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CREDIT IS THREE-DIMENSIONAL

**The Fed has little influence on the curve, or credit spreads,
and the concept of a national credit market is nonsense.**

Overview: The very old saying that "Credit is suspicion asleep" provided the most succinct explanation of pressures in the financial markets that concluded in severe turmoil in August. In a world considered to be made almost perfect by policymakers this was shocking. "Goldilocks" was the prevailing condition, financial panic rapidly became the new paradigm, but these events are not so new. Neither have been the ideas that were floated as the early signs of trouble appeared that it was "isolated", or could be "contained". Despite such comforts promised by the establishment the transition showed, yet again, that risk appraisal was indeed asleep.

Going as far back as Roman times history records many collapses in financial markets, and while the names of the credit instruments may change, the pattern has remained the same. A boom, with great confidence and a sudden change from exuberance to dismay and panic, has usually been followed by a cyclical contraction. Even the response by policymakers is so reliable as to be predictable.

Through a number of panics and contractions in the mortgage markets the "Genius" of the Emperor virtually created the New Deal in Old Rome, much as Roosevelt's "Brain Trust" created the New Deal in the US in the 1930s. It is ironical that the socialists who invented the New Deal were so ignorant of their own history that they didn't know that their counterparts had invented the same nonsense almost 2,000 years earlier. There is a comment by Cicero that problems in the credit markets in one part of the Empire inevitably would spread to all trading ports in the Mediterranean.

Various agencies created in Rome's long-running New Deal intended to help or bail out everyone from merchants to grain farmers to wine makers suggests that the hardships of a post-boom contraction hit virtually all classes in society. Particularly when out of a population of almost a million in the City almost half were on welfare.

Thus, the observation that credit markets are three-dimensional. One is that a credit contraction afflicts all classes of credit from low-grade to high-grade borrowers, as well as those who are wards of the state with no ability to borrow money to the state itself with the highest rating.

The next dimension is in time, whereby shorter-dated loans usually have a lower rate than longer-dated loans. Then in a boom the demand by speculators for near-term money increases short rates faster than long rates and the curve inverts. This is symptomatic of a boom but does not signal its demise. As with the experience in the summer, it is when the curve reverses to steepening that the most blatant speculations begin to fall apart.

It is worth noting that while the Fed can briefly influence short-dated market rates of interest it can't push long rates, so the policymakers have little influence on the curve. The curve as it reverses to steepening then becomes a sophisticated and impartial indicator of diminishing speculative demand for funds.

The next dimension of credit is the spread between low-grade and high-grade bonds, which in the final phase of a boom becomes very narrow. In so many words, in an over abundance of confidence investors buy risk to obtain a slightly higher yield.

The other historical aspect of credit is the third dimension of geography. Where the foundation of manipulative economics rests upon personal fantasies about a national economy the real world of credit has always been universal to wherever credit is used and created. Credit is global and policymaking is a parochial dream that can turn to a nightmare in the face of implacable market forces. A credit expansion is like a tide as it lifts all ships in all harbours – from the largest to the smallest. Contractions have been undeniable and do quite the opposite.

At the bottom of contraction it is typically real and cautious money rather than the borrowed kind that accumulates very unpopular stocks, corporate bonds, and commodities. Then, at the top inspired confidence leverages up on established price trends and participants enjoy the high life. In so many words, bull markets, like civilizations are born stoic and die epicurean.

Cicero's observations that financial distress in Tyre, with an unfavourable wind would inevitably be carried to Rome, has and will continue to be correct. Notions that credit markets are national will continue to be absurd.

These implacable forces, which by definition have always been well beyond the ambitions of even the most earnest of committees, have been cyclical. And the characteristics of change from contraction to expansion and back again have been methodical.

Of critical interest has been this year's changes in the credit markets. Typically in the late phase of a boom the action runs for some 12 to 16 months against an inverted curve and while this indicates developing strains in the financial markets it is not the killer, nor is the attendant rise in short-dated market rates of interest, such as treasury bills. The problem is that when the curve reverses to steepening the most blatant speculations begin to fall, with many of them failing.

The curve had reversed to steepening by the end of May, and June was the sixteenth month since inversion started in February, 2006. With this, our observation in July was that the contraction had started and that it would likely be the biggest train wreck in the history of credit markets.

The initial crisis came as a severe shock to market participants, policymakers and interventionist academics. Although the panic ran a brief course and ended later in August, the overall condition should not be considered as "fixable" or that the summer's turmoil was enough to naturally clear market imbalances.

An era of wild asset inflations, including stock and metal markets, matured in the summer of 1873 and following the initial panic, *The Economist* (October 4, 1873), wisely observed "The panic may be over, but the results of the panic are not over." The initial bear market lasted for five years and the business contraction lasted one year longer. The writer at *The Economist* offered appropriate advice on any shocking panic, especially as signaled by changes in the credit markets that started in May of this year.

Over most of the past two years the mantra has been that the Fed had again provided "Goldilocks" conditions and that within this "liquidity" was driving the markets up. In reality it was the usual leveraging up of all the hot games that provided the appearance of liquidity, and the health of the play depended upon rising prices. Of course, the threat to any impetuous boom is that any break in prices brings the margin clerk on to the stage.

