MacroMavens

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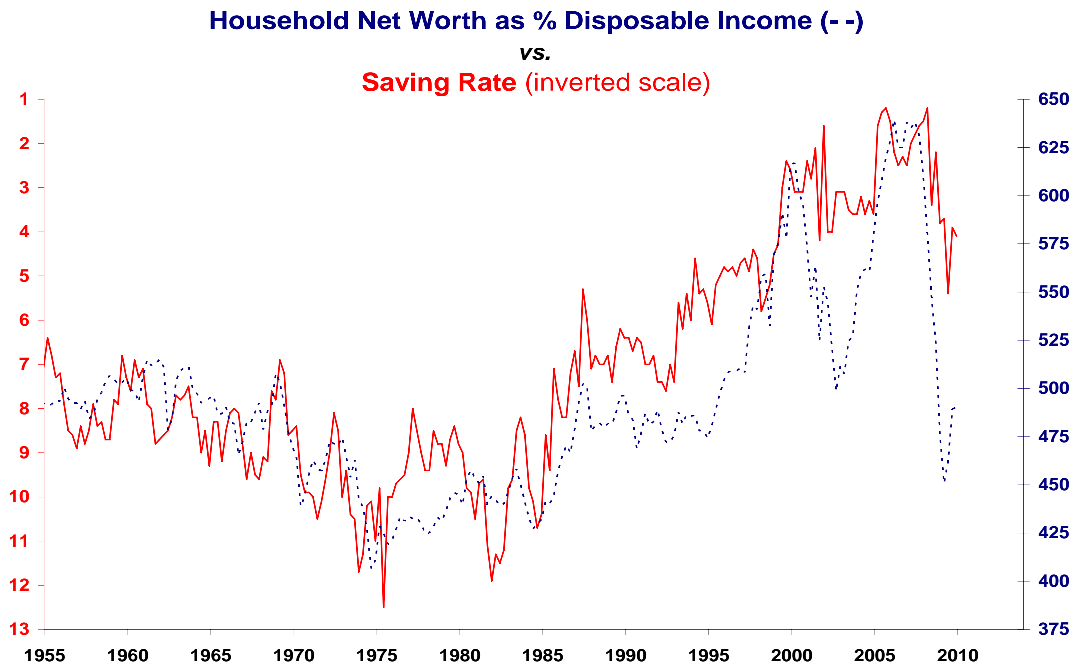
Delusions of Adequacy

Such is the affliction besetting the nation. I was led to that conclusion, not by the relentless stream of male enhancement ads that clog my email box each day (tho their being addressed to a woman does suggest a level of pandemic) but, rather, by a series of tantalizing headlines over the last two weeks. The first was the EBRI's (Employee Benefit Research Institute) latest Retirement Survey. While the media ran with the single nugget that more workers were delaying retirement, having studied prior releases from the EBRI, I knew full well that there was much, *much* more data there to be mined.

In true eco-geek fashion, I downloaded the 44 page report, poured some coffee and settled in. I was not disappointed. As expected, the media had glossed over some fairly interesting detail. Not least, that **while worker confidence in their ability to afford retirement stabilized over the last year (and confidence in the ability to cover basic expenses improved) *actual* savings for retirement went down.** Only 60% of workers surveyed reported that they were saving for retirement, down from 65% last year. That's the steepest drop in the history of the survey. Yet far from being anxious, these workers appear to be living the adage that ignorance is bliss. Less than half (46%) had even tried to calculate what they will need to retire! **To quote the usually snore-worthy EBRI, workers are "clueless" about their retirement needs.**

Before you wag your head in disbelief, as I did, consider that these workers may not be entirely to blame. It seems entirely possible that **their confidence has been imbued by the expectation** (rendered wholly rational during the Greenspan Era) **that saving out of income was a fool's errand.** Assets (specifically housing—which is excluded from the EBRI definition of 'saving') would fill the funding void.

So, while it is certainly possible that 40% of workers aren't saving because they simply can't afford to, **it is also possible that some portion aren't saving because they believe assets will rebound and bail them out.** The inverse relationship between Household Net Worth and Savings is powerful, as evidenced below. As Net Worth rises, Savings (inverted here) falls.



