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The Mark Twain Theory of Commercial Banking

A banker is somebody who lends you an umbrella & takes it away as soon as it starts raining
(Mark Twain)

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Introduction

- In November 2000, we published a study entitled "*A Review of US Economic Growth*" in which we concluded that the case for an outright recession in the US was very small.

- We made the points that, while the US old economy was probably going through a recession, the US consumer and housing sectors were strong enough for the economy to avoid any major problems. At the same time, we felt that the Virtual economy had a strong structural growth undertone.

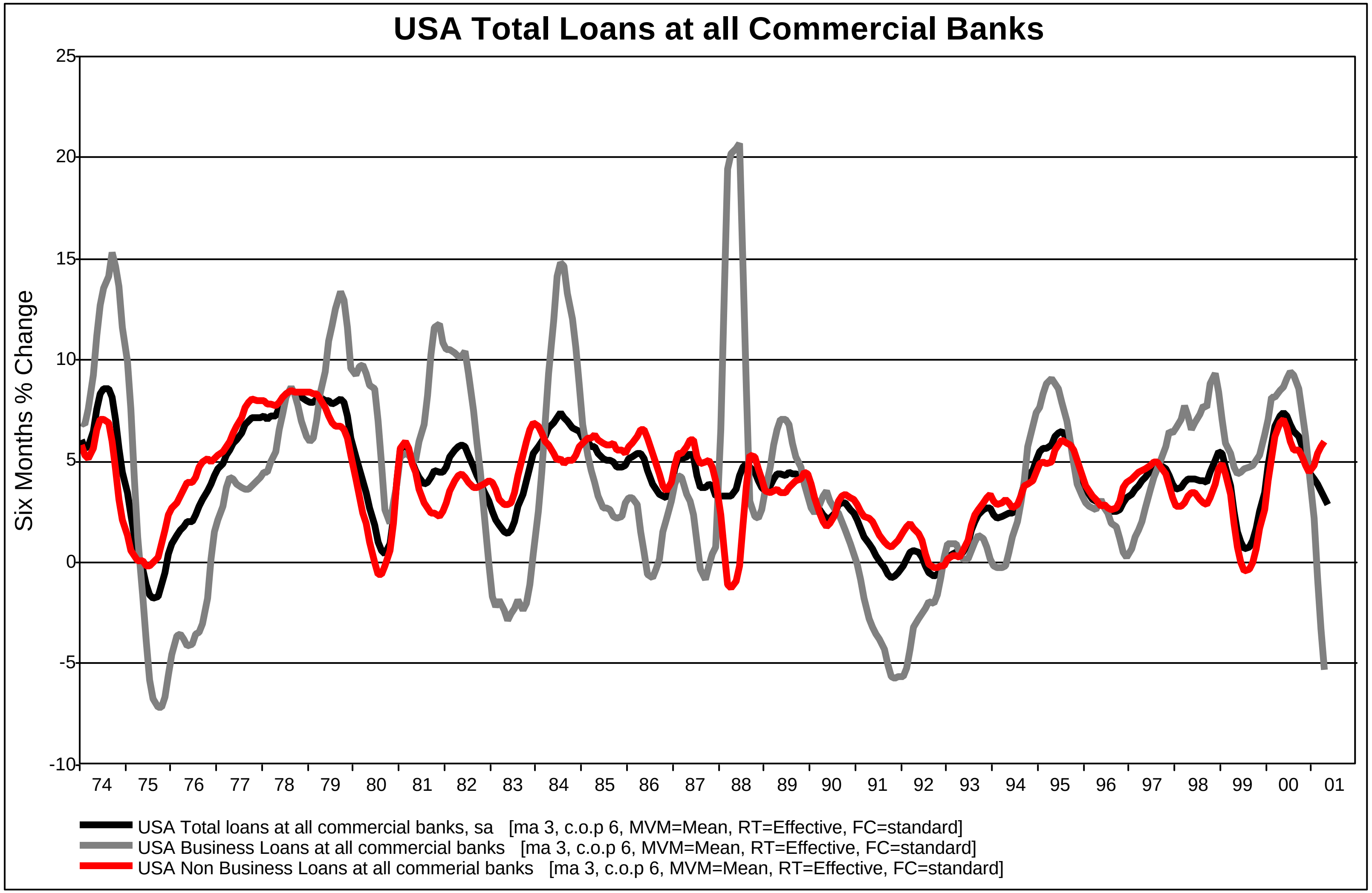
- Our theory, at the time, was that the US economy was in a serious liquidity crisis with the stocks and bond markets closed for new issues. Consequently, we concluded that the only danger for the US economy was for the commercial banks (the only source left for liquidity) to start panicking and cut lending aggressively. This would kill off both the Virtual and the Real manufacturing bases and possibly impact the consumer & housing sectors.

- In order to evaluate this threat, each week, we monitored (in the *Twenty Signs*) the total balance sheet of the US banking system. Surprisingly, nothing alarming appeared.

- However, the US manufacturing base behaved as if it was in a financing crunch. More worryingly, the virtual economy really fell out of bed. We had to conclude that we were either not looking hard enough or looking at the wrong indicators.

- We then found what we should have found much earlier, (and what, in truth, given past historical patterns, we should have expected): the commercial banks panicked.

The Banks Panicked



- The commercial banks did something quite unusual in the past year.
- They collapsed their loans to businesses and they simultaneously increased their lending to non business.
- As a result their total lending did not decrease significantly.
- But their actions killed the US manufacturing base nonetheless.

