Ira W. Sohn Investment Research Conference
David Einhorn, Greenlight Capital, "Good News for the Grandchildren"
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The views expressed in this speech reflect our opinions about certain companies or industries in which Greenlight Capital has a position or may take a position in the future.

Have you ever heard people bemoan the idea that we are passing on our debts to the next generation? If I were Jon Stewart running the Daily Show here, I would show a video montage of every leader we have had saying variations on that. Leaders scold and scoff and then they keep borrowing and spending and making long-term commitments to do the same. President Obama more or less knows what he wants to propose on nearly every topic. But, when it comes to the long-term budget problem, he kicks the can down the road by setting up a commission to brain storm without even committing to implement the commission's suggestions.

Politicians value staying in office more than they value the long-term health of the country. Spending money in the short-term buys votes. It's not good politics to take on the obvious long-term insolvency of popular programs that transfer wealth from the young to the old. The elderly reliably show up on Election Day. Children have no voice at the polls. The AARP is an extremely powerful interest group. There is no similar organization lobbying on behalf of ten year olds.

I have titled today's talk *Good News for the Grandchildren*. By that, I mean that I do not believe that there is a need to worry that today's debts will be passed on to our current youth. Before this recession it appeared that absent action, the government's long-term commitments would hit a wall in a few decades. I believe the government response to the recession has created budgetary stress sufficient to bring about the crisis much sooner. Our generation — not our grandchildren's — will have to deal with the consequences. If we do one thing, let's stop bemoaning the fate of our grandchildren on this topic. We might take the issue more seriously if we realize that our own future is at risk.

According to the Bank for International Settlements, the U.S.'s structural deficit — the amount of our deficit adjusted for the economic cycle — has increased from 3.1% of GDP in 2007 to 9.2% in 2010. This does not take into account very large liabilities the government has accepted by socializing losses in the housing market. We have not seen the bills for bailing out Fannie Mae and Freddie Mac and even more so the Federal Housing Administration, which is issuing government guaranteed loans to non-creditworthy borrowers on terms easier than anything offered during the housing bubble. Government accounting is done on a cash basis, so promises to pay in the future — whether they are social security benefits or loan guarantees — do not count in the budget until the money goes out the door.

A good percent of the structural increase in the deficit is because last year's "stimulus" was not stimulus in the traditional sense. Rather than a one-time injection of spending to replace a cyclical reduction in private demand, the vast majority of the stimulus has permanently increased the base level of government spending. A very large amount was dedicated to

preserving government jobs. How different is the government today from where General Motors was a decade ago? Government employees are high cost and difficult to fire. Bloomberg reported that from the last peak businesses have let go 8.5 million people or 7.4% of the workforce while the government has only cut 141 thousand workers, or less than 1%.

Public sector jobs used to offer greater job security but lower pay. Not anymore. According to a 2009 CATO Institute study the average federal civilian salary with benefits totals $119,982 compared to $59,909 for the average private sector worker and the disparity has grown enormously over the last decade.

The situation at the state and local levels is no more comforting. The excellent superintendent of the public school in the town next to mine just "retired" at age 58. He had a fully vested public pension but was not interested in quitting work. So, in addition to beginning to collect his pension, he moved to New Jersey to take a similar job and to begin earning a second public pension in that state. While there is no reason to begrudge him for operating within the system, there are consequences to arrangements such as this. His is not an isolated story — articles describing "retire and rehire" of public officials can be found in many local newspapers around the country.

There has been a lot of scoffing in financial circles about Greek civil servants earning 14 months of pay for 12 months of work. While the details are different, civil servant pay appears to be as big a problem here as well. I doubt it will be easier to reform this than other government entitlements. And, there are so many government workers that they are an important voting block that helps elect officials who won't challenge the current arrangement.

The question is how long can we travel down this path without either changing direction or having a crisis. The answer lies in two critical issues; first, how long will the capital markets continue to fund government borrowings that may be refinanced but never repaid on reasonable terms, and second, to what extent can obligations that are not funded through traditional fiscal means be satisfied through central bank monetization of debts — that is, by the printing of money?

The recent U.S. credit crisis came in large part due to capital requirements and risk models that incorrectly assumed AAA rated securities were exempt from default risk. We learned the hard way that when the market ignores credit risk, the behaviors of borrowers and lenders become distorted.

