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## listeningin

# Not Irrational

*Macro Issues Overwhelming Other Market Cares, Bianco Says*

*The European monetary union teeters on the brink of disintegration one day, and the markets go into a tail-spin, in lockstep. But wait, here come intimations that Germany and Greece may be finding common ground in some improbably leveraged bailout scheme, and markets rocket back into the stratosphere, in lockstep, again. Not only has volatility become neck-snapping, but all correlations, as they say in the Street, have gone to one — as they are wont to do in a crisis environment. But these wholesale market moves are not entirely irrational, says market macro maven **James Bianco**, the head of Chicago's eponymous **Bianco Research**. As Jim sees it, investments as disparate as **Apple Computer** and Brazilian copper mines these days share a common fundamental: A deeply held conviction on the part of investors that when the going gets tremendously tough, they can count on a massive government bailout. We talked about that market — and mind — twisting faith, as well as other structural issues dogging the markets earlier this week. Listen in.*  
**KMW**



**Jim, I know you're just back from Europe and I want to talk about what's going on there. But first, why don't you bring me up-to-date on what Bianco Research is doing these days?**

I am still president; we are still located in Chicago. Bianco Research came into existence in 1998, so it's been around now, if my math is right, 13 years. We provide macro research to institutional investors. We are the people who fly at 5,000 feet, occasionally go to tree-top level, but never really lower than that. We have about 400 institu-

tional clients worldwide. We are affiliated with a brokerage firm called **Arbor Research & Trading**, which is in Barrington, Illinois, but has offices in Chicago, in New York City, in London

*In Memoriam*  
**Archie F. MacAllaster, II**  
1928 - 2011  
MacAllaster Pitfield Mackay Inc.  
Barron's Roundtable Member  
Friend

welling@weeden

**Kathryn M. Welling**

Editor and Publisher  
welling@weedenco.com  
(973) 763 6320

*Published exclusively  
for clients of  
Weeden & Co. LP*

**Noreen Cadigan**

Institutional Research Sales  
(203) 861-7644  
ncadigan@weedenco.com

**Andrew B. Van Ogtrop**

Institutional Research Sales  
(617) 757-8730  
avanogtrop@weedenco.com

**Jean M. Galvin**

Business Manager/  
Webmaster  
(203) 861-9814  
jean\_galvin@weedenco.com

Distributed biweekly,  
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mornings, by  
**welling@weeden**,  
and  
Weeden & Co. LP.  
145 Mason Street  
Greenwich, CT 06830.  
Telephone:  
(203) 861-9814  
Fax: (203) 618-1752

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and in Geneva, Switzerland.

**And by macro research, you mean a combination of big-picture economics and strategy?**

Well, we tend to write on big picture macro themes. I use those words to differentiate myself from an economist and a strategist, although we do cover those areas, too. Economists talk mainly about the economy, strategists are always picking sectors and stuff, and we are in the middle, touching on those but also talking about market structure and lots of other things along those lines.

**Right now, it must seem like everybody in the world is focusing on your bailiwick.**

Yes. Actually when I was in Europe, I talked a lot about this. A number of people, including ourselves, have been talking about correlations in markets, including the guys at **The Leuthold Group**. **Matt Paschke** actually sent me his version of the stuff that Leuthold did about two weeks ago. If you look at the average stock's correlation to the underlying index – for instance, by correlating the 500 stocks of the S&P 500 to the S&P 500, say, over a rolling three-month period, the correlations that we're seeing now are the highest that they've ever been. Not just high, but the highest in 80 years. This means that every stock trades like every other stock to a degree that we've never seen before. This has gotten a lot of attention lately. **Herb Greenberg** on **CNBC**, laments about three times a day that everything is correlated. For all of those guys who tear up balance sheets and stuff, it's like what's the point? Stocks all go up together, they all go down together. The market isn't differentiating. The subtext of what most people complaining about this correlation are all trying to say is that somehow this represents a big irrationality in the market. This is wrong. The markets are creating a dislocation. To some

extent I agree with that, *but only to some extent*. The larger issue here is that there is a vein of rationality within all this correlation –

**There is? Where?**

It is that all of these companies now share a common fundamental – whether you're talking about Apple Computer or the Brazilian stock market or anything in between. That common fundamental is whether or not Greece will default, will that lead to a banking crisis or not, will Europe have a recession, will the U.S. have a recession? Will the Fed do Quantitative Easing 3 or not? Will the Fed do something

more or not? Will the President's jobs bill pass or not? But you could argue that they have always shared those sorts of fundamentals.

**Exactly. You're talking about the global macro environment, and I've never thought about stocks as inhabiting their own parallel universes.**

Right. But what's different now, in the post '08 crisis period, is that we *expect* massive and decisive government action, and I'm using "government" as a broad term to

include the parliaments and congresses and heads of state of the world and/or the central banks. We expect massive and decisive government intervention. This is the legacy of the 2008 financial crisis. There is an old saw in Wall Street that in a panic or in a crisis all correlations go to one.

**Because they do.**

The reason all correlations go to one is because in a panic or crisis all that matters is whether it's getting worse or getting better. That is what drives all the markets up or down. In this 2011 version of all correlations going to one, we may not have a panic or crisis as the explanation – though I do understand that some people think we are having a panic or crisis – but I don't think it's a crisis of the sort that the old Wall

**'What's different now, in the post '08 crisis period, is that we expect massive and decisive government action.'**

Street saw refers to. I think what we have now is the belief in the market that if things got bad enough, we would expect governments to come in with amounts of money that would approach infinity to try to fix this problem – and that’s why we have these high correlations. So I would argue that to some extent the correlations *are rational*. They are not completely irrational like Greenberg would tell you, when he says that the market has lost its mind. But I would also agree with Herb that this does set up some dislocations in markets – that some stocks are unduly benefiting from flooding the system with money. Bad companies go up, too. Some companies also are unduly getting hurt by it, because in a crisis when they all go down, that includes the good companies. But that is a part of the world that we live in. I’ve talked to a lot of clients about these correlations. I understand why they are there and, to some extent, it’s not completely irrational.

**Isn’t another culprit behind the high correlations the enormous popularity of financial instruments like ETFs, index funds and things like basket trading?**

I hear that a lot, but I think it gets the causation backwards. It wasn’t that we built the **SPDR** ETF or the **Russell 2000** ETF and everybody hit their head with their foot and said, “What a great idea, we should stop trading stocks; we should only trade this thing,” and then we ran that to the point where these instruments dominate the markets. I know you’ve probably talked to a number of small-cap managers who detest the Russell 2000 ETF because all the low-end stocks get whipped around by it. But I would argue that the correlation starts the other way; they started as we started realizing that the markets are either going to make it or break it, depending on whether the Fed does something or doesn’t do something or Congress does



something or doesn’t do something. In other words, the world was looking for a way to express a macro bet, to buy or sell an index, and the ETFs became the preferred method to do that because they were cheap and they were easy. In other words, I would agree with the crowd that the ETFs create the correlation but the crowd gets the causation backwards. We were looking for something to trade because we thought the correlations were there, and that turned out to be ETFs. It wasn’t that we started trading ETFs and invented the correlation out of whole cloth. Does that make sense?