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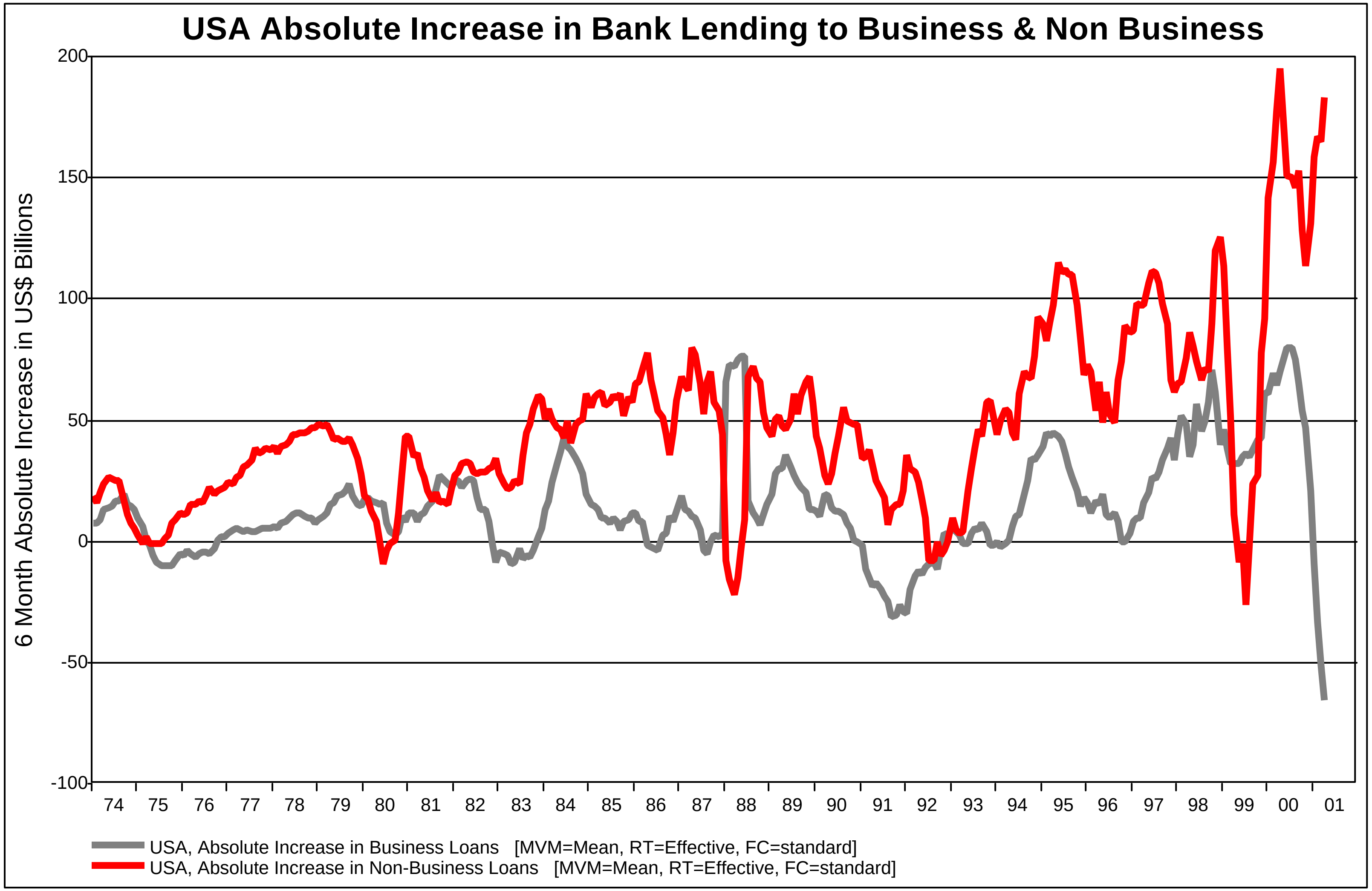
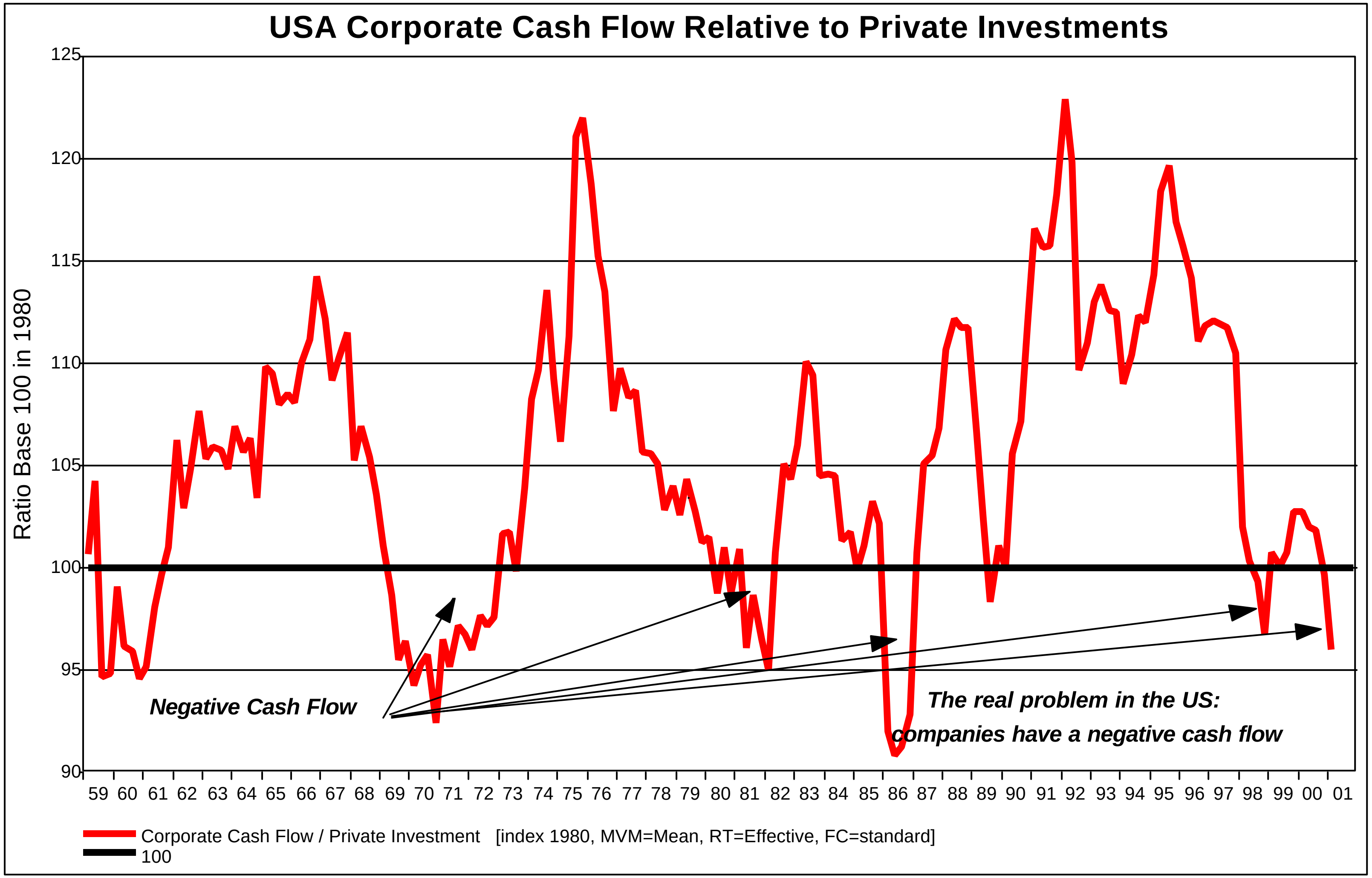
And Adjusted Their Portfolios



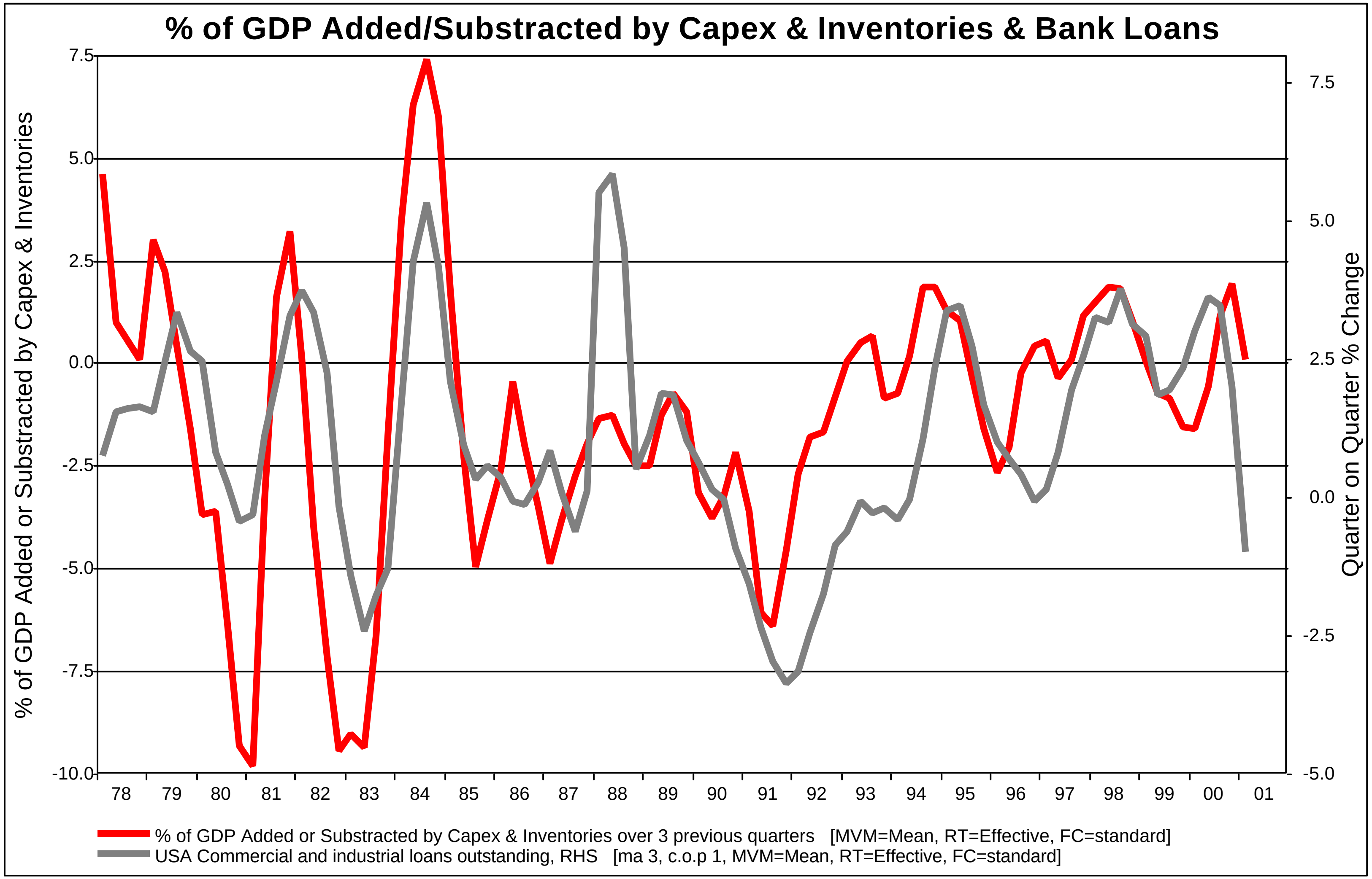
- The commercial banks decided suddenly that lending to businesses was dangerous.
- Needless to say, they took that decision all at the same time.
- Banks decreased their lending to businesses by over US$ 50bn (Telecoms & Tech?).
- And increased it to non business (mortgage & consumers) by more than US$ 150 bn.

