjcap.com). As can be seen from Figure 19, following a period of significant underperformance (between 2005 and late 2007), Japanese shares have now begun to outperform the Shanghai Stock Exchange Index. Moreover, it would also appear that the underperformance of the Nikkei Average versus the S&P 500 has come to an end (see Figure 20). I would therefore consider committing funds to Japanese equities to be timely — at least on a relative basis.

In this report I have taken a negative view of the UK and US...
commercial property markets. I suppose that in Asia a period of consolidation, or more likely a modest decline (10–20%), for both residential and commercial property prices is also ahead of us. Still, I maintain a moderately positive opinion about Singapore REITs, as outlined in the April 2008 GBD report where I recommended K-REIT (KREIT SP), Suntec REIT (SUN SP), CapitaCommercial Trust (CCT SP), Macquarie MEAG Prime REIT (MMP SP), Ascendas REIT (AREIT SP), Cambridge Industrial Trust (CREIT SP), and Mapletree Logistic Trust (MLT SP).

CLSA has just completed a 400+-page report on Asian property markets and their analysts also have a favourable view of AREIT, CREIT, and CCT. They also recommend, in Singapore, Ascott REIT (ART SP), UOL (UOL SP), and Capitaland (CAPL SP).

There is one more piece in the investment puzzle that needs to be addressed. What would happen to bond yields if the CRB Index rolled over and declined? Since commodity prices would decline because of a weak global economy, the obvious answer would be that bond yields would decline. However, this is far from certain, because economic weakness would presumably induce central banks around the world to massively ease their monetary policies. The bond market, however, may not like it and sell off. In addition, the bond market may assume that lower commodity prices will stimulate discretionary spending and lead to renewed economic vigour. I may add that yields on longer-dated US bonds appear to have bottomed out despite the Fed’s aggressive easing of monetary policies (see Figure 21). The bond market may no longer be buying the bogus inflation indicators published by the Bureau of Labor Statistics and may also be feeling the relative tightening of global liquidity that I mentioned above. Needless to say, higher bond yields should be supportive of the US dollar.

Kenny Schachter, who follows the art market closely, has kindly agreed...
to update our readers on the results of some recent auctions. His report follows.

Thereafter, I am enclosing a letter sent me by my friends at Child’s Dream about their efforts to provide emergency assistance to the victims of the recent cyclone in Myanmar. It is a saddening human tragedy for which a totally incompetent and vicious government is largely responsible.
Greed is Bad
Kenny Schachter, E-mail: schachter@mindspring.com

Inflation for basic food items is said to be up nearly 20% in the UK, and gas and oil have achieved prices levels never before imagined, with new highs sure to follow. Jobs in the financial sector are evaporating, property is largely un-saleable in various parts of the US, and the dollar is worth less than paper towels. Yet the art market inexplicably marches along like a crackhead version of the Eveready Energizer Bunny. It seems the entire banking sector has ground to a halt, but a small group of people still deemed it a steal to spend US$50 million on a Rothko (more on this), US$41 million on a Monet, US$40 million on a Leger, US$35 million on a Freud (more on this, too), US$30 million on a Munch, and — beyond all levels of comprehension — a Bacon triptych from only the 1970s for a grand total of US$86,000,000 (that had to be depicted with all the resplendent zeros). I have been in the art world for 20 years, but can someone please explain that to me? A bird eating the neck of a torso, distorted faces, and an abortion floating nearby — maybe he just couldn’t paint faces. I like to be shocked as much as the next person, but regardless; what is the concept of comprehending — a Bacon on a Munch, and — beyond all levels of comprehension — a Bacon on a Leger, US$35 million on a Freud. And the auctions are like showing a thermometer in the collective ass of society to take the temperature of the world’s disposable income. But you are only as good as your last sale, and contemporary auctions are occurring more and more often like a spreading rash. Besides, it is usually a red flag when there is talk of a new paradigm in the market — like the .com’s, which were going to rise forever, change the way we live, and forever alter the business cycle, before it went down 80%. However, never in history has a market been more talked down in the press and media by armchair prognosticators, for nearly a year already, with article after article and news segments on every channel forecasting the dramatic end to ten years of booming prices. And here we are now.

