MAULDIN ECONOMICS

Outside THE BOX

The Kingdom Of Denmark

JOHN MAULDIN | March 4, 2015

In *Thoughts from the Frontline*, I am in the middle of writing a series on debt. I realized on Sunday that the second installment wasn't ready for prime time, so I will work on it some more and send it out (hopefully) this coming weekend. In the meantime, in keeping with the theme of debt, for today's *Outside the Box* we have the following issue of *The Credit Strategist* from the ever-insightful Michael Lewitt. Michael starts out musing on debt and then shares a number of useful thoughts on a variety of market topics, with his usual panache.

> "The day-to-day volatility of the stock market is a side-show; the real story is the massive build-up of debt and what it means for the value of the currencies in which those debts are allegedly going to be repaid in the future. The truth is that those debts are never going to be repaid in constant dollars. Those who understand that and act accordingly will profit enormously; those who don't will fare very poorly."

I appreciate Michael letting me forward this letter to you. You can subscribe to his letter at www.thecreditstrategist.com.

As I send this note I am flying from Orlando back to a much colder Dallas, but spring can't be all that far off, can it? Better here than Boston, I guess. I am glad my travels have not taken me to the Land of the Frozen this winter.

Finally, I was saddened, as I know many were, to hear of the passing of Leonard Nimoy. He was, and always will be, Spock. He was part of the zeitgeist of my generation. The alien character he created with his acting made us think about what it meant to be human, in much the same way that Data did for later Trekkies. And while it is classified as sci-fi, Star Trek is a story about the human condition, and Spock was the perfect foil for the writers and creators of the stories.

I wrote a chapter in *Bull's Eye Investing* called "Finding Your Inner Spock," about the behavioral quirks that all investors have, suggesting that we all need to develop the ability to control our emotions in the investment process – by finding our inner Spock, so to speak.

Leonard Nimoy lived long and prospered, and now he boldly goes on to the next leg of his journey. I'm sure he will find it fascinating. I am, and will always be, his fan.

Your trying to understand debt analyst,

John Mauldin, Editor
Outside the Box

The Kingdom Of Denmark

By Michael Lewitt

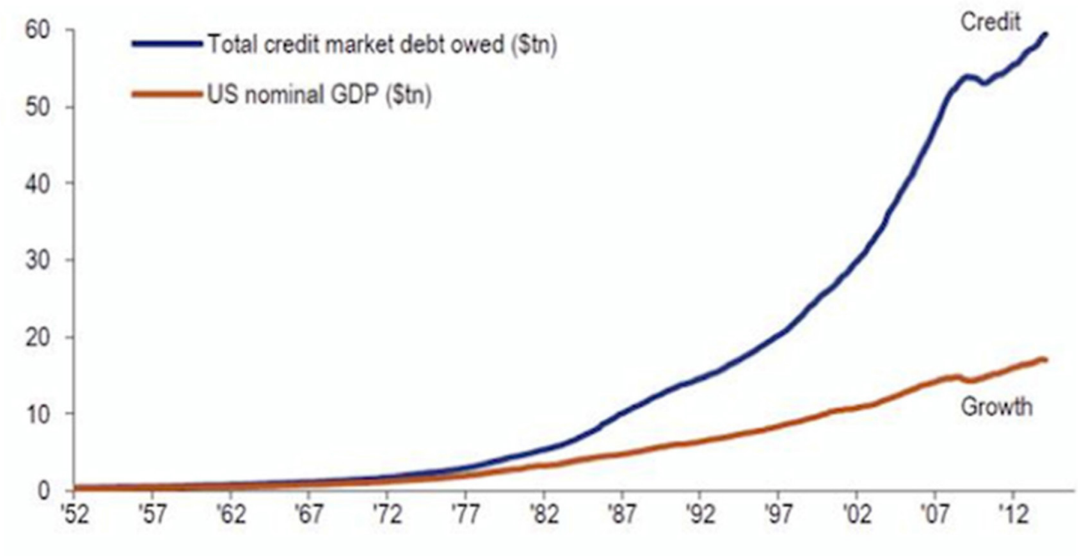
Excerpted from the March 1, 2015 issue of *The Credit Strategist*

