

## The Fiddler's Notion<sup>SM</sup>

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### All Fall Down

Having just disparaged Alan Greenspan, for whom we have significant respect in spite of that one key failing in his theory and practice, we really have no problem shifting to a fairly sharp critique of the rest of the various observers and participants.

And while we have not been fans to any degree of Mr. Bernanke, quite possibly the psychological framework he inherited from his predecessor along with initially benign conditions he inherited that did not really seem (at least on the surface) to require any special ministrations allowed for his worst instincts as an 'open' philosophy advocate from academia; ensuring he had no chance of ever being really effective.

And we focus here, as we have so often in the past, on the critical role of the Fed in setting the global psychology, because they are the true prime mover with responsibility for the system when all is said and done.

Yet, that does not absolve any of the other participants of their failings. And in our view that extends to esteemed economists and the financial fourth estate along with the usual culprits from the financial services industry that have been pilloried of late.

In the first instance, there has been almost no thoughtful and forceful coverage of the degree to which the US administration and the Fed have failed to address the US home foreclosure problem, and that is a significant failure of the press to focus on key issues on which they have so often in the past led the way. The same can be said for any of the esteemed economists' analysis I have read on this situation.

While it is informative and enlightening to read about their major views on the mechanisms that drive the banking business and the huge sums which they are able to assess in terms of global and individual country GDP percentages and the like, here again there has been no focus on the core problem.

We suppose that discussing how the US government can help an individual with a mortgage on a home of \$300,000 where the value of the home has sunk to \$240,000 is far less sexy and compelling to folks of such high intellect when compared to dealing with hundreds of billions of dollars that spillover into issues that blossomed into how you apply (to paraphrase and mildly satirize the late great popular astronomer Carl Sagan) "trillions and trillions."

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Of course, the industry also has its fair share of apologists and explainers who attempt to make sense of what is transpired. Citigroup ex-Chairman John Reed had a reasonably informed assessment of the causes of the current crisis posted as a letter to the Financial Times.

In fact, his "Crisis has resulted from honest misjudgments by finance sector" (from October 21, attached for your review) was substantially accurate insofar as it went. However, there is a missing element that we have revisited many times, and much of the rest of the industry is rue to stipulate: the influence of central banks' lack of timely action to cool global economic sentiment two years ago.

There was another very good column about the way forward in light of officialdom's desire of to improve the regulatory regime. In "Grand claims, but only tired ideas" (October 17), the FT Editor was right in to warn officials to engage in "...deep thought and prolonged preparation..." instead of seeking instant gratification on a major reordering of global regulation.

However, we believe his more important point was that these are not just matters of proper structure, but also the will to implement. As business naturally desires to exploit loopholes, policy makers must get back to firm 'guidance' instead of being reactive. Recent history in the US is a cautionary tale.

In a July 2006 letter to the FT Editor we noted "...its desire to be everybody's friend will actually make the Fed its own worst enemy." Quoting French fabulist Jean de La Fontaine, "Our destiny is frequently met on the very paths we take to avoid it."

Much as the UK's Mr. Brown ignored warnings on bubbles, the Fed's lack of tightening after the DJIA pushed to a new all-time high on October 4, 2006 encouraged excessive global asset appreciation assumptions. FT economic analyst/guru Martin Wolf is very right about central banks' need to lean against bubbles. The Greenspan Doctrine box score is Crises 2, Central Bankers 0.

Messrs. Greenspan and Bernanke both expressed concern on irregularities in mortgage originations, yet asserted this was not in their bailiwick. Yet, those were a major basis for derivatives the banks shifted to off-balance-sheet vehicles Mr. Reed now admits were a major problem. It would seem the Fed could have signaled banks this was not acceptable.

There are also implications for the future. One major questionable inference is that the Fed needs far greater regulatory powers because it is shelling out huge sums. It is possible this ends up a misguided knee-jerk institutionalization of temporary triage.

What the recent situation made clear is sustained liquidity injections border on the Fed making fiscal policy. This is something even Alan Greenspan says is not useful, due to its need to employ its balance sheet to modulate the economy. Regulatory reform is indeed desirable.

However, in addition to global coordination, central banks must get back to more anticipatory 'steering' of economies and 'influence' over the finance industry. They remain the only participants with both mandate and incentive to prevent a bad hangover by pulling the punchbowl when the party gets too raucous.