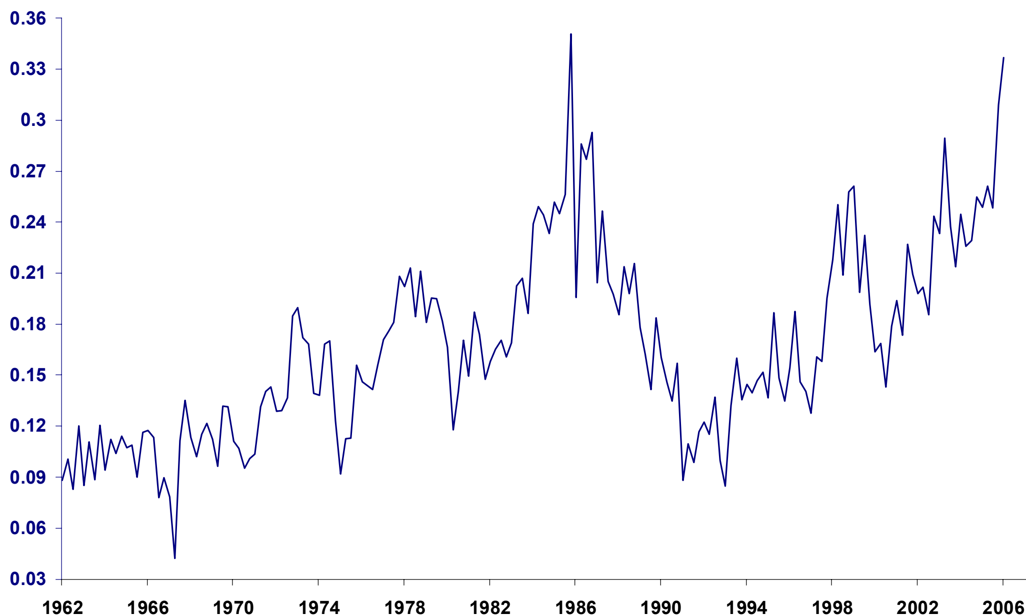
Stephanie Pomboy
212.989.3311

Captain Kirk

When Kirk Kerkorian's name resurfaced a little over a year ago in connection with his building interest in GM, two questions sprang immediately to mind. *That guy's still alive?* And: *What the heck does he want with GM??* Having read about Kerkorian's exploits back in the day, he had become a bit of a legendary figure for me… a sort of real life John Galt. It was this godlike image that made his interest in an aging and increasingly uncompetitive automaker so troubling. Had things started to turn a little mushy upstairs?? I mean what clear-thinking investor would want to bet on GM??