> "What is a debt, anyway? A debt is just the perversion of a promise. It is a promise corrupted by both math and violence. If freedom (real freedom) is the ability to make friends, then it is also, necessarily, the ability to make real promises. What sorts of promises might genuinely free men and women make to one another? At this point we can't even say. It's more a question of how we can get to a place that will allow us to find out. And the first step in that journey, in turn, is to accept that in the largest scheme of things, just as no one has the right to tell us our true value, no one has the right to tell us what we truly owe."
>
> – David Graeber, *Debt: The First 5000 Years* (2011, p. 391)

In *Hamlet*, Polonius advises his son Laertes as he sends him off to school: "Neither a borrower nor a lender be,/For loan oft loses both itself and friend,/And borrowing dulls the edge of husbandry." Borrowers and lenders have conducted themselves over the ensuing centuries in ways that would not have surprised Shakespeare, who understood human nature all too well. Later in the play, Marcellus, a soldier, warns Hamlet that "Something is rotten in the Kingdom of Denmark" after they are spooked by the ghost of Hamlet's father. This is a reference not only to the murder of Hamlet's father, the King of Denmark, but speaks to the fouling of the relationships that govern the kingdom. Those relationships are ones of blood and obligation; in one form or another, they are different forms of debt. Debt is not merely a contract between two parties; it is a solemn pact of trust. When it is sundered, not only is money lost but husbandry – the management of society's resources – is corrupted. We learn from Shakespeare's great drama that a world ruled by debt is extremely fragile.

February 13th marked the 25th anniversary of the bankruptcy of Drexel Burnham Lambert. I remember driving to work at Drexel's Beverly Hills office that morning having no idea what was about to happen. My years at Drexel in the late 1980s and those I spent managing the firm's private equity holdings in the 1990s were an intensive education in credit and human nature. Twenty-five years after Drexel's demise and seven years after a crisis that pushed the global economy to the brink of collapse, the world is drowning in debt and derivatives. As a point of reference, when Drexel filed for bankruptcy, it had a balance sheet of $3 billion. When Lehman Brothers filed for bankruptcy in 2008, its balance sheet was two hundred times larger at $600 billion. As Figure 1 below illustrates, debt has grown exponentially while the global economy has crept along at a petty pace. Six years after the financial crisis, interest rates have been driven below zero in much of the developed world,2 a sign that policy makers have failed to create sustainable economic growth. (The latest tally is that $1.9 trillion of European sovereign debt is trading with negative yields.) They have managed to inflate financial assets but left the real economy behind. For example, U.S. equity prices have gained 122% since 2009 while US nominal growth has grown by only 18% over the same period. Having exhausted their ability to employ interest rates as a policy tool, policy makers are now shifting their sights to currencies to stimulate growth. But currencies are themselves nothing more than a form of debt, a promise by a sovereign. And those promises are being actively debauched in a series of currency wars that are certain to end badly for those who depend on fiat money for their daily bread.

Figure 1
Unsustainable



Source: BofA Merrill Lynch Global Investment Strategy, Federal Reserve Bank, DataStream

