

# B | BLACKSTONE FINANCIAL GROUP, LLC

*An Independent Firm*

132 RIVERVIEW DRIVE, SUITE D FLOWOOD, MS 39232

769.216.3150 OFFICE 769.216.3153 FAX

bheadley@blackstonefg.net

lpeeples@blackstonefg.net

trussell@blackstonefg.net

jchar@blackstonefg.net

## REMEMBERING THE FUTURE

A Publication of the Blackstone Financial Group

Vol. 1, Issue 8, January- February 2010

### **A Cyclical Bull Within A Secular Bear: The Erinyes of 2010 and Beyond**

*John E. Charalambakis Ph.D., Professor of Economics, Asbury College*

#### Introduction

In his closing comments for 2009<sup>1</sup>, the legendary investor Richard Russell laments the fact that the federal government along with the Federal Reserve Bank did not allow the bear market to take the necessary toll on the economy. Moreover, nothing has been done regarding the failed model of collateralization/securitization/credit generation, expansion, and recycling. Finally, their actions accomplished nothing with regards to the zombie “too big to fail” institutions which produced and traded the toxic paper-assets at the heart of the financial crisis.

As we look at the prospects that 2010 brings we could say that the landscape is changing. Regulatory reforms will take place<sup>2</sup>. Specifically, we believe that the seeds of the break-up of those institutions will be sown this year. It will become clear that those institutions are too big to exist. It was the trading activities of those institutions that created the crisis in the first place, and it is those institutions that either still hold toxic assets on their balance sheets, or have passed them on to the Fed. A small example of the billions held in worthless paper of those toxic assets are the infamous auction-rate securities originated and traded by those large institutions<sup>3</sup>. The truth of the matter is that despite the repayment of

some of the TARP funds, the guarantees offered by the federal government are still in the hundreds of billions of dollars<sup>4</sup>.

The institutional and regulatory failures along with the deficit concerns will become a powerful force in a new regulatory framework for both the federal government and the Fed. It should be noted that our assessment is that 2010 will only see the beginning of the unfolding of what we describe in this issue (thus the title “2010 and Beyond”). Those needed reforms will have investment implications in three fronts: First, on sovereign-nation’s debt and on the bond market. Second, on paper/fiat money and on what really constitutes wealth preservation via hard asset accumulation. Third, a return to some roots, particularly related to dividends, intrinsic values, and growth opportunities in under-appreciated sectors and particular companies.

Before we close this introductory section, allow us to emphasize the following: First, we still believe that gold is the choice of prudent investors (something that we repeat also in this letter.) Second, more investment opportunities can be found abroad than in the US; thus the need for international exposure. Third, the decline of the US dollar (especially against hard assets) is a one-way street and is needed, if a true and sustainable recovery is desired. Fourth, the celebrated recovery is too fragile and too dependent on government funding, i.e. the bull market of the last several months is a parenthesis of a

---

<sup>1</sup> Dow Theory Letters, December 31, 2009.

<sup>2</sup> Fed officials hinted to that during the Annual Meetings of the American Economic Association in Atlanta, January 2-4, 2010.

See also <http://online.wsj.com?mod=djemalertNEWS>

<sup>3</sup> See related story in the Wall Street Journal, January 2, 2010.

---

<sup>4</sup> Those guarantees for Citibank alone exceed \$340 billion. Bloomberg.com

long-lasting bear market. The Erinyes are coming to restore the natural order.

**Investment Principles: The Erinyes of Public Finances, of the Fed’s Balance Sheet and the Long-Term View**

Most analysts talk about long-term investment horizons, but what really constitutes a long-term horizon? Would a ten-year period suffice? What did stocks do over the last ten years? In the next two figures we exhibit both the Dow Jones Industrial Average(an index of 30 widely held stocks) as well as the S&P 500(an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.) The pictures speak louder than words. The former is basically flat (it actually has lost some ground), while the latter has lost more than 25% of its value. Clearly then, the equities markets were not a good place in the last ten years, since they failed in the most important element that an investment vehicle should provide: the preservation of wealth.

