

# FINANCIAL SENSE ONLINE

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## *Newshour's Ask The Expert*

### TRANSCRIPTION OF INTERVIEW

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**Douglas C. Noland, Market Strategist at David Tice & Associates**  
**"Structured Finance & The Bifurcated Financial System"**



**Web Note:** We have edited this transcription for clarity and readability.  
The original real audio interview may be heard on Mr. Noland's [Ask The Expert](#) page.



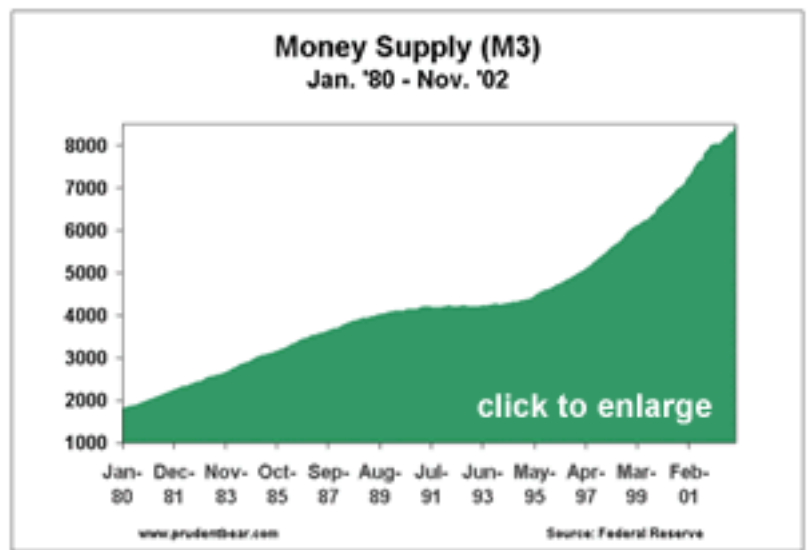
**JIM PUPLAVA:** Joining me on the program is Doug Noland. He is a financial market strategist at David Tice & Associates with thirteen years of investment experience as a trader analyst and portfolio manager. Doug posts a weekly column at the [Prudentbear.com](#) website, called [Credit Bubble Bulletin](#). Dave Tice and Associates is an investment, research and management firm based in Dallas. They publish, *Behind the Numbers* an institutional research service that provides quality of earnings in warnings and "sell" recommendations to more than 200 money managers. David Tice and Associates is also the investment manager for the Prudent Bear Fund and the Prudent Safe Harbor fund. Doug, welcome back to the program.

**DOUGLAS NOLAND:** Hi, Jim, thanks a lot for having me back.

**JIM:** I couldn't think of a more appropriate timing on my part, given the front cover of *Barron's* this week called "The Debt Bomb, America's household, business and government borrowings are at record levels." This is a good time to be talking to you. Doug as we get started, I want you to define for a lot of our new listeners and readers of this interview, a term that you use called, "structured finance."

**DOUG:** Well, that is a complex term, but let me give some background. Let's think in terms of the way that the financial system used to work. You had local banks being the main lenders. They lent to local businesses and the Federal Reserve could stimulate bank lending by buying government securities and adding reserves into the banking system. The banks could go out and lend those reserves and expand money supply and lending through that mechanism. Well, over time, we have developed almost a new parallel financial system, that I call "structured finance."

## STRUCTURED FINANCE



Structured Finance includes the asset backed securities market and mortgage backed security market, all the government sponsored enterprises, Fannie Mae, Freddie Mac, Federal Home Loan Banking system, the Wall Street Firms, and all the derivatives. What this system has mastered is it can go out and aggressively lend. It could be telecommunications loans, but today it is generally mortgages. They can take all these loans and pool them. They can put them into a trust and then they can go out and purchase different derivatives, to protect against interest rate moves and credit losses. Through this process, they then can get a AAA rating because of this structure. They can then go out and issue top-rated securities from this trust. It is a very efficient mechanism for lending and securitizing these loans. But because it is so efficient, it can be abused. And used in huge excess, it can lead to these huge lending booms and busts as we have seen in telecommunications debt and as we are witnessing today in historic proportions in the mortgage arena.

**JIM:** With a lot of these loans that are securitized, most people think of a mortgage on a home. But Doug, they are securitizing everything from car loans to credit cards.

**DOUG:** Oh, everything today. It can be healthcare receivables or aircraft leases; it can be fees to be earned by Mutual Funds. We are basically securitizing any and every thing. One of the problems that I have with this is if you think again of the way it used to work. You had local bankers studying businesses and lending against sound enterprises. We assumed they would hold these loans until maturity, versus what we have in structured finance, which dominates the system today. You have these originators who are all trying to lend as aggressively as they can.

Because they are selling these loans and other trusts to Wall Street, they don't have to live with these loans. They are just trying to originate them and sell them. The whole emphasis and credit analysis with sound lending and sound banking has been turned upside down by structured finance.

**JIM:** This is something that is much different than let's say, two or three decades ago, in the sense that you have your lenders divorced from the borrower. As you said, the old way we used to do things - when banks would lend money -- I think of an individual applying for a loan. The individual is sitting across the desk from the banker. The banker sizes up that individual. Perhaps in the old days, the banker even knew that individual, maybe went to Kiwanis or played golf with the individual. The banker had a vested interest in that loan because it was the bank's money that was at stake. But today, these loans are made and then securitized, packaged together, then off-loaded into the financial system. I wonder if we might talk about that next. I don't think people realize that a lot of this risk has

been off-loaded onto the financial system.

**DOUG:** There is no doubt about that. There is no transparency. There have been some articles written lately. We know there are enormous losses out there in telecommunications and corporate debt. We have so many bankruptcies and record defaults. The institutions, especially banks that have admitted to losses, are relatively small. Everyone is scratching their head saying, "Where are these losses?"