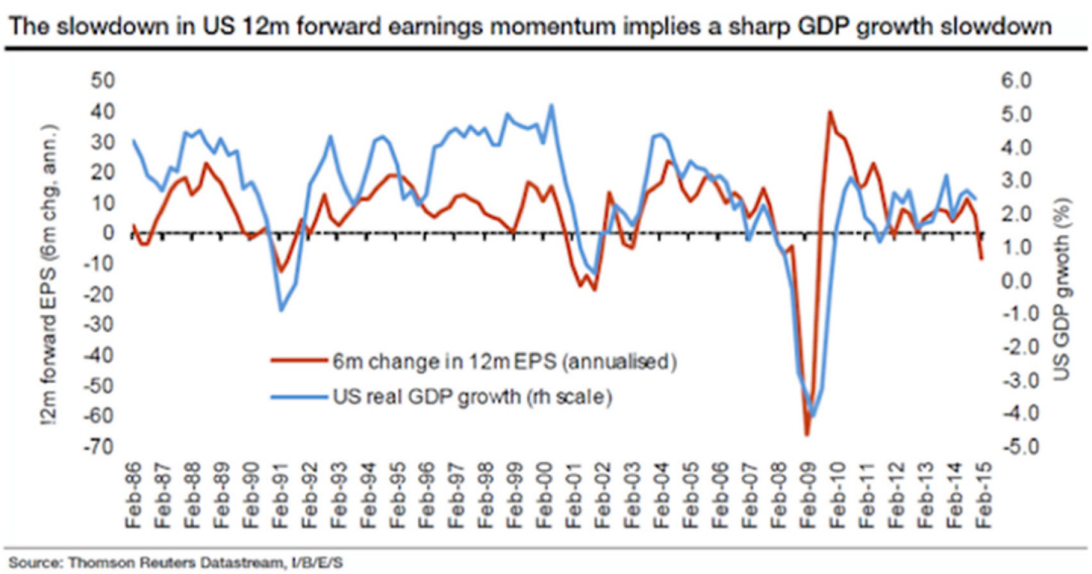
Drexel and its aftermath taught me many lessons. The most important is that the world of finance is the world of human nature in all its terrible beauty. And that world is driven by incessant change. Drexel was thought to be the most powerful firm on Wall Street, yet it collapsed overnight. That taught all of us working there not only a lesson in humility but a lesson in the fragility of all financial structures, especially those built on leverage. Those who fail to acknowledge and adapt to change are always flirting with failure. Today's investment landscape is filled with investors, strategists and media pundits who refuse to admit that we no longer live in a world that can pay its debts or respond to monetary stimulus as it did in the years before the financial crisis. Acknowledging these realities doesn't mean one has to stop investing or stop taking risk. But it does mean one better do so with one's eyes wide open.

U.S. Economy

Contrary to what the Federal Reserve, Wall Street and much of the financial media are telling people, U.S. economic growth is not robust. Uncritical focus on doctored economic data leads to the conclusion that growth is self-sustaining and accelerating. In fact, growth is sluggish and evidence that it can be sustained if interest rates ever normalize does not exist. Normalized interest rates still lie far in the future, however, so equity investors feel empowered to ignore these concerns and bid up stocks 'til Kingdom come. But just as they did 15 years ago during the Internet Bubble and 7 years ago during the Housing Bubble, when Kingdom comes it will come with the Devil.

Figure 2 below, borrowed from Societe Generale's Andrew Lapthorne, shows that downgrades in US earnings forecasts in February were the worst since the 2009 financial crisis. Mr. Lapthorne writes: "we believe that despite the many equity indices hitting post crisis highs, the message from within the equity market, and indeed from the strong performance of the sovereign bond market, is that investors are positioning themselves for an economic slowdown. For example, the relative and strong outperformance of higher quality stocks within the equity market has been highly positively correlated with the equally strong performance of sovereign bonds, both of which have rallied on the back of weakening earnings momentum. To simply disregard this economically consistent message as being simply a function of low oil prices, low inflation and central bank actions may be misguided to say the least." (Andrew Lapthorne, Societe Generale Cross Asset Research, "Global Earnings Estimates Analysis: Is the US heading back into recession?" February 24, 2015.) While Mr.Lapthorne may be placing too much emphasis on the performance of sovereign bonds, whose yields are artificially suppressed by massive central bank monetization programs, his point is well taken: earnings momentum is fading and doing so beyond the energy sector. It appears increasingly likely that S&P 500 revenues will experience their first year-over-year decline since the financial crisis and earnings may follow. The sharp drop in oil prices is a symptom rather than a cause of a global economic slowdown that is showing up in a broad array of data.

Figure 2
No Earnings Momo



Nobody, of course, is forecasting a recession. We are taught that recessions do not occur until the Fed tightens aggressively and the yield curve inverts. While the yield curve has flattened significantly over the last year, it is far from inverted. Whether this historical rule will apply at zero gravity remains to be seen. Trillions of dollars are counting on it.

