Steve Czech's - Anecdotes From The Road: "You Thought 2011 Was Volatile? Wait 'Til You See 2012" - Volume V., No. 1

Ladies & Gentlemen:

Hope all is well with you and yours!

Below, please find the latest installment of *Steve Czech's Anecdotes From The Road: "You Thought 2011 Was Volatile? Wait 'Til You See 2012"*. The following are some very interesting anecdotes I've gleaned from readings, meetings and conversations during the past month. (A pdf version is attached hereto for iPad users).

AMERICA ON THE ROAD TO RECOVERY: DAY 450

GM's STOCK PRICE AT THE IPO ON 11.18.10: $33.00/SHARE
GM's STOCK PRICE ON 1.13.12: $24.29/SHARE
ABSOLUTE % CHANGE FROM IPO PRICE: - 26.39%

QUESTION OF THE WEEK:

- Are you better off financially today than you were three years ago today?
- Think about that as you decide who to vote for in this year's upcoming U.S. presidential election.

THINGS TO WATCH IN 2012:

- ***Private Equity Industry:*** The largest players will continue to morph from LBO-only shops into asset management firms, offering their clients a wide array of investment strategies. In addition, many marquee private equity shops are aggressively pursuing a "buy-to-liquidate" strategy. Their investment periods are ending so they are buying companies who are in a free-fall. These companies, because of the free-fall, attract few bidders. Their investment thesis is to pay as low as possible and liquidate the companies over time. The hope is that what they realize from the liquidation exceeds what they paid for the company. Examples of deals we've seen along these lines are deals in community newspapers, small-market radio stations, magazines and industrial directories.
- ***The U.S. Housing Market:*** Those who: (i) purchased homes prior to 2003, (ii) are approaching retirement age; and (iii) who still have equity in those homes will be selling and renting to preserve what little equity they have remaining in their homes and use the proceeds to fund their retirement. The rental market will continue to strengthen and single family home prices are likely to continue to decline.
- ***The U.S. Banking Market:*** Banks like *BofA* and *Citigroup* are too big to manage. Watch for growing calls for their break-up.
- ***Europe:*** Greece has yet to be fixed; the EFSF is no longer viable in the wake of France's downgrade and the Continent's banks are insolvent and more levered than their U.S. counterparts.
- ***ObamaCare:*** Likely to be overturned in part or in total by the U.S. Supreme Court this summer.
- ***Iran:*** The Iranians are increasing their influence in the Middle East as Obama is retreating. The Strait of Hormuz is likely going to become dinner table conversation this year.

- ***The Middle East:*** Obama "led from the rear" in the various revolutions in Tunisia, Egypt and Libya. The fighting is over and the world's greatest proponent of democracy is nowhere to be found to fill the vacuum.
- ***The U.S. Presidential Election:*** An Obama defeat means 2-3 more years of the current malaise. An Obama victory means 4-8 years more of the current malaise.

DID YOU KNOW....

- That annual revenue at *Sears Holdings* (includes Sears & K-Mart stores) has declined from $53.0 billion in 2007 to $43.3 billion in 2011?
- That annual operating income at *Sears Holdings* (includes Sears & K-Mart stores) has declined from $2.5 billion in 2007 to $0.4 billion in 2011?
- That the market capitalization of *Sears Holdings* (includes Sears & K-Mart stores) has declined from $27.3 billion in 2007 to $8.3 billion in 2011?
- During the week of 1.9.12, *CIT Group*, one of the world's largest factoring companies, announced that it would no longer provide factoring financing to suppliers who sell to *Sears Holdings*. Other factors in the business have not cut off *Sears Holdings*, but have acknowledged that they are insisting on faster repayment and tighter terms *(Sources: Bloomberg Businessweek (revenue, operating income and market capitalization data, 1.9.12) and The Wall Street Journal, 1.12.12).*

U.S. GOVERNMENT REGULATORY INEPTITUDE OF THE WEEK:

- Salmon (as in "fish") that is found in U.S. salt water is regulated by one U.S. agency while salmon that is found in U.S. fresh water is regulated by another U.S. federal agency.
- Obama cited the aforementioned as example of something he could do to make it easier for small businesses to navigate the federal bureaucracy *(Source: The Wall Street Journal, 1.14.12).*

CLASSIC QUOTE:

- "Investors are well-advised to worry first about the return ***of*** their capital and second about the return ***on*** their capital" – *Will Rogers (Used in an article by Mohamed El-Erian, CEO of PIMCO in The Wall Street Journal, 1.9.12).*

NUMBER OF THE WEEK # 1: 372

- *Hostess*, maker of Twinkies, plans to file court papers soon (after entering bankruptcy court for the second time in three years, aka: "Chapter 22") that threaten to reject or modify its **372 union labor contracts that govern its day-to-day operations** *(Source: The Wall Street Journal, 1.11.12).*

NUMBER OF THE WEEK # 2: 12

- More than 80% of *Hostess'* 19,000 employees belong to 12 separate unions that are governed by 372 contracts.
- In some instances, union work rules mandate that separate trucks must deliver bread and cake products.
- Sometimes separate workers must load the trucks and additional workers must make final deliveries once a truck arrives at a supermarket.
- *Hostess*, which owes creditors more than $860 million and has struggled since emerging from bankruptcy proceedings in February 2009, tried to find a white knight that would buy the company outright or take individual businesses over the years to no avail, the people close to the situation said.