What the May 2008 sales — which altogether totalled over a billion dollars — illustrated, aside from very lenient worldwide monetary policies, is that art really is embraced and highly valued by the global economy (and maybe that too much money has entered circulation!). Jeff Koons should rename his series of animal-shaped mirrors from Easyfan to Easymoney, though I hope the art economy doesn’t resemble a hall of mirrors. Trading art these days is like the securities industry going full blast with no SEC; and art is seen as a derivative investment on taste and liquidity. On the downside, there is front running — that is, buying art on information gleaned from museums, institutions, and collectors prior to public announcements, and who-knows-what still going on behind the scenes at auction houses where the only visible face of bidders these days are dealers in the peanut galleries and banks of phone-wielding drones manning the sales on behalf of unspoken clients. As for the art industry, there is probably not another multi-billion-dollar, unregulated, inefficient market that is as lacking in transparency. Nevertheless, the public is more drawn to the fray than ever. Though the Americans still largely dominate auction activity, there is greater international involvement than at any other time in history; witness the major recent Qatari acquisitions of Hirst and Rothko for the first time. In certain instances, the Russians are even changing tastes from recent Western trends away from modern and Impressionist art. The art market is wearing gravity boots these days, still hanging against all expectations and managing to soar in the process, while the rest of the world is mired in the doldrums.

One marked move down, at least in terms of volume, was the welcome lack of recent Chinese contemporary art on offer in the major sales; perhaps this was a backlash to the inundating of mediocre works on the market. Cynically, much of this material seems tailored to appeal to perceived Western market tastes. Some auction highlights are as follows. Japanese artist Takashi Murakami, star of art institutions and collectors alike, recently exhibited at...
the LA County Museum and the Brooklyn Museum, where he installed a functioning Louis Vuitton boutique in both venues, for whom he has designed bags and other products. The seamless wedding of art and commerce could not be more harmonious (in the mind of Andy Warhol, anyway). At Sotheby's evening sale, the artist himself watched from the skybox and roared "Banzai!" when his work, My Lonesome Cowboy, fibreglass and paint, sold for over US$15 million. A work like this needs only a description rather than analysis, as it speaks for itself in no uncertain terms: it is a lifesize teen figure with a shock of cartoon-ish spiky blond hair and a penis as erect as one can be; the figure is wanking in one hand and twirling a fibreglass lasso comprised of the mother lode of his own cum in the other. Who can argue against the masturbatory nature of much of contemporary art nowadays?

Yves Klein, who is revered for creating Klein blue, a vivid royal shade of congealed deep-blue pigment, had sales results monumentally over estimate but reflected more the climbing value of gold than the health of his signature works of art. A monochromatic gold painting estimated at US$6–8 million sold for US$23.5 million, while a more familiar blue painting estimated at US$5–7 million sold for a mere US$17.4 million. A new gold standard was established for the artist. Lucien Freud, now the most expensive living artist in the world, sold a painting of an obese benefits clerk with blubbery flesh cascading down the couch (is she the only one?) and was lambasted in the red top press for being an anti-humanist misogynist whose formulaic work is calculated to shock. Though partly true, for US$35 million I'd want to get as much skin in my picture as formally possible. On the subject of greed as in the title of this piece, a Rothko failed to sell at US$33 million with a US$35 million low estimate, and a work by graffiti artist Banksy with an estimate of US$600,000 passed at US$550,000. I hereby profusely apologise to Mark Rothko for unduly making him spin in his grave by mentioning his name in the same breath as Banksy, but the fact that these two highly bid works failed to find buyers is a terrible reflection on the avarice that could ultimately be the downfall of the entire art market. If you decide to sell a work of art at auction, don't be so delusional as to turn your back on US$33 million for what is a mere painting on canvas; and what is even more inexcusable is to be a "collector" who turns down more than half a million dollars for a piece of crap by Banksy for which they must have paid a fraction of that just a few months before. Not that I have anything per se against crap; my entire collection could be said to resemble trash.

Damien Hirst had lacklustre but solid sales, including what must be his 2,000th coloured spot painting on canvas from 2006 that sold for nearly US$2 million. Won't someone sometime soon differentiate between the significance of an early spot work and that of one so far down the (production) line? I highly acknowledge the aesthetic, graphic, pulling power of these iconic works, which speak of our overreliance on pharmaceuticals, but will enough ever be enough — or will demand continue to dictate supply? Artists today have more employees than ideas, and certainly larger staffs than the world's leading galleries (many of which are now multinationals); in fact, they have more employees than some of the burgeoning cottage industries they have grown to resemble.