With Net Worth recovering, per last week's *Flow of Funds* report, these workers may not be delusional about their financial future. They may be **operating on the rational expectation that Ben will (if he hasn't already) inflate another bubble. Just as they did in 2002-4, households thus see no need to bring Savings to the 7-9% style levels that would normally correspond to the level of Net Worth.** The prospect that workers are banking on asset recovery finds support in the EBRI Survey. The last time this few workers (60%) were saving for retirement was when the market hit its peak in 2007. And the only time fewer were saving was 2004, after the market's 26% rebound from the DotCom lows in 2003.

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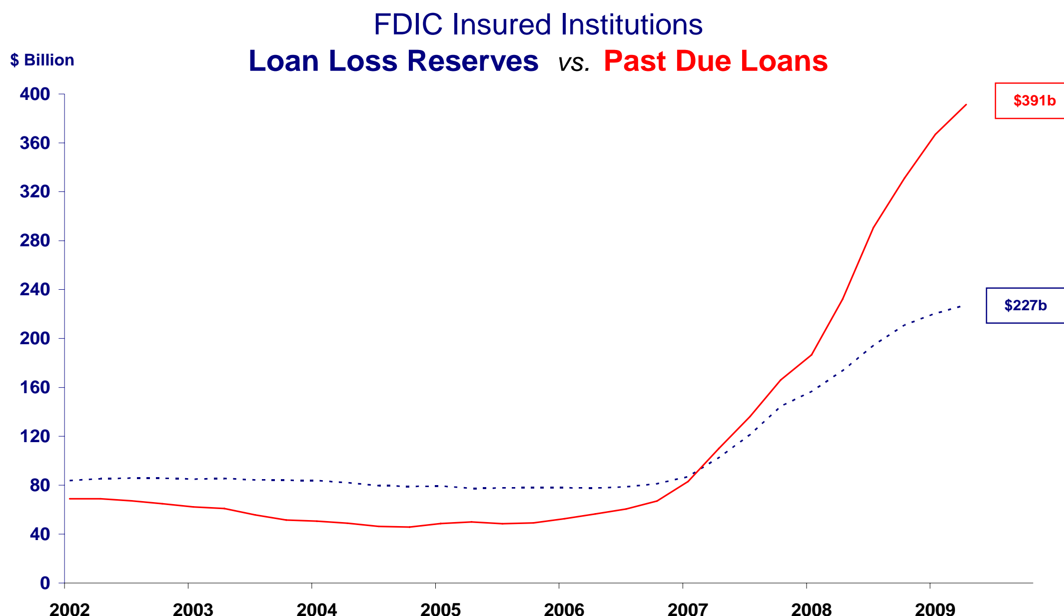
If workers are indeed making this bet, it would be good news in the near-term. For, **it would spare the economy the material hit to spending that would be required to bring savings into alignment with present net worth.** *(A return to 8% would require savings increase – aka spending decrease -- by $513b. On $10t of consumption, that's 5%).* **More importantly, it would imply that deflationary psychology hasn't yet set in.** And that the Fed still has a *chance* of success.

Of course, **if the rebound in Net Worth proves illusory** and the Fed incapable of reflating assets (or at least those which reside on US household balance sheets), **then we're in a dilly of a pickle!** The price of delusion will be dear. Going back to the EBRI survey results, **a staggering 27% of workers have saved less than $1,000 toward retirement.** That's up sharply from 20% last year.

<table>
<tr><th colspan="7">Total Savings & Investments* Reported by Workers</th></tr>
<tr><th></th><th>2007</th><th>2008</th><th colspan="2">2009**</th><th colspan="2">2010**</th></tr>
<tr><td>< $1k</td><td rowspan="2">35%</td><td rowspan="2">36%</td><td>20%</td><td rowspan="2">39%</td><td>27%</td><td rowspan="2">43%</td></tr>
<tr><td>$1-10k</td><td>19%</td><td>16%</td></tr>
<tr><td>$10-100k</td><td>36</td><td>37</td><td colspan="2">36</td><td colspan="2">34</td></tr>
<tr><td>>$100k</td><td>29</td><td>27</td><td colspan="2">24</td><td colspan="2">22</td></tr>
<tr><td colspan="2">Source=EBRI</td><td colspan="5">* Excludes Value of Primary Residence or Defined Benefit Plans
** Prior to 2009 there was no breakdown of <$1000</td></tr>
</table>

