When Markets Top Out Bad News Are Ignored!

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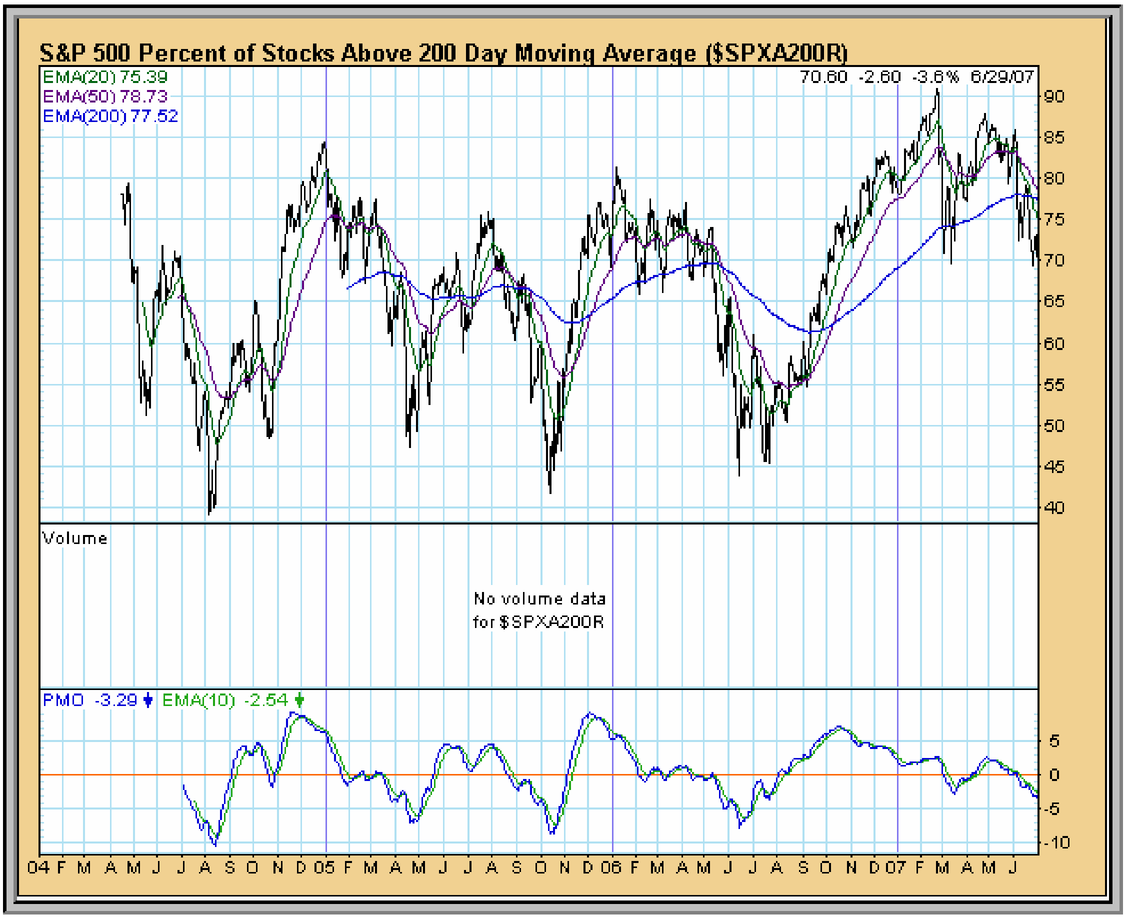
Given the likely scale of the problems in the collateralized debt obligation (CDO) market, the US stock market has held up well. In March, we mentioned that the problems in the sub-prime lending industry would likely spread to brokerage companies and other financial institutions (see Figure 1)

Brokerage Stocks: The Canary in the Coal Mine

Source: www.decisionpoint.com

As can be seen from Figure 1, although the US stock market made new highs in June, brokerage stocks (with the exception of Goldman Sachs) were unable to better their January/February 2007 peak. Technically this is a negative sign for the entire stock market. Why? Because a very large chunk (about 45% of S&P 500 earnings) are financial earnings derived from financial intermediaries directly (market capitalization of financials is approximately 23% of the S&P 500) and financial profits from treasury and consumer lending operations of large industrial giants (GMAC, Ford Motor Credit, GE Capital etc). It is probably fair to say that every multinational corporation has a hedge fund similar treasury department, whose objective it is to minimize borrowing costs and maximize the return on the treasury's cash holdings. It is, therefore, no surprise that the stock market has begun to have second thoughts about future corporate profits (see Figure 2).