Why? Companies Were in Negative Cash Flow



- In 2000, the financial markets went through a severe liquidity crisis.
- At the same time, the high capital expenditures of US companies had pushed them into negative cash flows.
- The combination of the above two events meant that US companies were extremely dependent on their commercial banks.

The Banks' Decision: Impact on Growth



- The decline in capital spending and inventories over the past couple of quarters has shaved close to 2 points off of GDP growth.
- Both inventories and capital spending are highly correlated to commercial bank lending.
- The commercial banks forced US companies into a massive inventory liquidation & capital spending freeze.

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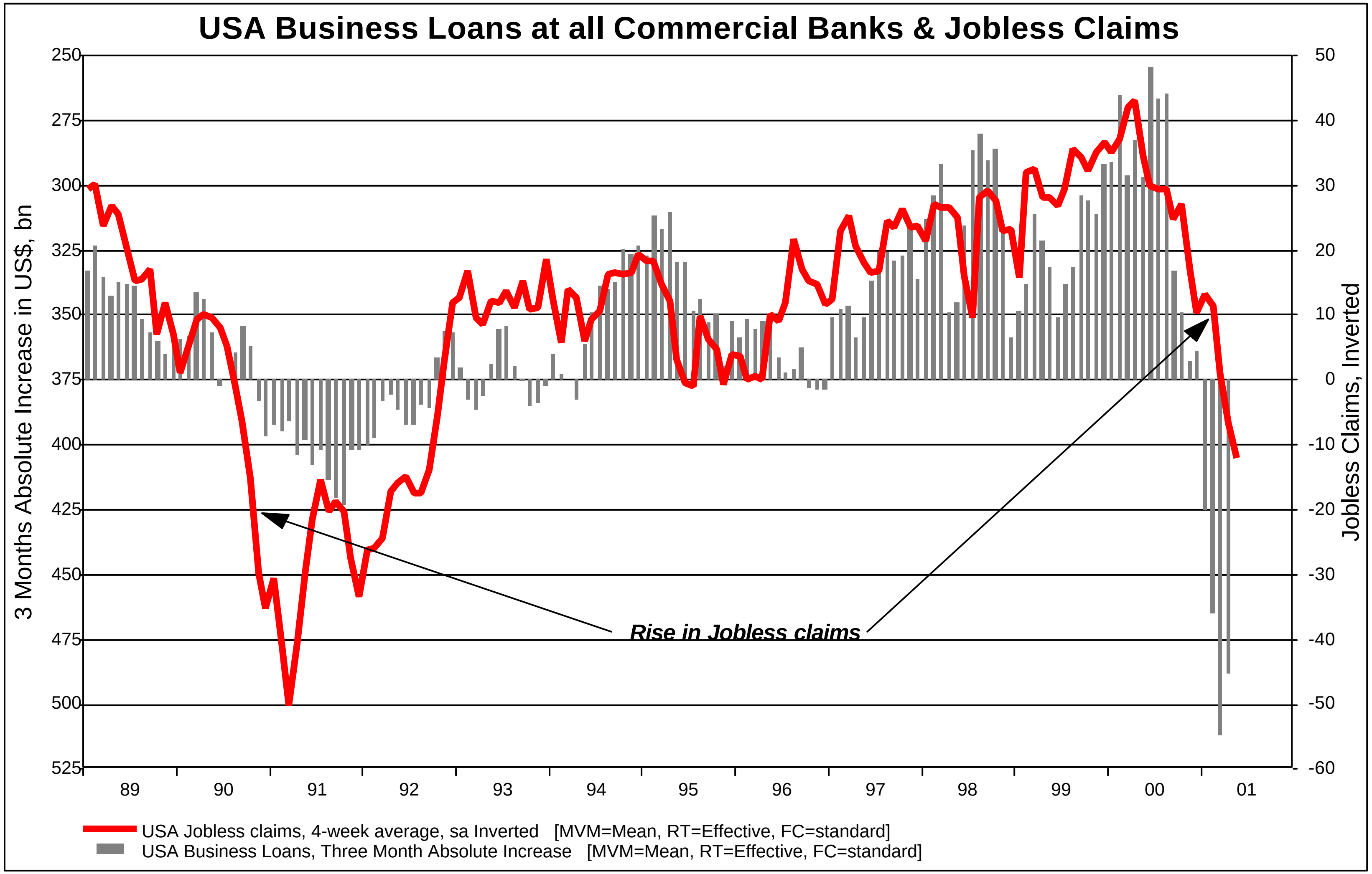
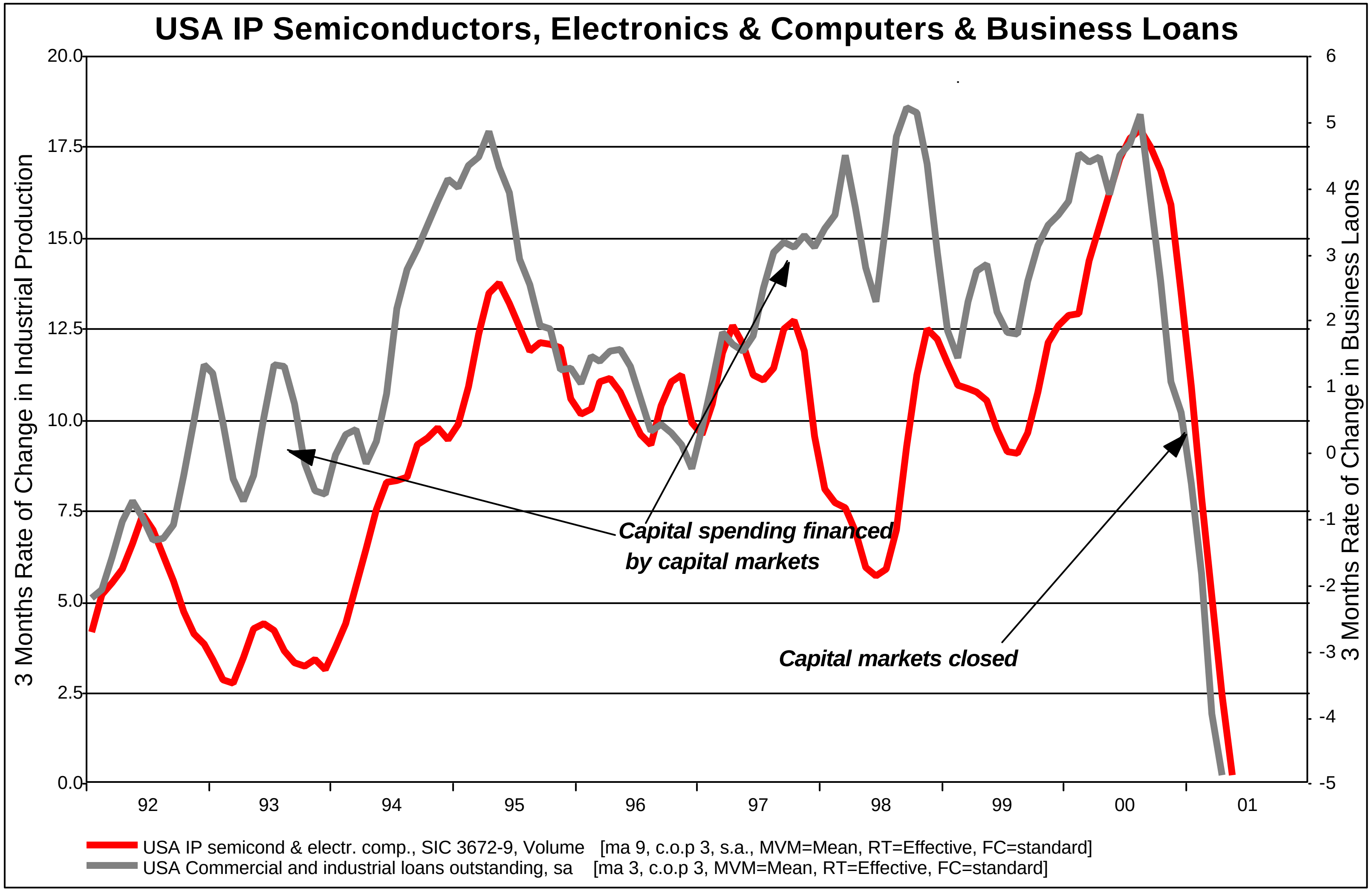
The Banks' Decision: Impact on the Work Force



