

Meltdown, rebound, and beyond

CFA Society of Indianapolis
April 21, 2009

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ENTROPY ECONOMICS

GLOBAL INNOVATION + TECHNOLOGY RESEARCH

- focus on innovation, technology, and global markets
- noted research on
 - Internet applications, content, and traffic growth rates
 - wired and wireless communications
 - China
 - Fed, monetary policy, currencies
- 12+ years advising investors and analyzing public policy
- often featured in *The Wall Street Journal* and *Forbes*

— TB/month

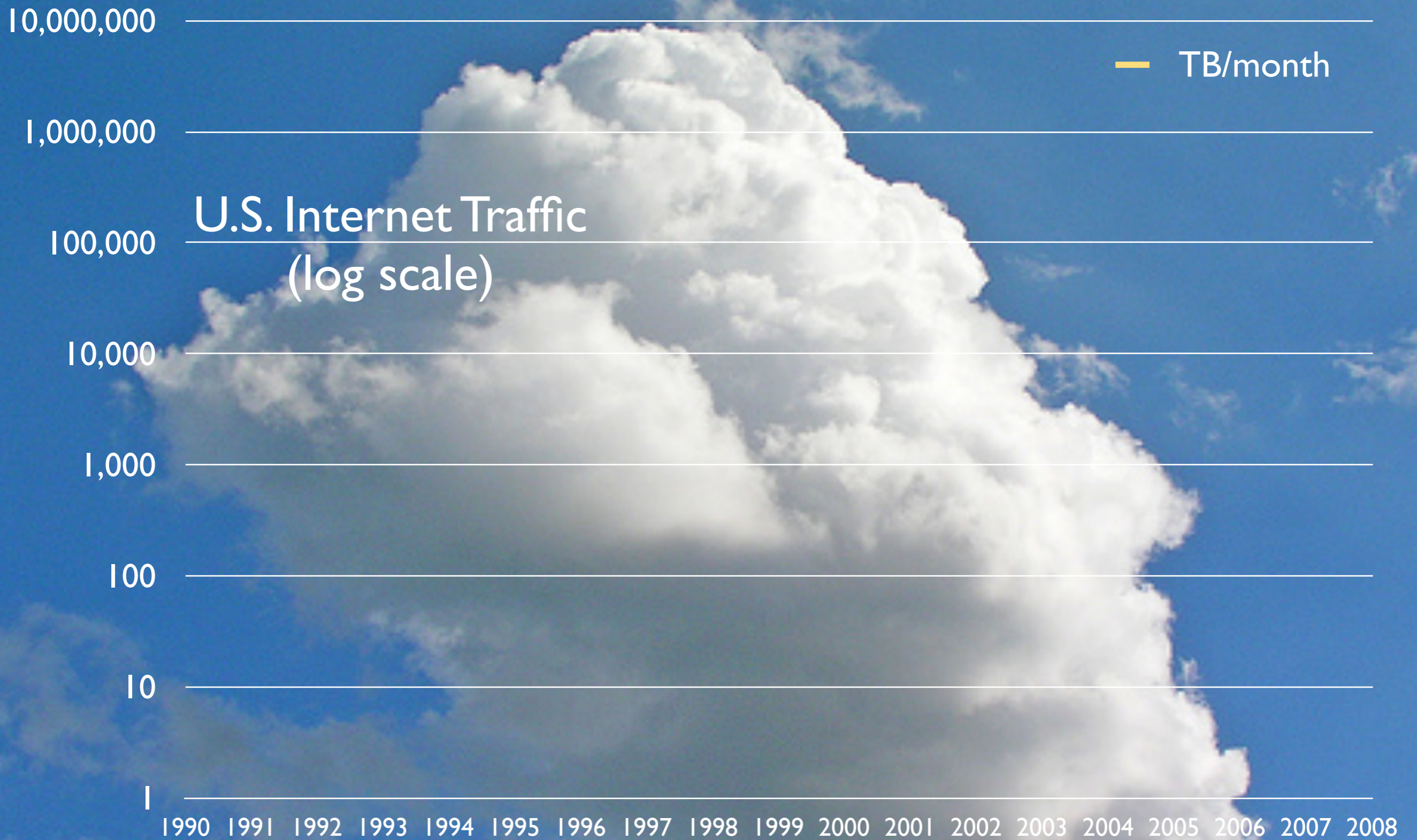
U.S. Internet Traffic (log scale)