It was once unthinkable that "risk-free" AAA rated institutions could fail, as they recently have. Their CEOs probably didn't realize when they crossed the line from highly creditworthy to eventual insolvency. Surely, had they seen where the line was, they would to-a-man have stopped on the solvent side.

Our government leaders are faced with the same risk today. What is the level of government debt and future commitments where government default goes from being unthinkable to inevitable, and how does our government think about that risk?

I recently posed this question to one of the President's senior economic advisors. He answered that the government is different from financial institutions because it can print money and

statistically the United States is not as bad-off as some other countries. As an investor, these responses do not inspire confidence.

Finally, he said the government needs to focus on jobs now, because without an economic recovery, the rest does not matter. This point is worth discussing, but is not an excuse to defer addressing the long-term structural deficit. If we are going to spend more now, it is imperative to lay out a credible plan to avoid ultimately falling into a debt trap and the ensuing crisis it would cause. Even using the administration's 10-year forecast that assumes a robust and sustained economic recovery, we will have problematic deficits for the next decade, which ends just as our commitments to baby boomers accelerate.

Modern Keynesianism works great until it doesn't. No one really knows where the line is. The government doesn't know, nor do the credit rating agencies. One obvious lesson from the crisis should be that we get rid of official credit ratings that inspire false confidence and, worse, are pro-cyclical. Congress has a unique opportunity in the current effort of regulatory reform to eliminate the credit rating system. For now, it does not appear interested in taking sufficiently aggressive action. The big banks and the big bond buyers have told Congress they want to continue the current ratings system. As Bill Gross put it in his last newsletter:

> *Firms such as PIMCO with large credit staffs of their own can bypass, anticipate and front run all three* [rating agencies], *benefiting from their timidity and lack of common sense.*

Given how sophisticated bond buyers use the credit rating system to take advantage of more passive market participants, it is no wonder they stress the continued need to preserve the Status Quo.

It would be better to have each market participant individually assess credit-seeking entities. Certainly, the creditworthiness of governments should not be centralized in the hands of a couple of rating agency committees.

Consider this description about the sovereign rating process an S&P analyst offered in an interview aired by the National Public Radio Morning Edition earlier this month:

S&P analyst: For any country we have two analysts who go to a country for that rating. Never send just one person because you need a second pair of eyes.

NPR interviewer: I think there are people listening to this who would say "just two?" Shouldn't you be sending seventy to rate a country's government?

S&P analyst: To be fair, what we are looking at is fairly narrow. Can you pay your debt fully and on time? What is your ability and willingness to do so? You know, I think two people…this has been our practice. It has worked well.

NPR reported that after interviewing some government officials, business people and journalists for a few days, the S&P analysts fly home and write a report. A five person rating committee debates the issue and holds a vote of hands.

S&P analyst: We always want an odd number because we don't want to have a tie and do the whole thing again.

NPR interviewer: How long does that take?

S&P analyst: Even if you are doing like a Canada which is [a] relatively boring rated AAA, you still have to go through all the steps. So two hours is sort of average.

That is about as long as it takes to watch a hockey game.

We have just watched the pro-cyclical behavior of the ratings agencies foster a private sector credit crisis. By continuing the official use of this system, public sector borrowers will experience the instability caused by rating agencies at the worst possible moment. Now, European leaders are learning the hard way that it isn't a good thing to have rating agencies declare that things are stable even as risks build and then, as problems reach a critical stage, accelerate the loss of confidence by declaring that things are not so good after all.

When Secretary Geithner promises that the U.S. will *never* lose its AAA rating, he chooses to become dependent — effectively putting all of his eggs in one basket — on the whims of the S&P ratings' committee rather than the diverse views of the many participants in the capital markets. It is not hard to imagine a future crisis where just as the Treasury Secretary seeks buyers of government debt in the face of deteriorating market confidence, a rating agency exacerbates the problem with an untimely downgrade, triggering massive additional sales by existing bondholders. This has been the experience of many troubled corporations, where rating agency downgrades served as the coup-de-grace.

The current upset in the European sovereign debt market is a prequel to what might happen here. Banks can hold government debt with a so-called zero risk weighting, which means holding it requires no capital. As a result, European banks loaded-up with Greek debt and sold sovereign CDS and now need to be bailed-out to avoid another banking crisis. As we first saw in Dubai and now Greece, it appears that the response to Lehman's failure is to use any means necessary to avoid another Lehman-like event. This policy transfers risks from the weak to the strong — or at least the less weak — setting up the possibility of the crisis ultimately spreading from the "Too-Small-to-Fails" like Greece to "Too-Big-to-Bails" including members of the G7.

