

# Trader's Perspective

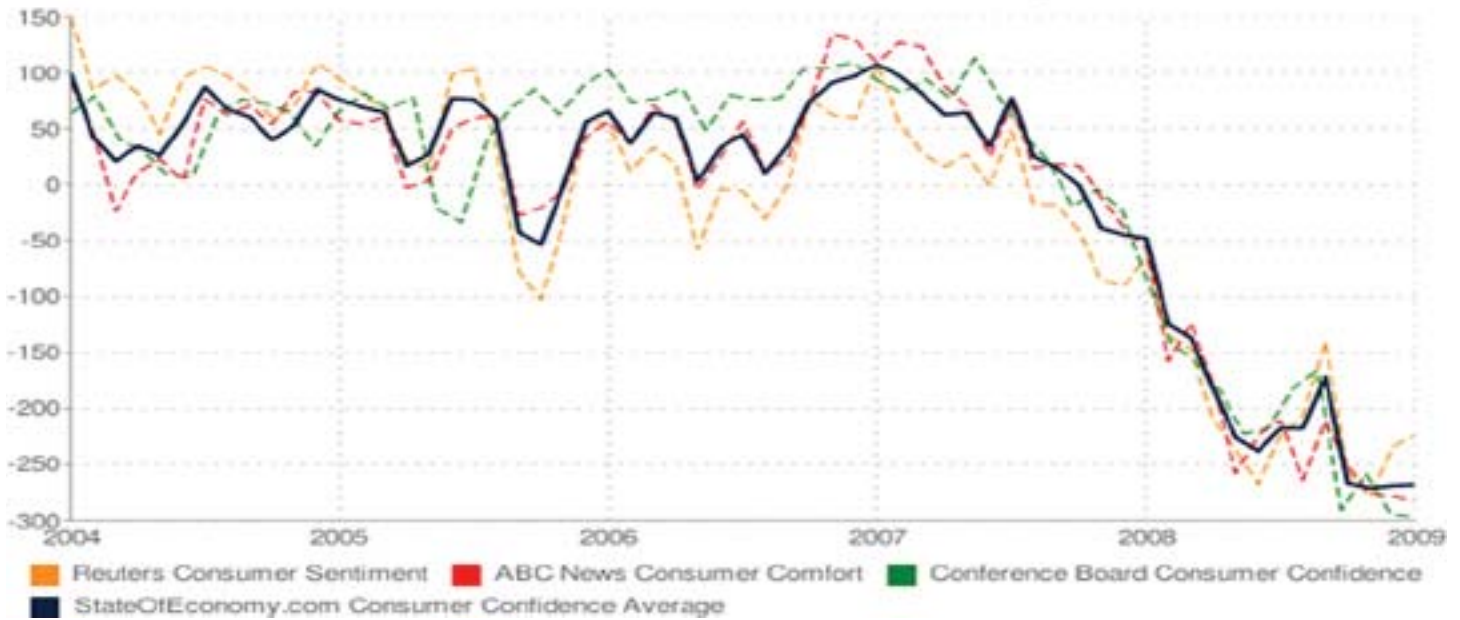
## **Pseudo Economics and the Riskless Society**

**By Tom Rehberger**

How did we get here? There are many different factors that lead to the largest economic downturn since the Great Depression. We all know that housing, subprime, Fannie and Freddie, the banks, lending practices, the rating agencies, CEO's, Wall street, mortgage brokers, Congress, the Fed, the Fed policy and the President's policies are all accessories. They were all in the car when the crime was committed. Who was the driver or the triggerman? It will be hard to say, since they all seem to have alibis. The only thing we know for sure is that the American people are going to pay for one of the greatest economic debacles of the century. Added to that, the banks and brokers sold toxic paper to many countries around the world. The rest of the world is going to pay as well, not only for the bad notes we sold them, but for the recessions and declining economies to come.

It is true; we have to act quickly to stem the tide of red ink hitting almost all sectors of our economy. We need to slow the descent and give people and companies time to react to the problems. The government will become the economic driver for the next three to five years as business restructures and defaults and failures occur. But maybe more importantly, the government has to restore some clarity to the future progress of our economy. Clarity is the most important factor in making decisions about committing capital. Investing, the ability to make a judgment about a company or municipality rests on the fact that we can turn to metrics to give us a clear view

## Consumer Confidence Average



of how secure that company or municipality is. There are two factors in judging risk, the risk of the asset and the overall economic risk. We can usually look at a stock or bond and determine how secure it is versus other companies in the same sector. But right now, the uncertainties of the overall economy are making all assets look bad because the economic risk is high. What can be done to change all of that? Clarity. We need the government and business to step up and set a course that we can understand, will offer some clarity. They need to bring confidence to the party, and fast.