Figure 1: DJIA Through the Years

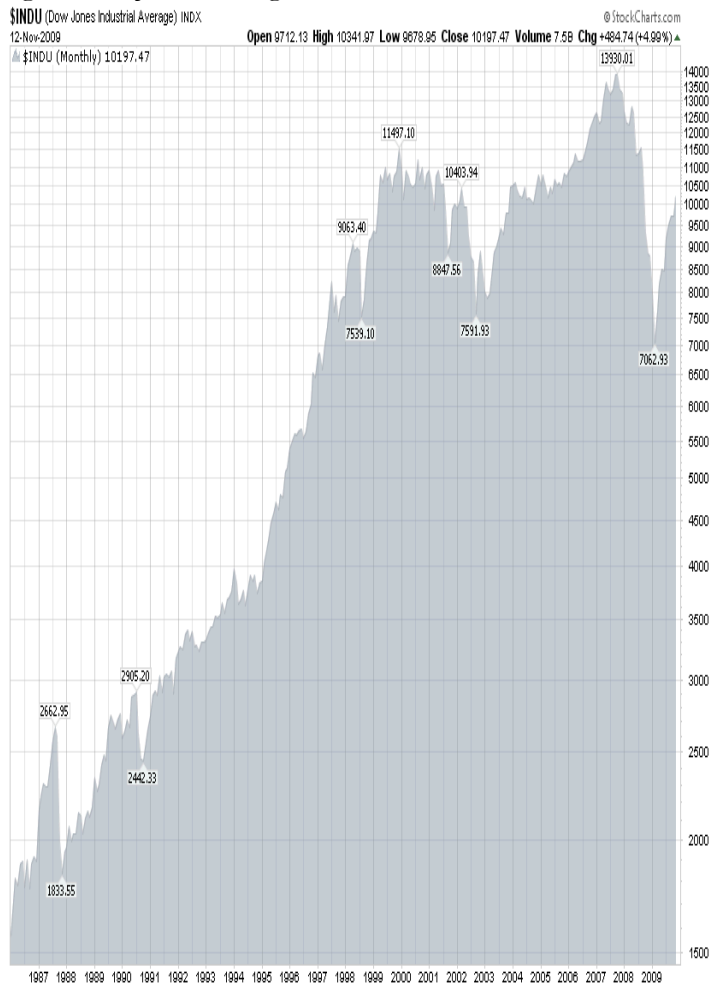
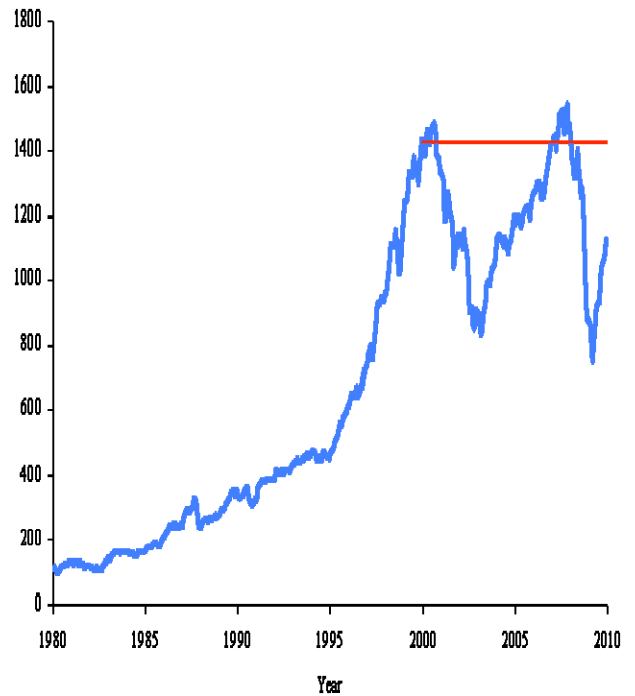


Figure 2: The S&P 500



Source: StockCharts.com

Excesses have always been bad for a person/institution who desires to have a healthy financial meal and diet. A basic measure (especially when we know that historically the Erinyes tend to reverse us back to the average/natural order) is the P/E (price/earnings) ratio. The figure below demonstrates the excesses we experienced and the bubbles that we tend to create. Parenthetically, we will only state here (but we may come back in a future issue regarding this topic) that these excesses could also take place at the national level, when current account imbalances (primarily trade deficits) force a strict diet on nations whose discrepancies exceed basic threshold levels (as a percent of local GDP.) Case in point: the Asian and some South American economies that had big trade deficits and limited foreign reserves. The result, of course, was the crisis that started in July 1997 and lasted for some until 2002.