A lot of these loans have been packaged in special purpose vehicles and then put into CDOs, which are collateralized debt obligations. There are all these sophisticated securities and instruments that have been sold, a lot of these securities have gone into the hedge-fund community. A lot were sold to the big European Banks and insurance companies. A lot have been sitting in money market funds and some other mutual funds. There are many instruments that people probably don't understand, and they don't recognize that there are losses here.

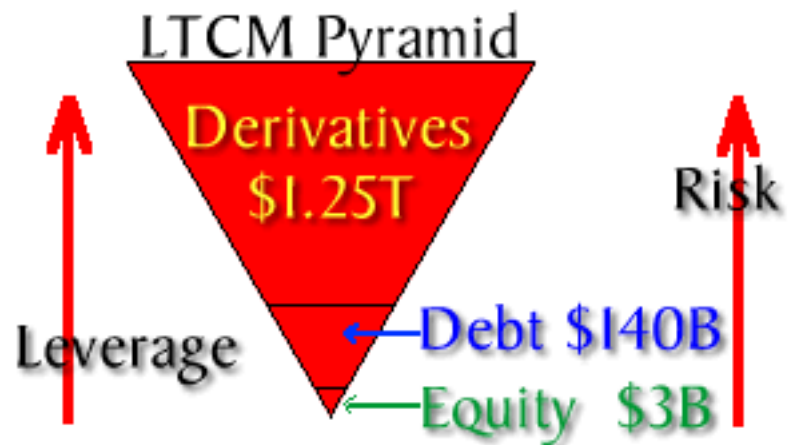
This type of mechanism is very efficient, especially during the boom. The transparency is an advantage because if no one sees the losses. Therefore, no one is concerned. But all of a sudden, we now know that there are real losses there and there is no transparency. That is when it can really cause problems in the system, because everyone is looking around wondering where these losses are. One thing we know right now is the big European financial conglomerates are definitely reducing their exposure to the US. They have been hit by some of these losses, and I think we are seeing the impact of a weaker dollar as they decide to reduce their exposure to the US financial system.

### THE DEBT PYRAMID

**JIM:** Let's talk about this debt pyramid in the US. We start out with a real economy, let's say at the base, it reminds me of an inverted pyramid, where you have the real economy at the bottom, you have on top of that the banking industry that makes loans, you have the financial markets, government sponsored entities, such as Fannie Mae and Freddie Mac, then on top of that you have the derivatives market. So the whole structure to me appears to be an inverted debt pyramid. It wouldn't take much, I would think, to knock it in one direction or another.

**DOUG:** I think you are absolutely right. I constantly use the terminology, "acute financial fragility." We have created so much debt and so much of it is non-productive. It is not like it is *real* sound collateral backing this debt. We continue to create more and more, and the pyramid continues to get larger. The system becomes more fragile.

I think we saw this in October 2002, when the corporate bond market was shut off. All of a sudden, the corporate bond credit problems started to wander into consumer finance. We saw the spread on Household International widen significantly. We had questions as far the credit quality of Capital One and Sears, even in Ford spreads, which was, what Ford was borrowing at versus what the Government was borrowing. So the system was coming under this very real and significant systemic stress in October. I don't think it is a coincidence that we had Fed Governor Bernanke and Chairmen Greenspan come out and basically tell the market, "We are on the case. We see the problems.



We are not going to allow any deflation or anything like that." In my mind, they were signally to the markets that they recognized there was stress, especially in structured finance and they were not going to allow this pyramid to rock. Whether it was successful or not, only time will tell. Clearly it is a very fragile structure.

**JIM:** As we look at this structured finance system throughout the 1990s, and you have written very eloquently about this, we see this growth in the balance sheets of government sponsored entities. Today we almost have a very independent, quasi-government agency that is exploding credit at an unbelievable rate. I was wondering if you might address that.

**DOUG:** It is something near and dear to my analysis. Again, with this structured finance, I look at this as a parallel financial system that has been running like a banking system without any controls. There are no reserve requirements. There is very little regulation. It has been a banking system, lending in enormous excess. We have seen it come under stress in this arena a few times. We saw it in 1998 with Long Term Capital Management.

We have this very unusual situation where Fannie Mae and Freddie Mac, and to a similar extent the Federal Home Loan Bank system, can aggressively balloon their balance sheets. They can aggressively go into the market place, purchase mortgages and other credit instruments, and re-liquefy the system. So in my mind, in my analytical framework, these institutions are basically quasi-Central Banks, because they have unlimited capacity to issue new debt, to issue IOUs and liabilities, basically to create contemporary money in credit. This is a very powerful mechanism that will stimulate credit creation, even in difficult financial times. What this does is coined in a phrase that Chairman Greenspan used way back before he was Chairman. In the 1960s, he referred to the Federal Reserve putting coins in the fuse box back in the 1920s and that is what led to the crash. The house eventually caught fire and burned down. They had monkeyed around with the market mechanism so many times and it led to such credit and speculative excess. That is what I see going on right now with these government sponsored enterprises.