What caused all the obscurity? It is easy to point to a number of major factors that are causing people to feel a low degree of confidence in the economy.

Here are just a few.

- Out of at least 15,000 professional economists, “10 or 12 foresaw the mortgage crisis.” \* Economists have low credibility.
- Rating agencies in many cases gave high ratings to the toxic financial products and now have low credibility.
- Banks and brokers needed a bailout and now they have low credibility.

- Congress was involved in changing the rules on banks and brokers to give them more access to leverage and pushed for more low income people to buy houses. Congress now has low credibility.

- The Fed’s models missed the downturn and possible deflation until late in the game. The Fed now has low credibility.

- The same people are still in charge of most of the financial institutions from when they created the products that got us here. The CEOs and management have low credibility.

- The financial institutions played fast and loose with home mortgages. Mortgages were and still need to be the bedrock of investing. Mortgages have low credibility as investments.

- The SEC turned a blind eye to the largest ponzi scam in the history of this country. They have low credibility.

These are all opinions of mine, shared by many. We count on all of these people and institutions to set the conditions for economic growth. They are the underpinnings of the economy and they all got it wrong. We have not yet

reached the point; if ever, where the government and business will accept the responsibility and make the necessary changes to bring back the checks and balances that keep outrageous behavior from taking over.

The incentives were too great and are still at the center of the bailouts. The stock market, on the other hand, is telling us with a great deal of certainty that we had better get a plan. The market is saying that we will continue in a downtrend until we get clarity. It is also saying that the financial sector will shrink and some of the large banks and brokers must be nationalized, dismantled and restructured as smaller, more efficient companies, or sold. Capitalism will force the change if we don't do it.

What will cure the low confidence in government and business? Is Nero fiddling while Rome is burning? Will the peasants eventually burn down the castle? While it is nice to speculate that the people will eventually right the ship that our leaders cannot, this correction takes a long time. We as Americans will change our leadership a number of times until the leaders get it right. Along the way, social upheaval and war are a normal consequence of this type of market debacle (see WWII). Plan for difficult times ahead!

What will cause the institutions and financial sector to restore some confidence and get the economy moving again? Sad to say, we will return to many of the rules and laws that were in place from the last downturn. Those old rules, coupled with new checks and balances, will re-

vive clarity and confidence. They will then remain in place and the economy will grow until we forget them again, in the next cycle. Next time let's go for 100 years!

## ***What will cause the institutions and financial sector to restore some confidence and get the economy moving again?***

Why do I call it pseudo economics and the riskless society? You can't have reward without risk! We wanted easy money, high leverage and high returns with low risk. In order to get things so wrong, we had to build up many wrong assumptions (pseudo economics) that people came to believe in. Think about all of the people involved in this debacle. Some of them

are college professors and businessmen and women, some of them congressmen and senators who all slowly bent the rules. The economists and rating agencies built models and gave opinions based on misguided data and incentive. The fog of the pseudo economics has been building up over a long period of time. We are mired in it now, and it will not lift until many of the misguided rules and laws are dissected and discarded. We cannot hedge, structure, legislate, or wish away risk. Capitalism is supposed to work this way. Failure means the restructuring of damaged businesses and bankruptcy of broken ones. Success means buying or taking market share from those who fail. Democracy is the peaceful change of governments, some good and some bad. You can't create a riskless society. If reward is present, then remember that risk is being shouldered by someone. Companies should never be too big to fail and governments should never perpetuate themselves,

and change is good. There is risk in capitalism and Democracy for a reason: the rewards. Success and failure are both grand opportunities for somebody, and both should be embraced. Capitalism comes with booms and busts. We dropped our guard and believed in the hype. Huge rewards were taken by a few and the risks were allowed to be spread over the rest of us. This pseudo economics must never be allowed to happen again. Risk must not fall on society because a few prospered. We had safeguards in place and they were removed. The system is not broken; it is just being distorted until the financial sector shrinks.

The road back to growth will be painful, but it will be quicker if the Obama administration gets it right and swiftly moves us back into the realm of clarity. If they continue to perpetuate the pseudo economics, expect a long four years!

We all must realize that we will never achieve true capitalism or true democracy. We live in the gray areas of both, but these are still great goals. We will restructure the failed businesses and shrink those that are too big to fail. We will reelect governments until they get it right. A few heads will roll. We will reinstitute checks and balances that will get us back on track. Clarity and confidence will return and then the economy will boom. We will learn from this economic debacle and then, hopefully, create a longer period of growth than the last 80 years that we have enjoyed.

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\*James K. Galbraith economist - excerpts from NY times interview.

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