9.30.11

This is the third in what will be a long running series of Gold Coast Wealth Management's commentary on the financial markets. These commentaries will not have a formal schedule and will be written when events or market related topics strike us as important.

"Nothing is Confirmed Until it is Officially Denied and….Bernanke's Hail Mary"

The title of this letter is inspired by an old political and diplomatic saw we first heard while watching a re-run of "Yes, Minister", the critically acclaimed and very popular BBC distributed political comedy from the 1980's. It seems very appropriate given what we've seen and heard from Europe in the past six weeks.

We spend a lot of time reading at Gold Coast, multiple publications a day, and then a few more on the weekends. Over the previous six plus weeks we have lost count of the sheer number of prominent Continental officials who have stated that Greece will not default, and that Greece will not leave the monetary union. We agree with half of what they say; either Greece defaults or they leave the monetary union. But to believe that they will do neither is pure non-sense at this point. The simple math does not work. The current market rates at which they fund are simply too high. Without a smaller debt load or without a new currency in which to pay it, the current Greek situation is not tenable. Using the current Greek situation as the backdrop and the impetus, after months of rumors and behind the curtain talks, it became obvious by mid September that French banks were having trouble finding US dollar funding. But, if you were a casual reader of the newspaper quotes given by French public officials and French banking firms, it seemed everything was 'affaires comme d'habitud' or 'business as usual' in the French banking sector.

A small anecdotal piece of data: At Gold Coast we hold a portion of our cash in a money market fund that has total assets of ~$13 billion as of this writing. In mid-July we started to get nervous about the holdings of money market funds. To ease, or flame, our fears we conducted a small amount of incremental research to make sure the money market fund we used was not overexposed to European banks. We would strongly advise everyone to have their outside advisors check on how their 'cash' and 'equivalents' are held because historically US money market funds were used as a large source of capital for European banks, meaning US money market funds were lenders to European banks. With that in mind, as of June 30th of this year the breakdown by country was as follows:

Country	Allocation[i]	Total Dollar Amount of Funding[ii]
France	5.7%	$969 million
Germany	1.9%	$323 million
Spain	3.8%	$646 million

By July 29:

Country	Allocation
France	2.1%
Germany	0.9%
Spain	2.1%

And by September 15:

Country	Allocation[iii]	Total Dollar Amount of Funding[iv]
France	1%	$130 million
Germany	0.6%	$78 million
Spain	0	$0

The remaining $130 million in France should be gone by the end of September as the commercial paper investment matures and we believe the money market fund manager will not roll it over.

From July 1st to September 15th French banks lost more than $830 million in funding, German banks lost close to $250 million in funding and Spanish banks lost close to $646 million in funding from the $13 billion money market fund that we use. To put this in context, according to the latest report released on September 14th by the Investment Company Institute (ICI), the Washington based mutual fund trade group, total taxable U.S. money market funds equaled over $2.3 Trillion.[v] So for arguments sake let's assume that French banks lost a lot more than $830 million in funding from U.S. money markets. The Wall Street Journal's [vi] analysis put the number at $700 billion going back to last year for European banks in total, with the bulk of it being felt by French, Spanish, German, and Italian banks. A big gap to fill and the markets were alive with rumors.

On September 13th as things escalated, BNP Paribas the large French bank, felt the need to answer that morning's Wall Street Journal op-ed piece and market rumors in general about its alleged U.S. dollar funding issues. BNP said the report contained 'erroneous information'[vii] and that it did not have issues obtaining U.S. dollar funding, and that it will contact the French stock-market watchdog to investigate the whole matter. Two days later a global effort led by the central banks of the U.S., the U.K., Japan, and Switzerland was needed in order to supply French, and European banks in general, 'unlimited dollar funding through the end of the year'[viii]. If French, and European banks in general, did not have U.S. dollar funding problems then why the need for coordinated global action? Good question. Maybe it was just something lost in translation, or as Colonel Nathan Jessup would say, maybe 'we can't handle the truth'.