Washin' the Bullshit Down

> "Whatever I was/You know it was all because/I've been on the town/ Washin' the bullshit down."
> Gordon Lightfoot

In grade school, we are taught to consider the source of what we read in order to appreciate that all discourse is colored by bias. Sadly, this is a lesson ignored by investors who stand to lose a great deal of money relying on the words of central bankers, Wall Street analysts and the financial media. Consider the bias of each of these groups as well as their accompanying forecast records, which are appallingly bad. (I owe a head's up to Societe Generale's Albert Edwards for pointing me to the studies referred to in the following discussion in his February 12, 2015 Global Strategy Weekly.) Recently, the San Francisco Fed published a paper entitled "Persistent Overoptimism about Economic Growth" (February 2, 2015, FRBSF Economic Letter 2015-03) in which it found that since 2007, the Federal Open Market Committee (FOMC) has consistently been too optimistic about U.S. growth. While that may be stating the obvious, it bears repeating since everyone hangs on every word uttered by the denizens of the Eccles Building. The authors of this paper – themselves Fed employees (we may live in Denmark but we do not live in Russia) – attribute these failures to several factors: missing warning signals about financial imbalances, overestimating the efficacy of monetary policy, and extrapolating the past into the future. To err is human; to do so repeatedly is apparently a job requirement of central bankers.

The private sector has proven no better at predicting recessions. The primary difference between private sector economists and government economists is that the former are better paid to be consistently wrong. Of course, the primary goal of private sector prognosticators is to convince their clients to buy as many stocks and bonds as possible, so their upward bias is not surprising. Readers looking for a comprehensive study of the failure of private sector economists to predict recessions should look at a presentation entitled "Fail Again? Fail Better? Forecasts by Economists during the Great Recession" given by IMF economists Hites Ahir and Prakash Loungani at the George Washington University Research Program in Forecasting Seminar on January 30, 2014 (http://www.gwu.edu/~forcpgm/Ahir_Loungani.pdf).

Finally we come to the financial media, which rarely features anything original or challenging to the bullish consensus. Dissenting voices are either dismissed or treated as minor interruptions to an incessant flow of happy talk. For example, Mizuho Securities USA's Chief Economist Steve Ricchiuto recently appeared on CNBC and told presenters Simon Hobbs and Sara Eisen that the U.S. economy is not "accelerating" and that the bullish consensus is nonsense. He left Mr. Hobbs and Ms. Eisen fairly sputtering in his wake. We likely won't see Mr. Ricchiuto back on the air any time soon, which is a shame, because he was correct.

(Of course, CNBC was much more willing to air the non-conforming views of one of the worst forecasters in history, former Federal Reserve Chairman Alan Greenspan. In a February 26 interview on the business network, Mr. Greenspan said that "Lower long term rates is [sic] not a conundrum, it's an indication of how weak global economic growth is" and that "effective demand is extraordinarily weak – tantamount to the late stages of the great depression." Fifteen years ago, as Mr. Greenspan was steering the economy to one bubble after another, this would have been front page news. Today it is consigned to zerohedge.com, which is by far the most useful media outlet for financial information on the scene today.)

With rare exceptions, the financial media traffics in noise rather than information. Noise is what we already know while information is what we don't know. Information adds to our store of knowledge and prompts original thinking and moves us closer to the truth. The consensus is noise, not information. But investors need information, not noise. Valuable analysis helps investors skate to where the puck is going rather than where it's been - and that means finding the flaws in the consensus and moving beyond it. The financial media, like public and private sector prognosticators, are noise machines. Value-added analysts are difference engines.

(This is why Real Vision TV is so valuable. It offers long-form interviews that allow the free-exchange of complex ideas about the markets, the economy and life in general. I was flattered to learn that more than 1,000 people viewed my recent interview on the site. I urge everyone to visit https://realvisiontv.com.)

Figure 3 below tells us what's really happening in the economy. After trillions of dollars of stimulus, U.S. GDP growth is still only 2%. People can point to the weather, lower oil prices and the strong dollar for why the economy cannot achieve escape velocity, but the primary reason is the suffocating weight of public and private sector debt. Even with low (or non-existent) interest rates, an enormous amount of financial and intellectual capital is devoted to debt service rather than more productive uses. The result is structurally slow growth. Too much emphasis is placed on a single data point – payrolls – which is a lagging indicator and remains far below the levels of previous recoveries. One reason for this emphasis is that employment is part of the Fed's dual mandate. The employment numbers have stabilized but they are not as robust as the headlines suggest. The broadest measure of employment, U6, is still running above 11%. The other figure that is cited to support the bullish case is GDP growth, but last year's GDP numbers were distorted by higher healthcare spending mandated by the Affordable Care Act. Theoretically, helping Americans live longer and healthier lives should lead to a more productive economy. Practically speaking, however, an economy that can't provide enough jobs for its healthy members may not realize the benefits that a healthier populace would produce. Only 44% of healthy adult Americans are members of the work force, the lowest number since the 1970s. This is hardly the sign of an accelerating or robust economy about to take off into the wild blue whatever.