**To some extent. Macro correlations may be more common in a globalized, internet-centric age. But I think there are some serious structural issues in the markets – issues brought on by the domination of trading by derivatives like ETFs. They’re extensions, really of the sort of fallacy of composition issues that surfaced back in ‘99 and 2000 when everyone who wasn’t overloaded in the internut stocks was indexed, in or out of the closet – and all correlations went to one.**

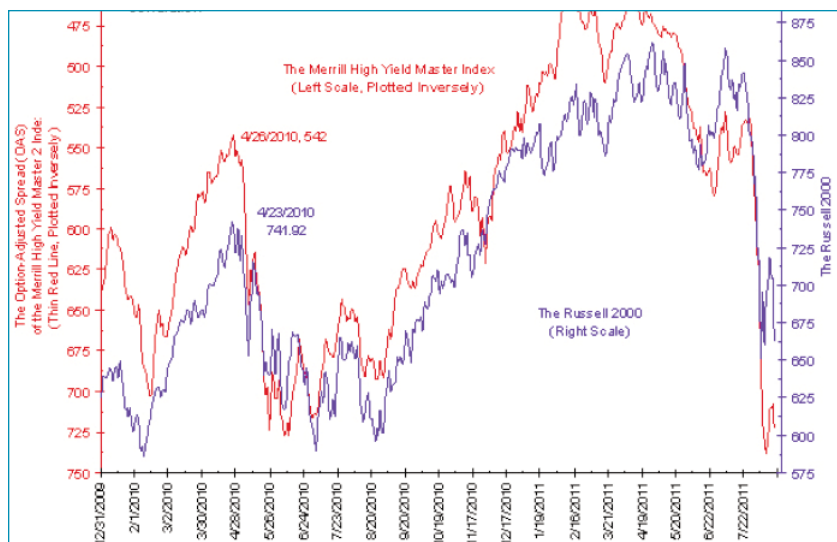
You are right. The market structure issue that we have right now is electronic trading. Just to give you one benchmark, in 2006, electronic trading made up only about 20% of **New York Stock Exchange** volume. Today it makes up

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contact:

Andrew Van Ogtrop  
(617) 757-8730  
avanogtrop@weedenco.com

Noreen Cadigan  
(203) 861-7644  
ncadigan@weedenco.com





about 75% or 80%, so in the space of a little more than five years we've had a wholesale shift in the way trades are executed. Electronic trades have gone from being a minority – at least on the New York Stock Exchange – to the majority – although there are no official statistics on electronic trading.

**Don't forget, at the same time, the NYSE has slipped from domination to one of the crowd, as the market fragmented –**

That's a whole other dimension. Nonetheless, the estimates are that somewhere around 75% of trades are executed electronically, with the largest part of that number being high frequency trading, although algorithmic trading and basket trading, all those other variations on that theme, are thrown in there, too. I would argue, again, that all of this electronic trading is best done on a macro level, that electronic traders are looking for ways to express macro bets, buying and selling lots of different securities in terms of macro bets. But let's leave off the table the high frequency traders. They are the digital version of trying to get between the wall and the wallpaper. In fact, what those guys are trying to get between is the glue and the wallpaper. The gap between the wall and the wallpaper is too wide for them right now.

**The thing about HFT is that they could be trading anything. All they trade are blips on a screen. They have basically turned the markets into video games.**

Yes. Exactly. As a matter of fact, at the beginning of last year, the website, **Zero Hedge**, did something I thought was very funny and spot-on. They did this thing they called the "Trader of the Month" to highlight extraordinary

traders making good decisions and making their clients lots of money – and then they awarded it to a **Cisco** router. That's basically what a stock trader is today, right? Market structure is very different. And, by the way, when you talk about market structure, here's something else that we've been highlighting: The stock market, we were all taught in school, is a *leading* indicator. When the equity market does something, it's supposed to be foretelling where everything else is going to go. So when things look bad, but the equity market rallies, that's a sign that things are about to get better. When it turns down, when things don't look bad, that's a sign that things are going to get worse.

**That's the theory.**

Exactly. Except that for the last couple of years, the stock market has not worked as a forecaster to the extent that we were all taught to expect. A great example of that is real estate. Prices peaked in '06, if you use the *Case-Shiller Index*, and then they started on their way down. In '07, credit peaked and started on its way down. In late '07, after the first round of the financial crisis, the stock market peaked, but then it really didn't fall apart until the fall of '08 and early '09. I emphasize, *it didn't really come apart until then*. Continuing down this line of reasoning, credit bottomed in December of '08, and the stock market didn't bottom until March of '09. I've actually been pointing out this lagging action by the equities market in some of the writings that we do. I have been running these overlay charts showing that credit is doing far worse than equities, like the one [nearby] showing the Russell 2000 following high yield spreads. And as I said before, we're in a highly correlated time, so that when you see a divergence set up like this, I would assume that the divergence would close. In a highly correlated time, divergences just cannot go on for months and months. And when picking which way the divergence closes itself – does it close itself with equities going to what credits are doing or with credits going to where equities are – I would say it's with equities following credit. Credit has been doing far worse, though maybe now we're starting to see equities realign with credit.

**What's your take on why equities are now the followers?**

My theory as to why that is, factors in the same market structure issues I've mentioned. With

some 75% of the trading in the equities market being electronic trading, what the equity market has lost is the *human being* who used to be making discriminations between good stocks and bad stocks, allocating capital efficiently, rewarding those who do the good things and punishing those that do the bad things. Instead we've got what we've come to refer to on Wall Street as the "risk on days" and the "risk off days."

### **Completely indiscriminate all or nothing trading –**

Right. By contrast, in the credit markets you don't have the electronic trading *to the degree you have in equities*. There is some electronic trading there, with the advent of credit default swaps, but it hasn't taken over to the degree it has in equities, at least not yet. So the participants in the credit market still tend to be fund managers – basically deciding that this credit is good, that credit is bad, and so we'll give money to the good ones and we'll take it away from the bad ones. That's why I think that the credit markets in recent years have assumed the leadership, or forecasting role that the equities market traditionally had. It's not about equities it's about allocation of capital. In equities, we're not really allocating capital anymore – we're just kind of throwing it at the S&P 500 or taking it away from the Russell 2000. So equities market transactions have lost their former ability to be a leading indicator. Instead, the equities market has become more of a coincidental indicator. So when you see a divergence open up, it's no longer a safe assumption, as it was in the old days, that it will be resolved in favor of the equities market. Forgive me, I watch a lot of TV here, but when **Jim Cramer** says something like, "Oh wow, the stock market is doing good, that means things are going to get better," I just shake my head and think, "Well, Jim, it hasn't been working that way for the last couple of years."

