Martin Bros Monitor

SPECIAL BULLETIN

Paul & Jarrod Martin are Authorised Representatives (259367 & 259249) of ABN AMRO Morgans Ltd.

The Panic Explained

We have decided to break with tradition and produce a Martin Bros Monitor 'Special Bulletin' Issue between production of the usual quarterly update. We take this step to try and explain in ordinary language what has happened, what is happening and why panic and fear have gripped the world (we thank the non sensationalist media coverage for their help!). This is our personal summary only of the events that have unfolded over the past year, and not the view of ABN AMRO Morgans research or strategy.

The sub-prime crisis that set the snowball rolling at the end of last year has certainly turned into an avalanche as it increased its mass and reach to ultimately affect all of us. The problem began when unscrupulous mortgage brokers began pushing loans onto un-creditworthy Americans who in turn pushed up house prices through unprecedented demand. By un-creditworthy we don't just mean a large group of Generation Y individuals who have overstretched on their mobile phone bills, but millions of NINJA's (***No Income and No Job or Assets***). These loans were structured with very little interest in their first three to five year period and then a higher interest rate thereafter. This was prefaced on the fact that by the time the loan rolled over, their house would be worth substantially more and the higher interest cost would be irrelevant.

Although the total number of loans to these people reached new heights, what we subsequently know now is the huge amount of flow on credit products that were created by bundling up these loans and on-selling them to (sometimes) unsuspecting investors. These are the type of products a number of our local councils were unfortunate enough to invest in - CDO's, or Collateralised Debt Obligations that were backed by these poor quality mortgages). This is where you may have heard the term in the media of 'leverage upon leverage'. Each time these loans were 'leveraged' up to offer a higher rate of return to investors, the room for error so to speak decreased. Many of these products were given very high credit ratings by monoline insurers who would 'lend' their high credit rating, for a fee of course. Here lies another problem, but more about this later.

When the first round of mortgages to NINJA's started to roll out of the initial 'honeymoon' term and they were forced to pay higher interest rates, no one could afford it (pretty hard without a job) and hence the supply side of properties exploded. All of a sudden the demand supply pendulum tipped over and house prices started to plummet. That led to defaults and as those defaults mounted, the leveraged sub-prime loan products began to implode.

We are still at the beginning of the whole saga. This initial drama was still very limited to specific parties who either had sub-prime loans, owned a house in America or who had bought into one of the CDO products (local councils, super funds, individuals etc).

As the losses or defaults grew, so did the pressure on the two main monoline insurers in America that had 'lent' their high credit ratings to the plethora of CDO investment products. Attention grew on these companies and the market worked out they had provided their credit rating (insurance) to hundreds of billions of dollars worth of CDO products, but were only capitalised to approximately $30 billion themselves. A minor shortfall in anyone's language.

The snowball continues. As the monoline insurers were now getting themselves into serious trouble, the large rating agency's (eg. Standard & Poor's, Moodys) were forced to reconsider whether these companies should continue to be rated as highly as they were due to their exposure to insuring CDO products. If these companies were downgraded, then the investment products they 'lent' their credit rating to would also have to be downgraded. This would be fine, except that many investors holding these securities (such as councils and super funds) could only hold these investments because of their high credit rating. Downgrade this credit rating and many investors would be forced to sell these investments. This creates a huge amount of supply (sellers) and no buyers (demand). Modern economics built around supply and demand only works when both exist.

Local councils and super funds were not the only ones to hold these CDO's. Many banks worldwide (luckily very few with overall exposure in Australia) also held these securities. These assets were forced back onto banks' balance sheets from the special purpose vehicles they were held in, as they could no longer fund these investments due to a lack of liquidity in this marketplace. Two problems then arose with banks holding these investments on balance sheet. One, ***they were no longer liquid*** (easily sold) and two, ***their value had begun to substantially fall***. This led to banks taking huge writedowns on the value of these assets which in turn affected their capital levels. Once these capital levels reached a minimum level versus their total loan book, banks were forced to raise capital to boost their balance sheet strength and/or sell these illiquid assets so the remaining funds could be invested elsewhere. P.T.O…………...it gets better overleaf………….