Why do we find this important? It is important to us because now more than ever global financial markets are intertwined. French banks, indeed almost all large European banks, have large lending portfolios in U.S. based business, in U.S. subsidiaries of European businesses, and also in their own subsidiaries that operate in the U.S. capital markets. European banks lend to airlines, shipping companies, logistical companies, automobile companies…etc, all of which do business in the United States. For example, Societe Generale, the large French bank, has said in lieu of potential U.S. dollar funding difficulties it is cutting back on lending in the "aircraft and shipping industries".[ix] Directly, the health of these banks influences the health of the U.S. economy and the financial markets that go in hand. Indirectly, we just do not know the ramifications that a Greek default will have on European banks and beyond.

For instance, in mid- 1997 what is now known as the "Asian currency crisis" started with the devaluation of the Thailand currency, the baht. At the time Thailand was a small regional player at best, and it was thought a devaluation of its currency might affect its region but nations outside of south-east Asia would scarcely feel a thing. The general thinking was wrong. The Thailand baht devaluation caused panic in south-east Asia, and a huge repatriation of capital from the region. Growth in the region declined precipitously, the U.S dollar strengthened, oil dropped (which had a hand in igniting the Russian currency crisis of 1998), and the U.S. equity indices experienced a mini crash in October of 1997 with the S&P500 falling over 10% in four trading days. It was short lived, but it was very powerful to those who experienced it.

After 15 years of globalization in financial and non-financial markets it is hard to quantify how a default of a small-to-medium sized economy inside the world's largest economic zone (European Union) will affect global markets. The more certain any expert is of the ramifications, the more we would be inclined to disagree with said expert. It is an unquantifiable event in our mind, similar to our feeling on the debt ceiling fiasco that started to surface in April of this year. Therefore, we will continue to do what worked well for us and our clients in April and remain relative spectators to the event. In effect it means we will continue to keep our client's cash allocation at the current elevated levels and our client's equity allocations relatively low until we feel this crisis has passed.

Excuse us for that long winded side bar, which could have easily been redacted to "don't believe what you read in the papers or hear on television, especially so when it pertains to politics or money, and especially especially so when said or written by a politician or a banker." In times like these it pays to do your own research and to use your own common sense. Our research said that French banks lost at least $25 billion in short term funding from June to September, and our common sense said they needed to find it someplace else or there could be liquidity problems. As it turned out they found it, compliments of the dusted off liquidity facilities put in place during the Lehman crisis of 2008. At Gold Coast we were prepared for the worst, as this latest problem joins the litany of issues that have piled upon the global financial markets since May of this year. We continue to preach caution as we believe the European issues are not going away so fast. We continue to preach patience in waiting for the right time to invest the large cash positions that have buffered us and our clients since April of this year.

Bernanke's Hail Mary

Moving on to another small news item, it seems the U.S. Federal Reserve Bank has decided to shift its rather large portfolio of fixed income assets into longer duration instruments. Citing "significant downside risks"[x] to the economic outlook, the policy making committee decided that instead of using a machine gun to kill a honey bee, they will use a butter knife to take on a charging elephant. The proverbial knife to a gunfight. The language used by Bernanke was so terrifying because it's the most demonstrably negative language we've heard from the Fed in a long time. Additionally, it is coupled with a response that is widely agreed to be grossly inadequate. Even scarier, it's probably all the Fed can do at this point as its arsenal is empty. The Fed's monetary guns are out of bullets, and it seems even Bernanke's famed dollar-bill dropping helicopter is out of gas.[xi]

How bad was the "significant downside risk" comment? By itself "significant downside risk" is troublesome, but when coupled with the measures the Fed took in response to the affliction, it becomes extremely foreboding. Yes, the Fed said, we will begin to purchase longer duration bonds in our portfolio. But in the rest of the communiqué the Fed failed to assure us that they think these measures will work! Let us try to put it in context. In their March 18, 2009 statement, released in an environment where the broad equity market indices had lost over 50% in the previous 9 months, where large multinational banks had disappeared, where the very idea of capitalism was being questioned…the Fed still had confidence that its response would be successful. The last sentence in the first paragraph of the March 18th 2009 statement reads:

"Although the near-term economic outlook is weak, the Committee anticipates that policy actions to stabilize financial markets and institutions, together with fiscal and monetary stimulus, ***will contribute to a gradual resumption of sustainable economic growth****."*[xii]