Figure 3
Difference Engine

February US economic data: above or below expectations

MISSES

- Personal Spending
- Construction Spending
- ISM New York
- Factory Orders
- Ward's Domestic Vehicle Sales
- ADP Employment
- Challenger Job Cuts
- Initial Jobless Claims
- Nonfarm Productivity
- Trade Balance
- Unemployment Rate
- Labor Market Conditions Index
- NFIB Small Business Optimism
- Wholesale Inventories
- Wholesale Sales
- IBD Economic Optimism
- Mortgage Apps
- Retail Sales
- Bloomberg Consumer Comfort
- Business Inventories
- UMich Consumer Sentiment
- Empire Manufacturing
- NAHB Homebuilder Confidence
- Housing Starts
- Building Permits
- PPI
- Industrial Production
- Capacity Utilization
- Manufacturing Production
- Dallas Fed
- Chicago Fed NAI
- Existing Home Sales
- Consumer Confidence
- Richmond Fed

BEATS

- Personal Income
- Nonfarm Payrolls
- JOLTS
- Markit Services PMI
- Case-Shiller Home Price

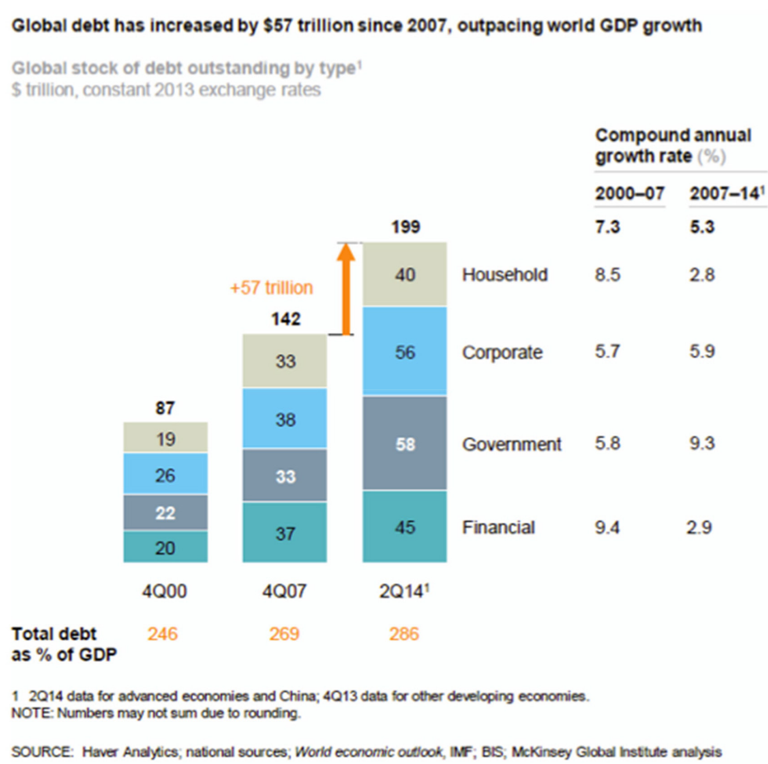
Source: Bloomberg via Zero Hedge

The Deleveraging Delusion

Last September, the Geneva-based International Centre for Monetary and Banking Studies published a study entitled *Deleveraging? What Deleveraging?* reporting that "[c]ontrary to widely held beliefs, the world has not yet begun to delever and the global debt-to-GDP is still growing, breaking new highs." Going further, the report's distinguished authors warned that, "in a poisonous combination, world growth and inflation are also lower than previously expected, also – though not only –as a legacy of the past crisis. Deleveraging and slower nominal growth are in many cases interacting in a vicious loop, with the latter making the deleveraging process harder and the former exacerbating the economic slowdown. Moreover, the global capacity to take on debt has been reduced through the combination of slower expansion in real output and lower inflation."

