

“Some Current Thoughts on the Financial Crisis”

The Bigger Picture

The Supercycle of private debt, the key financial feature of the post-war period, is almost certainly over and will be replaced with a new supercycle of public debt. The downward spiral of the global economy can only be aborted by transforming private into public debt, in a similarly excessive manner. And no country will be spared because this is the first globally synchronized crash since the Great Depression, but compared with then, national economies are far more integrated than was the case in the 1920's.

The consequences have already rewritten the rules for central bankers. Businessmen and investors are struggling to adjust in the face of essentially a new and poorly understood economic order. The future is certainly murky, and there are a number of disturbing questions that must be considered. For example, are we simply trading a private sector debt crisis for a public sector debt crisis? Will the EU survive? Some countries have already pushed Government debt/GDP ratios to extremes. These heavily over-indebted countries may see devaluation (impossible as part of the Euro) as a way out of their inability to reflate. As unemployment spirals up around the world, will nationalism become uncorked and politicians find pressure to opt for protectionism impossible to resist (or more likely impossible not to exploit!). What will become of the international monetary system which, since the end of Bretton Wood in August 1971, has proved to be catastrophic? What will

replace the discredited theory and practice of modern finance? The answers to these questions will tell us if we are entering a secular bear market.

There are, to be sure, many things to both think about and lose sleep over and these will be issues to explore in future notes.

Quick Thoughts on the Markets

The Economic and financial news has become increasingly frightening day after day. Employment and production continues to spiral down, bank and shadow bank write-offs continue to destroy capital to the point where many major financial institutions in the world are insolvent, close to insolvent, nationalized or quasi-nationalized. Projected fiscal deficits are exploding at rates that only a few months ago defied imagination and increasingly one hears comments that Governments won't be able to sell their bonds, currencies will collapse (the U.S. dollar?) and gold will be the only safe asset.

True to form, the Davos gathering of the great and mighty is off to its usual start, articulating what we already knew that happened last year, extrapolating that into the future and pointing the finger of blame for the crisis at anyone other than themselves.

One thing we do know is that, by definition, major stock market bottoms, following severe bear markets, always occur when the economic news and forecasts are at their bleakest, just as tops occur when news and forecasts are at their most optimistic.

In trying to assess whether we are at or around a major low, good practice is to watch for a series of milestones or benchmarks that we would expect to fall into place so that our

degree of confidence in the market can begin to change in a positive direction. This is a much safer and more useful approach than trying to position oneself as either bullish or bearish.

Obviously the situation is extremely fragile and dangerous. While the norms of the past 50 years may well be totally obsolete, there are some timeless signals that have proven their worth over many decades. One of these is market resistance to bad news. In the past few weeks, the news has been so dreadful that even the bears are shocked. Yet, the market, so far, is holding above the October/November lows and sell-offs have lacked staying power. This could, of course, change in the near future.

Also, it is apparent that the supply/demand balance for riskier assets has improved significantly. This can be seen in the high yield market, the TED spread (the gap between Treasury bills and bank CD's), the commercial paper market and the riskier end of the stock market. Small and mid caps are outperforming large caps, although this could be just the 'January' effect.

A second benchmark (relevant for today's environment) that is worth following is China. That market has been outperforming as well. This is significant for several reasons. One, China had one of the biggest bubbles and busts. Second, China is considered pretty risky in general. Third, the whole world is looking to Chinese growth to pull the rest of the world out of recession (how conditions have changed!). And finally, small caps in China are outperforming large caps.

The Chinese economy appears to have turned up, money supply is growing and the authorities have implemented a truly massive infrastructure spending programme.

A third benchmark we would like to see is improvement in the U.S. housing market. The excesses followed by the bust in that sector provided the initial shock to the U.S. and world financial system and triggered the global collapse. Therefore, stabilization of the housing sector will be crucial for any hope of sustainable recovery.

Unfortunately there is not much to go on that is positive, other than a sharp improvement in affordability and preliminary evidence of the start of reduction of inventories of unsold homes.

Until banks are able to unload subprime-related assets on the Fed or the new “bad” bank, the health of their balance sheets is inextricably linked to the U.S. housing market. There are three main indicators that will help to give us confidence of stabilization in the housing market: price, sales/inventory and affordability.

The Case-Schiller index shows a decline of 18% over the last year, 25% since the peak in June 2006 plus 35% in some markets. Although not seasonally adjusted, the monthly trend indicates a continuation of 20% yoy declines. Reinhart and Rogoff (2008) conducted a review of all major post-war banking crises in 18 developed nations. Their sobering realization is that, on average, house prices declined by 36% and that the downturn went on for 6 years. Given the scale of the current crisis, the length and magnitude of the previous bubble and its’ global nature, the U.S. market could easily fall further than that average.

The National Association of Realtors (NAR) December data shows the inventory of existing homes declined 11.7% over November, 7.5% over a year ago. This is a positive initial sign, but sales continue below trend. The NAR also indicates that affordability is improving. However, their model relies on income data from the Census Bureau, which shows median family income increased by 1.8% in 2008. We would expect income data in 2009-2010 to fall significantly as unemployment spirals up. Moreover, the dramatic drop in the stock market will substantially shrink funds available for down payments while institutions have sharply increased required down payments.

For a clear and more positive pattern to emerge, we would look for sustained improvement in sales and inventory data supported by stable prices. (more on housing in the future)

Conclusion:

The situation, on balance, remains fragile and dangerous and the rate of deterioration in the economy has continued to catch everyone off balance. For investors, as always, the key is to get a handle on what has already been discounted into today's prices. That is why we must continue to focus on achieving the milestones which would gradually indicate improving odds that, at some point, the worst is behind us. We have quite a bit further to go but the next few weeks might give us more confidence that a good bottom has been forming.

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