
Paint It Black

By Editor Test Sun, Oct 21, 2012

Investment gurus at the recent Big Picture Conference—the annual financial opinion-fest in New York created by market-maven Barry Ritholtz—took an almost unanimously bleak view of the future of our financial system.



The first speaker at this year's Big Picture Conference in New York on October 10 was Neil Barofsky, author of *Bailout: An Inside Account of How Washington Abandoned Main Street while Bailing Out Wall Street*. A special inspector general on TARP along with Elizabeth Warren, Barofsky shared some details from his book of what he considers a failed project.

Rather than pursue its bi-partisan mandate to break up banks and preserve home ownership, he said, TARP rewarded the biggest banks and made them 20% to 25% larger. Very little of the money set aside to help people stay in their homes and pay their mortgages actually went for that purpose. Far from lending or renegotiating the terms of troubled loans, banks actually took more money from consumers in higher fees.



Barofsky (left), who now teaches at New York University, said that Treasury Secretary Tim Geithner and the other Goldman Sachs alumni who ran TARP treated him and Ms. Warren as though they were “stupid” because they didn't have financial institution experience. The bankers also tried to turn Barofsky and Warren against each other, he said.

As for TARP's mandate to be transparent, Barofsky said the program was anything but. “TARP wasn't just anti-transparent, it was hostile to transparency,” he said. Geithner et al were more interested in protecting the banks than the people.

Barofsky still believes the government should break up the largest banks—either through a modified form of the Glass-Steagall Act or by raising banks' reserve requirements. “An incredible opportunity was lost,” he said. In the end, “Dodd Frank was an *illusion* of effective regulation.”

Hyperinflation?

The next gloom-purveyor was Dylan Grice, the author of *Popular Delusions* and a global strategist at

Societe Generale, who warned that the Fed's "quantitative easing" policy may bring hyperinflation. In his view, it debases the currency, destroys trust between debtor and creditor, frays the social dimension of money, erodes the basis of capitalism and invites social unrest. When you print money instead of raising taxes, he added on a populist note, you benefit the rich at the expense of everyone else.

Grice (right) quoted Keynes on inflation: "By continuing a process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some."



"We need a recession to help stabilize the future," he said, in a pitch for the cleansing power of deflation. Otherwise we risk "great disorder" of the kind already manifest in the activities of the Tea Party and Occupy Wall Street movements. Europe has coped with its credit crunch by taking money from pension funds, he said; Japan has been printing money and lagging economically for 20 years.

Call him 'Lucky Jim'

It was not all fire and brimstone. Jim O'Shaughnessy (below left), chairman and CEO of O'Shaughnessy Asset Management, introduced a positive note by arguing that it's now a great time to buy stocks because the stock market makes its greatest leaps when the country is emerging from recession.

"I still believe we're living in a Great Recession and this is the time to make sure you're fully diversified," he said.



O'Shaughnessy's three-part formula calls for investing on the basis of Quality (Companies with strong financials), Value (Underpriced companies); and Yield (Companies that pay a reliable dividend). Most investors, he noted, do the opposite. Even during the stock market's worst 20-year period, from 1929-1949, stocks generated an average annual total return of 6%, he said.

He holds 50% stocks, 19% REITs and 16% high-yield bonds. Echoing Grice's comments, O'Shaughnessy said inflation is a subtle and pernicious tax; but he believes that even during periods of high inflation stocks, convertible bonds, and high-yield bonds will do well.

David Rosenberg, the chief economist and strategist at Gluskin Sheff & Associates, a Canadian asset

management firm, addressed the New Normal, i.e., the current subpar recovery in which headwinds like the depressed net worth of U.S. households and an unacknowledged jobless rate of 15% continue to buffet the markets—despite government fiscal and monetary responses.

The economy should be growing at a rate of 8%, not 1.8%, he said. Since the ill effects of a credit collapse typically last five to seven years, he added: “I like to think we’re halfway through the credit curve.” But “the world is awash in debt,” he mourned, pointing to Europe’s recession and slower growth in China and Korea.

Time to “short Starbucks”?

Perennial Big Picture guest speaker James Bianco of Bianco Research, an affiliate of Arbor Research & Trading, suggested that the economy should be growing at a rate of 2.5%; instead of hovering close to zero. Year-over-year corporate earnings are in the same ballpark, Bianco (below right) said.

“Earnings suck,” he said. “We’re not increasing wealth, we’re just reducing loss.” There hasn’t been any real deleveraging, he believes, and compares QE 1, 2, and 3 to “trying to drink yourself sober.”

Indeed, the recession may not actually be over, opined Michael Belkin, a financial market strategist and author of the *Belkin Report*. Despite the healthy-looking stock market, he believes we’re slipping back into a recession. He advises investors to short the broad market, get out of technology and industrial materials, short Starbucks, and load up on consumer staples, health care, utilities and financials—in that order.



As at last year’s Big Picture Conference, speakers warned about high frequency trading, or HFT. Sal Arnuk, co-founder and co-head of Themis Trading and Josh Brown, a reporter for the *Wall Street Journal*, described the disturbing rise of HFT, which may now account for 70% or more of market turnover.

“HFTs don’t have any of the responsibilities of the exchanges but they’re collecting riskless profits from them—a process that certainly seems rigged,” Brown said. Using specialized order types, they get direct feeds of spreads ahead of the consolidated tape and calculate the best bid and offer before the rest of the nation knows about it.

It’s all in your mind

Barry Ritholtz, who created the conference, is CEO and director of equity research at Fusion IQ. Focusing on behavioral finance, he described the typical bull market investor’s sad journey from initial optimism and excitement through anxiety, denial and, finally, despondency. Investors tend to remember the pleasant and forget the unpleasant, he said.



The more self-confident an investor is, the worse his track record, Ritholtz told his audience of Wall Street veterans. We all have a tendency to seek out facts that confirm our biases. We focus on recent data points and fail to see long-term trends. If a bull market is announced on a magazine cover, Ritholtz reminded anyone who needed reminding, you can be sure that it's over. "Optimistic people, he said, "are unable to evaluate their own ability and it's devastating to their investments."