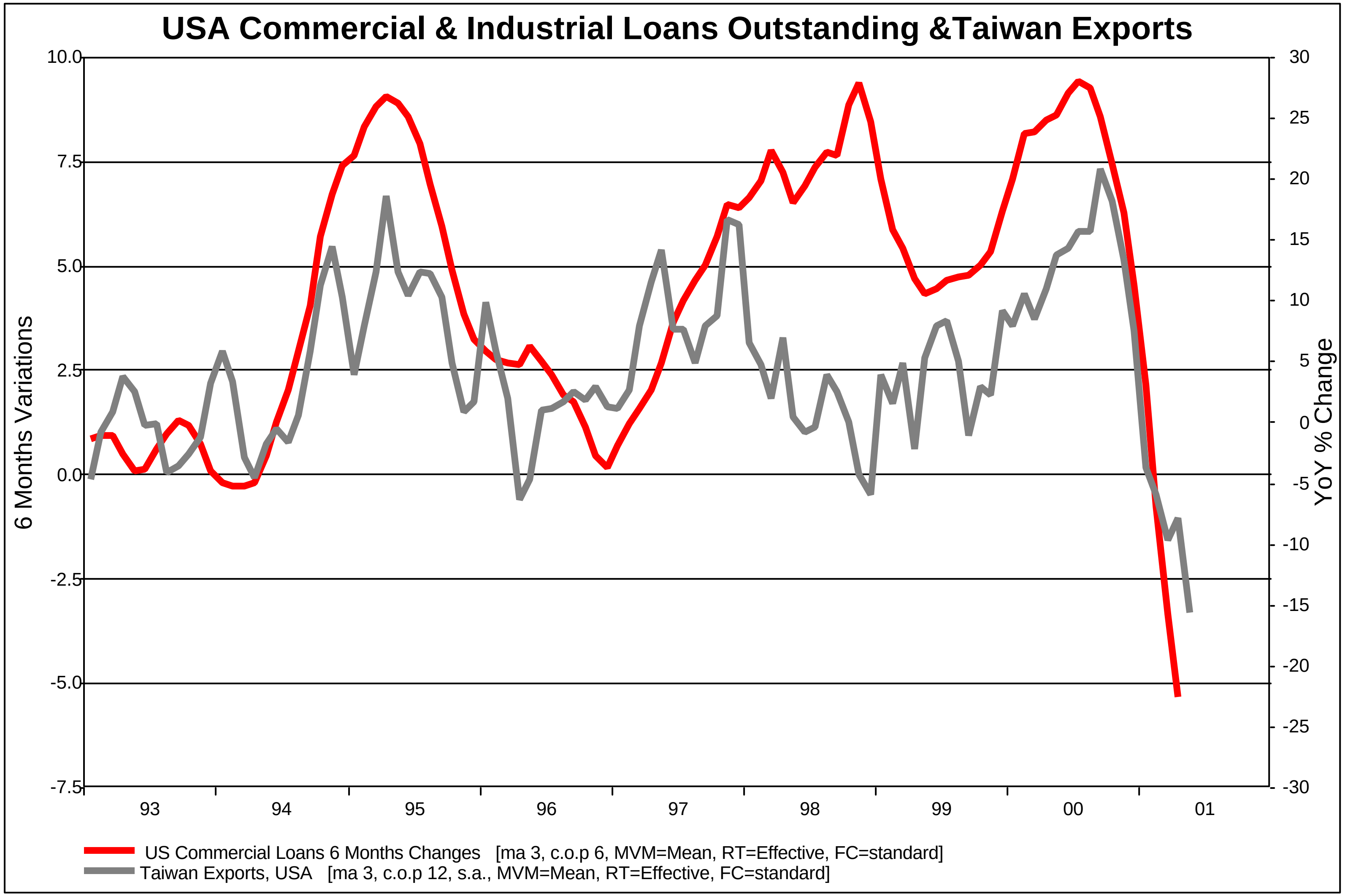
- The workforce is, somehow, a type of inventory.
- An executive whose company is in a negative cash flow and who can not get access to capital has limited options. He needs to fire people.