The most recent case is the PIIGS of the EU (Portugal, Ireland, Italy, Greece, and Spain.) Their huge budget deficits have forced a downgrading of their bonds –some may even be unable to borrow in the future from the ECB (European Central Bank) when the ECB will stop accepting paper rated below A- which will freeze credit and the interbank market for those countries. This rejection of paper would

raise the cost of capital, squeeze budgets, restrain spending, and slow down growth, while raising unemployment.

Another recent case in point is the near bankruptcy of Dubai. Moody's warned<sup>5</sup> of serious problems in the sovereign nations' debt, stating that sovereign risk is one of the gravest threats in 2010. It seems that the Erinyes are coming to haunt not just companies, but nations at the same time<sup>6</sup>.

The exit strategies of the world's Central Banks – with the Fed taking the lead – will play a very important role in avoiding a wider downturn in the financial markets. It seems that anything less than an extremely well-designed and executed exit strategy by the Fed and the ECB will choke off growth, or create havoc in the markets if they are kept for too long. Central bankers have made it clear that emergency measures are coming to an end in the next three months<sup>7</sup>. Once the emergency cash infusions (known as quantitative easing) stop, then some economies (and banks) may implode, yields may increase substantially - stay away from anything that has a maturity of over two years – and the real cost of the crisis may show its face in terms of debt affordability.

However, the Erinyes may also come for triple A economies (e.g. France and even the US) unless they repair their balance sheets in the challenging context of slow growth (double dip recession for some) without the benefit of declining interest rates. On the contrary, we may see real interest rates rise (if deflation becomes reality and central banks start raising rates), which will exacerbate sovereign risk, bond market sell offs and may even lead to default for some sovereign nations. If the reserves accumulated in the banking system are not withdrawn properly, then we may see significant inflationary pressures (especially if capacity utilization picks up speed), while if withdrawn too hastily will jeopardize the fragile recovery. In both cases of a less than perfect scenario, reserve withdrawals of both stocks and bonds will fall, which will create the conditions of a perfect storm where all markets are dropping while public finances prohibit further stimulus. Hence, the key for the return of the Erinyes

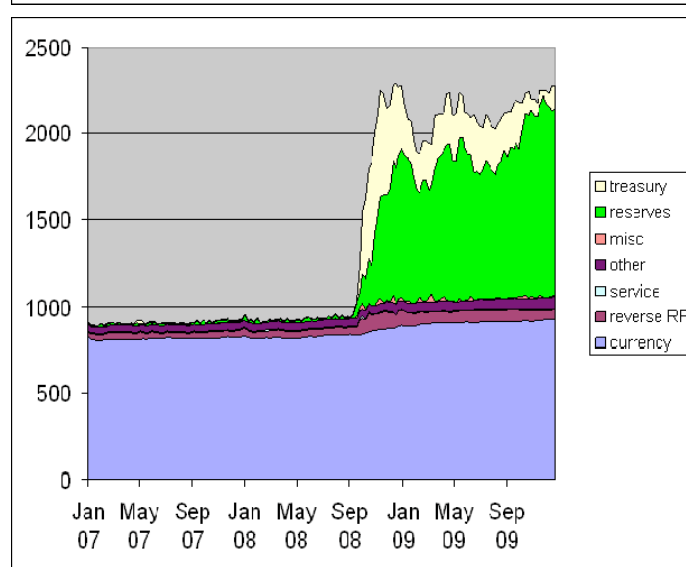
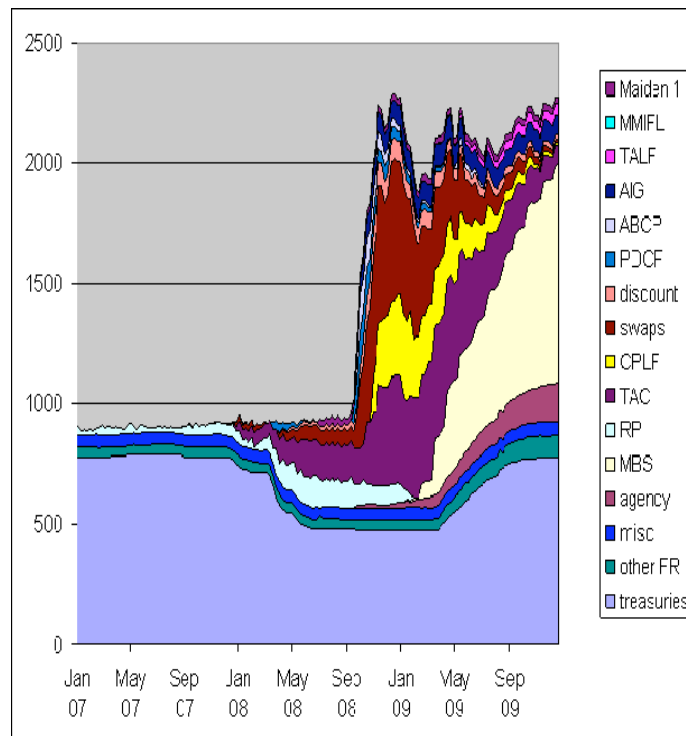
<sup>5</sup> See Moody Report entitled Sovereign Risk states: “The crisis of public finances that has beset many rich countries is the final – and disturbingly long lasting – stage of the global crisis after the financial and subsequent economic crises.”

