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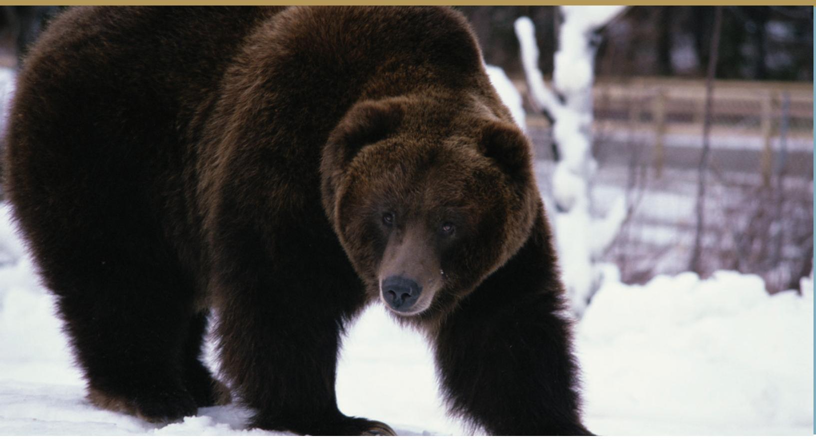
LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



A Rolling Stone Gathers No Moss

Over the past several months, the New York City-based Rolling Stone magazine has published two articles very critical of the various dealings of Wall Street banking leviathan Goldman Sachs.

Also, at Long Wave Analytics, we published a Winter Warning newsletter on the same topic, entitled For the Love of Money, dated February 15, 2010. However, since the behavior of Wall Street firms remains very much in the financial news, we are choosing to revisit the subject of Goldman for a more comprehensive study.

The Teflon Cloak Wears Thin

In the decades since the Second World War, Goldman Sachs had grown as a successful investment bank within a culture of secrecy and confidentiality and the firm had largely escaped any major scandal or notoriety. Indeed, many top federal government posts have been filled from within its high-profile ranks on a regular basis, from Secretary of the Treasury Department (Hank Paulson under former President George W. Bush) to the current President of the New York Federal Reserve Bank (William Dudley). However, with the bursting of the U.S. housing bubble in mid-2008, we learn that an inexorable contagion of greed permeated Goldman's corporate offices, creating packs of avaricious wolves pursuing ill-gotten gains. Underwriting securitized mortgage issues with the full knowledge that they were being misallocated 'AAA' ratings by the debt rating agencies was bad enough, but shorting these same issues to unsuspecting clients in the secondary market as part of Goldman's proprietary trading initiatives, was clearly immoral.

The American International Group (AIG) Bailout

We learn that during the first half of 2008, Goldman received $5.9 billion (U.S.) as collateral against AIG insurance contracts it held, circumventing any potential ruling to the contrary from a bankruptcy court, simultaneously, pushing AIG into a liquidity crisis. Then, when AIG was taken over by the U.S. Government in September 2008, Goldman received 100 cents on the dollar for $12.9 billion (U.S.) of additional AIG insurance contracts, rather than the 60 cents on the dollar that AIG negotiators were demanding. Moreover, Goldman was allotted billions of U.S. dollars in TARP (Troubled Asset Relief Program) funds directly from the U.S. Treasury. We contend that Goldman received this special treatment from the regulators because of its preferred position as one of the members of a banking cartel which owns and controls the Federal Reserve. Financial control is the catch phrase! This is why the Fed so jealously guards its so-termed 'independent' role as a bank regulator and formulator of United States monetary policy. During the current drafting of financial reform legislation by the U.S. Senate, the Fed has been consistent and insistent by asserting that it must retain the ability and authority to regulate large and small U.S. banks alike.

The Money Tree

Also in the fall of 2008, Goldman Sachs received federal government permission to become a bank holding company, enabling the firm to apply for additional federal funds. Deemed too big to fail by the government, not only would Goldman be eligible to borrow $10 billion (U.S.) under the TARP legislation, but also, would be able to borrow huge amounts of money from the Federal Reserve at historically low interest rates close to zero. To have access to billions of dollars at these low rates and invest them in U.S. treasury bills and short term notes at yield spreads of 1-3 % represents a license to 'print money' for your own account. Moreover, by early 2009, despite the fact that the major banks were still not lending money to consumers and small businesses, another new federal government facility aptly named the Temporary Liquidity Guarantee Program enabled Goldman to borrow anther $29 billion (U.S.) with the backing of the Federal Deposit Insurance Corporation (FDIC).

