Conway • Jarvis

Quarterly Investment Outlook

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Could the Sub-Prime Meltdown Sink the Economy?

In our previous issue we touched on what could overturn the "just right" conditions of our "Goldilocks Economy". First on that list was the anticipated downturn in the US real estate market that we predicted would fall short of triggering a recession. Well, here we are, one quarter later, confronted with a meltdown in the sub-prime mortgage market that has created a crisis of confidence in the credit markets that extends beyond the mortgage industry to major financial institutions, pension funds, and highly leveraged hedge funds. Much like an iceberg, most of the trouble in the mortgage lending industry lies below the surface. As expected, there are major losses ahead for a number of mortgage lenders and their sub-prime borrowers. However, the purchasers of those securitized mortgages are exposed to losses as well. This could have serious consequences for investors thinking they have no direct exposure to the sub-prime real estate market. We'll explain how that could affect liquidity in the banking system and what that could mean for the equities markets.

The Sub-Prime Market and Beyond

It's been our view that the abundant liquidity fueling the Global Industrial Revolution would cushion the blow from any significant downturn in US real estate market. We based our opinion on the fact that Sub-Prime lending comprised less than 10% of all outstanding mortgages and that it was unthinkable that the entire sector would lose all value. That remains true today and, as one might expect, losses have accrued to mortgage lenders, their borrowers, and purchasers of mortgage-backed securities. The pain is being felt where it should be. We expected broader, second-order effects on the stock market arising from the resulting slowdown in consumer spending, but nothing beyond the normal cyclicality of the economy and its markets. It's why we, among others, looked to the underlying fundamentals of companies and the modest valuation of this equities market in calling for higher stock prices by year's end. We're not abandoning that view but the roiling of the credit markets has clouded the outlook and raised concerns about whether sufficient systemic liquidity can be maintained in the short run to support it.

In this news-rich environment, we expected to see this recent sharp increase in stock market volatility. What gives us pause was the sharpest rise in credit market volatility since 2004 with the 90-day T-Bill trading more wildly than it did in the aftermath of 9/11. Risk is rapidly being re-priced in the credit markets with widening yield spreads that translate to greater costs for consumers and companies that must borrow. We believe the credit markets are telling us that the possibility of failure by a major institution or investment fund has increased along with the probability of recession. Banks, borrowers, investors, politicians, and the financial media are imploring Gentle Ben and the Fed to act quickly and decisively to save them from certain doom as the stock market rises and falls with speculation as to what will happen at the September 18th Fed meeting. Pardon us if we decline to join in.

It sounds to us like the Fed and the Treasury, AKA taxpayers, are being asked to bear the cost of poor decisions made by borrowers and lenders in real estate, and speculators in asset backed securities. Unlike the talking heads at CNBC, who are afraid you won't watch if the markets go down, we believe the Fed's raison d'être is to maintain sufficient liquidity in the system to facilitate the workings of the economy and its markets. That's a mouthful, but simply put, their role is to expand or restrict the availability of capital to consumers and banks thereby driving the economy on a path somewhere between the extremes of inflation or deflation. We believe the Fed should be reactive rather than preemptive in fulfilling their mandate. It should be left to the markets to allocate gains and losses among its participants who, hopefully, based their decisions on an assessment of risk and reward. In this case, the Fed should stand ready to facilitate the flow of capital through the economy, not bail out those who flunked Risk & Reward 101. Doing so sets a dangerous precedent and invites even riskier behavior from investors who think a Fed-built safety net will save them the next time around.

Whose Problem Is It Anyway?

Where the problem began and who should pay appears on the surface to be a simple question with a simple answer. However, where the bill for the sub-prime debacle ultimately lands may come as a surprise to many investors. Let's follow the path of where sub-prime liability flows. Mortgage lenders and borrowers are the obvious first stop. You can't pay me? I take your house. That's happening at an increasing rate with foreclosures this year more than doubling those of 2006. And it might get worse with more than 2 million sub-prime mortgages resetting to higher rates between now and the end of 2008. Too many of those and some lenders could be in trouble as well. Already, a number of publicly-traded mortgage lenders and numerous smaller ones have closed their doors this year. Also exposed are those who bought sub-prime mortgages in securitized form from lenders who, rather than carry them on their books, combined them with other higher rated mortgages in the form of collateralized debt obligations ("CDOs"). As defaults and foreclosures increase, the value of these asset-backed securities has declined. This in itself doesn't spell disaster, only acceptable losses for pension funds and financial institutions that owned them. So far, so good.

And then we have the Hedge Fund Industry and those institutions that finance them. Just like real estate investors, hedge funds love to use leverage to enhance their returns. It helps them justify the big bucks they earn through performance incentives. However, much unlike real estate where you don't get to borrow more than a property's market value, hedge funds were able to borrow a multiple of their equity collateral from any number of major investment banks. A recent issue of The Economist estimated that some funds borrowed from 40 to 70 times their equity using, you guessed it, CDOs as collateral. Just as returns expand with the use of leverage, so do small problems become big ones. As CDO values become more suspect due to foreclosures and the decline in US residential real estate, banks will soon reassess the value of their collateral and, if found wanting, request a payment to compensate them for the shortfall and increased exposure. This is why you will hear the term "marking to the market" with increasing frequency these days. It's a friendly way of being called to deposit additional collateral for a loan. If you can't come up with that, the bank can call the entire loan. Oh, Oh. I'm already leveraged to the sky, what's a hedge fund manager to do?

This is how the sub-prime meltdown, rather than confined only to those with direct exposure, can become a banking problem that Bernanke & Co. are watching with intense interest. It also has the potential of becoming our problem as investors in the equities markets. Why? Hedge fund managers love to receive checks not write them. With the bank calling for more money and nervous investors withdrawing funds, the first place a manager looks is to assets that have discernible value, those with a bid price. No such luck with the CDOs, so that could mean selling other debt instruments and stocks as well to raise cash to meet outflow obligations. How much do they owe? How much do they have to sell? Who's holding the bag if they can't pay? All good questions, but since the hedge fund industry lies beyond the scope of regulation and disclosure requirements that we money managers adhere to the simple answer is that "Nobody knows, not even Ben". Adding to some banks' woes is the potential liability arising from their role as an insurer of CDOs rated by agencies specializing in sub-prime obligations. Any resulting claims could deliver a nasty blow to their balance sheet and further constrain liquidity in the system.

The bottom line is foreclosures on Main Street could, through the failure of the CDO market, have severe ramifications for Wall Street……..Or Not. This is the height of uncertainty and, as we all know, the stock market hates uncertainty. In our view, this recent market rally is a manifestation of wishful thinking about the Fed cutting rates later this month. From our perspective, cutting the Fed Funds rate is like pushing on a string. It's unlikely to help the already super-leveraged consumer continue spending and does little to increase liquidity in the banking system. That will require further cuts in the Discount Rate. If we see that, it tells us that the problem may be bigger than previously imagined but that the Fed stands ready to provide needed liquidity to bridge the economy past this crisis. Time will tell whether what we don't know will hurt us. Successful investors position themselves to profit from what is probable rather than remotely possible. That would hold true in the current environment. Nothing has happened yet and nothing we speak of here may occur but if it does the stock market could react dramatically. Throughout history and as recently as 2002, stock market reactions to untoward events and surprises have proved to be opportunities for investors with a long-term investment horizon and capital in reserve. We count ourselves among those who stand ready to take advantage of such an opportunity.

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