

## La Forza Del Destino

When asked once what in politics he feared the most, Harold Macmillan, the British Prime Minister of the late 1950s and early 1960s, retorted “events dear boy, events.” It seems like we picked a good couple of weeks to be offline. In fact not being in a position to monitor every lurch and gyration of the amazing roller-coaster of recent days has, in retrospect, probably been a blessing. Aside from the fact that many of you would likely have been too frazzled to read much in the way of any research, our relative isolation has, we hope, enabled us to gather our thoughts rather than pump out knee-jerk comments that would have been rapidly overtaken by Macmillan’s dreaded events.

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The bottom line is that, unfortunately, the collapse of the greatest global Ponzi scheme of all time is playing out very much to the script that **DSGAsia** has been outlining since the middle of the decade.<sup>1</sup> We do not want to be seen to be penning “we told you so” articles but every time we read in the press or self-serving broker releases that nobody could have seen this coming, we are left with an urge to do as the judge did in Pink Floyd’s “The Wall.” There have been a number of commentators, admittedly mostly independent ones such as ourselves,<sup>2</sup> but also admirably a few with more compromised paymasters,<sup>3</sup> who have called this well.<sup>4</sup> And it really should not have been that difficult since although the scale of the collapse might be unprecedented (the scale of the preceding bubble also was unmatched), the toppling of the dominos, and the reactive policy initiatives, have all been

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<sup>1</sup> As we opined in “The Demise of the Monetarist”, November 24<sup>th</sup> 2006: *We remain less than sanguine about the explosion in non-bank credit and credit derivatives products. Aside from the dilutionary impact on monetary policy traction, we believe the mushrooming of such instruments has encouraged a binary mis-pricing of global event risk – “nothing has happened and the alternatives are so horrendous, we cannot even start to price them.” More mundanely, there are issues of settlement and counterparty risk in the event that someone wants to redeem a decent chunk of change from illiquid fancy structures traded between prop desks and hedge funds.... It does not smell right.*

<sup>2</sup> Tim Lee of PiEconomics and David Roach of Independent Strategy would be two of those whose work we would highlight.

<sup>3</sup> Our old boss George Magnus, chief economist emeritus at UBS, and Bernard Connolly at AIG Financial Products, deserve special mention given just how spectacularly their employers have screwed up.

<sup>4</sup> Shame there won’t be any one left to pay us....



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eminently forecastable, even if the exact timing has not. For as John Kenneth Galbraith wrote in “A Short History of Financial Euphoria”

*All financial innovation involves in one form or another, the creation of debt secured in greater or lesser adequacy by real assets.... All crises have involved debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment....<sup>5</sup>*

From very early on we have been saturnine in our warnings that the end game will be effective nationalisation of large swathes of the financial systems on both sides of the Atlantic, and as a *quid pro quo* higher taxes, re-regulation and rising general government interference in all aspects of economic activity. In the middle of 2007 we argued that:

*If this was just a matter of a few financial types getting hurt when the pyramid scheme implodes then such wilful neglect would not be such a major problem. However, financial systems are the very lifeblood of the capitalist system and the consequences of major dislocations can rarely be contained to the monetary economy.... Our medium-term view remains that a free-market unwind of global credit and asset price excesses will be politically unacceptable and therefore a repeat of the 1930s experience seems highly unlikely.... The flipside will likely be therefore the debasement*

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<sup>5</sup> As Galbraith continues: *Regulation and more orthodox economic knowledge are not what protect the individual and the financial institution when euphoria returns, leading on as it does to wonder at the increase in values and wealth, to the rush to participate that drives up prices, and to the eventual crash and its sullen and painful aftermath. There is protection only in a clear perception of the characteristics common to these flights into what must conservatively be described as mass insanity. Only then is the investor warned and saved. There are, however, few matters on which such a warning is less welcomed. In the short run, it will be said to be an attack, motivated by either deficient understanding or uncontrolled envy, on the wonderful process of enrichment. More durably, it will be thought to demonstrate a lack of faith in the inherent wisdom of the market itself.*

*Supporting this euphoria.... is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavour in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.*



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*of fiat money, rising protectionism, the wide-scale re-imposition of controls on interest rates and international capital, and highly redistributive fiscal policy. One not only needs to think about which assets and currencies you want to own in such circumstances, but where you own them and what passport you carry.<sup>6</sup> Whatever you do, do not become a “Forgotten Man” – the man who never is thought of.... He works, he votes, generally he prays – but he always pays....<sup>7</sup>*

