

The End of Capitalism as We Know it

By Jason Leavitt

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There was a scary moment Thursday when Goldman Sachs and Morgan Stanley, the last two independent investment banks, collapsed and it probably acted as a tipping point with regards to the government's role in dealing with the financial crisis. Ben Bernanke is considered an expert on the Great Depression. Perhaps he saw flashbacks to 25% unemployment and lines around street corners just to get a loaf of bread. Hank Paulson is the former CEO of Goldman. Perhaps he saw his pride and joy giving up its independent status and being swallowed up by a clumsy bank – maybe even a foreign bank. Whatever was the case, a threshold was crossed, and it was decided that bailing out the financial markets – even if it cost a half-trillion dollars – was better than the path we were on. Paulson said it was a necessary evil within the context of horrendous alternatives.

Paulson's objective this weekend when he meets with law makers is to paint a picture so horrific, that Congress doesn't have a choice. The picture has to be one of gloom and doom – that if drastic measures are not taken, the entire US economy would not just slow down, but would grind to a halt. That even if it costs \$500 billion dollars, it's better than the alternative (a second Great Depression, a massive blow to capitalism (does it really exist), and domino effects which may include more authoritarian rule in Russia among others). (Oh and one other thing. There are 535 members of Congress, and I'm willing to bet not 5 of them have any clue how or why any of this works – including Obama and McCain. Paulson on the other hand is extremely smart and talented, (as a former CEO of Goldman should be) so Congress pretty much doesn't have a choice but to go with whatever Paulson says. Most members of Congress couldn't carry on an intelligent conversation pertaining to the economy, so it's not like they'll be able to argue with him).

The problem with most banks and brokerages is they have "toxic" holdings on their books, and these are preventing them from engaging in "business" transactions. In short, their hands are tied while they carry huge losses on their balance sheets. It's as if you had 10 stock positions – 8 working well and 2 that were down 90%. Your overall portfolio would be down a huge amount, but if you could just get rid of those two bad positions, you'd be doing just fine. The mere presence the two positions paralyze you. You can't live your life as you normally do. Your world stops – or at least pauses.

So along comes the government with the biggest bailout in the history of the world. They do three things to put a floor under the market.

1) They **form a Resolution Trust Corp. (RTC)** – call it a garbage can for toxic balance sheet holdings. I don't know what the gov't will pay for these holdings – perhaps 10 cents on the dollar or 20 cents. In any case, an RTC gives banks and insurance companies a place to dump their losers, so their balance sheets look much prettier. The banks then breathe; they loosen up some; they start lending again. After all, the #1 factor that influences the economy's ability to expand or contract is liquidity – the flow of money. It is believed these illiquid assets are choking off system, and without them, the system would be free to function again. Paulson says this will cost hundreds of billions of dollars. It requires the approval from Congress. This is what he'll be selling this weekend.

2) They are **guaranteeing money market funds** – essentially providing insurance for the accounts. I guess this would be similar to FDIC for bank accounts and SIPC for brokerage accounts. This perplexes me. The money market industry was created to meet the demand of people who were willing to take on a little more risk in exchange for a higher interest rate. People choose to put their money in money market funds instead of a simple checking or savings account because the funds paid higher interest. People were willing to be in a slightly riskier instrument in exchange for a higher return. Now the government is stepping in and saying: “we'll insure that.” I guess “no risk, no reward” doesn't apply any more.

3) A temporary **ban on selling financial stocks short**. The list includes 799 tickers, and if GE and a few other companies get their way, there'll be a few additions to the list this weekend. This is the only measure they're taking which directly interferes with the free market. It is widely and wrongly believed the short sellers are the primary cause of the financial crisis – that greedy, money-hungry traders teamed up and “attacked” stocks and drove them down for their own benefit. Nothing could be further from the truth, but since the public wants someone blamed, why not target those who are making money during the sell-off? It's exactly what the totally ignorant public wants to hear. But what the public doesn't realize is the extent which short selling is a necessary and constructive activity in the market. It adds liquidity. It dampens the movements. It gives buyers a chance to buy at lower prices. For the market to flow smoothly there needs to be a buyer for all sellers and a seller to all buyers. But if sellers are removed, spreads will widen and fills will be terrible. Without a free market – one that permits anyone to buy or sell whatever he wants whenever he wants – Wall Street becomes a Ponzi scheme, a true house of cards.

