MARKET OBSERVER

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We called for continued economic growth in our June newsletter, albeit at a slower pace, with stubborn inflation. We also believed that the risk of a financial accident was high due to the very speculative behaviour in the credit markets which might move the Fed into rate reduction mode. Our prime candidate for impending financial trauma was the institutionalized stupidity of collateralized debt obligations and the U.S. mortgage market. This was no surprise to our readers, as we have been concerned at what we termed the "inanity" of these thoroughly modern credit fashions for some time.

The Verb "To Crater"

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Unfortunately, we were right on in our conjecture. The swelling defaults in sub-prime mortgages in the United States flowed through to the asset-backed securities that had invested in them. These "cratered" in price. The verb "to crater" in bond parlance means that there were no bids and lots of offers which causes a deep hole in price which is very hard to climb out of. Complicating the situation was the illiquidity of these complex securities which are opaque and very difficult to analyze. Many were held by very few investors. The innate belief of Wall Street quants in their "mark to model" values was demonstrably challenged as many of these highly rated structures fell more than 50% due to their leveraged exposures to sub-prime mortgages.

Complicating the situation was that many hedge funds had purchased these "sliced and diced" pools of bonds, mortgages and loans on margin. When Bear Stearns, the preeminent mortgage bank on Wall Street, had two of its mortgage based hedge funds implode and plunge to cents on the dollar in early July, the market knew something was amiss. It now seemed that the ten to one leverage that was a good idea when financial assets were rising in value might not be such a bright strategy when things were going down!

Every Banker for Himself!

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The prospect of financial turmoil and Wall Street profits and particularly bonuses being under pressure was too much for the financial class to bear. The demands for liquidity from the Fed became louder and more strident. The Fed seemed resolute in the face of the pressure. "Fix yourself" seemed to be the Fed's message to Wall Street, "It's your mess to clean up". This was a major break from the Greenspan Fed which dropped interest rates at any real or imagined crisis in the financial markets. It was clear that the new Fed Chair, Ben Bernanke, was trying to avoid the so-called "moral hazard" of the "Greenspan Put" which alluded to the financial markets assuming risk on the assumption that the Fed would always bail them out of their financial mistakes.

The Fed inaction and fears of the credit unknown caused a wave of hysteria to swell up in the boardrooms of Wall Street and anything asset backed became suspect. Those who blissfully relied on the credit rating agency seal of approval were now paralyzed by their worst credit nightmares. This meant inter-bank lending seized up as bankers suspicious of the credit quality of their own portfolios grew suspect of their peers. "Every Banker for Himself" became the mantra of Wall Street. Like the terrified occupants of a life boat kicking the hands of those in water trying to board, the self-preservation instinct of bankers kicked in.

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The tsunami of credit fear rolled from its Wall Street epicenter to the far corners of global financial markets. The sub-prime troubles seemed to be relentless: a British bank here, a German state bank there, an Australian hedge fund. When it turned out that money market funds were buying Asset Backed Commercial Paper that had substantial sub-prime exposure, the buying of ABCP dried up and demonstrated once again the immutable financial truth that funding long term assets from short term sources is idiotic.

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"What Do We Want? Liquidity! When Do We Want It? NOW!"

The pressure on the Fed to act grew over the summer and peaked in early September. In an opinion piece in the Wall Street Journal on September 12th entitled *"Liquidity Now!"*, Professor Martin Feldstein of Harvard argued strenuously for a Fed rate cut. *"But it would be a mistake to resist an interest rate cut and risk a serious downturn merely to avoid the indirect effect of helping those market participants……A sharp reduction in interest rate would attenuate that very bad outcome."* These were pretty snippy words from an academic economist directed at his former peer, Professor Bernanke of Princeton. Poor Gentle Ben must have feared protest marches of chanting economists and bankers storming the Federal Reserve: *"What Do We Want? Liquidity! When Do We Want It? Now!"*

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In the days after the Feldstein piece, the pressure from bankers, economists and politicians grew inexorably. Loathe to be burned in effigy on the steps of the Federal Reserve by the Wall Street financial mob, Bernanke and the Fed relented. At the FOMC meeting of September 18th, the Fed lowered the Fed Funds rate by .5%, shocking the markets who had expected a .25% decrease.

