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MARKET OBSERVER

February 2008

What a difference a year makes! The *Canso Market Observer* of February 2007 was a lonely and outmoded voice of credit caution. We argued that the credit problems brought about by excessive monetary stimulation were being manifested in the institutional absurdity of Collaterized Debt Obligations and other securitized structures. Where Alan Greenspan, financial regulators and market commentators believed that the securitization of financial assets would "smooth" the credit cycle, we felt precisely the opposite:

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> *"Given our contrarian souls and many credit cycles of experience, unlike the WSJ, we do not have any difficulty imagining circumstances that could end today's financial orgy. Our prime suspect is the lack of caution in the credit markets that will eventually prove its own undoing. Many commentators suggest that the securitization by banks of loans into Collaterized Debt Obligations (CDOs), Collateralized Loan Obligations (CLOs) and the development of Credit Default Swaps (CDS) will insulate lenders from the foibles of their borrowers. Since the banks, it is argued, have sliced and diced up their loan books, sold them off to investors and can insure what is remaining in the CDS market, there is not the risk that lending will shut down as in prior cycles. This argument amazes us by its sheer inanity."* Canso Market Observer, February 2007

We went on to point out that when these so-called marketable investments fell into credit disrepute, there would be no bid available and banks would be back to directly financing their customers. Now that the securitization market has shut down almost completely and banks are paralyzed by their exposures to toxic loans, I think our point has been made. Rather than improving the credit system by laying off credit risk to those with the expertise to evaluate them, the Greenspanian credit system had the risks assumed by those who didn't know what they were getting into! The credit pain is now being felt in the complete breakdown of securitization as investors recognize the danger in the opacity of these investments and the foolishness of the credit ratings they relied on.

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Citibank's Free Lunch Ends in Food Poisoning

The length and depth of the credit meltdown will reflect the unprecedented monetary ease of Alan Greenspan's "War on Investment Terror" and its subsequent credit absurdities. The investors and financial institutions that participated in this mass suspension of financial disbelief have only started to recognize their losses. Their quantitative risk management techniques, credit enhancements, accounting subterfuges and derivative hedges have provided them with little of the expected protections. The they made levered bets on pools of mortgages and loans should never have been underwritten in the first place. Their shared illusion that they were "protected" or "hedged" now seems to be incredibly naïve, as the experience of Citigroup shows.

Citigroup is our poster child for the credit mania involving the securitization of financial assets. Not too long ago its $100 billion of Structured Investment Vehicles were "off balance sheet" (the accountants said they weren't theirs) and required little of Citi's capital. The SIVs were financed by yield starved outside investors who readily parted with their money because of the very high credit rat-

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ings of the debt issued by the Citi SIVs. The Citi structured product brain trust also took advantage of the yield curve, financing in the short term market and pocketing the difference between lower short term funding rates and the higher yields on the longer term assets in their SIVs. To Citi and its management, there certainly seemed not only to be a free lunch but free breakfast and dinner as well.

The free meals that Citi gorged on are now giving it a severe case of portfolio food poisoning. The securitization music stopped over the summer and SIV sponsors scrambled for funding. It quickly became obvious in this game of financial musical chairs that someone had walked off with all the chairs and the Citi SIVs were in a lot of trouble. Citi announced at the time that it was insulated from the problems with its SIVs due to their non-recourse nature. It also joined in the efforts of Treasury Secretary Henry Paulson to rescue the SIV sponsors and prevent the forced selling of SIV assets.

Abu Dhabi Do!

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Despite its initial bravado, Citi soon started liquidating assets from the SIVs to fund debt maturities. As write offs were announced and the Citigroup stock swooned in sympathy, CEO Charles Prince walked the dismissal plank in early November. To shore up its dwindling capital base, Citigroup was forced into a $7.5 billion equity injection from the Abu Dhabi Investment Authority. No sooner had Citigroup hung out its "Under New Management" sign than its new CEO, Vikram Pandit, announced that it was putting its remaining $49 billion of problem SIVs back onto its balance sheet. To us, this was the death knell for the securitization mania. The trend that had increasingly encouraged financial institutions to lay their credit risk off onto third parties for the last fifteen years was over.

The most interesting aspect of the Citigroup decision was its implicit rejection of the interventionist contortions of Henry Paulson and his Wall Street chums and their proposed "Master Liquidity Enhancement Conduit". The MLEC was targeted at keeping SIV assets off the balance sheets of the sponsoring financial institutions and preventing the fire sale of the financial assets held by their SIVs. The ulterior motive of the MLEC backers was to limit the "mark to market" losses from the SIV meltdown for the major U.S. investment banks and preserve their capital and stock prices.