- *Hostess*, for instance, pays about $100 million cash annually to some 40 multiemployer pension plans that cover workers at a wide array of companies ***other than Hostess***. *Hostess* wants to switch to a so-called "single employer plan" so that it only has to pay the pensions of its employees and not those of 40 other companies *(Source: The Wall Street Journal, 1.11.12).*

PLEASE STOP SAYING THAT!

- For the past three months, the talking heads on business & network television and their guests have been sanctimoniously preaching about how strong the U.S. banks are and how much better off they are relative to European banks.
- Nothing could be further from the truth and here's why.
- Prior to October 2009, if the value of collateral securing a loan from a U.S. bank declined below the value of the loan itself, the *Federal Deposit Insurance Corporation* ("*FDIC*") would make a bank write down the value of the loan to reflect the deterioration in the value of the collateral *regardless of whether or not the borrow could make the scheduled principal and interest payments.*
- The resulting write-down would result in a reduction in bank profitability and a corresponding reduction in a bank's capital buffer.
- In October of 2009, for the first time ever, the *FDIC* told banks the following: Even if the collateral securing a loan declines below the amount of the loan, so long as borrowers are making their scheduled interest and principal payments on time, banks are NOT required to write down the value of the loan to reflect the deterioration of the collateral securing the loan.
- Why did the *FDIC* do this?
- Because had the *FDIC* adhered to the old standard, every bank in the U.S. would be insolvent overnight, given that residential and commercial real estate loans comprise a large portion of most banks' balance sheets and given the fact that most residential and commercial real estate has declined in value anywhere from 30% - 60% since 2007, depending on where the real estate is located.
- How bad is this problem of bank capital and liquidity being overstated?
- According to *Fannie Mae and Freddie Mac*, there is approximately $11.0 trillion of residential mortgage debt in the U.S and according to *CoreLogic*, approximately 25% of U.S. homeowners have mortgages whose balances exceed the values of the home. If you apply a 25% haircut to the $11.0 trillion, that means that banks would have had to write down their real estate (this excludes commercial & industrial loans) by $2.75 trillion. Last time I counted, the cumulative write downs the U.S. banking sector have been a fraction of that amount. Like Obama, bank executives are hoping the economy will recover, increasing the value of their collateral and reducing the need to write-down these over-valued loans.
- The punch line?
- *Nominally*, banks in the U.S. have more liquidity and capital than their European peers. *Effectively*, they are likely as worse off as their European peers.
- The bottom-line? Until U.S. banks recognize these losses, lending will be impaired and credit will become more scarce, more expensive and less flexible than it has been in our lifetimes.
- If you want to invest in a bank stock, consult someone who has actually worked in a bank as opposed to analysts who never have.

ANECDOTES FROM THE NEIGHBORHOOD:

Background:

- During the past few weeks, it appeared that the mass media and most investors started acting as though Europe's problems were solved, the U.S. economy was on solid footing and that nirvana was just around the corner.
- As you'll read below, nothing could be further from the truth. The fact of the matter is that we, the U.S. economy, are in a more precarious position starting 2012 than we were at the same time in 2011.
- What follows, is a summary of some personal anecdotes I came across during the holiday season that highlight how the no-growth Obama policies are impacting the so-called "millionaires & billionaires" that Obama likes to blame for the no-growth U.S. economy.

"Mr. Czech, When Is This Going To End?"

- That was the question put to me by an electrician working in my house the day before Christmas.
- His workload is 40% of what it was in 2008 and declined as much as 90% in 2009.
- No longer working on building new homes, I asked him what he spent most of his time doing.
- He replied that most of his time is spent "decommissioning" large portions of homes in Greenwich, Darien and New Canaan, Connecticut.
- What is decommissioning?
- If a home has 10,000 s.f. of living space, all of that living space has electrical power in the walls. Regardless of whether you have appliances plugged in, electrical power is running to those outlets.
- According to this electrician, residents of Greenwich, Darien and New Canaan with huge homes are asking him to literally cut off the power to certain parts of the house in order to reduce their electric bills because they are so cash strapped.

"The Greenwich Foreclosures Are KILLING Us!"

- That's what a very good friend of mine, a builder of custom homes for the past 25 years in Fairfield County, CT in the $3.0 - $7.0 million range, told me over the holidays.
- He hasn't been able to build a new home since late 2007. Between 2002 and 2007, he built 3 homes per year, on average.
- Why?
- Prior to 2008, people who wanted a very nice house in Greenwich, CT had to spend $7.0 million - $10.0 million to get the size of home they wanted. Those who couldn't afford Greenwich built in Westport or New Canaan, spent $3.0 - $6.0 million and got the size of home they wanted.
- Fast-forward to today: There are so many foreclosure sales of high-end homes in Greenwich that a home that was built for $7.0 - $10.0 million in 2007 can be purchased at a foreclosure auction for $3.0 - $6.0 million today.
- As a result, builders like my buddy can't get anyone to look at a $3.0 - $6.0 million new house in Westport or New Canaan CT when buyers can get the same size house (if not larger) for the same or lesser price in Greenwich.

