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Liquidity Crunch Phase 2

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Inside This Issue

I trust you all had a warm and rejuvenating holiday with your families and friends, and are ready to face the trials and tribulations of the New Year. At first glance there seems much to worry about.

Phase 2

The liquidity crunch continues to threaten the financial system, with worldwide repercussions. ('Liquidity Crunch' www.chrishoran.ca.)

What started as a problem with poor-quality mortgages in the US has compounded into a crisis of confidence in many asset-backed securities, with the result that some banks' ability to lend money is curtailed or threatened. The markets' (and my) perception of the issue was transformed with CIBC's disclosures in December that their subprime exposure totaled $9 billion – on bank shareholder equity of $12 billion. With this information the situation went from serious to potentially fatal for CIBC.

A liquidity crunch is a brake on the economy because it reduces the amount of money available. A lack of liquidity is dangerous because it has the potential to spin out of control with very nasty economic consequences: Japan's deflationary spiral has been dragging on for almost 15 years. The captains of the banks, the regulators, and other players will have to navigate carefully, and there is no time to waste.

However, based on the evidence at this point, it seems that it can be resolved without an economic catastrophe. The US subprime problem is a fraction of the Savings and Loan crisis of the 1990s and the technology stock meltdown of 2000-03. Those crises were resolved without disastrous economic consequences. Already (January 2008) interbank lending rates are declining, indicating some easing of tensions behind the scenes.

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Assante WEALTH MANAGEMENT

The US Consumer

The big question is whether the US consumer spending will deteriorate enough to drive a Category 5 recession. It is possible, but not likely.

First, house prices do not drive the economy. Interest rates drive both the economy and house prices. The degree to which a housing price decline will impact consumers' propensity to spend is simply not known. However, the evidence seems to be that house price adjustments tend to drag out over years, independently of the economy. For example, Toronto house prices declined at least 35% in the early 1990s and took about 9 years to recover, yet the economy expanded with only a very brief and mild interruption.

What's far more important to the consumer is the health of the economy. People with jobs pay their mortgages. Here the evidence is good. US exports have responded quickly and strongly to the decline in the US currency and are now increasing at 18% per year. Housing accounts for only about 4% of US GDP, whereas US exports account for 12%. The increase in exports is a natural counterbalance to a consumer slowdown, and has been anticipated by economists* for some time. ("Deficits Dollars and Markets" www.chrishoran.ca January 2005). In addition, corporate financial health is excellent, making the need for widespread layoffs low.

Interest Rates Reasonable

Interest rates are reasonable. This is not 1981 when mortgage rates at 18% simply blew homeowners out of the water. Many mortgage renewals will see an increase in interest rate, but these modest rate increases are not necessarily a disaster, according to the Bank Credit Analyst, an independent research firm. Mortgage interest is tax-deductible in the US, which further mitigates the pain.

The primary constraints to lower interest rates are the currency and inflation. Low interest rates weaken the currency and tend to cause inflation.

Core price inflation is not on the radar screen. The spike in corn prices is a 'price shock' caused by an ill-conceived experiment with biofuels that will end soon. Banking crises and real estate price declines are deflationary, because they take money out of the system. Low-cost goods from developing nations are also deflationary, because they increase the value of money. The BCA feels that deflation is actually closer than we think.

The US currency does not seem a problem: the dollar has declined significantly from its peak in 2002, and the decline has been orderly, even with declining interest rates. It is in nobody's interest, including China's, to have a run on the greenback.

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New Website

Please check out my new website www.chrishoran.ca. Past issues of the Newsletter are easily available.

Please refer a friend who you feel might be interested.

Interest Rates Reasonable continued from page 2

With inflation nowhere on the horizon, the Federal Reserve and the Bank of Canada have room to aggressively lower interest rates to keep the economy growing. Central banks don't want a recession any more than you do. A recession, if any, will likely be brief or shallow, or both. Look for a media frenzy anyway. [Note that last year's boogeyman, the US trade deficit, is resolving itself in an orderly way, as the US dollar declines.]

Investment Markets Outlook

The fear on most people's minds is a disastrous decline in investment markets. Such a decline is possible, but not likely, for several reasons.

Some people argue that since the stock markets of the world have been going up for 5 years, they should be ready for a fall. But the US market has only recovered to about where it was in 2000 - 8 years ago - before the bear market began.

