



The Black Swan and the Politics of Greed

The current economic situation in the United States can be blamed squarely on the very administration that failed to learn from the mistakes of the past, and were in the end, doomed to repeat them. What they also did not learn is that history has an annoying habit of repeating itself.

The bailout of large financial institutions like AIG, Citigroup and Bank of America giving rise to the 'too big to fail' argument, the US regulatory authorities and the Federal Reserve clearly did not learn from the Long Term Capital Management (LTCM) debacle some ten years earlier. LTCM was a hedge fund founded in 1994 by Nobel Economics Prize winners Myron Scholes and Robert Merton, along with John Meriwether. The fund returned 40 per cent annually in its first two years of operations; being based upon complex models that generated small likely gains balanced against the less than likely probability of a huge loss. The fund lost \$4.6 billion in three months during 1998 amidst the financial crisis that originated in Russia.

The Russian crisis was an outlier event that lay outside their financial model. It was what Nassim Taleb (*The Black Swan; published 2007*) describes as a Black Swan event; an outlier event that carries an extreme impact, and the fact that human nature compels a rationalization of the event as predictable, when in fact it was not.

LTCM held numerous positions with counterparties worldwide, and a bankruptcy would have triggered a financial meltdown at that time. The US Federal Reserve exerted its 'influence' on major players on Wall Street until a total of fourteen banks put up over \$3.5 billion for a 90% share in the fund, thereby averting a near global financial collapse. This was the birth of the 'too big to fail' scenario. Compare this to the recent events involving AIG and Citigroup in particular, who also hold large counterparty positions with institutions worldwide and even countries, and the picture becomes clear: No lessons were learnt in the LTCM crisis.

Another Black Swan event occurred with the bursting of the Dot Com bubble in 2000. This event erased \$5 trillion in the market value of technology companies from 2000 to the third quarter of 2002. It crystallized the term 'Irrational Exuberance'. Wall Street hyped up numerous dot com companies to unsuspecting investors. Then Fed Chairman Alan Greenspan, instead of taking measures to protect the situation from getting out of hand, did the exact opposite. The economy was flooded with cash and this cash cascaded into IPO's with returns ranging from 500 to 1000 per cent. The immortal words of Michael Douglas as Gordon Gecko in 'Wall Street' that "Greed is good" rang true in no uncertain terms. The subsequent bankruptcy filings of many of these dot com companies are well documented.

Following another Black Swan that occurred with the September 11 2001 terrorist attacks in the US, the Fed voted to

decrease rates to a low of 1% in 2002, from a high of 6% in 2000. This was the embryonic stage of the housing bubble that would come to terrorize world financial markets several years later. In early 2004 Chairman Greenspan suggested that homeowners should take out Adjustable Rate Mortgages. Yale professor Robert Shiller estimated that home prices doubled between 1998 and 2006 (*Irrational Exuberance*). The high in 2006 was 60 per cent higher than previous highs, an outlier event. With the Federal Reserve providing the gunpowder with 1% interest rates and the match provided by willing Wall Street bankers financing home loans, the stage was set for a huge explosion.

The Federal Reserve began increasing rates in 2004, culminating in a rate of 5 ¼ per cent in 2006. This spelt havoc for the ARM mortgage holders, not to mention a trainload of borrowers who would not have qualified for mortgages under normal conditions, and who were granted home loans with risk premiums attached to their loans; enter the sub prime animal. The housing crisis and the catastrophic impact on many financial firms is the result of the Fed once again letting the situation spiral out of control, just as in the LTCM crisis ten years ago. Moreover, the rise of the Collateralized Debt Obligations (CDO) backed by assets that were impossible to value and sold by Wall Street bankers to investors (*wait, did this not happen in 2000 with the tech bubble, is history repeating itself?*) has created huge mess that will take years to unravel. New Fed head Henry Paulson did nothing to stem the flow of the toxic waste that masqueraded as mortgage investments that were sold to an unsuspecting public. Raise your hand in this reminds of Greenspan's similar inaction in 2000.

In fact, an article by James Quinn titled; In the Midst of an Extreme Black Swan – September 2008 hit the nail on the head when it came to the Wall Street sentiment. He stated, *'Whenever someone (Wall Street) did something... and risked worldwide financial collapse, the Fed would ride in on their white horse'*. It was this knowledge that caused Wall Street to gamble in a high stakes, high risk game where they knew they could come out on the winning end, no matter what happened; the classic gamblers' Nirvana.

Current Happenings in Local and International Markets:

- Ansa McAL reports \$665m profits
 - ICBL to enter mortgage market
 - Distributors confirm falling food prices
 - Banks raise interest rates
 - FCIB launches new BA Visa platinum card
 - Jamaica in recession since '08 start
 - BOJ wields interest-rate shield - Jamaican dollar falls 10 per cent year to date
 - US Employers cut 533,000 jobs in Nov., most in 34 years; unemployment rate rises to 6.7%
 - Oil hits 4-year low on unemployment news
 - Merrill Lynch, Bank of America shareholders approve BofA's purchase of the investment bank
 - Bank of England Cuts Key Interest Rate to 2%
 - Credit Suisse to Eliminate 5,300 Jobs After Losses
 - ECB Delivers Biggest Rate Cut Ever as Economic Slump Deepens
 - Merrill Said to Cut Bonuses by 50% as Revenue Slumps
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Table 1: Regional Market Performance (as at 4 December 2008)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
TTSE Composite	860.69	-1.60	-5.95	-12.36	-10.40
All Trinidad	1,167.58	-1.22	-5.56	-2.76	-2.01
JSE Index	82,940.01	-3.26	-12.53	-23.18	-20.23
JSE Select	2,003.62	-5.56	-22.09	-31.59	-30.39
All Jamaica	74,824.57	-4.90	-20.56	-29.93	-28.36
BSE Composite	980.18	-0.30	-1.78	-4.73	-4.51

Table 2: International Market Performance (as at 4 December 2008)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
S&P 500	845.22	-4.78	-15.52	-42.44	-42.22
Nasdaq Composite	1,445.56	-5.65	-18.46	-45.50	-44.82
Dow Jones Industrial	8,376.24	-4.01	-12.70	-36.85	-36.78
German Dax	4,564.23	-2.17	-12.30	-43.42	-41.55
FTSE 100	4,163.60	-1.48	-9.15	-35.52	-34.07
Nikkei 225	7,924.24	-5.36	-13.06	-48.23	-48.81
Hang Seng	13,509.78	-0.31	-6.08	-51.43	-53.22
DJ Eurostoxx	2,368.72	-2.44	-14.02	-46.16	-45.41

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