



The Sub-Prime Liquidity Crisis: Keeping the Market in Perspective

The last several weeks have been a volatile time for the stock market and an anxious time for investors. With panic headlines dominating the news, this is a good time to try to put things into perspective. For quite a while now, I have been writing that our economy is performing very well. President George W. Bush seems to be the Rodney Dangerfield of politics. He just can't get any respect. After the tragedy of 9/11 and the successful passage of his tax reforms, the economy has gained traction and has perked along nicely on his watch. Stock prices have followed suit over the past five years.

We all know that the stock market can't go straight up without an occasional pull-back. The problem is, we have no idea when a significant dip will occur. Just a few weeks ago, the "expected" world growth rate was revised upward, earnings reports were overwhelmingly positive, and the S&P500 hit an all-time high. Times were good. Of course, since that time, the market has corrected something in the neighborhood of 10%. The drop has really been impressive, but hardly newsworthy as 10% pull backs are more the norm than the unusual. In fact, I frankly think the current market dip is healthy. We needed something to clear the air and to bring investor expectations back down to earth.

From a macro-economic perspective, Main Street America is in fine economic shape. According to the latest reports out of Washington, industrial production, one of the most important coincident indicators out there, is steadily rebounding. Overall, it's up 2.9 percent annually over the past three months. Manufacturing is up 4.7 percent. Auto output has increased 19.4 percent. Computers and office equipment are up a whopping 25 percent.

These are big numbers and Americans are buying what these businesses are producing. Overall retail sales are up an annualized 4.8 percent for the past three months. Sure, housing is still soft. But building-material sales are up 11.4 percent for the past three months. General merchandise and department stores are up roughly 10 percent. Clothing stores are up 12 percent. Low-end retailers are doing well. Much maligned Wal-Mart has been beaten up by Wall Street lately for expected growth of only 2 percent. But the company actually posted a 49 percent gain in profits over the past year. Wal-Mart's \$11 billion in profits came with sales of \$345 billion which is an 8.8 percent gain over a year ago and nearly twice the growth of the U.S. nominal GDP. At Costco, profits have gained 14 percent. Profits at Target are up 20 percent.

A global economic boom, as represented by surging U.S. exports, provides yet another cushion to the overall economic story. Globalization continues unabated. The globalization process drives down wages, increases productivity, forces firms to be nimble and forces each country to embrace open trade and low tax rates on capital. While productivity continues to increase, interest rates are still relatively low.

The latest inflation numbers from the consumer price index are tame. Headline inflation is up 2.4 percent over a year ago, and core inflation is at 2.2 percent. On a more accurate chain-weighted basis, the overall CPI rose only 2.1 percent with a core increase of 1.8 percent. The historical norm as a rule of thumb is an annual rate of 3%. Gasoline prices have dropped about 50 cents at the pump.

Many respected economists expect second-quarter GDP will be revised up from 3.4 percent to over 4 percent, while third-quarter GDP will come in at a minimum of 2.5 to 3 percent. So, despite the fact that stocks have hit an air pocket and credit markets are suffering a temporary disruption, the country is *not* plunging into recession.

From a micro-economic perspective, we will always have issues that need to be resolved in the short-run. Right now, the biggest issue affecting trading and creating volatility in the equity markets is the mortgage market, in particular exotic and risky “sub-prime” loans. Actually, the sub-prime mortgage problem is grossly overstated because the sector is a very small part of the overall mortgage market and the economy in general. Only 14% of the approximately 44 million mortgages in the U.S. are considered to be sub-prime. Of these, approximately 13 out of 100 are late on payments. The majority of late payers are working through their problems with the banks. Crunching the numbers, only about 0.6% of U.S. mortgages are actually in foreclosure. This amount is up only slightly from 0.5% in 2006. Things are actually better than these numbers suggest since sub-prime mortgaged homes are less expensive than prime mortgage homes. Therefore, the dollar impact of a sub-prime default is smaller than a conventional mortgage default.

So, you might ask, what is the problem? The answer in two words is “hedge funds” and “leverage”. Hedge funds are run by Wall Street’s “fast money guys”. They are generally not very transparent meaning they are very secretive about what they are doing and, therefore, their investors generally have little idea how they invest or what they invest in. Many hedge funds saw opportunities in the “sub-prime” mortgage market and, in conjunction with investment bankers, figured out a way to invest in them. Several years ago Wall Street started to pool mortgages outside of more conservative Fannie Mae and Freddie Mac guidelines, including higher risk mortgages. They cut the same pool of mortgages into different slices, offering very conservative pieces to some investors and the highest risk ones to others. While the homeowners paid their normal interest rate, investment bankers paid different rates to investors based on the perceived risk of each slice, known as a “tranche.”