The belated and to us inevitable “conservatorship” of the GSEs and the announcement of a new era RTC<sup>8</sup> bring us no joy but in the words of Macbeth “If it were done when ‘tis done, then ‘twere well it were done quickly.” The table we reproduce overleaf from the end of Q2 (Bear Stearns aside) shows that even being charitable about the real valuations of some of the Level 3 (in essence too hard to value properly) assets on the US financial system’s books, equity capital was always going to be pretty much wiped out. (This table had been saying as much ever since we started to produce it in early 2007). In theory the Sovereign Wealth Funds and other

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<sup>6</sup> Asian Asset Market Quarterly Q3 2007 – Part I, The Big Picture Backdrop, July 10<sup>th</sup> 2007.

<sup>7</sup> Thanks to various disturbances we have only managed to get about half way through Amity Shlaes’ monumental “The Forgotten Man – A new history of the Great Depression.” The full quote, attributed to William Graham Sumner in 1883 is: *As soon as A observes something which seems to him to be wrong, from which X is suffering, A talks it over with B, and A and B then propose to get a law passed to remedy the evil and help X. Their law always proposes to determine what C shall do for X, or in the better case, what A, B, and C shall do for X.... What I want to do is to look up C. I want to show you what manner of man he is. I call him the Forgotten Man. Perhaps the appellation is not strictly correct. He is the man who never is thought of.... He works, he votes, generally he prays – but he always pays....*

<sup>8</sup> *It seems a pretty fair bet that sizeable sums of public money will be injected into the US financial system and that the public purse will also be employed to help restructure the mortgage payments of the innocently errant and hapless (though not, one hopes, the deliberately fraudulent; in practice distinguishing between the two groups may be somewhat difficult.) The electoral calendar may determine that responses between now and November may be more tepid than they would have been otherwise. However, once a new administration is in situ it will be able to blame the problems on its predecessor and argue that a more generalised bailout is the only sensible option. And if a similar message has by then also permeated the skulls of the eurocrats then all the better. Timelines for Financial Sector Resolution, March 31<sup>st</sup> 2008.*

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cash rich private sector players (notably from Asia) could have been there to help plug the gap. After all, the best money one can ever make is when dances on somebody else's grave.<sup>9</sup> In practice, having been burnt by earlier forays, and now having no confidence whatsoever about the transparency of pricing, they have been holding their fire. Perhaps co-investment with a US government entity will now be more palatable.

### US Financial Institutions' Level 3 Assets (Latest)

USD bn	Level 3 Assets	Equity Capital	Level 3-Equity %
<b>JPMorgan</b>	99	126	79%
<b>Citigroup</b>	160	128	125%
<b>Lehman</b>	43	32	132%
<b>Bear (end 2007)</b>	20	13	154%
<b>Fannie Mae</b>	63	39	162%
<b>Goldman</b>	96	45	215%
<b>Merrill</b>	82	37	225%
<b>Morgan Stanley</b>	78	33	235%
<b>Freddie Mac</b>	157	27	587%

As mentioned, nationalisation brings with it its own baggage but we have reluctantly viewed it as the least bad option (if 'twere done 'twere well done properly to further paraphrase our delusional Scottish friend above) in such circumstances. For the alternative of a re-run on the 1930s, ethical and moral hazard considerations left aside,<sup>10</sup> would have been just too horrible to countenance. So to that end, Bernanke (who to be fair inherited much of this mess from an abominably culpable predecessor) and Paulson deserve at least some credit. The markets are cheering for now but the medium-term implications for economic efficiency, growth, general tax burdens, and as a result asset price returns, are bleak. The next few weeks may see a stronger and longer-lasting bounce than others we have experienced in recent times, but it should be viewed as an opportunity to unload the toxic waste that should have been jettisoned many moons ago.

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<sup>9</sup> We would love to be reminded who (we seem to recall it was one of the New York hedge fund superstars) originally came up with this nugget. Answers on a post card please.....

<sup>10</sup> We are on record in arguing for the return of debtors' prisons for errant bankers, the confiscation of their personal assets, and the selling of their wives and children into indentured servitude...