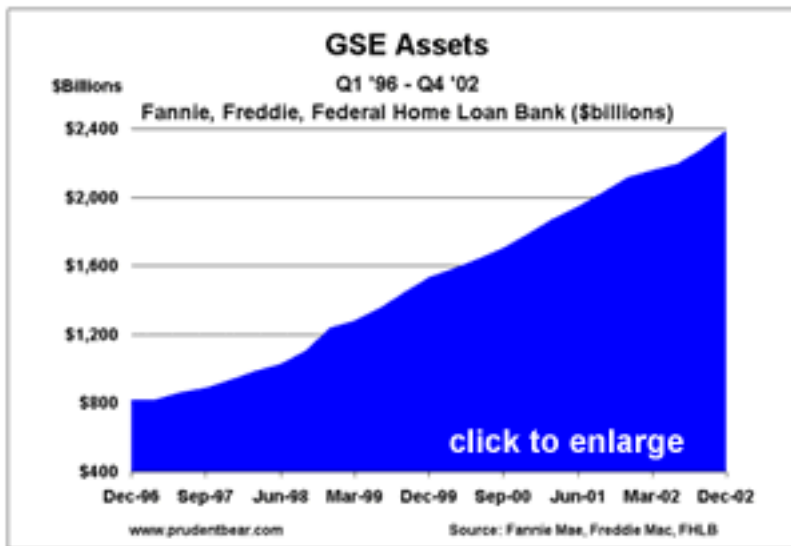
With Fannie Mae and Freddie Mac, it is just amazing. I see in the fourth quarter that Fannie Mae expanded their assets by \$50 billion at a 24% annualized rate for a company with about \$900 billion worth of assets. To me it is amazing to watch how this system works, because we haven't seen anything like this in history. And I will also interject that in my mind, the structured finance in this type of credit excess is directly responsible for the weakness we see in the dollar because this parallel banking system is creating new dollar claims or new dollar financial assets. It basically is devaluing the existing dollar financial claims. We are just creating

new ones on top of old ones. So not only do we devalue the dollar, we are also increasing the amount of non-productive debt. We have more dollar, non-productive debt. This parallel financial system is basically funneling this finance into the asset markets. That is leading to more financial fragility and an asset bubble. All these dollars are going into over consumption and fueling trade deficits. It is a very volatile mix of money and credit and trade deficits and dollar weakness that has now caught up to us. All you have to do is look at a chart of the dollar. Something has changed and it is not an environment of "King Dollar" anymore.



## GOVERNMENT SPONSORED ENTITIES

**JIM:** Well the other aspect, I don't know if you would agree with this, but it seems to me that these government sponsored entities are in direct responsibility for creating the housing boom. They are not only making these loans, but they have also moved into what they call the sub-par market. I think in some markets they were experimenting where you could rent the house then later on, buy it. Certainly the down payment and equity that a new buyer would have to put on a home has been reduced dramatically. It used to be a rule of thumb that you had to have 20% down. Now you can get into a home for sometimes as little as 5%.



**DOUG:** It is amazing to see what has happened in mortgage finance during this cycle. I refer to this as the [mortgage finance bubble](#). I don't say the housing bubble, because I don't say there is a huge bubble in housing prices, although there certainly is in pockets of the country. What I am saying is that this huge amount of finance is going into one sector. A lot is being extracted into home equity loans or through refinance. A lot of this is what is stimulating the trade deficit and over consumption.

Let's back up just a moment. You made this comment about how the GSEs [\[Government](#)

[Sponsored Entities\]](#) were directly inflating the mortgage finance bubble. My analysis tells me that the GSEs are more directly responsible for the stock market, technology, and the telecommunications bubbles. With these institutions, especially in 1998 with the problems with Russia's collapse and the Long Term Capital Management collapse, the system came under incredible stress. The GSEs ballooned the balance sheets and created all this money and credit, which was really a major part of the fuel that went into this stock market mania. These GSEs have been causing instability in our financial system and economy for many years.

What frustrates me is that now we see them continue to do this to even a greater extent and it is going right into the consumer debt sector. The last thing we needed after the stock market bubble and all the nonsense in technology was for one last wild period of speculative excess throughout consumer mortgage credit, where all the homeowners in the country take out this additional debt. I can't believe what we have witnessed. I can't believe that there isn't someone in Washington saying, "We can't allow this to keep going." We can't allow one bubble to lead to the next larger bubble and one that makes the technology bubble look pretty small, unfortunately.

**JIM:** Hasn't there been an attempt by several in Washington to try and rein this in, but it has been repelled by a lot of lobbying?

**DOUG:** I have read that Fannie Mae and Freddie Mac in particular have some of the strongest lobbies in Washington. These are incredibly powerful institutions. I hope a lesson that we learn here is that we can't allow institutions, especially quasi-Governmental lenders, to become so large, basically to become the whole mortgage market. You can't allow that. Because once you go in that direction, there is no turning back. I wrote, even last week, these institutions are too big to regulate. They are too big to even allow any slowing down. They have become the main instigator of the credit excess that the system now needs to be stable. We are dealing with the credit bubble financial system that needs all this mortgage credit just to function, or we come under immediate systemic illiquidity and financial problems.

**JIM:** The amazing thing about all of this to me is I think back even a decade ago, you put down 20% if you bought a home. What amazes me is banks have been reluctant to lend to business for capital spending. Credit spreads have widened. And yet, they will go out and make home equity loans up to 100% or more equity in a home. There is absolutely no collateral left. What happens if a person loses a job or housing prices drop five or ten percent? There is no equity.

## EASY CREDIT TERMS

**DOUG:** It is absolutely reckless. There are even all these new programs, these non-profit organizations, that have popped up all over the country that will basically take a donation from a seller of a home, be it a builder or someone who wants to sell their home, who will donate to a non-profit. The non-profit will take the money and use it as a down payment for someone else who doesn't have enough for a down payment. They can at least make the minimum 3% for an FHA loan or perhaps a little larger for a loan that Fannie or Freddie will purchase.



As we saw with all the craziness that happened during the technology boom, if you threw all this money and credit at a sector, we're going to come out with all these ingenious mechanisms to try and take advantage (earn profits) of it. We are seeing it run rampant through mortgage finance now. It is very easy to buy a home with no down payment at all. People will come into a home with no savings and they will be immediately under water if there is any problem with their work or medical expense or whatever unforeseen financial problem that may come about. It is reckless for the system to allow so many who don't have enough financial means to own homes.

