

Failure, Contagion, Panic, ... and the Future

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Failure

"This is a once in a half century, probably once in a century type of event"
– Alan Greenspan, September 15, 2008

Failures of judgment appear to have been epidemic in the US economy. A brief summary of major failures includes:

- Insufficient regulation of banking system leverage,
- Lack of regulation in mortgage origination,
- Low interest rates and too much borrowing
- Indiscriminate purchase and bundling of imprudent mortgages,
- Public mania in real estate,
- Insufficient enforcement of existing securities regulation
- Institutional competition toward unlimited investment leverage,
- Accounting rules that unfairly punish illiquid securities,
- Concentration of credit risk within AIG,
- No prepared means to resolve a breakdown in interbank lending.

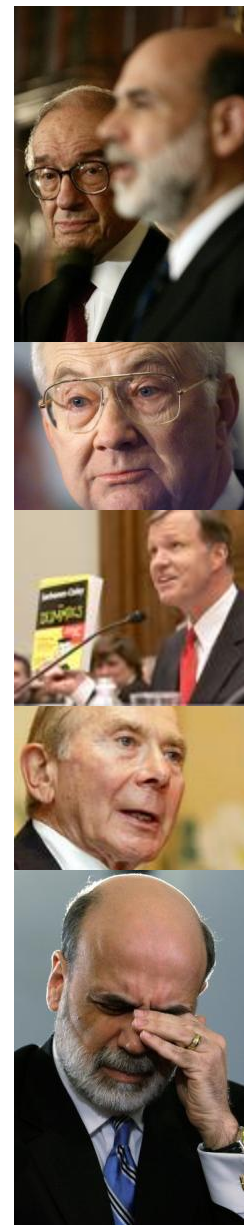
These failures revealed themselves like layers in an onion as credit became unavailable and investors sold into falling prices.

Contagion

Bad mortgages are generally blamed for causing this crisis, but they were just the trigger. Think of them as the match that lit the bomb that caused the crash. Fundamentally reasonable declines in mortgage securities were magnified many times by fundamentally unreasonable leverage in the banking system. These magnified losses drove a small number of financial institutions toward insolvency, so they were forced to unwind their investments. The contagion had begun.

Selling became a race because as selling drove down prices, overleveraged institutional investors lost their collateral to support their portfolios. So selling begat selling. Because falling prices and a lack of buyers drove companies like Bear Stearns, Merrill Lynch, and Lehman Brothers into collapse, a new kind of risk was exposed: counterparty risk.

Counterparty risk is generally ignored in securities valuation, but if the party that owes you



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money (or oil, or stocks) fails, then counterparty risk becomes important. People stopped trusting their counterparties so lending and trading between banks slowed way down. Some markets had “no bid” and stopped trading entirely.

When your investments have lost money and you are forced to reduce your leverage, you hope for a liquid market with ample buyers. But with counterparty risk seizing the markets, there were only vultures to be found.

Panic

Large institutional investors could not sell because trading had seized. The few transactions that occurred were at desperation prices. Meanwhile, new laws requiring institutions to quote their assets using “mark to market,” as if all similar securities should be priced like the few transactions taking place, added further chaos. The paper losses from a small number of desperate sales multiplied against the entire asset base of the banks. On paper, many banks instantly became insolvent. Counterparty risk suddenly became the priority and credit markets failed to operate. Prices plunged, fear spread to the public, and mutual fund redemptions jumped to \$75 billion in September (3 times the previous record set in 2001).

All manias and all crashes are, at their core, psychological. But psychology is very real, and in crowds it drives society and the economy. Free markets are subject to free fall when everyone wants to sell and there is nobody willing to buy.

With a somewhat dispassionate perspective, it’s curious to watch the public enthusiastically follow momentum: euphorically buying high and fearfully selling low.

The Future

The Valuable US Dollar

The collapse of the credit system is (or was) highly deflationary. As the volume of credit declines, so does the money supply, and with less money each dollar is worth more. That is why commodity prices fell in half, stocks crashed, and home prices declined. On the flip side of the coin, the recovery of the credit system is (or will be) highly inflationary. In addition to recovering toward the reasonable availability of credit, the government has also pumped a lot of new money into the system. While the short-term may be deflationary, the longer-term appears to hold significant risk of a US dollar that is declining in value.