FOUR FACTORS BEHIND THE TEPID U.S. JOBS "RECOVERY":

1. The glacial pace of U.S. GDP growth;
2. A structural mismatch between worker's skills and available jobs (Translation: American workers are becoming increasingly under-qualified for the high-tech work available in most companies);
3. A geographic mismatch, exacerbated by the housing depression, that leaves U.S. workers trapped in homes and in areas with few jobs; and
4. Increased productivity in the workplace as evidenced by the surge in capital equipment investment used to reduce the number of workers per unit of output *(Sources: RBC Global Asset Management & The Wall Street Journal, 1.7.12)*.

CAN'T MAKE THIS UP!

- ***You Need A "Sting" To Catch This Guy?*** A Florida man who went shopping for al-Qaeda flags was arrested after a sting operation in which he allegedly planned attacks with bombs and guns in the Tampa, FL area, authorities said *(Source: The Wall Street Journal, 1.10.12)*.

- ***Congress Can Insider Trade – You and I Cannot:*** Members of Congress are allowed to trade on information they gather as part of their daily work (said information may be material and non-public) so long as they disclose their trading activity.....months later.

- ***The FDA Can "Insider Trade" – You And I Cannot:*** The *U.S. Food and Drug Administration ("FDA")* advisers, in a recent vote, said the benefits of four popular *Bayer AG* birth-control pills outweigh the blood-clot risk. What the *FDA* didn't disclose is that three of the advisers have had ties to *Bayer*, serving as consultants, speakers or researchers. *FDA* advisory committees are designed to give the agency independent judgments on medical issues. The *FDA* says members of the public speaking before advisory committees MUST declare any financial relationships to the relevant drug maker, to "ensure ... transparency." However, *FDA* committee members must disclose potential conflicts only to the *FDA*, which doesn't generally make the information public *(Source: The Wall Street Journal, 1.11.12)*.

- ***Is It Genetic Among Democrats To Avoid Work?*** Indiana House democrats are again boycotting the chamber to block a bill that would crimp labor union influence *(Source: The Wall Street Journal, 1.6.12)*.

- ***"Liar, Liar Pants On Fire"*** Obama's appointments of Richard Cordray and three others to the *National Labor Relations Board* appear to run counter to Obama's own views as a senator, when he regularly criticized President George W. Bush's assertion of expansive presidential authority *(Source: The Wall Street Journal, 1.6.12)*.

- ***GM's Volt Is Really "Hot":*** *GM's Chevy Volt* sales in 2011 fell 23% short of *GM's* goal to sell 10,000 in the U.S. The company sold *7,671 Volts* in 2011...BEFORE their batteries started catching on fire. *GM* is looking to sell 45,000 *Volts* in 2012, more than five times what it sold in 2011, and has been eager to resolve the battery issue. *GM's* Mark Reuss said the company will only build that many if it believes the company can sell them *(Source: The Wall Street Journal, 1.6.12). Editor's Note: Manufacturers of fire extinguishers expect production to increase by at least 45,000 units in 2012 in anticipation of GM's plan to increase the production of its Volt)*.

- ***Oprah Really Is "O" ...As In "Zero":*** For the month ended 12.18.11, *The Oprah Winfrey Network ("OWN")* averaged about 210,000 viewers for its prime-time shows, down 16% from the same period in 2010, before the channel launched and when it was still known as *Discovery Health*, according to *Nielsen (Sources: Nielsen & The Wall Street Journal, 1.3.12)*.

- ***"Move Along! Move Along! Nothing To See Here..."*** Congressional investigators are stepping up their inquiry into how deeply credit-rating companies examined the disastrous bet that sank *MF Global Holdings Ltd.* and whether the firms overlooked crucial information in their evaluations, according to people familiar with the matter *(Source: The Wall Street Journal, 1.5.12)*.
- *Editor's Note: Memo to Congress: The CFTC, which was given expanded oversight authority in the wake of Dodd-Frank, had its regulators SITTING IN MF GLOBAL'S OFFICES days before MF Global filed for bankruptcy and STILL has no idea what happened to $1.2 billion of CLIENT money (that the CFTC was there to watch) nearly three months after the bankruptcy filing!!!!)*

ANOTHER SECOND PLACE FINISH FOR OBAMA'S ECONOMY:

