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### CREDIT MARKETS

#### “Credit is Suspicion Asleep”

In a boom, even the most insecure borrower finds it impossible to refuse a loan and then the contraction starts. What’s more, there is a typical pattern to the end of a dramatic credit expansion and when the contraction gets vicious even formerly good credits have difficulty in getting a loan. Near the end of a contraction, a stalemate can develop as AAA borrowers protect that illustrious rating by not borrowing and banks maintain that stature by only lending to AAA accounts – who are not borrowing.

The transition from one opposing condition to the other involves a credit expansion against, ultimately, the most fantastic stories and, as history shows, the street will believe the most preposterous promotions – and fund them until the price action breaks.

In July, we conclude that “the greatest train wreck in the history of credit” had started, and advised that most banks and financial were a “Widows and Orphans Sell”.

The steps were methodical and began in April, 2007 when we noted that every great boom concluded with a frenzy of “Rational Exuberance”. This was based upon the observation that often the final stage of a boom runs for some 12 to 16 months against an inverted curve. It was frequently mentioned that June,, 2007 would be *Month 16* since the curve inverted.

However, it was worth emphasizing that inversion and concomitant rising short-dated market rates of interest are an indicator that the boom is on and does not justify the usual establishment worries about increasing interest rates. The danger arrives when the curve reverses to steepening and short-rates such as treasury bills turn down.

What follows are some of the key calls or explanations as the market methodically and rationally worked its way from exuberance to crisis and at times panic. The drama of August was mainly due to widening credit spreads with the discovery of a massive loss of liquidity in derivatives.

The following documents our advice through the initial phase of this contraction.

#### **May 3, 2007:**

“The steepening trend is on, and although it may not be as bad as recorded with the contractions that started in 2000, 1929, and 1873 bubbles, steepening could be significant.”

On **April 4, 2007** the Financial Post had an article that included *“the rapid evolution of products”* and that *“The new strategies include collateralized loan obligations, currencies and credit-default swaps.”*

In returning to the WSJ.com article which also noted that dealers offer *“derivatives in dizzying variety. The values of some are tied to single stocks, others to baskets of stocks or market indexes, still others to bonds, oil, or even the weather.”*

And exemplifying another piece of financial jargon Buffett is quoted again, *“total-return swaps make a mockery of margin requirements.”*

The important thing to be noted is that this is not the first time that financial innovation has inspired new instruments, and when it arrives – chagrin.

The earliest huge mania that was complete with all the miracles of financial innovation was the South Sea Bubble of 1720. Bitter disappointment followed and was nicely recorded for posterity:

*“the English Nation run a madding after new inventions, whims, and projects [promotions], that impoverish, fiddle them out of their money, by the strange, un-heard-of engines of discount, transfers, tallies, debentures, shares, projects, and the devil and all figures and hard names.”*

That bubble peaked in May to June of that fateful year. The market drifted with weak rallies during the summer and crashed in the fall. The South Sea Company, which was the big-cap wonder, crashed from a high of 1000 to only 120 in only six months.”

**May 17, 2007**

### **DEARTH OF CREDIT**

The full understanding of credit and its cycles has been provided by the Austrian School of Economics. Its leading exponent has been Ludwig von Mises and some of his comments bear witness to today's one-way excesses. It is imperative to have an understanding of credit that works in both financial and tangible asset booms.

"An increase in the quantity of money or fiduciary media is an indispensable condition of the emergence of a boom. The recurrence of boom periods, followed by periods of depression, is the unavoidable outcome of repeated attempts to lower the gross market rate of interest by means of credit expansion. There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.

The breakdown appears as soon as the banks become frightened by the accelerated pace of the boom and begin to abstain from further credit expansion. The change in the banks' conduct does not create the crisis. It merely makes visible the havoc spread by the faults which business has committed in the boom period.

The dearth of credit which marks the crisis is caused not by contraction but by the abstention from further credit expansion. It hurts all enterprises – not only those which are doomed at any rate, but no less those whose business is sound and could flourish if appropriate credit were available. As the outstanding debts are not paid back, the banks lack the means to grant credits even to the most solid firms. The crisis becomes general and forces all branches of business and all firms to restrict their activities. But there is no means of avoiding these consequences of the preceding boom.

Prices of the factors of production – both material and human – have reached an excessive height in the boom period. They must come down before business can become profitable again. The recovery and return to "normalcy" can only begin when prices and wage rates are so low that a sufficient number of people assume that they will not drop still more."

The Austrians did not distinguish between financial and tangible asset booms, and did not provide any examples or a forecasting model.