<sup>6</sup> See also Financial Times, “Moody’s warns on sovereign debt”, December 16, 2009.

<sup>7</sup> See recent Fed Press Release about a Term Deposit Facility, December 28, 2009.

is being held by the Central Banks and the reserve liabilities they have accumulated in the last two years.

In the next figures we show the Fed's balance sheet and the dramatic increase in reserves liabilities that the Fed has credited to the banking system and which it needs to take out. Moreover, it shows that its assets are not in a great position, especially when we take into account that its loans have decreased while the non-Treasury securities (a.k.a. toxic assets) have exploded. Maybe the Erinyes need to return in order for reason to be restored, while notions of what constitutes and creates wealth will be re-evaluated on a global scale.



Source: Federal Reserve Board of Governors; Econbrowser

The above graphs of the Fed's balance sheet are very disturbing. The traditional composition of the Fed's Reserve Assets (Gold, Special Drawing Rights, and Treasuries) has been distorted and been allowed to skyrocket with toxic assets via programs known as TARP, TALF, PDCF etc., while its liabilities (read reserves) have exploded. The return of the Erinyes and their focus on restoring order could mean one of three things: Option one would be for the Fed to enhance its balance sheet via real hard assets (e.g. a re-valuation of its gold reserves or accumulation of other assets), while at the same time contemplating implementation of a scheme such as time-deposits for banks. Option two would be the reduction of the Fed's inventory of toxic assets via returning them to their issuers (of course pricing issues and balance sheet deterioration for the issuers come into the picture, thus a possible financial earthquake cannot be excluded.) The third, option would be a combination of the previous two, where the Fed retires a good chunk of its liabilities/reserves via returning a portion of the toxic assets to their issuers while enhancing its balance sheet with hard assets.

The unfortunate thing is that when we take into account the ferocious position of public finances in the developed world (especially in the US) along with the Fed's balance sheet, we can only see problems down the road. That in turn would translate into a prolonged secular bear market with few dim lights of optimism, where cyclical bulls could carry the day. Therefore, the long-term prospects of the markets are bearish, unless balance sheet enhancements along with regulatory reforms take place at the Fed.

### **And then There Were the Residuals: The Erinyes of Valuation and the Return to Reason**

In the November issue we contemplated the reasons for which the equities that pay healthy dividends are better positioned in the years ahead. After careful screening we evaluated some names, which we consider as part of an overall equities strategy. As always, we would be happy to share that list with you, so feel free to contact us.