- Hong Kong again beat the *NYSE* in new stock offerings in 2011.
- One reason the U.S. economy isn't creating enough jobs is that it's not creating enough employers. After another dismal year in 2010 for American initial public offerings ("IPOs"), some had predicted a strong 2011. But now the results are in and as *The Wall Street Journal* reported the week of 12.26.11, "the comeback never came."
- Fewer companies went public in 2011, and the offerings raised less money.
- For the third year in a row, the world's leading exchange for new stock offerings was located not in New York, but in Hong Kong. And even without counting Hong Kong's $31 billion in deals, the various exchanges on the Chinese mainland slightly exceeded the $41 billion combined total of *Nasdaq* and the *New York Stock Exchange*, according to *Dealogic*.
- Given that the U.S. is still home to the world's largest economy, there's no reason it shouldn't have the most vibrant equity markets—unless regulation is holding back the creation of new public companies. On that score it's getting harder for backers of the *Sarbanes-Oxley* accounting law to explain away each disappointing year since its 2002 enactment as some kind of temporary or unrelated setback.
- And don't try blaming all the problems in U.S. equity markets on the European crisis. *The London Stock Exchange Group* said on 12.28.11 that proceeds from 2011 initial public offerings in London rose 27% from 2010, and that 2012 "promises to be another exciting year."
- There will certainly be excitement in 2012 for *Facebook's* expected IPO, but for many innovative U.S. companies the regulatory burden of being a public company is simply too great. Every Presidential candidate should do as Newt Gingrich did in *The Wall Street Journal* on 12.28.11 and make the case that America's markets should be the most hospitable in the world for companies raising equity capital. Gingrich called for full repeal of *Sarbox*, which would be a good start *(Sources: Dealogic & The Wall Street Journal, 1.3.12)*.

COMRADE OBAMA IS AT IT AGAIN:

Incapable and unwilling to meet, negotiate and/or comprise with Congress (including members of his own party), Comrade Obama is reverting back to his Chicago-style, "Community-Organizer" tactics. The following is a summary of what he's been up to while you were away for the holidays.

Contempt for Congress:

- Obama makes recess appointments when there's no recess.
- Remember those terrible days of the Imperial Presidency, when George W. Bush made several "recess appointments" to overcome Senate opposition? Well, Czar George II never did attempt what Obama did on 1.4.12 in making recess appointments when Congress isn't even on recess.
- Eager to pick a fight with Congress as part of his re-election campaign, Obama did the Constitutional equivalent of sticking a thumb in its eye and hitting below the belt. He installed Richard Cordray as the first chief of the *Consumer Financial Protection Bureau* and named three new members to the *National Labor Relations Board ("NLRB")*. He did so even though the Senate was in pro forma session after the new Congress convened this week.
- A President has the power to make a recess appointment, and we've supported Obama's right to do so. The Constitutional catch is that Congress must be in recess.
- The last clause of Section 5 of Article 1 of the Constitution says that "Neither House" of Congress can adjourn for more than three days "without the Consent of the other" house. In this case, the House of Representatives had not formally consented to Senate adjournment. It's true the House did this to block the President from making recess appointments, but it (the House) is following the Constitution in doing so. Let's hear Obama's legal justification.
- Democrats had used a similar process to try to thwart Bush's recess appointments late in his term when they controlled both the House and the Senate. Prodded by West Virginia's Robert C. Byrd, who has since died, Senate Majority Leader Harry Reid (Democrat-NV) kept the Senate in pro forma session. Some advisers urged Bush to ignore the Senate and make recess appointments anyway, but he declined. Now Reid is supporting Obama's decision to make an end run around a Senate practice that Reid pioneered!
- Some lawyers we respect argue that a pro forma session isn't a real Congressional session, and that's certainly worth debating. But that isn't the view that Reid ***or then-Senator Obama took in 2007-08***, and it would certainly be an extension of Presidential power for the chief executive to be able to tell Congress that he can decide when Congress is really sitting and when it isn't. In any event, that still wouldn't explain the violation of the language in Section 5 above.
- These appointments are brazen enough that they have the smell of a deliberate, and politically motivated, provocation. Recall the stories over the New Year's weekend, clearly planted by the White House, that Obama planned to make a campaign against Congress the core of his re-election drive. One way to do that is to run roughshod over the Senate's "advice and consent" power and dare the Members to stop him.
- Cordray's appointment also plays into Obama's plan to run against bankers and other plutocrats. The President justified his appointment on 1.4.12 by saying that Senate Republicans had blocked Cordray's nomination "because they don't agree with the law setting up the consumer watchdog."
- Obama knows (and has acknowledged) that Senate Republicans haven't called for the dissolution of the consumer financial bureau, or personally attacked Cordray, as Democrats like to claim. Republicans have said they'd be happy to confirm him if Obama agrees to reforms of the bureau that would make it more accountable to elected officials and subject to Congressional appropriations.
- As it stands, the bureau is part of the *Federal Reserve* but Cordray sets his own budget and doesn't report to the *Fed* Chairman...or anyone for that matter. His rule-makings also don't need to worry about such inconvenient details as bank safety and soundness.
- The bureau has been up and running since July 2011 and is already pushing the boundaries of its examination powers. With Cordray on board, he says the bureau can now begin to issue rules, including oversight of nonbank institutions and the ability to define what constitutes an "abusive" act or practice, an invention of the *Dodd-Frank* financial reform that will surely lead to mischief.

