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Financial Follies

At first blush, JP Morgan Chase and Facebook have little in common. The former is a centuries-old financial institution, one of its namesakes perhaps the most powerful figure in the history of American banking. The latter is not yet a teenager, a social-media-tech brat, another in the long line of companies ready to conquer the world.

Yet there they were, not quite joined at the hip, but each sporting more than enough egg on their face to warrant embarrassment. For Morgan, it was a large trade gone bad, for Facebook it was an IPO gone haywire.

Let's start with JP Morgan Chase. Shortly after reporting first quarter earnings that were well-received if not spectacular, the bank dropped a bomb on Wall Street by disclosing trading losses of two billion dollars. The losses, emanating from the firm's Chief Investment Office, came just weeks after CEO Jamie Dimon had dismissed rumors of trading problems as "a tempest in a teapot".

In another place and time, this news would have warranted headlines for a day or two, then quickly faded into oblivion. For Mr. Dimon, it was no such luck. Not when JP Morgan Chase is America's leading banking institution. Not when "too big to fail" and "the Volcker rule" are hot topics of debate. And not when we are just a few years removed from the financial crisis, TARP, and too many haunting memories.

So this story had legs; and offered a free potshot for every politician, pundit, or average Joe who felt like taking it. No matter that the loss was quickly disclosed, the CEO truly contrite. The headline number grabs attention, and the details are a bit pesky, especially since the losses may still be accumulating. If we assume the estimated loss is quadrupled, as rumors have suggested, the figure would be significant if not quite staggering. It would represent one-half of the bank's annual earnings, four percent of shareholder equity. Yet it would be unlikely to change the bank's dividend payments, or its prospects for future earnings. And it could be offset by gains on other positions. A loss this size certainly will not jeopardize the bank.

So there they were, lining up for their shots. Worst among them, as usual, was Congress. They just cannot help themselves. When opportunity calls, sound the alarm, summon the witness to Washington and put him on stage. Lights, camera, action! But Congressional testimony is rarely high drama. Half the members of Congress were deferential to Mr. Dimon. A few just wanted their sound-bites for the evening news back home. The rest simply forgot that when it comes to global finance, banking, US lending institutions -- call it what you want -- Mr. Dimon was not only the smartest man in the room, but perhaps on the planet.

And so a story with legs goes a bit limp, rightfully so. Trading losses are a part of financial markets. Risk management is not about avoiding losses, but minimizing them.

Among the earlier potshots, it was suggested that Mr. Dimon should step down as a director of the Federal Reserve Bank of New York, perhaps even step down from JP Morgan Chase. We still do not know the full extent of the trading losses at the bank. But we do know, as shareholders, the last thing we want is a new CEO. Talk about a tempest in a teapot.

Facebook Folly

On to Facebook! Silicon Valley's newest version of the uber-brat. The firm's meteoric rise is well documented, memorialized in both novel and award-winning movie form.

As a refresher, the origins go something like this: college tech-wizard wets his lips by tapping into a computer system(not his) and capturing photos(not his), which he displays on a website. After the project is scuttled, in a college dorm room(not his), a business idea(not his) is formulated, start-up capital(not his) is raised, wizard moves to a house in California(not his)… and they lived happily ever after…

Well, not quite. But they did conquer the social media world while building a company worth 100 billion dollars, all in less than a decade. As start-ups go, it's not too shabby.

You can't blame people for being too successful; a bit greedy is another thing altogether. In its latest crowning achievement, Facebook issued one of the largest initial public offerings in history. But before the deal was done, it pushed for more. So the offering size, already near record proportions, was increased. So too the price. No matter the dramatic slowdown in new user-growth rates, or management's whispers to the underwriters that financial metrics were running below target. No worries that the smart-money venture investors were selling.

Go for it! The deal was priced, the shares opened, traded higher.. and then the wheels fell off. The listing's exchange, Nasdaq, suffered a major computer glitch. Orders to buy and sell were not properly matched; traders were unaware of how much they owned, if anything at all. Orderly systems -- the hallmark of US stock trading -- were out of order. In three weeks time the stock lost 32 percent of its value, and whatever goodwill a public offering can generate was destroyed, ten-fold.

As for the aftermath, Nasdaq will sort out its legal and financial obligations. Trading snafus are its own problem.

For Facebook, a few challenges remain, above and beyond that ephemeral goodwill.
Here are three for it to tackle:
First, with 900 million users, Facebook is already bumping up against the rules of diminishing returns. To double its size, Facebook will need to tap into 25% of the world's population. This seems a tall task.
Second, the tech world is migrating to mobile devices, which plays against Facebook's strength; its social media service was designed as a desktop product, and that is still where most of its money is minted.

Third is a reminder, Facebook was not the pioneer in social media; companies like MySpace had a big head start. Google, Microsoft, and other firms will be looking for entry into the game… perhaps joined by a few smart-aleck kids in a college dorm room.

That should keep them busy. If Facebook can meet these challenges, its opening stumble will quickly be forgotten. If not, it will make for an entertaining sequel.

The Great Euro Folly

Add one more to the mix -- Europe, and its ongoing debt fiasco. In hindsight, the 2010 version of Europe's troubles represented the prelude to a crisis. The 2011 version was act one of the crisis. That brings us to the present, act two, where crisis threatens to become calamity.

Time for a very brief history lesson of how Europe dug itself into this hole. It has been twenty years of fantasy since the Maastricht Treaty was signed, then a European Union formed, the Euro currency adopted, more and more members added -- a country club of sorts whose primary goal somehow morphed into one of adding more members.