In the special review/assessment issue last month we advocated our position regarding hard assets and especially gold. At this point, and without

repeating ourselves, let us share with you two additional facts:

First, central banks around the globe are buying the hard asset and re-positioning the asset side of their balance sheets. This is the first time they are doing it, protecting their currencies, and uplifting their prospects in anticipation of a possible major reform that will return some reason to valuations, prices, and debt liabilities (especially to foreign creditors, given that a re-valuation of hard assets reduces liabilities, enhances the asset side of the balance sheet and reduces instability pressures.) When we compare our first figure with the gold developments over the last ten years (see figure below), then we could easily conclude that while the equities markets failed to preserve wealth, the "barbaric relic" not only didn't lose ground, but gained more than 270% in the last decade. Our long-term view is that the Erinyes are back and are bearing with them some reason as a gift to central bankers.

Figure 4: Gold over the Years



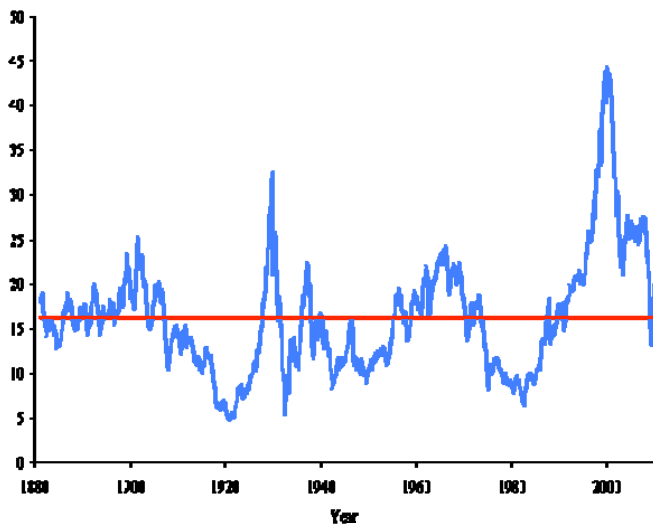
Source: StockCharts.com

Second, to the above statements, one also needs to add that many things have been declining in terms of gold, including equities, bonds, housing, and all the other markets, which point to a potential double-sword scenario (deflationary in the beginning and inflationary in its evolution, especially if the exit strategies of central banks are not well-designed and executed.) As our special issue last month explained, gold has some significant catch up to do. When that catch up is implemented, along with additional acquisitions of hard assets/enhancements of the asset

side of the Fed's balance sheet, then confidence in the dollar will be restored, bonds will enjoy a healthy environment (and thus sovereign risks will subside). Additionally, the problem of unfunded liabilities will be reduced, and paper/fiat money will be anchored more properly.

Now, as far as what the Erinyes is bringing back to the equities markets, we would simply state that these chthonian gods do not suffer from an identity crisis and will stick with their main mission: to restore reason and rationale while debunking excesses. The figure below is a clear picture of the equities markets excesses using the price/earnings (P/E) ratio over the course of almost 130 years. Whenever the equities markets diverted from the reasonable average, excesses were created, bubbles spread, credit exploded, paper assets were used as collateral-assets, and a catastrophe took place.

Figure 5: The P/E ratio



Source: StockCharts.com

We believe that the Erinyes are bringing with them a valuation method that will restore pricing according to a company's worth<sup>8</sup>. Investors will start looking at intrinsic values and not so much at multiples. The intrinsic value is determined by adding a discounted return on equities to the book value per share of the particular company<sup>9</sup>. By doing so, we

<sup>8</sup> Benjamin Graham explained that in chapter 10 of his legendary book The Intelligent Investor.

<sup>9</sup> Stephen Penman's Residual Income Model (RIM) articulates the methodology, where consensus forecasts of ROE (return on equity) and book value are discounted by the opportunity cost of capital e.g. 6%, and that discounted flow is then added to today's book value, in order to determine the intrinsic value of

anchor the firm's valuation on the earnings power of its assets, while we also count for the opportunity cost of capital. Thus we take into account both value and growth potential over time.

If we applied that methodology to today's equities market, we would see that the overall market is over-valued by at least 15% while only a few sectors may represent intrinsic-value opportunities. Some examples of the latter are the commodities sector and the reinsurance/insurance sectors<sup>10</sup>.

Of course, the obvious question will be what kind of allocation would the Erinyes bear with them? The answer to that question, along with our currency assessment, forms our concluding thoughts for this issue.

### Concluding Remarks

Based upon a truly long-term view (i.e. five years) and according to the analysis above we believe that the following allocation may prove to be prudent for an individual or institutional investor who desires preservation of capital, value, and growth over time.