- As Ohio Attorney General, Cordray was tight with the tort bar and launched a barrage of national lawsuits worthy of Eliot Spitzer. His new job might be a nice populist springboard for running for Ohio Governor, should he choose to do so. Look for Cordray to announce new and controversial rules or enforcement actions, oh, say, around Labor Day.
- As for Obama's three *NLRB* appointees, he only notified Congress of his intent to nominate them on December 15, 2011. The Democratic-controlled Senate hasn't had time to hold a SINGLE confirmation hearing. The nominees, two Democrats and one Republican, will give the labor board a quorum that it wouldn't have had with the December 31st expiration of the term of previous recess-appointee Craig Becker.
- Under the Obama Administration, the supposedly nonpartisan *NLRB* has become a partisan arm of Big Labor, and that will probably continue this election year. Appointee Sharon Block is the Labor Department's Congressional liaison and former aide to Ted Kennedy. Richard Griffin is general counsel for the *International Union of Operating Engineers*.
- Remember a year ago when Obama was talking about "regulatory relief" and moving toward the political center? He even sent *The Wall Street Journal* an op-ed.
- Congress can't do much immediately to stop these appointments, but it ought to think creatively about how to fight back using its other powers—especially the power of the purse.
- However, private parties will have standing to sue if they are affected by one of Cordray's rule-makings, and that's when the courts may get a say on Obama's contempt for Congress *(Source: The Wall Street Journal, 1.5.12).*

***Contempt for the Constitution*:**

- The U.S. Justice Department just invented a legal rationale for Obama appointments.
- Where's John Yoo when Obama needs him? The famous Bush Administration legal official was much maligned for issuing opinions supporting Presidential power, and he surely would have come up with something better than the junk law issued by the Justice Department's Office of Legal Counsel on 1.12.12.
- The 23-page memorandum (dated January 6, 2012) by Assistant Attorney General Virginia Seitz is meant to justify Obama's recess appointments last week of Richard Cordray at the *Consumer Financial Protection Bureau* and three new members of the *National Labor Relations Board*—even though the Senate was not in recess but was holding pro forma sessions. The House also did not consent to the Senate's adjournment, as required by the Constitution's Article I, section 5, clause 4.
- Seitz concedes that "The question is a novel one, and the substantial arguments on each side create some litigation risk for such appointments," and little wonder. Most of the opinion is an off-point digression on the constitutionality of recess appointments between Senate sessions, which no one disputes. But on that "novel" question, Seitz's legal reasoning is remarkably weak.
- Seitz avers that the pro forma sessions aren't technically sessions. As "a practical matter," she writes, in those sessions the Senate isn't capable of receiving and acting on nominations to the executive branch and therefore cannot exercise its advice and consent duties. Seitz points in particular to a Senate "standing order"—the rules of order it adopts to govern its procedures—that no business would be transacted during the pro forma sessions.
- If the Senate itself says it can't conduct business, she says, then the President can conclude it isn't really in session.
- The problem is that the Senate does most of its work by unanimous consent—meaning without objection from present Members and without a vote or quorum. Even a single Senator alone on the floor (or "as a practical matter" one from each party) can use this process to modify the standing order in a heartbeat and conduct business.

- The Senate did exactly that to pass Obama's payroll tax holiday in December 2011, changing a standing order by unanimous consent to conduct business during an ostensibly pro forma session.
- **Obama signed THAT bill. Either that was a real session and therefore his recess appointments are unconstitutional or the bill was invalidly enacted and therefore unconstitutional. Both can't be true.**
- The practical effect of Seitz's legal logic is that the President could make a recess appointment when the Senate adjourns for the day, or for lunch. He could also decide that the Senate isn't functioning to his liking—for instance, by dragging its feet on his nominations—and recess appoint nominees even when the Senate is conducting other business.
- Last week, White House spokesman Jay Carney claimed Obama relied on the advice of White House counsel and didn't mention that the Office of Legal Counsel had been consulted beforehand. Now we know why: The Administration's position is a "made-to-order" legal invention *(Source: The Wall Street Journal, 1.13.12).*
- *Editor's Note: Ms. Seitz may wish to request a refund for the tuition she paid to the University at Buffalo University Law School where she earned her constitutional "law" degree".*

EUROPE IS NOT FIXED!

Background:

- Over the holidays, I had conversations with nearly two dozen money managers who manage several different strategies.
- What struck me was how little most of these managers knew about the current state of affairs of the European debt crisis and how little they cared.
- There was almost a sense of "It's their problem, not our problem"; "It's been fixed"; and "Things are getting better here – we're de-coupling".
- As a service to our readers, the following is a summary of where this crisis started and where it is today.
- As you'll read below, NOTHING has been resolved since the European crisis broke in Greece in May 2010. NOTHING!
- (i) Greece is on the verge of a free-fall bankruptcy as I type, (ii) the *European Financial Stability Facility ("EFSF")* is now in need of "Financial Viagra" in the wake of France's downgrade on 1.13.12, and (iii) the European banks are, for all intents and purposes, insolvent.

Current Situation - The ECB's Backdoor Bailout:

- December 21st's mammoth lending spree won't fix what ails the euro zone.
- Bring out the punch bowl, Mario. *The European Central Bank* in late December splashed out €489 billion ($638 billion) in three-year loans to 523 banks across the Continent. Overnight, this new long-term lending program produced the single biggest liquidity injection in *ECB* history, a huge boon to banks that have struggled to fund themselves in private markets.
- The injection of money, with another three-year auction due in February, reduces the short-term risk of a liquidity-driven banking meltdown in the euro zone. But it won't solve Europe's sovereign-debt problem.
- *ECB* President Mario Draghi has been at pains to point out that this sort of lending to banks is a normal central-bank function. By making liquidity available to banks, and at the same time easing its collateral requirements, the *ECB* is reducing the banks' cost of funds and—at least in the short term—the risk of a *Lehman*-type bank run in the euro zone.

