

# ► On Target

Martin Spring's private newsletter on global strategy

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## **Is This Rally a Bull Trap?**

There has been an upsurge of optimism about the credit squeeze and its implications for the world economy since central banks made it clear at their get-together in Rome that they will adopt radical strategies, if necessary, to solve the crisis.

Meaning... throw unlimited money at the problem, relieve irresponsible banks and funds of their dodgy credits, and prevail on governments to spend their way out of trouble. This will happen largely at the expense of the blameless – taxpayers, fixed-income investors, and banks facing unfair competition from state-guaranteed rivals.

Some stock markets are already rallying strongly. Gold and other commodities have seen their prices fall sharply. Even that goliath of the currency world, the euro, is starting to weaken in yen terms.

My friend and great analyst David Fuller speaks about “stunning technical action” on the European and American stock markets that “validates bullish sentiment indicators.” He suggests “the ranging chart patterns that we see look like base formation development prior to upside trending action.” In other words, he thinks the bear phase is probably over, and the bulls will soon be charging again.

Shares of the Swiss banking giant UBS jumped strongly after it announced a stunning \$19 billion write-off in the value of its US mortgage-related investments and a \$15 billion fully-underwritten rights issue to boost its capital. The markets liked the Swiss willingness to face up to the nasty problems and act convincingly to restore financial strength.

But is the end of the credit crisis really in sight?

One of the strongest arguments for believing that investment markets generally are at or near their trough is that advisers are overwhelmingly negative, which in the past has been a great indicator of market bottoms. David Fuller is caustic about those who say it's “different this time.”

I rarely disagree with him, but I have two problems with this argument.

One is that if advisers are so overwhelmingly negative, why are equity valuations still so high relative to what they were at the bottom of previous bear markets, with the majority of analysts continuing to forecast that corporate earnings will grow, rather than contract?

Equity markets are valued well above their long-run averages relative to cyclically adjusted earnings and the replacement cost of their assets. The housing market in the US and some other major economies remain expensive relative to earnings and rents.

Secondly, things really are different this time in the sense that this is the worst broad-based financial crisis in nearly 80 years. This could mean that sentiment gets even worse before the markets hit bottom – relative to the dangers, the pessimists may still not be pessimistic enough.

It just doesn't feel like the end of a bear market. Nor do the fundamentals support that argument.

Notwithstanding the current outburst of optimism, the credit squeeze is getting tighter and has much further to run. It is starting to destroy economic growth, and I fear the worst is yet to come.

The key negative is not lack of confidence in the credit markets – that will slowly be resolved – but the certainty that banks will continue to move towards much more restrictive, low-risk and low-yield lending under the hammer blows of political and regulatory punishment, shareholder and client anger, mammoth write-offs and painful capital and human-resource restructuring.

The crisis had its origins in “sub-prime” – the foolish lending of money for property purchase to Americans who were clearly highest-risk borrowers, as they were without income, employment or personal assets. But sub-prime debt is a tiny part of global debt -- so why are rising defaults by those borrowers having such widespread consequences?

### **Like deliberately spreading a deadly virus**

► Sub-prime and similar high-risk credits were added to investment packages consisting mainly of low-risk assets such as the bonds of semi-government agencies, to enhance their yield. This was like injecting deadly viruses into otherwise-healthy bodies.

Those securities were sold on by banks to long-term investors such as pension funds. More dangerously, they were also sold to hedge funds and other speculators who borrowed cheap money from banks to buy large quantities of these higher-yielding assets.

It's now become clear that supposedly reputable "investment" banks have often borrowed as much as 97 per cent of the money they invested in such assets. It only takes a fall in the value of those assets of more than 3 per cent, for whatever reason, to wipe out the banks' own investment.

► The packaged investments "lack transparency." It's extremely difficult for those who lent money to the speculators to value their assets.

How much sub-prime and similar high-risk credits are contained in those assets? And how can those assets be valued when there are no markets for them? There are no buyers, because buyers are too frightened by the financial risks of "catching a falling knife."