Five years of positive market returns is more a testament to the 45% decline of the bear market than it is to the heights we are at today. The phrase 'all-time highs' does not have the same meaning now as it did when the tech bubble pushed valuations into the stratosphere. That was last time.

This time, investment market valuations are reasonable by historical standards. Major bear markets usually start from high valuations, when investors are euphoric and don't believe prices can fall, not when they are gloomy or fearful and valuations are reasonable.

Compared to bonds, the equity markets are as *under*valued today as at any time since 1982, according to the Bank Credit Analyst and the 'Fed Model'.

For instance, Royal Bank generated a 23% return on equity in its most recent results. Its exposure to subprime loans, according to its CEO, is less than 1/10th of 1% of the bank's assets. At the current share price (~$50, Jan 08) the dividend yield is about 4% - about the same as government bonds. Normally bank stocks yield much lower than bonds, because dividends tend to increase as profits grow.

The banking crisis will actually improve the profitability of well-run banks. The era of free money is now over, which means banks and other financial intermediaries will get paid again for discriminating between high and low-quality borrowers. As well, lower short-term interest rates mean banks pay less for deposits and make more on loans.

RSP Reminder

The deadline for 2007 RSP Contributions is **Friday, February 29th, 2008**. The limit is $19,000 for the 2007 tax year and for 2008 it rises to $20,000.

Your personal limit is on your Notice of Assessment from your 2006 Tax Return; your contributions to-date are on your Assante RSP statement.

If you currently do your banking online, you can now send your Assante contributions via internet banking. (Please call Barb McKenzie to find out how!)

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Danny Bubis, managing partner of Tetrem Capital Management, said in a conference call (January 2008) that the currently depressed bank stocks prices represent a once in a 10-year buying opportunity.

Market valuations today are low or reasonable because many professional investors have been worrying for 3 years about how the US consumer will deal with the end of super-low interest rates. This means the risks are to a large degree already 'priced in' – reflected - in current prices.

In fact, the strength of the resources markets (and emerging markets in general) leads the BCA to observe that the shares of resource companies and emerging markets are likely to be market leaders as soon as the subprime/housing funk is resolved.

Volatility Normal

Stock market corrections are normal, although never predictable. Stock market declines of 10% usually occur at least once a year. Declines of 15% – 20% occur frequently as well – every 3 years or so. While steep market declines are never pleasant, they should only be a surprise to people with short memories.

The US and Canadian markets have seen peak to trough swings of about 20% since July, so this bout of volatility now counts as a serious correction. While serious declines are never pleasant, the current episode is not at this point abnormal.

The situation today is reminiscent of 1998, when the Far East currencies imploded, oil prices went to $12 forcing Russia to default on her bonds, in turn causing LTCM, a $6 billion hedge fund to blow up, and bank stocks to decline 40% in about 6 weeks (sound familiar?). That was plenty scary, as the Federal Reserve Chairman Alan Greenspan summoned the heads of a dozen US banks to an unprecedented Sunday meeting in his office to coordinate the unwinding of LTCM.

Today is also reminiscent of 1987, when rising interest rates threatened the economic 'recovery' and the unprecedented crash in world stock markets of about 20% in a single day (October 19). And of the tech stock crash of 2000 – 2003 which destroyed $10 trillion of wealth, equivalent to a full year's US GDP.

Each of these was unprecedented – stunning – in its own way, and very scary to those of us who were there. And yet each ran its course with very little or no economic recession. History has proven that investors who kept their wits about them, who had balanced, high-quality portfolios, came through the difficult times without serious damage.

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.

Volatility Normal continues on page 5

Markets are much more volatile than the real economy. Markets suffer from the emotions of the herd – aided by a willing accomplice, the financial media. The lemmings stampede into low-interest mortgages and then stampede out again.

At this point (February 2008) we do not know if we are at the bottom or not. The Canadian stock market could decline another 10% from here, for a peak to trough total of 30% or so, before finding longer term support levels. However, the captains referred to earlier seem to be moving quickly and decisively to solve their problems. US banks have already written off $150 billion, and have brought in outside financing to repair the damage. The Federal Reserve dropped interest rates by ¾% and the Bank of Canada by ¼% during the week of January 21st.

The advice from the flight deck: keep your seat belt fastened, but don't lose sleep. Chances are we're more than halfway through.

Bonds Explained

One of the most common questions is why bond prices go up when interest rates decline, and why bond prices go down when rates go up.