**May 17, 2007, Pivotal Events:**

“On the bigger picture, typically the final stages of a bull market run against yield curve inversion for some 12 to 16 months and then the action tops. May is **Month 15** and typically the play runs out of momentum as the curve reverses to steepening. The chart below shows the similarity or the change now to that in the fall of 2000. Indeed, this is the case at the end of any great boom.

**THE YIELD CURVE (FROM BILLS TO BONDS)**



The curve has turned to steepening in a manner unseen since November, 2000, when the wheels started to fall off that great speculation.

**May 24, 2007, Pivotal Events:**

“**Credit Spreads:** One could say that risk no longer exists. Obligations made on every bond, note, or (shudder) derivative will be met. To doubt this truth is to doubt the **‘truth’** about capitalism and the good life causing global warming.

There is ample reason to doubt both, but this page will stay with credit markets.

Junk has narrowed from 530 bps in January to 425 bps which is a new **“low”** for the move. Considering the strength in stocks and base metals it is not surprising that exuberance is showing up in the sector as well.

However, the spread market is eligible to change and there can be seasonal forces to recognize in this sector. We used this in May 1998 to forecast that spreads would widen *“to dislocating conditions in August-September”*.

It is that seasonal widening that took out LTCM, and if it happens this year the change could have some interesting results.”

**May 31, 2007**, Pivotal Events:

*“May usually sees the seasonal best for spreads and this has brought junk into 423 bps.”*

**June 20, 2007**, Pivotal Events:

*“It is worth noting that at important turns (top or bottom) short-dated market rates of interest have led changes in the senior central bank’s administered rates by a number of months.*

*Hey, it’s the way it works – welcome to the rational fringe.”*

**June 28, 2007**, Pivotal Events:

**“Signs Of The Times:**

The Peoples Bank of China recently did a survey that noted that over 40% of Chinese households plan to invest in the stock market, a 10 percentage point increase since 1Q.

On June 22, Halkin Services editor Robin Aspinall added: *“They trust a bubbling stock market more than dodgy banks.”*

*“Then there is California, where housing woes helped to push the unemployment rate to 5.2% in May from 4.8% in December. If more people lose their jobs, expect more pain in the mortgage-backed securities market. Of the loans backing all subprime securities issued in 2006, 28% originated in California.*

*Don’t expect the Fed, which meets this week, to ride to the rescue.*

*Inflation concerns remain paramount at the Fed and Fed officials still argue that the pain from the subprime mess will be contained.”*

- Wall Street Journal, June 25

*“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

The subprime mortgage bond we’ve been following (the ABX HE BBB) which was quoted at par in August, fell to 73 on February 27. It rebounded to 84.6 on May 24 from which it has dropped to 71.8 yesterday – a new low since the bear started in August.

As for the ‘no big concern’ complacency:

***“Woes of the U.S. subprime mortgage market reached across the Atlantic to claim a new victim.***

***Queen’s Walk Investment fund has been positioned in mortgage-backed securities and its stock is down 39% since early in the year.”***

- Wall Street Journal, June 27

The problem is not as simple as having an old-fashioned rally with enough power to create the dynamics for a top. It is the additional hazard of a financial culture that admits no risk because risk has been banished.

The notion is that with the Fed managing things ***“nothing can go wrong”***. Ironic as it is, the resultant confidence increases the amount of risk carried.

Over the centuries, the private-side of the investing world can voluntarily create huge speculative bubbles even when the senior central bank was being held responsible by a convertible currency.

Near a top speculators can believe the most preposterous stories so long as the market is going up. That’s without reinforcement from the notion of a super agency that virtually guarantees prosperity. The last combination of these forces created the high-tech ***“Goldilocks”*** mania that blew out in the first half of 2000. Until the tech-crash the abilities of the Fed were celebrated around the world.

Then in January 2001 when the Nasdaq had given up 3.5 trillion, bitter op-ed pieces in the Financial Post and Wall Street Journal condemned the Fed for allowing the crash to happen.

Our view on interventionist economics is essentially that it has been a highly speculative experiment that the investing public has little choice but to speculate equivalently against the Fed’s weapon of choice – chronic currency emission and depreciation.

Official speculation exacerbates private speculation.

In underwriting, risk can be reduced by limiting bond flotations to AAA credits. However, and likely unfortunately, some financial agents (not in government) found the risk-reduction game profitable. The first example was equity ***“portfolio insurance”*** of 1987 that turned what would have been a normal stock market correction into a unique crash.

Recently the chimera of risk elimination has developed in debt markets.