We can only hope that the 27% are new entrants to the workforce -- kids right out of school, sharing apartments and still struggling to pay their rent. Unfortunately, and rather surprisingly, the EBRI does not break down the responses by age. But if their panel is representative of the nation as a whole, **with 54% of the labor force over 40 years of age, the figures are truly alarming. Doubly so given the increasingly retractable nature of pension promises.** While many private sector employees (like those toiling for airlines and auto manufacturers) have already suffered this disloyalty, State and Local employees may soon discover their gold-plated benefits are made of tin. If and when these contracts are abrogated through bankruptcy, or the threat thereof occasions their revision, many will be left with far less than they presently expect. And the resulting need to save -- *aka not spend* -- will have a material economic impact. After all State & Local workers comprise 15% of total employment.

Dangerous as the *Delusion of Adequacy* afflicting households may be, they can be excused for lacking the financial sophistication to appreciate how deep a hole they're in. The same however, cannot be said for **financial institutions.** And as other info streamlining in over the last couple weeks reveal, **their affliction is no less acute.** How else to explain the conclusion that reserving for losses no longer need be done? The $10b reduction in loss provisioning versus last year was a major contributing factor to the gain in 4th quarter earnings. Meanwhile, **loan loss reserves cover just over half (58%) of those loans presently past due!**



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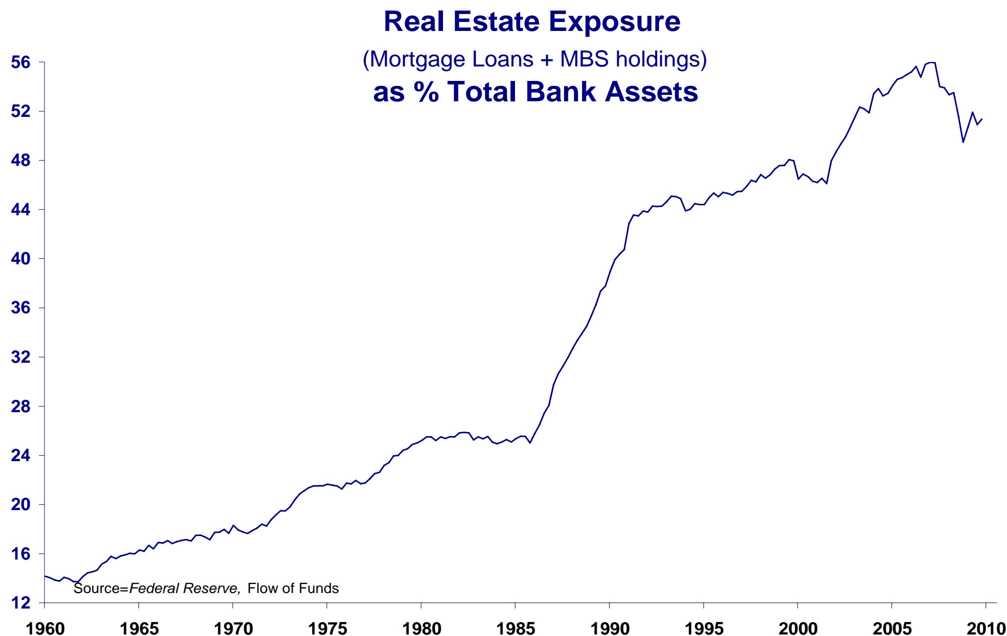
While it is true that not all Past-Due loans will ultimately be charged off, there's good reason to believe that a great *many* will. And that they will do so even as **new loans turn bad.** 'Tis the inglorious nature of a Jobless Recovery. As Sheila Bair herself observed a few weeks back, "even the good mortgages are going bad because people are losing their jobs".