Figure 2: Percent of S&P 500 Shares Trading above 200 Day Moving Average

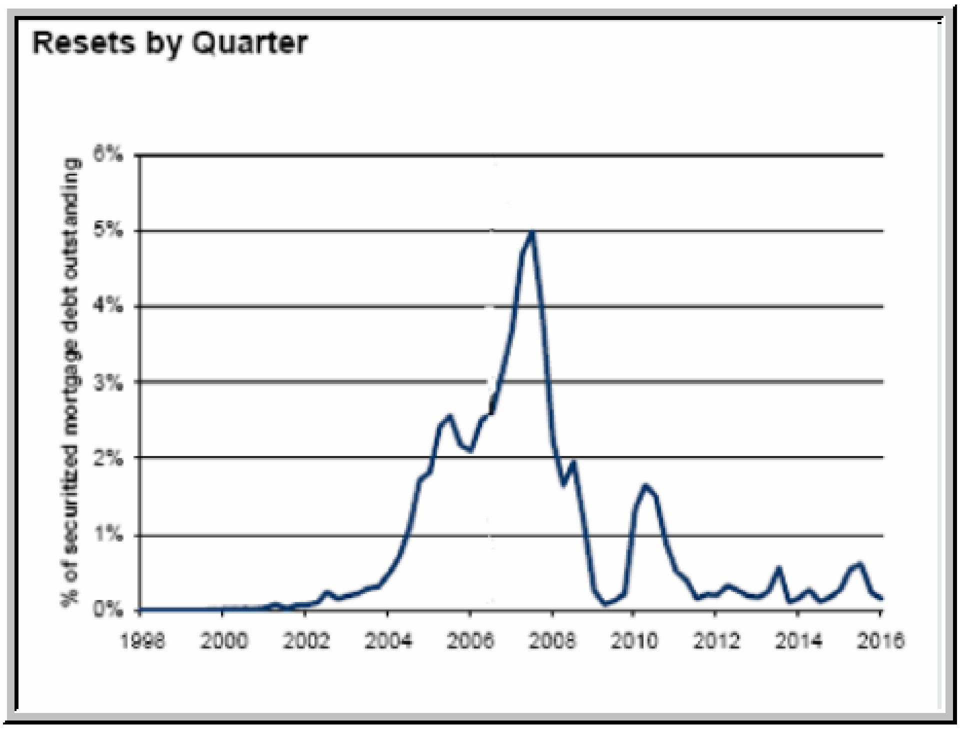


Source: www.decisionpoint.com

A few points: Although the US stock market became oversold at the end of June in the very short-term, the market is certainly not oversold from an intermediate point of view and is still grossly over-bought from a longer term perspective. An oversold condition would be reached if only 45% of stocks would trade above the 200 Day Moving Average (MA). A truly oversold condition would be reached if only 10% to 20% of shares would trade above the 200 Day MA.

The CDO market problems are likely to worsen for quite some time. First of all we are moving into the peak season for Adjustable Rate Mortgages (ARM) resets, the use of which Mr. Greenspan actually recommended in 2003 and 2004 right at the bottom of the interest rate cycle (see Figure 3).

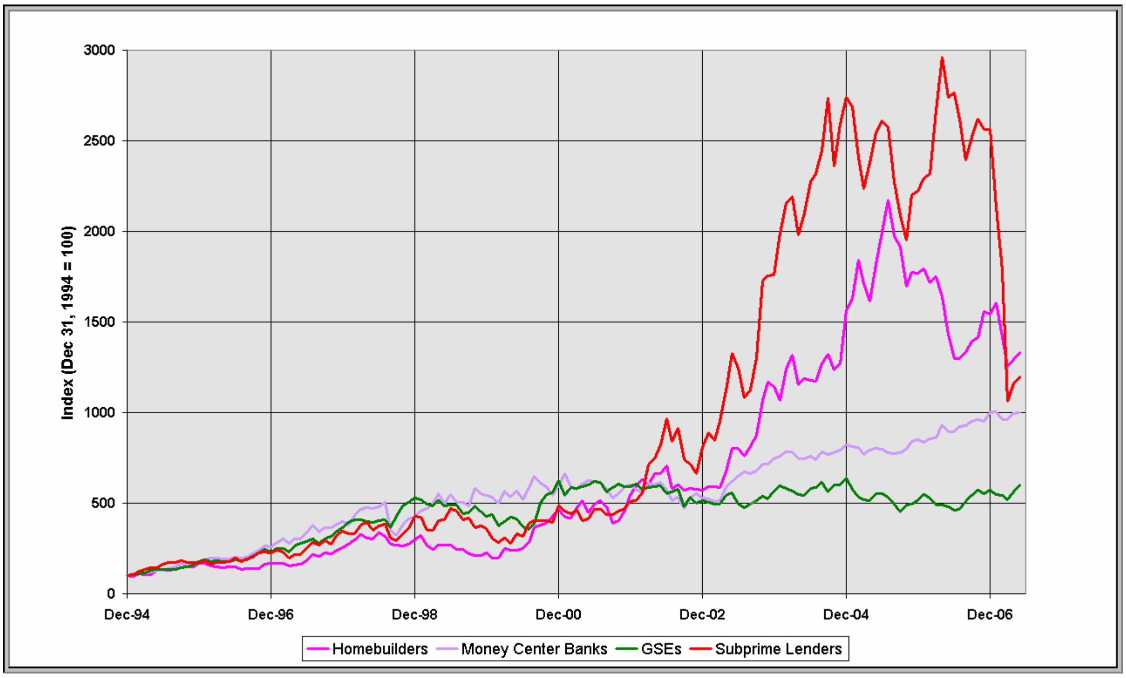
Figure 3: Adjustable Rate Mortgage Resets, 1998 – 2016



Source: Gerard Minack, Morgan Stanley

Since a large number of ARMs will be reset over the next 18 months at a time when the housing market continues to deteriorate and lending standards are tightened, defaults are likely to increase much further! But now listen to this. After Mr. Greenspan applauded the sub-prime lending industry for allowing also poor US households to purchase a home in 2003 and 2004, last week US banking regulators told mortgage lenders to toughen standards for sub-prime home loans. But look at Figure 4 which shows the performance of sub-prime lenders' stocks (red line).