Now, just a few months later, The McKinsey Global Institute has issued a report reiterating this daunting message. McKinsey's version, entitled *Debt and (Not Much Deleveraging)*, tells us that since 2007, global debt has grown by $57 trillion, raising the ratio of global debt-to-GDP by 17 percentage points. Developing countries have accounted for half of this growth; government debt has soared (by $25 trillion) and private sector deleveraging has been limited. Households in the U.S., UK, Spain and Ireland have deleveraged somewhat, but elsewhere they have not. In particular, China's total debt has quadrupled from $7 trillion in 2007 to $28 trillion by mid-2014, fueled by real estate and shadow banking (but honestly, who knows what the real numbers are?). In an anodyne statement befitting a management consulting firm, McKinsey concludes that "[i]t is clear that deleveraging is rare and that the solutions are in short supply." In fact, the solutions are not in short supply; what is in short supply is the political and moral courage to implement them.

Figure 4
Denmark



Both the McKinsey and the Geneva reports demonstrate beyond a shadow of a doubt the unsustainable and dangerous path on which the global economy is set. The question is whether global leaders will let the train run off the tracks, or whether someone will demonstrate the necessary leadership to take action. The message for investors is that they and their money are living on borrowed time. The currencies in which their financial assets are denominated are being diminished in value every minute of every day. Rather than sit passively and receive a crash course in nominal value, they should actively be seeking ways to protect the real value of their capital. In many cases, this will require them to abandon managers that aren't generating adequate absolute returns and shift their assets to those who have demonstrated a genuine understanding of what is happening and an ability to connect the dots. The day- to-day volatility of the stock market is a side-show; the real story is the massive build-up of debt and what it means for the value of the currencies in which those debts are allegedly going to be repaid in the future. The truth is that those debts are never going to be repaid in constant dollars. Those who understand that and act accordingly will profit enormously; those who don't will fare very poorly.

Oil Update

Oil has rebounded by nearly 40% from January's lows but remains well below last year's prices. (As of February 28, Brent crude was trading at $62.58 per barrel compared to a low of $45.19 on January 13 and a high of $115.00 in June 2014.) This has led to rebounds in some oil equities and junk bonds. Investors are breathing a sigh of relief that oil producers are reacting to the plunge in prices by sharply cutting back drilling. Unfortunately, these efforts have yet to actually cut production; year-over-year production is still up. Companies have idled rigs for 12 consecutive weeks, bringing the rig count to its lowest level in five years, but they will need to do much more to stop the growth in production. The same improving technology that gave rise to the fracking boom and the ability to exploit the most promising acreage has rendered the rig count of limited use as an indicator of future production.

Oil prices were hit by a perfect storm of oversupply, slowing non-financial demand and sharply lower financial (i.e. trading) demand. The last factor is particularly noteworthy because it was triggered by concerns about global growth on the part of commodities traders in early-mid 2014. It makes eminent sense that a world suffocating under an ever-increasing burden of debt is going to struggle to grow. This is confirmed by reams of economic data from around the world. Other economically sensitive commodities such as iron ore, aluminum and copper are telling the same story. Markets are living organisms, however, and the oil market is no exception. Oil producers are cutting production as quickly as possible and oil prices are stabilizing. The International Energy Agency is predicting that oil demand will increase by 912 million barrels-per-day in 2015 and another 1.13 million barrels-per-day in 2016. Rising demand will meet lower supply to stabilize prices. The world will adjust. The only question is how much damage will be inflicted on overleveraged companies in the interim.

Figure 5
Whoops!

Correlations

R-Squared: SSS Growth vs. Macro factors: 1Q07 - 3Q14

	YoY % Change								
	Disposable Personal Income	Nominal Wages	DCF	Savings Adj. DCF	Non-farm Payrolls	Unemployment Rate (bps)	Gas Prices	Food at home CPI	Net Worth
WMT U.S.	20%	11%	0%	13%	2%	0%	1%	50%	27%
Sam's Club	39%	0%	31%	16%	10%	10%	44%	25%	2%
TGT	28%	9%	36%	38%	30%	36%	28%	0%	38%
COST	30%	7%	30%	29%	19%	26%	72%	0%	34%
COST U.S.	45%	11%	41%	40%	42%	49%	56%	4%	35%
COST U.S. ex-gas	34%	13%	34%	38%	65%	68%	7%	7%	32%

