

>: The Secret Villain Behind Our Economic Collapse

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"EMBARRASSING"

That's the word our Treasury Secretary used to describe how he felt begging Congress for money to bail out America. Around him were seated our Federal Reserve Chairman and our Securities & Exchange Commission Chairman.

And that's what happened in front of the camera. Behind the scenes, God knows how many foreign governments we've gone begging to. Don't sell our paper to us and hit the market. Please. Please. Please. Okay, we'll agree to include you in the bailout and buy it back from you.

Paulson had it right. Embarrassing.

Lot's of folks are looking for people to blame. People on the left want to blame Republicans. People on the right want to blame Democrats. Even reasonable, normally level-headed people feel that their government has let them down.

Our government is a Republic. The premise is that we elect "responsible" people who won't be swayed by a "mob mentality" to guide the rest of us who can be swayed in our feelings from day to day. That's why many folks are upset and are blaming government. The people we put in charge of taking care of us were asleep on the job.

Fair enough...

But whether you have a Republican government like ours, a pure citizen democracy, a king, or a dictatorship they all have one thing in common - they are all run by humans. One, few or many.

And there is one thing we as investors must never forget about human nature - at certain times, it is prone to excessive optimism. At other times it is prone to excessive pessimism.

So let other people point fingers and look for people to blame.

As investors we must know that being mad at humans for being human would be like being mad at two people for falling in love.

Or like being mad at myself for having dark hair. It was a bull market of the greatest magnitude, and many folks got caught up in it. It's our nature to do this and every once in a while it happens in excess.

And unless human nature itself changes, you can bet it will happen again. And as investors we can't afford to be angry about it or we won't be able to profit from

Let's study it together...

I think what made this bubble more powerful than most was the sheer magnitude of the people who benefited from it. In my judgment, that made the positive, reinforcing feedback loop much more powerful than the "dot com" bubble.

Rising home prices made existing homeowners very happy. They were able to take home equity loans which made the credit card and home improvement and restaurant companies happy.

New homeowners were happy because they were able to afford new homes. That made Congress happy because constituents would send in letters thanking them for creating legislation that helped Jack and Diane get their "dream home." And of course builders were really happy because they were able to charge high prices and sell a lot of homes at the same time.

Wall Street was happy because they had something to sell to fund managers starving for yield. Subprime bonds are GREAT in a low interest environment. And that meant a lot of fees and big bonuses for Wall Street. And the fund managers were thrilled because they were never quite sure how they were going to fulfill their retirement obligations to millions of baby boomers in the first place. But getting higher yields is a good place to start, so why not invest in private equity!

Insurance companies were happy because that tired industry finally had some growth. At 83 years old, Maurice "Hank" Greenberg has a stronger pulse than **AIG (AIG)**, so let's give it some growth. We can write a policy covering the trade between **Lehman Bros. (LEH)** and **Merrill Lynch (MER)** because "they ain't going anywhere."

Even the village idiot got in on the act.

He went from flipping burgers to flipping houses in two years and was well on his way to becoming the next Harry Helmsley. And that made television producers happy because if the village idiot could do it anyone could do it, and that makes for great TV.

The home improvement business was happy which made shareholders of all these companies happy because of rising stock prices. And of course

government on every level was happy because big tax revenues means money to improve schools and roads.

The list goes on and on and on and on...

That's a lot of "shiny happy people." Thrilled actually. Who wants to turn off the music and shut down the bar when the party is raging? The few people who did sound the alarm sounded like party poopers. Who cares if the neighbors are complaining about the noise? Tell 'em to loosen up and join the party!

(Antiquated Regulation Strong Economic Growth Excess Liquidity = Excessive Optimism squared (or credit/asset bubble)

This ecstasy feedback loop was particularly powerful because people weren't just making money. They were underwriting "the American Dream"? Isn't that what it's all about? In that way, this bubble was stronger than the "dot com" bubble or the Tulip bubble.

It was almost as powerful as a gravitational black hole. Every person who felt it paid it forward, and every person who received it felt good about themselves (wouldn't it be nice to get thank you letters from first-time homeowners thanking you for making their dream possible?) and paid it forward twice as much. Once you get sucked in, you're in.

And like all bubbles, this one had an official mascot, a single reference highlighting the level of absurdity. Whereas the "dot com" bubble had the "sock puppet," the credit bubble had the "no income mortgage."

And like all bubbles this one had an official peak. It's the corporate version of an overdose. When a company does something so dumb that it shocks the other drunk party goers. I'm talking total destruction of shareholder value. In 2001 it was AOL buying **Time Warner (TWX)**. This time it was **Wachovia Bank (WB)** buying Golden West Financial. Wachovia was like the guy at the party who gets taken away by the ambulance - you know he won't ever be the same.

Paulson was right to be embarrassed on behalf of the American people. We lost our cool. We couldn't handle our buzz. We didn't know when to stop. The cops had to break up our party.

But I have a feeling this is going to be good for us. What makes America great is our incredible ability to self-correct. That's really our secret sauce. We know when we have to change course. Clean up. Get our act together.

We will analyze these problems honestly and openly. And after much self-reflection, we'll improve. We will come out of this with better regulation and a much stronger and stable capital markets system. We will come out of this with more fiscal discipline.

But most importantly, we will come out of this remembering how good we've had it and how close we came to losing it.
Sometimes liver disease is the only way to get someone to sober up.



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