### **You're stomach is stronger than mine. I've long since switched channels.**

I understand, but my point is that these days you've got to pay more attention to what the credit markets are doing and maybe to what the commodities markets are doing – because we have not taken those markets and turned them into a bunch of Cisco routers banging on each other – at least not to the degree that we've turned the equities market into that. We're trying to, and we'll eventually get there – ruin

those markets, too – but we haven't quite pulled that off yet.

**Call me a cockeyed optimist, but I'm still holding out a slim reed of hope that we'll think twice before doing to our other capital markets what we've done to stocks. Even some corporate executives are getting pretty exercised about what they perceive as the way their stocks' valuations have come unhinged. Granted, I've never met a CEO who didn't think his stock was undervalued, but they're now complaining about price movements that shred any notion of a linkage between corporate fundamentals and a stock quote. Yet Wall Street has spent the last 30 years training them – and designing corporate incentive systems – to be all about "enhancing shareholder value."**

It's funny, because if I really want to get my fund manager customers irate, I make this statement: "Okay, so we have all this correlation and so really what the CEOs are attempting to do or not attempting to do with their companies almost takes a back a backseat to what Bernanke is going to announce. And this is not because it's new, the Fed has always done that. It's because now have we stuck three zeros at the end of what Bernanke is doing – or we might have stuck six zeros at the end of what Bernanke is doing – anyway, we have changed the whole structure of the amount of money the Fed employs. So what I've argued is, "Sure, Mr. Corporate CEO, Mr. Fund Manager, certain stocks might be unfairly punished and they might represent good value." Then I would say, "But if you have a long-term time horizon, like a five-year time horizon, you might be able to really take advantage of this situation."

### **But try finding a CEO or a PM with that sort of a horizon anymore –**

Precisely. Every fund manager I've ever said that to has replied, "Oh, we have a five-year time horizon; we invest for the long-term, we do exactly that." But then I say, "Yes, but the only stocks you hold for five years are your winners. Give me a list showing how many stocks you have held for four years that are still not making you money and where you still believe in the story." I always get silence on that. But that is what the definition of five-year winner is. I bought this thing in 2007, I'm 30% underwater from when I bought it in '07, but I still like the story. It's easy to hold something for five years when it's working for you. The holding

period is more like six months when they don't start to work out for you. That's the problem with the correlated markets. You might buy a bunch of cheap stocks today and you might be sitting in 2013, two years from today, still without having made any money in them. But if you hold on to 2015 or '16, they might be screaming home runs. You have to be ultra, ultra patient. And a large part of the fund management community has lost that patience.

**Sure, they've lost it because their clients have lost patience in large measure. They're measuring their PMS' performance on a daily basis, if not intraday.**

I agree. They are a product of the client base that they have. The managers didn't choose to have those time horizons. The customers demanded that they have those time horizons. That feeds into this frustration that everybody has – “Yes, I understand that I'm trying to do the right thing at my company and yes, I understand I'm part of the S&P 500. So whether or not we're going to have Greek default and the banking crisis seem to pummel the index of which I'm part – and meanwhile nobody cares about whether or not we've got a new product. So my stock is falling and nobody cares that, if I'm **Boeing** (BA), say, our new Dreamliner is coming out today; we're making delivery to **All Nippon Airways [ANA]** (ALNPF:US; 9202:Tokyo) of the first Dreamliner today. It gets to be very, very frustrating. And when you look at my stock, if I'm Boeing (to use my example again), and you look at the S&P 500, it's hard to tell the two apart at times. So why do I keep banging my head against the wall trying to run this company if all I am is just another cog in the S&P 500 index? That frustration I understand and I think, to some extent, that *is* creating inefficiencies that are hurting the economy over the long-term.

**It is hurting capital formation, quite evidently. Which is supposed to be why we have capital markets in the first place.** Yes. It is hurting capital-raising and capital formation. It is hurting the allocation of capital. To that extent, you can blame the 2010 *Time Magazine* Man of the Year, Ben Bernanke. All of his “extraordinary means” and Operation Twist last week and all the other central bank machinations dominate the conversation in such a way that equities are trading with very high correlations. But in the long-term, what we really want to do is take what I do – focusing

on macro themes – and put that focus back in the fixed-income market; take this macro fixation out of the equities markets. Because traditionally, that's the way most fixed-income managers operate; they operate more on macro themes than anything else. That is why my client base is more fixed-income, although it's growing to include more non-fixed income managers by the moment, it seems like.

**Didn't you say earlier that the credit markets have been leading the equities markets because credit managers are still being somewhat discriminating – doing some fundamental analysis of credit quality?**

Yes, and they *are* doing more than equities managers – but that's not saying a whole lot. Fixed-income managers still tend to operate mostly on macro themes, just as they always have. We may want to go back to equities managers discriminating between good and bad companies, but I'm not holding my breath. We're not going back to that time any time soon because we still seem to want to worry about what Bernanke is going to do today or what he's going to do next week and fixating on that as critically important for everybody and everything.

**Don't you find it absurd that equities investors are clearly looking for a – call it what you want, a *Deus ex machina*, in literary terms – that's going to bail everybody out whole? It's pure mythology that governments or central banks have those *Wizard of Oz* levers to pull. I know markets are confidence games, but this is getting ridiculous.**

Where it's the most ridiculous is in Europe, with the European financial crisis.

**Did you glean any new insights into that unholy mess on your latest trip?**

I like to say that on its face, it's not hard to understand. The source of the European financial crisis is that they created the euro. In creating the euro, The European Union did something never before done in history, which was that for the first time ever, they created a monetary union without *first* creating a fiscal union. The way you usually have gotten monetary unions is that a bunch of countries have banded together and called themselves some particular name, like the Soviet Union. In other words, 15 countries or 17 countries come together and they call themselves the Soviet Union and *then*

they issue the ruble. They didn't issue the ruble first, while maintaining their separate statuses as 17 different countries. But, that's what Europe did in creating the euro.

**You're saying it has been an experiment destined to fail from the get-go?**

Yes, it has. I think the big mistake with the euro – and this gets to your question about everybody waiting for the solution – is that early on in the euro's life, we had what was called in bond trading parlance, the convergence trade. The situation in which the interest rates on the debt of all European countries traded within two basis points because the market thought at that point they were all the same thing. When that happened, the Greeks and the Portuguese and the Irish said, "Hey, the market thinks we're Germany and we can borrow an unlimited amount of money because the market thinks it is handing it to Germany. So let's do it." As a result, they borrowed way too much money and they got themselves in way over their heads and now that's simply what the crisis is. A bunch of countries have borrowed too much money and they can't pay it back.

**The lenders are not exactly blameless innocents in all this.**

No. They made a critical error; they thought they were lending to Germany. Then about two years ago, they had an epiphany, "Oh my God, we lent to Greece, we didn't lend to Germany!"