Source: Company data, BEA, BLS, Census Bureau, Goldman Sachs Global Investment Research

Data shows that lower gasoline prices are still not translating into a consumer spending boom. As I have maintained all along (to the criticism of many), cheaper gas is unlikely to send consumers racing to the mall when the cost of healthcare and everything else is still rising. The Bureau of Economic Analysis, an arm of the Department of Commerce, reported that Americans spent $21.4 billion, or 18% of all spending on goods and services, in the fourth quarter of 2014 on healthcare. Those expecting lower gas prices to boost consumer spending should consider Figure 5 taken from a report by Goldman Sachs analyst Matthew J. Fassler. It shows that "the correlation between [Wal-Mart Stores, Inc.'s] US [same-store-sales] and gas prices has been nearly zero" *since the beginning of 2007*. (Matthew J. Fassler, "Wal-Mart Stores, Inc.: Results troughing, outlook plodding but improving nonetheless," Goldman Sachs Research, February 15, 2015.) Figure 6, taken from the same report, looks at other major retailers like Sam's Club, Target Corp. (TGT) and Costco Wholesale Corp. (COST) and shows only marginally more evidence that lower gas prices translate into higher retail sales, but Goldman deems the evidence "statistically insignificant." On its most recent earnings call, Home Depot (HD) also confirmed that it has seen no correlation between lower gas prices and higher spending at its stores.

Figure 6
Statistically Insignificant

Correlations

R-Squared: SSS Growth vs. Gas prices: 1Q07 - 3Q14

	YoY change in Gas prices with a lag of:						
	None	1-qtr	2-qtr	3-qtr	4-qtr	5-qtr	6-qtr
WMT U.S.	1%	3%	22%	16%	12%	6%	1%
Sam's Club	44%	26%	21%	5%	0%	2%	0%
TGT	28%	13%	2%	0%	1%	0%	0%
COST	72%	30%	0%	7%	10%	2%	0%
COST U.S.	56%	35%	6%	1%	3%	0%	0%
COST U.S. ex-gas	7%	17%	8%	1%	0%	0%	0%

Source: Company data, BEA, BLS, Census Bureau, Goldman Sachs Global Investment Research

So where are the savings going? J.C. Penney CEO Myron Ullman suggested that consumers are using their gasoline savings to pay down their credit card bills or buy necessities. While many experts expect consumers to behave as they have in the past and spend their gasoline savings on other disposable items, perhaps they should consider that earlier periods of sharply lower oil prices did not coincide with either higher government mandated healthcare spending or an ecommerce revolution. Consumer behavior is occurring in a radically different environment today and is unlikely to produce the same kinds of consumer spending boom as it did in the past.

Credit Derivatives in Denmark

High yield bonds performed poorly over the second half of 2014, particularly the lowest-rated credits. Between mid-June and mid-January, the spread on the Barclays High Yield Index widened by 185 basis points and the average bond price dropped by 7 points (performance has since recovered). The severity of the drop was not, however, fully reflected in the credit derivatives market; the spreads on credit default swaps (CDS) did not widen as much as spreads on the underlying cash bonds. One possible explanation for this anomaly is that investors are concerned that CDS contracts will not be enforced in the manner investors expect. The last time something like this occurred was in 2009 when counterparty fears led investors to question the value of CDS protection. This issue arose recently when requests were submitted to the body that determines whether payments are required to be made under CDS contracts in the cases of RadioShack and Caesars Entertainment Corp. (Caesars). This body, the ISDA Credit Determinations Committee (the "Determinations Committee"), produced a split vote regarding Caesars even after the gaming company defaulted on a bond payment due on December 15, 2014. This has raised questions about the integrity of these credit protection contracts and the stability of the markets.