Figure 4: Bearing Credit Bubble Index (Index December 1994 = 100)



Source: Bill Laggner, Bearing Asset Management (laggner@bearingasset.com)

So, after the collapse of the industry (more than 40 sub-prime lenders have already closed down) the regulators woke up and belatedly asked mortgage lenders to tighten standards for sub-prime loans! According to Bloomberg, Fed Governor Randall Krozner said in an email statement at the end of June that regulators expect ``lenders to make sure sub-prime borrowers not only can afford their monthly payments while the introductory rate is in effect, but also after the interest rate resets…..It is the right thing to do for the borrowers' sake."

My regular readers will know by now that I do not have a high regard for the Fed (or for that matter most central bankers) but when I see this happening I really have to shake my head in disbelief. How could the Fed encourage reckless lending and borrowing with its artificially low interest rates policy and with its statements for years? But not only that! The regulators also totally failed to supervise the sub-prime lending industry. But now, following the collapse of sub-prime lenders, the regulators request financial institutions to "toughen" lending standards……

It should also be understood that the request by regulators to toughen lending standards was unnecessary. Why? Because the market has already tightened lending standards by pushing up credit spreads (see Figure 5 and Figure 6).

Figure 5: Sub-prime Lending Spreads

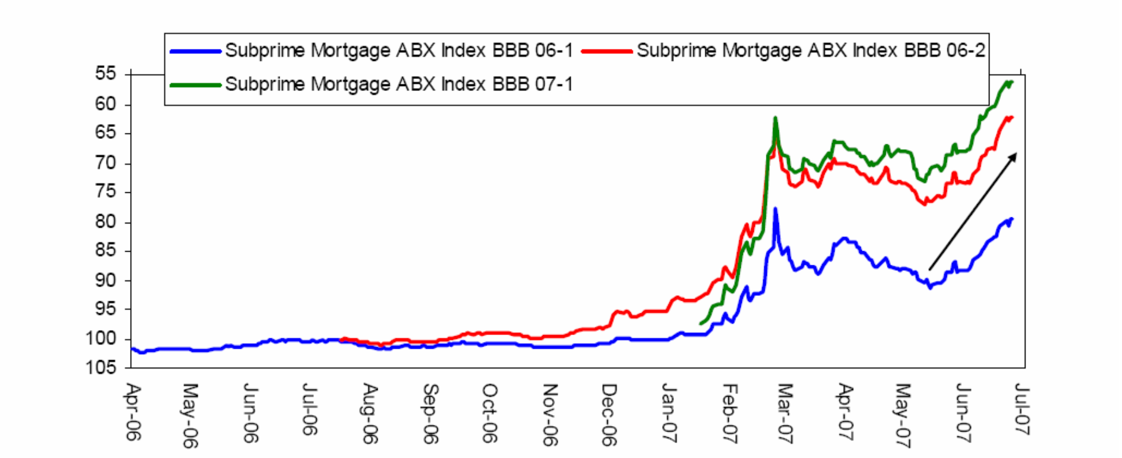
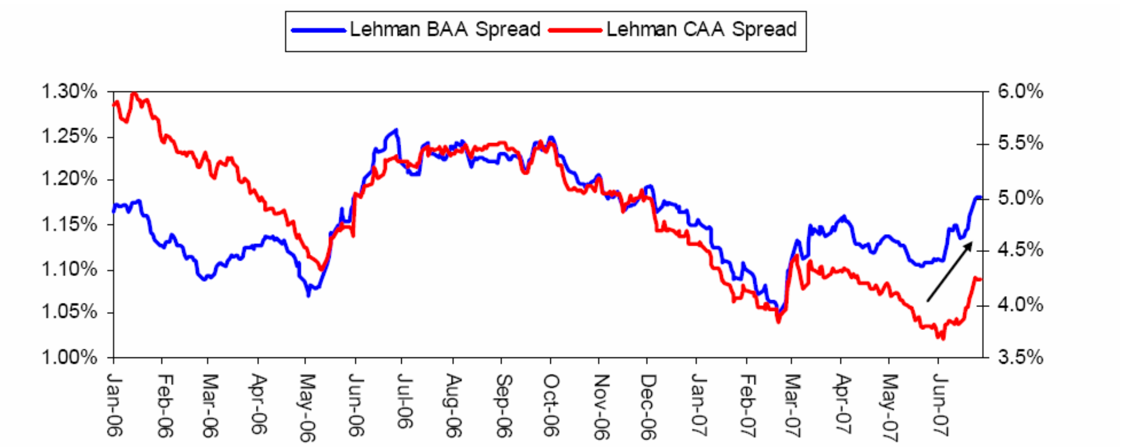


