

Storm front

The global financial storm rumbled on through the second quarter, battering away at the assets of global financial institutions, forcing some to board up their windows and go home and others to knock on the US Federal Reserve Board's door, alms bowl in hand.

Ever since investment banker Bear Stearns Cos. Inc. managed to fob off its worst debt on the US taxpayer via the US Federal Reserve Board (the Fed), the word has gone out that there's a new junk buyer on the block – one with no discrimination and the deepest pockets in the world. All you need for a handout is some political pull, and a scary story about global financial collapse.

And, indeed, during the second quarter, pressures on the US and global financial system increased markedly as investor confidence in banks and bankers around the world evaporated.

During the second quarter, those financial sector woes manifested once again very publicly in the form of a projected US\$2.8 billion quarterly loss at Lehman Brothers Holdings. In the first three months of the year, Carlyle Capital Corp. and Bear Stearns Cos. were only the first of what would turn out to be a string of big-time bank problems surfacing in the second three months.

Turns out Lehman Brothers was next in line for a beating, as word of its losses came with a hope that it would have to raise billions of dollars in new capital. This particular crisis isn't over yet, as another wave of bad loans washes over the sector's already badly leaking boats. Global giants like UBS AG are increasingly vulnerable, as it expects further writedowns on its mortgage-based securities gone bad.

But instead of going into a tailspin they way they did in the spring, stock markets have been simply eroding away bit by bit, descending gradually into a bear market state. And the reason for that is the absence of the kind of mind-numbing fear that surrounded the Bear Stearns debacle. You see, investors now have their radar screen the possibility that the US Federal Reserve Board will be the buyer of last resort for that questionable debt that nobody seems to want.

Check the new disclosure rules proposed by the US Securities and Exchange Commission (SEC). They were designed to provide more disclosure on the metrics used by Credit Rating Agencies (CRAs), such as Moody's, Fitch, Standard & Poor's, and Dominion Bond Rating Service, which issue ratings on corporate debt. The idea is to provide more disclosure about what goes into those various degrees of ratings.

The logic behind these new disclosure rules is subtle and, on the surface, seem to be designed to provide investors with greater clarity. But beneath the surface, it may have more to do with posturing than with clarity.

Consider that the SEC issued new rules for CRA disclosure less than a year ago. The new rules set out just a couple of weeks ago were introduced without giving much time for the initial set of rule changes to be absorbed, let alone to know if the previous changes had the desired effect. Beyond more paperwork and questionable beneficial disclosure from CRAs, what is the point?

The point may be another step forward in setting the stage for the Fed to become the buyer of last resort for the worthless paper currently in circulation.

The Fed has been busy swapping high-quality Treasury securities for “high quality” mortgage-backed debt. In that sense, it has been becoming the lender of last resort to a financial industry in dire straits.

Becoming the buyer of last resort means that the Fed (read the US taxpayer) absorbs the “high quality” mortgage debt and removes it from the books of financial institutions. As you can imagine, there is an enormous moral hazard if the Fed takes this step. Essentially the Fed is saying that it (the US taxpayer) will be there with a pot of gold at the end of every speculative rainbow that the financial industry may design.

That will not sit well with US taxpayers. Certainly it won't past muster if the Fed does not lay an attractive enough foundation before taking this step. And the only way the Fed can do that is if authorities take appropriate steps beforehand allowing them to state with reasonable certainty that such a situation will not happen again.

US Treasury Secretary Paulson took some of the initial steps when he talked about giving the Fed more authority to regulate US chartered banks and US investment banks, moves that will take eight to nine years to implement – just long enough for a new two-term President to come and go.

The new SEC disclosure rules may simply be another bit of political icing on a very toxic cake, presentation being everything.

If you doubt the logic of this, take note of comments made to the Senate banking committee by Fed vice-chairman Donald Kohn. He suggested, without naming any names, that the Fed would stand ready to implement another bailout if necessary to protect the financial system. He could have been talking about Lehman. More than likely, however, he was referring to Fannie Mae and Freddie Mac.

If you've ever wondered what a real financial crisis feels like, you can stop wondering. We're in the middle of one now, a big one.

The fear factor ramped up considerably towards the end of June and into the beginning of July, as a wave of selling hit shares of Fannie Mae and Freddie Mac, the two largest mortgage providers in the US,

with a combined total of US\$5 trillion in liabilities, including mortgage and other debt. The hybrid, government-linked companies felt the chill of investor anxiety concerning their exposure to declining housing prices and rising mortgage defaults.

