



Andrew Mellon vs. Bailout Nation

2008 was the year when the United States led the charge of bailout nations, lending and literally guaranteeing trillions of dollars of private liabilities in an effort to avoid the advent of another Great Depression. Nothing, with the possible exception of George Bush's IQ was the subject of greater debate. To begin with, the rescue plan itself was controversial even amongst its implementers: Congress voted against it, then a week later voted for it; Treasury Secretary Paulson designated it "TARP" (short for "Troubled Asset Relief Program"), then a month later did a 180°, refusing to buy subprime mortgages and asserting his right to change his mind because the facts themselves had changed. But the broader question reached beyond politics and into the realm of the dismal science itself. Was it necessary and productive to mutate 21st century American-style capitalism into a thinly disguised knock-off of the New Deal?



Better, some thought, to have followed the advice of early 1930s Treasury Secretary Andrew Mellon: "Liquidate labor, liquidate stocks, liquidate the farmers – purge the rottenness from the system."

The Mellons of the world argued that bailouts were akin to pouring gasoline on a fire, adding trillions of dollars of

new debt to a domestic and global economy that had broken down because of, because of, well, because of – too much debt.

Wall Street, the Fed, and Newport Beach took the other side. Those steeped in economic history felt that the Great Depression and more recently the "lost decade" in Japan had both experienced a "liquidity trap," a monetary black hole where lenders, savers, and ultimately consumers were frightened into stuffing their money into a mattress rather than circulating it in classic capitalistic fashion. Sensing a freezing of credit markets following the default of Lehman Brothers, policymakers decided it was better to become a bailout nation than a sunken ship.

The debate, of course, can never be resolved. You can't prove a negative nor recreate history to show what might have been. What we do know, however, is that even with US and indeed global bailouts, almost every major economy entered recessionary territory in 2008 and that the "D" word, while unmentionable in official policy circles, was nevertheless on the tip of their tongues and at the forefront of their contingency plans. As we closed the year, "quantitative easing" was the publically acknowledged future policy of the Federal Reserve, which in short meant "buy assets, support Wall Street, and in the process, hope that some of it might trickle down to labour and the farmers." Ben Bernanke is no Andrew Mellon. There may be rottenness in the system, but our Chairman surely doesn't believe in starving a cold, or pneumonia for that matter. The Fed's willing accomplice was the United States Treasury and the FDIC, extending not only \$350 billion of TARP money but literally guaranteeing three quarters of the liabilities of US banks. For those who fear nationalisation of our financial system, the destination seemed just over the horizon.

Still, while such a transformation is, to put it mildly, undesirable, the policies are necessary. As outlined in these pages, the US and many of its G-7 counterparts over the past 25 years have become more and more dependent on asset appreciation.

Under the policy-endorsed cover of technology and somewhat faux increases in financial productivity, we became a nation that specialised in the making of paper instead of things, and it fell to Wall Street to invent ever more clever ways to securitise assets, and the job of Main Street to "equitise" or, in reality, to borrow more and more money off of them. What was not well recognised was that these policies were hollowing, self-destructive, and ultimately destined to be exposed for what they always were: Ponzi schemes, whose ultimate payoffs were dependent on the inclusion of more and more players and the production of more and more paper. Bernie Madoff? As with every financial and economic crisis, he will probably go down as this generation's fall guy – the Samuel Insull, the Jeffrey Skilling, of 2008.

But Madoff's scheme has a host of culpable look-alikes and one has only to begin with the mortgage market to understand the similarities. Option ARMs or Pick-A-Pay home loans allowed homeowners to make monthly payments that were so small they did not even cover their interest charges. Two million mortgagees either chose or were sold this Ponzi/Madoff form of skullduggery, believing that home prices never go down and that shoppers never drop. One can add to this the trillions in home equity/second mortgage loans that extracted

“savings” in order to promote current instead of future consumption, and one begins to realise that Bernie Madoff and our cartoon’s Wimpy had company all these years.

What about the shabby performance of the rating agencies? Were they not equally at fault for perpetrating a giant charade that was bound to end in tears? Of course: Aaa subprimes structured like a house of straw; Aaa monoline insurers built like a house of sticks; Aaa credits like AIG, FNMA, and FHLMC where only a huff and a puff could expose them for what they were – levered structures dependent upon asset price appreciation for their survival. Ponzi finance.

I will go on. Municipalities with begging bowls now extended for over a trillion of Federal taxpayer dollars, based their budgets and their own handouts on the perpetual rise in home prices, the inevitable upward slope of sales taxes, and the never-ending increase in employment and personal income taxes. To add injury to insult, they conveniently “balanced” their books with a host of accounting tricks that Bernie Madoff could never have come up with in his wildest imagination. Now, with cash flow insufficient to meet current outflows, they are proving my point that we have met Mr. Ponzi and he is us – all of us: auto companies that siphoned sales dollars to

make labour peace instead of research and design expenditures; hedge funds that preposterously billed investors for 2% and 20% of nothing; a President and politicians who thought they could fight a phony war for free and distract the nation’s attention from \$40 trillion of future social security and health care liabilities. Ponzi, Ponzi, Ponzi.

Still, future policymakers must confront the reality that is, not the one that should have been. And investors must do likewise, casting aside personal philosophies for a clear-headed view of the future horizon. PIMCO’s view is simple: shake hands with the government; make them your partner by acknowledging that their chequebook represents the largest and most potent source of buying power in 2009 and beyond. Anticipate, then buy what they buy, only do it first: agency-backed mortgages, bank preferred stocks, and senior bank debt; Aaa asset-backed securities such as credit card, student loan, and auto receivables. These have been well-advertised PIMCO strategies over the past 6 months but there are others in clear sight. An Obama administration will quickly be confronted by the need to provide those hundreds of billions of dollars to states and large municipalities. Their requests total nearly a trillion dollars and to think California or NYC would be allowed to fail is, well – unthinkable. Municipal bonds then,

selling at historically high ratios relative to US Treasuries, offer attractive price appreciation potential, or at the very least a defensiveness with high carry that a 2½% 10-year Treasury cannot.

Here's another thought. While TIPS or inflation-protected securities cannot logically be a recipient of Uncle Sam's chequebook over the next 12 months, they can benefit if and when the government's efforts to reflate begin to take hold. 2½% real yields cannot possibly be maintained unless deflation as opposed to inflation becomes the odds-on favourite. What bond investors know as "breakeven inflation rates" are currently signalling a future where the US CPI averages (-1%) for the next 10 years. Possible, but not likely. As an additional strategy, global bond investors should recognise the value in high-quality investment-grade corporate bonds in many markets. Yields of 6%+ for intermediate maturities are still common and readily available.

There is legitimate concern as to the ultimate destination and outcome of our "bailout nation." Realistically, quantitative easing, a two-trillion-dollar expansion of the Fed's balance sheet, and the near certainty of future budget deficits approaching 6 – 7% of GDP should alert bond investors to once again become vigilant as was the case in the 1980s and 90s. Vigilantes we should be, but that is a battle to be fought in the Treasury market where low yields offer little reward and increasing risk. For now, our Ponzi-style economy and its policy remedies encourage bond investors to mimic Uncle Sam and its global compatriots. Buy what they buy, but get there first. Andrew Mellon would surely have disapproved. Liquidation was his game. Wimpy? Well, he's gonna have to start paying for those burgers on Monday, even in a bailout nation.

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