**Actually, they knew that all along, they just preferred lending to Greece because that's where they could earn slightly fatter spreads – without having to hold more regulatory capital –**

Right. So now you come up to 2011, you come up to today, and even while we are talking there's breaking news coming across my screen that the EU finance ministers have announced something or another yet again. It's almost like the market is still waiting for that red *Bloomberg* headline to come up that makes us all collectively slap our hands on our foreheads and go, "Oh my God, that's the answer, why didn't we think of this 15 months ago, that's how we fix this problem!" Well, that *is* mythology. That headline is not going to appear. That painless solution that everybody thinks exists out there somewhere *doesn't exist*. All we have are a bunch of really bad choices. Does Greece default? If they do default, do we have a banking crisis? If we decide to make the rest of the

European Union fund Greece and keep throwing other countries' taxpayer money at them, how long is that going to go on? The Greeks have shown an inability to actually cut spending because they don't have to; because they are getting financed by Germany and France. That is the essence of their problem and it grows by the day and it grows by the hour. You are right, that mythology is alive in the markets; that is what everybody is waiting for. And that is also leading to more correlations because we expect some kind of answer to this big difficult question. But the reality is that there isn't an answer to this big difficult question.

**The Europeans you just visited are waiting for a bailout, too?**

When I was there last week, what I found was that they're all over the map on this right now in Europe. There are some Europeans who say we are very near Armageddon and there are others who think the problem is being vastly overstated. And, of course, there are some in between.

**Let me guess, the Germans you talked to were in the first camp and the Spaniards in the other?**

Well, I was in Austria, Germany and Switzerland last week, so that's who I tended to talk to. Although, within each firm, they tended to have nationals from just about every European country, so there would be Frenchmen in the Swiss firms and Germans and Englishmen too. My point is that on the European financial crisis, they were all over the lot. I've always taken that as a sign of confusion. No one is exactly sure what to make of any of this. The Europeans are over the lot. So what I have said, as far as the European crisis goes, is that the simple answer is there is no apparent solution now. I know I am being a little redundant in the way I said it – but that's because I want to emphasize the word *now*. There is no solution now. That doesn't mean there won't *ever* be a solution but most likely the European financial crisis has to get worse, first.

**Meaning that European leaders have to get really scared?**

Yes. I liken it to '08. If Bernanke and **Henry Paulson** had held a press conference in the spring or summer of '08 and Bernanke appeared with white hair like he'd just seen the burning bush (Paulson couldn't have, because he's bald), and they had said, "We just talked to



God, we've seen the future, it's not good and we're going to propose a Troubled Asset Relief Program, which is going to be a \$700 billion recapitalization of the banks, and the Fed is going to print \$1.75 trillion in quantitative ease," nobody would have bought it. Not in the summer '08. Not only would we have rejected those ideas, we would have demanded that those guys resign for even thinking about them. But when the situation got sufficiently bad enough, after Lehman, all that we wanted was for the crisis to go away. So that fall, we were more than willing to accept those programs and then even make Bernanke *Time Magazine's* man of the year for doing some of this. I tend to think that Europe is kind of in a pre-Lehman type of mentality now. Remember, pre-Lehman here, the big watchword used to be "moral hazard." Now, what "moral hazard" means to me was that we were worried more about the equity and propriety of where taxpayer money was going than about fixing the problem. And Europe is in that mode now. They are more worried about the equity and propriety of where German taxpayer money is going or where French taxpayer money is going than they are about fixing the problem. And I completely understand that. But then, post-Lehman, all we said was, "Make it go away, I don't care what it takes, just make the crisis go away." That's when we got TARP and that's when we got quantitative easing. Well, at some point, the Europeans have to get to that mode, where they say, "I don't care about the propriety of using French taxpayer money or German taxpayer money, just make the crisis go away." But in order to get to that mentality, I think the situation has got to get worse first. Now, how bad does it have to get? Does it have to get as bad as Lehman? Or worse than Lehman? Or, did they learn lessons from Lehman so that they'll get religion before it gets that bad? I have no feel on that.

#### **Darn.**

When I was talking about this exact question in Europe with a lot of people, they were all over the lot. A lot of them said, "Oh, it's got to get way worse than Lehman." A lot of them said, "No, we had the near-death experience in '08, so it doesn't have to get that bad before we get the solution." So we'll just have to see how bad it gets. Then, what happens next – whether we see a complete bailout – is open to lots of different interpretations. We might get a complete bailout of Greece; we could get a recapitaliza-

tion of the banking system. We could see the ECB get the ability to do quantitative easing like the Fed. We could get all of the above, some of the above or something else we haven't thought of yet. We're still in the mode where, when anybody proposes to do anything to fix the problem, at the EU level or the ECB level, immediately they get pushed back. Somebody says it's unfair. It's unfair to some taxpayers, it's unfair to some countries but not to others. It's unfair. It's unfair. That's what "moral hazard" was here. But once the crisis gets bad enough, nobody will care about the fairness of the solutions. They will just want the problem to go away. But they're not there yet, and that's why I think it has to get worse.

#### **You mean they're still not staring into the abyss?**

No, they're staring into the place where they stare into the abyss! I guess they have to stare into it, too. I do think it has to definitely get worse before it gets better.

#### **That doesn't argue for calm markets for quite some time.**

No, I don't think that we are going to have calm markets for a long time – because we still haven't fully dealt with the credit crisis of 2008. The way we've explained it is that for 30-plus years, until 2007, the developed world (and let's define that as the EU and the United States) moved forward on the basis of credit creation. The idea was that as long as we kept borrowing more money, we kept improving our standards of living and our GDP growth rates. When the economy slowed, the central banks of the developed world (the Fed and the European central banks and the ECB, eventually), would cut the cost of credit, lower interest rates. That would encourage people to take out more loans, the growth rate of debt would go back up and the economy would speed forward. Conversely, when the economy was growing too fast and we worried about inflation, we would raise interest rates and slow down that debt creation – and the economy would slow down. It was a very simple process. But starting around 2007 or 2008, *the private sector* (let's leave governments off the table for a second) found it had borrowed too much money – and couldn't pay it back, especially in real estate but even also at the corporate level. So the private sector started to deleverage – and no amount of cutting the cost of credit, driving interest rates to zero, would get people to take out fresh loans to buy