There is something else I will throw in here. In Dallas, it is interesting. On my drive here to work there is one long block. I think it is about 1/3 of a mile in between these two major thoroughfares. During the summer, there were four "for sale" signs. Now on this block, there are about 16 "for rent" or "for sale" signs. This is in an older middle class neighborhood. These homes are not selling and they can't rent them. Now 10-15 miles away, we have this whole group of major homebuilders that are building new homes in huge numbers. They are selling them with no down payment and on easy credit terms. Because of their relationship with Wall Street, they are able to package these loans to securitize them and then sell them. So existing homes now can't be sold, because everyone is just gravitating to these new homes that are just a little further away that have all these enticements, especially easy credit availability.

So in my mind, I can see the huge problem developing now. The real estate market in Dallas has turned, but the whole financial structure is so distorted that there is still money being thrown at the home builders to continue to build as many homes as they can possibly construct and they can find buyers for. It is amazing to watch what is going on right now.

**JIM:** The other thing I worry about is, and you are probably seeing the same thing in your town, is the

sale of automobiles or furniture for the new homes you are talking about. The ads that we see in San Diego are no money down, no payments, 0% interest and no sales tax. They are delaying these payments for at least a year. I am not sure. It is at least three or four months on autos as each dealer has its own program. But what happens a year from now, when all of a sudden those payments start? I mean it is easy now. You just go to the furniture store or you buy your new home with no money down, and then you go get the furniture with no money down and no payments.

**DOUG:** Well, again, these types of programs help the economy on the "near" term and we have seen the aggressive financing terms in auto finance continued. Last year was another big year of auto sales, but at the same time the inventory of used cars is piling up. The prices of used cars are weakening monthly. We are seeing all types of businesses use easy credit terms in desperation. I heard a story recently of a major national lender starting to get in real trouble with some loans they had with one of their retailers. The retailer had gone to no payments until 2004 just to get new receivable out into the marketplace so they don't have to worry about delinquencies for a year - making their ratios look better. In my mind, this is even worse than I would have suspected. It is not only to try and stimulate sales, it is also to try and make their credit performance look better. It is very disturbing to see this kind of financing going on at this stage of the cycle.

## RECORD CONSUMER SPENDING

**JIM:** Do you think the one distinguishing characteristic of this last recession that it so unique in comparison to the others? Typically, if we look at the financial behavior of consumers and the fact that during a recession, housing leads the downturn in the economy, consumers would begin to retrench. They would pay down debt and rebuild savings. And Doug, we would go through a period where there would be this pent up demand from paying off debt and putting money in the bank. So when this recovery came, this pent up demand leads to this robust pick up in economic activity. This time around, the consumer has been going full throttle, denying themselves nothing. I don't care if it is new homes, new cars furniture, big home entertainment systems, electronics or vacations. You name it and they are spending for it.

**DOUG:** It is record consumer spending. The consumer has not slowed down a bit. That is what makes the analysis very troubling. I don't even look at it as a recession. I look at it as a bursting of the stock market bubble and the technology bubble and those related adjustments. We haven't even started the adjustments on the consumer side. From my analysis, as far as the credit bubble is concerned, it is alive and well and running to historic excess as we speak. The real problems, like the traditional recession problems, will come later.

The consumer will have to slow down spending. There will be severe credit problems in the consumer sector. Lenders will pull back and there will be credit availability problems. We are just beginning to see that on the fringes of manufactured housing and some of the sub-prime credit cards. That is where the shoe that will drop and I think it is in the process right now.

I was looking at the fourth quarter numbers of some of the lenders. The type of deterioration we are seeing in credit quality, especially in the historic refinancing boom is very troubling. The fact that the credit excesses are so extreme and we are probably only going to see one perhaps two percent annualized GDP growth again is very troubling. We are seeing less economic impact from credit excess. I know that down the road this excess will be reversed. This type of lending and speculative excess will lead to a reversal and significantly less lending and speculating going forward.

**JIM:** Why do you think that nobody -- maybe some do and just don't want to talk about it -- but it

seems that very few people on Wall Street or in Washington seem to see this debt pyramid as a problem? In this weekend's edition of *Barron's*, the front cover story was "The Debt Boom." Some of the statistics they talk about are shocking. Credit market debt now equals 296% of GDP. That is in comparison to 160% in 1980 and 264% in the Great Depression. *Barron's* goes on to say that from 1980 to the third quarter of last year, outstanding debt -- we are not talking about pension obligations or social security -- but existing debt went from \$4 trillion to \$31 trillion. That is a lot of money.

**DOUG:** It doesn't make any sense. I continue to look at these numbers. The Federal Reserve continues to publish numbers quarterly that are excellent which describe the amount of credit creation in different sectors of the economy. To me, it is unbelievable. The fact that the Federal Reserve is not doing something to try and limit the excess, especially throughout mortgage finance, is stunning to me.



I will throw out another number. I am guessing that the system will have created almost a trillion dollars of total mortgage credit annualized during the fourth quarter. To put that into perspective, I think we were at \$300 billion during 1997. The credit excess has gone exponential. I guess if people will look at it and say that mortgage credit was only up 10% last year, that it wasn't *that* excessive. But it has been up 9 and 10% continually. So you are compounding excess on top of excess. That is how you get these numbers as far as the percentage of GDP. They don't make any sense at all.

### IMPORTS AND FOREIGN FINANCIERS

**JIM:** It seems like it is taking almost \$2.5 trillion a year of new credit to make our economy hum along. You have the November trade deficit figures of \$40 billion. So we have trade and current account deficits at over half a trillion. We are taking in almost all of the world's savings just to supply our trade deficit. The reason I bring this up is that there is a lot of debate in Washington right now, in terms of stimulus packages, to get the economy going. The emphasis seems to be on consumption as the "be all and end all" to economic problems. The problems I see is that even if they can stimulate consumption, get consumers to go deeper into debt, spend money and consume, a lot of those dollars are going to imports so they are not benefiting US industry or the US economy.