Monetizing the U.S. Debt

In March 2009, the Federal Reserve announced that it would institute a $300 billion (U.S.) program of 'quantitative easing' – the direct purchase (printing money) of U.S. Treasury notes and bonds, across the full spectrum of the yield curve, in an attempt to influence fixed income yields lower in the secondary market. Since Goldman amassed billions upon billions of profits during this time frame, we are convinced the company must have been aware of this Fed initiative well in advance. Indeed, both the Fed and the Treasury were consulting regularly with private advisory boards that included every major firm on Wall Street. The Treasury Borrowing Advisory Committee (BAC) has a JP Morgan executive as its chairman and a Goldman executive as its vice chairman. When the Federal Reserve announcement was made, the yield on 10-year Treasurys, for example, fell by 50 basis points (from 4.00% to 3.50%), enabling Goldman to unload a massive amount of notes and bonds from its inventory and reap fantastic profits. There is just no other way that Goldman could have earned those kinds of massive trading profits in so short a time period and definitely not just from client orders.

Poster Child for International Bullies

Earlier this month we observed Goldman issuing a court challenge to Calgary-based Shaw Communications over the cable operator's Ontario Superior Court-supervised purchase of insolvent broadcaster CanWest Media. In seeking leave to appeal the court decision, Goldman observed: "the court-supervised sale of CanWest reflects a remarkable abuse" of the Canadian bankruptcy protection process and "total failure" of CanWest's corporate governance. The previous week an Ontario judge reprimanded Goldman for attempting to disrupt the sale process by presenting an eleventh hour bid for CanWest. Nevertheless, Goldman warned that: "Without (Ontario) Court of Appeal intervention, this matter will continue down a path of acrimonious and time-consuming litigation in which we will ultimately prevail." According to the Bloomberg News, we also noted that Goldman may have been instrumental in advising the Greek Government how to disguise certain debt issuance transactions as currency swaps, in order to circumvent euro zone rules. Any proliferation of this slight of hand within euro zone membership would not sit well with fixed income investors, that's a certainty. In doing "God's work", as Lloyd Blankfein, Goldman's Chief Executive Officer, is prone to boast, there seems to be no limit to where the firm will stoop in order to serve the rule of money.

In his book, The Big Short, just published and highly recommended by us, Michael Lewis shows how Goldman Sachs shorted the very sub-prime bonds it was selling to its customers. The firm along with Lehman Brothers was notorious for packaging America's worst home loans. P. 105.

Actually, Goldman's history of placing itself ahead of its clients goes back over 80 years. John Kenneth Galbraith wrote a book, The Great Crash, 1929, in which he devoted an entire chapter to Goldman Sachs, fittingly entitled "In Goldman, Sachs We Trust." It seems that the firm was instrumental in bringing to the market, very late in the game, some very large investment trusts (similar to closed end mutual funds), which were sold to the public after the firm had purchased a majority of the shares at a discount. Typically, the shares traded to a significant premium after coming to the market, which allowed the firm to sell out at a substantial profit. Moreover, Goldman Sachs purchased its own shares in the market to place in the trust. These large purchases of its shares added significantly to their value.

“Years later on a gray dawn in Washington, the following colloquy occurred before a committee of the United States Senate.

Senator Couzens. Did Goldman, Sachs and Company organize the Goldman Sachs Trading Corporation?
Mr. Sachs. Yes, sir.
Senator Couzens. And it sold its stock to the public?
Mr. Sachs. A portion of it. The firm invested originally in 10 percent of the entire issue for the sum of $10,000,000.
Senator Couzens. And the other 90% was sold to the public?
Mr. Sachs. Yes, sir.
Senator Couzens. At what price?
Mr. Sachs. At $104. That is the old stock…..the stock was split two for one.
Senator Couzens. And what is the price of the stock now?
Mr. Sachs Approximately $1.25.” Pps 64-65.

Clearly, in Goldman’s case it pays to have friends in high places. More importantly, it pays to be a part owner in the Federal Reserve, the very body charged with overseeing the likes of Goldman Sachs and other banking institutions, some of which are also Federal Reserve owners.

The Greater Fool Theory

Evidently, nothing has really changed in the mindset of major banks such as Goldman in terms of their business plans and models. Even as the stock market bulls set their sights on the Dow Jones Industrial Average (DJIA) approaching the 11,000 level, ‘bubble economics’ – speculating in crowd psychology rather than investing on solid economic fundamentals is alive and well. Historically, this has been known as ‘the greater fool theory’ – purchasing securities at times when markets may be driven to unrealistic heights by excessive speculation, because “some fool” will surely come along to buy your securities, enabling you to realize a capital gain. Within this speculative mindset of assuming more risk, investors are ignoring the inevitable and potential dire economic consequences of the global debt problem – sovereign, corporate and consumer-based alike. The national debt of the United States now stands at $12.67 trillion and is accelerating at a rate of $6 million (U.S.) a minute. Where will America’s destiny lie when the mega-entitlements of Medicare, Medicaid, Social Security and federal employee pensions, all of which the government cannot afford, come due? Caveat emptor!

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