Fear about the safety of sub-prime-related investments has infected confidence in the vastly greater and more important derivatives sector -- the market in risk -- which also seriously lacks transparency.

► Markets have behaved in ways that were quite unexpected. When banks and funds suddenly needed lots of cash to meet an avalanche of exiting lenders, they found they could not dump their lowest-quality assets because there were no buyers. They had to sell off the only assets in which a liquid market remained -- their highest-quality securities.

### **Marking-to-market magnifies the problem**

Regulation has also had totally unexpected consequences. After Enron and similar scandals, regulators and auditors insist that assets such as the above-mentioned packages have to be "marked to market" when accounts are produced.

In markets where values are in any case falling, this puts values under additional pressure to fall. And where markets have dried up, auditors have no choice but to value very conservatively, so huge losses have to be "taken to book," further spreading panic.

Central banks are seeking to contain the global crisis by cutting interest rates, flooding the system with money, and starting to transfer risk from the private sector to the state -- lending to financial institutions against the security of dodgy assets, guaranteeing such securities, and nationalizing banks.

That process has much further to go.

It can be argued fairly, as the policymakers do, that they have no alternative but go to the rescue of the bad boys -- because the global financial system is so integrated that the failure of a major player could trigger seizure of the entire system, with catastrophic consequences.

Central bankers ought to ride to the rescue of responsible players, not the ones who took greater risks and showed the greatest irresponsibility to boost their

corporate profits and executive bonuses (Bear Stearns in the US, Northern Rock in the UK).

Unfortunately, that is not always possible because of “systemic” risk – the danger that the collapse of the most irresponsible major players could have such widespread consequences that it could produce a “financial nuclear winter,” destroying a system that is essential to all modern economies.

I was amazed to see that other financial institutions’ exposure to Bear Stearns – their counter-party in derivatives contracts – was \$10 TRILLION.

Central banks’ panicky measures do address the problems of illiquidity, and in time will succeed, as they can “print” unlimited amounts of their own currencies. But they won’t do much to deal with the problems of insolvency.

**Illiquidity** in the credit markets is about perceptions. It’s when people become reluctant to lend because they fear their loans won’t be repaid.

**Insolvency** is about reality. It’s when borrowings cannot in fact be repaid in full, because values of assets have fallen below those of debts.

Asset values have fallen, and are continuing to fall, for several reasons. The boom in real estate is over. Mortgage borrowers are renegeing on their debts. Owners of fixed-income securities of all kinds are selling them to raise cash and reduce their exposure to financial risk.

“Debt,” says *The Economist*, “is now a four-letter word.”

Governments and central banks, acting together, can solve problems of illiquidity if they are prepared to provide money and/or guarantees without limit to financial institutions – especially the irresponsible ones whose practices have raised the greatest fears they will default. They seem to be preparing to take that route.

But they cannot solve the problems of insolvency unless they are prepared to pay off the debts of borrowers – especially those who have taken on the greatest debts relative to their assets and income-earning potential, through greed or gullibility.

### **Investing now is like catching a falling knife**

Although there is plenty of money available to solve the current crisis – trillions of dollars in pension, insurance and sovereign wealth funds – managers are largely unwilling to use it to buy credits that seem cheap, because they have a nasty feeling they could get even cheaper. “Every time you buy anything, it is worth less the next day,” moaned one fund manager.

The “sovereign welfare funds,” as Christopher Wood, the strategist at investment bank CLSA Asia-Pacific, calls them, have already suffered the painful experience

of buying into major banks because they seemed to offer cheap, once-in-a-lifetime opportunity, only to see billions of dollars of value in their investments evaporate within weeks.

Judging by the latest estimates by financial experts, the credit crisis has a lot further to run. One study suggests that write-offs of bad debts in the US alone could reach \$600 billion and knock-on effects \$900 billion – enough to cut 1 to 1½ percentage points off economic growth.