**DOUG:** Absolutely! It is just adding to the problem. It is more credit creation and more of our liabilities that are being held by foreign source financiers. That is a problem for the dollar. It doesn't make any sense to try and stimulate financial consumption today. But that is exactly what they will do. Everyone thinks in those terms. It is all about GDP growth and there is very little concern as far as financial stability. There is very little concern as far as what the ramifications are of a weak currency. I don't see much in Washington outside of what we would expect from politicians, to grow at all costs. We are at a point today where that cost is rising exponentially.

**JIM:** One of the aspects we know about from economics is that when you have these big credit booms and credit bubbles that we have seen, there is nothing that has been as big as we have going in the United States. Depressions usually follow when you have a credit bust. They tend to come after

years when you get this credit built up. You get to the point, like in Japan, when monetary easing no longer worked and interest rates were at zero. There was no further debt service relief available to an over-burdened business, households or consumers. That situation in the past, in Japan and in the US in the 1930s, led to deflation.

## THE US DOLLAR AND ARGENTINA

I want to bring up the aspect of Argentina today because the US is a different country than it was in the 1930s. We are no longer self-sufficient in energy. We are no longer self-sufficient in manufacturing. We are no longer self-sufficient in capital. Even when you have countries such as Argentina, the value of their currency didn't really help their economy because they were importing so much. Is it possible, if we have this debt contraction, that you get to a point where you no longer have a willing lender, whether it is a bank or finance company, or for that matter a willing consumer? Where do we go from there?

**DOUG:** Well, this could be a long-winded answer. I will try and keep my thoughts straight. Right now we have this credit bubble in the US. The numbers you were talking about, the \$2.5 trillion annually, is exactly right. We have to think in terms of both the *real* economy and the financial system, because we have a distorted bubble economy and we have this credit bubble or this bubble financial system. Both the economy and the financial system need enormous amounts of new credit to keep them levitated.

The *real* economy is so distorted with these massive trade deficits and it is so based on the financial sector and services related to housing and asset prices. It takes an enormous amount of credit to sustain. In the financial sector, we still have a bubble in the stock market. We have an enormous bubble in the bond market -- be it treasuries, agencies, mortgage backs, or structured finance. This takes enormous amounts of credit to keep that going. It gets back to this [dual financial system](#) that I talk about.

Structured finance takes an enormous amount in new money and credit to keep all of this weak debt structures functioning. If it continues to function - let's say the Fed can convince the marketplace that it can keep the system liquid and we can continue to create all this money and credit - then we have an immediate dollar problem. I think that is where we are today. We have to create all of this money to keep house prices and security prices levitated. These dollars are going to leap overseas and foreign source creditors are not going to want to own these securities today and we have a dollar problem. If it gets out of control, let's say structured finance has a real accident and it collapses, we could have a real deflationary problem. We could have a collapse in housing prices - a collapse in all types of asset prices.

But the other scenario is the Fed and the GSEs keep this credit system functioning and we have a real dollar accident, which gets us into the scenario of Argentina. Argentina had an economy that looked like it was functioning well, with stable prices. There was a huge bubble that developed in its currency. Then with the currency lost its peg to dollar, and with all the related derivatives and then the exodus by the speculators, along with capital flight, the currency collapsed. Over the boom years, their economy had invested very little in manufacturing. So they didn't benefit at all - or at least very little - from the collapse of their currency. They went into financial collapse and it is just a disaster down there.

The US has an Argentina-type problem. All this money and credit that we are creating has not gone into manufacturing. Very little of it has. It is so dysfunctional. The GSEs and the structured financed complex are just inflating non-productive debt. But, if we do get into the scenario where structured finance holds together, then we will likely see a dollar crisis due to the excess credit created. We are going to be faced with rising

prices for a lot of things. We are going to be paying higher prices in oil and in a lot of things we import. I almost think that over the last few months, this has been made clear. The real issue is not inflation or deflation. The real issue is: What are the consequences? What are the ramifications of an on-going dollar problem?

**JIM:** On top of all that, as we take a look at all of this as foreigners start to pull money out, I wonder if we will get to the point were, like the 1970s, when we no longer backed the dollar and defaulted on our gold obligations. Foreigners pulled out of the country and the dollar started to go down. But eventually, like when I got in the market in the late 1970s, even American investors weren't buying anything -- paper assets or financial assets. Everything was going into what was tangible and real because of what was happening to not only the dollar, but also what was happening to paper investments.

**DOUG:** I think we are seeing hints of that. I sense a totally different environment. We are seeing the move in gold and in a lot of commodities. I think people would like to own something hard (as opposed to financial). Certainly, I think the sophisticated foreign players recognize that we have a real problem here in the financial system and we will inflate dollar claims. I think the sophisticated money is heading for the exits. I think the problem we are going to have is that there could be a lot of sellers of dollars. I am just not sure who the buyers will be, if we get into a real serious run from the dollar. I don't think it is an exaggeration to think that is a possibility. We have seen that type of credit or speculative bubble blow up. We have seen the consequences for the currencies in South East Asia, in Russia and in Argentina. Unfortunately, these types of reversals in currencies and speculative currency bubbles usually lead to some type of dislocation and that is what really has me worried this year, going forward.

**JIM:** We look at the dollar, which is getting to lower levels. We have more credit creation. We have geopolitical risks with Iraq and Korea. There seems to be so many things out there that impact this system. After 9/11, one of the things that the Fed was able to do was liquefy the markets, the GSEs liquefied the markets, and we saw that begin in the fall. What happens if we have another terrorist attack or the war doesn't go as well as the experts are expecting it. For that matter, let's say you have a major financial entity that goes into default, much in the same way we saw the financial stress in the first quarter of last year, with Enron and WorldCom and K-mart.