The Banks' Decision: Impact on Virtual Economy



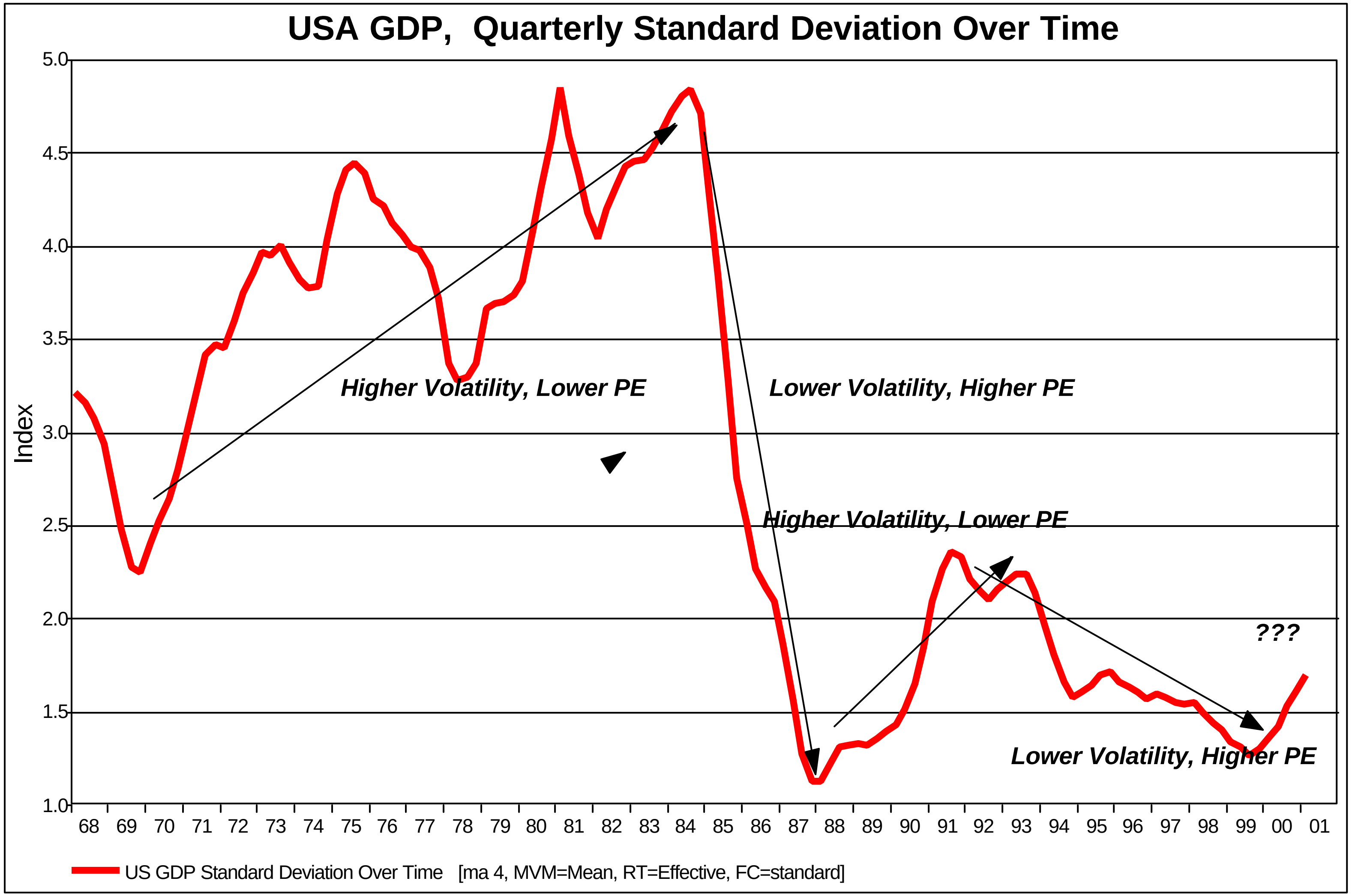
- When bank lending collapsed in 1993 and 1998, it had no impact on capital spending because banks were replaced by the venture capital funds, junk bonds & IPO markets.
- Not in 2000. The liquidity crisis hit all sources of financing.
- Consequently, capital spending collapsed.

The Banks' Decision: Impact on World Growth



- A large part of the US manufacturing process now takes place abroad, whether in Taiwan, Mexico, Korea or elsewhere.
- Because, of the lack of credit, US companies had to liquidate inventories. They also canceled all their orders.
- As a consequence, Taiwanese, South Korean, Singaporean exports fell precipitously…

The Banks' Decision: Impact on Valuations



- As we have written frequently, (See *The Death of The Banker*…) the reduced roles of commercial banks has led to a smaller volatility in economic growth.
- In turn, this has led to higher valuations for financial assets. As we have often stated, the US economy has moved from being a cyclical stock to a growth stock.
- If the banking system returns to its former preeminence in financing growth, then the volatility will increase structurally & the PE ratios will move lower.

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Sequence of Events in a Liquidity Crisis

In a liquidity crisis the scramble for cash in on. In this scramble, the sequence typically goes like this:

1. The stock market, being the easiest source of raising cash (i.e.: selling one's portfolio) is usually the first one hit. Next comes the bond markets where quality premium open up massively.

2. Unable to raise cash in either the equity or bond markets, companies have to turn to their banks. If those do not lend, investments, inventories and employment all fall precipitously.

3. Sensing the heat, companies raise their cash levels; narrow money supply aggregates (MZM, M1…) rise significantly.

4. Banks continue to panic and cut their loans. At the same time, healthy debtors repay their debts because of the increase in the cost of money. This double hedged sword leads to a deterioration in the loan books of the banks.

5. At this point, the Fed fears for the health of its banking system and cuts rates aggressively. As an immediate consequence, the return on short term deposits collapses.

6. With the rise in money supply and the collapse in bank loans, the ratio of M3 to Bank loans goes through the roof. So much so that commercial banks have balance sheets expanding massively on the deposits side and no risk free outlets to invest in anymore. They may decide to buy government bonds but the profitability is mediocre. Moreover, if the Government bond yields go up, they could nurture huge losses.

7. After a while, banks are therefore forced to lend again, at least if they want to meet their RoE targets. The economic cycle bottoms, recovery starts.

Where Do We Go From Here?

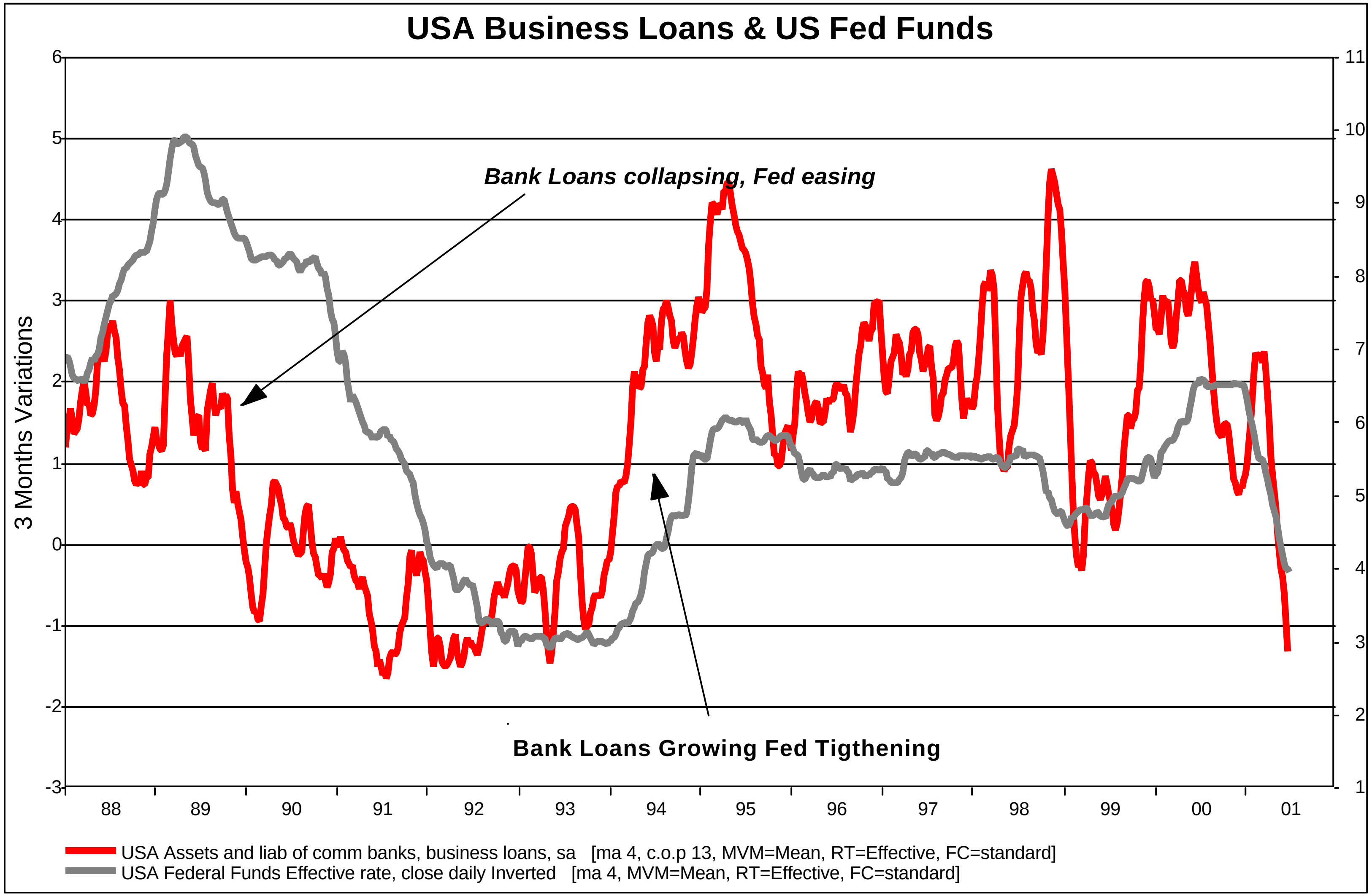
- While blaming all the World's ills on commercial banks seems intellectually logical, it does not answer the question of what we should now expect. What are commercial banks likely to do now? And how will the economy react? In other words, where are we in the liquidity crisis process described on the previous page?