Bonds are known as 'fixed income'. Fixed income refers to the fact that a bond pays a fixed stream of interest dollars. If you remember this, you are well on your way to understanding bonds. Here's why:

A bond is debt – it is a promise to repay the interest and principal under certain terms. Most bonds pay interest for a number of years to maturity, when the principal is due. Investors look at bonds from the perspective of a lender (not borrower), which is why the interest is 'income' and not 'expense'.

A bond can be bought or sold on the open market, so the price is subject to market forces. The price of a bond depends on a number of things, most importantly the interest rates prevailing in the market, and the investor's confidence that the borrower (the 'issuer') will repay the principal, or face value, at maturity.

So far so good, but here are a few twists.

Rates Up, Bond Prices Down

Say the bond is a 6%, face value $1,000, with 20 years to maturity. It pays interest of $60 per year for 20 years, when you get the $1,000 back. The bond is said to 'yield' 6%, since $60 is 6% of the original face of $1,000.

The important thing is that the *dollar* amount of income - $60 per year - is fixed for the life of the bond. Whether the $60 is actually a 6% yield or not depends on whether you paid $1,000 for the bond. Since the bond price can change, if a new buyer pays a different price, the $60 fixed interest payment will work out to either more or less than the 6% depending on the price the new buyer paid.

So if the interest rate – the yield - on 20-year bonds declines to say 5% your bond goes up in price because it pays $60 per year, when a new investor could only get $50. The price of your bond rises until its interest payment aligns with prevailing yields. In the 6% example above, the value of your bond rises to $1,200 - because the $60 interest payment is 5% of $1200.

On the other hand, if interest rates *rise* to 7%, your 6% bond *falls* in price to $857 because the $60 fixed payment stream is 7% of $857. This is how you lose money in bonds: when interest rates rise, the interest payment on your bond doesn't go up, the price goes down.

Bonds' Achilles Heel – Inflation

Since the interest income in dollar terms is fixed for the life of the bond, the value of the bond is sensitive to inflation, because inflation erodes the purchasing power of the income (and the principal). A longer term bond, such as 20 or 30 years, is very sensitive to inflation, because the inflation can corrode the value for a long time.

Say you estimated inflation was going to be 2% when you bought your 6% bond, so you were counting on a real return of 4%. Now what happens if inflation goes to 6%, where it was in 1990, or 12% where it was in 1984? This would be bad news: even though you were still receiving your $60 per year fixed income, the purchasing power of your capital would be decreasing by 12% per year.

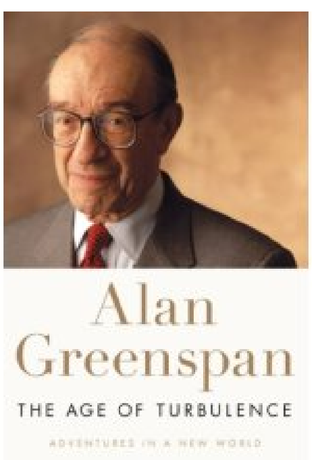
This erosion of purchasing power is reflected immediately in the market value of the bond. In our 6% example above, if inflation went to 12%, interest rates might be 15%, and the value of the bond would drop to $500 – half its original value! (This actually happened to bonds in the ‘70s.) The bond market is a sensitive detection device, able to discern hints of inflation at great distances.

Bonds’ Day in the Sun – Deflation

If inflation is the nemesis of bonds, then deflation is their time of glory. Declining interest rates are almost as good. In our example above, if 20-year rates went from 6% to 1% (as they have in Japan), a 30 year bond would increase in price from $1,000 to about $3,000.

Book Review

“Alan Greenspan, *The Age of Turbulence*”



The current turmoil in financial circles has focused attention on the subprime problem and investment bubbles in general. The man at the centre of the world financial system for 20 years as Chairman of the US Federal Reserve has come under some fire for contributing to the housing ‘bubble’ by keeping interest rates low after the tech bubble, and for contributing to that bubble, too.

Greenspan’s very readable memoir/essay sheds some interesting light on his views of debt, among other things. For instance, he says it is likely that an economy can handle more debt as it becomes more sophisticated; measures such as consumer debt to GDP are overly simplistic and do not capture this increasing capability.

(The best book on bubbles is Charles Kindleberger’s ‘*Extraordinary Popular Delusions and the Madness of Crowds’.*)