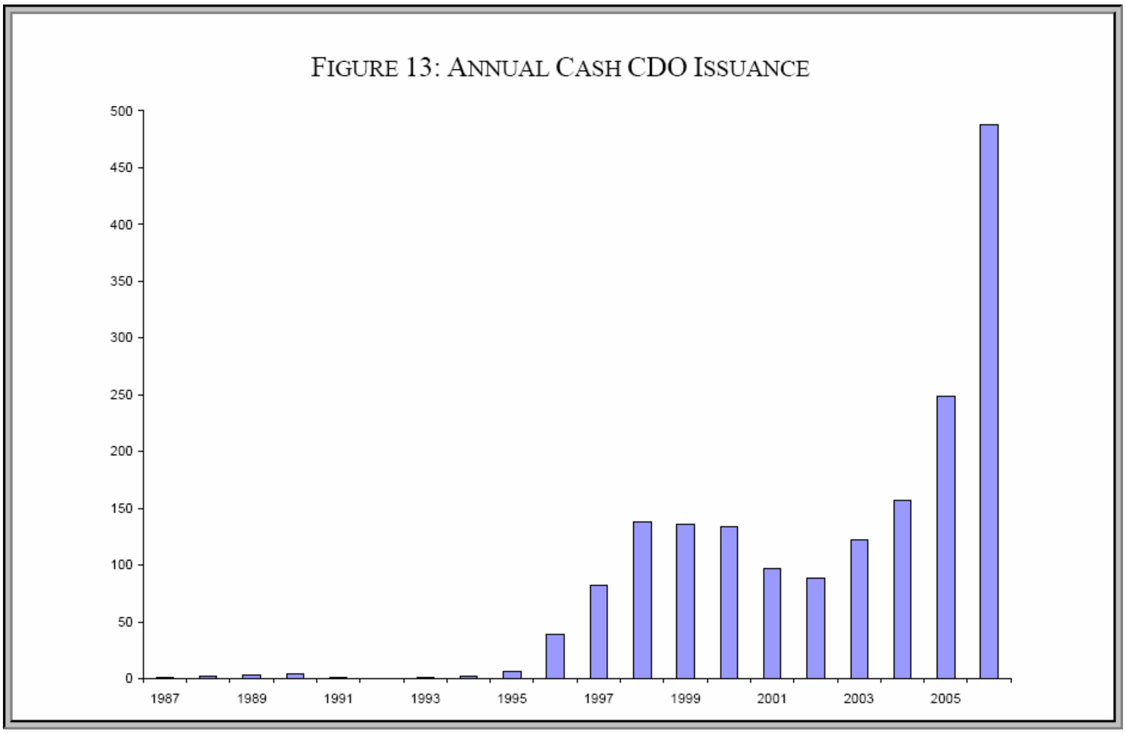
Figure 6: Credit Spreads are Widening



Source: Bridgewater Associates

How big is the sub-prime lending industry? Tough to tell, but a reasonable estimate would be around $2 trillion – therefore it is a large enough debt sector to infect other sectors of the credit universe. One sector which has already been hit hard is the collateralized debt obligation (CDO) market. According to the BIS, sub-prime mortgages made up more than half of the $503 billion in collateralized debt obligations sold in 2006, but another $524 billion in "synthetic" CDOs were also issued (see Figure 7).

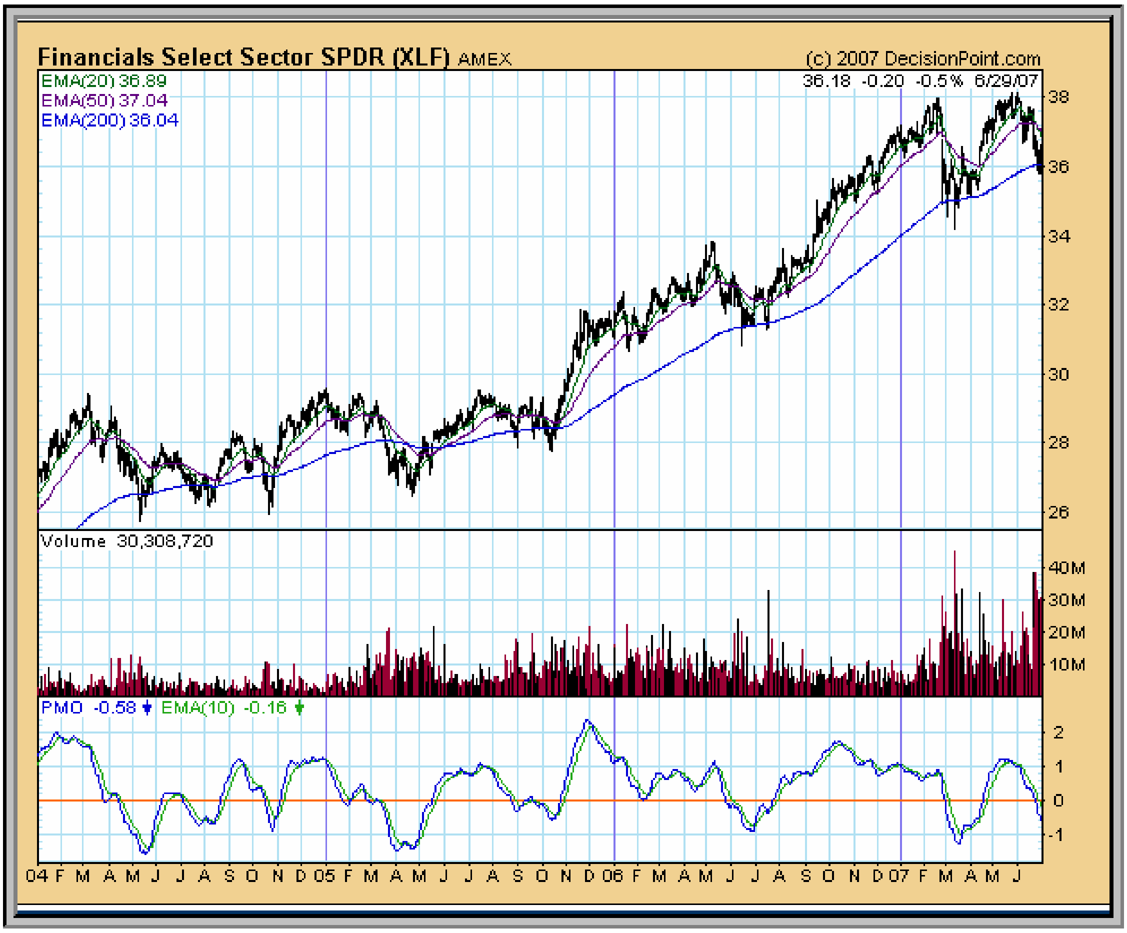
Figure 7: Collateralized Debt Obligation Issuance, 1987 - 2006



