



## MASTER OF DISASTER

In 1933, after the greatest asset market bubble in US history, Glass Steagall was enacted to separate investment and commercial banking activity due to excessive speculation by banks with customer deposits (FDIC also created) and the perceived conflicts of interest inherent in underwriting and brokerage. In 1998, after Fed Chairman Alan Greenspan gave the thumbs up, Sandy Weill nailed the coffin shut on Glass Steagall when he merged Travelers, Smith Barney, Salomon Brothers and Citicorp into Citigroup. Congress, of course, would go on to repeal Glass Steagall after the merger had taken place with the support of Treasury Secretary and current Citigroup director Bob Rubin and President Clinton.

Once the walls of regulation were broken Citigroup consistently pushed the financial barriers to extremes. Their fingerprints would be found on many financial implosions Glass Steagall was designed to prevent, from the cozy relationship with LTCM (LTCM's John Meriweather was ex Salomon MBS trader and Citigroup would be heavily leveraged to LTCM's book which was obviously heavily leveraged) to the Worldcom collapse and Citigroup's analyst/investment banker Jack Grubman conflict of interest scandal. Few also remember Citigroup's involvement in the previous sub-prime mortgage collapse in 2000 when they purchased The Associates, the largest consumer finance company, for \$31b. The purchase would bring scores of lawsuits and defaults as The Associates was a leader in originating junk mortgages.

Keeping with tradition, Citigroup would be at the forefront of the latest financial debacle in the implosion of leveraged structured products. Citigroup invented Structured Investment Vehicles in the late 1980s. These off-balance sheet partnerships served two functions; one was to provide high yielding fixed income assets to banking clients, the other was to allow banks to provide financing over and above what their capital requirements and balance sheet could accommodate. They went relatively unknown throughout the 1990s (unless you consider Enron's off-balance sheet partnerships some sort of SIV) but they exploded during the recent real estate bubble to accommodate the reckless highly leveraged speculation. [In The Anatomy of a Typical Boom and Bust we noted:](#) *These structured products and off balance sheet financing was the last frontier of credit creation that became necessary to foster the expansion of balance sheets required to support the underlying collateral values, just as Soros described 20 years earlier.*

We went on to draw the correlation between credit and the effects on the value of the dollar saying: *This massive expansion of credit has been one of the main factors behind the falling dollar. Essentially this new generation of financial engineering provided for the creation of dollars (supply) to increase at a rate that far exceeded the growth in the economy (demand). Since most credit is collateralized the supply is at risk when collateral values decline.*

Many readers of the Ex Ante Factor know that we have been looking for a low in the dollar and that we suspected a reversal of the credit cycle would be a major catalyst. We couldn't have scripted the credit collapse any better and now we just need to see the dollar follow through. The events of the past couple of weeks may have lit the wick.

In Following the Bouncing Banks we speculated: *Consider the back of the napkin math on Citigroup. Before its all said and done say worst case scenario they write off \$40b (equal to 50% of their off balance sheet SIV exposure). The multiple goes to 1x book and the stock could ultimately be worth around \$20 or another 45% downside.*

Well, it didn't take long. Friday Citigroup announced they would absorb SIV assets back on their balance sheet, worth \$49b. These SIVs were reportedly worth \$87b just months ago, a decline of 43%. The difference of \$38b represents 32% of Citi's current estimated book value which remains unknown. Who knows whether they are responsible to the \$38b on their balance sheet, but the point is the same regardless, capital is evaporating at an alarming rate.

Now that Citigroup and others have taken down the SIV assets and are covering their debt, it's time for them to work on the leveraged loans that total in the hundreds of billions. These leveraged loans used by private equity firms to LBO public corporations are adding insult to injury with regard to the bank balance sheet. Arguably had we not experienced the LBO boom along side the real estate boom banks would have been better capitalized to absorb the structured vehicle implosion. The \$200b odd of unsold LBO debt sits on the balance sheet at a loss and constricts future lending. No doubt this is why LIBOR remains elevated and the risk spread to T-Bills continues to widen. But this wasn't just a sub-prime real estate bubble, it was a full blown credit bubble and these banks and their balance sheets were at ground zero when the debt bomb blew up.