If membership has its privileges, it was also meant to have requirements. Among them for each member state: inflation rates no more than one-and-a-half percentage points higher than the three lowest member states' inflation; government deficits measuring no more than three percent of GDP; accumulated government debt not to exceed 60% of GDP; nominal long-term interest rates not more than two percentage points higher than the three lowest members' rates.

To be polite, these goals are now laughable.

Let's pretend no members lied their way into the club(sorry Greece), or hosted a Summer Olympics it could not afford(sorry Greece), or established social policies it could not sustain(sorry Greece). If the requirements for entry into the club were met, what were the ongoing obligations of membership? Very little. Sure, there is a "Stability and Growth Pact", meant to encourage compliance. But then again, it has no teeth. Of the 17 EuroZone members, there may be one or two who have maintained the standards for entry, but we cannot name them. Without strict sustainability requirements, harsh penalties for non-compliance, or provisions for nations to exit the Euro, it was a disaster waiting to happen. Did they really believe it would last forever?

The late, great Nobel-laureate economist Milton Friedman predicted the Euro would fail within a decade. So finally, he got one wrong, but only by a matter of degree.

In truth, the Euro has already failed. It includes crippled governments whose borrowing needs can neither be supported by their banks nor bond markets; it includes failing banks who cannot be bailed out by their governments. As governments and banks decay, economies collapse. Troubled nations need a release valve. They need defaults, restructuring and a printing press for more money. EuroZone nations have no printing press. They also have member states urging them to forego default. The release valve is stuck.

The EuroZone nations created a monetary union without the necessary fiscal union, social union, banking union, regulatory union, political union. The Euro has forced Germany and Holland and France to consider the cost of saving Greece and Spain. In a year or two, it may force Germany and

Holland to consider the same of France. If there was an easy way out, we would have seen it by now. The Euro will survive, but even in its survival, the Euro has already failed.

As for the Europe Union, it too will survive. Europe's compass always points to institutions, unity, collectivism. Some strange combination of austerity and growth initiatives will be formulated -- strange in that the two are inherently contradictory. Greek and Spanish citizens will give a little, adding to their pain. Bondholders will sacrifice as well. German taxpayers will give too much, all to save whom? The profligate spenders.

On the verge of calamity, deals are struck. Most likely, the Euro will remain whole, the compact strengthened by a move toward both banking and bond market unity -- two ideas barely in the conversation until recently. Necessity is still the mother of invention.

Groundhog Day

Two years ago, US financial markets began the year with a strong move higher, with stocks peaking in April before settling back in a summer swoon. The decline took US equities within shouting distance of a bear market. The primary concerns? Slowing growth in the US and abroad, along with the emerging threat from the EuroZone debt crisis.

Last year, US markets began the year with a strong move higher, peaking in April before another summer swoon. The decline took US equities within a whisker of a bear market. The primary concerns? Slowing growth in the US and abroad, along with the continued threat from the EuroZone debt crisis.

This year? Need we continue? Stocks rose 13 percent through early April, only to give back all but two percent of the gain before stabilizing. The concerns? Well, they are the usual suspects. The US economy is growing, but not accelerating its pace. China is still growing, but with a measurable deceleration. Europe is in recession, only its depth and duration uncertain. And then there is the EuroZone debt crisis.

Which brings us to present day US markets and the prospects for lightning to strike a third time. While possible, the odds seem low. The case for stabilization is still the most likely scenario. Stocks are cheap; if earnings hold up, stocks prices should too. Our best guess is that Europe averts catastrophe, the US avoids recession, and stocks suffer nothing more than a correction, much of which has already occurred. We also expect that by year end, the tight correlation between US and European markets will break. At some point, Europe needs to stand on its own, while US companies and markets do the same. We look forward to the day when we do not wake up and immediately ask "what's happening in Europe?"

S&P 500 January 2010 – June 2012

Sources:
Bloomberg
Wall Street Journal
Wikipedia
Europa.eu

Tidbits..

California, New York, Illinois, Massachusetts named as worst states to do business by Chief Executive Magazine.

Can we stop pretending that high taxes and high regulation do not matter?

Delta Airlines to purchase refinery in effort to mange rising fuel costs; targets one-year payback.

If it works, great idea; if not, what were they thinking?

Consumer credit rises to highest level since early 2008.

Revenge of the over-leveraged consumer.

US Postal service, losing $1 billion per month, proposes plan to save $500 million per year.

Disconnected from reality.

Yahoo ousts CEO Scott Thompson after resume-padding is exposed by dissident shareholder.

With fourth CEO departure in five years, Yahoo serves as real-life soap opera.

US Treasury notes reach record low yield at 1.45%
Mortgage rates drop to all-time low levels.

Crude oil prices fall 30% since February.

Should we blame the speculators?

Federal Reserve study shows financial crisis clipped US household net worth by 39%, back to 1992 levels.

Two decades of wealth creation extinguished.

Healthcare spending to account for 20% of US GDP by 2021, government report projects.

Far too high, and worsened by Obamacare.

Microsoft previews "Surface" tablet computer, Windows 8 phone.

Awakening the sleeping giant.

Federal Reserve lowers growth forecast, extends "Operation Twist" through year end.

More easy money.

Moody's cuts credit rating of 15 large banks in US and abroad.

Markets shrug; old news is old news.

New home sales reach two year high in May.

But still down 73% from 2005 peak.

Cyprus becomes fifth EuroZone nation needing bailout.

How did Cyprus get in the Euro?

Stockton, CA files bankruptcy, largest US city to do so.

Take notice, California.