Source: Lucas, Goodman, and Fabozzi

One of the problems associated with the CDO market is that it is very illiquid and that so far securities were valued according to some mathematical models or at face value. If all the CDOs had to be valued at market value it could erase a significant portion of financial institutions' equity. According to Institutional Risk Analytics, a Hawthorne, Californiabased company that writes computer programs for the four biggest accounting firms, 25% of face value of CDOs is in jeopardy, or about $250 billion. To understand the magnitude of the problem, $250 billion in losses would compare to US commercial banks capital of $ 875 billion! Therefore, I would stay clear of financial stocks for now (see Figure 8).

Figure 8: Avoid Financial Stocks



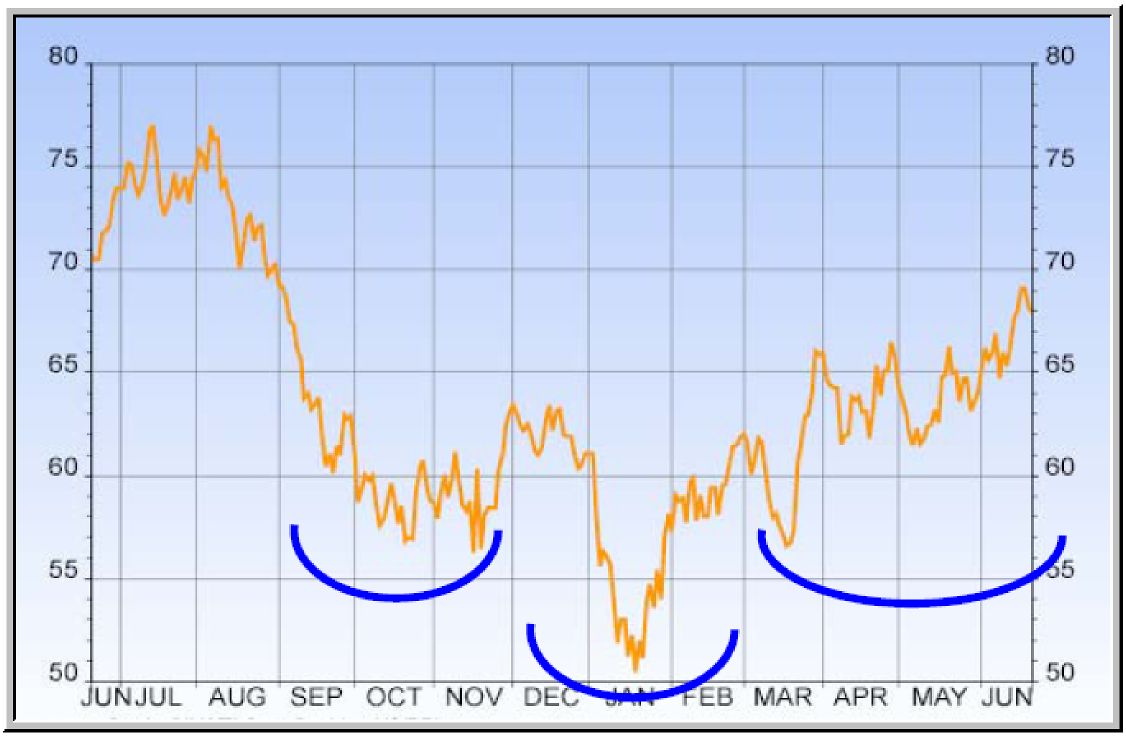
Source: www.decisionpoint.com

Two more points: According to a Bloomberg report, "Losses (in CDOs – ed. note) may rival the savings and loan crisis of the 1980s and 1990s. The Resolution Trust Corp., formed by the U.S. government to resolve the thrift crisis, sold $452 billion of assets at a cost to taxpayers of about $140 billion." Moreover, and this is important in the context of US consumption, "the current debacle threatens the growth of asset-backed bonds, securities that use consumer, commercial and other loans and receivables as collateral. That market, which includes mortgage securities, has doubled to about $10 trillion since 2000, according to the Securities Industry Financial Markets Association, a New York-based trade group".