A month ago, Phillips' first foray into "design art" sales in London transpired at its Howick Place showrooms. The sale came with a £1.4–2 million estimate and made £2,282,513, comfortably over its high estimate; no easy feat. The mid-century and contemporary design offerings included major works by French designers Jean Prouve, Charlotte Perriant and Le Corbusier, and "important" contemporary works by Marc Newson, Ron Arad, and the upstart Martino Gamper. The word “important” is a much-overused buzzword in the art world, alluding to historical significance but rather referencing present market value and status. Accompanying the sale was a panel entitled: "Rethinking Design", said by Phillips to be the first in a series of "think tanks" to coincide with opening previews, a service kindly provided by the auction house and outside furniture dealers. "Think tank" is an odd term to use to define a group of industry insiders espousing investment in a series of objects presently on offer; I'm fairly certain there was not much in the way of an objective, open, accountable process of analysis at the drinks party accompanying the discussion prior to the onset of the sale.

Of the 246 lots on offer, roughly 40 could be said to be of the contemporary variety of design; much of the remainder, more conservative fare, comprised what seemed like lot after lot of candy dishes and teapots. At times the works on offer in design sales resemble the contents of a boot sale (or flea market, for US readers). Surely the time has come to bifurcate the mid-century and contemporary material into distinct sales, rather than continue to tax our collective short-term attention spans. Let Design Art live on its own; for better or worse, that is the term that best encapsulates the notion of this burgeoning new sector of the furniture market, a hybrid from the worlds of art, design, and architecture resulting in new forms of utilitarian objects — if you can call certain pieces of contemporary design usable. Simon de Pury of Phillips is the Buster Keaton of auctioneers; he is not so much a physical comedian, but uses his voice physically like a musical instrument, and coaxes bids with ad hoc, boisterous humour. And drum up bids he did; but he had better be good, as the design outings are just about every month these days and on the heels of the contemporary sales.

In the sale, a couch resembling crushed tin foil, by architect and designer Ron Arad, sold for over US$180,000; and a carbon fibre table resembling a sleek sports car, by
market-leading industrial designer Marc Newson, sold for nearly US$240,000. (He has previously sold a chair for US$2 million.) The design market is an accessible niche of collectibles that is open ended, not as cutthroat or political as art, and still has a tremendous amount of room for growth. Aside from most art fairs' and gallery owners' trepidation at incorporating art with design, soon most art institutions will come around — as the auction houses already have — and embrace this new material in the same way photography was ultimately accepted into the canon of contemporary art. Finally, Gagosian Gallery, the world's largest, has stepped up to represent Marc Newson, and Timothy Taylor Gallery in London is now exhibiting Ron Arad. Why are the galleries so retrograde and always so late to respond and react proactively to new currents in the marketplace?

As a postscript, I must admit to hypocritically partaking in all of the manipulative commercial machinations as described above.
Dear Marc,

Over the last few days we all have been seeing the horrific images from the Irrawaddy and Rangoon division areas in Burma. On May 3rd, cyclone Nargis hit Rangoon, Irrawaddy and Pegu divisions. Aid agencies estimate that 100,000 people have died and warn that this figure could rise to 1.5 million without provision of clean water and sanitation.

While the UN and international NGOs await visas for Burma in Bangkok and the few emergency relief supplies are blindly handed over to the military regime, some of our partner organizations from the Thai–Burma border have put together an Emergency Assistance Team. This team is currently on the ground in Rangoon and the Irrawaddy Delta and is working with networks of community based organizations and concerted individuals. The team is split into 8 groups with 5 members each. They are distributing water purification tablets, procuring rice and other food, building shelters and repairing houses, assisting with cremations, and providing basic medical treatments, including oral rehydration supplementation. These groups are communicating via satellite phones with team leaders based in Mae Sot, Thailand for funding and logistics.

As during the tsunami catastrophe, Child's Dream is very critical and cautious about how emergency relief efforts are organized and implemented. Also during this crisis we have been observing various attempts to bring help to those who really need it. We heard of the above initiative through our existing networks of community based organizations and feel that this is the most effective and efficient way of providing emergency relief assistance. We were informed that THB10 million (USD325,000) can responsibly be distributed over the next three weeks. Our partner organizations have already raised USD100,000 but are still lacking the remaining budget that is required.

Therefore, our two organizations, Child's Dream and diversethics Foundation, have committed to support the Emergency Assistance Team with USD200,000. Both our organizations today have the financial strength to absorb this additional commitment, and the money is needed urgently now. At the same time we are approaching donors to specifically raise money to cover the USD200,000 we spent for this urgent purpose. Further funding might be required, and should that be the case, we will inform you accordingly.

We are convinced that this grassroots-level approach will save many lives and bring much-needed relief to the communities.

Best regards,

Child's Dream / diversethics Foundation
Marc T. Jenni • Daniel M. Siegfried