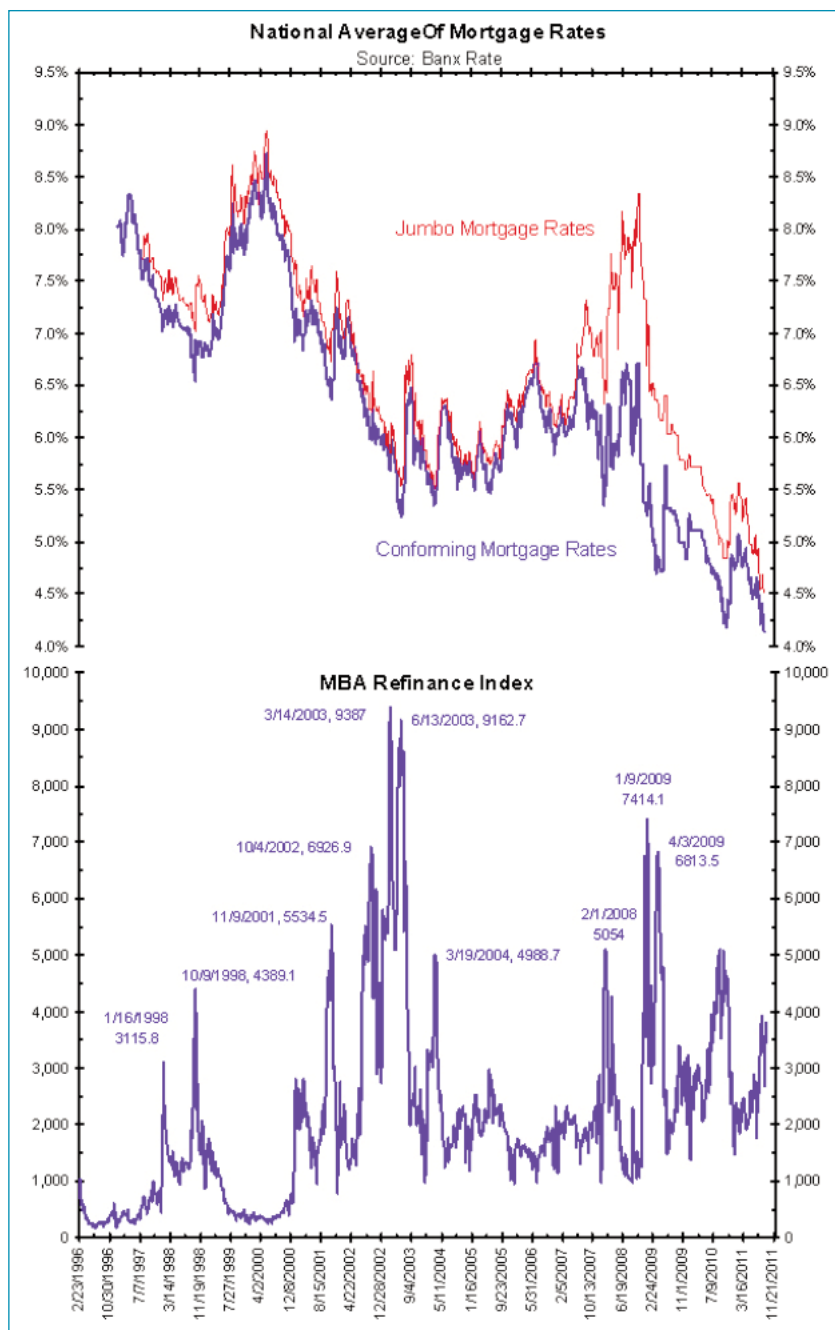
a house or even to refinance. In the fixed-income world, there's a big discussion now because even with these ridiculously low interest rates, we're nowhere near record volumes of refinancings. But that is part of the deleveraging process. Credit standards are too difficult right now for the people who are under water on their mortgages or who don't have a job to refinance. And that won't change no matter how much lower they drive interest rates, with Operation Twist or anything else. [See nearby chart.]

**No. Sooner or later, those loans have to be radically restructured – meaning losses will have to be taken and recognized to clear the market.**

Yes, the question is, how quickly? We were deleveraging in '08 and '09, but that is an ugly and a painful process and things got out of hand. So the governments of the world stepped in and *they* releveraged. They ran huge budget deficits; they funded huge bailouts. They funded gigantic stimulus programs in order to offset the private sector deleveraging. To some extent, it worked. It calmed markets down. The markets rallied and the economy pulled out of its recession. But it only worked to the extent that it could *before* the releveraging of government balance sheets hit its limits. That started last year in Greece and now the whole southern periphery of Europe (because we're still talking about the developed world) can no longer borrow anymore at a reasonable cost. We're worried now that that's going to spread into the northern part of Europe and restrict their borrowing. Even today, **S&P's** sovereign credit raters said that if Europe expands its EFSF [**European Financial Stability Fund**] bailout facility to \$2 trillion – and they *have* talked about leveraging it to \$2 trillion – then S&P would cut the triple-A credit ratings of everybody in Europe.

**Of course, why anybody still pays any attention to the credit rating agencies is a whole other issue.**

Right, but while some mutual fund managers and some hedge fund managers may no longer pay attention to the ratings agencies, the thing is that credit ratings are written into the Basel III capital requirements for banks and are still written into the rules of the central banks. So were those governments' bonds to lose their triple-A ratings, it *would matter* to bank credit, it would matter to the idea that you can borrow



them without a haircut and it would matter to everything else. By the way, in the U.S., we've gotten away with it because the U.S. is still a *split-rated* triple-A. S&P lowered its rating on the U.S. to double-A-plus, but **Moody's** and **Fitch** are still at triple A. Since two of three are still at triple-A, we can still pretend that S&P did nothing. The next downgrade, if Moody's or Fitch were to follow S&P's lead, would actually matter *a lot*. That's why, even though we went nuts on the S&P downgrade, it's really the next one that will matter. The next one that issues a downgrade would make the U.S. a split-rated double-A-plus, which would change some of the

rules.

**In any event, you're saying the governments of the developed world have hit the limits of releveraging?**

Well, as far as the U.S. is concerned, I might say the United States government still has the *ability* to borrow more money but is lacking the *political will*. That's why we have the **Tea Party movement**, that's why we went to the brink of default with the debt ceiling bill last month, and why we briefly flirted with going to the brink of yet another government shutdown on September 30, when the continuing resolution got held up. So the economists and the financial guys can assert that the ability of the U.S.

government to borrow "X" trillions more is still out there in the marketplace, and that may be true. But we're retarding that ability via political will. In Europe, their borrowing capacity is being retarded by the financial markets, which are just saying, "Too much." So where does that leave us?