The job descriptions of the central banker and the margin clerk are very different. The central banker's job is to get the accounts over-leveraged, and the latter is compelled to get and keep the accounts onside – no matter what! Seriously, it is ironical that the way it really works is that the world of policymaking has always fostered unsustainable speculation and then at the top hands the baton of power in the credit markets to Mr. Margin.

This contrasts with macroeconomics which considers that contractions are due to "exogenous" events, which essentially means that if you didn't put it in your computer model then it can't happen. The equivalent in investing has been quantitative modeling and one such "quant" described the credit shock as not just one "10,000" year event, but that there were 3 days of them.

Conventional wisdom holds that interventionist policymakers will "fix" the problems. A thorough review of history suggests that policymaking with its chronic accommodation is a large part of the problem and the contraction could be severe enough to "fix" interventionist meddling.

In the 1600s Amsterdam was the commercial and financial center of the world, and some Dutch terms for finance have meaning today. The term "easy" money still has the same connotation, and soon so will its opposite – "diseased" money. The October 20th edition of The Economist cover story was "Central banks have worked miracles for 30 years. Don't count on that continuing."

Well they got the last part right, but rather than calling the thirty years a miracle the practical Dutch would have called it "easy" money, and also had the vocabulary for its consequence.

Dimensional Update: As part of rejuvenated markets the yield curve flattened as the 10s to 2s came in to 48 bps on October 18 and has steepened a little to 60 bps. Also providing modest warning is that the BBB corporate bond spread, over treasuries, has widened from 129 bps to 137 bps.

However, the event that provided an outstanding warning on the August panic was the initial signal as the BBB subprime mortgage bond turned down in June and the killer was when the AAA subprime bond plunged from 99 ½ to 91 in the first two weeks of July.

The rebound took the top-rated bond to 97 ½ in late August from where it declined to 96.25 on October 18. In the past 5 trading days it has slumped to 88.25 – taking out the low of August, which is a strident warning.

Although we have been discussing price it should be emphasized that the plunge also reflects severely widening credit spreads and one chart shows the crash in the "A" subprime bond and the slump in the S&P.

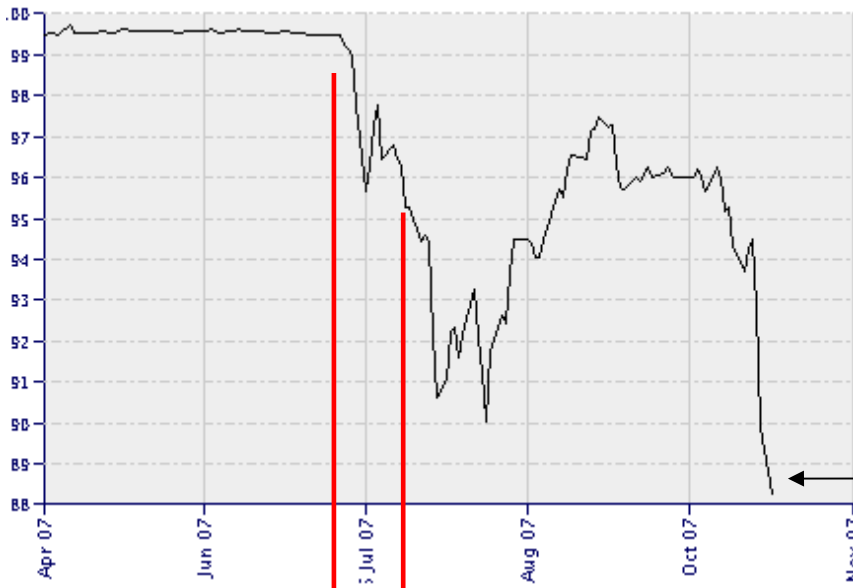
The other chart shows how the crash in the BBB subprime bond has afflicted the preferred shares of Royal Bank – Canada's biggest.

Related Article: Our report titled "The Unholy Trinity" (July 23) reviews that arbitrary manipulations have culminated in the biggest credit bubble in history. Culpability starts with the Fed and its prerogative of artificial money as well as interest rates and continues with the creation by Wall Street and Academe of synthetic securities such as subprime mortgage bonds. Then math models are contrived to provide an artificial price, as well as artificial credit ratings from formerly august rating agencies.

