

What a difference a year makes. Just twelve months ago, investors were so shell-shocked by the near-death experience of the last quarter of 2008 that they had lost all confidence in the financial markets, trashing equities and credit securities like there is no tomorrow. But as spring was nearing, markets finally found their bottom and started a powerful rally that very few saw coming.


Fast forward to now: equity markets have rebounded more than 80% from their March 9, 2009 lows and credit markets are behaving like the 2007-2009 crisis never happened. In the meantime, the tentative 'green shoots' that sparked the rally have been confirmed by the strong rebound in the world economies, with the United States once again leading the pack in the developed countries. As usual in strong recoveries the analyst consensus has been lagging the real numbers posted by companies, which was a significant factor that fuelled the rally. For the last quarter of 2009, no less than 72% of the companies in the S&P 500 index beat their consensus' expected earnings.

The reason of this sharp recovery is no secret to anyone in the financial industry. Governments worldwide have been injecting unprecedented amounts of liquidity into the system, and have quickly moved to bail out a number of economically critical industries. The banks, which are widely considered as the cause of the whole crisis, have been the primary beneficiaries of this massive help. As things stand today, it seems that governments have indeed being successful in saving the system.

So are we really out of the woods yet? Well, we don't think so.

Short term, the equity markets (at least at the time of writing) are clearly overextended. First, both the steepness and the magnitude of the market recovery are discomfoting, especially as this was not supported by significant volumes. There are obviously many investors that did not buy into the rally and remain on the sidelines. Second, the 'Fear Gauge Index', the VIX, is back at levels that are not likely to be sustained and that suggest an imminent correction. Finally, as we will see, the overall picture is far from rosy and the markets are again behaving with remarkable short-sightedness.





Let's address first our view of the economy. The strength of the recovery is not surprising given the unprecedented magnitude of the stimulus - we will address the consequences of that later. The zillion dollar question now is whether this recovery is self-sustaining or not. Central banks are waiting for 'clear' signs of sustainable growth to start withdrawing monetary stimulus, but are obviously reluctant to do so before they see a marked improvement in the unemployment rate. As long as inflation remains subdued, they believe that they can afford to be a little late in kicking off the tightening cycle. This situation goes a long way in explaining the current bullishness in the financial markets, where risk-takers (and carry traders) enjoy an incredibly favourable set of circumstances. To the credit of the governments and their central banks, the evidence so far is confirming that developed economies have indeed emerged from the worst recession since the 1930's. The acid test will be when governments start to phase out the stimulus. We continue to believe that when that happens the developed economies will struggle with subpar growth for most of the coming decade. Unsurprisingly the bright spot will be the developing economies, with the BRIC countries as uncontested leaders in the world economy.


Let's now drill down and discuss the state of the banking sector. Clearly the Federal Reserve and the ECB could not bail out every financial institution, so they had to deploy their efforts on the most desperate cases and figure out a solution for the rest. By allowing banks to borrow unlimited amounts at virtually zero interest rates, central banks have facilitated the generation of earnings to replenish bank's capital bases. Thanks to accommodative accounting rules<sup>1</sup>, banks can artificially delay the recognition of losses on their loan books and offset them with this freshly generated capital. While this has worked out for the largest institutions (which also benefitted from increased revenue from their capital market operations), many US banks ultimately failed: the number is a staggering 140 in 2009 and... 43 so far this year, according to the FDIC. The dreadful state of the US real estate market, with around one quarter of all homeowners underwater and a commercial market that still has to find a bottom means many years - not quarters - of loan losses in the pipeline for US banks. Add to that more regulation, leverage limits and bonus curbs and the outlook does not look really exciting for the regulated financial sector<sup>2</sup>. Hopefully this will make it less risky, but let's not forget the amazing ability of this industry to

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<sup>1</sup> Just to mention one: banks are allowed to keep booking at par home equity loans that are still current, despite the fact that a significant proportion of those loans no longer have any collateral backing them. Once underwater borrowers finally decide to stop paying interest, the recovery value of countless of these second-liens loans will drop to zero and banks will then have no other choice than to write them off. This is no small issue as there is currently \$1.1 trillion worth of home equity loans on the US banks' balance sheets according to Bloomberg.

<sup>2</sup> The unregulated financial sector will be the primary beneficiary of the vacuum left by the commercial banks. With an opportunity set increasing significantly as banks close their proprietary desks, alternative managers, best accessed through managed accounts, are filling the void quickly.





invent, create and sell to gullible investors products that no one can understand properly. Just look at the incredible mess emerging now in hundreds of municipalities worldwide that were sold derivative contracts a few years ago by banks with the seemingly altruistic goal of helping them to reduce their borrowing costs. Now these complex products are blowing up in their face, leaving many of them with huge losses that will take generations to pay out. Watch out for more public outcry, politician involvement and lawsuits as this scandal unfolds.


Our main concern is not the banking sector, however. Few in our industry will deny that debt was the primary cause of the financial crisis. Over-leveraged banks, homeowners and investors suffered phenomenal losses when the music stopped and asset values dropped precipitously. Only governments could break this downward spiral and they stepped in with great determination, as we have highlighted above. With their ability to print unlimited money, they are the lender of last resort. And print money they have – big time. Ballooning deficits and soaring sovereign debt levels are the rule today in all developed countries. Excess private debt has been simply replaced by excess government debt – but it is still debt! No one cares now because we all have a vivid recollection of how close to the edge of the cliff we found ourselves 18 months ago. But sooner or later we will have to address this issue, and there are no easy solutions. The difficulties will be especially pronounced in countries with unfavourable demographics and structurally low economic growth. Tax burdens will inevitably increase, which will further depress economic activity. Long-term rates will increase and remain at stubbornly high levels, which will create a toxic debt spiral (something Greece is experiencing now). Some economists believe that eventually governments will capitulate and accept that the only way out is to let inflation soar, which is likely to end in a most unwelcome hyper-inflationary rout. While this is unfortunately a very realistic scenario, it is not the only one.

We recently had the pleasure to have Woody Brock<sup>3</sup> in our office for a refreshing discussion on the economy. Woody's view is that governments should focus their stimulus on the most pro-growth areas of the economy. If they are successful in boosting growth, and manage to get above-trend growth for a number of years, then the debt problem will become less of an issue, for two reasons. First, tax receipts will allow balanced budgets (and even debt reduction), and second, the debt-to-GDP ratio will decline, too. In doing so the toxic debt spiral scenario mentioned above can be averted.



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<sup>3</sup> Woody is the President of Strategic Economic Decisions, Inc., a New-York based economic think-tank.



One of the obvious pro-growth areas is the Green sector, in our view. Considerable investments in energy, transport and water infrastructure are needed worldwide to ensure that future generations can maintain the same living standards that we have today in the Western world. The good news is that most governments seem to have understood that. China has already positioned itself as the leader of the pack, not only because it is already facing daunting environmental issues, but because there is simply no other way to achieve sustainable growth. The US and Europe are close behind, and have allocated hundreds of billions to Green infrastructure projects and in subsidies to promote Green investments by the private sector. We believe that the Green sector will outperform the broader market at least for the next ten years. Ignore that at your own peril...

Robert A. Seiler  
Investment Manager

Contact:  
Peak Partners S.A.  
25, rue de la Coulouvrenière  
CH-1204 Geneva, Switzerland  
[info@peakpartners.com](mailto:info@peakpartners.com)  
Tel: +41 22 818 02 20  
Fax: +41 22 818 02 28



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