- Fine and well. But nobody should think this *ECB* exercise is cost-or-risk-free.
- The central bank's 1% lending rate is a long way from Walter Bagehot's penalty rate, and thus amounts to a de facto bank subsidy. The *ECB* has also reduced its collateral standards so low—to single-A asset-backed securities in some cases—that it runs the risk of losses down the road. This too is a backdoor bank rescue.
- Draghi said on 12.19.11 that the *ECB* lowered its lending standards because some banks were in danger of running out of eligible collateral. And even with the lower standards, at least two Italian banks seem to have borrowed a page from Greece and Portugal, issuing bonds to themselves that they can then post to the *ECB* as collateral.
- A government-guarantee program put in place by Italian Premier Mario Monti earlier in December means that these new bonds are treated as nearly risk-free. At least Rome's bond guarantee doesn't apply to existing Italian bank debt—the policy error that sank Ireland.
- The abrupt crash in Spanish, Italian and other peripheral bond rates the week of 12.19.11 suggests that markets also expect banks to use the ECB's long-term loans to buy more sovereign debt. French President Nicolas Sarkozy specifically encouraged that the week of 12.12.11, and Draghi on 12.19.11 acknowledged that some banks would likely do so.
- The euro leaders added to this likelihood by taking private losses on sovereign debt off the table at December's Brussels summit. Even so, Spanish and Italian government-bond yields moved higher after the 12.21.11 auction, and traders reported that the *ECB* waded back into government-bond markets. Most banks apparently saw better uses for this cheap money than taking a flyer on Italian debt.
- The failure of even 12.21.11's mammoth auction to produce a lasting reduction in euro-zone bond yields could be a blessing. A huge rally in Italian and Spanish debt driven mostly by emergency central-bank lending could send a false signal that Europe's crisis is over.
- That in turn would be a fatal signal to national capitals that they can go back to spending and borrowing as usual, without making the reforms needed for growth.
- The *ECB*'s backdoor bailout may have bought the euro zone some time. If all it accomplishes is to give the politicians another reprieve, the time will have been worse than wasted *(Source: The Wall Street Journal, 12.24.11)*.

Current Situation - Five First-Quarter 2012 Flashpoints for Europe:

- The euro-zone crisis subsided for much of December 2011, but it may return with a bang early in 2012. Here are five key risks investors should have on their radar in the first quarter.
- **First**, Greece aims to conclude its "voluntary" bond swap in January 2012, chopping €100 billion ($130 billion) off its debt and over time reducing the debt-to-GDP ratio to 120% from more than 160%. However, it's not clear that enough investors will sign up, potentially throwing the swap and Greece's bailout into disarray. Even if they do, the fear remains the deal doesn't do enough. *The International Monetary Fund* may yet conclude Greece's debt is unsustainable and stop lending.
- **Second**, European credit ratings are set to fall. *Standard & Poor's* downgrade 14 euro-zone countries, and *Moody's* also plans to revisit its sovereign ratings. While much of the focus has been on France's triple-A, a greater risk may face Italy, which may fall to the triple-B category. Not far from junk, that could knock some of the country's debt out of bond indexes and increase collateral margins charged on Italian bonds, further constraining investor demand.
- **Third**, Europe's bailout mechanisms will be in focus. The *European Financial Stability Facility* has failed to boost its firepower through leverage and has seen investor demand wane, but will need to issue bonds to fund Portugal. In March 2012, euro-zone governments will discuss the €500 billion cap on the *EFSF's* successor, the European Stability Mechanism. There will be pressure from the likes of Italy to boost the size of the fund, potentially causing even more intergovernmental friction.

- **Fourth,** Eastern Europe may yet stir fears about bank exposures and increased political tensions within the wider European Union. Hungary in particular is cause for concern.
- The government, in the face of vocal opposition from the *European Central Bank*, the *European Commission* and the *IMF*, on 1.6.12 ratified a bill that reduces the independence of the National Bank of Hungary, giving government-appointed officials more sway in monetary-policy making. That poses a risk to Hungary's access to markets and complicates talks with the *IMF*.
- **Fifth,** with euro-zone policy driven by consensus, there is always the chance of unexpected moves from hard-line countries such as Finland, which held up the agreement on bailout funds in 2011. The first quarter of 2012 will also see the political focus move to France and rhetoric gear up ahead of April's presidential elections.
- Incumbent Nicolas Sarkozy has been trailing Socialist Party candidate Francois Hollande in the polls; a change of government could generate fears of further delay and renegotiation in dealing with Europe's problems.
- Of course, investors will also have to absorb a constant flow of data from Europe's economies, bank earnings and government-bond auctions. With banks deleveraging and governments trying to reduce their debt burdens, there is the real risk of weaker countries facing serious economic contractions—spooking markets over their ability to tame deficits. The one thing investors can be guaranteed of is that the December lull won't last long into January *(Source: The Wall Street Journal, 1.3.12)*.