Also, according to The Bank for International Settlements (BIS), the total notional value of global derivatives in existence has grown by now to $415.2 trillion, which is almost 800% of global GDP. Should, therefore, the fall-out from the sub-prime lending and CDO market affect other sectors of the credit market, which is in my opinion almost inevitable, some derivative defaults could aggravate the problem and lead to a "perfect" credit storm!

So, what should one invest in? In general I recommend investors to move away from complicated financial instruments and anything related to history's greatest debt bubble, and to shift funds into hard assets such as oil, gold, and farmland, whose quantity cannot be increased at the same speed as paper money is created by irresponsible central bankers (see Figure 9).

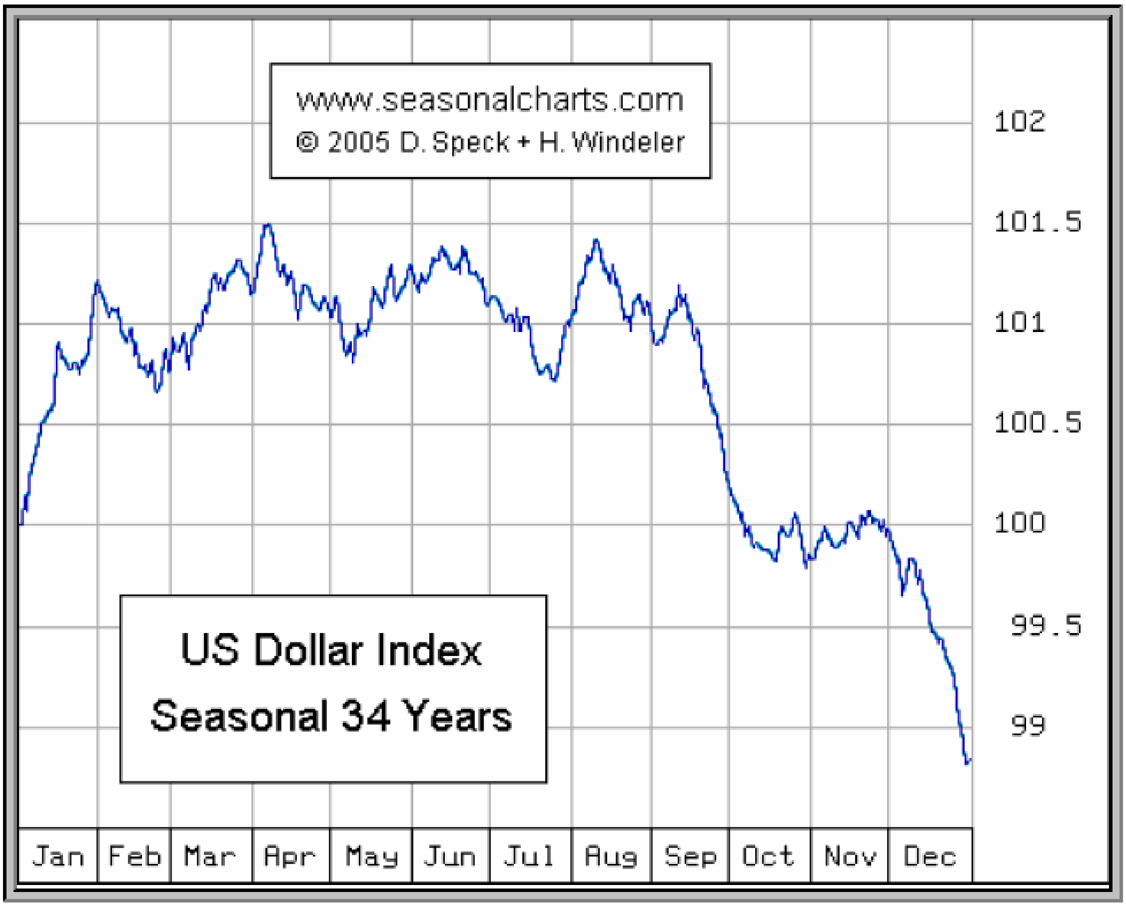
Figure 9: Crude Oil – An Inverse Head and Shoulder



Source: The Institutional Strategist Tis@TISGroup.net

I have to admit that I am hesitant to buy oil now since it has already appreciated considerably following its bottom at $ 12 in 1998. However, in real terms (inflation adjusted) oil is still down by about 50% from its 1980 peak and looks technically strong (see Figure 9). Moreover, I could see the following scenario unfolding in the second half of 2007: The problems in the housing industry worsen, sub-prime loan default rates soar, the CDO market collapses, and the US economy does contrary to expectations not recover. The Fed is forced to ease massively and cuts interest rates. The US dollar resumes its downtrend. As can be seen from Figure 10, the US dollar tends to be seasonally weak in the second half of the year.