Citigroup Supersizes Its Capital and Sinks the Super SIV

The move by Citigroup to assume its SIVs now makes the MLEC redundant. There had been substantial debate whether the U.S. government should intervene in the crisis when the MLEC idea was first announced, as opponents argued it would only delay the inevitable markdown of the SIV assets and questioned why a "Super SIV" like the MLEC would be able to function more effectively than the underlying SIVs. Paulson, a former investment banker and chair of Goldman Sachs, charged ahead with his plan, under pressure from the Bush Administration and politicians of all stripes to be seen to be doing something about the credit meltdown.

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Citi shareholders must be wondering about the Geneva Convention at this point. The prior market opportunities "captured" by Citi have been a financial waterboarding for the captive Citi shareholders. Citi shares have swooned from above $50 in June of 2007 when the credit crisis unfolded to around $25 at the time of Pandit's press release. Citibank's insatiable need for capital doesn't reflect its opportunistic desire for investment opportunities, it reflects the movement of assets from securitizations onto its balance sheet.

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Greenspan's Discredit

The implications for the financial markets of the current trend away from securization are many and important. In the conventional banking system prior to securitization, the lending of money required knowledge of the credit risk of the borrower and capital to be set aside by the lender. The brave new credit world of Alan Greenspan encouraged neither. The credit decision was delegated to credit rating agencies and lenders selling off their loans did not have to allocate or risk capital on the loans they sold. Perversely, they actually did better as their loan volumes increased through higher selling and underwriting fees, which is the root cause of the current meltdown. A lending system that is biased towards higher volumes is a bad idea and this credit cycle was no exception.

To illustrate the effect of "de-securitization" on the capital markets, we can examine the financing of account receivables. In the bad old days of conventional banking, a business would bill its clients and generate account receivables. A bank would then lend against these receivables. The typical margin on account receivables was 75% which meant that the borrower could put $750,000 on its bank line for each $1,000,000 in account receivables. The bank lending the $750,000 would need to fund the monies advanced and have the capital to support the loan. Using a 10% capital standard, this would mean the bank would need to have $750,000 in deposits to fund the loan advance and $75,000 in equity or other forms of capital set aside to cover this exposure. A finance company had an even higher capital requirement of $187,500, as credit raters demanded 25% equity for an investment grade finance company.

No Money Down Lending

Early securitizations saw banks sell their interest in account receivables to a trust which would then issue its own debt. The bank could then recover its $750,000 and release its capital except for the equity necessary for the trust. Credit rating agencies initially demanded some equity in the trust to give the senior debt the highest credit ratings. Banks funded this by leaving some money in the trust in the form of equity or subordinated debt. Eventually the credit raters were persuaded to allow the "excess spread" to build up a cushion which became the defacto equity. They also acted as agent for a "Receivable Purchase Facility" to allow their clients to sell directly to the trust, removing the need to use any of their own capital or fund the receivable.

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In the final stages of the securitization mania, issuers got the credit raters to reduce the contributed equity to very low levels on the basis of historically low default and loss statistics. The senior tranches were also highly rated on the basis that the subordinated tranches would absorb "first losses". The banks also got outside investors to buy the most deeply subordinated "equity tranches" on the basis of their projected (hypothetical spreadsheet) rates of return. Many securitizations effectively delivered 100% financing or even better as the very thin credit spreads on the debt issued allowed the lenders to take more out than the book value of the assets they had put in! In a so-called "whole loan sale", a sponsoring lender could sell a package of loans to a trust securitization at an attractive funding spread, monetize the excess spread above this and then act as the servicer for a fee.

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Buyers Strike Out Securization

The current meltdown in the credit markets results from the disintermediation of this securitization funding channel. Investors relying on stellar credit ratings were caught unaware by the sub-prime meltdown. A buyer's strike has now developed as all securitized credit ratings are suspect and debt issuance by securitized structures has ground to a halt. The SIVs and Asset Backed Commercial Paper cannot fund their maturing debt and have to sell assets to pay off their debt holders. The securizations with liquidation "triggers" to protect the senior tranches are forced to sell by their very structures.

While forced selling into a bear credit market is not a pleasant experience for those involved, the effect of this is minor compared to the overall constraints on credit that will evolve from the breakdown in the securitization financing channel. With securitization not viable for at least the immediate future, we are back to a financing world where banks and other financial institutions will be forced to fund their clients' borrowings using their own balance sheets.

Unbalanced SIVs

This means two things: firstly that financial institutions will need to fund these loans from their own resources and secondly that they must have capital available to do this. Since all the assets coming back onto the balance sheets, as is the case with the Citigroup SIVs, did not previously use capital, this will severely strain the capital ratios of financial institutions. In addition, the losses these financial institutions are taking on their loans and securitization participations also reduces their available capital. The math is not too complicated. The $45 billion in Citbank SIVs coming back onto the Citibank balance sheet has to be funded as its current debt rolls over and allocated 10% in equity capital. The $7.5 billion equity injection in Citibank from Abu Dhabi covered the $4.5 billion in capital needed and some of the maturing debt but substantial further funding was still necessary as the currently outstanding debt of the SIVs rolls over. That is why Citi and Vikram Pandit took advantage of the issuance window in January to issue whatever capital they could.