**Good question. And the answer is –**

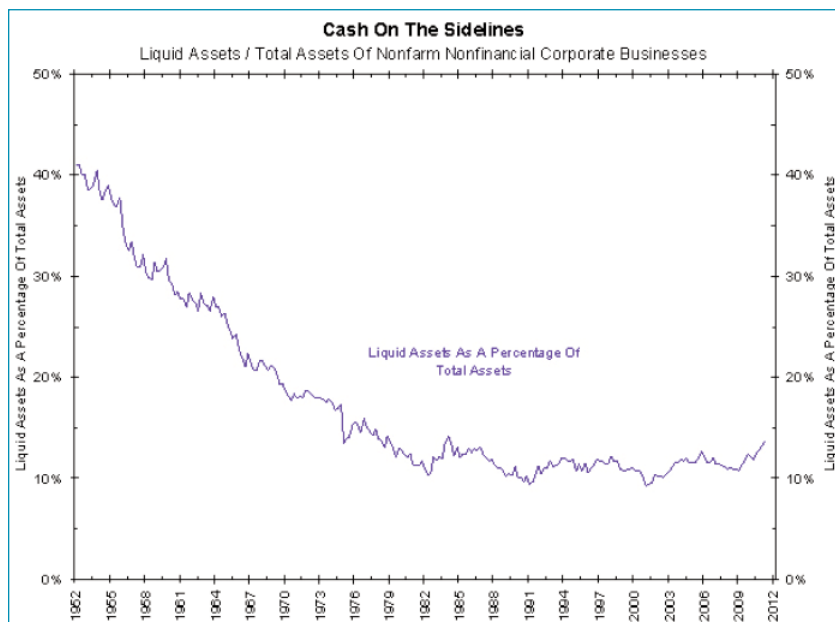
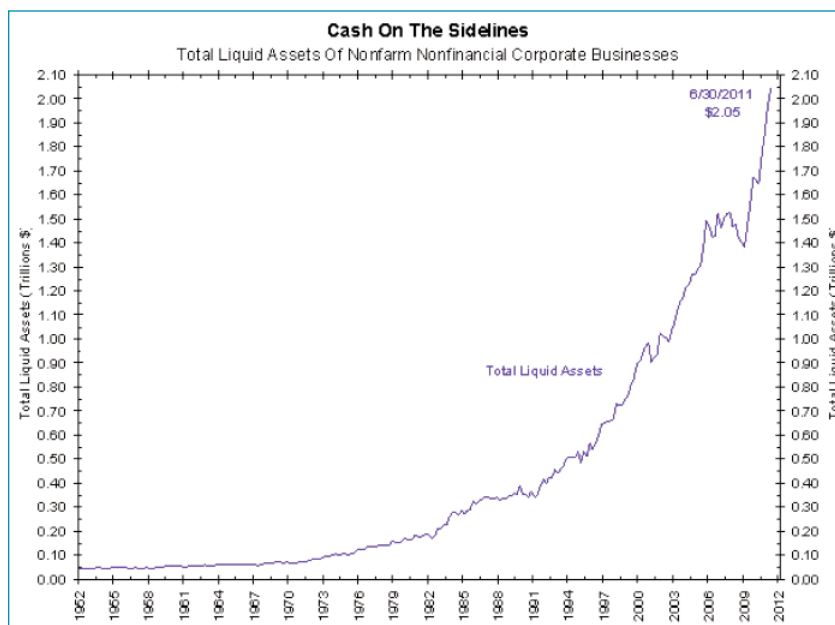
Well, while corporate deleveraging continued but was being offset by the government releveraging also continuing, that calmed markets down and economies got better. But now that we're starting to see the end of the government releveraging – and I won't go as far as to say that we're seeing government *deleveraging*, but governments cannot continue to borrow, borrow, borrow – and yet the private sector is continuing to default and borrow less and default and borrow less – all the sudden now we're getting an overall deleveraging. So now, the government can't offset private sector deleveraging – and that's why the instability in markets started to kick in again this year. That is what has been driving this instability – the idea that we're back in the deleveraging mode again. That same ugly word that we did not like in 2008 now it looks like it's back again.

**What do you say when people invariably point out that major corporations have trillions in cash on their balance sheets and so theoretically don't need to continue deleveraging?**

We wrote something about that myth of cash on the sidelines last week. Everybody likes to use the number like you pointed out, saying that there are "trillions on corporate balance sheets." But that's the *nominal number*, much like the nominal level of GDP, it rarely decreases. Of course cash on the sidelines is at a record nominal level – it usually is. It's the old story about "one hand clapping." [See top chart, nearby.]

**Tell me about it!**

The balance sheet cash has to be compared to something else on the balance sheet for relevance and so we compared balance sheet cash to total assets of all of those corporations [bottom chart, nearby]. And when you compare total assets to cash, lo and behold, what you find is that the number is slightly elevated but really still within the range that we've seen over the last 25 years. There's *not* really that much excess cash on corporate balance sheets. So



there are \$17 trillion of corporate assets according to the Federal Reserve's flow of funds number, against \$2 trillion of cash. That ratio is about 13%; it's only slightly high. Over the last 25 years or so, that ratio has run at around 10% or 11%. So the current level of corporate cash is nothing extraordinary like people want to make it out to be. So what I would say is that yes, corporations are running slightly higher-than-normal cash levels, but that's because they're deleveraging and the numbers are not extraordinary. People often try to say that the \$2.05 trillion liquid assets number means that corporations are swimming in cash, but that's not necessarily the case.

### Did you also run a calculation comparing liquid assets to liabilities, for example?

Yes, I don't have the numbers memorized, but it came out to something similar. Over the last year or so, we actually calculated a quick ratio for all corporations and did stuff like that. All of the calculations showed that cash is slightly elevated, but not that extraordinary. It's not some two standard deviation thing that's way out there like people want to believe. So it just doesn't represent extraordinary buying power for corporations or tremendous insulation for them, either, for that matter.

**I'm also curious about how much of that cash is matched by a balance sheet liability – is there only because large corporations have been in an almost unique position to take advantage of zero interest rates – versus how much is actually cash thrown off by operations.**

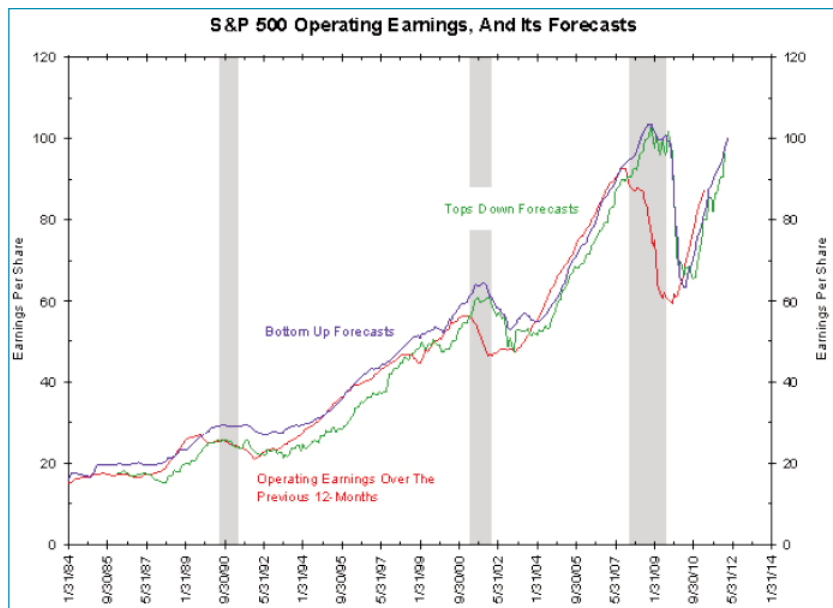
Good points. I was going to add that what everyone tends to forget, too, is that earnings are cyclical.