Figure 10: Seasonality of US Dollar

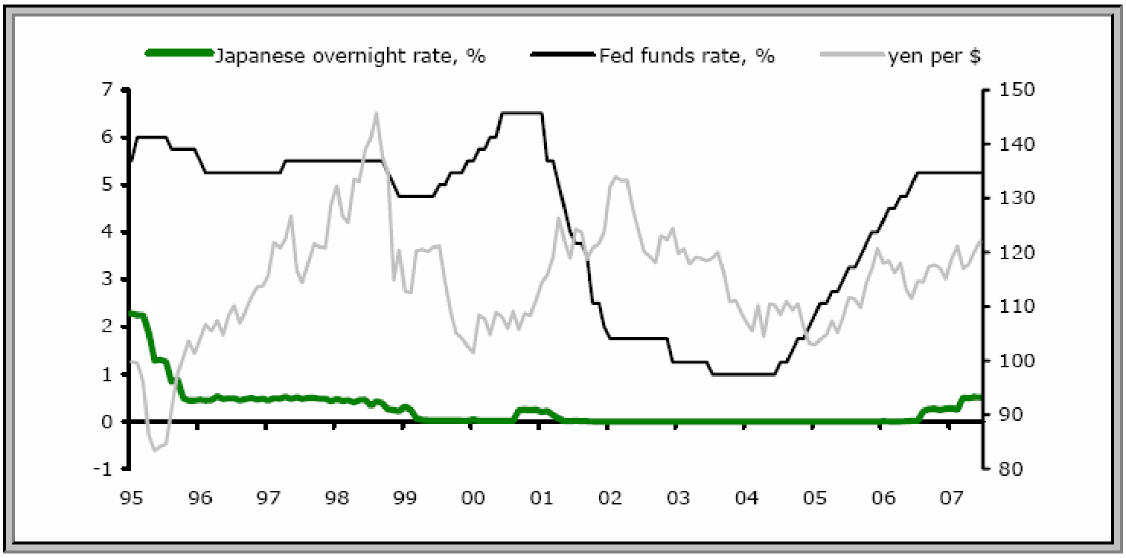


Source: www.seasonalcharts.com

In the meantime tensions in the Middle East increase as it is neither in the Russians' or Chinese's interest that the US and its allies succeed in the struggle for the control of the world's largest oil producing region. As an aside, it is now a well-established fact that Chinese weapons find their way to the Taliban. And since all Chinese weapon manufacturers are state controlled it is a fair assumption that these weapons are supplied by the Chinese government. Increased tensions will be very commodities supportive – this particularly in the case of oil, precious metals and the entire agricultural complex (including cotton).

Last month I recommended the purchase of Two years Treasury notes and expressed the view that the US dollar should strengthen. I have to say that given the scenario I just outlined it would be difficult to maintain a bullish stance for the US dollar. Still, I do not regard the US dollar to be particularly vulnerable against the Euro. The Yen, however, is another story. Let me explain. Everybody believes that the Yen carry trade will come to an end when Japan increases its interest rates. That may be the case but does not necessarily have to be so. In 1998 the Yen appreciated against the US dollar from almost 150 Yen = one dollar to around 100 Yen = one dollar (15% in one week alone) **without Japanese interest rate increasing** (see Figure 11).

