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Liquidity Crunch, Summer 07

September 2007

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The Trilogy

As it turns out, this newsletter forms a trilogy. The January 07 newsletter ('Housing Crash?' and 'Storm Clouds'), and the June essay ('Note on Risk') are the first two installments in what is now a 3-part series on the current liquidity crunch.

Also by coincidence, the sub-prime problem is an excellent example of the illusions 'Overconfidence' and 'Anchoring', discussed in the April newsletter 'Psychological Illusions'. Past issues are available at www.chrishoran.ca or please call and I'd be happy to send them to you.

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We start with a quick background of the problem, because, as always, current events are so much richer when you understand where they came from.

Primer on the Asset-Backed Problem

After a bank has lent out money as a mortgage, it has become commonplace for them to bundle up the mortgages and sell them off to investors. The investors, usually large sophisticated institutions, liked the interest income and the diversification that many mortgages provided.

Sometimes the investors would repackage the mortgages into different slices according to the credit quality of the underlying mortgage, and sell each slice to a different investor. The high quality bundles would get an 'A' rating from the independent debt rating agencies, while the lowest would receive BBB ratings or would not be rated at all.

These types of investments are known as 'structured products' or 'derivatives', because they are assembled from various pieces, and because their behavior is linked to or derived from the underlying financial instruments. In recent years, an entire industry, known as 'structured finance', has grown up around the idea of packaging various assets and selling them to investors.

In the past, mortgage-backed securities tended to be bought by longer term investors, but recently they and other structured products have found their way into securities with shorter term horizons, such as commercial paper (CP). As well, the companies assembling these structured products would issue commercial paper to finance the products until they could be resold.

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The commercial paper market is where corporate treasurers with extra cash can lend it out for a short time, usually a few weeks or months. Traditionally, commercial paper was backed by the credit quality of the issuing company, and might also be backed by the issuer's bank (a Banker's Acceptance or BA).

One important feature of the CP market is because it is short term, credit problems surface quickly, so the CP market is very sensitive to the health of companies. The CP market is the proverbial canary in the coal mine for corporate credit problems. The end of the road for O&Y, Enron, and the great Penn Central Railroad were first signaled when the commercial paper markets balked at lending to those companies.

The Time Bomb

Meanwhile, the banks and finance companies that put together these structured securities began to get more creative and more daring. In addition to mortgages, they would package up car loans, aircraft leases, even credit card balances, and sell them off to investors who wanted high interest income.

And just to make it really exciting, they would sometimes leverage the security itself by including a loan within the package. These leveraged securities gave investors $150 worth of mortgages for only $100, because the security itself would carry a loan for $50.

The result is that these securities morphed into sophisticated animals: they contain bundles of assets, each of which has different characteristics; and the leveraged ones have a whole other dimension of complexity. It all became opaque and difficult to analyze, for those that bothered to look. Please pass the matches.

The investors (lenders) loved the returns so much that they, in the opinion of the retired founder of Dominion Bond Rating Service (in a letter to the Globe), 'conveniently chose to ignore' the information and the warnings of other market professionals.

But intelligent investment people knew that some of these asset-backed securities came with a time bomb: commercial paper is a short term vehicle, while the mortgages and loans were frequently longer term at more fixed rates. Funding a long-term asset with short term debt is asking for trouble.

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Asset-backed CP (ABCP) is thus exposed 3 ways to the classic financial squeeze: rising interest rates i) boosts defaults on the underlying (sub-prime) mortgages, ii) leveraged paper suffers if the embedded loan rate rises, and iii) commercial paper needs to be renewed at least every 9 months, which means the borrower has to either pay it off or roll it over to a new lender. If the lender balks, the holder is stuck collecting on the collateral.

The Problem Gets Rolling

So here's how the problem got rolling: the US home financing industry, desperate to lend money to people desperate for a house, saw rapid growth of the sub-prime mortgage industry. While some sub-prime borrowers are excellent credits, for example recent immigrants without a credit history, some are not. The worst of these loans are known as NINJA loans (no income, no job, no assets).