Now the good news and the bad news. The good news: they were right. Conditions improved in the economy/financial markets and the worst case scenario was averted. The bad news: **that same level of confidence is nowhere to be found in the current communiqué**. Before anyone jumps to the conclusion that it could be an honest omission or an unimportant parsing of words, please remember the importance the Fed places on its statements. There was an important research paper done in 2003 by Donald Kohn (former Vice Chairman of Federal Reserve 2002-2010, essentially the 2nd in command for both Ben Bernanke and Alan Greenspan) and Brian Sack that said because policy statements 'receive intense scrutiny by market participants'[xiii] they can be 'used an effective substitute'[xiv] to policy actions . In other words, the Fed is acutely aware that the wording of these communiqués is studied with a voracity normally reserved for tea leaves and the Kremlin. There are no honest omissions.

Looking Forward

We are nearing another inflection point in global finance and economics. We have a default looming in Europe with unknown consequences that is running parallel with a potential recession

in the United States. And China's slowdown has not even been mentioned yet. If things work out perfectly the U.S. avoids a recession and ekes out a small gain in GDP while the European Union's finance ministers' figure out a way to rescue Greece and their region's banks without any hiccups. In this case we believe a relief rally across several months would ensue with global equity indices' rising 15%, U.S. treasuries giving back some of their recent gains, junk and credit rallying in the developed and developing world, and in general it would be a 'risk-on' trade. If things do not go perfect and the U.S. does enter a recession or a 'recession like' environment, while the Greek default hits a few snags causing or exacerbating a "European banking event" global equities could see another gap down to the tune of 15-20%, happening across maybe a few weeks to one month. We could see the S&P 500 below 1000, treasury yields at generational lows, and credit and high-yield underperforming.

Using the above two scenarios as baselines we are not thrilled with the current prospects of putting more risk into our clients portfolios. We believe we will have enough of a runway to see conditions improve, and hence not lose much potential upside if markets do benefit from positive outcomes in Europe and the US. It is the possibility of a very quick and painful drop in risk assets that has us afraid. Very afraid. In our view, the loss of capital is to be avoided at all costs. Producing flat returns is a victory when markets are down as much as they have been since April. Being flat while holding large cash balances means when the time is right we can advise our clients to buy from the sale rack.

But, we firmly believe that the lows of 2008-09 will not be revisited. What happened in 2008-09 was an acute event where panic resulting from intense liquidity and solvency issues caused investors to price in the potential collapse and disintegration of global financial markets. With the global coordinated facilities put in place to fund banks and financial institutions in the post-Lehman world, we believe liquidity problems and **some** of the solvency issues that come with it, will not be a problem this time around. Things are likely to get worse but we believe the floor in equity prices are above the lows of 2008-09.

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[i] Fund assets equaled $17 billion
[ii] Estimate using the total fund AUM and the stated allocation provided by fund company public filings
[iii] Fund assets equaled $13 billion
[iv] Estimate using the total fund AUM and the stated allocation provided by fund company public filings
[v] Forbes, Associated Press, September 15, 2011
[vi] Wall Street Journal (website), September 15, 2011 "Europe Lending Woes Deepen", Sara Schaefer Munoz, Carrick Mollenkamp, Brian Blackstone
[vii] BNP Paribas (website), Press Releases
[viii] Wall Street Journal (website), September 16, 2011, "Central Banks Pour Dollars into Europe", Brian Blackstone
[ix] Bloomberg (website), September 12, 2011, "Societe Generale Plans to Sell $5.4 Billion in Assets to Boost Its Capital", Fabio Benedetti-Valentini and Mark Deen
[x] FOMC Monetary Policy Statement, September 21, 2011
[xi] Bernanke had a famous quote attributed to him before he became Chairman of the Federal Reserve where he said a fiat currency regime could use a helicopter to drop money from the sky to prevent deflation.
[xii] FOMC Monetary Policy Statement, March 18, 2009
[xiii] "Central Bank Talk – Does it Matter and Why?" Donald Kohn, Brian Sack 2003. Board of Governors of the Federal Reserve System, Washington D.C.
[xiv] Ibid

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