In reaction to all this, the market surged Friday. The Dow moved up 3.35%, the SPX gained 4.03%, and the Nasdaq 3.4%. But these are not massive gains. They're nice. They feel good. But they aren't unheard of, and considering everyone and his short-selling brother probably covered, Friday's performance wasn't that spectacular. Before everyone gets too giddy – and yes, I'm sure many Americans are breathing a massive sigh of relief right now – I want to let these same Americans know they're not benefiting from this as much as they think. If I were to write a letter to Joe Sixpack who puts

money into his 401K every month and doesn't plan on taking the money out for 20 years, this is what I'd write.

Dear Joe,

Friday's gains were great, huh? And combined with the move off Thursday's low, you probably went from a state of deep concern to one of total relief. You were afraid you were gonna be able to buy that new flat panel TV, huh. Well now you can. Congratulations.

But I'm sorry to tell you, although you're breathing easier this weekend, what the gov't did and how the market reacted didn't help you; it hurt you. Yes that's right. It hurt you – that is unless you sell your stock holdings very soon. You see, you're a long term investor, and you plan on holding your investments for 20 years. You should be happy when the market goes down because it gives you the opportunity to buy at lower prices. But because the market soared on Friday, you now have the opportunity to buy at higher prices. How does that sound? As of Thursday's low, you could have bought the S&P 500 at 1133.50, but now the S&P is at 1255 and probably going higher over the next week. In fact by the time you get paid at the end of the month and put money into your 401K, you'll probably have to pay 1300 to get a piece of the S&P. How does that sound? You thought the gov't was saving your ass when in fact they're costing you money in the long run.

If you consider yourself a long term investor who averages in every payday, and if you believe that in time, stocks go where they're 'supposed' to go (you can't not believe this – in the short term stocks often go "too high" or "too low" but over the course of 20 years, they go exactly where they deserve to go), congratulations. You just got screwed. You think the gov't just did you a favor because your retirement account looks much better at Friday's close than it did Thursday morning, but in reality you are the big loser in this manipulation game because you now have to buy at much higher prices.

When the SEC first made the announcement to ban the short selling of the financials, the SPX was bottoming at 1133.50 on Thursday, and let's say by the end of the month when you put money into your retirement account, the S&P sits at 1300. What long term effect will this have on your retirement in 20 years? The answer: 12.8%. Yes that's right. Every dollar invested at the end of this month at S&P = 1300 instead of at S&P = 1133 will cost you 12.8% over the next 20 years. Now tell me how happy you are.

It would appear as if the people who will benefit most from this are those who now have the opportunity to dump stocks at higher prices, but if you aren't dumping, you aren't benefiting. In fact, you just got screwed.

Sincerely,
Jason

So free market capitalism is dead. It's been dying slowly for many years, but it seems to be accelerating. I'll admit the capitalism we had wasn't pure, but it was better than a gov't controlled marketplace.

The gov't bought Fannie Mae and Freddie Mac, so they now own half the mortgages in the country.

They bought an 80% stake in AIG, so they own a huge portion of the world's largest insurance company.

Via social security, they already own your retirement.

And of course they already own the educational system (K – 12th grade).

This isn't meant to be a political statement, but if Obama becomes president, he'll nationalize the health care industry.

And there are other objectives which aren't so obvious. The government gave JP Morgan \$29 billion to help buy Bear Sterns; they essentially forced Bank of America to buy Merrill Lynch; and they turned their heads when Lehman Brothers was on life support thus "allowing" them to go under. And just like that, three of the five major investment banks are no longer.

Why are these steps important? Because if the gov't wants to have control, having less players to oversee is easier than having more. The gov't doesn't want many major banks, hundreds of smaller banks, several investment banks etc. They want consolidation. They want a small handful of massive institutions because a smaller number is easier to control.

I'm not sure I like the direction we're headed.

We have a problem the gov't helped create and now they're riding into town on their white horse committed to using every weapon in their arsenal to restore order and play the role of good guy. They'll manipulate the market, dilute the dollar, build on our national debt, and tinker in the marketplace in a way that's never been done before. Taxes will be raised, interest rates will be higher, money market funds will fetch less interest, and we get to go to sleep every night knowing the great experiment started 232 years ago is being driven into the ground. It would not surprise me to wake up one day to learn the dollar bills in my pocket are worthless pieces of paper that need to be exchanged for a some new currency – possibly a North American Union currency.

I don't like the direction we're headed.

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