- As always, we have little to form a judgment on, apart from History and Reason. While we do not claim to have much of the latter, we know (from painful experience) that those who do not study History are condemned to repeat its mistakes.

- We will therefore look at times in the past, where, similar sets of circumstances occurred and attempt to identify the developments that followed.

- Once again, we will be able to conclude that, if anything, the knowledge of History leads its possessor into a tough time in reaching decisions. Nevertheless, we continue to find reasons to be optimistic about growth in the United States over the near future. In fact, we believe that the liquidity crisis is over and that, consequently, banks will be forced to re-open for business over the coming weeks, if they have not already.

How The Fed Works



- Mr Greenspan knows how commercial banks work.
- When the banks stop lending, he cuts rates and the Fed “replaces” commercial banks.
- When the banks lend, he increases short rates and becomes restrictive.
- In other words, he acts as a counter cyclical force to commercial banks.

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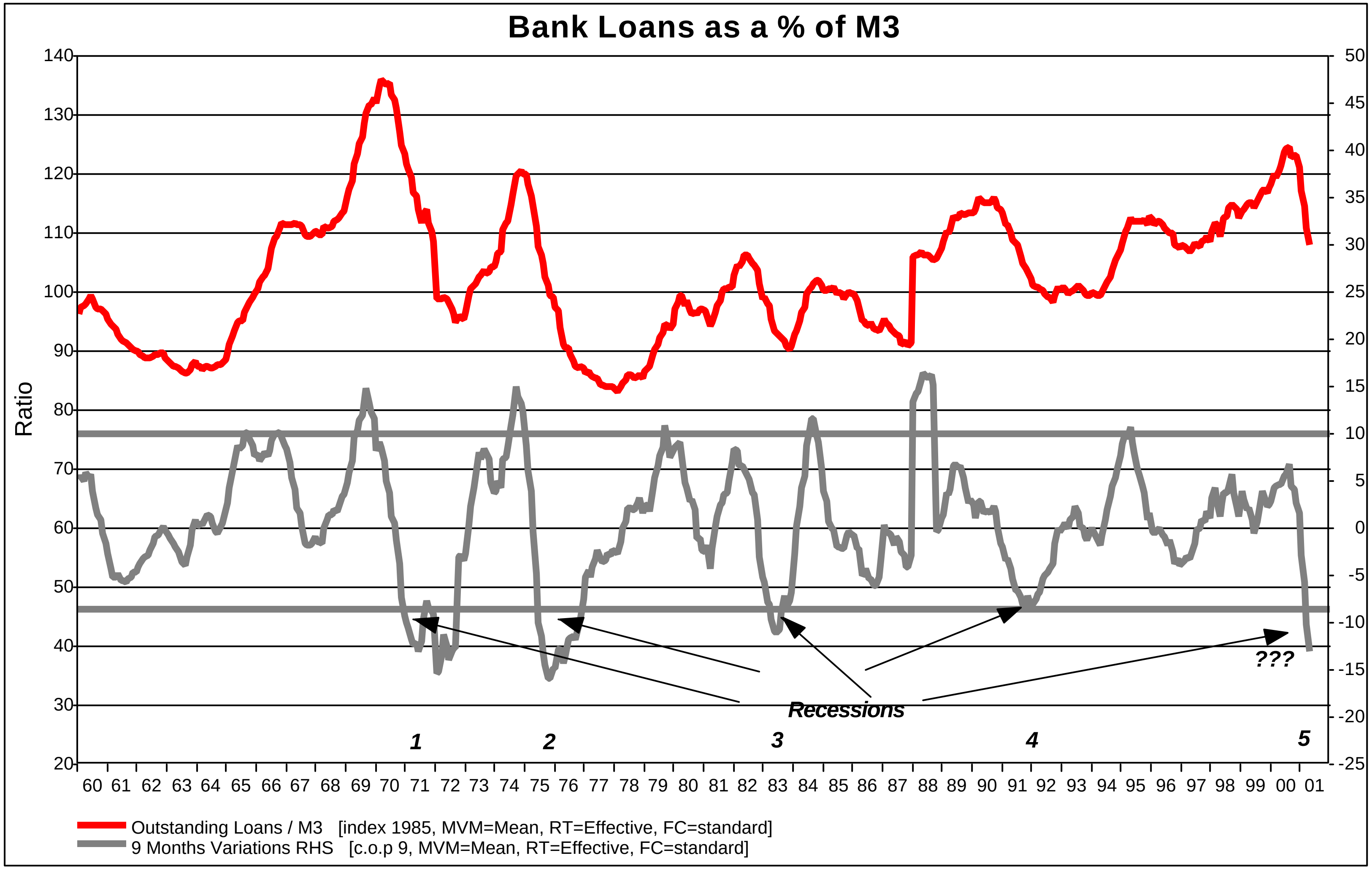
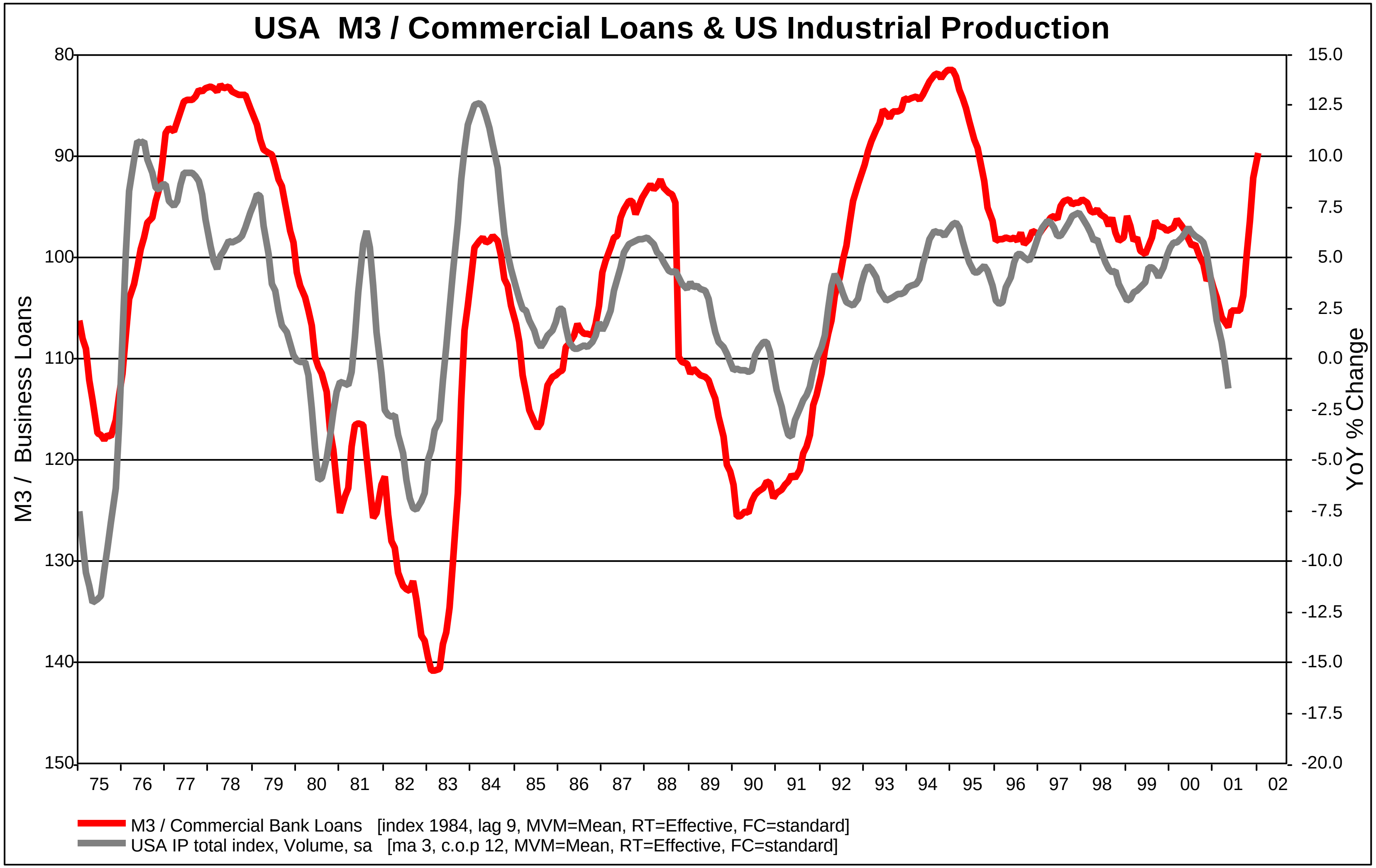
A Monetary Adjustment



