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Quarterly Review and Outlook

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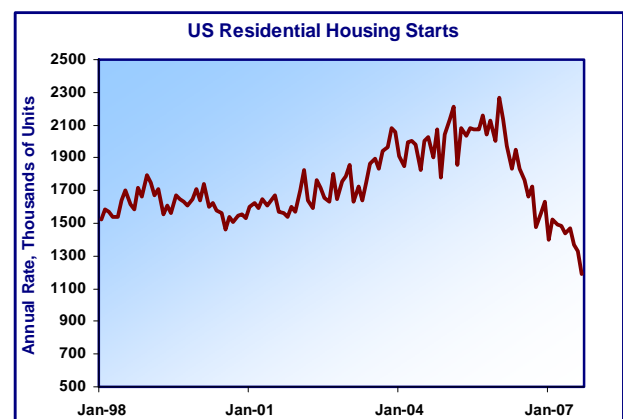
A Blast from the Past

It seems like only yesterday we were taking a crash course in off-balance-sheet financing, “special purpose entities”, and complex risk-management models that were pullulated by the brightest minds and could only falter as the result of a once-in-a-hundred-year cataclysm. When Enron collapsed like a house of cards, millions of individuals were wounded and a whole new regulatory regime emerged under the rubric of Sarbanes-Oxley, aimed at preventing future smashups and promoting “transparency” in financial reporting. By some estimates, the total cost of this additional oversight has reached \$1.4 trillion, not counting the opportunity cost of lost underwriting business with firms that chose to go public in countries with a less burdensome environment. So, in exchange for this tremendous expense and constraint, we must surely have acquired a modicum of security from a repetition of these off-the-books train wrecks, right?

Well, it seems like déjà vu all over again. Only this time it’s not some rogue CEO of a Texas pipeline company, but many of the major financial institutions on Wall Street that proved themselves too clever by half, and the resulting blowback nearly sank the international credit markets and created a liquidity crisis that prompted central banks around the world to lay aside their inflation

fears and dump cash into the system. The impact was truly global and illustrates the interconnectedness of the international capital markets: a butterfly flaps its wings in Los Angeles (well, actually a sub-prime mortgage broker goes belly up) and an institution in London experiences a good old fashioned bank run. Meanwhile, equity markets also caught the bug in late July and early August, with the Dow shedding ten percent from its previous high. In short, volatility returned with a vengeance and investors rediscovered the quaint concept of risk. Fortunately for those trepid investors, Dr. Bernanke administered a steroid injection and stimulated a stock market rally that gave back most of what the credit meltdown had taken away.

Meanwhile, looking forward into the fourth quarter, the indicators are contradictory. But the greater risk seems to be to the



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downside, as the burden of the housing sector bust and the lingering effects of the credit crunch will continue to weigh down the economy for some time yet. By nearly any measure, the residential construction market is sick and not yet improving, and will exert a drag on job creation and GDP growth well into next year; the question is, how big of a drag? Meanwhile, the Federal Reserve's ability to mete out stimulative rate cuts is hampered by the inflationary impetus of record high energy and raw material costs and a flagging dollar. The US stock market rallied 300 points on the news of the Fed's last rate cut, but shouldn't be too sanguine about the likelihood of another one soon.

So how did these Wall Street geniuses manage to gum up the works this time? The particular vehicle which these latter-day Whiz Kids nearly drove off the cliff is a little-understood but ubiquitous credit arrangement known as asset-backed commercial paper (ABCP for you acronym lovers). Traditionally, commercial paper was a type of corporate IOU issued by banks and large corporations to finance short-term working capital needs (less than nine months) but was less costly to issue and maintain than bank lines of credit since it cut out the middleman and was only available to very creditworthy issuers. However, a new breed of CP was developed that issued short-term commercial paper to raise capital, and used the proceeds to buy longer-term debt obligations like car loans, credit card accounts and mortgages, including some sub-prime mortgages, that had a higher expected rate of return than the short-term debt. The issuers profited from the difference in the rates (called "credit arbitrage"). By June of 2007, 54% of all

outstanding commercial paper was this riskier asset-backed variety totaling nearly \$1.2 *trillion*, much of which showed up in money market mutual funds.

