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Today's Notes:

1. The Next Shoe Drops

We have now had the next financial shoe drop. The global LIBOR probe is now a risk-on play. LIBOR stands for London Interbank Offered Rate[i]. It is a rate set by the 16 largest banks. Libor is used as a benchmark for $360 trillion in global securities. Yes, I said "global" and "trillion."

It appears that as far back at 2007 (well before the July 2008 advent of the Great Credit Crisis) [ii] the New York Federal Reserve bank[iii] seemed to know that there were irregularities (underreporting) of the LIBOR rate that could benefit the big banks. A few days ago (July 7, 2012) Barclay's CEO Robert Diamond stepped down after conceding that price fixing relative to the LIBOR was involved. It appears that the British regulatory authorities may have known and / or been supportive.

Yesterday, Bloomberg noted,

"Barclays Plc Chief Executive Officer Robert Diamond to quit last week after the U.K.'s second-biggest lender was fined a record 290 million pounds ($450 million) for attempting to rig interest rates. At least a dozen banks are being investigated for manipulating Libor."

The international banking system, comprised now of banks "too big to fail," is now under scrutiny for price fixing. The Senate Banking Committee will question both Fed Chief Bernanke and Treasury Secretary Geithner on what they knew and when they knew it. The House Financial Services Committee is also seeking information relative to Libor price fixing. There are many issues that continue to impact confidence in the global financial system. Peregrine Financial filed for bankruptcy this AM. Client accounts in the commodity firm have been frozen in this reprise of MF Global. Peregrine's founder Russell Wasendorff attempted suicide earlier this week.

The litany of detritus goes on, Bear Stearns, Fannie Mae, Lehman Brothers, Bank America, MF Global, Barclay's and most recently Peregrine Financial. Even J.P. Morgan got caught on the wrong side of the futures market with a $2 to $4 billion trading loss aggravated by its own attempt to sell the trade. CEO Jamie Dimon has testified to Congress on how JPM's risk management failed.

These events will overwhelm market liquidity, the return to smooth functioning of the world's banking system and by implication the capital markets. In other words, at some point, there may be a systemic effect. This AM the plight of Greece seems to be a mere footnote in the maelstrom.

Perhaps more important, banks have been made even "too much bigger to fail." Increased regulation is on the way. It will be poorly thought out. Nevertheless it is coming.

While the global banking system is scrutinized by politicians, the deleveraging process, at least in the consumer sector, is proceeding slowly and clearly retarding global consumption. The IMF forecasts consumption to grow at a meager 2.2% pace in the U.S., the world's leading consuming nation.

The following chart from the Economist (***World Economy: The Great Deleveraging Race***, July 3 2012). You can see the bleak history of private global consumption from 2007 through 2011 in 5 specific countries. This data is taken from an IMF study[iv]. The Economist noted,

"The study found that housing busts and recessions in rich countries lasted longer, and had a greater negative impact on the affected economies, if "preceded by larger run-ups in household debt. These recessions tended to see larger reductions in real GDP and private consumption, higher unemployment, and reduced economic activity for "at least five years."

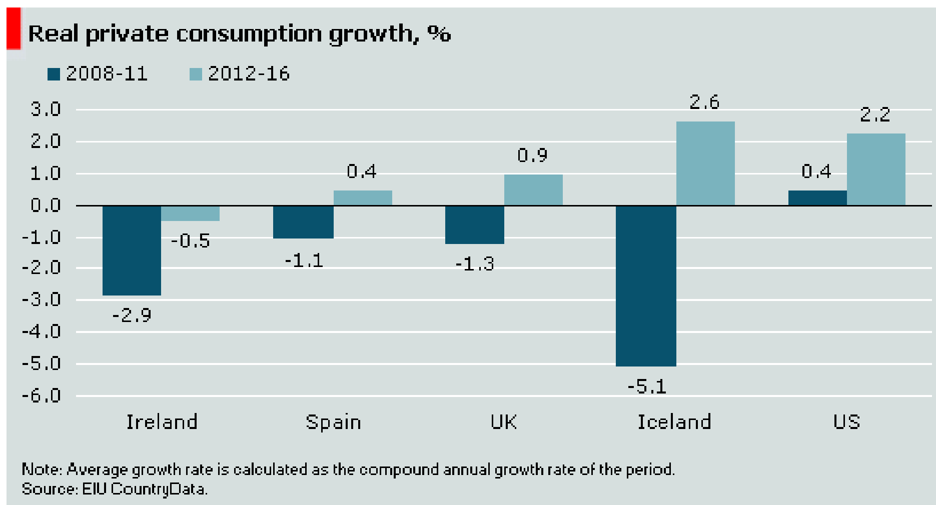
The IMF forecast a 2.2% compound growth rate for private consumption in the U.S. between 2012 and 2016. This forecast is based on more debt write downs, restructuring and payment smoothing programs here in the U.S. a little better than other countries because of government intervention in the mortgage and student loan debt markets.

This resurfaces the thorny issue of "moral hazard" and "too big to fail" in the banking system. It also brings "big government" intrusion into the picture once again. The U.S. financial system, comprised of banking, capital and commodity markets, is clearly in limbo today. Zero interest rates cannot last forever and they are deleterious to investors. Commodities are under pressure as a flight to the dollar buoys that currency.

In 2007 / 2009 the system was saved from self-destruction by massive injections of government debt (ultimately taxpayer liabilities). Today it is operating in neutral and further deleveraging must now have a direct impact on the system. It will be the lender (financial system), borrower (consumer) or taxpayer (citizen) who must realize the forced deleveraging of the system.

There is no easy way out of 60 years of excess leverage in the U.S. economy. This is not your father's economic crisis but one of a very different mettle, in a very different time.

What about Discovery our foremost investment theme? You must select projects and companies that will come to fruition quickly, are currently cash flowing or will begin cash flowing in the near term and those not requiring massive capital infusions. For the current banking system and the capital markets this is perhaps the most ominous minefield a real risk on play and one to be avoided at all costs.



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[i] The **London Interbank Offered Rate** is the average interest rate estimated by leading banks in London that they would be charged if borrowing from other banks. It is usually abbreviated to **Libor** or **LIBOR**, or more officially to **BBA Libor** (for British Bankers' Association Libor) or the trademark **bbalibor**. It is a benchmark, along with the Euribor, for interest rates all around the world.

[ii] On Sunday July 14, 2008 Treasury Secretary henry Paulson, late of Goldman stepped to the Plate to reassure the world (aka China) that Fannie and Freddie were solvent. Thus began the great Credit Crisis whose extended denouement will quite likely be the Great Deflation.

[iii] The New York Federal Reserve Bank was under the direction of current Treasury Secretary Geithner.

[iv] The IMF's recent *World Economic Outlook* dedicated a chapter to the issue of household debt and its consequences for recovering economies. ".