### You are a killjoy.

No, no, no, but the truth is that the earnings numbers we're seeing right now might be cyclical highs. And one of the things that leads to me thinking they're at a cyclical high is that margins are at record levels – and the reason that margins are records is – remember **Al Dunlap** at **Sunbeam**?

**"Chainsaw Al,"** sure. I assume you're referring to his ruthless cost-cutting, not the accounting fraud he used to goose sales and earnings?

Right, companies would bring him in, during the 1980s and 1990s, and he'd lay off half the work-



force and, for the next couple of quarters, the earnings would look fantastic because they hadn't quite lost half their customers but they'd lost half their expenses. Then two or three years down the road, there'd probably be a train wreck, but at least initially it would look good. Well, corporations have been following *part* of Chainsaw Al's example. They have pared back quite a bit on their expenses, cut, cut, cut, cut. So their margins look pretty good. But the next question is what happens to their top lines as we move forward from here? This gets into a whole discussion about Wall Street's absolute inability to forecast earnings. It's just absolutely an embarrassment the way that Wall Street forecasts earnings. [See chart, S&P Operating Earnings and Its Forecasts, nearby.]

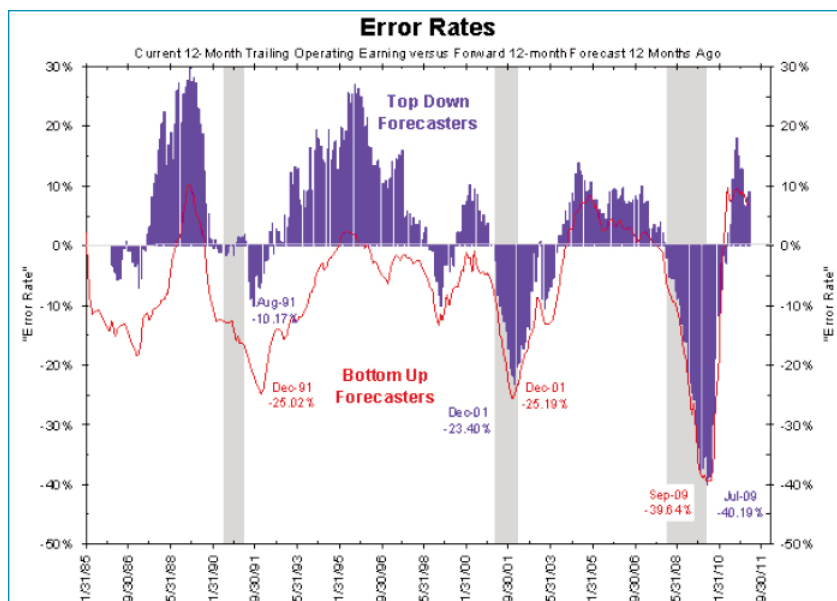
### And then uses those forecasts to try to justify valuations –

Exactly. Right now, trailing 12-month operating earnings on the S&P 500 are about \$90 a share. The consensus estimates that 12-months forward earnings will come in at a little over \$100 and be at around \$110 for the end of 2012. That's the rhetoric that you hear from everybody in Wall Street – "Oh, look at that \$110 earnings number and then look at the S&P 500 at under 1200, or at 1150, where it is right now."

**Right, it's a screaming bargain – assuming those earnings come in as expected, which is a heck of a stretch.**

Right, the forward P/E says the market is a great bargain, buy it. But what *I say* is that will work *only* if that forecast comes in. I want to





add another quick word about Wall Street's forecasting ability. We do this chart of an earnings forecast statistic we call "error rates." The error rates are the difference between the 12-month forecast and what actually is reported. Over the last 25 years, the error rates have been getting larger, *not* getting smaller. Wall Street is the only place where, when you practice something, you get worse at it. So analysts have had 25 years of trying to guess earnings and they're actually doing a worse job now than they or their predecessors were doing in the '80s or the '90s. [Chart nearby.] It's interesting, too, to note how the error rates of the top-down and bottom-up forecasts have varied.

### What a shock, the Street does better with the tailwind of a bull market.

Sure, and we all know the typical reasons for it. The earnings forecasts are more marketing aids than actual honest assessments, then there are the conflicts of interest inherent in investment banking relationships and the analysts' own need to retain access to the companies – which they might lose, were they actually to say something negative about them. It all shows up in these horrible earnings forecast numbers. Anyway, \$110 is what's being projected and if that happens, you would say the market is cheap and I'd agree with that. However – and here's a big however – if we have a recession, the average Wall Street earnings forecast has missed in the last three recessions by at least 25% and by as much as 40%. So the \$100 number becomes \$75. S&P 500 earnings go from the actual \$90, where they are now on a trailing 12 month basis, to \$75, a 10%-15% retracement in earnings – but a 20%-25% (if not more) retracement from forecast. So, if we have a recession, and we get \$75 of earnings, today's same 1150 on the S&P is expensive because you'll get contracting multiples as well.

At the same time, all that corporate cash you were talking about that now looks like it's "on the sidelines" will start to disappear. That gets back to this idea that amid this deleveraging, corporations are in great shape. Well, as I said, they don't have as much cash as people think they do on the sidelines and second, if we have a recession it's going to blow a giant hole in the side of their earnings and probably in their revenues, too. And all of a sudden, the "cushions" that the companies have had won't be there. One final thought for you on that: The last recession was *the worst* since the Great Depression and we saw earnings miss by 40%. Now, they probably won't miss by that much if the next one is a mild recession, you might think. But the 2000 recession was *the mildest* recession we've had in 100 years and the earnings forecasts still missed by 25% on that one. So it almost doesn't matter what severity of a recession we have. No matter what, we're going to have a big miss in the earnings numbers – at least that's what history says and what I think will continue to be the case.

**I would put money on it.**

Which is why I say it really comes down to the macro thing, again. Are we going to have a recession? Aren't we going to have a recession?

**Okay. Here's a drum roll. What's your call?**

I've got the chance of a recession at 51%.

**That's an odd number –**

I picked that number *not* because I have any kind of model. I picked that number for two reasons: First, because the consensus on Wall Street, as I've been reading and understanding it, is that there's around a 30% chance of a recession, maybe as high as 40%. I wanted to go higher than the consensus, so I picked 50%. But then I thought 50/50 sounded wishy-washy, so I picked 51%. That's because, if you were to ask me, "Well, yes or no on a recession?" I would say, "Yes." So that's why I didn't go with 49%.