Reflation for the Nation

The financial markets were clearly surprised and rejoiced at Professor Bernanke's reprise of the Greenspanian liquidity injections. After talking tough about moral hazard, Professor Ben finally threw in the towel and lowered the Fed Funds rate more than the jubilant markets expected. While the stock market rebounded and Wall Street bankers breathed a sigh of relief at their improved bonus prospects, the long end of the bond market came under pressure at Bernanke's *"Reflation for the Nation"* monetary policy. It is very obvious that the Fed has now put continued economic growth and financial stability ahead of inflationary concerns. Global investors agree. The U.S. dollar is falling, the price of gold is making record highs not seen since the inflationary blowout in the early 1980s and oil has charged through the $80 barrier.

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We think that the tension between the "slowdown" and "inflation" camps will take some time to resolve. Granted, the housing market is in serious trouble and it looks like we are still in the early stages of the sub-prime crisis. On the other hand, the lower U.S. dollar is powering U.S. exports to the still economically strong rest of the world. At the time of writing in early October, with the U.S. stock market making new highs and manufacturing and service sector reports coming in stronger than anticipated, it certainly looks like the credit and housing woes are not slowing the U.S. economy as much as the liquidity consensus feared.

Bernanke's Dollar Flop?

It is hard to forecast the final resting point of U.S. interest rates at this juncture. Our bet is that the U.S. economy will weaken from the housing slump but will avoid outright recession as it is dragged along by the continued growth of its trading partners. Unlike past bouts of economic slowing, demand from the rest of the world for commodities should keep their prices high in depreciated U.S. dollars. This could combine with rising import prices to keep inflation at a higher

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level than the market suspects. If the severe housing weakness is offset by enough dollar induced manufacturing strength, the employment damage might be contained. This would reduce the downwards pressure on wages that typically accompanies economic weakness and would support inflation at a higher level than historically has been the case.

The twin keys to our outlook are the U.S. dollar and the propensity of the Fed to ease. If Professor Bernanke continues his version of the Greenspan interest rate swan dive, the damage to the U.S. dollar could be severe from the Bernanke Dollar Flop. This would put further downwards pressure on the U.S. dollar and upwards pressure on U.S. inflation. Whatever Mr. Bernanke chooses to do, he had better get it done quickly. The Bernanke Fed doesn't have much room for maneuver. With a U.S. Presidential election looming in 2008, the Fed will probably be on hold for much of the next year for political reasons.

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Our Outlook

The global stock markets should continue to do well with U.S. monetary ease and continued global economic growth. In the U.S., companies with extensive foreign sales will benefit from the rise of their foreign revenues in U.S. dollars which means that U.S. equity returns will vary substantially by sector. Short of an "emergency" low interest rate policy by the Fed, the financial sector will be hamstrung by its increasing reliance on securitization over the past few years. All those securitized receivables and other financial assets will be coming back onto financial institution balance sheets. This is using up capital and widening financial bond spreads which makes for more expensive financing. Combined with losses on existing bond and loan holdings, the profits of financial institutions and their share prices will be under pressure.

The outlook for the U.S. bond market is more problematic. Short of an outright recession and falling prices, the U.S. bond market is not cheap relative to existing levels of inflation. Global credit spreads will continue to widen as the securitization mania draws to a close and the 100% financing of financial assets shudders to a halt. The Canadian bond market will outperform the U.S., as the higher Canadian dollar keeps inflation lower in Canada than in the U.S.

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The risk that the credit crunch worsens and affects both the global economy and world financial markets remains. If this is indeed the case, equities would sell off. In particular, the euphoric Asian markets seem ripe for a fall. Clearly investing and gambling are not differentiated in the Chinese stock market and this suggests a major setback is possible. A fall in Chinese equities could knock on into the world's other stock markets. A falling stock market and continued credit crunch would not be a happy time for the speculative hedge funds and their bankers. Margin liquidation is not something built into the risk models of Wall Street. The results would not be pretty.

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