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A. Hamilton

UNITED STATES: INVESTMENT BANK **Government For Profit - Public and Private** By **Wayne Jett** © **October 7, 2008**

The largest investment bank in the world (and the only one in the U. S.) is to be owned by the federal government. It will be capitalized entirely with borrowed money, meaning its leverage will be infinite.

To what end? Its sponsors – Congress, the president and his Treasury secretary - represent its purpose as being to stabilize credit markets so financial firms and investors will resume extending credit to creditworthy applicants. As with much federal economic legislation, consequences almost surely will be unintended and harmful.

Government Is Here to Help

How is the federal bailout fund an investment bank? Treasury secretary Henry Paulson is an investment banker. He is given broad discretion in running the fund, and he is hiring other investment bankers to assist him. He has \$250 billion and perhaps \$700 billion to invest. That is 100 times bigger than the largest hedge fund four years ago. He is given discretion to demand warrants for ownership of common shares in every private firm which sells “distressed assets” to the fund he controls. Paulson’s fund will be the new source of liquidity for financial firms, and he can demand ownership interest in borrowers who need the liquidity. That is what Wall Street investment banks once did.

The major U. S. investment banks ended 2007 with record revenues and record profits. Nine months later, all are gone. Even quasi-survivors Morgan Stanley and Goldman Sachs morphed into commercial banks to accept regulation by the Federal Reserve System, and Merrill Lynch was acquired by Bank of America. What caused the sudden change of fortunes?

A London firm called Markit formed in 2001 to assist valuation of credit derivatives started the ABX index of sub-prime mortgage bonds in 2007. The ABX was tied to a small number of specific, identifiable mortgage backed securities (MBS), which made the ABX susceptible to easy gaming. Investors could buy (or sell) credit default swaps on each bond in the ABX. If more CDS are bought (betting the bond will default), the ABX declines.

Buying CDS is comparable to buying fire insurance on someone else's house. CDS owners hold a vested interest in the house burning. No fire insurer sells a policy that permits the holder to gain if the property burns. The insured must retain a financial interest in keeping the property safe from destruction. Yet financial firms have sold many billions in CDS to holders with no skin in the game. In the Spring of 2007, the ABX began falling sharply as the underlying bonds fell to short selling and CDS buying.

Rule 157: Good for Goose, Not for Gander

Also in 2007 (see a pattern here?), the Financial Accounting Standards Board promulgated its Rule 157, requiring financial assets to be marked to market value and reported in each quarterly financial statement, as if the assets were being sold under current conditions. This produced financial statements with current cash operating results completely overwhelmed by vicissitudes in mortgage markets. Sarbanes-Oxley federal law threatened prison for auditors or executives violating accounting principles. Auditors found ABX and cited its manipulated readings as market values of MBS even though the assets were held for long term performance.

Last week, in testimony to Congress, Federal Reserve chairman Bernanke opined Paulson's fund should be permitted to value "distressed assets" according to their held-to-maturity worth, *but concurrently insisted that financial firms presently owning such assets must not be permitted to account for them on that same basis*. How much more obvious must malevolent purpose be? Paulson's aim to gain the assets at prices determined largely in his own discretion is clear enough, as is his political influence that enables proceeding almost entirely unimpeded.

Hidden Discretion

But not all is completely obvious. Does Paulson have power to require private firms to sell him their financial assets, even if they do not choose to do so? Provisions of the Emergency Economic Stabilization Act are so ambiguous that regulations announcing that power (like eminent domain for financial assets) may be forthcoming. Even without such actions, Paulson and his successor can use powers granted to *suppress* market prices of those financial assets, depending upon how they exercise discretion.

One-and-a-half trading days after the Paulson plan was enacted by Congress, no doubt should remain that it fails to remedy the real ailments of financial markets. The DJIA dropped from 10,743 at 1:05 pm EDT Friday when Paulson's dream came true to 9,540 at 2:45 pm EDT Monday, October 6 (11.2%). Markets around the world crashed even more severely.