The June 25 Barron’s Online story headlined: ***“A Mortgage Meltdown for MBIA”*** and reviewed the risk in the giant municipal-bond and corporate-debt insurer.

Another hazard has been CDO legerdemain whereby enough low-grade debt is bundled together in order to merit an investment grade ***“star”*** from a credit rating agency. This has always been suspect, but another level of hazard has been the placing of so many of these instruments that don’t really trade with the comfort of pricing by mathematical model rather than by market transactions.

As the saying goes – the street can believe the most preposterous stories so long as the “*price*” is going up. The “*price*” on many schemes to eliminate risk is starting to falter.”

**July 5, 2007**, Pivotal Events:

*“The illiquidity problem is rippling out and our Bank Trading Guide is dramatically reversing, which we are taking as a “Widows and Orphans” sell.”*

**July 12, 2007**, Pivotal Events:

“**Credit Spreads** have been widening – with cause. The delusion about pricing and rating issues by math models is being smashed along with some prices.

The BBB subprime mortgage bond we’ve been following plunged from 68.20 to 63.03 (no typo) yesterday. The panic low in late February was 73 and the rebound made it to 84.60 on May 24. The 73 was taken out on June 29 and the 7-point hit in only 2 trading days is the worst on the whole decline from 100 in August. (chart follows)

Today, Bloomberg reported that mortgage foreclosures for all of the US climbed 87% in June compared to a year ago. In the chilling dryness of the report *“There were 164,644 loan default notices, scheduled actions, and bank repossessions in June, led by filings in California and Florida, where home prices have plummeted.”*

Some of the blame is laid to the rise in mortgage rates and the story notes that the scheduled increase in adjustable mortgage rates has yet to kick in.

Pressures in the sector have moved fast this week and spreads in traditional corporates have had a modest move. The high-yield spread, over treasuries, widened from 285 bps on Friday to 307 bps. Similarly junk has gone from 480 bps to 517 bps. These were at record narrows at 238 bps and 418 bps (respectively) only 4 weeks ago, and are now the widest for the year.

Our advice earlier in the year was to avoid all lower grade securities and to use each treasury rally to get defensive by positioning the 4 to 5-year maturities.

Steepening and widening is going to be awesome. ”

**July 21, 2007:**

## **THE UNHOLY TRINITY**

The structure of today’s credit markets is interesting. On top is the establishment’s convictions that the Fed can infallibly set the right level of interest rates that will “keep the recovery going”.

The result has been virtually chronic lending accommodation, which has fostered the biggest and most reckless financial party in history – the bender of last resort.

The business of arbitrarily manipulating interest rates has been on since the Fed opened its doors in early 1914. Two other equally arbitrary constructs are more recent and have become rather acute hazards. These are the now widely discussed, and in some quarters already dismissed as the worry-stuff that drives bull markets. The most egregious is the notion of pricing by a mathematical model, rather than by market transaction.

The last element in this trilogy of artifice is that rating agencies came up with a mathematical model to assign a credit rating to a bundle of securities of doubtful parentage.

Professor James Tobin was a leading interventionist economist until he passed away in 2002 at the age of 84. In the early 1980s he defined a bubble as: "*Speculations on the speculations of other speculators who are doing the same.*"

No doubt he was thinking of the 1980 binge in metals, crude oil and real estate, and with no little irony it can be applied to the current establishment's trilogy of artifice.

Financial innovations to create credit out of thin air are always tempting but it takes a truly reckless culture to make it a tool of policy makers. It seems like another world away, but there was a time when such tools were shunned. Brokerage bucket shops flourished during the late 1800s. These store-front operations provided the retail account a way to play price changes of big board stocks without entering orders through the floor. Margins offered were as low as 1%. The operations were subject to manipulation in the "shop's" favour.

This form of unenforceable contract had earlier been seen as wonderful and then calamitous in the infamous Tulip Bubble of 1637 whereby the "Lunatic Fringe" brought down the senior economy, in a typical post-bubble contraction.

Now it seems that an experiment in credit innovation that would be scorned by earlier generations of bankers and financiers has become the financial culture of Academe, Main Street, as well as Wall Street. As with any intense speculation, participants can ardently believe the most preposterous story so long as the price is going up. Then the inevitable speculative exhaustion is followed by chagrin.

Belief in the Unholy Trinity of central banking, derivatives and artificial rating of credit is dependent upon an always rising price. In one sector – subprime – this is not the case as the BBB bond has plunged from 95 at the first of the year to 54.