**DOUG:** That is the problem with having such a vulnerable financial system. There is so much fragility with all the derivatives and all the guarantees. We have the whole structured finance and the risk that is out there and no one really knows where it is. The system is poised for a crisis of confidence. It is such an abnormal system and we can't expect that it will respond well to shocks. I think everyone is a little complacent today, because they know what the Fed was able to accomplish after September 11th.

Unfortunately after September 11th, the market recognized that the Fed was right behind the Government Sponsored Enterprises. The Fed was basically going to guarantee the re-purchase agreement market. What the Fed did after 9/11 was critical as far as these wild, unprecedented excesses we have seen since then in mortgage finance. That is another real problem. I think a lot of Americans are complacent that the Fed can resolve any problem no matter what. It is almost bullish if there is a geopolitical event that makes folks nervous. I think we are getting to the point that it is not a liquidity issue anymore. The Fed's mastered and the GSEs have mastered creating liquidity. Now, it could be a dollar problem. It could be the foreigners deciding to dump US assets. All of a sudden, what the Fed has mastered is a negative. If they start creating all this liquidity and come to the rescue of the markets by creating more money and credit, the foreigners would likely move exit even more quickly. That is another issue that is much different than it was before because we are at a point dollar weakness.

## DEALING WITH DEFLATION NOT THE BIGGEST PROBLEM

**JIM:** What surprised me were the speeches given by Bernanke and Greenspan in November that seem to be a turning point for the market. You even have the bond people, people such as Bill Gross and Paul McCulley at Pimco calling for Keynesian-style stimulus. In fact, during the Christmas holiday most of the business magazines and investments magazines that had their forecasts for the New Year, one of the primary things in the new forecast was economic stimulus. People seem to think this is going to be the big winner for the economy and the financial markets with massive government stimulus. Looking at the President's plan, in reality only \$50 billion goes into the economy this year and \$100 billion into the economy next year. The \$674 billion is actually over a 10-year period. Wall Street has actually gotten on board. If you watch the cable channels or pick up an investment magazine, everyone is very positive about this.

**DOUG:** Maybe I am a little too cynical. When Wall Street starts talking deflation, I kind of read it as Wall Street saying there is a risk to our structured finance we have created. When they started talking deflation, especially in October, I think a lot of it was related to the severe stress in structured finance and the problems in the corporate bond market. These problems were rapidly moving into the consumer sector of structured finance. I think that the motivation really is to get the Fed to inflate, to continue to create money and credit excess to keep this whole structured finance monster that they have created, levitated. It is really kind of self-defeating.

The problem today, at least from my analytical framework, again, is not a problem for deflation. We are creating all of these dollar claims. Wall Street may want the Fed to come in and ensure that the system will continue to perpetuate excess. In the end it is going to lead again to a dollar problem or some type of systemic crisis. You can't continue to create this non-productive type of debt without having to "pay the piper" at some point.

## AN ANCHOR-LESS MONEY SYSTEM AND CREDIT SYSTEM

**JIM:** It seems to me if you take a look at all of this analysis, the fate of the economy rests on the American consumer and the American consumer's ability to borrow more money and spend. The fate of the American consumer rests on the housing market. It seems like it is a very fragile system. Would I be summarizing that correctly?

**DOUG:** I think you summarize it very well, Jim. That is some of the reason why, in my work--folks may think I am an extremist--but in my work, this has been the absolute worst-case scenario. You don't want your entire economy, your entire financial system, to revolve around mortgage finance. Especially when it is generating such excesses as we are seeing today. That is a very weak type of credit creation. It creates a very fragile, not only financial structure, but it is so distorting to the economy. Even today, we have all these retailers that continue to build new stores and this whole service sector economy continues to expand; while we close down manufacturing plants. It only gets more distorted by the year.

What we really need is a significant adjustment period. It is going to be painful. But we need it to get this economy back on an even keel. So we don't have \$40 billion monthly trade deficits, so we don't have all this credit being directed at the housing market, rather than at sound business investments. Something has to change, because we have created these monetary processes--these financial structures--that is directing speculative finance basically to the wrong place.



Today the hedge funds and all the proprietary traders, they will just leverage and speculate on mortgages backs or agency debt or credit card

receivables because that is where they can make easy profits. Nobody wants to go out and fund a *real* business. No one really wants to go out and own some *real* sound corporate debt. The whole thing is so distorted, that perpetuating this distorted system is only going to lead to greater problems down the road. There is just no escaping this. I hope that is what we learn from this. Once you allow these bubbles to begin, they take on a life of their own, and they move around and distort the whole economy. There is really no escaping this. You have to keep the financial system contained and nip these financial excesses in the bud. They only grow.

I have mentioned before on your program that early students of Central Banking recognized that there was a problem with discretionary monetary policy. Because if the Central Bank made a mistake and had all this discretion, and they would make another mistake and these mistakes would compound. That is kind of the way our whole system is working right now. We have an anchor-less money and credit system. There is nothing harnessing these excesses. The greater the excesses are, the more stress in the system, the more everyone says, "We need more money and credit. We need more of this inflation because we have a deflation problem." It is not a deflation problem. It is a collapse of all these wild excesses. The thing then only gets further and further out of control and we are left where we are today, where it takes unimaginable amounts of credit to get 1 or 2% GDP growth.

## THE STOCK MARKET & CORPORATE EARNINGS

**JIM:** Well, let's bring this to the stock market today. Wall Street is bullish as never before. It is very rare that we have had four back-to-back years of losses in the stock market. That has happened only once from 1929 through 1932. Your firm publishes an investment research paper, *Behind the Numbers*, where you actually take a look at the quality of earnings. One things that strikes me today is the wide spread use of pro-forma earnings. To me, one of the reasons I think we see pro-forma earnings used is that if the *real* earnings were being used, the P/E numbers would be so high, that people would still see that we are dealing with an over-valued market.