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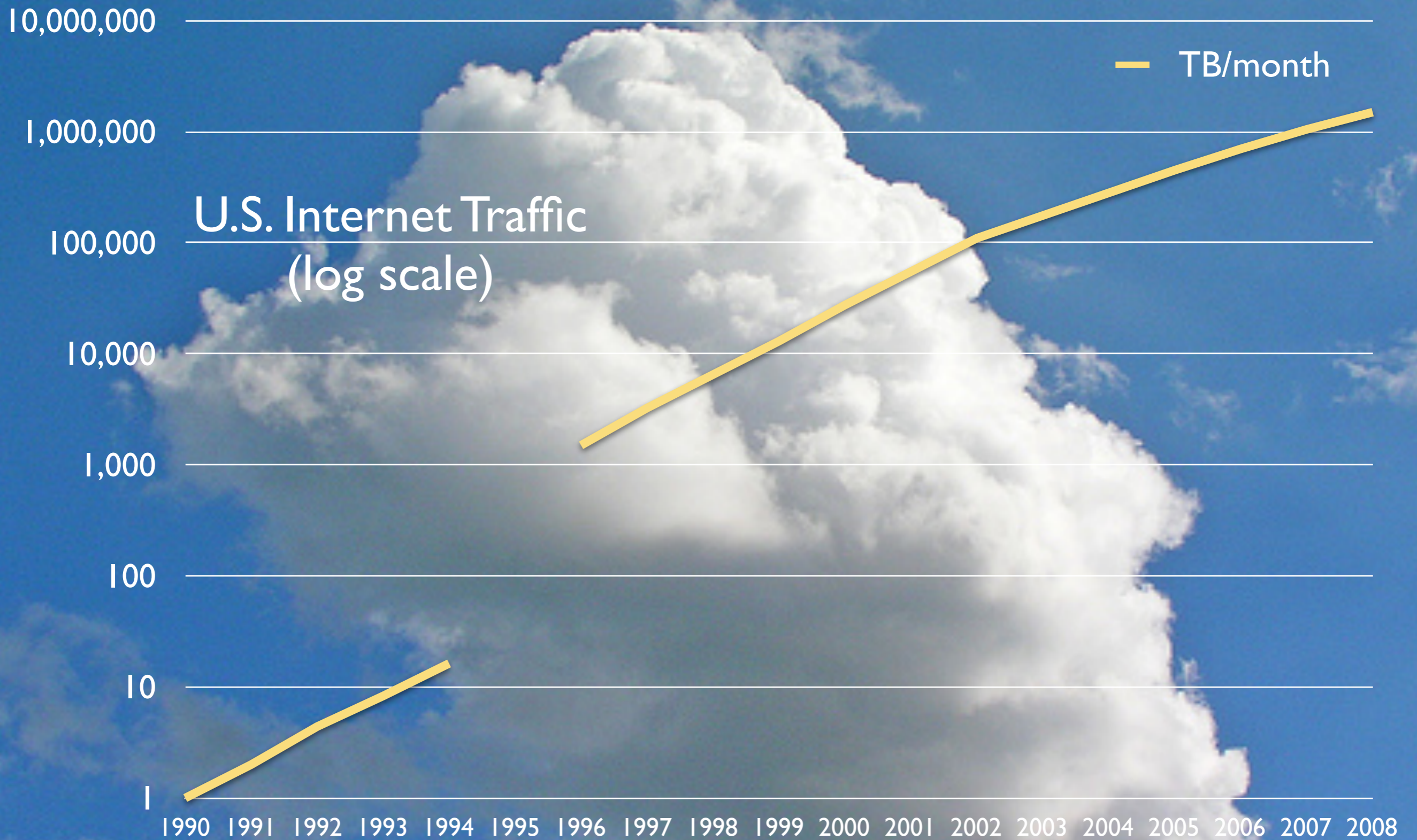


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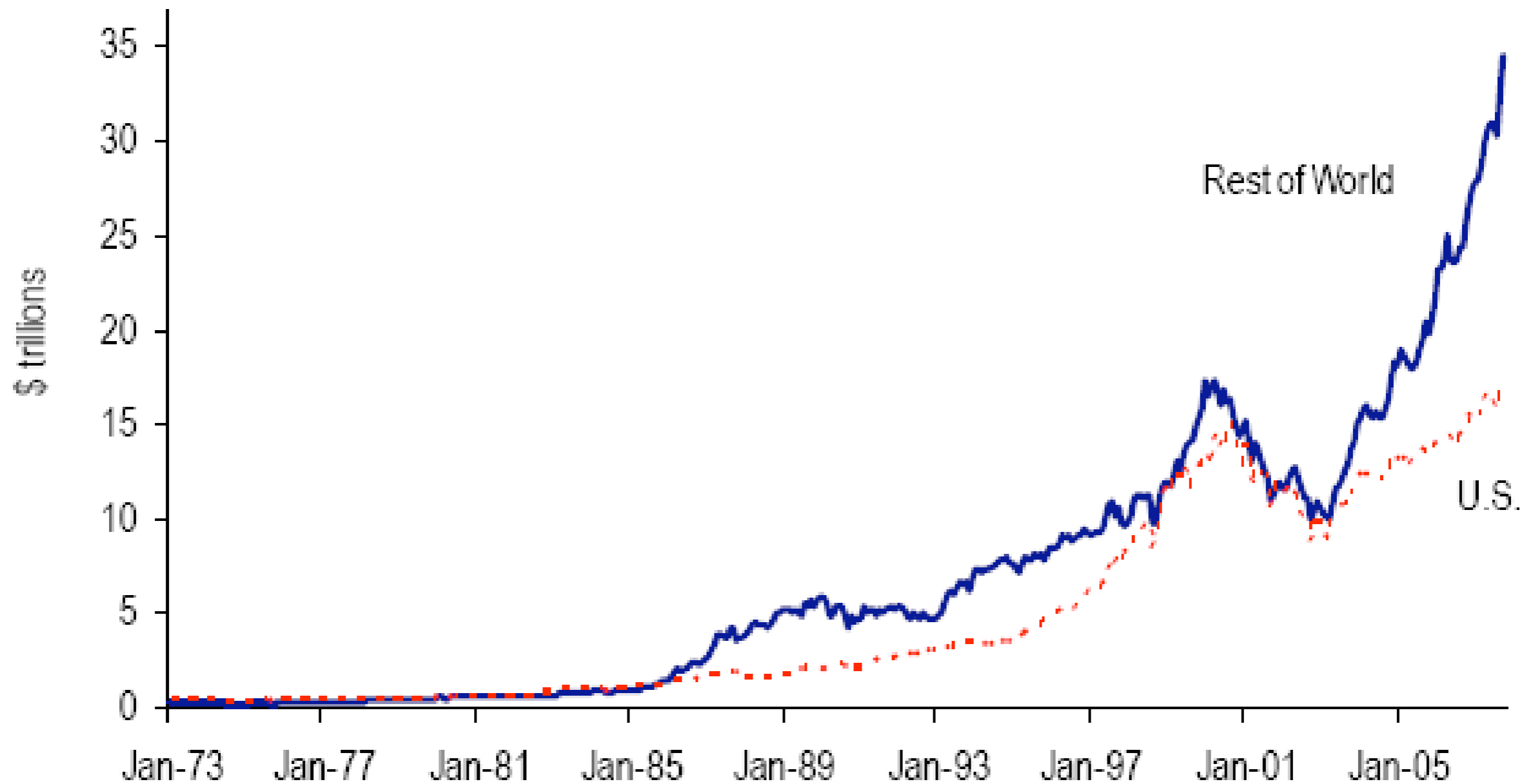
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How we got here