Leverage in the banking system directly reflects the debt of companies and of people. Debt is one side of the leverage ratio, with reserves on the other side. As leverage is brought down to more reasonable levels, the overall level of debt must, by definition, be reduced. That means that corporations and people must pay down debts in order to deleverage the banking system. If leverage ratios are cut from 20x to 10x, then we must all (on average) pay off half of our debts. This will have a depressive impact on consumer spending and economic growth and could lead to big problems if it is done too quickly.

Many companies finance their operations using debt, and many will fail. Profitable companies often finance their growth using debt, using their operating profits to pay bigger salaries and bonuses and if this debt is cut in half then there will be less investment to grow companies, and less money for salaries and bonuses. People who are in debt will



have to consume much less because consumer credit could be cut in half. Dollars become scarce and the value of the dollar goes up. In summary: deflation and depression. The government is going to great lengths to avoid this!

“There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction.”
– John F. Kennedy (1917 - 1963)

1. **Bailout** – Government can provide banks with additional reserves.

If the Federal Reserve or the Treasury buys debt or equity in banks, it can have the proceeds used as reserves and go directly into the Federal Reserve as “high powered money”. This would reduce the leverage of the banks and allow them to continue operating as usual. Because of the reserve ratio, every dollar invested into a bank’s reserves has many times as much impact on credit and the money supply. If the reserve ratio is 9:1, for example, then, because of interbank lending, the impact on credit and the money supply can be as much as 99 times. That is why it is called high power money, and this would be a very potent way to fix the credit markets in the short term. In the long term, the banks would have lost some of their own equity, and would work to avoid such a loss in the future.

The downside of this form of bailout is that the government would own part of the banking system, spend taxpayer money to do it, increase the money supply, increase debt, and not do anything to fix the structural problems that led to so much leverage.

2. **Regulatory Overhaul** – Government can change the system to engineer a soft landing.

New regulation of reserve ratios, credit, and securities markets are probably required to reduce the chances of systemic failure in the future. We think there should be a target reserve ratio just as there is a target fed funds rate. Credit regulation should include minimum collateral limits for derivative securities such as mortgage backed securities, credit default swaps, and other derivatives linked to a credit spread. Securities brokers would be responsible for reporting aggregated (clients remain anonymous) positions and collateral by security type.

The dollar has been strengthening lately as an anomaly within a long downtrend. This is no coincidence: the strength of the dollar reflects big investors reducing their leverage, repatriating US cash, selling down leveraged international investments, and generally holding more cash. As banks reduce their leverage, the money supply shrinks, so each dollar is worth more. The dollar was falling in value for years as leverage increased (money supply increased) and now, very quickly, the opposite has happened.

“Decoupling”

We have heard the argument that decoupling is dead: that international trade has brought every market into shared economic cycles. We don't see it as a question of “either/or”, but rather as a continuum. Global growth is diverse and strong. There are certainly correlations caused by shared trends (such as trade, technology, cultures, etc.) and shared sources of capital, but these have been exaggerated in the past few years by excessive leverage that has given excessive influence to global institutional investors.

As the world economies emerge from the current financial crisis, expect lower correlations. In other words, expect some countries to emerge very strong and others to remain depressed for much longer. Countries with healthy political and economic foundations, along with abundant natural resources, are in the best positions. Brazil, Canada, India, Mexico, and China may be very strong.

The Fundamentals of the World Economy are Better than you might Expect

This is true whether you are talking about the American workforce or global economic statistics: the fundamentals are generally fine. Some of the statistics are clearly *not* strong but the overall picture is far from a disaster.

Gross World Product (GWP) growth has slowed from a 5% rate in mid-2007 to an estimated 3.7% in 2Q 2008, with 3% growth projected for the second half of this year. International liquidity growth slowed from 12% to 1.6% and global capital investment growth slowed from 6.5% to 3% over the same period. GWP, liquidity, and capital investment are all still growing. Liquidity growth has slowed from an unsustainable pace (more than double the growth rate of GWP), but it is still growing. This is far from a global contraction, and growth is more globally diverse and inclusive than in any previous time in economic history.

