

The Sub-Prime Crisis, Gold, and Forecasts for the Stock Market

Joe McNay is the founder of Essex Investment Management, a Boston-based institutional asset manager with \$3 billion under management, including long-only and long-short hedge funds, with a focus on commodities and growth stocks. Doug Kass is the founder and President of Seabreeze Partners Management, a short-only fund. Both are contributors to Barron's and to the financial media, and were the featured speakers at a panel discussion at the Harvard Business School hosted by the HBS Association of Boston – "The Sub-Prime Crisis, Gold, Commodities and Where the Stock Market Goes From Here."



Joseph McNay



Douglas Kass

Two veterans of the investment industry, Joe McNay and Doug Kass, provided a somber assessment of the financial markets, identifying sparingly few areas for opportunity over the next several years.

Kass and McNay had hardly any kind words to say about the political and financial leadership responsible for creating the current crisis.

Kass refers to Bush, Paulson, and Bernanke as the "three stooges of 21st century capitalism," claiming they were "asleep at the wheel" during the period leading up to the credit crisis. He believes their policies, which facilitated excess leverage and poor lending standards, were "timid and unimaginative" and led to "challenges our economy and markets have never before seen." Kass characterizes these policies as "Ponzi finance," although he credits the Federal Reserve for its aggressive and appropriate action since the crisis unfolded last August.

"The actions taken by the Fed [interest rate cuts and the Bear Stearns rescue] speak to the depth of the crisis," says Kass. "Derivatives have poisoned the system. Leverage of 30-to-1 is like playing Russian roulette with five of the six



chambers loaded. When you include off-the-balance-sheet items like credit default swaps, it is like having all six chambers loaded and pulling the trigger.”

Kass reminded the audience that at the time of the Bear Stearns bailout, 1 month T-bill rates had dropped to 12 basis points and 3 month rates to 56 basis points – lower than comparable Japanese rates for the first time since July of 1993.

“With nanoscale interest rates, the twin diseases of greed and leverage compounded a situation where the financial system refused to look at itself in the mirror,” says Kass.

McNay says “we are in a set of conditions that are potentially catastrophic.” Emphasizing this point, Kass cites Merrill Lynch, which ended 2007 with \$37 billion in equity but has subsequently written off 73% (\$25 billion) of that amount. Citibank ended 2007 with \$118 billion in equity, and has written off \$38 billion. “These are remarkable figures and beyond belief,” says Kass, adding “Merrill will never again be Mother Merrill.”

Kass and McNay agree the Bear Stearns’ bailout was the right decision, and Kass stated the markets came “as close to collapse as anyone dares to imagine.” He says the time to deal with moral hazard was much earlier, but that would have required “a degree of foresight and forthrightness” beyond the capabilities of the collective leadership at that time.

“Quantitative models have led to investments in companies that the investors know nothing about,” says Kass, adding that this “did untold damage to the ability to distinguish value from lack of value.”

McNay traces the roots of the credit crisis to 1991, and cites a slow and gradual growth in leverage over a 15 year period, exemplified by home loans that were made with increasingly smaller down payments and homeowner equity. “This led to open ended greed on the part of all players.” McNay agrees with Kass and believes that nobody saw a problem coming. “It was irresponsibility on the part of investment banks consumed with greed,” he says.

McNay emphasized that growth in the money supply at critical junctures amplified the problem. “Greenspan increased the money supply in 1997 in response to Chinese troubles, in 1998 in response to impending Russian defaults, and with another major increase in connection with the Long Term Capital Management bailout. It was also increased at the end of 1999 in response to Y2K fears,” he noted.



Investment Opportunities

McNay operates on the principle that what is bad for something is good for something else and, in the current environment, believes gold is “the answer.” He believes the value of the dollar is being destroyed, and cited a 50% decline against the Euro. “If OPEC decides to stop accepting dollars for oil, we are a dead duck,” says McNay, adding “there will be a day when someone says ‘no’ to more dollars, and that will be a total disaster.”

“Gold is the best hedge against a falling dollar and inflation,” says McNay and he views the metal as appropriate insurance for anyone’s portfolio.

McNay notes it is easier to own gold, through ETFs such as GDX (which owns gold-related industries) and GLD (which owns bullion). McNay claims if gold prices properly reflected inflation, it would be a \$4,000 or more per ounce. [This is based on a 1980 price of \$850/ounce and an average inflation rate of 6%.] “Gold has not received nearly the public attention that one might have thought,” says McNay. McNay thinks the peak in gold will come when it is widely viewed as a “must own” asset, which is not yet the case.

In the US markets, McNay cautioned fixed income investors to stay in Treasuries, adding that certain currencies – Australian, Canadian, and Chinese – will perform well. McNay specifically advises against long term debt, and says that short term debt might be acceptable. “We are heading into a really dicey long term period.”

“The Euro is in trouble, as Europeans have as big a real estate problem as does the US,” says McNay. McNay believes short positions are good diversifiers in the current environment, and singled out “dynamic growth” companies, such as Google, Apple, and RIMM to perform well, along with companies that derive at least half of their income from exports.

Kass, plugging his own fund, points out that there are only \$5.4 billion in pure short funds, and most is in one large fund (not his own). “This is an unpopulated area, and potential investors are not knocking on our doors,” he says, arguing that lack of investor interest is creating market inefficiencies he can exploit. McNay countered by noting that current markets have the highest level of short interest ever, and cash in brokerage houses is also at an all-time high.

Kass forecasts “lumpy and inconsistent economic growth” over the next two to five years. “It will be a hard time for corporate managers to deal with a lack of pricing flexibility, and this will produce substandard returns for investors. All the tailwinds to growth, including fiscal and monetary policy, are turning into headwinds,” he says.



Impact on the Consumer

While most of the discussion centered on the machinations of Wall Street, Kass and McNay also addressed the plight of the consumer on Main Street. Overall, Kass believes a number of “prosperity killers” will impair the growth in the economy:

- Despite the Democratic “tsunami” that struck two years ago, the middle class is still being squeezed and there is a lack of job growth
- There is nascent but significant inflation, especially in food and energy
- Higher tax rates are inevitable
- Heavier regulation will occur, especially in the financial sector
- Trade protection will be implemented, which McNay called out as being “particularly scary”

McNay summed up the situation by saying “the US consumer is gradually getting destroyed.”

Kass carefully pointed to a number of positive developments in the economy:

- The process of addressing elements of the credit crisis has been underway for months.
- The housing marketing is “bottoming out.” When questioned about this assertion, Kass claimed the housing market has already declined by 20-22% and further declines were unlikely, based on an analysis of housing affordability data. [Note: the S&P Case Shiller housing price [index](#) shows a decline of only 12.4% from its peak in June of 2006. The housing affordability [index](#) indicates homes are becoming more affordable. However, this data is published by the National Association of Realtors and we do not believe they are a source of unbiased research.]
- Corporate balance sheets are in “terrific shape, although the same cannot be said of consumer balance sheets.” [This calls into question Kass’ prior claim regarding the affordability of houses.]
- Sovereign wealth funds, aided by the falling dollar, are eager to invest, particularly in financial institutions
- Stocks are not expensive relative to interest rates



Despite the near collapse of the markets which they describe, neither Kass nor McNay foresee an apocalyptic scenario. “The world is not coming to an end,” said Kass, “but this is a time to worry about preservation of capital, not return on capital.”

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