GREECE:

- Talks between Greece and its private creditors over a planned debt restructuring are at an impasse and will likely resume on 1.18.12, a senior government official said on 1.13.12, amid signs that the negotiations had stalled over key elements of a deal.
- The IIF agreed in October 2011 that it would negotiate a "voluntary" deal on the basis of a 50% cut in the face value of Greek bonds held by the private sector. The main dispute between the two sides on 1.13.12 related to the annual interest payments on new bonds that would be exchanged for old.
- The negotiations have been tortuous. After first insisting no default by any euro-zone country would be possible, EU leaders agreed in July 2011 to seek a deal to cut about 10% from the face value of Greece's bonds in private hands. By October 2011, Greece's prospects had deteriorated, and euro-zone governments and the IIF agreed to pursue a deal to cut the face value by 50%.
- Since October 2011, Greece's economy, which is entering its fifth year of recession, has weakened even further, worsening the state of its government finances and making the current bailout insufficient in terms of euros.
- That means a bigger gap in Greece's budget that must be filled either by more debt relief or more new lending from official creditors *(Sources: The Wall Street Journal, 1.13.12 & 1.14.12)*.

THE EUROPEAN FINANCIAL STABILITY FACILITY ("EFSF"):

- As it is currently structured, the EFSF rescue fund is backed by guarantees from the 14 euro-zone countries not being rescued themselves.
- When it needs to lend cash, the EFSF goes to market to borrow it. But in order to preserve the fund's own triple-A rating, it pledges that all of its borrowings will be covered by guarantees of only the triple-A countries.
- Without France and Austria, the sum of triple-A guarantees falls from €451 billion ($586 billion) to €271 billion ($352 billion), more than 75% of which comes from Germany. (The balance is from the Netherlands, Finland and Luxembourg.)
- The rescue fund is committed to providing about €200 billion ($260 billion) in funds to help rescue Portugal, Ireland and Greece, depending on how much Greece needs.

- That would leave virtually nothing to fund any aid to other countries that might need help such as Italy, Hungary and others.
- The EFSF fund has a few options.
- First, it could change its policy and accept a lower debt rating for itself. But that implies higher borrowing costs and narrows the universe of potential investors. The EFSF fund markets itself to big central banks and other reserve managers as a high-quality borrower.
- Second, it could try to brush off the French downgrade. The fund and the euro-zone governments that control it may conclude that being considered triple-A by the two other agencies will suffice. But that strategy is risky, too. If *S&P* is joined in its downgrade by one or two of its peers, the fund could quickly find itself shunned by investors who demand triple-A ratings by multiple firms.
- "I believe investors will see S&P as just the first of more actions, and will shun EFSF bonds even more so than previously," said Nick Firoozye, senior European rates strategist at *Nomura* in London, referring to the rescue fund *(Source: The Wall Street Journal, 1.14.12)*.

THE STATE OF EUROPEAN BANKS:

Overview:

- Mounting signs of a lending freeze by European banks suggest the downturn could deepen, leading to more action from the *ECB* later in the first quarter, analysts said.
- The *ECB* took aggressive steps last month to spur bank lending by extending €489 billion ($638.2 billion) in low-interest loans to euro-zone banks for a maturity of three years.
- The central bank continues to purchase Spanish and Italian government bonds to keep yields from rising too high.
- But there is little evidence that the measures are having their intended economic effect.
- European banks parked €453 billion ($591 billion) in overnight deposits at the *ECB* on 1.3.12, a record sum suggesting banks prefer to hoard their cash rather than lend it to other banks, even at a higher rate *(Source: The Wall Street Journal, 1.5.12)*.

Investors Are Paying Germany To Safeguard Their Cash:

- Investors agreed to pay the German government for the privilege of lending IT money.
- In an auction on 1.9.12, Germany sold €3.9 billion ($4.96 billion) of six-month bills that had an average yield of ***negative 0.0122%***, the first time on record that yields at a German debt auction moved into negative territory.
- This means that unlike most other short-term sovereign debt, in which investors expect to be repaid more than they lend, investors agreed to be paid slightly less.
- And they are willing to do that because they are so worried about the potential for big losses elsewhere in Europe *(Source: The Wall Street Journal, 1.10.12)*.

UPDATE - THE IMPLOSION OF ILLINOIS:

Background:

- For the past several months, I've been highlighting the death spiral that the state of Illinois has put itself in.
- Logic would dictate that after watching California and New York in the same situation years before itself, Illinois would take measures to avoid its current death spiral.
- Not so.

- During the past three months, every deal I've evaluated for Illinois-based companies falls into one of two categories: (i) an Illinois-based company looking to sell itself to a non-Illinois-based company; or (ii) an Illinois-based company seeking to move its operations out of Illinois.
- The following is more anecdotal evidence of why the "Land of Lincoln" is quickly becoming the "Land of Leavin'".