Bank balance sheets are no doubt contracting and it's safe to say the credit cycle has peaked. We think the deflationary forces that are consistent with credit contraction and a dollar rally are obviously showing up in collateral values but consider the widening of the spread between PPI and CPI. This week producer prices rose 7.2% YOY while consumer rose 4.3%. October was a similar difference with PPI at 6.1% v CPI at 3.5%. This consumer strain is also showing up in the gasoline/crude oil discrepancy and no doubt soft holiday sales. This stagflationary data can't be comforting to the Federal Reserve who specifically targeted commodity prices in [Tuesday's statement](#).

The DXY bottomed Friday 11/23 at 74.48. The following Monday, 11/26, the Abu Dhabi sovereign wealth fund announced they would invest \$7.5b in Citigroup in the form of an 11% convertible preferred. Tuesday 11/27 the Euro topped at 148.97. Did Citigroup, Masters of Disaster, put a low in the dollar when they capitulated and paid junk bond yields to the sheiks in desperation? We can't be sure the dollar low is in but we are encouraged by the price action off the bottom. We suspected petrodollars would play a roll in the bottoming of the dollar but are also encouraged by other foreign investors in Asia and Europe that are starting to show interest in distressed dollar assets. This week's Lufthansa investment in Jet Blue was another example among many. Should the dollar firm and start to work in favor of these foreign investors as opposed to against them it will only foster further investment as their real returns would soar in a dollar rally. Consider Abu Dhabi's investment at 148.97 euros. If in the next few years the dollar just rallies back to parity with the euro, assuming the price of Citigroup is at the same level, their \$7.5b investment would be worth close to \$10b and their 11% coupon worth closer to 15%. We think this presents a compelling risk/reward for the greenback and want to thank Citigroup for selling the low.

## RISK PREMIUMS

Indicator	Yield	Chg 1 W	AVG 2007	2007 High	2007 Low
Source: Barron's					
SPX Earnings Yield	5.36%	0.13%	5.59%	5.93%	5.23%
SPX Dividend Yield	1.90%	-0.01%	1.86%	1.99%	1.77%
High Grade Yield	6.01%	0.12%	5.99%	6.30%	5.68%
Medium Grade Yield	7.51%	0.10%	7.08%	7.51%	6.62%
US 10YR Yield	4.24%	0.13%	4.65%	5.18%	3.94%
Implied Equity Return	7.26%	0.12%	7.45%	7.84%	7.13%
Implied Credit RP	3.27%	-0.03%	2.43%	3.42%	1.92%
Implied Equity RP	3.02%	-0.01%	2.80%	3.60%	2.03%
High/Med RP	1.50%	-0.02%	1.08%	1.57%	0.86%
Equity-Debt RP	-0.25%	0.02%	0.37%	1.17%	-0.27%

The opinions, projections, assumptions and thesis contained in "The Ex Ante Factor" are strictly those of The Ex Ante Strategic Group, LLC at the time of release and are subject to change without notice. The term "ex ante" and Latin translation, "before the event" are in no way to be construed as literal prediction of actual and specific future market and economic outcomes. The Ex Ante Strategic Group, LLC makes every effort to ensure that the contents contained herein have been compiled and derived from sources it believes to be reliable. The Ex Ante Strategic Group, LLC makes no representation or warranty, expressed or implied, of the accuracy of the contents and takes no responsibility for errors or omissions which may be contained herein and accepts no liability whatsoever for any loss arising from the use of or reliance on the information and its contents, including charts, technical analysis, market and economic projections. Each individual is should consult with their respective financial advisor before making any transactions in securities. Financial securities inherently contain risk and with futures and derivatives the risk can exceed the initial investment of capital. The contents and information contained herein is not in any circumstance an offer to sell or solicitation for an offer to buy or sell any securities. The Ex Ante Strategic Group, LLC, its affiliates and respective officers or employees may from time to time take a position in securities mentioned herein. No part of this article may be reproduced without consent of The Ex Ante Strategic Group, LLC.