But even if the economy starts creating jobs tomorrow, banks will still have to wrestle the 800lb gorilla that is renewed home price declines. After all, they're still obscenely exposed to real estate. Per the hot-off-the press *Flow of Funds* release last Thursday, **at yearend 51% of US commercial bank assets were tied to real estate…**



… and as has become woefully clear, the stabilization in home prices late last year that emboldened banks to stop provisioning was illusory. **Housing activity has slumped back over. That it has done so even *before* the first time homebuyer tax credit expires next month paints a dark picture of conditions thereafter.** It looks increasingly likely that the 5% of homeowners now clinging to the edge will be gurgling alongside the 24% of homeowners already under water. According to First American CoreLogic, these sorry sots collectively owe $800b more than their homes were worth. And, remember, that's as of yearend. **It scarcely need be said** (but I will) **that the longer prices fail to recover and jobs fail to materialize, the more of that $800b loss will be realized.** It's just a start, but the FDIC has already fingered $45b in loans on which it would like banks to forgive principal.

Should banks heed the FDIC's request it would quickly shatter the delusion of capital adequacy. **To say nothing of the prospect that banks are finally forced to mark-to-market all the toxic securities they are now carrying at cost.** In case you missed it, last week the FDIC sold $1.8b in notes securitized by RMBS it acquired from failed banks. Those RMBS had outstanding unpaid balances of $3.6b. **In other words, the FDIC just marked similar RMBS to market at 50%.** *Gulp.*

Frankly, the conversation about bank capital 'inadequacy' could stop there. But we haven't even gotten to the good stuff!!! **Moody's – hardly known for overstating the bear case— believes US banks are not even HALF WAY through the write-down process.** They estimate total losses from 2008-2011 at $536b, of which $240b has been booked. If I may do the math: that leaves roughly $300b…against provisions of $227b.

	2008 – 2011 estimated losses	2008-2009 writeoffs	Remaining losses
Residential RE	$173b	$72b	$101
Commercial RE	100	30	70
C&I loans	66	39	27
Other	197	99	98
TOTAL	$536	$240b	$296b

Source=Moody's

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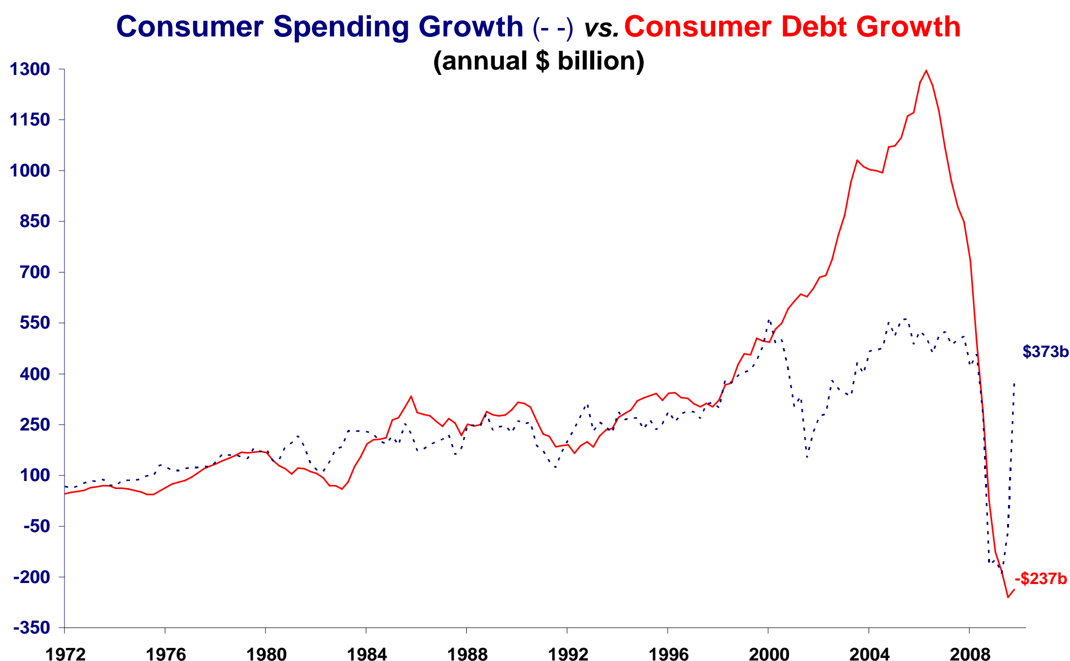
And one presumes that these loss estimates are based on rather conventional Unemployment and Home Price forecasts. If reality lands closer to MacroMavens' expectation, the losses will be far higher. Either way, **re-provisioning what they only just de-provisioned,** as Moody's itself points out, "will extend the period that many banks will be unprofitable well into 2010***…and will reduce capital levels".*** From any other source that would hardly qualify as an earth-shattering insight. But from a group that's managed to underestimate the downside at every turn, this modest acknowledgement of reality is cause for alarm.

