

Key Points

- ◆ Derivatives total \$180 trillion in the top 25 banks in the US
- ◆ JP Morgan alone has over \$90 trillion in derivatives
- ◆ Derivative pool 16 times larger than the US GDP

The Trillion Dollar Secret

By John Riley
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For the past year or so, the investment world has been wrapped up in their version of a steroid scandal - the sub-prime mortgage mess. Banks are taking write-offs in the tens of billions and estimates are that write-offs will reach as high as \$100 billion before long. CEO's are losing their jobs and having to settle for multi-million dollar pensions. (Don't you feel bad for them?)

Who to blame for this mess will be the subject of a myriad of Congressional hearings in the future. After spending millions investigating the whole sub-prime disaster, they will come to this simple conclusion: lenders got too aggressive and borrowers got in over their heads. In other words, risky loans ended up being risky. What a surprise!

But there is a secret right in front of everybody that the Fed, Wall Street and the banking industry wants to make sure investors don't notice. It is the incredible growth in derivatives. If you think the sub-prime problem is big, you ain't seen nothing yet.

According to the Comptroller of the Currency, total Derivatives in the top 25 banks in the US amount to about 180 Trillion dollars. Not billion, trillion. 1000 times a billion.

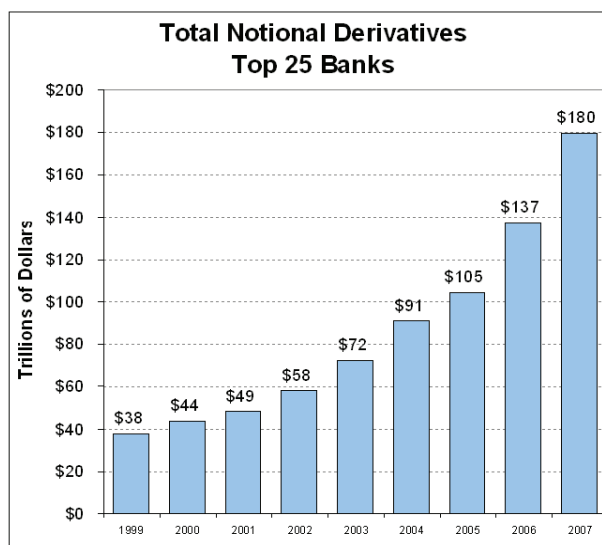
To put this in perspective, the US GDP was about 11 Trillion dollars. So they are playing a game with a pool of fictional money that is 16 times bigger than our economy.

Let that sink in.

Now that you are interested, here's some background info so you can get a grasp on what is going on.

What are Derivatives?

Derivatives are private contracts (bets) between financial institutions. They can be on the direction of commodities, the stock markets or currencies, but the banks' favorites are interest rates. (You can go to the Comptroller of the Currency website to get their quarterly reports and see for yourself what Wall Street hopes you never see.)



Source: Comptroller of Currency, 3rd Quarter of 2007; Format: CIS

(For those of you that are derivative experts, I am not going to go into an in-depth discussion of derivatives and all of their various types and uses. Nor am I going to get into the specific mechanisms of how they trade, how they are leveraged up to astronomical amounts and what notional means. This report is for investors, not derivative experts. It will be equivalent to explain-

ing how a car works by saying your car goes when you hit the gas and stops when you hit the brakes. The details of how the gas pedal is attached to the linkage that controls the carburetor or how the brakes slow the car are left out and we completely ignored the transmission. If you want to learn the specifics of derivatives, the Comptroller of the Currency's [website](#) is a good place to start.)

The scariest part of derivatives is their leverage. Like exchange traded options, derivative contracts can control assets for only a fraction of the contract value. The banks take the leverage to an extreme and have very little in assets backing up their derivative portfolios. According to the Comptroller, the top 25 banks have assets that only amount to about 6% of the Notional



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Key Points

- ◆ JP Morgan's assets amount to only 1.60% of their derivative portfolio
- ◆ Derivatives are thought to be risk-free money by the banks
- ◆ Derivatives are almost completely unregulated

Value of their derivatives. JP Morgan, the biggest player in derivatives, has assets backing up its portfolio of only 1.60%.

What happens if the value of the portfolio were to change by 2%, what happens to the banks' assets? And with all of the recent scandals in Real Estate and other "creative strategies" the banks have been employing recently, how do we even know if their asset numbers are correct? Is it possible that the \$1.40 Trillion in assets JP Morgan claims is somewhat less, thanks to writ-offs and bad real estate?

Derivatives have barely any regulation on them. For years, Congress tried and Greenspan stood in the way. Banks barely mention them in the annual reports except for a footnote.

Thanks to the lack of regulation, derivatives have grown dramatically. There has been a 473% increase in the Notional Value of derivatives at the top 25 banks since 1999.

And why not? They can produce billions in almost free revenues to the banks. Free revenues? Yes.

Why do Banks use Derivatives?

Here's how they work. According to some sophisticated formulas and theories, if you make opposite bets with 2 different trading partners, you can capture the difference in the middle and get virtually risk free profits. If your 2 bets cancel each other out, then whatever is left over in the middle is profit, with zero risk.