Worried about the companies' ability to raise new capital, investors sold Fannie Mae down to a market capitalization amounting to only one third of its reported first-quarter capital cushion of US\$42.7 billion, according to an editorial in *The Wall Street Journal*. Freddie Mac fared even worse, with market cap falling to US\$6.8 billion, compared with first-quarter reported capital of \$38.3 billion. Clearly, investors are heading for the exit doors concerned that existing capital won't be enough to keep the companies solvent in the face of relentless pressure from the imploding housing/mortgage market.

Not to put too fine a point on it, this is bad news.

If the US Federal Reserve Board felt that Bear Stearns Cos. – quintessentially a private, nongovernment financial institution – needed a dramatic bailout by the US taxpayer, we wonder by what stretch of the imagination the same criteria would *not* apply to Fannie and Freddie, originally creations of the federal government and still symbiotically linked to the government. Like Canada's own Crown corporations, these entities are part pork barrel and part functioning business entity, and almost entirely moral hazard.

If the rationale for guaranteeing Bear Stearns worst debt was that the company was too "interconnected" with the global financial system to be allowed to fail, then that goes the same for Fannie and Freddie, compounded at least by a power of 10.

Although Treasury Secretary Henry Paulsen and other members of the administration have previously stated repeatedly that the government will not back the debt of the two mortgage giants, the US government has been busy for months making contingency plans for just this crisis, further solidifying the belief that they are indeed "too large to fail."

Sure enough, The US federal government acted by the script, and by the middle of July had taken steps to ensure that US Treasury lines of credit for the two companies would be extended and that the Treasury would be authorized to buy shares of the companies to "ensure they have sufficient capital to serve their mission" – the nature of which is to provide funds for home mortgages. Never bet against a sure thing.

Meanwhile, shares of the fourth-largest investment bank in the US, Lehman Brothers Holdings Inc., plummeted to new in the second quarter, as more investors abandoned the rapidly sinking financial ship. Rumors began circulating that some large clients were scaling back business with Lehman. Although these were denied by several of those large clients, including PIMCO, the damage was done, and Lehman shares plunged, down about 74% year to date.

Given the political capital that is about to be expended on Fannie and Freddie, it's becoming increasingly likely that Lehman will be too late to the window, and unless a white knight buyer is found, might in fact be allowed to fail. Think it can't happen? California-based IndyMac Bank, a deposit-taking institution with over US\$32 billion in assets, was seized by the US federal government in July, as nervous depositors withdrew their money on rumors of IndyMac's solvency – shades of last September's run on Northern Rock Plc, the UK bank that was subsequently nationalized by the British government in February.

The credit crisis isn't contained to the US either. A recent report by Genuity Capital Markets estimated that third-quarter writedowns at Royal Bank of Canada related to exposure to the US subprime mortgage market could amount to as much as \$1.5 billion. CIBC has already taken \$6.7 billion in credit-related charges since last summer, with the potential for another \$1.5 billion to come.

Still, compared with the wreckage south of the border, Canadian financial institutions look like bastions of fiscal probity and financial strength. While US institutions teeter on the edge of the abyss as the Fed shovels buckets of million-dollar bills at them, the Bank of Canada said it is *closing* its emergency fund that was set up to shore up the banking sector. This little tidbit of news was not widely reported, but it is extremely significant. It means the Bank of Canada believes that the Canadian banks have now taken their lumps and remain financially sound.

If a bailout of Lehman becomes necessary to “protect the integrity of the financial system,” it will likely set the wheels in motion for the Fed to becoming both the *de facto* and *de jure* buyer of last resort. The distance from bailout to buyer of last resort is a very short one. And the transformation from moral hazard to entitlement is usually imperceptible.

A tenet of the so-called classical Austrian school of economic theory is often boiled down to the slogan, “There ain't no such thing as a free lunch.” In other words, somewhere, somehow the piper (or cook) must always be paid – by someone.

And this is where inflation comes in.

The tidal wave of liquidity sloshing around the world has triggered a round of rising commodity price inflation that we haven't seen for a long time.

Everywhere you look, it seems inflation is making the headlines these days. From emerging nations like Vietnam, where inflation in May is raging at a 25% annualized rate, and China, where prices are rising at an annual pace exceeding 8%, to Europe, where eurozone inflation surged to a record 4.0% annualized in June, and the US, where inflation was running at an annualized rate of 5% in June.

Most observers point to rising energy and food prices as the culprits behind the global resurgence in inflation rates. (The old debate goes on, of course, between the Keynesians and Monetarists, about whether rising commodity prices are a cause or an effect of inflation. Monetarists would echo the late Milton Friedman's argument that inflation is always and everywhere a monetary phenomenon.)