**DOUG:** Definitely. At our firm, we diligently study individual companies and spend a lot of time analyzing a lot of companies, the economy and macro-issues. That is what is so troubling to us. We see problems wherever we look. It is very difficult for me to look at an earnings statement and make any sense out of it. There are so many extraordinary items or pro-forma and again, once you get off track and the system starts to allow the manipulation of earnings and this and that, it takes on a life of its own. I think it is very difficult for companies today just to come clean and say, "This is what we are really earning." There is a huge motivation to say, "We had a recession, things are behind us and they are looking up now." I think there is still an incredible amount

of pressure on these companies to try and make their earnings look much better than they are. I think the market is clearly richly valued if you take earnings for what is presented. Unfortunately, we think there is still a lot of monkey business going on, a lot of inflated earnings out there. My emphasis is in the financial sector and I still look at these institutions taking very small provisions and they are under-reserved for future credit losses. I look at their earnings. I would say they are grossly inflated for the financial sector.

**JIM:** Has it surprised you that the media has not picked up on this in terms of what *real* earnings are? I don't know about you, but 20 years ago--even 10 years ago--it was very easy. A company announced their earnings. You looked at the balance sheet. You looked at the bottom line numbers. If it was lower, you knew where things were. But today, there's a good example of what we have been talking about. Today we had Citigroup and Ford announce earnings that beat estimates. But in the case of Ford, they lost \$130 million. In the case of Citigroup, they were down approximately 40%. Last week IBM beat estimates, even though net income was down 56%. It almost seems to be this game. Rather than talk about the bottom line, we are talking about these companies beating estimates --which, heck, I think my dog could beat estimates.

**DOUG:** It is kind of an indication that we are still in this bull market mentality. People really haven't accepted that we are going to have to go through this really difficult period because these gains are still continuing. These companies are not going to come clean. I think we know that we are at the bottom of the bear market when we really see disastrous earnings and companies taking these really huge writeoffs and saying it is going to take some time to return to profitability. So far, especially if you look at Citigroup, they continue to expand enormously. If you look at Ford, they continue to have incentives and all these things that inflate revenues. I look at my universe of companies and see that there is no way we are in that bear market-type of capitulation and resolve to get everything on the table, get it cleaned up and then move forward. I think it is still pedal to the medal and try to grow as quickly as possible and worry about the consequences later.

## INVESTOR SENTIMENT

**JIM:** Has it surprised you that in this bear market, we have had for the first time since the 1970s or even 1939-1942, where you had three back to back years of losses, but it was less than \$20 billion dollars that investors pulled out of equity funds last year?

**DOUG:** That is one more of those numbers, Jim, that is frightening. Considering what we have seen, people haven't really reduced their exposure and decided that the bull market won't continue. If investors really do decide to tear down their mutual fund investments, that is one more real problem that the market has to deal with. Again, it fits with my scenario that we are still in the midst of the boom, the credit bubble. We are seeing enormous money and credit excesses. In the household sector, at least in a lot of it, they have never felt wealthier because their home value has shot up and they have been able to extract equity. I think for a large segment of the population, they haven't really been hit that hard. I mean, in the technology sector and those investors, they lost a lot of money. But there is a lot of the economy where they are still optimistic. If anything, they are more optimistic because they think they have survived a terrible bear market and a tough recession. I don't think there is recognition that we have difficult years ahead of us.

## INVESTING IN TODAY'S MARKET

**JIM:** How do you play this? What are you guys doing at Prudent Bear? It seems to me with the dollar in serious trouble and almost a global synchronized down-turn in the economy, that gold and silver are resuming their historical role as real money. Also we have seen certainly a move in commodities,

**the price in energy, and the rice in the CRB index. It seems that maybe strong foreign currencies, gold, silver, commodities and short to market is the way to play this.**

**DOUG:** It is obviously a very exciting environment. Think of it this way. For several years, we have had "King Dollar." Basically if you were an investor, a speculator here in the US or in the Cayman Island, or in Europe, it was a very easy decision. You wanted to be in US dollars. Then it was, Did you want to own stocks, mortgages backs or bonds? What did you want to own? It was in US dollars. So in that environment, you wouldn't want to own any of these peripheral currencies. You would look negatively against the Australian Dollar. You wouldn't want to own gold. In fact, if you were a speculator, you would say, "Wait a minute, with the dollar so strong, why don't I short something like gold? Or, why don't we short the Euro and take those dollars from selling something short, and put them in US dollars or putting them in the Mexican peso that had been basically pegged with the dollar?"

Now, what we are seeing is the demise of "King Dollar," with this opening up of a new world for the foreign markets, foreign currencies and commodities and giving it a new look. It is hard to tell which ones will win and which ones will lose. But at least it is worth really looking at the world differently today, knowing that the investment scenario has changed, with money possibly coming out of the dollar and dollar instruments and looking for another place to go. Clearly, in this environment, gold seems to be the easiest pick. It is something hard and for centuries, it has held its value. So certainly that is one of our top picks. We think we are pretty early in what will be a long-term gold bull market.

**JIM:** Some of the bears, especially the precious metals investors have cited, that we have these two back to back years where the HUI [Amex Gold Bugs Index/HUI Index] was up 100% last year. It was double digits in 2001. So gold has been one of the top performing sectors in the market. Some are saying this as a bubble. In my mind, I don't see this as a bubble, in the sense that you have, number one, supply deficit, growing demand and diminishing supply from a fundamental point of view. And number two, I just don't see the widespread institutional support of buying gold, which is indicative of the second phase of the bull market. Or for that matter, we haven't seen the widespread participation by the American consumer and investor.