First, a minimum 25-30% allocation in hard assets. Second, an 8-10% allocation in energy (both conventional and renewable.) Third, a 10% in sectors that are under-valued based on the RIM model and other assessment tools. Fourth, 25% in global securities, especially ones denominated in currencies that we anticipate to be revalued/appreciated such as those of BRIICs<sup>11</sup> (see comment below.) Fifth, a 15% allocation in companies that pay healthy dividends. Finally, the rest of the portfolio should be kept in short-term money instruments for liquidity purposes as well as for opportunities that may arise.

As closing comments, please allow us to differentiate from the conventional thought (advocated by Chairman Bernanke as well as by Martin Wolf of the Financial Times) that it was the savings glut of the Chinese that produced the low interest rates, which in turn created the housing bubble and the financial collapse of 2008. We may

the firm. The methodology further suggests that equities that exceed the intrinsic value by e.g. 20% should be sold, while those that fall below a pre-specified level e.g. 20% should be bought.

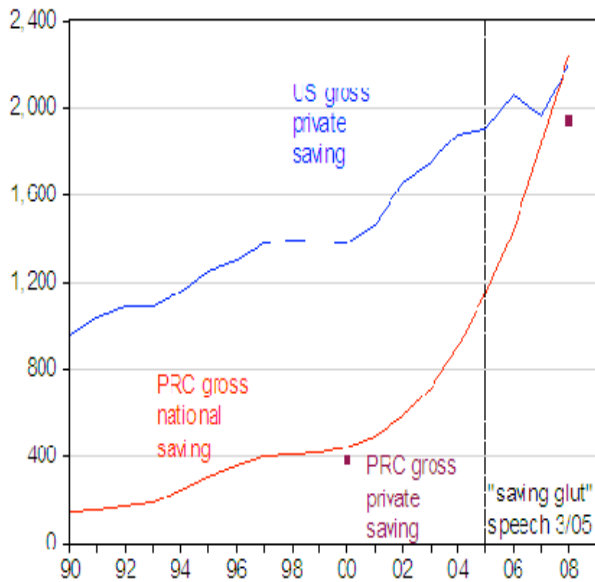
<sup>10</sup> We may revert back to this issue in future writings.

<sup>11</sup> To the well-known BRICs (Brazil, Russia, India, and China) we suggest to add Indonesia thus the acronym BRIICs.

return to this topic in the future, however we believe that three comments are in order at this juncture.

First, the figure below clearly indicates that the Chinese savings were well below US savings (especially when that theory was advanced) to cause extremely low interest rates, let alone the meltdown.

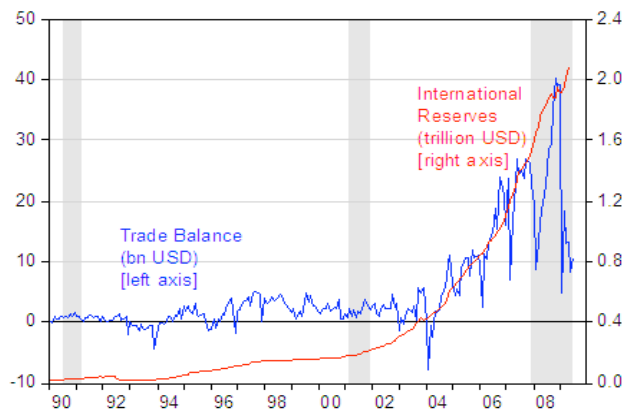
Figure 6: US vs. Chinese Private Savings, Debunking the Glut Hypothesis



Source: World Bank WDI, BEA, Econbrowser

Second, it was the accumulation of international reserves via collateralization, securitization, and credit creation that caused the collapse, as we repeatedly have advocated, and as the following figure from the International Monetary Fund confirms.

