



# Lombard Street Research

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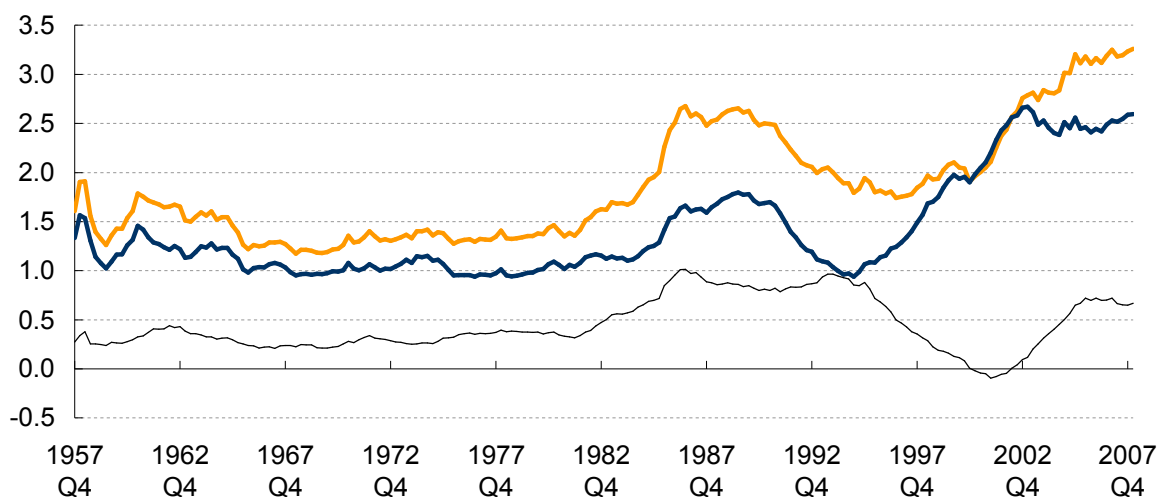
## Warren's 12 beats Hånk the hunk's 700

**WE SUGGEST:** Market to stay cheap, but downside risks are less

**SUMMARY:** Warren Buffett's move into Goldman supports our view that stocks finally offer good value. This is more powerful than Mr Paulson's bazooka: people who think the US needs a renewed free flow of credit are part of the problem, not the solution. That will consist of equity for debt substitution (amongst other things).

Warren Buffett is not infallible. But he has an exceptionally good track record, and has specialised in buying into bombed-out situations where there remains value and others – seeing losses already made – fear to tread. A contrarian with good timing, in other words. In two notes last week, I explained why the US stock market as a whole now offers good value for the first time since 1994, save Oct-02 to Mar-03. The obvious nuggets of value are not in stocks, but in the epicentre of the hurricane, CDOs – eg, triple-As priced on the Markit website at 50 cents in the dollar. Corporate junk offers good value over three years, but with the recession yet to come it is too early: corporate spreads are a lagged indicator. The problem with CDOs is that no bank will sell them unless it has to. That is why they are so cheap: only distressed sellers are willing to part with them. So the obvious proxy for CDOs is the security most depressed by market fears about CDO values: investment banks. Once this point is hoisted on board, it comes down to timing: over to Warren Buffett.

**Incremental nominal debt/GDP ratio**  
total, private & gov't. sectors, 5-year moving totals



Hånk the hunk has a different motivation. Buffett is simply trying to make money. Consider Samuel Johnson, the 18<sup>th</sup> Century sage: "A man is seldom more innocently

employed than when making money”. Paulson is not trying to make money. In an unholy alliance, he is at one with (for example) Paul Krugman in wanting to end the credit crunch. The free flow of credit, it is asserted, is needed to get the economy moving again. In this he/they are exactly wrong. The free flow of credit is exactly what needs to be stopped, until US households for sure, and non-financial businesses for the most part, realise they need to repay debt, not borrow more. The free flow of credit in current circumstances is, as we have many times said, like reviving an alcoholic with a bottle of whisky (note spelling: Scotch!). If the US government wants to intervene in the market it should at least not let itself be taken to the cleaners: it should only take unwanted assets off banks if a good chunk of equity in the bank is part of the deal. Of course, we have to ask whether the Paulson we are seeing in action is the tribune of the US taxpayer, the rescuer of a beleaguered Wall Street, simply bouncing off the walls, or merely the former head of Goldman Sachs. You decide.

The US economy is going to have to recover – when it does, which is not yet – on the basis of net exports leading demand, households repaying debt and saving more, and businesses recapitalising themselves with equity to reduce debt. The free flow needs to be in stocks, not credit. For this to happen stocks have to be good value. Our analysis says they are. It is gratifying to have Warren Buffett agree - & it is gratifying for Mr Paulson that he is showing this by buying Goldman!

Charles Dumas

[charles.dumas@lombardstreetresearch.com](mailto:charles.dumas@lombardstreetresearch.com)