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You may have been wondering about the title of this week's missive. *La Forza Del Destino* or *The Force of Destiny* is a rather depressing (and implicitly racist) opera by Giuseppe Verdi (or Joe Green to his English mates) which we managed to take in on a recent trip to Vienna.<sup>11</sup> The tale of helplessness and of forces larger than anyone can understand or control pushing us towards a tragic end<sup>12</sup> seemed curiously apt. Fortunately the massive resources of the **DSGAsia** family foundation had managed to push the euro down prior to our trip<sup>13</sup> so the experience was somewhat less eye-wateringly expensive than it might have been. But we still came away with the impression that the euro and sterling remained fundamentally mispriced. Our travels concluded with a couple of days in Stockholm for a conference which serendipitously gave us the chance to research in greater details the Nordic banking experience of the early 1990s.

The alternative of a re-run on the 1930s would have been just too horrible to countenance

Sweden's problems (and those of its neighbours Finland and Norway) were rooted in the normal culprits of financial liberalisation, leading to yawning current account deficits, excessive credit creation and real estate bubbles, eventually going into reverse. In addition, Sweden was part of the Exchange Rate Mechanism (ERM) of the European Union, one of the myriad soft-precursors to monetary union, and therefore exacerbated its downturn by continuing to shadow the Deutschmark. Like the British Pound, the Krona was ultimately forced to abandon the link which did much to aid the recovery process.

We may see a stronger and longer-lasting bounce than others we have experienced in recent times but it will still be a bear market bounce

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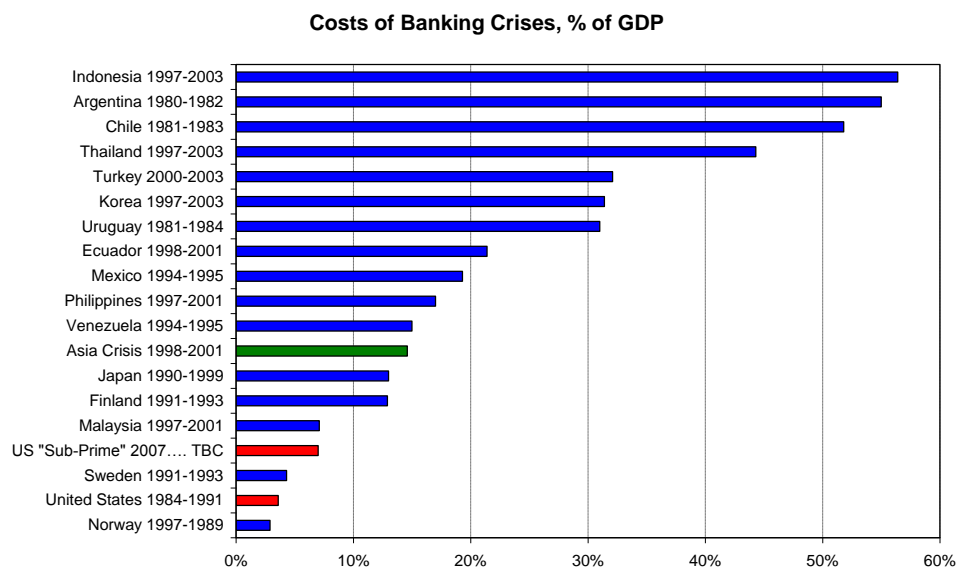
<sup>11</sup> Hong Kong has many attractions but culture tends to be largely confined to the morning yoghurt. As it happens we were in Vienna at the same time as the OPEC meetings though one would never have known. This was in pleasant and surprising contrast to such shindigs in the SAR, which virtually grinds to a halt thanks to the security and road closures whenever one of the Beijing Boot Polish Barnet Brigade comes on an inspection tour. As an aside, we had never understood the PRC leadership's pre-occupation with ridiculous hair dye-jobs until we read a review of Daniel Bell's "China's New Confucianism" in the latest *Far Eastern Economic Review*. He quotes a passage from Mencius stating that white-haired people should be cared for rather than employed in hard work. No mention though of how to deal with slap-heads and comb-overs....

<sup>12</sup> Especially if one happens to be a mixed-raced fellow messing about with the ladies of a respectable, white aristocratic family....

<sup>13</sup> So now you know which cabal really controls global finance.



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In September 1992 the government instituted a blanket guarantee for bank deposits and other non-equity creditors. In November the ERM shadow was abandoned (the UK had been ejected in September) and a month after a USD14 billion restructuring fund was set up. Certain institutions were nationalised at a steep discount while others remained in private ownership but were forced to meet strict capital requirements and to apply for public funds in return for harsh write-offs if they could not deliver the required ratios. The overall cost of the exercise was estimated at around 3.6% of GDP (see the chart above) not materially different from America's S&L experience.

