MARKET UPDATE

Dangerous Shoals Ahead

It is early September and, quite often, the most dangerous time of the year for equity markets. The purpose of this letter is to place the recent “subprime” mortgage-financing debacle in America into the context of the market.

Integrated Worldwide Economy

Some of my previous letters have tried to illustrate how the economy has truly become a monolithic worldwide phenomenon. And other financial newsletters talk about the importance of the BRIC markets; BRIC representing the powerful emerging economies of Brazil, Russia, India, and China. The strength of economies in Brazil and Russia as well as Canada and Australia are due to the natural resource industries and their use by China and India to power exports to the rest of the world. The integrated world economy means that a structural change or financial impact in one part of the world can have a major influence in a completely foreign jurisdiction.

The United States is still the most powerful influence in the world and so is its economy. The deficit in trade, the current account imbalance and the rise in the debt level of the U.S. government has been one of the striking features of that economy in the past six years.

Past newsletters to clients have noted the high tech mania and crash; and the real estate boom (and now becoming bust) that has resulted from the distortions created by the Federal Reserve Board as it attempted to right the floundering ship. There is a new captain at the tiller in Ben Bernanke. Whether he is more capable than Alan Greenspan of wringing excesses out of the system before it crashes ashore remains to be seen – but it will be very difficult.

Asset Backed Commercial Paper

The most recent manifestation of distortions in the U.S. financial system has been the Asset Backed Commercial Paper (ABCP) meltdown. A brief explanation of this financial paper, as well as what went wrong and where it may lead, is required.

Commercial Paper has been in existence for decades and is a very necessary financing tool throughout the economy. Manufacturers, for instance, need financing to bridge the gap between production and sale to wholesalers; merchants need financing to bridge the gap between inventory building and sale to retail; service providers need financing to bridge the gap between paying wages and collecting on the service provided. And so on throughout all advanced economies. Banks could provide the financing but those loans can be expensive. So 30-day, 60-day and 90-day paper (IOU’s) were provided for this bridge financing which rolled over into new loans as it matured. This paper was called Commercial Paper, was short term, and backed by the assets provided by the issuer. Therefore arose the term Asset Backed Commercial Paper.

Mortgages used to be provided by Banks, Trust Companies and Credit Unions and were closely monitored to ensure that the loan was well covered as to interest and principal. While there were periodic episodes of overenthusiastic lenders and borrowers, the fallout was usually well contained. This latest iteration isn't. The cause as usual is greed. Depositors and investors alike saw short-term rates drop into the low single digits and were begging for higher returns. The smart money men turned this desire into an opportunity – leading to the woeful refrain "Be careful what you wish for".

MBS's, CDO's, CDS's

Merchant Banks, Large Brokerage Firms, Hedge Funds, Private Equity *et al* saw an opportunity. Mortgages developed that bore little resemblance to past conservative lending practices. Among the more common speculative offerings were 100% loans; no interest payments for periods of time up to a year; teaser mortgages whereby low interest rates for a period of up to two years would be followed by standard interest rates, causing monthly payments to increase significantly after the two year hiatus; and so-called NINJA mortgages which were provided to applicants who had No Income, No Job or Assets. Obviously, many of these mortgages would go bad but the originators took no risk because they packaged the mortgages and sold them as high yield Mortgage Backed Securities (MBS).

Someone else realized that he could earn another fee by packaging some of the risky mortgages with a larger proportion of high grade mortgages and have one of the rating agencies rate the packaged set as triple A which is the highest debt rating. The mortgages would be AAA because there would be a negligible risk of this package defaulting even though it was almost guaranteed that one or more of the low grade mortgages in the total package would default.

But it gets worse. Another financial genius realized that it would be possible to buy loans from banks and other lending institutions that had backed loans for furniture, cars, clothes or any kind of collateral. The originators of these new loans would take a fee and then sell them to investors at a slightly higher yield. These "investments" were called Collateralized Mortgage Obligations (CMO), Collateralized Debt Obligations (CDO) and Collateralized Debt Securities (CDS).

And now, finally, the coup de grace. The genius of all financial genii found that he could sell huge amounts of debt masquerading as AAA by combining these low-grade mortgages with the collateralized debt obligations and attached to ABCP. The result was toxic.

The ABCP market

The ABCP market in the U.S. is different than in Canada. It has existed for a longer time in the U.S. and there are hard and fast rules. In America, the originator of the loan is required to roll the paper over. But, of course, the investor need not renew his purchase. Hedge funds and large Brokerages (read Bear Stearns, etc) were the prime originators and they have enormous liabilities on their books due to their leveraging the loans up massively because "they were such money makers". Investors are not buying the ABCP because, as noted above, they really don't know what the assets are that are backing the paper. So there is a "short-term paper" crisis. This has slowed down the lending process and this should also slow down the economy as economic transactions are delayed due to financing delays.

In Canada, there is no obligation on the part of the originator to renew the loan upon maturity. Theoretically, the loan can be called or the assets sold to realize on the loan. Fortunately it hasn't come to that because the ABCP program is much smaller and some of the lending institutions have banded together to relieve private investors in money market funds of negative consequences. However, there are a large number of corporations that have money tied up in this paper and who now have an illiquid investment, at best, and a short term "riskless" investment that may not be made whole. Almost surely the ABCP program will have an impact on financial transactions.

Consequences

The problem has had worldwide consequences. A smaller bank in Germany has been absorbed into a larger one because of the significant portion of its equity that comprised ABCP investments. The largest Merchant Bank in Australia has been severely impacted by this crisis. It has been estimated that China, which holds more than $US 1 trillion in foreign exchange, has more than 5% of its assets in ABCP. These assets permeate the economy throughout the world. The biggest problem is finding out what assets back each of the loans. Who will want to buy a pig in a poke? And how much will this slow the wheels of commerce?

In my end of first quarter letter, dated April 30, I suggested that we were near a market top and headed into a bear market. This ABCP financial crisis only heightens my concern and confirms that attitude. A man much wiser than I once said "They don't ring a bell at the top" so you know my comment is a prediction and not a certainty but I have enough confidence to say that your investments should be underweighted in financial securities and that an investment in an ETF that increases in value as the equity market declines is more an investment than a speculation.

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