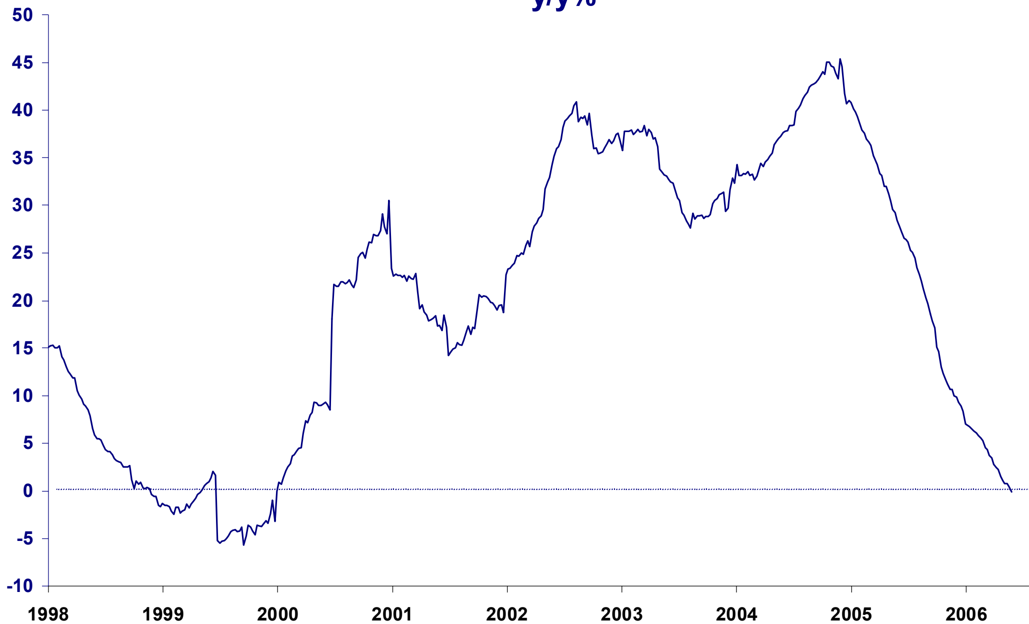
At a time when global financial markets are in total chaos, trying to gauge Kerkorian's mental acuity might seem a rather idle exercise. And it would be were it not for the fact that so many **global investors were now betting with him.** As they yank their dough from all corners of the world and take 'cover' in the U.S., investors have joined Captain Kirk on the USS Enterprise. **GM is, after all, a near-perfect microcosm of the U.S. economy at large.** Like GM, the U.S. long ago ceased being profitable on the manufacture of stuff and now gets by on feats of financial engineering. And, like GM, the U.S. is saddled with an increasingly geriatric workforce requiring it to borrow in mind-boggling amounts to make good on the retirement benefits to which these workers are entitled.

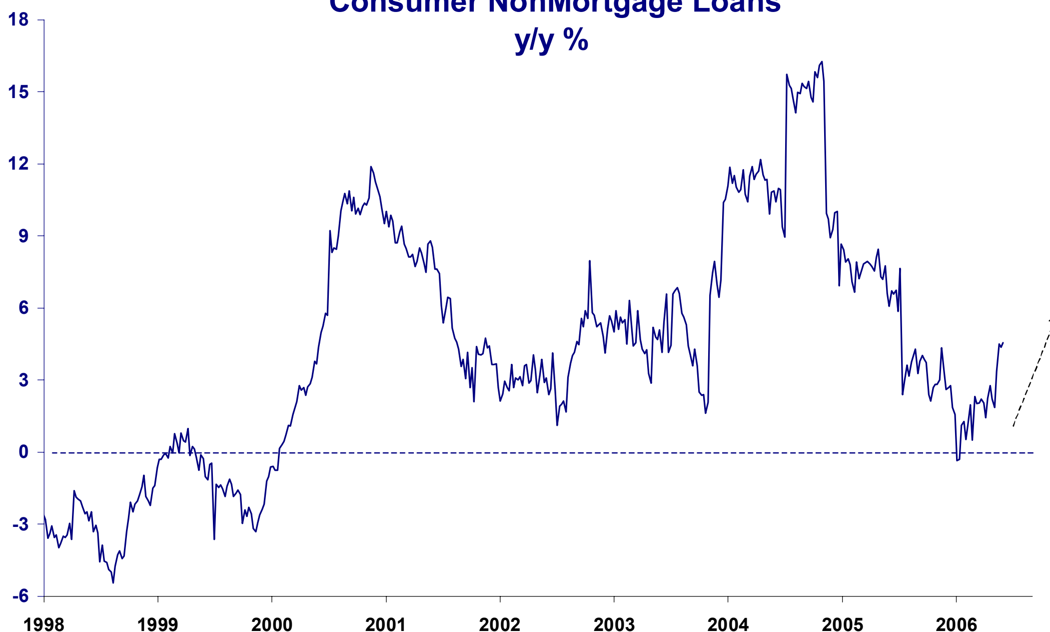
Just how torpid and unrewarding this whole business had become was underscored last week with the Fed's quarterly *Flow of Funds* update. The data reveal that **it now takes 34 cents of borrowing to generate each $1 of GDP. That's the worst credit 'mileage' since 1986.** It is pretty scary to think that the last time we were consuming this much credit fuel it was because interest rates were notching secular highs, whereas they are bouncing off secular lows today. **Wait 'til the mortgage reset cycle really kicks in!!!** It won't be long before we hear Sulu cry: *"I just can't push her any farther, Cap'n!"*