**DOUG:** That is exactly why we think this is so early in the gold bull market. If you think of the incredible pool of finance that has been created over this last decade, a lot of it is speculative finance, a lot of hedge funds and proprietary trading debts. With all the money that has been created and gone into mutual funds and different investment vehicles, if only a small part of that went to gold, it would fuel an incredible move. I can't predict which way gold is going to go in the short-term, but to think we are in some type of gold speculative bubble today, to me just doesn't make any sense when you see all the money and credit going elsewhere. This also gets back to what I was saying.

It makes sense to assume we are going to continue to devalue the dollar. We are going to continue to create huge amounts of new dollar claims to keep the system levitated. This in itself will lead to higher gold prices, forgetting all of these other issues that are very important for the market only making gold appear a better opportunity.

## WHAT'S AHEAD

**JIM:** Finally, looking at the year ahead, what do you think are some key factors or things that investors should be watching out for, in terms of some telltale signs on the direction the economy and our markets are headed?

**DOUG:** First of all, I sound like a broken record, but we need to watch the dollar carefully. Even a day like today, all of a sudden, the Mexican peso is down 2%. Is this related to a flight away from the dollar and economies close to the dollar? We need to watch the dollar carefully and try and recognize what this means for different types of prices. The key is to focus on relative prices. If we look at the economy, we know that this is a consumer-driven economy. Today we have to focus on the consumer sector. We have to follow closely the credit data that comes from the different lenders to see if things continue to deteriorate. Right now, we have very high foreclosures in the mortgage area and very high delinquencies too. To see these numbers already looking poor, while recognizing the degree of current mortgage credit excess, leads me to believe that is a critical area we have to watch closely.

I know most feel we have passed the recession and the job market will improve, so the credit situation in the mortgage area will look better. My view is we haven't started the *real* problem. The *real* problem in the mortgage area is when credit availability is lessened --when all this credit excess is eventually reduced. Right now we need to focus on consumer finance and on the dollar. Those will be the two keys for the year. It is going to be a very difficult and volatile year in the market. I am not saying that the bears are going to make easy money being short US stocks this year. I think it is going to be a tumultuous year, because we are at a period of transition. Everyone is going to be studying to determine which sectors are going to win or lose and how this is going to evolve. I think there really is an unusual amount of uncertainty this year, even more than the last couple of years.

**JIM:** You write your [Credit Bubble Bulletin](#) every week at Prudentbear.com. Before we end our session, why don't you tell our listeners about the funds offered at Prudentbear.com, specifically the Prudent Bear Fund and the Safe Harbor Fund? What do they do and what are their objectives?

**DOUG:** Basically, the Prudent Bear Fund is short US stocks. We try to do a real fundamental analysis on companies and find companies that would do poorly in this environment - where we can make money on our short positions. We also have a rather significant gold position. We own a lot of gold companies that we think are excellent opportunities. We also will buy put options and try and get exposure and down-side protection in the market with our put options. We do all kinds of things in the Prudent Bear fund to try and profit from the unfolding environment.

We then have the Safe Harbor Fund, which is a totally different vehicle. What we are trying to do there is to provide investors a vehicle to preserve their international purchasing power. We are seeing a real dollar problem and we are going to have a lot of our savings in this country devalued. They will be devalued as far as the amount that can be purchased internationally. When I say internationally I am talking about gold, oil or imported goods or whatever. We have this vehicle that generally holds what we think are sound government bonds issued by countries that are doing the right things fiscally. We own about 10% gold stocks in what we consider the safe and sound gold companies in the Safe Harbor Fund. We are trying to find vehicles that can preserve people's wealth in these uncertain times.

**JIM:** Doug, why don't you give us your website and tell people what they can find at Prudentbear.com? There are a lot of good commentaries that you post on your front page. Why don't you speak about that for a moment while we end?

**DOUG:** I will do that. If they are used to coming to your site and then come to ours, they are going to think, "What the devil are they doing at Prudent Bear?" Yours is so great that I feel embarrassed to even mention ours. But, since you brought it up, I will. It is [www.prudentbear.com](http://www.prudentbear.com). What we are trying to do is inform and

educate. We provide commentaries and news links and try and help people become more aware of what is going on in this tumultuous financial environment we have found ourselves in.

**JIM:** As always it has been a pleasure having you on the program and I want to thank you for joining us today on Financial Sense Newshour. I hope to speak to you again in the future and have you back.

**DOUG:** Thanks again for having me. As always I am honored that you would even invite me on the show. You are doing a great job and I am happy to be a part of it. Thank You.

## Definitions

**CDOs - Collateralized Debt Obligations:** A “structured” bond-like security created by Wall Street from a diversified portfolio of corporate loans. These securities are issued by a trust, or special-purpose vehicle, that often incorporate derivative protection and other guarantees to garner top bond ratings. [[back to text](#)]

**Acute financial fragility:** A state of severe financial system vulnerability that is the consequence of excessive borrowings (weak debt structures) and speculating. [[back to text](#)]

**Mortgage finance bubble:** A circumstance of enormous unsustainable mortgage lending that fuels housing price inflation as well as over-consumption. Mortgage Credit excess, and its resulting asset inflation, are self-reinforcing and lead to severe distortions to both the financial system and economy. [[back to text](#)]

**GSEs - Government Sponsored Enterprises:** Financial institutions, of which the three largest are Fannie Mae, Freddie Mac and the Federal Home Loan Bank System, that were created by the federal government and operate with special privileges and benefits. These quasi-governmental institutions’ liabilities enjoy implied federal government backing in the marketplace, and thus are especially vulnerable to over-issuance. [[back to text](#)]

**Dual financial system:** The notion that Wall Street “structured finance” – with its asset and mortgage-backed securities, money market funds, Government Sponsored Enterprises and securities firms – is creating money and credit in much the same way as the banking system, but outside of traditional reserve requirements and banking regulations. This system creates monetary processes that are especially susceptible to over-financing asset markets and fueling speculation. [[back to text](#)]

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