And that's without taking into account the wider effects of falling house prices. Increasingly, borrowers who owe more than their homes are worth are just walking away from their debts. They call it “jingle mail” – the borrower posts the keys to the lender.

Eventually as many as 20 million American families could fall into “negative equity” – having mortgage liabilities greater than the value of their houses.

Nevertheless, it seems likely to me and some other analysts that the current bounce in the stock and credit markets and loss of upward momentum in commodities could be the start of something important. Not of new bull markets, but of a major rally in ongoing bear markets.

In other words, a bull trap.

### **Cheaper gold, Asian stocks and other goodies**

The rally should provide an opportunity to sell more dollars and other unattractive assets you're still holding, at better prices, and to buy more of the ones that remain in long-term bull trends, such as precious metals and other commodities.

*The Wall Street Journal* rightly suggested recently: “The stock market may rally, until it once again decides that easier money can't remedy what is fundamentally a problem of bank solvency.

“That problem can only be resolved by financial institutions and regulators coming to grips with the losses, raising more capital to cushion the blow, and closing or selling those banks that can never recover.”

The most important reason why the crisis is likely to worsen is continuing uncertainty.

Lenders can't value their assets because credit markets are paralyzed, or seriously distorted by temporary factors. Nor can they confidently value banks, funds or financial companies to which they would normally lend because they cannot gauge with accuracy whether they are still solvent.

Investors no longer believe what officials say, because they know the latter all have a major vested interest in promoting optimism.

It is going to take several years to sort out this mess – restore markets to their normal efficiency, establish realistic valuations, write off losses, shut down the insolvent, and recapitalize banks.

The magnitude of the problem is frightening because regulators and governments were asleep at the wheel, allowing the financial services industry to take sound concepts of securitization and gearing to dangerous extremes.

“The sheer scale of leverage in the system... remains the fundamental problem,” says Christopher Wood.

Funds-of-funds resorted to leverage (use of borrowed money to finance asset purchase) “to juice up... otherwise mundane investment returns.” Increasingly they invested in leveraged hedge funds, which in turn borrowed money from highly-leveraged investment banks.

One of my favourite commentators, Gillian Tett, says banking “has become so complex and opaque in recent years, as a result of financial innovation, that when shocks occur in one obscure corner of finance, this creates all manner of unexpected chain reactions.”

One example would be how the crisis in dodgy credits hit the value of the soundest ones, because the latter were the easiest to sell if you needed to raise cash in a hurry.

Mike Lenhoff, the chief strategist at Brewin Dolphin, suggests that the Fed may become a buyer of long-term government bonds. Adding to demand for them in this way would have the effect of holding down mortgage rates linked to bond interest rates, which “might help to steady the housing market.”

Incidentally it would also be politically more acceptable as it would help all borrowers, not just those with the most strained finances.

### **Foreign investors say: You’re responsible**

Another commentator, John Dizard, suggests that government-sponsored entities such as Fannie Mae and Freddie Mac are likely to be nationalized. They won’t be able to raise enough private-sector capital to keep them afloat, while foreign central banks who have invested heavily in their bonds “have made it clear to the US government that it will be held responsible” – it has no such legal responsibility, but in practical terms it has no choice.

Fed chairman Ben Bernanke recently publicly urged mortgage lenders to write off part of the capital – not just outstanding interest -- of troubled mortgage loans.

Wood says he “cannot imagine a better way to encourage borrowers to default, and therefore further undermine the solvency of the banking system.”

The political consequences of governments being seen ready to commit billions of taxpayers’ money to rescue banks, so recently icons of profligate executive compensation, rather than the victims of their greedy behaviour (sub-prime borrowers, pension funds), are also going to be far-reaching and unpleasant.

Taxes or state borrowing are going to have to be increased to meet the huge costs of going to the rescue of the financial system. The burden of bureaucracy on the private sector is going to burgeon, adding to costs and reducing growth.