These types of mortgage-backed securities and “collateralized mortgage obligations” (CMOs) have been around for years. In the view of the hedge fund operators, if a little bit is a good thing, a lot would be better, so they created ways to leverage their positions. Among recent changes is an additional layer of speculation known as a “collateralized debt obligation” or CDO. CDOs involve pooling various bonds (including mortgages) and slicing them into tranches as well. The net result is that one could invest in a tranche of a tranche of a pool of mortgages. If this sounds confusing, it is. The smart minds on Wall Street developed investments that even hedge funds and investment bankers now admit produce results that no one can clearly predict.

Rising home prices and speculative mortgage lending went hand-in-hand over the past six to eight years. The mortgage market then came up with ever-craftier ways to help would-be homeowners buy their houses. Interest-rate only loans allow homeowners to pay the interest (but no principle) for the first couple of years. Some mortgages were so flexible that they would even allow homeowners to defer part of their interest payment for a period of time. Then there were “piggyback” loans. These combined a traditional 20%-down mortgage with a home equity loan to cover the 20%. The net result was that homeowners could borrow substantially the entire price without paying costly private mortgage insurance (PMI). Many loans also came with a “teaser” interest rate which would be fixed at a low rate for the first two or three years and adjust thereafter. Add all these features together, and many homeowners were engaging in a far higher degree of speculation than they realized and hedge funds continued to buy into pools of mortgages backed by these aggressive mortgage lending practices. Hedge funds have magnified their investments in mortgages by borrowing additional money to fund their investments.

This whole thing began to unravel last year when mortgage rates on sub-prime mortgages to borrowers with low credit scores started rising. Many of those old teaser rates were starting to expire leaving homeowners to face much higher payments now that floating rates for mortgages are much higher than they were a couple of years ago. This exposed the real risk and illiquidity in these exotic investment devices. Several hedge funds, including two run by highly regarded Bear Stearns, had to fold up shop recently because of leveraged bets gone bad. Hedge fund investors began demanding their money back. This caused the hedge funds to try to sell their positions, which in turn drove down the prices of mortgage securities even more. While the losses in the underlying mortgages are going up moderately, the multiple degrees of leverage and speculation by hedge funds and their investors have turned it into a bigger problem. The big surprise, and there are always big surprises in these type situations, is how much of these risky CDO investments have been soaked up by foreign hedge funds making this more of a world wide liquidity problem proving that greed does not recognize international borders.

So what is the answer? Basically, the markets will have to work through this and they will. These kinds of things seem to happen every few years as excesses are corrected. The media is constantly attempting to define current events in terms of past crises. In my opinion this is not a replay of the 1987 crash. Both the U.S. and the global economies are much stronger, corporate America is very well financed and has no problem raising additional capital as necessary. This is not a replay of the Savings and Loan crisis of the early 1990s. The sub-prime market is relatively small and we are not dealing with government guaranteed mortgages. This is not a replay of the unwinding of the Internet Bubble in 2000. The public in general was much more involved at that time buying dreams and wishes instead of real assets and reasonable growth. This is not anywhere as serious as the prospect of Russia defaulting on its debt which precipitated the Fortune Magazine cover story, "The Crash of 1998", or the bursting of the Japanese equity bubble in 1989 which plagued the Japanese economy for more than a decade.

If I had to draw a parallel to a recent past event, I would point to the failure of Long-Term Capital Management in the late 1990s. Everybody thought they had it all figured out. Long-Term Capital Management (LTCM) was a hedge fund founded in 1994 by John Meriwether (the former vice-chairman and head of bond trading at Salomon Brothers). On its board of directors were Myron Scholes and Robert C. Merton, who shared the 1997 Nobel Prize in Economics. The company had developed complex mathematical models to take advantage of fixed income arbitrage deals (termed convergence trades) usually with U.S., Japanese, and European government bonds. As LTCM's capital base grew, they felt pressed to invest that capital somewhere and had run out of good bond-arbitrage bets. Initially enormously successful with annualized returns of over 40% in its first years, in 1998 it lost \$4.6 billion in less than four months and became the most prominent example of the risk potential in the hedge fund industry. The fund folded in early 2000.

So what should you do to weather the current situation? There are always challenges and concerns. Hold on to your hats and find comfort in the fact that we have seen instances like this many times before. We employ tried and true investment concepts that we believe will minimize the pain to your portfolio. However, we can not shield you from the emotions generated by these situations. In this case the media is constantly in your face blaring headlines designed to get your attention and stir up your emotions. We believe the economy is capable of withstanding the current situation. The Fed has all the tools necessary to deal with this liquidity problem, recognizes the problem and is taking the necessary steps to ease the situation. This to will pass.

Respectfully,

James W. Kyle