Regardless, because the price of energy is an essential input component of just about everything else, prolonged, steep price increases in oil eventually seep into every cog and wheel of the modern global

economic engine, from raw material extraction, to manufacturing, to processing and transportation, and finally into wages and the services sector. Canadian services prices, for example, are advancing at 3.3% year over year, even though “core” inflation posted only a 1.5% 12-month change in April.

Some economists are now arguing that so-called “core” inflation is no longer a valid metric for gauging price stability. Core inflation calculations typically strip out food and energy prices, because these have in the past been volatile, leading to short-term distortions in measuring the rate of price increases. But because energy and food prices have lost their volatility and are simply climbing steadily, the argument goes that core measures now ought to be abandoned altogether. This, of course, has significant implications for investors, because until now central banks have used core inflation rates as a key factor in determining the level of their administered, “official” interest rate levels.

And in fact, it appears that central bankers are becoming more inclined to take this viewpoint. The US Federal Reserve has “paused” in its emergency campaign of rate cuts to alleviate the subprime mortgage-induced credit crunch that nearly brought the global financial system to a screeching halt.

The Bank of Canada followed suit, holding rates steady in June instead of implementing another cut, as it had been widely expected to do. You can be sure that the BoC, the Fed, the European Central Bank, the Bank of England, Bank of Japan, and others around the world are keeping an eye on inflation across the board. Any signal that inflation is settling in for a secular increase is likely to be countered with some pretty aggressive tightening of monetary policy going into 2009.

Portfolio and market outlook

Credit crises unfold in slow motion. That’s because it takes time for the effects of interest rate movements, broad loan defaults, and tightening credit conditions to work through the economy. Let’s not forget that the consequences of the crisis in the US subprime mortgage sector didn’t become visible until a year ago. The troubles had been building up for at least a year before that. And it has been grinding on ever since, like a really heavy, slow-moving freight train that takes miles to stop. If you’re stuck on the tracks, you can see it coming, but there’s absolutely nothing you can do about it.

The US housing market continues to sag in what has turned into a vicious cycle. Shrinking home equity and rising inflation have clamped down hard on consumer spending (“pinched” is how the Fed delicately puts it), which in turn shrinks activity in the manufacturing and retail sectors, which results in higher unemployment, which reduces housing sales, which lowers prices, which shrinks home equity. Compounding the problem is that troubles in the mortgage market inevitably spread to other types of credit, including commercial lending and revolving personal credit like credit cards.

To mitigate the risk of eroding its own balance sheet, the Fed will most likely allow more banks and lending institutions to fail in coming months instead of backstopping everything in sight, but in some sort of “orderly” fashion. Fannie and Freddie, the world’s biggest mortgage lenders, will more or less be nationalized. And the economy will slow down even more. This is likely to grind on through the second half of the year, possibly extending into 2009 before the train finally stops. The Fed has already revised its estimate for 2008 GDP growth down to 1% – it could come in even lower than that.

Deteriorating confidence, of course, eventually translates to massive global stock price drops as international financing dries up and earnings estimates are ferociously recalculated downwards. M&A and IPO business mostly will dry up until financial sector credit confidence sorted out.

The rate of inflation, meanwhile, will continue to increase stubbornly as the tidal wave of central bank-created liquidity over the past couple of years has its inexorable effect on general price levels. This has manifested, for example, in booming Asian economies using vast trade surpluses to bid up oil prices. So far, commodity prices have ballooned in what can be regarded as a financial bubble. At some point, though, supply and demand have to come into balance, and that's when the bubble pops.

All in all, we expect to see a great deal more economic instability in the next two quarters, which translates into a great deal more downside risk in both equity and debt markets.

We currently remain overweight in Canadian equity, with US exposure through US Treasury bonds. Our largest US weighting in our pools is still long-term US government bonds, although we also hold approximately 20% in cash as Government of Canada Treasury bills, none of which are leveraged.

With cash in our arsenal, we seek to invest opportunistically in distressed debt, but haven't found suitable opportunities at this point.

We continue to write options against US T-bonds as part of our strategy and remain satisfied with our positive 4% return on bonds, compared with the prevailing negative returns on the US equity market. We remain in a net long position in US equities, but underweighted compared with the benchmark.

Writing options against our equity holdings continues to provide a measure of downside protection as well as an income stream.

Volatility and downside risk continue to be the watchwords for this phase of the market downturn. The combination of short positions (hedged with options), writing options on long positions, and a conservative fixed-income weighting means that we are in the enviable position of accumulating capital despite a global financial storm accompanied by a volatile, heavily sentiment-driven market environment that is likely to prevail for the rest of the year. ■