**Well, 51% doesn't sound like you're very confident in your "yes" call. Why not say the odds of a recession are 75% or 90%?**

Again, in my mind this isn't any kind of formula. It's a conceptual number and it kind of says the same thing. I'm more pessimistic than the consensus and I would probably bet on a recession being more likely than not. I have a couple of reasons why I would bet on a recession. First of all, year-over-year economic growth at the end of the second quarter was 1.5%. Every time, since the end of World War II, that we've had year-over-year growth sink below 2%, we've had a recession – every single time. We're in that mode now and we've only had 0.8% growth in the first two quarters of this year. So we're already very, very close to being in a recession to begin with; we've already slowed down. That's always been my dig on economists. They always talk about a "soft patch" or a "mid-cycle slowdown." But I've always said there is no such thing – that's what they call the economy right before a recession. It doesn't ever speed back up from these levels. It goes into a recession every time it slows down like that. That's just the way economies work. The second reason I'd bet we're in a recession is that when I look at the economic indicators, I'm old school in the way I analyze them. I like to look at the leaders and the coincident indicators and the laggards. I use **Lakshman Achuthan's** stuff over at **ECRI** more than the **Conference Board's**, and the ECRI work does not look good at all right now. The leaders look poor and the coincidental numbers are starting to look bad. The Chicago Fed's National Activity Index, which is a good coincident indicator, also came out looking ugly this week. Then, I throw into the mix my expectation that Europe has got to get worse before it gets better, and that puts more pressure on the banks, not to mention that we're all worried – or all hoping – that Bernanke is going to pull some big rabbit out of his hat, but I don't think he will or can. That's why I come up with a 51% chance for a recession that would blow a giant hole in the side of earnings forecasts. So all of a sudden the market doesn't look nearly as ultra cheap as everybody thinks it is.

### **It already *feels* like a recession, even if it hasn't been officially designated –**

Have you heard the expression, "nowcasting?" – I think **Jon Stewart** on *Comedy Central* invented it. It means to take an event that just occurred and predict it will happen, and then claim credit for being right. That's largely what occurs in Wall Street. It takes events that just occurred and says they're about to happen. For instance,

I heard two people on *CNBC* today saying, "No, I don't think we'll get into a recession. We'll get slow, 1-to-2% growth. Well, that's what just happened in the last 12 months – we *had* 1-to-2% growth. But they were now *predicting* it like it's about to happen, so they're "nowcasting" it. My point is that the slow growth already started a year or a year and a half ago, so slow that it feels like a recession. The economic numbers are worse now than they were in January. It's always hard to predict the economy, but it looks like everything is pointing towards much lower numbers.

### **Especially what's going on in Europe, you were saying?**

I think definitely in Europe, it has to get worse. One other thing that I heard a lot, from the Europeans I just visited was that what they called "this American view" that kicking Greece out of the eurozone would fix their problem, is a non-starter. As one fund manager said to me, "Remember, part of the reason that we created the euro is the history of Europe, always warring with each other. So if we were to make one of the rules of being in the EU that you serve at the pleasure of Germany and France and if you misbehave, you get kicked out – but Germany and France will never get kicked out for misbehaving. That's not a good way to go." I completely agree. They can't kick Greece out of the euro anymore than we could kick Illinois out of the United States because it is running irresponsible budget deficits – as it is! Besides, the eurozone has been more than a generation in the making and they're not going to let the thing unwind because of a year and a half worth of default stories. They believe that the euro is here permanently – or for as long as Europe is going to be here – that's what they believe – and they would remind us that Europe has been around for 1,000 years already. It's not just a little experiment. They intend to stay together. The problem there remains that in a financial crisis, where we needed only to get three people in a room – Paulson, Bernanke and the President – to make decisions, they have to get about 50 people in the room, speaking eight different languages, and half of them hate the other half in the room. And that's why it's so impossible to get anything decided upon there unless it gets so bad that they just don't care about any other stuff and they just want the crisis to go away.

### **That doesn't bode well for the markets**

**there – or here.**

Most likely not. There was there was a story in the *Wall Street Journal* at the beginning of the month that the New York Fed was telling American banks to distance themselves from European banks because of all the problems that they faced. But that was like asking me to distance myself from my foot because it has an infection in it. I really can't do that unless I want to cut my foot off – and that's not a good thing. Well, likewise the banks are so intertwined in the developed world banking system that you cannot ever say that the American banks have a problem but the Europeans don't or that the Europeans banks have a problem but the American banks don't. They all go up and down together. They're going to sink together or they're going to swim together. We're not just eating popcorn and watching what's going on over in Europe, and thinking, "Boy, this is an interesting story." It has a direct effect on us, if for no other reason than that it has a direct effect on our financial system, our banking system.

**Which, you might add, is still nowhere close to the shape it should be in, three years after the financial crisis.**

Yes, because we've stalled the restructuring in the banking system.

**And actually consolidated it instead of breaking up the too-big-to-fail banks.**

Yes, I was talking with a client about this right before I left for Europe, we were remarking that the two things that we've accomplished since the financial crisis are that we decided concentrated financial assets are bad – so we made the system more concentrated. And the other thing we've done is that we've gotten rid of almost none of the bad actors. As I said, we managed it for a while because the governments relevered, the governments spent money like crazy, the governments funded all the bailouts and ran huge budget deficits. So for a little while, things looked like they were getting better. But now we're talking about debt ceilings and government shutdowns here in this country; meanwhile, the periphery can't borrow in Europe and they're creating leveraged bailout funds there. Plus, we just heard that the bailout fund needs a bailout. We're starting to look at the

limits of government borrowing. Yet with the private sector not ready to go on another borrowing binge, the developed world's growth now hinges on the governments' ability to borrow. If the governments can't do it and the private sector isn't doing it, economies are going to suffer. If neither side can do some borrowing then we have to suffer through the deleveraging until somebody gets to the point where they can do some borrowing.

**Not a pretty outlook, is it?**

It isn't a pretty story. But what I like to tell my clients is that we've seen this before in the last 10 years or so. So maybe it'll set up another March '09 buying opportunity that we could be properly ready to pounce on – instead of being on our knees praying for no more losses. So maybe we can invest and make money on the rebound.

**Given that, are you making asset allocation recommendations?**

I do a little bit of that. I believe the correlations in the markets aren't going away. I believe there's going to be a recession. I believe Europe is going to get worse, so as much as I hate the phrase, I do like the risk-off markets. I like the concept: Underweight equities, underweight credit, overweight government bonds because they're not going to lose any money. Last time I checked, the stock market has cost me 17% since May; the two-year note can't do that unless it goes to about 11% yield or maybe even higher. I do like those trades. To be honest, I was also saying that maybe a small speculative position in gold would work. And I actually think that it might still work. But I recognize what it has been doing here lately so I'm not pounding the table as a big, big gold bull right now. Actually, I have been pushing this idea about the risk off trade and want to stay in that defensive mode because once things get worse, I want to be in a position to jump into the risk on trade and make money on the rebound.

**Great, thanks, Jim.**

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