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NOTE

October 7, 2010

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The Bailout Trade Meets the Bernanke Put

After exhausting nearly every politically viable opportunity for restarting the economy and stabilizing financial and real asset values through recapitalizing financial institutions and auto makers, direct stimulus, cash for clunkers, and home buyer tax credits; and after pushing monetary policy making to the absolute edge of its efficacy, the U.S. government and the Fed (together with central banks in Japan and Europe) are about to christen QE2 (the second round of quantitative easing).

The bond and equity markets have risen in tandem over the past several days – for the first prolonged, post-crisis period (stunted by yesterday's ADP report signaling further problems for private sector hiring and a potentially negative employment number from the Labor Department tomorrow) – together with the portion of the commodity complex that benefits from essentially free money.

This is the **Bailout Trade** – market behavior indicating that the economic environment is so clouded and compromised that anticipation of more quantitative easing and cheaper money is offsetting the existence of fundamental obstacles to recovery in the form of weak final demand, an excess of global capacity of labor and productive resources, and a barely whittled-down overhang of bubble-era indebtedness in all sectors of the developed world.

The FOMC, baring a few members with interesting counter-theories, is focused intently on the foregoing risks to the economy despite a few weeks of salutary data suggesting that they could perhaps afford to be less concerned and take a good long nap while the world sorts itself out. The Fed's staff economists, however, are looking under the bed and what they are seeing is indeed scary:

- But for the recent tanking of the U.S. dollar against the Euro and the Yen, recent faint whiffs of positive price movement would have been absent and we would be seeing real downward pressure on prices, also known as deflation.

- Private sector employment gains are fading and state and local governments are trimming their payrolls as fast as they can. With near-10% unemployment and 16.5% underemployment, wage deflation is more likely than not, as employers with positions to fill will soon find success in doing so cheaper. After a point, the out-of-work and underemployed will do what they can to make a buck, especially when/if they lose confidence that their old jobs and wages are waiting just around the corner.

- The Japanese have hit the wall on the Yen and (albeit unsuccessfully to date) have intervened in currency markets in a desperate move to save what's left of their economy, which has become increasingly dependent on exports to mainland Asia, as well as North America and Europe.

- The abstemious Europeans – with the only major currency supported by a central bank key lending rate above 0.5% (ECB 1.00%, BOE 0.5%, FRB 0% to 0.25%, and BOJ 0% and negative if they could make it so) – cannot hold out much longer. The Europeans are in the process of trying to wean their weakest banks off ECB funding and lack control over member states' fiscal policies - making it more difficult for the EU to pursue blatant easy money policy – to say nothing of the fact that the Germans and the Dutch are culturally too straight laced to allow for such a luxury. But with everyone else piling onto the currency debasement bandwagon, even the most economically conservative German burgher/exporter will eventually crack and urge the ECB to hop on.

- How odd that Treasury Secretary Geithner spoke this week to warn others against a beggar-thy-neighbor currency war when the U.S. – without direct intervention of course – is pursuing just such a tactic through its easy money policy. While the policy is chiefly designed to preserve domestic asset values and reignite domestic growth by insuring ample liquidity and spurring greater risk taking, it also has a direct effect on the value of the currency – thus making imports less desirable and exports more competitive.

- China is not falling for Geithner's narrative. As we wrote for David Leonhardt's blog in the New York Times on September 22nd, the Chinese have read the history of the 1985 Plaza Accord pursuant to which the Japanese agree to allow their currency to appreciate, resulting in the *endaka* ("strong Yen") crisis of 1986. After about 18 months of near recessionary conditions, the Japanese had enough, tanked the Yen and pumped money out to anyone who would take it – resulting in the formerly greatest bubble of all time. A "strong Yuan' crisis is most decidedly NOT in China's playbook, as Premier Wen Jiabao has reminded us consistently, and in no uncertain terms, since late last month.

- With everyone, directly or indirectly seeking an exchange rate race to the bottom, and the Chinese having drawn a line in the sand (which, unlike the Japanese in 1985, they are able to do because they are most definitely not a dependent of the U.S.), QE2 seems to the Fed to be the only policy choice to keep the deflation wolf from the door. A policy amounting to "ease or be eaten."

But the voyage of *QE2* may set a course towards *Titanic* trouble.

- The prevailing easy money policy of the developed world (which, lets face it, has been the policy of the Fed for eight years of this past decade – and of Japan for nearly 20 years) has not produced the thrust needed to create economic escape velocity. This is due to a variety of fundamental reasons – the subject of a later piece – best summed up with reference to a global glut of labor and productive capacity, resulting from the end of the cold war and the emergence of the BRIC nations, facing a level of demand that has not get grown sufficiently to absorb the supply. Effectively, supply-side economics on mega-steroids (and heavy steroid use eventually kills you).

- Near-permanent easy money policy, together with prior rounds of quantitative easing, in the developed world have created a liquidity bubble, suspended in a solution of moral hazard, that has produced the following outcomes:

    - a flow of money to the relatively under-leveraged emerging nations, threatening their economies with asset bubbles;

    - a build up of unutilized bank and corporate deposits, in the highly levered developed world, that cannot be effectively lent or spent until consumer balance sheets are repaired, fixed assets are de-levered, and employment and final demand create an environment justifying the taking of risk;

    - the socialization of private indebtedness which has been taken onto public balance sheets;

- exogenous, and temporary, support of the value of fixed assets (homes, commercial real estate, etc.), resulting in the overall retardation of the process of de-levering and the taking of resulting capital losses necessary to clear out the lingering effects of the bubble years; and

- an interim bubble in the hard asset sector of the commodity complex (chiefly in gold) and the developed nations' equity and high yield bond markets.

In pursuit of its goal of price stability, the Fed may actually be undermining its other mandate to optimize the domestic employment situation. The Fed is between a rock and a hard place. Global competitiveness has boiled down, in many instances, to competitive wage rates. Emerging economies are transitioning up the value added curve and supplying intellectual resources faster than anyone could have imagined 15 years ago – creating greater challenges to high wage rate countries.

While we are loath to imagine this, re-employment in the U.S. may actually require a carefully controlled wage deflation (which inevitably creates price and additional fixed asset deflation) to a modest extent – and we believe that is fundamentally impossible without de-levering and a final round of fixed asset revaluation,

If that is the ultimate reality, QE2 is setting sail on a cruise to nowhere and the affected markets will soon realize they are heading back to the port from which they departed.

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