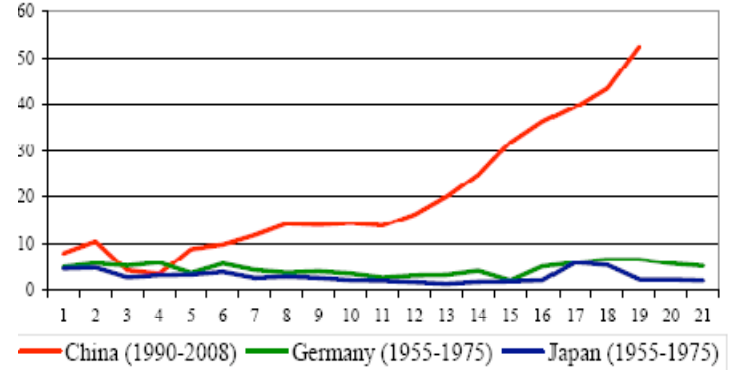
Figure 7: Growth of Reserves Around the World



Finally, the reserves that the Chinese have accumulated exploded after the “savings glut” speech

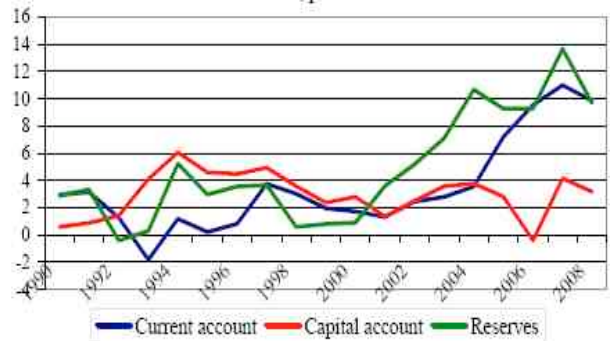
as figure 8 below shows. Moreover, no nation has accumulated as much in terms of international reserves as a percentage of domestic GDP, and no nation has had trade surpluses that exceeded 7% on an annual basis, let alone 10+% in terms of China (see Figure 9 below), whose currency did not experience a revaluation/appreciation.

Figure 8: Foreign Currency Reserves as a percent of Domestic GDP



Source: IFS

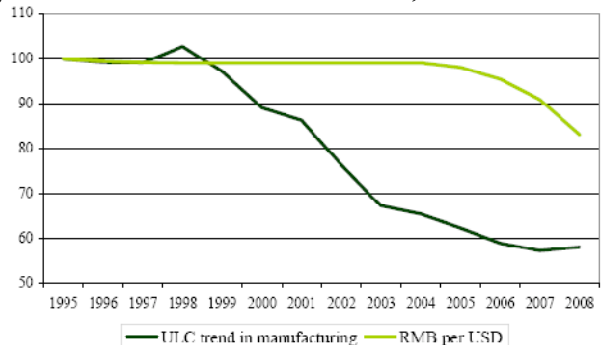
Figure 9: Chinese Current Account, Capital Account, Reserve Account as a Percent of GDP



Source: IFS

The source of those surpluses is the dramatic decline of unit labor costs (ULC) in China since 1995 (when they devalued their currency.) The ULC in China today is about 40% lower than it was ten years ago, as figure 10 below shows.

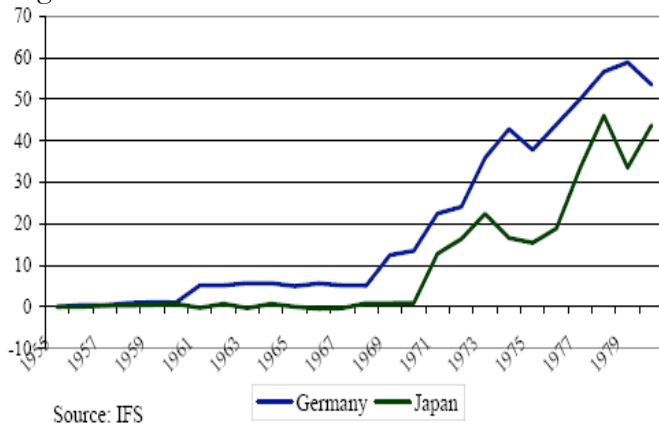
Figure 10: Unit Labor Cost in China, 1995-2008



Source: CEIC, Bureau of Labor Statistics; Goldman Sachs (Hong Kong).

Our concluding remark thus is that the Erinyes will do to the Chinese currency (RMB) - starting probably in 2010 - what they did to the German and Japanese currencies during the era of gold appreciation.

Figure 11: Historical Currency Appreciations of Rising Industrial Powers



As always please, enjoy the ride!