**Government agencies should not seek to become warehouses but rather to establish market clearing prices for otherwise illiquid assets**

In both cases, the government agencies did not seek to become warehouses but rather to establish market clearing prices for otherwise illiquid assets and force financial institutions, not under direct government control, to mark their books likewise. It was this philosophy combined with the requirement to demand sizeable haircuts when taking assets onto the public sector books that minimised the ultimate cost to the taxpayer.<sup>14</sup> Already it

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<sup>14</sup> The S&L Crisis erupted in the mid-1980s but was allowed to rumble on for the best part of three years before the politically unpalatable decision was taken in February 1989 to employ public funds. Even then, the markets underestimated both the debilitating impact of financial sector dysfunctionality on the real economy, and accordingly the amounts of additional capital that the banks would require. Stocks did not make their sectoral low until almost two-years later at 70 cents on the 1989 bailout dollar. The equity market recovery in

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seems highly likely that the American public purse is going to be raided for a considerably larger chunk of change this time.

Just how much will depend on the as yet unannounced details of how this is all going to work. What concerns us is that little has been mentioned about the prices that will be paid for purchases of dud assets, the mechanism for setting such prices, and the accounting practices of those institutions which hold similar assets but are unwilling to surrender these to the newly created state behemoth. If we were being charitable we would say that the announcement had to be rushed out to prevent complete financial system meltdown and that having been achieved, the mechanisms that are in the end instituted will be designed to maximise banker and asset manager pain, and minimise the burden on the hapless taxpayer. The sceptic in us says Washington has been for far too long in hoc to a Wall Street that has argued for capitalism on the way up and socialism on the way down. Moreover, given the looming elections and the fractious nature of the policy debate across every spectrum of society, the Forgotten Man is going to take it right up the Khyber. We will reserve judgement for now....

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What have not changed all that much to us since Friday are the real economic consequences of this jarring deleveraging process. Since our core call has been one of socialism rather than a great depression, we have never argued for complete economic meltdown but rather a grinding lower of global activity and corporate earnings as credit is incrementally destroyed. If there has been one picture we have trotted out more than any other it is our global real credit and money chart on the following page. Whichever way one looks at the world after Friday, it is mighty hard to see an imminent reacceleration in credit supply. And like a bike that topples over when you stop peddling, the lack of new liquidity being pumped into a hitherto addicted system will incrementally destroy real growth prospects.

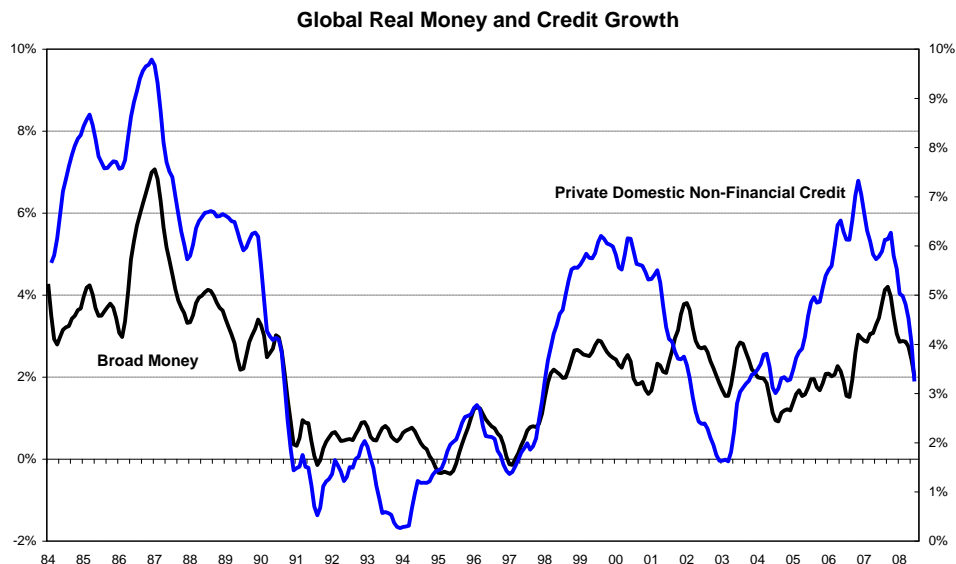
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Sweden was more rapid but the banking sector was only trading at 0.2 times book at the time of the government's intervention.



