



Todd Harrison

Freaky Friday Potpourri: Conversation with Mr. Practical

September 26, 2008, 8:45 a.m.

Toddo: So, what's the good word?

Mr. Practical: I hope everyone is well, and well aware of what is going on right now in Washington. The socialization of markets is accelerating. The government continues to change the rules, as they usually do under times of stress. I'm happy, however, to share my thoughts on where I think we currently stand.

Toddo: Hit me, cookie.

Mr. Practical: Hank Paulson and Ben Bernanke have asked for too much "money" with too little detail. They have also asked for immunity from review. This is very strange. Why not implement their plan with clear guidelines, accountability, and transparency? Nothing really happened from a few weeks ago to create this sense of urgency.

Frankly I think the public is giving much too much trust to a few men who might not really understand what they are doing or worse, have a different agenda than protecting tax-payers. Perhaps they are trying to protect our Asian lenders instead? Or perhaps it is because of the Fed's complicity in our current state of affairs and thus their desire to bail out the equities of banks?

Whatever it is, on its face they plan to assume ownership of debt at a price much higher than would clear the market. This is not appropriate. When the government assumes the market is not pricing assets properly and uses taxpayer money to bid them higher, that is socialism, pure and simple.

But their argument to do so is flawed. This is not merely a liquidity issue as they profess: there is not enough capital to support the debt. It is a solvency issue. To ignore that economic implication is naivety at best: as the government re-prices assets, risk will grow, not be reduced, and growth will slow. So any plan that injects capital into insolvent banks at the very least needs to offer equity to the fund they plan on creating.

I am not advocating what they are doing. I am pointing out the very least that should be done if they are going to go this route: minimal and staggered funding, full transparency and accountability, and dilution of equity from failed institutions.

But their goal seems to be to spur stock prices higher through their ban on short selling, which is shameful, and using taxpayer money to transfer profits to financial companies. That will only protect the wealthy establishment at the expense of the middle class, as any bailout tends to do.

The middle class will pay for this in either higher taxes or a much lower dollar in the future. Their claim that the taxpayers may actually make “money” out of this is ridiculous. Even if the fund eventually gets the same amount of dollars back *nominally*, those dollars will be so devalued there will be huge actual economic loss.

Toddo: Do they have a choice? Wouldn't a failure to act suck our entire finance-based economy into the abyss.

Mr. Practical: There needs to be culpability and consequences for those who have misjudged and mispriced risk. The savers in this country don't care if JP Morgan, Bank of America, or Citigroup trade at \$2, they simply need to know that their deposits are safe. That is much less expensive for taxpayers than keeping value in the equity, of which there is little if any.

The way to eventually heal the system is to let bad banks fail and just protect the savings at those banks. The dollar, ironically, would remain stronger in the long run if we let the right amount of debt be destroyed without supporting equities of insolvent institutions.

Toddo: So you're saying we should basically “hit tilt” and start over.

Mr. Practical: Don't support worthless equity and print only enough dollars to protect savings. This is the only way to eventually attract private capital back into the market. They keep talking about instilling confidence, but the only way to instill confidence for investors is to not print money/create more debt to solve a debt problem. If not, private capital will remain on the sidelines and the only liquidity will be from borrowing from the future.

Toddo: You were of the view that all roads lead to deflation. Is this massive bailout package a game changer that jumps the shark to hyperinflation?

Mr. Practical: The bailout is a form of monetization, although a small one. The Fed mechanically already expanded its balance sheet on a more permanent basis by printing currency and buying treasuries from the government a week or so ago. The Fed's balance sheet has grown an alarming 35% just in the last month. This was a clue to what a massive monetization would look like.

What if Mr. Paulson really needs his \$700 billion immediately because the Chinese want a bid on all of the bonds they own? If there were massive pressures on our interest rates because of something like this, the Fed could monetize: print massive amounts of currency and buy up U.S. treasuries.

This would be a hyperinflation and send all prices up massively only to eventually destroy the economy. Let us hope the government has more sense than to do this, although from what I have seen I am not hopeful that is the case.

Toddo: We've been beating the drum that capital preservation, debt reduction **and** financial intelligence were steady tenets of any intelligent approach. If this scenario comes to pass, capital preservation *wouldn't* protect investors who have squirreled away savings. Where should people put their money?

Mr. Practical: For the time being, my opinion is that it's safest in U.S. Treasury securities or if you want to be out of the dollar as I do, invested in sovereign securities of another country. There is enormous debt denominated in dollars, much more than there was in 1929 relative to GDP and much more than Japan had to deal with in 1990. That debt must be repaid in dollars or destroyed, so for the time being that should continue and the further

collapse of the dollar. Minyans are witnessing the destruction of the largest asset bubble in history and risk is very high.

If sensible people take control of the government's response to this problem, they will allow the market to wind down this debt with as little monetization as possible. This will lower the standard of living in the U.S. for some time, but will eventually clear the decks for future economic expansion. Savers will eventually begin to lend again, so having savings will be very valuable.

If the wrong people remain in control of the government response to this situation, the dollar will eventually be completely destroyed and a hyperinflation will occur. This will sap vast wealth from the middle class.

If this is the case, just at the right time one must buy gold or even raw property in the U.S., for eventually it will be un-buyable in dollars. I have no advice on timing and thus would recommend just sitting pat: staying out of debt, and that may mean pinching pennies and lowering your standard of living (saving) and enjoying your family and friends.

I hate to talk like this but that is the way I see it. What is paramount now is that sensible people running the government do not abuse their power and do what is best for taxpayers. Hopefully they will realize that in the long run the market is actually their best tool for eventually letting the problem run its course.

Toddo: Thank you Mr. Practical. Wise words as always.

R.P.

Todd Harrison is the founder and Chief Executive Officer of Minyanville. Prior to his current role, Mr. Harrison was President and head trader at a \$400 million dollar New York-based hedge fund.

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