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Lower Margin for Error

The meltdown of the securitization market also means that clients will not receive as much for their financing receivables as they did by selling them to securitized structures. Where securitizations provided 100% margining for high quality receivables, the banks are required to allocate capital and will margin the assets. This means that clients used to receiving 100% financing on their receivables will now get probably 90% or less. Given the current loan losses and risk aversion of lenders, it might be much less.

We believe that this means that credit spreads will be under pressure from both banks increasing their credit spreads to compensate for the increased demands on their capital and new issuance from financial institutions which require funding on balance sheet to replace their securitizations.

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Loan Fruit Goes Rotten

We will not get into the sheer magnificence of the credit stupidity that was displayed by credit rating agencies and buyers of these structures, as we have railed against these for some time. We will however point out that these structurally stupid investors were forced to buy whatever they could source to "get invested" and provide higher volumes and fees for the originators. The CDOs and SIVs became the largest buyers of bank loans funding the private equity deals of 2007.

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Of course when the credit binge ended, the banks were saddled with loans they couldn't sell since the CDO market had imploded. They have had to mark them down like the neighbourhood greengrocer with time expiring fruit: *"Citgroup Inc., Goldman Sachs Group Inc., Morgan Stanley and JP Morgan Chase & Co. are offering discounts of as much as 10 cents on the dollar to clear a $231 billion backlog of high-yield bonds and loans"* according to Bloomberg.com (Citigroup, Goldman Cut LBO Backlog with 10% Discounts, December 28th, 2007). This inability of the banks to foist their loans off on pliant CDOs and SIVs is also why the private equity "Masters of the Ludicrous" are now reneging on the deals that they had competed to do a few short months ago. The privatizations of Sallie Mae, PHH and United Rentals have all been shelved in large part due to their private equity sponsor's inability to obtain financing. This loan indigestion is starting to hurt borrowers as well. Bankers are predictable in the way they overextend credit and then yank it back when faced with defaults. This credit cycle is no different. The Wall Street Journal reported on February 5th that one-third of the U.S. banks and about two-thirds of the foreign banks responding to the Federal Reserve survey of senior bank-loan officers had *"tightened lending standards on commercial and industrial loans… About half the banks said they have widened the spread between their cost of funds and what they are charging borrowers."*

Sullied Mae?

A good example of the spreading tentacles of the credit crunch is Sallie Mae, the largest U.S. student loan provider. Sallie Mae saw its private equity deal fail after the cutbacks in Federal subsidies to private student loan lenders. It is also reducing its non-guaranteed lending through higher risk schools and to higher risk individuals after significant loan losses. It is seeing much wider funding spreads in its efforts to refinance a large securitized funding conduit . On its Fourth Quarter 2007 Earnings Call on January 23, 2008 its management reflected its frustration with lenders. In particular, they said that their marketing of the AAA rating of its securitization was met with comments that investors had lost a lot of money on "Super Senior" AAA rated securitized deals. Sallie Mae had done its tightest spreads ever for government guaranteed student loan conduits at LIBOR + .27% in June of 2007 and now faces LIBOR +.7%. The .4% increase might not sound significant but it is huge for a lender that starts with a lending spread of less than 2%. The net effect is to reduce the availability of student loans and set the interest rates higher.

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Hedgies Get Edgy

The losses on highly rated securitized structures are causing immense soul searching on the part of financial institutions and regulators. They now have further cause for alarm with the Societe General trading scandal. This featured a complete breakdown of modern "risk management" systems that led to the $7 billion loss by Jerome Kerviel, a junior trader. Monsieur Kerviel was supposed to be "arbing" the slight differences by going long and short in the equity futures market. SocGen was reportedly contacted by the futures market he was trading in because of his outsized positions. He must have been making money for his sup-

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posedly sophisticated derivatives bank since they didn't react to the report. Kerviel, who is reported to have not profited personally from his deceptions, wanted to be a "star trader". He decided to attain this reputation by taking huge directional positions, reportedly $70 billion euros, that were more than his bank's total capital and not hedging them as he was supposed to. He then reported offsetting fictional hedges that kept his bosses happy.

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The real question for regulators seems to be that the current "swap culture" encourages huge wagers on risky financial instruments on the premise that the absolute risk can be "hedged" by offsetting positions in the other direction. The damage to SocGen from Kerviel's deception and to other financial institutions from their exposure to financially troubled mortgage insurers and other weakened counterparties really questions the basis for much of the paper profits of financial institutions over the past number of years. Sure they got temporarily rich from the fees they charged on both sides of the transactions, but is this a worthwhile and useful activity for a chartered bank? Should regulators charged with the financial health of the banking system allow their charges to engage in such economically useless and reckless behaviour? As we've seen recently, the demands of financial institutions to be rescued because of their "special status" belie their former fervor to be deregulated.