The inevitable trend towards tighter regulation of the financial system coincides with growing acceptance of the need to impose restraints on a wide range of activity to combat global warming. And a rising tide of hostility to globalization, putting the blame for job losses and other economic problems on foreigners (the two Democrat presidential contenders in the US are showing the way).

There is now “a strong intellectual tide running against free markets and in favour of increased state action,” warns the British commentator Roger Bootle.

Where to invest now?

If there is a major rally over the next few months in the dollar and equity markets generally, hitting the prices of assets that have performed so strongly in recent months such as precious and base metals, agricultural commodities and the euro, that should provide an opportunity to buy into such assets, as they still look good for the long haul.

It will also give an opportunity to buy the equities, bonds and currencies of emerging Asian economies. They have strong manufacturing industries, well-capitalized domestic banking systems, and the huge forex reserves and savings ratios that give them the resources to offset troubles in export markets by stimulating domestic demand – building infrastructure and encouraging consumer spending.

### **Future gains in low-risk growth assets**

Some of these countries have seen their stock markets hit even harder than those of developed economies. But that reflects a tendency for frightened international investors to bring back home the capital they invested in less-familiar foreign countries, and for domestic investors to go liquid as a reaction to global uncertainties.

I am confident that when it becomes clear that global financial markets are stabilizing, it will also become clear that many emerging economies are fundamentally sounder. They will bounce back much more strongly than those of developed economies with fundamentally inferior growth prospects.

The balance of advantage should then swing away from low-risk assets such as gold and major-nation government bonds towards low-risk growth assets such as well-managed multinationals that have strong brands or abundant natural resources, leading-edge technology development, strong cash flows, low debt and exposure to high-growth emerging economies.

They will be little hurt by the credit crisis and will benefit from a flight to quality as owners of large amounts of capital, such as sovereign wealth, pension and insurance funds, seek to increase their holdings of low-risk assets offering long-term growth.

## **An Independent View on Asia**

One important reason why Asian nations are so successful economically is because they have strong governments, argues my friend Barry Fletcher, the international tax adviser.

"Whether it is Singapore, where I am a resident, or Vietnam, with its changing policies and economics, or Hong Kong, even under PRC rule, or Taiwan, all these governments are strong," he says. "They decide on what to do and do not brook interference."

They "devise tax schemes which are deplored by the EU and the OECD, whose tax systems are designed for slow-growing, inefficient economies that depend on unfair and ridiculously high tax revenues for progress and welfare."

The high growth rates of Asian economies is driven by:

- ▶ A continuous inflow of foreign direct investment, bringing with it the expertise of the most inventive economies and companies;
- ▶ Every conceivable incentive, no matter what the cost;
- ▶ Few labour laws;
- ▶ Highly productive labour forces, which are supplemented by imported workers;
- ▶ Low or even no taxes for expats and their companies.

Tax is "one of the most productive tools -- no tax on foreign incomes and capital, no capital gains taxes, no estate taxes in most cases, low rates of sales or value-added tax, large tax holidays, few or no withholding taxes. Tax rates are very low, such as 20 per cent, with effective rates lower than that."

Barry says huge amounts of capital have been moved into Singapore from Switzerland, and in the form of injections by the Asian rich.

"When the OECD tried to impose secrecy and information-exchange laws, and countries like Switzerland had to impose withholding taxes to escape this, Singapore and Hong Kong refused - and are enjoying the benefits."

Barry shares my view that "the next great growth explosion awaiting the world" is going to be Vietnam.

"Like the Chinese, Vietnamese are among the hardest working people." He points to the experience of the US, where young Vietnamese "with no background except hardship under Communism and war, filled top positions in schools and universities, and are very successful in business."

Foreign companies are now pouring billions of dollars into Vietnam. Banks and other financial institutions are setting up. The government is relaxing restrictions and there is now, in practice, free flow of capital.

## Tailpieces

**Families in trouble:** American consumers face recession with "a conspicuous lack of financial insulation," the *Financial Times* reports.