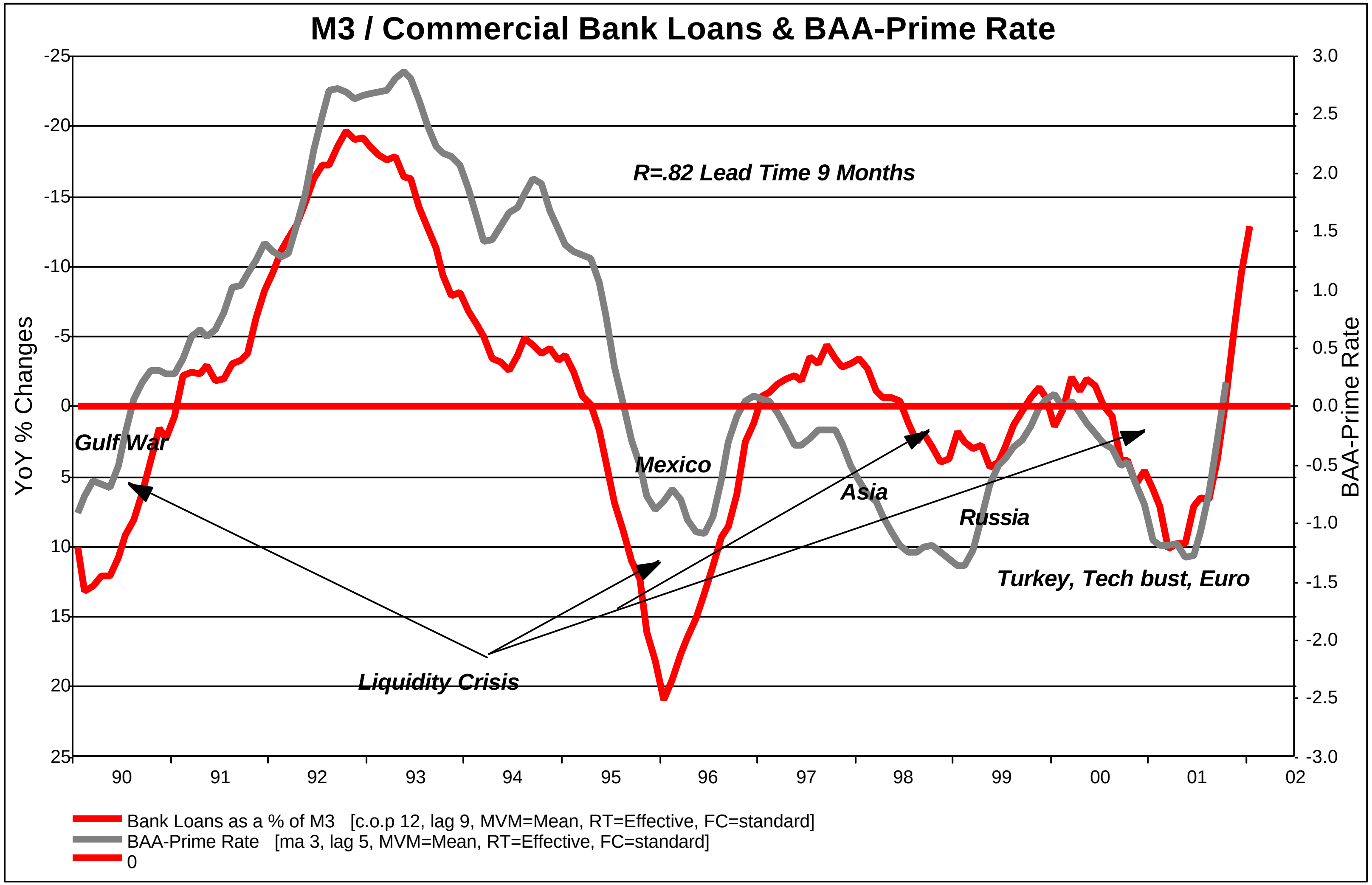
- When banks cut their lending, the preference for liquidity goes through the roof.
- Consequently, deposits increase massively.
- The ratio of M3 to bank loans collapses.
- The liquidity of the economy increases dramatically.
- The bottoming of the ratio usually coincides with a bottoming of the economy.

From Liquidity to Economic Activity



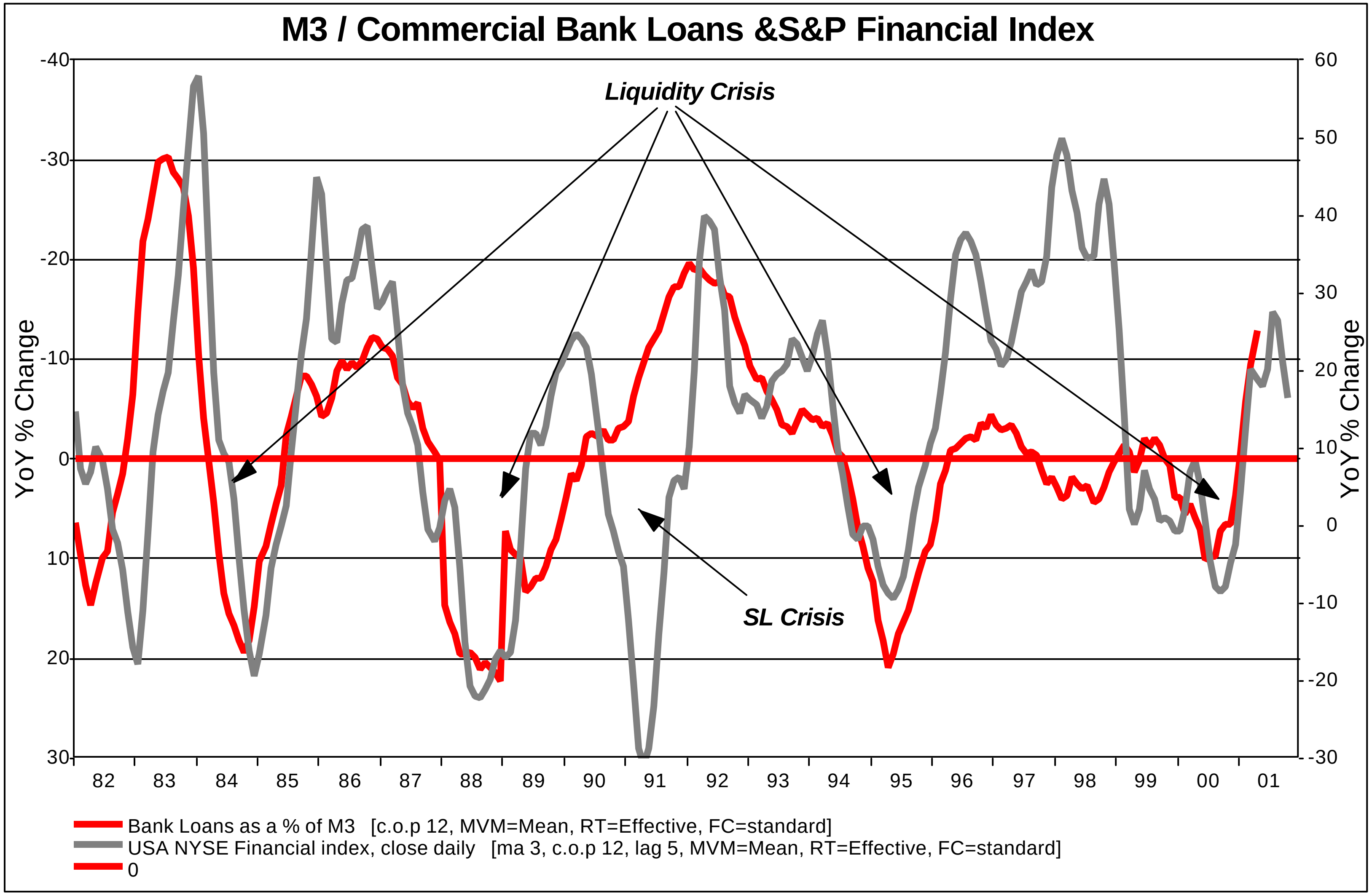
- One year after a rebound in economic liquidity, industrial activity reaccelerates.
- Or at least, it did in every previous occasion.
- We therefore believe that the US economy is bottoming right now.