Liberals Love the 1% - A Lesson In Big Business Tax Favoritism In Illinois:

- Or at least they love them if they are big businesses threatening to flee higher taxes. That's the story in Illinois, where during the week of 12.18.11, the Democrats who run the state government ladled out $85 million in tax relief to the *Chicago Board of Trade* and the *Chicago Mercantile Exchange*, plus tax credits for *Sears Holdings Corp.* (see "Code Blue" above) worth $15 million a year for the next 10 years.
- In January 2011, Governor Pat Quinn and his fellow Democrats passed a $2 billion tax hike, the biggest in Illinois history, with the income tax rising 67% and the effective corporate tax rate rising to 9.5% from 7.3%, which gives Illinois one of the highest business tax rates in the nation.
- That law fired up a motorcade of lobbyists from major Illinois companies like *Motorola*, *Caterpillar*, *Sears* and others to descend on Springfield and seek tax breaks lest they leave for states where business taxes are much lower. More than a dozen companies have already left for Indiana and Wisconsin.
- So Quinn started giving special tax passes to the biggest and most influential 1%. *The Chicago Tribune* reported in May that Quinn had already doled out corporate welfare to at least 80 firms, costing the state nearly $500 million since 2009. *The Chicago Merc* and the *Board of Trade* complained that the Quinn tax grab would cost them $50 million a year.
- Naturally, Quinn justifies the carve-outs as essential to job creation. But in January 2011, Illinois ***Democrats claimed that tax increases would have no economic impact***. Now small and medium-sized businesses that don't have lobbyists are stuck paying the higher tax rates. Quinn's policies benefit the 1% of politically connected businesses at the expense of the other 99%, often small shops with 10, 20 or 50 employees.
- Quinn's other claim in January 2011 was that the tax hike was essential to balance the budget. Yet the Illinois Policy Institute recently calculated that over 15 years the revenue loss from all the corporate tax giveaways will exceed the revenues raised from the corporate tax increase. Oh, and there's still a budget deficit!
- Once again the lesson is that high tax rates fail to raise the revenue that liberals claim, not least because liberal politicians follow their tax increases by passing out favors to the rich and powerful.
- The same will happen in Washington if Obama gets his way to allegedly soak the rich. Too bad the liberal media won't admit it *(Source: The Wall Street Journal, 12.20.11)*.

UPDATE - THE FRAUD KNOWN AS "GREEN/CLEAN ENERGY/TECHNOLOGY":

- Another day, another taxpayer-funded, green-energy failure. This month's flop is *Range Fuels*, that former darling of green Silicon Valley, which a few years ago was boasting it would build the nation's first commercial cellulosic plant, near Soperton, Georgia. More than $225 million later, *Range Fuel*s only factory was auctioned off in a fire sale last week, for a mere $5.1 million. It had produced not one ounce of cellulosic ethanol.
- *Range* did help to waste taxpayer dollars. In 2007 the Bush Energy Department gave *Range* a $76 million grant—of which *Range* received $46 million. In 2009 the Obama Administration signed off on a further $80 million loan guarantee—of which $42 million was doled out. The state of Georgia kicked in a $6 million grant, and county officials coughed up tax abatements. That's aside from the more than $160 million *Range* drummed up from private investors.

- *Range* bet those dollars on technology and products that were unproven and incapable of competing in a marketplace without government mandates and support. These are the common characteristics behind all of Obama's green energy fiascoes—from the bankruptcies of solar company *Solyndra* and storage firm *Beacon Power*, to the growing struggles of electric battery makers *A123 Systems* and *Ener1*. The question is increasingly not which will fail next, but whether any will succeed.
- When these columns published a critique of *Range* a year ago, we were rebuked by *Range* investor Vinod Khosla, who claimed that the company's virtue was in allowing political venture capitalists like himself to "assess what was economic and what was not." That was no doubt helpful, given *Range*'s factory was ultimately sold for pennies on the dollar to New Zealand-based *LanzaTech*, a start-up whose top backers include . . . Khosla. *LanzaTech* has also been awarded millions in federal funding *(Source: The Wall Street Journal, 1.14.12)*.

Sincerely,

Stephen J. Czech
email: sczech@sjccapital.com

This report is neither an offer to sell nor a solicitation of any offer to purchase any securities, investment product or investment advisory services in any investment fund (the "Fund"). Any such offer will be made pursuant to a formal offering memorandum to be furnished to prospective investors at a later date, which memorandum will contain more complete information necessary to make an investment decision, including the risks associated with investing in the Fund, loss of the entire amount of principal and/or lack of liquidity. A prospective investor considering a direct investment in a Fund should rely on such memorandum.

All opinions and views expressed constitute judgment as of the date of writing and may change at any time without notice and without obligation to update. Such information may be based on certain assumptions and involve elements of subjective judgment and analysis. The opinions expressed are that of the author and the author, or its affiliates, accept no responsibility for the information and/or opinions discussed. Actual results may differ significantly. All forecasts are subject to change at any time and may not come to pass due to changes in market or economic conditions. This material has been prepared using sources of information generally believed to be reliable but no representation can be made as to its accuracy. This material is intended for informational purposes only and does not constitute investment advice, or a recommendation or an offer or a solicitation to purchase any Fund. There has been no independent review of the information presented in this report. This report is private and confidential and is intended exclusively for the use of the person to whom it has been delivered by Stephen J. Czech. This report does not constitute an offer to sell or a solicitation to invest in any jurisdiction where the offer or sale would be prohibited or to any person not possessing the appropriate qualifications. This report is not to be reproduced or redistributed to any other person without the prior written consent of Stephen J. Czech.