The boom years, now over, were good ones for owners of assets, especially residential property, because of capital gains. But income earners didn't do very well because competition from abroad kept a lid on pay increases.

"As wages have stagnated, and the cost of staples such as fuel, food and healthcare have risen, so many households have run down savings and cashed in on inflated assets, primarily homes... to keep increasing consumption."

Now it's all going wrong. Jobs are disappearing, rising prices are eroding purchasing power and capital gains have evaporated. Consumers face having to spend less, reduce personal debt and rebuild their savings.

The key element in global wealth creation in recent years – American consumers, accounting for 70 per cent of demand in the world's largest economy – is rapidly losing traction.

**It's not about trade, it's about policies:** With job losses from international trade competition a populist issue that both the Democrat presidential candidates have been seeking to exploit, it's interesting to see that although the state of Ohio lost 10,000 positions over the last ten years, Texas created 1.6 million new jobs.

Local policies, it seems, are much more important than those nasty foreign competitors. Ohio has one of the worst ratings for friendliness to business in the US, with high taxes and a suffocating grip by organized labour – workers can be

forced to join unions. Texas is a “right to work” state that continues to attract multinationals to build plants there and create employment.

**Desert drought:** Saudi Arabia has cancelled all its subsidies to domestic food production because of a developing water shortage. Supply from aquifers and other non-renewable sources has fallen over the past ten years from 35 billion cubic metres to 15 billion. Having achieved self-sufficiency in food production, the country is now looking to move to importation of all its food needs in eight years’ time.

**Northern Wreck:** No wonder Britain’s Labour government committed mega-billions of taxpayers’ money to rescue the Northern Rock bank, whose work force, borrowers and individual investors are concentrated in the party’s Northeast England heartland. Apparently most of the employees belong to the trade union Unite, which just happens to be the largest corporate donor to the Labour Party.

**Firearm fallacies:** I see the right to own guns has re-emerged as an issue in the run-up to the presidential election in America, where burglars tend to avoid breaking into occupied homes for fear of being shot. Only 13 per cent of burglaries take place while the victims are at home, compared to 59 per cent in the UK.

It may seem a sensible idea to restrict gun ownership by individuals to reduce violent crime, but that’s another of the politically correct fallacies. Switzerland, where most homes house automatic weapons (army reservists keep their guns at home), has hardly any nasty shooting incidents. But in the UK, where hand-guns are totally banned – even shottists have to practise in other countries – crimes where guns are used is the fastest-growing category.

**Double Dutch:** It’s interesting to see, in a world where individuals are increasingly oppressed by bureaucrats and politicians seeking to impose their own beliefs on others’ personal behaviour, to see where they draw the lines between what’s permissible, and what isn’t.

In Amsterdam the local council plans to fine dog owners who let their pets off the lead in the Vondelpark rose garden – but permits gay sex in public, providing coupling only takes place in the evening or at night, and used condoms are cleared away.

The same city, having joined in the global hysteria, has banned smoking in places of entertainment. Smoking tobacco, that is. They’ve decided to exempt from the ban cafes where the patrons are allowed to puff away on marijuana.

**UK dottiness diary:** The Scottish Executive has spent the equivalent of \$5 million on teaching people to wash their hands, including the employment of 14 Hand Washing Co-ordinators, each costing about \$100,000 a year.

Corby, which has a high unemployment rate following the closure of its steel works, has lost 80 public-sector jobs because its population is regarded as “too white and British.” The jobs, in the Prison Service, were moved to Leicester to “attract a more diverse workforce” – that is, from ethnic minorities.

When a motorist objected to being fined by a local council for not having a parking ticket, its traffic warden insisted he had checked all the windows of the vehicle, and looked inside, but did not see a valid ticket. The local authority persisted with seeking to enforce its penalty. Until the case was dismissed on appeal – as it had to be, as the offending vehicle was a motorbike.

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