M3 Relative to Bank Loans & Liquidity Indicator



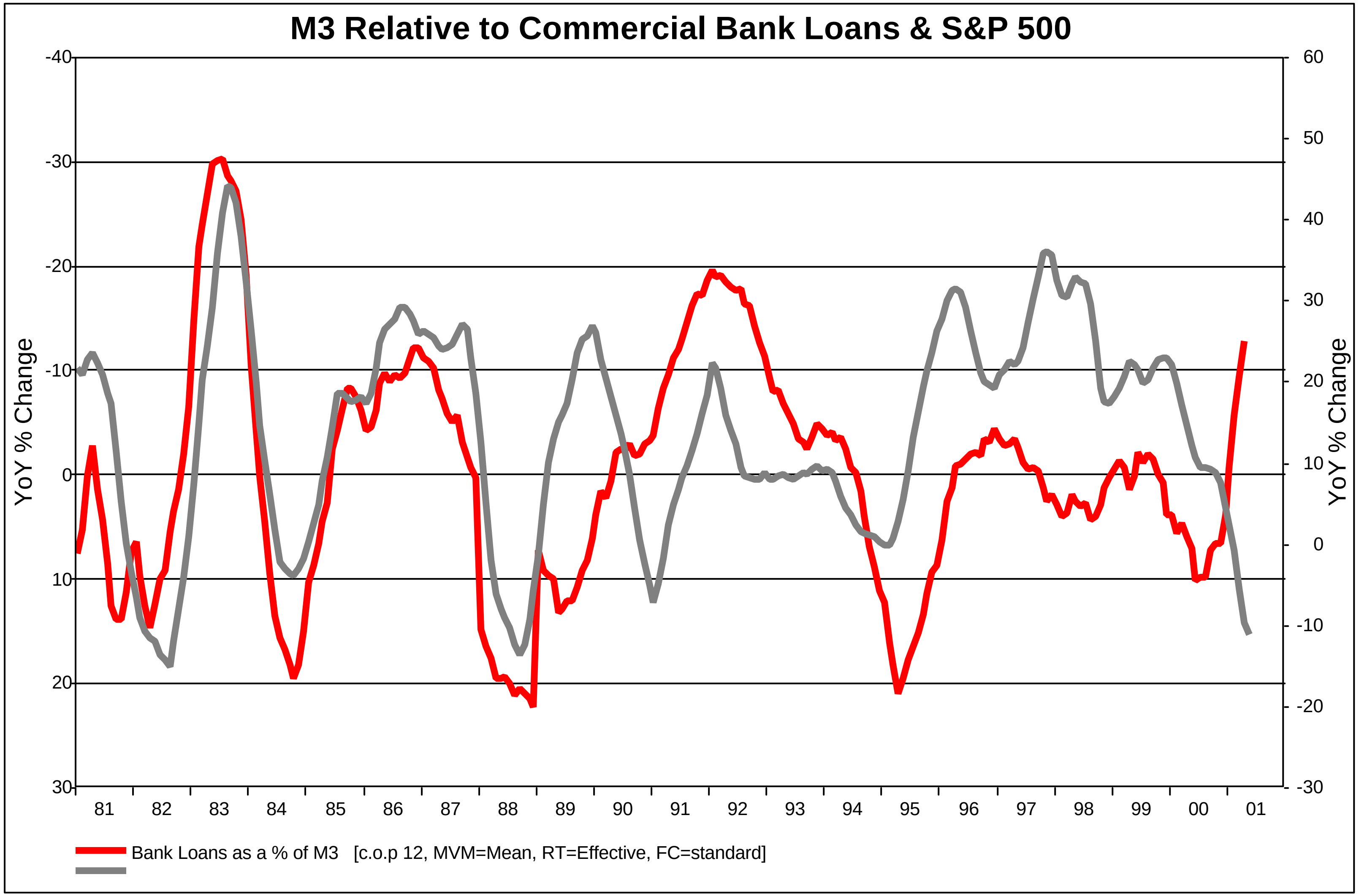
- One of the many indicators of a liquidity crisis is the difference between BAA & prime rates.
- Why? Because when bond markets are closed, banks fleece their clients.
- The increase in money supply against business loans implies that, within 9 months, the spread between the BAA and the prime rate will widen massively.
- The US banking system will need to start lending pretty soon.

A Liquidity Trap?



- When the ratio of money supply relative to commercial loans increases, it means that liquidity is returning in the system.
- The danger then is a Keynesian liquidity trap, such as the one experienced by Japan. This happens when the banks are bust.
- If bank shares are going up strongly, then it means that the next cycle should be normal.
- So far everything seems to be on target.

From Liquidity to Equity Markets



- We already have had the rise in financial shares.
- Financial shares usually leads the general index by a few months.
- If, and when, the rise in the S&P 500 materializes, then we shall know that the cycle is normal.
- But by then, it will be too late to play the rise in the global equity markets!

Conclusion

- ✍ From 2000 to now, we have had, in the US and all over the World, a very classical liquidity crisis. Like a Greek tragedy, it unfolded with a sense of unavoidability and we hoped, at every turn, that the unavoidable was going to be avoided.

- ✍ Undeniably, this was the triumph of hope over experience, and we looked in dismay as events unfolded. As usual, commercial banks played their usual amplifying role in the crisis. At the beginning, in the middle, and at the end.

- ✍ The first piece of good news is that Mr. Greenspan seems to understand both the liquidity crisis process and the commercial banks' ways better than anybody. At least better, than his colleagues in Euroland or Japan.

- ✍ The second piece of good news is that this cycle, so far, has been very similar to the previous ones. Indeed, despite all the prevalent talk of structural over-investment, massive over-capacities, forthcoming negative wealth effects etc… the US economy seems to be holding up.

- ✍ Once again, as soon as the liquidity crisis is definitely finished (we monitor the weekly commercial and industrial bank loans as the last missing piece) then we will be left with the real structural questions: capital spending in the US and in the rest of the World and the long term outlook for productivity growth. In our eyes, this remains the all important question.

- ✍ We reiterate our recommendation to be fully invested in equities and overweight high beta, cyclical stocks.

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The charts in this presentation are available updated in the chart room of our website:

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