- 1% Fed Funds in 2003-04 even after growth and commodities rose briskly
- “accommodative” policy “for a considerable period”
- Fed basically ordered banks and hedge funds to lever up – “borrow dollars, buy anything”
- weak dollar policy pushed money into hard assets like homes, oil, and other commodities ... and out of other U.S. assets
- excess money and credit led to surge of “creativity” in mortgages and derivatives

Weak Dollar

Equity Market Capitalization: U.S. and Rest of World (last obs. October 2007)



Source: DataStream; Bear, Stearns & Co. Inc.

Top market caps in Dec. '07

1. Exxon Mobil – \$511 B
2. Petrochina – \$453 B
3. General Electric – \$414 B
4. China Mobile – \$405 B
5. ICBC – \$333 B
6. Microsoft Corp. – \$328 B
7. Gazprom – \$287 B
8. Royal Dutch Shell – \$281 B
9. Sinopec – \$276 B
10. China Life Insurance – \$257 B

Crash

- the leverage cycle
- mismatch between inflationary hard asset prices and inability to pay for them
- weak dollar discourages private recapitalization of banks
- Merton: loans/mortgages = put options
 - falling asset values (homes / bank stocks) massively increase risk and volatility beyond models' capability to predict ... turn supposed 10-standard deviation events into 2-SD events
- financial system cracked
- panic, counter-party mistrust, capital drain, credit shrivels, velocity plunges
- interplay of CDS, naked shorts, mark-to-market & regulatory capital creates deadly vortex

Centrality of dollar

“It is these periods of transition, where the value of the currency is changing fast, but before price changes filter through all commerce and contracts, when financial and political disruptions often take place.”

– Bret Swanson

The Wall Street Journal

August 12, 2006

3/19 Proposed Fed Expansion

Fed program	Size, billions US\$
TALF	1,000
Agency MBS	1,250
Agency debt	200
Treasury purchases	300
Previous balance sheet expansion	975
Total	3,745

Good

- Mark-to-Market relaxation
 - stocks turned up on March 6 upon whispers of M2M changes
- Fed expansion
- positive yield curve ... bank profitability
- most commodities stabilized and/or rising
- credit spreads narrowing
- velocity rising
- signs of housing bottom

Bad

- Fed's TALF moving too slow
- Fed's MBS purchases too slow
- refusal of TARP repayments
 - Washington micromanagement of banks
- preferred-for-common swaps
- mortgage "cramdowns"
- credit card limits
- only half way on Mark-to-Market

Ugly

- historic tax and budget shifts
- health care shift
- energy shift
- financial industry shift
- centralization of power, money, influence, information in D.C.
- less decentralized entrepreneurship and innovation
- wild cards: inflation and world trade?

Historic budget shift?

- Federal tax receipts averaged about 18% of GDP in post-war period (no matter the tax rate)
- Federal outlays have been around 20% of GDP
- In 2009, Federal outlays will be almost 28% of GDP
- New budget could shift long-term Federal outlays toward 25%+ of GDP, even with Defense cuts

Tax rates, more important than spending

- Top Federal income tax rate easily moving toward 45%+
- Rate increases, lost deductions, phase outs, possible increase in FICA cap, more complexity
- Cap gains and dividend rate goes to 20%

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Thank you.

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