We should have learned by now that every credit — no matter how unthinkable its failure would be — has risk and requires capital. Just as trivial capital charges encouraged lenders and borrowers to overdo it with AAA rated CDOs, the same flawed structure in the government debt market encourages and therefore practically ensures a repeat of this behavior — leading to an even larger crisis.

I remember hearing that the rating agencies would *never* downgrade MBIA or Fannie Mae. Mr. Geithner may learn that never is a long time. The next crisis might very well rhyme with the last. Greenlight continues to hold short positions in the common stock of the rating agencies, Moody's and McGraw Hill (owners of S&P).

I don't believe a U.S. debt default is inevitable. On the other hand, I don't see the political will to make voluntary efforts to steer the country away from crisis. If we wait until the markets force action, as they have in Greece, we might find ourselves negotiating austerity programs with foreign creditors.

Some believe this could be avoided by printing money. Despite Mr. Bernanke's promises not to print money or "monetize" the debt, when push comes to shove, there is a good chance the Fed will do so, at least to the point where significant inflation shows up even in government statistics. That the recent round of money printing has not led to headline inflation may give central bankers confidence additional quantitative easing can be put in place without inflationary consequences. However, printing money can only go so far without creating inflation.

Now, government statistics are about the last place one should look to find inflation, as they are designed to not show much. Over the last 35 years the government has changed the way it calculates inflation several times. For example, under the current method, when the price of chocolate bars goes up, the government assumes people substitute peanut bars. So chocolate gets a lower weighting in the index when its price rises. Even though some of the changes may be justifiable, the overall effect has been a dramatic reduction in calculated inflation. According to www.shadowstats.com, using the pre-1980 method CPI would be over 9%, today compared to about 2% in the official statistics. While the truth probably lies somewhere in the middle, this doesn't even take into account inflation we ignore by using a basket of goods that does not match the real world cost of living.

For example, we all now know that healthcare, which is certainly a consumer good, is about one-sixth of our economy and its cost has been growing at a rapid pace. So what is the weighting of healthcare in the CPI? About 6%. The government doesn't count the part which the consumer doesn't pay out of pocket. So, if your employer has to pay more for your health insurance, it doesn't count, even if it means you have to accept lower wages. Similarly, Medicare cost increases don't count, even though everyone has to pay higher taxes to fund them. Income and payroll taxes, which are part of the cost of living, are not counted in the CPI either.

On the other hand, one-fourth of the index is comprised of something called owners'-equivalent-rent. This isn't something that anyone actually pays for. If you own your house, the government assumes you are foregoing rental income. The amount that you could receive from a hypothetical renter — the government implicitly assumes you rent it to yourself — is counted in the basket. So, rising taxes, which you do pay, don't count; the fast rising cost of healthcare, which someone else pays on your behalf, doesn't count; but hypothetical rents which you don't pay, and conveniently don't rise very quickly, have a huge weighting.

The simple fact is that if your goal is to never see inflation, you won't see it until it is rampant.

Low official inflation benefits the government by reducing inflation-indexed payments including Social Security and Treasury Inflation-Protected Securities. Lower official inflation

means higher reported real GDP, higher reported real income and higher reported productivity.

Subdued reported inflation also enables the Fed to rationalize easy money. The Fed wants to have an accommodative monetary policy to fight unemployment, which in a new trickle-down theory it believes can be addressed through higher stock prices. The Fed hopes that by keeping rates low, it will deny savers an adequate return in risk-free assets like savings deposits and force them to speculate in stocks and other "risky assets" to generate sufficient income to meet their retirement needs. This speculation drives stock prices higher, which creates a "wealth effect" where the lucky speculators decide to spend some of the gains on goods and services. The purchases increase aggregate demand and lead to job creation.

Easy money also aids the banks. Arguably, we still have many inadequately capitalized or insolvent banks. There has been so much accounting forbearance and extend-and-pretend loan collection that it is difficult to get an accurate gauge on the health of the system. However, each week the FDIC seizes more failed banks and when it does so, there are very large losses to the deposit insurance fund. In most cases, the failed banks' most recent financial statements claim that they were solvent which implies that the banks' balance sheets are not stated conservatively. It probably isn't just the banks that fail that are taking advantage of accounting forbearance.