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From a parochial Asian perspective, this still means that economic activity and earnings expectations remain too high albeit what is being priced by markets has become increasingly realistic in recent months. Moreover, we continue to be believers in a second round decoupling thesis on the basis that a few abominations aside, the region's financial systems remain largely functional.<sup>15</sup> We will return to our normal stamping ground in greater detail next week when we discuss China's apparent policy capitulation, the prospects for its own financial and property sectors, and its ability to act as a counter to weak if not outright contracting economies in Europe and America. In short, while we are not expecting a PRC collapse, bank asset quality is going to be compromised and growth will still be slowing. The resources unwind has further to go in our opinion.

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Rightly the vast majority of the focus has been on the US in the last week or so (with some entertaining diversions in its sister Anglo bubble economy, the UK), and as a result, the dollar has understandably given up some of its recent gains. Nevertheless, we continue to harbour deep concerns that what lurks under the carpet in Europe is potentially just as grisly, and as a result, the currency markets remain an ugly beauty parade. In essence it is 2am at

**Asia faces more pain albeit we continue to believe in second round decoupling since the region's financial systems remain largely functional**

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<sup>15</sup> No prizes for guessing who remains the principal outlier. KDB's putative and thankfully aborted tilt at Lehman reminded us of Oscar Wilde's description of fox hunting; "the unspeakable in pursuit of the uneatable."



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the disco and the choice is limited to who might be the least unpalatable partner to leave the club with.<sup>16</sup>

Currencies have become even more than normal a credit issue. The dollar's rally against the euro had been as we expected a function of the belief that whatever America's problems, many of the same could be found in a Europe of fundamentally overvalued exchange rates. The near-death experience of the GSEs and AIG once again reversed such relative perceptions but the effective nationalisations and backstopping of the past few days should in turn prevent an imminent return of fears of a major dollar collapse.

As we noted earlier, the details of the Federal government's nouveau-RTC are as yet extremely sketchy while the news flow over the weekend suggests that Congress is unlikely to give Paulson and the boys a free hand in its creation. Hence while uncertainty and Congressional squabbling prevail and American woes remain to the fore, the dollar may drift lower again. Nevertheless, when all is said and done, the US has been acting and seems likely at least to come up with a mechanism to head off complete systemic meltdown. By contrast, while problems in Continental Europe have yet to flare up in such a spectacular fashion, the political impediments to resolution are far, far greater.

Thus far, the ECB window has been the primary mechanism for dealing with toxic assets since there is no real mechanism within the monetary union for individual countries and rump central banks to prop up local companies that get into trouble. Moreover, explicit fiscal transfers for such purposes from one country to another are even more of a political no-no since asking, for example, Germans to bail out Spanish and Greek entities is likely to spark riots on the streets. True to form, the eurocrats have been surreptitiously trying to bury such interventions behind the façade of ECB monetary operations. However, even these have started to be challenged with questions being raised over the quality of, and the ease with which, assets can be pledged to the monetary authority. As a result, collateral standards have recently been tightened, which may be morally the correct thing to do, but is hardly helpful at this juncture in the global credit cycle.

Currencies have become a credit issue. It is now 2am at the disco and the choice is limited to who might be the least unpalatable partner to leave the club with

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<sup>16</sup> The same conclusion may not always be justified in the light of morning.

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On the assumption that sizeable explicit eurozone wide bailouts cannot be arranged and countenanced in any great hurry, and on the assumption that no member country is going to imminently leave or be ejected from the single currency, the implication is that a number of countries are going to have to go through near or outright depressionary adjustments.

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Disentangling cause and effect and feedback loops will remain devilishly hard and subject to furious debate. However, we would broadly characterise the difference between America's and Europe's problems as follows. The US (and the UK) has experienced primarily a financial crisis brought about by excessive leverage that is steadily poisoning (and will continue to do so) the real economy. By contrast, although the eurozone and its shadow countries represent what is arguably an even greater credit bubble, in essence the manifestation will be a real economy crisis which will in turn increasingly infect the individual banking sectors across the continent.

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There is no doubt that the dollar continues to resemble a huge steaming pile of doggie-do yet whichever way one looks at it, a strong euro is equally difficult to envisage. This leaves the Yen and, especially once every central bank starts to panic, gold<sup>17</sup> as the default winners, along with a few other selective strong balance of payments and/or hard asset backed currencies. In Asia we continue to expect relative divergence between the region's strong and weak BoP countries, but minimal gains from here on a trade weighted basis. Come back and see us next week for a fuller home turf discussion.

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<sup>17</sup> We had partially reduced our p.a. gold holdings this year expecting a pullback to near 720 as the world embraced another deflationary scare and had already planned to buy the full position back when we returned to Hong Kong. Curses Lambsy!



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