World trade volume growth has also been slowing significantly, declining from 9.3% in 2006 to 7.1% in 2007. This year, world trade volume growth has slowed to zero in May/June according to the latest official data. This is not world production, but world trade. World trade puts downward pressure on prices so a slowdown in World trade is inflationary.

Global inflation (CPI) rose from 2.2% in mid-2007 to 7.8% in 2Q 2008. Headline inflation in the industrial economies has risen from 1.4% to 4.2% in the past year, and is at double-digit levels in many emerging markets, the Middle East, South Asia, and Africa.

Global industrial output growth has slowed from 4.4% in mid-2007 to 1.6% in 2Q 2008. In the OECD, which accounts for 73% of world production, output growth has slowed from 3.4% to 0.7% in this period. In non-OECD, industrial output growth has slowed from 8.4% to 4.7%. The OECD represents a shrinking proportion of a growing global demand for resources for industrial output.

In the U.S., Q2 U.S. real GDP grew at 3.3% up from the 0.3% average growth of the prior two quarters.

GDP growth came mostly from export growth. Consumer confidence is at 30-year lows. Disposable personal income in the US rose \$596 billion in May from the Economic Stimulus Plan, and consumers saved 84% of that. July data on consumer spending and personal incomes showed contractions in both areas. US Consumers are building up cash and righting their financial positions.

How you Invest

First things first: pay down debts or be ready to do so. We've been calling for readers to lock in interest rates on mortgages since [July '06](#). Credit may be more expensive and more difficult to obtain in the next few years. Companies that rely on credit to finance continuing operations will suffer.

Don't let fear control you. Buy low. The dollar is strong and securities are cheap. Hoarding cash at a time like this is folly. Invest and diversify into Assets, Commodities, and International Equities. Companies that have international demand or that earn foreign profits may be particularly undervalued. Missing even a few days or weeks of equity or commodity price recovery might mean missing 20% or more in returns. Maintaining your strategic asset allocation balance is more important now than ever, and the dramatic volatility means rebalancing often.

Divest of long term US Treasuries, fixed income securities, and companies that require debt financing to survive. Investments that pay you back as a fixed number of future US Dollars may be eroded by inflation. In the short term, credit markets are essentially seized. In the longer run, it may be decades before debt financing becomes this easy again.

We are in the midst of major global shifts toward free societies, fair markets, growing consumption, and the magnetic attraction of purchasing-price-parity. The biggest drivers of global growth are unshaken:

1. Expanding production into international (including developing) markets,
2. Rapid global sharing of social systems and technologies that improve production,
3. Expanding global trade in both goods and services,
4. Improving alignment of tax codes and central banking policy in line with global best-practices,

Global investing appears fundamentally very strong, probably more so than at any other time in human history. The current financial crisis should be seen as an opportunity to use strong dollars to buy global investments.

Good luck,



Dan Von Kohorn

More on Money

"The process by which banks create money is so simple that the mind is repelled."

– John Kenneth Galbraith

"That is what our money system is. If there were no debts in our money system, there wouldn't be any money."

– Marriner S. Eccles, Former Chairman of the Federal Reserve Board

"Whoever controls the volume of money in our country is absolute master of all industry and commerce...and when you realize that the entire system is very easily controlled, one way or another, by a few powerful men at the top, you will not have to be told how periods of inflation and depression originate."

– James A. Garfield, assassinated President of the United States

"The Government should create, issue, and circulate all the currency and credits needed to satisfy the spending power of the Government and the buying power of consumers. By the adoption of these principles, the taxpayers will be saved immense sums of interest. The privilege of creating and issuing money is not only the supreme prerogative of government, but it is the government's greatest creative opportunity."

– Abraham Lincoln, assassinated President of the United States

"Until the control of the issue of currency and credit is restored to government and recognized as its most conspicuous and sacred responsibility, all talk of sovereignty of Parliament and of democracy is idle and futile...Once a nation parts with its control of its credit, it matters not who makes the nation's laws...Usury once in control will wreck any nation."

– William Lyon Mackenzie King, former Prime Minister of Canada

A cartoon explanation of the banking system:

<http://video.google.com/videoplay?docid=-9050474362583451279>