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The Credit Crunch and the Market

The past month has been a roller-coaster in the financial markets.

At the first hints of falling prices in the mortgage backed securities markets, Bear Sterns announced the bankruptcy of two large hedge funds, and 90% losses in a third fund which had \$850 million invested in highly rated mortgage-backed securities. In the following weeks, other major funds also announced losses. Goldman Sachs' Global Alpha hedge fund fell 27% this year through Aug. 13, prompting clients to ask for \$1.6 billion in redemptions, investors told Bloomberg. DE Shaw, a pioneer of quantitative investing based on complex mathematical and computer techniques, has been hit hard in August. DE Shaw's Valence fund is down more than 20% through August 24th, according to a fund of hedge fund manager.

These high-profile losses are prompting redemptions, and as cash flows out of hedge funds, managers must sell. Around the world, leveraged funds anticipate redemptions and are deleveraging (selling).

“When you can't sell what you want, you sell what you can.”

Because the markets for mortgage-backed securities dried up so completely and so quickly, managers began selling positions that remained liquid and well-priced. In a sense, they had to sell good investments because they couldn't sell the bad ones. What started as a series of collapsing mortgage strategies has spread into just about every other market that hedge funds touch. Prices fell in investments ranging from emerging market bonds to the price of hogs. In all, more than \$1 trillion in value has been lost in US stock markets, alone. Many foreign markets and alternative asset classes suffered worse declines.

The trigger event is a credit tightening: mortgage issuers extended too much credit, were too loose with their lending standards, and may not have adequately communicated their loan terms. In response, lending standards have been increased and credit is tighter. US consumers might slow their spending, which might trigger a broader slowdown in the US economy, which might have implications for global growth. Uncertainty and fear prevail.

We view this fear as primarily psychological, wildly overestimated, and only loosely related to market fundamentals (See Figure 1). But that may not matter.

Figure 1

Total US mortgages \$10.4 trillion.
Of this, subprime \$1.35 trillion
Of this, delinquent \$189 billion
Of this, foreclosure \$67 billion
Of this, expected losses \$33 billion
If losses expand by 200%, they might reach \$100 billion.

... but this is *less than 1%* of the US mortgage market.

... and *only 0.14%* of the \$70 trillion in total US wealth.

The fear of sub-prime mortgage defaults is wildly overestimated and only loosely related to market fundamentals.

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Psychology can impact fundamentals

Increases in the money supply raise expectations for inflation

Contagion

The pricing of risk is driven by psychology. Investors require compensation for the possibility of loss and also for the inconvenience of uncertainty. So rising risk can cause capital to become scarce, lending rates to go up, and spending to slow. In this sense, the psychology can impact the fundamentals in what is sometimes called a "contagion".

The "Greenspan put" was like a safety net, providing the comfort that credit would be made available on those occasions when it was needed. Bernanke has reiterated this strategy, but it remains to be seen if he has the same appreciation for what Keynes called the "animal spirits" of the market. Contagion is a real phenomenon, generally starting with a crisis in one market or a large fund, then spreading to other asset classes as volatility rises and investors require higher premiums for risky investments.

In our view, the excessive lending in the mortgage industry could trigger a contagion in a variety of ways, such as:

- Rising rates and tightening lending standards leads to a contraction in home prices, reducing consumer spending and slowing economic growth.
- A new awareness for the risk of debt investments causes borrowing costs for corporations and governments to rise, reducing investment and slowing economic growth.

These risks can be self-reinforcing, and could change the fundamental characteristics of the economy. These are the type of events that could change our investment strategies if they appear to develop out of control.

So far, these contagions have not caused a significant slowdown in economic activity.

Volatility triggered by major hedge fund failures is different; it generally causes sharp declines in recently popular asset classes followed by recovery. These declines can proceed in unexpected ways, and can continue for some time because each price shock runs the risk of triggering another failure. It is surprising how many hedge funds use leverage sufficient to make them incompatible with price shocks. As months pass, however, these shocks can be a blessing because they offer rare value opportunities.

We should all hope that a full-fledged contagion does not develop, and be thankful that the world's central banks are standing guard.

The Federal Reserve

It is important for the government to intervene if a contagion might damage the economy in fundamental ways, but also important for the government to avoid interfering otherwise.

The Federal Reserve and foreign central banks play an important role in managing the stability of economic growth by changing the availability of capital at money-center banks, but interventions can also cause distortions in currency exchange rates, changes in the money supply affect inflation expectations, and reliance upon government intervention can lead investors take excessive risks.

On the 17th, the Federal Reserve followed several foreign central banks (European Central Bank, Australia, Japan, and others) by pumping capital into their nations' banking systems in response to the recent volatility. This intervention increases the monetary supply, but the psychology of selling is still driving down many market prices as global investors reduce their exposure to risk and shift their portfolios to hold more cash and US Treasury Bonds.

Credit tightening is a reasonable response to excessive lending, but the signal from global central banks is that they are ready to smooth the volatility, even if it means increasing the money supply. This indicates that they may intend to inflate their way out of potential economic pain. As a result, we are less concerned about a recession, but our long-term expectations for inflation have risen. This combination makes stocks and real assets more attractive because they are better hedges against inflation, and reduces the value of fixed income instruments (such as US Treasury Bonds). Meanwhile, the global investor crowd has been doing the opposite. If higher inflation will be the ultimate outcome of this recent roller coaster, then the massive global shift toward cash and fixed income may ultimately be reversed.

Finding signals in the noise

If you look at the energy picture in the world and you see that the demand is rising and the supplies are not rising at a similar level, then it will either lead to colonial wars of the 19th –early 20th century time, or to some system by which people agree among each other how the supplies are going to be shared.

- Henry Kissinger, 3/26/2007

Global growth is now projected at 5.2 percent in 2007 and 2008—0.3 percentage points higher for both years than projected at the time of the April 2007 *World Economic Outlook*. The major upward revisions have been in emerging market and developing countries, with growth projections for China, India, and Russia each marked up substantially. Among the advanced economies, growth in the United States is now expected at 2 percent this year (0.2 percentage points lower than projected in the April 2007 WEO)

- IMF Forecast