Stephanie Pomboy
212.989.3311

How, o how, will the credit-guzzling U.S. economy sustain its momentum as the cost of credit begins to rise? **Consumers are already scampering to maintain the lifestyles to which they've become accustomed**. As they find their home equity pipelines closed shut, **consumers have been forced into higher cost modes of financing.** In addition to the surprisingly large surge in Consumer Credit last month, the weekly bank asset data highlight how the demise of Home Equity loans has led to a surge in 'other' (non-real estate) consumer loans.





Source=Federal Reserve, H8 Commercial Bank Assets

These are the last acts of the truly desperate. **It won't be long now before these consumers are forced to do the unthinkable---spend less.** *Shudder!* **Undaunted, or blissfully unaware of this inevitability, global investors are now *overweighting* the U.S.** To wit, in the great liquidity flush that began on May 10th, the U.S. has vastly outperformed. The –2.5% decline in Treasury prices and –6.5% haircut in the S&P are mere nicks compared to the –21% rout in Emerging Market Stocks, -15% decline in the Nikkei and -20% decline in gold.

	May 10 - Present
Dollar	+1.8 %
Treasuries	-2.5
S&P	-6.5
Euro Stoxx	-9
CRB	-9
DJ World Stock Index	-11
Nikkei	-15
Gold	-20
DJ Emerging Market Stocks	-21

Many argue that it is not near-term economic prospects, so much as risk aversion that is driving U.S. out-performance. If so, that's even more disturbing! Obviously, these folks missed S&P's report last week which concluded that, **on its present path, the U.S. budget deficit will swell from 4% of GDP currently to 29% by 2050!!** Of course, we would be demoted to junk status long before then, in 2025. My copy may be out-of-date, but in my investment lexicon, *junk* is not synonymous with *safe haven*.

To be fair, S&P's research staff confidently concluded that the 'sweeping' fiscal changes necessary to forestall this outcome are about to take place. We, however, have our doubts. If a second term Republican with nothing to lose by cutting spending (and control of both houses!) can't get the job done, why should the next guy or gal have any greater success? On top of which, the economy they'll inherit is virtually guaranteed to be slowing now that the home-asset foundation has begun to crumble.

But, hey, there will be plenty of time to worry about these issues mañana. Of **more immediate concern is the fact that the deterioration in U.S. corporate credit quality appears to be well underway**. For all the talk about improved balance sheets, fully **85% of the companies making S&P's global negative creditwatchlist reside in the U.S.!!!**

	Negative Credit Watch	Negative Credit Outlook	Total
Asia pacific	13	27	40
Canada	9	31	39
Europe	38	83	121
Other	5	11	16
U.S.	101	339	440
Total	**166**	**491**	**657**