Inflation Tension

The credit contraction reaches into all corners of the U.S. and world financial markets. It makes goods and services more expensive to produce and sell. It also makes it much harder for U.S. consumers to live beyond their means. This tension between more expensive goods and services and pressure downwards on consumption is the most important determinant of the economy and financial markets ahead.

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We had previously called for a slowing U.S. economy with higher levels of inflation than the markets expected which is pretty much what we saw in the latter part of 2007. We now think that the credit drag on the U.S. economy will result in a more substantial drop in consumer spending, as home equity loans and other consumer financings react to the breakdown in securitizations and dropping home equity values. Some Wall Street economists and most U.S. politicians now believe that the U.S. economy is already in recession. Whether the U.S. economy will actually tip into recession is a statistical exercise that will not be known until well after the fact.

Panicked Policy

What really matters is the policy reaction and it is clear that policy makers believe that the U.S. economy needs some economic energy drink. Ben Bernanke is said to have spent the Martin Luther King holiday at his office at the Fed watching the financial markets outside the United States melt down. After scaring himself silly, he arranged a telephone meeting of the FOMC which decided on a .75% "emergency" Fed Funds decrease. Not only was it highly unusual to cut rates just before a scheduled meeting in reaction to financial market gyrations, the subsequent .5% decrease at the scheduled FOMC meeting met Wall Street's loudly proclaimed "expectations".

Professor Bernanke and the Fed has obviously decided to err on the side of "caution" by taking out some "insurance" in the form of monetary stimulus. The monetary stimulus is being accompanied by fiscal stimulus as well. The hastily created "Stimulus Package" of tax cuts being rushed through Congress also smacks of desperation and the unwillingness of politicians to go to the polls in November facing a weak economy.

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ority to the political and economic elites. Big and interventionist government is now the solution to all economic ills. Free markets and strict monetarism have been utterly repudiated in the corridors of power in Washington and Wall Street. It is ironic that the same Wall Street bankers who cherished freedom from government intervention are now brazenly demanding it. I guess when your bonus is threatened, conservative economic ideology is easily shed.

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Weathering a Chinese Storm?

The severity of the global credit contraction also looks to us to be combining with the slowing U.S. economy to raise the prospect of a more severe global economic slowing than we had previously expected. The real question is whether the slowdown will be severe enough to be accompanied by falling inflation. This really depends on the ability of China to weather a consumption led slowdown in the U.S. and potentially in the rest of the world. Thus far, China has been able to sidestep the weakness in the U.S. It will be increasingly difficult for China to sustain its strong economic growth going forward, given the export orientation of its economy. China produces far more consumer goods than it could possibly consume domestically.

The booming Chinese economy is ripe for a fall. A weakening Chinese economy would be first reflected in global commodity prices as Chinese manufacturers cut back on their orders for raw materials as their orders decline. This could be somewhat breathtaking, as the global frenzy of the Chinese to secure resources has bid up the price of commodities to record levels. The red hot and speculative Chinese stock market would then tremble and finally cave to this drop in final demand from consuming countries as manufacturers' profits fall.

Risky Assets Will Stay Risky

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Ben Bernanke is pulling out all the stops to prevent what he sees as the risk of a serious U.S. economic downturn. We hope that he is right about serious U.S. weakness, as the stimulation he has unleashed to calm the financial markets risks another financial bubble on the scope of that created by the Greenspan Fed. As we have said, we think the U.S. is slowing substantially, and if it isn't a statistical recession it will sure feel like one. If the global economy does succeed in muddling through a U.S. slowdown or recession, it will probably result in slower global growth with inflation. This is what economists in the 1970s called "stagflation". We believe that this would lead to a very steep bond yield curve as central bankers lower rates to stimulate economic activity and the bond market reacts to potentially higher levels of inflation going forward. A severe enough slowdown or an actual global recession with falling commodity prices would generate a retrenchment in real asset values. This would combine with the deflation in financial asset values from the credit crunch to threaten serious overall deflation.

We do not believe either scenario will be good for risky financial assets. Slow growth will not be good for equity markets with or without inflation. Falling inflation implies a rather severe economic setback in which profit declines would harm equity valuations far more than they would benefit from falling interest rates. Slower growth with inflation would also lead to moderating profits in the face of rising costs and interest rates.

Although we are taking advantage of the distress in financial issuers, we are keeping our portfolios cautious. The economic picture will become clearer and we should soon know if Professor Bernanke's interest rate heroics were warranted.

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