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Banks were also joined by insurance companies in holding these CDO investments. Insurance companies hold large portfolios of a predominantly fixed interest nature as a capital reserve to fund claims. AIG (American Insurance Group) was one of these organisations. AIG has subsequently been saved from bankruptcy by the US government—they were just too big and provide too many insurance policies to let fail.

Once some of the first banks began getting into trouble, the ‘sell at all costs’ scenario saw some of these sub-prime related CDO’s trade at levels of approximately 15 cents in the dollar (15% of their original or face value). The snowball continues. This set off a chain reaction throughout the globe as those investors left holding CDO’s were forced to mark to market their investments. This means they were now forced to value these investments at their last traded price, which was now the market price.

As you could imagine, with hundreds of billions of dollars worth of CDO’s in the market place, banks and insurance companies holding these were forced to ‘write off’ the difference between what they paid for these assets and what the market was now saying they were worth. This led to a massive decrease in capital adequacy and many banks and other large corporations were left in a tenuous position to say the least.

And the snowball is still rolling. As banks become increasingly deficient in their capital adequacy, the risk of them going under also increases dramatically. In a bid to try and save themselves they stopped lending money, even to each other. The only party they would lend money to was the US government. During an amazing few weeks of sheer panic and fear we saw US Treasury Bills (short dated US government lending) actually trade into negative territory. That means people were actually ***paying*** the US government for them to take their money and hold onto it! This will go down in history.

This was a dire situation. If all the banks stopped lending to each other and other corporations, for any prolonged length of time, the world economy would stop dead in its tracks. This is what the equity markets around the world were so scared of and what drove markets down over 15%, in the week ending Friday 10th October.

That weekend we saw the governments from around the world come out and save the day. Which is what they were always going to do; they just had to be forced into it by the debt and equity markets. The markets already knew a central solution was needed, they were just waiting for the governments of the world to wake up. And lucky they did, because if they had taken months or even years to get serious about this, we would have had a 1930’s global depression. ***But they did and we won’t.***

Some key debt market indicators such as the LIBOR and TED spread (sorry no room to elaborate here, you’ll have to Google it or call us for an explanation) have gradually been improving over the past two weeks since the historic weekend moves by central governments. This is what we need to continue for equity markets to gradually improve. There is a very good chance that the capitulation of fear was on Friday 10th October as the markets now start to digest events and try to guess the length of the global economic slowdown (recession most likely).

Markets are ultimately driven by fundamentals (economic environment) and will always continue to be. Right now, the Australian market is factoring in company earnings effectively falling off a cliff over the next six months. We just don’t see that happening. Rapidly falling interest rates, likely to levels not seen since after the September 11 terrorist attacks, the $10B stimulus package and tax cuts to come should help avoid this. If company earnings deteriorate by only 5-10% over the next six months (but still substantial), ***our market is very cheap***.

Equity markets are a leading indicator of the economy and the best gains are often made within the first six months after a bear market. The only problem is, you never know when the bear market ended until you are looking back six months later. Miss out on this six months and you will likely miss out on at least two thirds of the recovery.

Yes, this bear market is much worse than most ever thought possible, particularly in Australia with our substantially stronger economy and government firepower (budget surpluses and a starting point of higher interest rates in which to cut to stimulate activity). But cast your mind back to March 2003, equity markets around the world had fallen 20-30% and the world was on the brink of another Gulf war. Pessimism was rampant. Different circumstances but everyone was negative. We still remember going to fund manager presentations and they ***all*** were saying the same thing. The high equity market returns of the late 1990’s are a thing of the past, expect single digit returns for the next ten years. Then we had a four year Bull market. Now, we’re starting to hear the same rhetoric.

But we would rather follow the theory of America’s greatest investor, Warren Buffet, who said last Friday that “the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up”.