Source=S&P global fixed income research

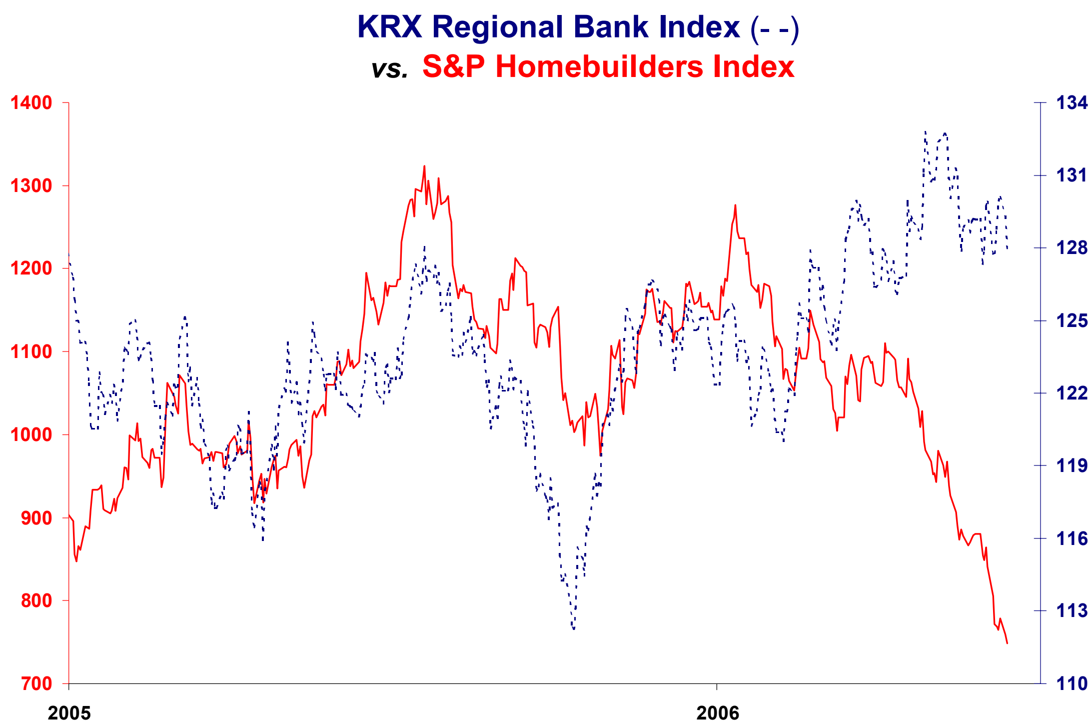
Stephanie Pomboy
212.989.3311

That investors are clamoring, "Beam me up, Scotty!", frantic to depart alien markets in favor of the U.S., would be troubling enough. But **that they're hunkering down in financials stretches the bounds of reason**. Up until this week the financials had been beating the pants off the S&P. And this 2-day setback was strictly a result of weakness in the investment banks (following Goldman's earnings report). The bank stocks in general, and consumer finance in particular, continue to outperform.

Long financials at the peak in the credit cycle??? At 89 we can forgive Kerkorian for being a little soft in the head. But what's everyone else's excuse? **Despite universal acknowledgement that the housing bubble is deflating (the debate being one strictly of degree), investors continue to clamor into financials.** Isn't it obvious that these are two sides of the same coin: housing on one side, and the folks who finance it on the other?

Indeed, **if the last real estate bust in the late 1980s is any indication, the next few years are not likely to be happy ones for the financial sector.** Obviously, the end of that boom brought about the S&L Crisis. With real estate values much farther extended than they were then and mortgage innovations exposing more home 'owners' to negative equity, the danger would seem even greater today.

Yet, you sure wouldn't know it to look at the stocks! Perhaps no segment of the financial sector is as exposed to the fortunes of the housing market than the regional banks. While the big banks derive their revenue from a broad array of dubious activities, from investment banking, to prop trading, to prime brokerage and beyond, **the regional banks are uniquely exposed to the housing bubble. Their business ...like the real estate market itself... is local. That is what makes their divergence from homebuilders so astonishing!**