The growth of the US sub-prime mortgage and structured finance industry was part of a wide tendency on the part of many investors to underestimate the risks of the investments they were making (see 'Storm Clouds' January 07). And because there hadn't been a problem recently, lenders became complacent (see 'Overconfidence', April 07).

Unfortunately, when interest rates began to normalize in the last three years, as widely expected, defaults on mortgages began to rise. There were rumblings in February, but the poop really hit the fan in July, when Moody's, one of the debt rating agencies, announced they were rethinking their ratings on sub-prime debt.

The announcement threw a wrench hard into the machinery of the commercial paper and loan markets, particularly asset-backed commercial paper (ABCP). Suddenly nobody wanted anything to do with asset-backed securities of any kind.

Everybody got nervous at the same time, jamming the money markets. Since nobody really knew which was good commercial paper and which was not, nobody would touch anything. Even the big banks were pulling back on overnight loans to each other. It was (and still is) a classic scare.

To try and ease the logjam, the US Federal Reserve and the Bank of Canada stepped in to encourage banks to lend to each other.

Where does that leave us?

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World Waking to Higher Rates

The world is waking up to the fact that interest rates were kept abnormally low in the wake of the 2000 - 2003 tech-stock crash. (US rates were 1% until June of 04.) The steady increases, necessary to dampen inflation, have created stresses in marginal areas such as sub-prime debt.

The unwinding of the sub-prime problem is just one step in the ongoing adjustment of the economy to more normal interest rates. This adjustment has been a topic of conversation among analysts for at least two years and nobody in the financial industry should be surprised by it. As one analyst quipped, 'What did you expect? That's why we call it sub-prime'.

The ripple effect will be felt throughout the risk spectrum as interest rates that lenders (investors) require for risky investments rise. Some higher-risk projects may be cancelled if they are not profitable enough to pay investors adequately. This is not necessarily a problem. Risky projects that cannot pay their way should not be made, just as households that can't pay a mortgage shouldn't get the loan in the first place.

The Problem

One problem at this point (September 07) is that nobody really knows where the bombs are, who is holding them, or even how big the bombs are. In previous financial crises, the banks with the most bad loans would blow up, their shareholders would eat their losses, and then the game would start over.

This time, the dispersal of the credit risks to many different lenders means it will take much longer to determine the extent of the damage, or even if there will be any lasting damage.

Technically, ABCP that is guaranteed by the issuer's bank will be covered by bank credit lines until the money market machinery is running again. Holders of unsecured commercial paper may have to go through the painful and possibly costly process of collecting on the collateral backing the loans.

Please note that I have been assured by virtually all of your money managers that none of them have any direct exposure to any unsecured ABCP. So you don't need to worry about your portfolios.

Do you know someone who should be using Chris as their Financial Advisor?

If so, please have them call or email, or better yet, call me directly and let me know.

The Fears

The fear is that a credit crunch can cause a general economic slowdown. A credit crunch occurs if banks - correctly - go carefully with new lending. If banks fill their balance sheets up with credit lines to help customers cover their CP, it may restrict their capacity to make new loans. This slowdown in lending reduces the amount of money around and can slow the economy down.

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Wouldn't a US recession mean economic Armageddon?

No. Deep recessions and serious bear markets are caused by the tight monetary conditions that are used to fight inflation. Inflation remains consistently very low by modern historical standards and therefore an interest rate-driven recession is not in the cards at this point.

In fact, policy makers have lots of room to lower short-term interest rates to avoid or moderate a recession, and they have every incentive to do so. US Federal Reserve Chairman Ben Bernanke has said that he is ready and willing to lower interest rates if the US economy threatens a recession. A US recession, if it happens, is likely to be mild or brief or both.

Will the broader US housing market collapse?