Figure 11: Japanese Overnight Rates, Fed Fund Rate and Yen, 1995 - 2007



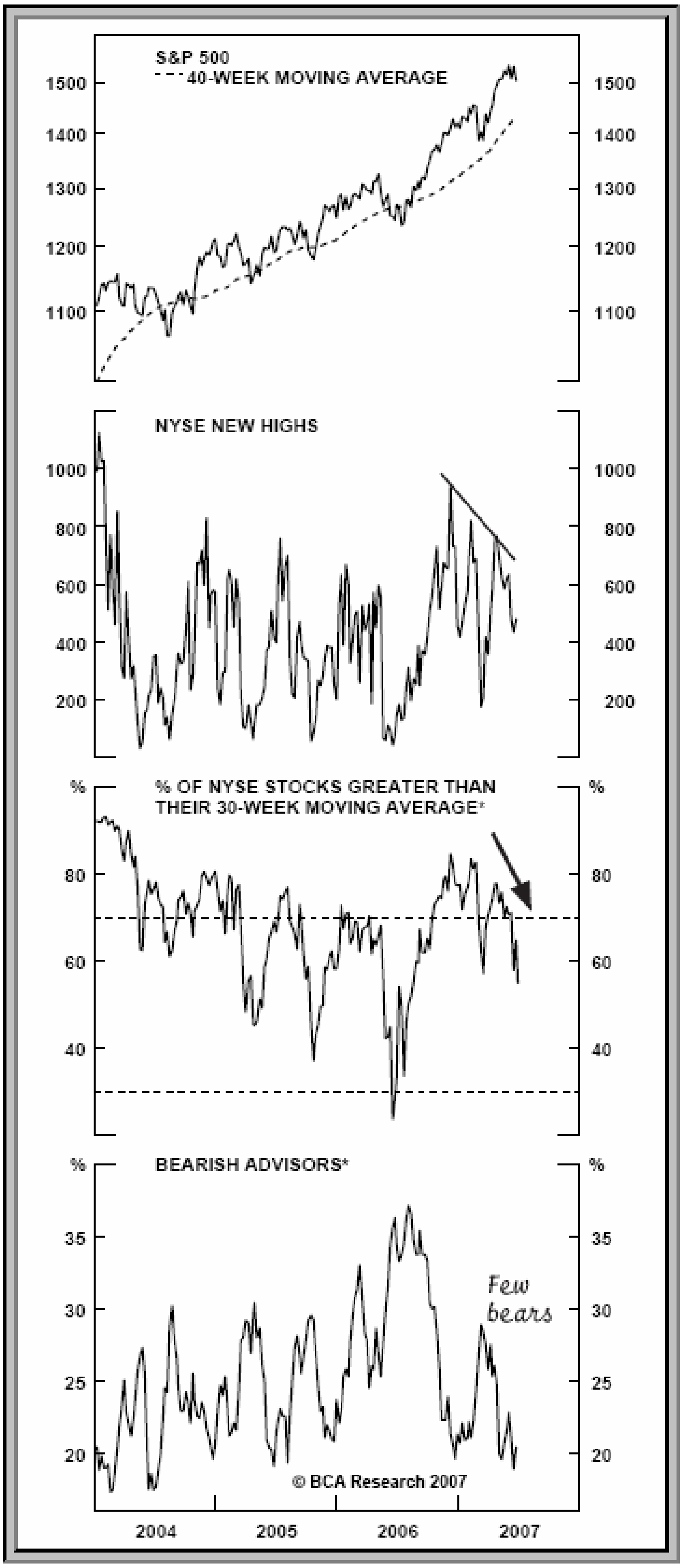
Source: Robert Lind, ABN-AMRO

According to Robert Lind of ABN-AMRO the following happened in 1997 and 1998: In 1997, the Fed had hiked its funds rate to 5½%. In the aftermath of the Asia crisis, the Fed had held the funds rate steady, but the rate differential with Japan encouraged a dramatic weakening of the yen. In February 1998, the yen was trading at 123 against the dollar. By mid June, the yen had fallen to 146. This triggered concern among G7 policymakers and following a meeting in late June, the US intervened to sell dollars and buy yen. This temporarily pushed the yen up, but this was reversed and by August the yen had fallen again to 147. In August, there was a major shock for financial markets. The Russian government defaulted on its debt and the subsequent losses caused the collapse of LTCM. This triggered greater volatility in financial markets and the yen began to strengthen. In September, as the crisis continued to unfold, the yen traded in a range of 130-135.
At the end of September, the FOMC met for a regular policy meeting. In spite of continuing concerns about inflation, the FOMC decided to cut the funds rate by 25bp in response to growing risk aversion in financial markets. The dollar fell sharply and the yen began to strengthen. In the first week of October, the yen rose 15% against the dollar. Tiger, a macro hedge fund, had been aggressively shorting the yen and made heavy losses as the yen unexpectedly rallied. Its attempts to cover its position magnified the yen's move".

So, if Japanese interest rates will not necessarily kill the Yen carry trade what will be the catalyst for the unwinding? According to Robert Lind, "It's currency volatility that ultimately kills carry trades. In 1998, the collapse of LTCM was the 'Black Swan' event that triggered more volatility and the end of the trade. By definition, none of us can forecast these events. But in a world of unprecedented financial imbalances, there are plenty of potential triggers for renewed currency volatility and an end to the current carry trade".

I agree with this view. There are huge speculative excesses everywhere in the system. Hence, even a relatively minor event (a US fed fund cut in the fall) could trigger a massive re-pricing of risk and lead to an unwinding of all carry trades. Therefore, a gradual accumulation of Yen and Swiss francs should be considered. In the meantime, I would continue to lighten up positions in equity markets around the world. Figure 12, shows the technical deterioration which has taken place in the US.

Figure 12: Technical Deterioration is Evident in US Stock Market



Source: The Bank Credit Analyst

As can be seen from the above figure, there has been a meaningful contraction in the number of NYSE stocks making twelve months new highs (while new lows have recently increased and have occasionally exceeded new highs). Also visible, as already explained in the context of Figure 2, is that the number of NYSE stocks hovering above their 30-week moving average has been contracting, and the low level of bearish investment advisors. In fact, I just received a report by one of these advisors entitled: **"This coming 18 months will be a New Dawn in America, and we will again be seen as the richest and most powerful nation on earth, with no equal."**

But when I look at the sub-prime and CDO mess, the current account deficit, the precarious position of the US dollar, a Fed, which has lost control over money and credit growth, and a government which is ineffective and lacks any sensible direction in its foreign policy, I wonder!

I am enclosing a short report by Bill Gross, which highlights some of the problems in the credit market.