Let's say I bet with bank A that interest rates are going to go up. And I bet with bank B that they are going to go down. Both cancel each other out. But thanks to various strike prices and durations, we can get a small amount of difference in what I sell one contract for and what I buy the first one for. That difference

is the whole game. The pennies I make in the middle are free. So I can keep them and make lots of money if I do it big enough.

According to the Comptroller, about 85% of all banks derivatives are this type. Which leaves 15% not. 15%, is not a lot, right. Not until you figure 15% of the 179 Trillion is \$26.85 Trillion, still more than double the US economy! And more than double the amount of all the banks' assets put together.

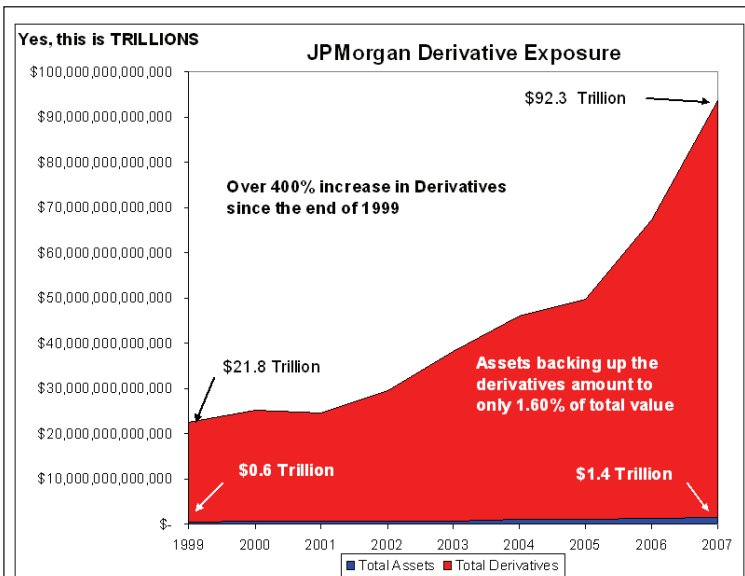
Here's where the fun begins. Remember the example above? Well that is not really what they do. Some derivatives do not offset each other directly because the computer models tell them they may have some over correlations in other areas.

Let's say that the bank wants to hedge the Yen against the Dollar. With one bank, they may sell the Dollar versus the Yen and with the other, buy the Dollar versus the... Euro. Euro? Maybe their computer Model has told them that buying the Euro might give them a small advantage, hedging the yen bet actually better than the yen itself.

Well you and I both know that this is foolish. The only thing that could possibly hedge the Yen bet would be the Yen. But their computer models are very sophisticated, working with all sorts of data input and constructing all sorts of scenarios to determine the least risky way to go.

Since the end of 1999, the assets backing derivatives at the major banks has dropped from a

shockingly low 11% to just about 6%. And the question you have to ask yourself - How much of those assets are real? How much of those assets are inflated real estate in New England or California? How much less is actually backing these derivatives?



Source: Comptroller of the Currency, 3rd Quarter 2007 Format: CIS
 JP Morgan is the biggest player in derivatives in the US.
 Assets amount to only 1.60% of the Notional Value of their derivative portfolio.

What Could Go Wrong?
 This is just what Long Term Capi-

Key Points

- ◆ Long Term Capital was the warning shot ignored by the banks
- ◆ LTC was a fraction of the size of JPM's portfolio, but Greenspan said it's failure threatened the entire financial system of the US
- ◆ The Fed bailed out LTC, just like they will bail out today's banks

tal (LTC) did back in the late 90's. Remember them? They were the hedge fund that utilized the Black Scholes options model to run its derivative hedge fund to the point of bankruptcy. The fellas that ran LTC were only Nobel Prize winners (in economics) and the Black Scholes model was heralded as "the answer". It is still used today.

What they failed to do was to have all of the bases covered. A funny thing happened - a sovereign nation wasn't supposed to default on its debt. But Russia didn't know the rules and so when they defaulted in the late 90's, LTC went in the dumper. These rules are going to become more important later on.

The Fed to the Rescue

So along came Alan Greenspan on his white horse to the rescue. He assembled a group of Wall Street bankers in a room and blessed the billions of dollars they each anteed up to help bail out LTC. It was about \$100 billion total.

As Alan Greenspan told Congress months later in explaining why the Fed bailed out a private hedge fund, he told Congress that if he hadn't, the entire financial structure of the US would have been in jeopardy. And this was just one little hedge fund with only about \$100 billion. Imagine what damage JPMorgan could do with 92 trillion of derivatives.

So that brings us back to the rules and what is going on today.

Choice Between Two Bad Options
Without going into details, the US Dollar is toast. (Too much debt, out of control trade deficit, too much currency creation...) The

housing market isn't getting any better any time soon and the consumer is keeping his hands in his pockets. Along with that, overseas consumption is driving up inflation over here.