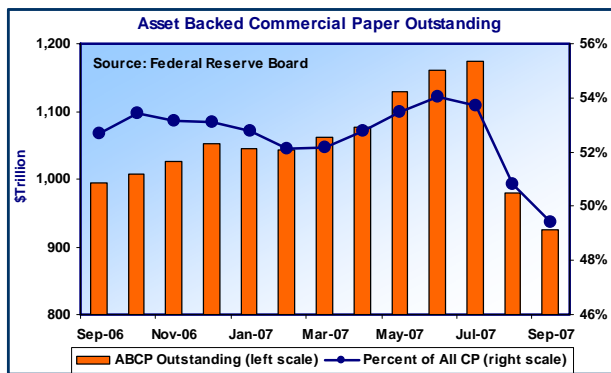
Not only were these instruments highly complicated and abstruse, but many of them were structured so as to be held "off the books" by the financial institutions that spawned them. In an eerie resemblance to Enron's "special purpose entities", the banks placed these ABCP deals in "structured investment vehicles" or SIV's which were then removed from the balance sheets of the issuing institutions. The SIV's generated handsome fees for the bank but did not properly reflect the magnitude of the bank's risk, since they weren't listed as bank assets and liabilities. In an even juicier version, an SIV-like entity called a "conduit" functions much the same way, but allowed the entity to use leverage to gain even more exposure. The largest issuer of SIV and conduit vehicles in the ABCP market was Citigroup, who had a total exposure to \$160 billion in these instruments but made only an oblique reference to the conduits in a footnote to their annual report, and made no mention of the SIV's at all.

Of course, financial engineers are paid generous bonuses as long as the fees keep rolling in, but what happened in August was another example of the "unexpected event" that their models predicted could not happen in a hundred years (we typically get these every 36 to 48 months). When the sub-prime mortgage market seized up, all risky assets including car loans, credit card receivables, corporate bonds and the like were re-priced to reflect the spike in perceived risk. The banks now had no choice but to take large and

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unexpected charges against earnings (multi-billion dollar charges in many cases) to reflect the decline in the collateral held by the SIV's and conduits, even though they had not previously listed the assets on the books. These write-downs obviously came as a rude surprise to shareholders.

The other kick in the head to these venerable institutions was that the short end of the debt supply dried up. As the riskiness of the assets backing these SIV entities became more apparent, institutions suddenly lost their appetite for the short-term paper that funded the vehicles. As the original loans came due, the issuers couldn't find anyone to lend them the money to refinance. Had the situation continued, the issuing banks would have been forced to take the assets back onto the books and incur potentially larger losses, possibly even triggering the freeze-up of the entire global credit market. This in fact nearly occurred, and as a result the outstanding value of ABCP dropped sharply in the two months following. It was



at that point that the Fed stepped in on August 17 with a 50 basis point cut in the discount rate charged to member banks who borrow from the Fed to meet their statutory reserve requirements. They followed with a half point cut in the Fed funds rate on September 18, setting off an ebullient buying spree on Wall Street, and

leading many commentators to opine that the worst of the credit crunch "is clearly behind us".

It is not at all clear, however, that the worst is over. Because of the complexity and lack of transparency of these vehicles, we still do not know the value of assets at risk, but it is likely that more write-downs are likely in the future. Furthermore, the credit rating agencies are presently downgrading asset-backed securities at an *increasing rate*, implying that the scope is not yet known but may well continue to widen in the months ahead. If the Fed begins to sense inflationary pressure and opts to hold interest rates steady at the next meeting, the market is not likely to respond favorably when it has already priced in a rate cut. But even if the Fed does cut, the *real* impact (other than the psychological adrenaline boost) has a 12- to 18-month lag. And the next cloud on the horizon may prove to be a significant decline in earnings growth or even a standstill in earnings for the fourth quarter, causing a revision in investors' price expectations for stocks and perhaps a curtailment of corporate buy-backs that have partially turbocharged returns. So far, at least, the good still outweighs the bad as consumers continue to spend and job growth remains positive if not robust. Nevertheless, it would seem prudent to at least be aware of the risks of a more significant slowdown in the months ahead.

Two predictions, however, are easy: 1) the regulators and legislators will now get busy closing the barn door, and 2) it won't be a hundred years before we see the next hundred-year anomaly.

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