Probably not. Today's higher rates will definitely slow things down in the US. However, major housing market adjustments take years and have little direct effect on the economy. The 1990 recession, and the subsequent 5-year decline in house prices, were each caused by interest rates at 14%. The house price decline did not cause the recession.

Does this mean the US will avoid a recession?

Maybe, maybe not: the retrenchment of the US consumer is the natural and necessary response to higher interest rates, and it may well tip the US into recession. It is impossible to tell. If there is a US recession, it will probably happen independently of the US sub-prime problems.

Will a cut in US interest rates stoke inflation?

A cut in interest rates will be designed to counter the deflationary effect of a credit crunch, so a burst of inflation isn't likely. The bond market knows all, and the 30 year bond is telling us that the risk of inflation is low. Bernanke will be keeping inflationary forces on a tight leash by keeping upward pressure on interest rates after this tempest has passed.

Good News

The health of the US consumer – and the housing market - is more dependent on the job market than house prices. People with jobs pay their mortgages. US and Canadian companies are in very good financial health. The US economy is benefiting from the declining US dollar, and China continues to boom.

Toyota, Honda and other car companies are expanding production in Canada. Canadian unemployment is at a 35 year low. Our currency is strong, our interest rates and inflation are low. How good does our economy need to be before the media stop telling us how bad things are?

More Good News

The abrupt end of the sub-prime mortgage market is likely to have a small economic impact. The Bank Credit Analyst, a high-end research firm, feels that the losses on sub-prime mortgages might total around $200 billion (US), and since the losses will be spread over a number of years, the economic effect will likely be trivial. (Stock markets fluctuate by more than $200B every day.)

The more important positive impact is that investors everywhere will be sharpening their pencils and having a much closer look at derivative type investments and their potential exposure to losses. The derivative market will be a healthier place, and there will be less chance of a much bigger problem down the road.

Equity Market Impact

It looks like a perfectly normal correction at this point. The peak to trough decline was only 10% - 12% in the major markets, and they have recovered more than half their decline to date (September). Most markets are up modestly for the year to date. The longer term uptrend of the markets is still unbroken.

Because the markets tend to look into the future, they have already been pricing in an economic slowdown. The stock markets are not expensive – the so-called private equity boom is because sophisticated investors know that with stocks earning 6% and interest rates at 4%, stocks are reasonably valued.

Summary

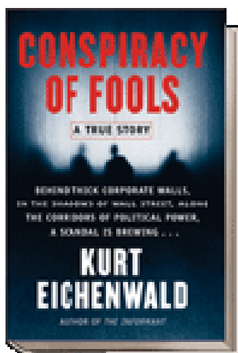
If you are a holder or issuer of commercial paper, this crunch is a big deal and you have been talking to your bankers and lawyers since August. Everyone else can ignore it.

Equity prices are very reasonable, the economy (especially in Canada) is booming, and the central bankers have promised to lower interest rates if a recession threatens. The resources markets have held up the best and valuations are very reasonable.

Storms can always get worse, but that's not my read of the situation at this point.

Finally, thank you to everyone. You have been so calm through this media frenzy. It is a pleasure to work with you.

Book Review: Conspiracy of Fools



Kurt Eichenwald weaves the threads of the Enron story in a very readable way. I found it a bit of a page-turner, even though we all know how the story ends.

The chilling message of the book, between the lines, is how highly intelligent, educated people can have their ethical compasses redirected, in very small increments, so that over a period of time, almost imperceptibly, they find themselves facing 180° to the direction they should be.

For instance, in the midst of all the shenanigans, Ken Lay, Enron's chairman, brought in the deposed junk-bond king Michael Milken to the annual senior management retreat. (Milken's fall from grace in the 80s brought down Drexel Burnham Lambert and resulted in jail time). Milken's keynote subject was corporate ethics. That evening the chat around the bar was, 'What is Lay doing having that guy come and talk to us? We're Enron. Milken's a *criminal*'.

Makes you think.

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