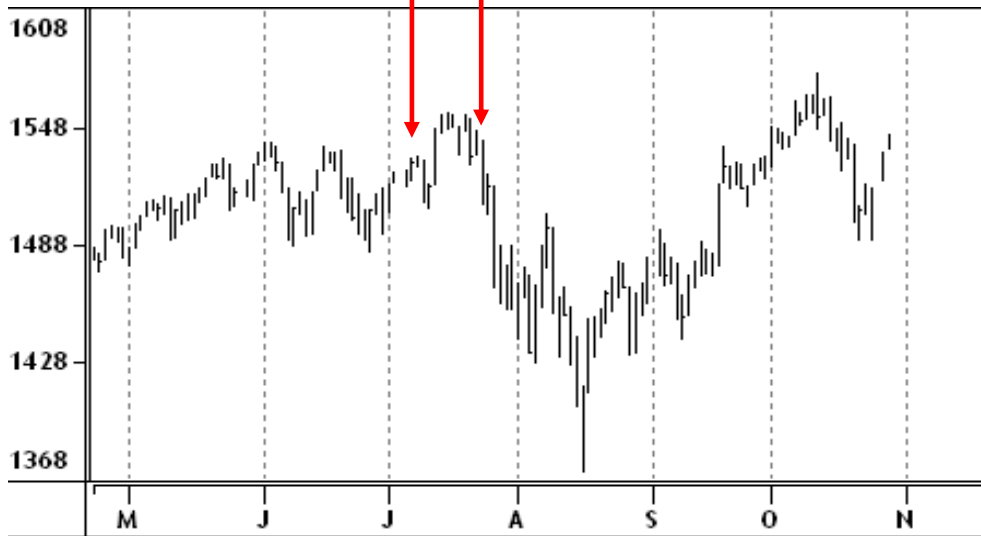
This can be reviewed on the Institutional Advisors website at

www.institutionaladvisors.com/pdf/070723_HOYE-UNHOLY_TRINITY.pdf

AAA Subprime Bond

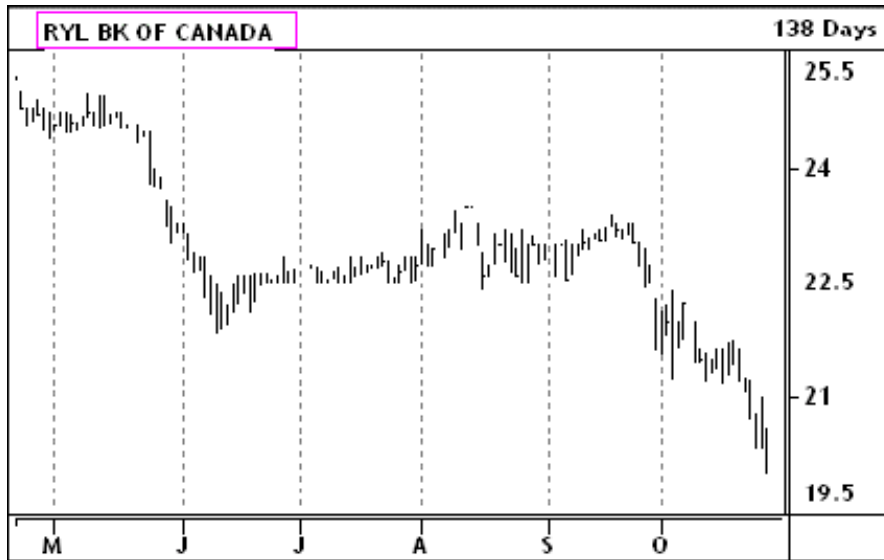


Triple - Yikes!

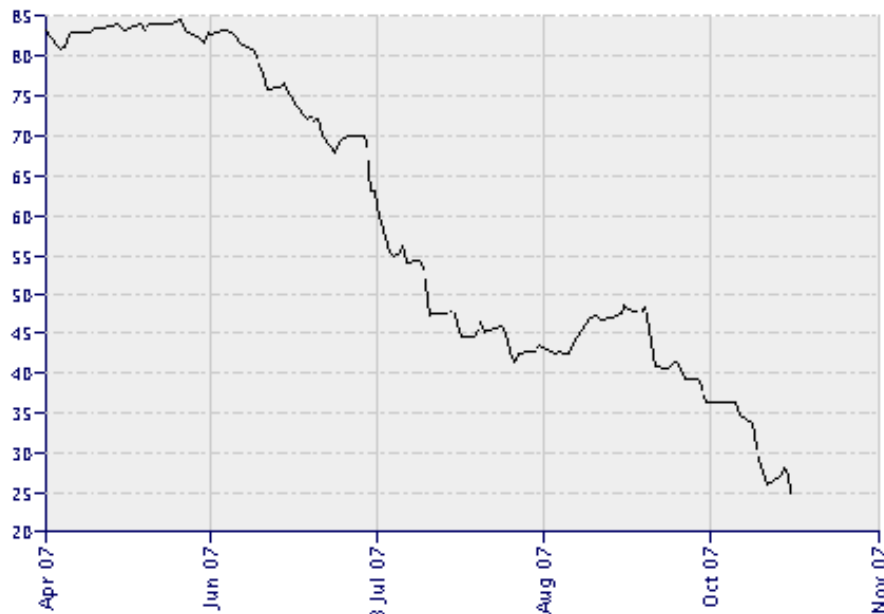


S&P

SUBPRIME CONTAGION



Preferred shares of
Canada's largest bank



BBB Subprime
mortgage bond

- Freddie Mac says that *“the subprime slump is contained”*
- Fund manager says *“The whole subprime mess has been basically looked over and is not taken as a big concern.”*

– Bloomberg, June 26

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