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At the meeting of the American Business Forum on Europe on 2/16/2010 Steven H. Reynolds, Chief Investment Officer of Graig Drill Capital, New York City, gave a most interesting analysis of the financial and economic perspectives for the year ahead. Since you might not have been able to experience this important speech we thought we make it available to you in the form of this ABFE Bulletin. In case you would like to become a member of the ABFE ($180 per year) please call us at the number at the bottom of the Bulletin.

The global economy naively entered 2007 with two types of countries: those with sound financial systems and others which had grown complex, opaque, and over-leveraged with toxic assets. Unfortunately for the well-behaved, the globalization of the financial system had tied the good to the bad, and no country was spared the pain of the ensuing financial collapse and severe worldwide recession.

Endless books, multiple congressional hearings, and countless hours of financial news reporting have documented the causes, chronology, and initial consequences of the crisis. However, there are more subtle and longer lasting effects that will continue to produce profound effects on global economies.

The countries with sound financial systems, in spite of their prudence, were ensnared in the downward economic spiral. Their financial systems were strained, but not permanently impaired. They weathered the storm as if it were a traditional credit-induced recession. They responded with massive monetary and fiscal measures to stabilize and restart their economic engines, and to a country, they were successful. Quick recoveries followed and many have already begun to withdraw their stimulus programs. Interest rates are being raised and money supply and credit growth moderated. The citizens of Australia, New Zealand, Canada, Norway, India and China, to name a few, can take pride in the wisdom of their leaders.

However, the unfortunate citizens of those countries that allowed their profligate financial institutions to undermine the fabric of their economies have years of financial, economic and cultural adjustment ahead of them. The United States, Great Britain, and Europe are among the most prominent.

The United States faces the prospect of years of sub-par growth, deleveraging, and high unemployment. A number of hurdles impede a return to “normal.” One problem is that, during systemic debt repayment, monetary and fiscal policies are emasculated. Lenders do not want to lend. Borrowers do not want to borrow. The conduit connecting the government stimulus to business and the consumer is broken.

Furthermore, the magnitude of the leverage and toxic assets dwarfs Washington’s understanding and political will. The cures are meager in relation to the size of the problems. An additional

hurdle is the extremely high level of unemployment. Too great a portion of the "stimulus" dollars are required to provide an ever increasing safety net for the needy and maintain basic government services. Continued declining tax revenues at the state and local levels and the need for federal funds make future new job creation difficult. The hopes for economic stimulation have only resulted in stabilization. While there has been justified criticism of the politicization of the government's programs and its ineffectiveness in creating private sector growth, the real culprit continues to be the deleveraging of a profligate financial system.

Economists attempt to describe patterns of business activity by the shape of a letter. Will the recovery be an L, U, or V? The more appropriate symbol for the economic outlook may be a "square root." In the 1Q of 2009, real GDP had a sharp quarterly decline of roughly 6% followed by the recent snapback of 5+%. The economy is now at the beginning of a long period of below-trend, 2-3% real growth.

The reasons for this tepid performance are the continued deleveraging of the private sector and the limits, political and financial, on the government's ability to be the sole source of credit and job growth. The hand-off of economic growth from the public to the private sector will continue to be painfully slow.

As this transition occurs, the removal of government largesse will be difficult for the weaker participants. Those that have been unable or unwilling to mend their ways will continue to be severely challenged. Dubai and Greece will most likely be followed by others before the system is totally stabilized. In the short term, there is little appetite for allowing failure, and the risk is contagion. Monetary authorities are now well-versed in "creative" ways to fix the system. Unfortunately, the solutions do not address moral hazard and entail the creation of more debt. They may also have the unintended consequences of forming new "bubbles." Longer run, the inflationary implications are problematic.

The road from the public creation of credit and jobs to private sector self-sustainability will be bumpy. There will be a great deal of uncertainty and psychological swings. Financial markets will probably reflect this with heightened volatility. Traditional asset allocation and diversification models will prove to be ineffectual in this environment. Flexible, unleveraged and hedged strategies would seem most appropriate.

For U.S. investors, the most likely scenario is a period of slower than expected economic growth, ample liquidity, rising corporate profits, and tacit government guarantees. This environment should be friendly for equity markets, with the stocks of companies with above average growth favored. Nominally low interest rates, with the prospect of modest increases, make bonds less attractive. In both asset classes, a historically disproportionate portion of the portfolio should be in securities from those "sound financial system" countries. Given their competitive advantage, they will be gaining share of the global profit pie.

Over the longer run, there remains the problem that many feel that the financial system has been cleansed. Not so. The risk lies at rest awaiting the proper future time to spring and overwhelm its prey. At the heart, the global economic system remains vulnerable to an interconnected, complex, and massive global financial system.

In the 1980's with the advent of financial engineering, an evolution in the role of financial institutions began. Profound change was the result of a number of parallel, interconnected and reinforcing phenomena. They transformed local financial companies into global behemoths that almost brought the world to its knees. The components of change included as follows:

- communication: the high speed linking of global participants,

- technology: the ability to execute, process and settle massive numbers of trades,
- innovation: the development of complex institutions and products,
- regulation: a laissez-faire environment,
- globalization: interconnectivity and interdependence,
- leverage: low cost, available funds, and
- hubris: intellectual arrogance.

Together these factors allowed, over roughly 20 years, the "modern" financial system to evolve into a business that dominated global commerce. In the post-crisis blame game, there is a great debate over which of these forces was most instrumental in causing the crisis. I would contend, none. While they all were enablers and abettors in inflating the "bubble," they were not the root cause.

Underneath it all was a gradual, but persistent diminution in the concept of the fiduciary. As the industry's size, complexity and demand for growth accelerated over the two decades, the fiduciary was quietly put to rest with a quiet passing and no eulogy. The core values of "first due no harm" and "the customer comes first" were replaced by maximizing short-term profits (especially for publicly-traded firms), size, market share, and incentive bonuses.

The Honorable Paul Volker, in his recent testimony to Congress, implied that it is not material whether proprietary trading and internal money management lost money or were instrumental in causing bank failures. The need for their separation is a matter of ethics. Banks and their shareholders should not benefit from profits made on low interest loans subsidized by the public taxpayer. And, banks should not be allowed in their internal investment activities to front run their customers. He went on to warn Congress that if allowed, banks would revert to avarice and "if the new regulation gives free reign to speculation (with taxpayers' money), I may not live long enough to see the crisis that causes, but my soul will come back to haunt you!" Instead of asking for clarification of his ethical concerns, his remarks were met with snickers. Enough said.

The re-regulation of the still massive, complex and interconnected global financial system slowly moves ahead. Bankers, lobbyists, Congressmen, and special interest groups are pitted against each other to ensure they do not kill the goose that has given them all so many golden eggs. The outcome will be a nip here, tuck there, less reported leverage, fewer "exotic" products, except for the compensation plans. Realistically, Chairman Volcker stated, "As with any new regulatory approach, authority…needs to be broad enough to encompass efforts sure to come to circumvent the intent of the law." Unfortunately, strong regulation is not likely.

The forces that resulted in the evolution of the "modern" global financial system to its present form cannot and should not be reversed. Politically, the system cannot be meaningfully changed. The prospect of legislating morality on the best and the brightest is absurd. So, the fiduciary rests in peace and we trudge on, looking over our shoulders, intoning: *Buyer Beware*.

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