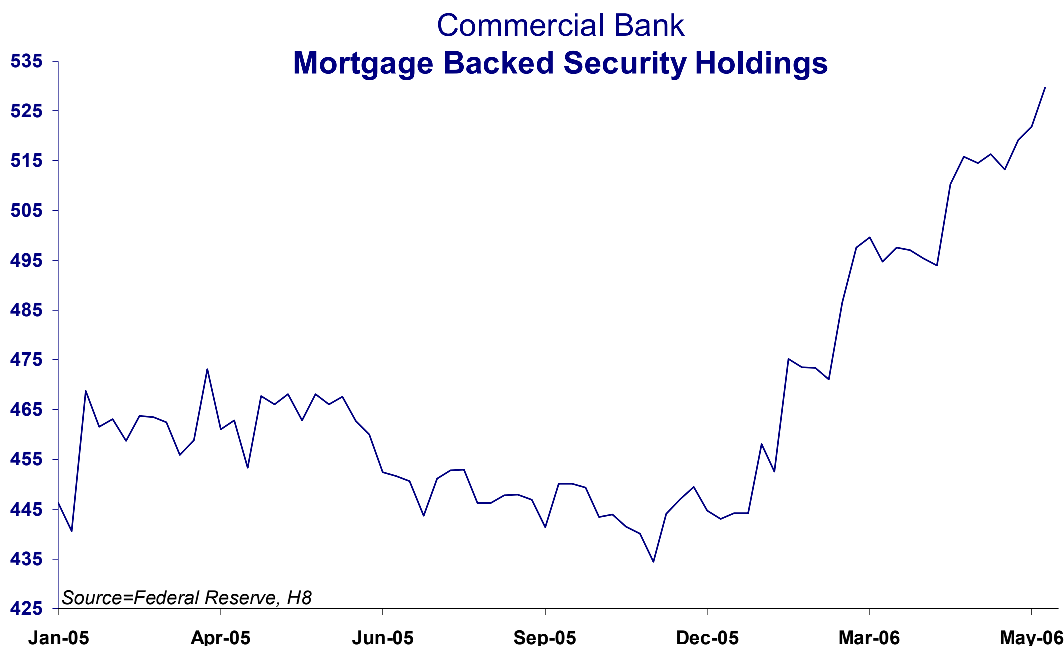
Perhaps the bet is that consumers are now so addicted to their credit crack that these financial institutions will be able to sustain their revenue stream by simply shifting consumers from one form of

Stephanie Pomboy
212.989.3311

credit to another. As the earlier charts suggest, this business is already picking up. However, at a time when mortgages are resetting in record number and housing prices are deflating, any lending volume bankers recoup is sure to be offset by rising delinquencies.

Woops! Did I let that slip? We're supposed to believe these guys have no exposure to rising delinquencies. They shrewdly offloaded all their risk in the great securitization boom of the last few years. It's now some unsuspecting foreign bank or insurance company's problem. *Sigh.* If only that were true. The fact is, **the U.S. banking system is more exposed to the real estate sector now than at any time in the postwar experience**. It is true they securitized a lot of mortgage debt, but the banks still have $3t in direct mortgage loans sitting on their books. That's a record share (43%) of total bank assets (see addenda).

On top of which, the banks have been avid buyers of the stuff that was securitized. In addition to their direct mortgage loans, they've amassed a portfolio of mortgage-backed securities. Indeed, it appears that **U.S. bankers are not yet satisfied they've built sufficient exposure to the housing bubble**. Just to be sure, they've ramped-up their purchases of MBS. **Since the beginning of the year, they've increased their holdings of MBS at a 48% annual rate!**



It will be an unhappy day when those now taking cover in financials discover theirs is but a levered bet on the housing market. On the bright side, they say misery loves company…and these folks will have plenty! **All those investors frantically pulling up global stakes in favor of the U.S. will soon discover they've inadvertently overweight the GM of the global economy**. Like Kerkorian, they've bet on a mature and debt-dependent business. Worse still, they've done so at the peak in the credit cycle!

In the meantime, investors will continue to clamor aboard the USS Enterprise, hoping it will boldly go where no economy has gone before…a credit galaxy in which the gravitational pull of rising rates and asset deflation have been repealed.

MacroMavens is the exclusive trademark of MacroMavens, LLC. The commentary released under its banner may **not be forwarded**, reproduced or referenced without the express consent of **MacroMavens**. While we presume the information and data contained herein to be accurate, it is not guaranteed.

Stephanie Pomboy
212.989.3311