So with the sharp declines in the market and the obviously slowing economy, the Fed's are looking to give us a present, a stimulus package. (read more about it in Irish Coffee)

The stimulus package is inflationary. It will kick the Dollar even further down. It will lower rates and everybody knows that is good for the economy and will "save the day." (Not really, read article mentioned above)

But the Fed has to make a decision, lower rates and save the banks, but ignite inflation and kill the Dollar, or let the banks cave in under the weight of some bad derivatives but stave off inflation for a bit and protect the Dollar.

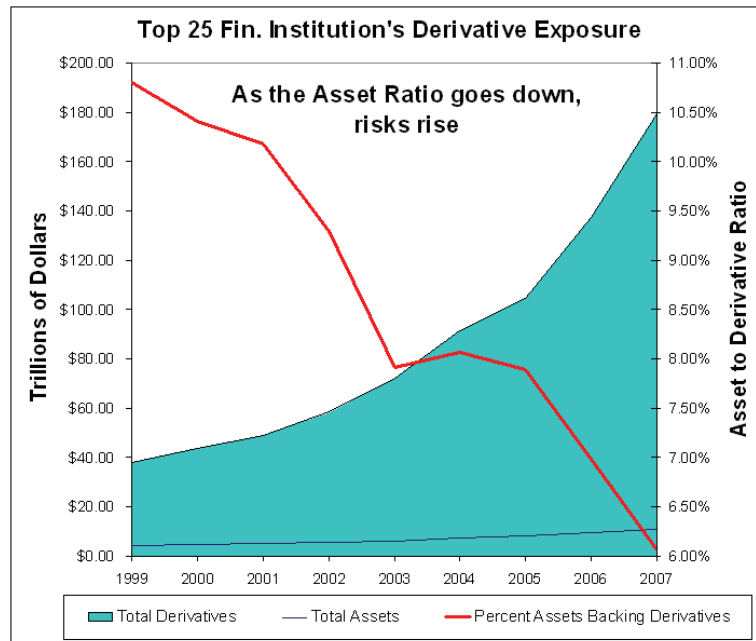
I think the Fed has determined that a bank failure would cause more damage to the economy than the collapse of the Dollar and higher inflation. I think they look at the decline of the Dollar so far and tell themselves, it hasn't killed us yet.

Monetary World View

We've discussed this before ([Money, Money](#)) and its importance comes clear now. There are a number of economic theories that economists espouse. One that most of Wall Street and the Fed shares is their Monetary World View. Regardless of what you call it, it is the belief that

interest rates control all things economic. Raise rates and the economy slows. Lower rates and the economy revives.

Without getting into the pro's and cons, this is the basis for much of what they believe. And because of this, banks are comfortable putting trillions of dollars into interest



Source: Comptroller of Currency, 3rd Quarter 2007; Format: CIS

rate strategies and derivatives that rely on this theory.

It is vitally important that the Fed continues to play the game as laid out by the Monetary World View. If they were to deviate, say raising

Strategy

- ◆ The Fed is more worried about banking failures than a declining dollar and inflation
- ◆ Prepare for inflation
- ◆ Avoid banks
- ◆ Expect bank failures
- ◆ Hedge US Markets

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rates to protect the Dollar at a time when the economy was slowing, it could be disastrous, since the banks would have been betting trillions on lower rates to rev up the economy. This then could put certain banks in jeopardy of failure as some have a little as 3% of their assets backing up the mountain of derivatives.

And forget about surprise moves. The Fed signals well in advance any expected turn in policy. A sudden shift could cause a bank to be left out on the wrong side of a \$100 billion derivative. Big oops.

Conclusion

When thinking about the next Fed move, consider the implications of a 180 trillion dollar mistake. And even if you eliminate the derivatives that are netted out, that still leaves a pool more than double the size of the US economy.

Who is the Fed working for? Who is the Fed most concerned about? Who is the Fed likely to consider before making any moves. Given the choice between a Dollar crash or a major bank failure and closure, which do you think the Fed fears most? If you think the Fed doesn't take the bank's derivatives holdings into consideration, you have not been paying attention. It seems everything the Fed has been proposing since the summer (2007) is designed to throw the Dollar under the bus and let inflation run. All to protect the banks.

The sub-prime disaster is a drop in the bucket compared to the massive derivative monster in

the banks. Don't think the Fed doesn't know this.

Investment Implications

Investors need to have exposure to investments that can benefit from higher inflation. These would include gold and commodities. TIPs could also benefit from higher inflation.

They also should hedge their Dollar positions with strategies to benefit from a declining Dollar.

Lastly, a big problem at a major bank could happen at anytime. Having a hedge position on the US markets is advisable. I think it will take a long time to unwind any problems at the banks and the unwinding could put a long term strain on the US stock markets. Longer term hedges like bear market funds should be a better long term choice to profit from the market decline.

Fortunately for our clients, none of this is a surprise to us at Cornerstone. Our portfolios are already structured to benefit from the wonderful scenario described above.

Questions? Comments? Observations? Or for more information [Click here](#)

Epilogue: On January 24, 2008 we got a glimpse of the potential for the problem with this news story:

[Societe Generale Loses \\$7 billion in trading Rogue Flight: Societe Generale's Kerviel Tags Leeson](#)

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