Joshua Rosner of Graham Fisher & Co. has written some excellent papers on this topic exposing flaws in the process used to determine the occurrence of "credit events" that give rise to payments under CDS contracts. The Determinations Committee is comprised of the 15 largest users of credit default swaps. Ten voting members are sell-side firms and five are buy-side firms; the list includes the usual suspects. As a result, it is highly likely that the voting members will own a position in the instruments on which they are being asked to vote. Further, the determinations process lacks any of the normal procedural protections associated with what is effectively a juridical process. The following language from the Committee's disclosure document highlights the problem:

The procedures of the Determinations Committees are set forth in the DC [Determinations Committees'] Rules. A Determinations Committee in accordance with the DC Rules may amend the DC Rules. None of the ISDA [International Swap Dealers Association], the institutions serving on the Determinations Committees or any external reviewers owes any duty to you in such capacity, and you may be prevented from pursuing claims with respect to actions taken by such persons under the DC Rules. Institutions serving on a Determinations Committee may base their votes on information that is not available to you, and have no duty to research, investigate, supplement or verify the accuracy of information on which a determination is based. In addition, a Determination Committee is not obligated to follow previous determinations or to apply principles of interpretation such as those that might guide a court in interpreting contractual provisions. Therefore, a Determinations Committee could reach a different determination on a similar set of facts. If we or an affiliate serve on a Determinations Committee, we may have an inherent conflict of interest in the outcome of any determinations. In such capacity, we or our affiliate may vote and take other actions without regard to your interests under a Credit Transaction." (International Swaps and Derivatives Association [ISDA] Credit Derivatives Determinations Committee Rules, September 16, 2014 Version, http://www2.isda.org/functional-areas/legal-and-documentation/disclosures/)

To characterize this process as arbitrary would be generous. The Committee can act without any duty to anybody, can ignore all principles of fairness, can act in absolute secrecy, and claims to have no liability to anybody. Investors in credit default swaps sign away all rights when they enter into standard CDS contracts. The members of the Committee are authorized to act in their own interest in the name of exercising their fiduciary duties to their own investors. Fairness and market integrity be damned.

The Determinations Committee failed to agree whether Caesars' failure to make interest payments on certain bonds on December 15, 2014 constituted a default (a "credit event" in the CDS contract parlance) that would trigger payments on $1.68 billion of notional outstanding CDS contracts that were due to expire on December 20. While the company made it clear that it would not make those interest payments and was planning to file for bankruptcy pending conclusion of negotiations with bondholders, it still had a 30-day grace period in which to change its mind and make the payment and had sufficient cash on hand to do so. Accordingly, some might argue that the default did not occur until the earlier of the end of the grace period or the date of bankruptcy filing (bondholders filed an involuntary bankruptcy petition on January 12; the company followed with a voluntary petition on January 15). Unable to reach a decision, the Committee is convening an external arbitration panel for the first time in six years to determine whether a "credit event" occurred with respect to the CDS contracts that expired on December 20.

Concerns have been raised because Elliott Management, a large Caesars bondholder that sued the company on November 25, is one of the 15 members of the Committee. Elliott's presence on the Committee – indeed, the presence of any market participant on the Committee –raises serious questions about the integrity of the determinations process. The market would be much better served by a process that recuses interested parties from participating in decisions involving their own investments. This would seem to be both an obvious and an easy problem to fix; it is also an important problem to fix in order to improve market confidence. The credit default market, while smaller than it was before the financial crisis, is still $20 trillion in size, large enough to pose a systemic threat. Recently, the big banks were able to convince Congress to keep their hundreds of trillions of derivatives contracts inside their FDIC-insured subsidiaries. As a practical matter, this changes little since the size of these derivatives are so overwhelming that the government will have no choice but to step in with some type of blanket guarantee during the next crisis regardless of where these instruments reside. But leaving them inside taxpayer-insured entities sends a signal that Congress doesn't appreciate the risk these products pose and is enabling moral hazard to flourish. Credit default swaps constitute only 3-4% of all outstanding derivatives yet at $20 trillion could easily wipe out the capital of the world's banks in the blink of an eye. The least that should be done – and done immediately – is for an independent procedure for determining "credit events" to be put in place. The current regime is inadequate.

Share Your Thoughts on This Article

Post a Comment

Like *Outside the Box?* Then we think you'll love John's premium product, *Over My Shoulder*. Each week John Mauldin sends his *Over My Shoulder* subscribers the most interesting items that he personally cherry picks from the dozens of books, reports, and articles he reads each week as part of his research. *Learn more about Over My Shoulder*