But the real doozy -- **the most profound indication that capital levels are far less adequate than investors would like to believe – is buried at the end of Moody's report.** To ostensibly ZERO fanfare, **the ratings agency is now providing a two-tier rating system for financials: an overall, or 'senior' rating, and a stand-alone rating. The latter reflects the institution's creditworthiness when stripped of the blanket of parental or systemic support.** With apologies to Ken Lewis and Jamie Dimon, it should come as no surprise that, for bankers, naked is not a good look. In the extreme, Bank of America falls 4 notches when deprived of 'too big to fail'.

	Stand-Alone *BSFR** Rating	Nature of Support	Senior Rating	Rating Uplift
Bank of America	C-	Systemic	Aa3	4
Citigroup	C-	Systemic	A1	3
Wells Fargo	C	Systemic	Aa2	3
HSBC	C	Parental	Aa3	3
Bank of New York	B+	Systemic	Aaa	1
JP Morgan Chase	B	Systemic	Aa1	1
SunTrust	C-	Systemic	A2	1

Source= Moody's *Bank Financial Strength Rating

And that, dear friends, brings us to ***the Grand Delusion:* the fantasy that there is *any* inherent substance to the improvement in the economy and financial sector beyond GOVERNMENT support.** As clearly detailed above, were it not for their morbid obesity—many of our largest financial institutions would be trading as Junk. And as for the vaunted economic 'recovery', the invisible hand of the government is clearly at work there to. One need look no further than the chart below. How, pray tell, did consumers muster a $373b increase in spending in a year when wages declined -$239b and borrowing declined a like amount?



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Sure, sure. As discussed in "The Virtue of Vice" (3/4/10), *some* of that spending may have been buoyed by cash freed-up by default. But we'd be talking chump change. Fact is, there's just no way of getting around the gargantuan role that Washington has played in goosing consumption. **Between $325b in tax cuts and $231b in transfer payments, consumers received a cool $556b in income supports from the government last year. That's a 5% increase in income right there!**

	2009
Tax cuts	$325b
+ Govt transfers	231
= **Total income supports**	**$556b**
Consumer Spending	*$373b*

Relative to these enormous handouts, the increase in spending should be viewed as *disturbingly* unimpressive, not celebrated as betokening a return to health. To put numbers on it, of every dollar the government handed consumers, 67 cents was spent. And that's before we even get into the **unquantifiable psychology lift from the Fed's asset reflation which, courtesy of the rebound in stocks, buoyed Net Worth by a cool $2.77 TRILLION last year!** If we add that to the equation, every $1 of income and *asset* supports translated to spending of 11 cents!! *Oy!*

Low as the bang for the fiscal and monetary stimulus buck may be, unless or until employment or home prices recover, it's all we've got. So the question becomes: ***how sustainable is this government-fostered financial and economic recovery??*** Or, more accurately: *how long can we endeavor to borrow our way out of our excess borrowing scrape??*

As the latest TIC data should make clear, the jig is already up. Our global creditors have long since tired of supporting our unsupportable lifestyles. Far from adequately funding our capital needs, foreigners yanked $285b *out* of the US over the course of 2009. **If January sets the pace for year, some $400b in capital will flee our shores in 2010.** That alone, *you would think(!)*, would shake the smug conviction that we'll somehow pull off this feat of fiscal derring-do or, at least, the notion that we can do so without great cost.

For, at the risk of stating the blaringly obvious (MacroMavens' forte) **the only way to sustain this artificial, stimulus-based "recovery" is for the government, once again, to circle the square.** Specifically, **for Ben Bernanke to lend the Treasury what our one-time creditors will not.** *That's* what makes this week's market action so remarkable. **The fact that investors paused—even *momentarily*—to consider the possibility that the Fed would pave the way to tighten, betrays the depth of their affliction.** Somehow, they have bought into the government-manufactured illusion of economic growth and financial sector soundness.

Meanwhile, the evidence (as laid out herein) is clear. Absent government meds, the US economy and financial system upon which it rests are anything but virile.

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