As a result, the Fed prefers to keep rates extraordinarily low in an effort to help banks earn back their unacknowledged losses. However, this discourages banks from making new loans. If banks can lend to the government, with no capital charge and no perceived risk and earn an adequate spread walking down the yield curve, then they have little incentive to lend to small businesses or consumers. Higher short-term rates could very well stimulate additional lending to the private sector. Given the enormous gains in the prices of bank stocks, it might be quicker to have banks deal with their questionable assets through additional equity offerings and more aggressive loss reserving than waiting for years for profits from an easy money policy to repair the balance sheets.

Easy money also helps the fiscal position of the government. Lower borrowing costs mean lower deficits. In effect, negative real interest rates are indirect debt monetization. Allowing borrowers including the government to get addicted to unsustainably low rates creates enormous solvency risks when rates eventually rise. I believe that the Japanese government has already reached the point where a normalization of rates would create a fiscal crisis.

While one can debate where we are in the recovery, one thing is clear — the worst of the last crisis has passed. Nominal GDP growth is running in the mid-single digits. The emergency has passed and, yet, the Fed continues with an emergency zero-interest rate policy. Perhaps, an accommodative policy is still appropriate, but zero-rate policy creates enormous distortions in incentives and increases the likelihood of a significant crisis later. Further, it was not lost on the market that during this month's sell-off, with rates around zero, there is no room for further cuts should the economy roll over.

Easy money policy has negative consequences in addition to the obvious inflation of goods and services and currency debasement risks. It can feed asset bubbles, such as the internet

bubble and the housing bubble. We know that when such bubbles collapse, there are terrible consequences.

Nonetheless, the Fed has a preference to inflate bubbles. Sometimes Fed officials tell us that there is no bubble or that bubbles are hard to identify. Afterwards, they tell us that monetary policy was not to blame. Earlier this year, Mr. Bernanke said that the housing bubble was not caused by monetary policy. Essentially, he did a statistical analysis which found that there are many times when extraordinarily easy monetary policy has not led to a housing bubble. As a result, he argued that one can't generalize that easy monetary policy causes housing bubbles in all circumstances. From this, he reached the dubious conclusion that easy monetary policy was not responsible for the housing bubble he presided over. He must feel it is important to disclaim responsibility for the last bubble at a time where the Fed appears to have a desire to foment a fresh asset bubble.

In recent years, we have gone from one bubble and bailout to the next. Each bailout reinforces moral hazard, by rewarding those that acted imprudently. This encourages additional risky behavior feeding the creation of a succession of new, larger bubbles, which then collapse. The Fed bailed out the equity markets after the crash of 1987, which fed a boom ending with the Mexican crisis and bailout. That Treasury financed bailout seeded a bubble in emerging market debt, which ended with the Asian currency crisis and Russian default. The resulting organized rescue of LTCM's counterparties spurred the internet bubble. After that popped, the rescue led to the housing and credit bubble. The deflationary aspects of that bubble popping created a bubble in sovereign debt despite the fiscal strains created by the bailouts. The Greek crisis may be the first sign of the sovereign debt bubble popping.

Our gold position reflects our concern that our fiscal and monetary policies are not sufficiently geared toward heading off a possible crisis.

In addition to owning gold, we have recently added African Barrick Gold (ABG on the London exchange), an operator of gold mines in Tanzania to our portfolio. It was brought public in March through a 25% carve-out by Barrick Gold, the world's largest gold producer. We think ABG is much cheaper than all the other gold miners because it trades at about half the value of its peers on just about every valuation metric including less 6 times 2010 EBITDA, less than $200 per ounce of reserves and a 10% FCF yield. ABG management incentives are well aligned with shareholders, since they recently received stock options and share incentives so that much of their compensation depends on the performance of the shares.

Further, we believe ABG is likely to be added to the FTSE All Shares index and may even be added to the FTSE 100 index as well in mid-June. The added index buying that should accompany this inclusion could represent a meaningful percentage of the free float of this company which we see as an added near-term positive to the longer-term story.

We own gold and some gold stocks for our investors and ourselves. We will worry about the grandchildren later.