Bleeding Internal Wounds

The real ailments of financial markets continue to be utter lawlessness of trading practices, FASB Rule 157, the SEC's service as Wall Street's shield against criminal prosecution, and the CFTC's similar role enabling manipulation of energy prices through crude oil futures and derivatives trading. Do not be fooled into thinking naked

short selling has been curtailed. It continues even in financial shares, as SEC permits market makers to sell short without pre-borrowing of shares.

This financial and economic collapse may exceed the 1980 debacle for worst performance in a presidential election year. The next most recent landmark collapse is Herbert Hoover's 1932. Either of those comparisons is a truly ignominious burden strapped to the back of the Bush presidency by Henry Paulson Jr.

Wall Street surely dominates leaders of both houses of Congress as well as Treasury and the White House. Bipartisan dissidents defeated Paulson's bill in the House September 29. But Senate majority leader Harry Reid (D-NV), with assistance from Banking committee chairman Christopher Dodd (D-CT), loaded the bill onto tax legislation previously passed by the House, plus other provisions chosen to attract votes, and passed it by a wide margin. With Wall Street's media machine braying so loudly the unprecedented outcry from taxpayers was nearly drowned out, the House knuckled under to its leadership and passed the Senate bill Friday, October 3.

Fed's New Business Plan

On October 7, global credit markets remained seized and equity shares continued to decline. The Federal Reserve announced new open market operations to buy corporate commercial paper. "Wonderful," the Fed's admirers exclaimed, "precisely what should be done!" The investment banking sector is destroyed and replaced by Treasury, while private credit markets are frightened into hiding and the Fed assumes the role of funding corporate credit. Meanwhile, House leaders launch inquiries into failed financial firms, charging their demise resulted from corporate mismanagement and excessive compensation. This is progress?

No, this is the manner in which private pecuniary interests used government to cause major economic displacements, and then made matters intentionally worse by pretending well-meaning "solutions." Those pecuniary interests, more powerful by far than ever before, are at work presently in bringing about the course of events.

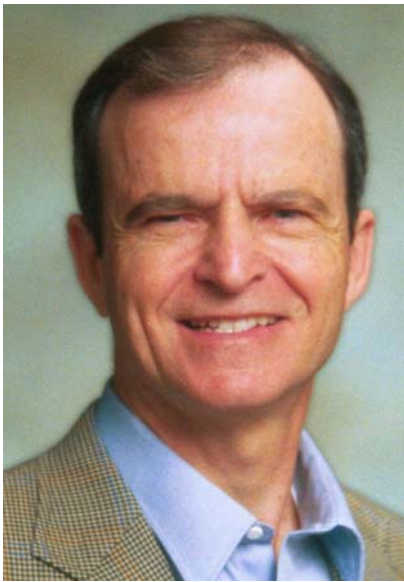
Clues to Predatory Design

One investigative reporter with great integrity and valor, Mark Mitchell, [describes precisely](#) how trading manipulators exploited SEC regulatory loopholes to destroy Bear Stearns, Fannie, Freddie, Merrill, Lehman, Washington Mutual and AIG. These firms could not have been destroyed as they were without approval by the "economic czar" at Treasury.

Wachovia Bank is yet another target which illuminates Paulson's design. Paulson has FDIC pressure WB into a takeover by Citigroup at a wipeout price for WB shareholders, sweetened further with federal financing. Before Citigroup can gobble its prey, Wells Fargo Bank offers to buy WB entirely – no federal financing, no sloughing of bad debt, much better price for WB holders. Citigroup screams like a banshee and files suit against Wells Fargo, claiming damages of \$20 billion if Wells takes the WB prize away! How much more evident must these financial crimes abetted by the federal government be before they are prosecuted?

Last week, dissident Democrats and Republicans in the House glimpsed the truth that elimination of naked short selling and empowering the Department of Justice to investigate and prosecute such financial crimes without interference by SEC would largely resolve the financial crisis. These keys must be recovered from the economic rubble produced by Paulson's law and used soon. Otherwise, the way back to relative prosperity will be so long and steep as to imperil Western Civilization. ~

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