Within this the plunge from 85 in late May is becoming severe and at what price below, say 85, can a BBB still be considered investment grade?

At what point does the establishment no longer believe that the subprime mess is isolated or can be contained?

And, at what point does the general public finally understand and condemn the Unholy Trinity?

**July 26, 2007, Pivotal Events:**

**"Signs Of The Times:**

*"Foreigners put more money into American stocks and bonds in May than in any previous month in history."*

- Drudge Report, July 20

*"Foreign governments, flush with cash and no longer content with the meager returns to be had on safe but low-yielding investments like Treasuries, are becoming increasingly aggressive players on the equity front."*

- Wall Street Journal, July 24

***“There is only a small likelihood that default rates [for collateralized loan obligations] are going to increase meaningfully in the next 12 to 18 months.”***

- John Mauldin, July 20

As we have been saying, so long as the price isn't going down the most preposterous things can be believed. Maybe the price of these suckers is going down now, in which case when will initial concerns about default in this sector come to the surface?

***“Trying to cash in on investors' fascination with alternative investments, Wall Street is concocting a complex new product that aims to mimic hedge-fund performance while avoiding the gigantic falls.”***

- Wall Street Journal, July 24

## FINANCIAL CONTAGION

The first crash in subprime mortgage bonds wasn't noticed until the price had plunged to 73 in late February. When it was discovered by Wall Street strategists it was quickly judged to be an isolated event. Then, with the rebound to 84.60 in late May it lost its focus even as an event, let alone a contagious one.

Then the price of the mortgage bond again turned down to take out the February low in late June, when a number of Fed spokesmen argued that ***“the pain from the subprime mess will be contained.”***

The breakdown was at 73 and the plunge took it to yesterday's 51.62, which decline seemed to prompt yet more observations that the distress could be isolated.

History provides a reliable instruction on credit expansions and credit contractions. One causes the other and the corruption of central banking from the duty of providing a sound currency to being the bender of last resort has exacerbated the booms, which in turn will exacerbate the inevitable contraction.

Those armed with interventionist theories rather than with the evidence of financial history seem compelled to deny a natural turn towards a credit contraction, when its time has come.

This occurred with the culmination of the tech-mania in 1Q 2000. Pundits stayed with the theme that you had to buy the stock market because ***“there was no inflation”***. One of the features of that boom was that it did not include commodity price inflation – mainly inflation of stocks prices .

Today's story has been remarkably different as ***“you have to buy equities because there is inflation in commodity prices.”*** However, although the pitch is opposite to that of 1Q 2000, a boom is a boom and the actual stories, while interesting, have been controlled by the credit markets. Typically near the culmination of huge speculative action the yield curve will turn from inversion to steepening, at which time usually the wheels begin to fall off the most egregious speculations.

Recent examples would include nickel's 40% plunge and the subprime “mess” becoming more acute as it afflicts the traditional corporate bond market.

Describing the problem as a “mess” implies that it is isolated and eligible for fixing.

This was the case with the “Asian Crisis” that started with the Thai baht on July 1, 1997. The problem followed excessive local speculation blowing out and on the usual liquidity crisis the central bank suffered a shocking loss of reserves. The financial media overlooked the real problem and described it as “*currency turmoil*”, with the implication that it could be fixed by wise policy. The other reporting blunder was the insistence that credit distress would be isolated to Thailand.

Then when it afflicted the Philippines, media still insisted that it could be contained. Well, as the world discovered, the distress couldn’t be contained and despite the affliction spreading U.S. corporate spreads did not adjust for risk until it was too late and in October suffered the worst hit in a decade.

All the way down the slide the establishment insisted that it was currency turmoil and that it could be contained.

The subprime “mess” turned acute early in the year, and traditional corporate spreads remained immune until mid June. After basking in splendid isolation at record narrow spreads, widening has taken junk from 418 bps over treasuries to 595 bps. With this the yield has jumped from 9.50% to almost 11%, which would knock some 13 points off a representative junk-bond.

Usually junk-bonds and the stock market go up and down together. Given the nature of credit the stock market will get in line with the building liquidity crisis.

As with the end of previous credit inflations, the contraction is progressing from sector to sector. This time around it started with subprime mortgage bonds and has now taken out junk which most of the time acts like a stock.

This is likely the biggest train wreck in financial history and until today, in looking at the senior stock indexes the bulls are getting aboard the last train *into* Dodge City.

**August 8, 2007**, Pivotal Events:

### **KEY POINTS**

- Credit expansion is dependent upon rising prices. Those unfamiliar with the long history of violence in credit markets observed the late credit boom and described the phenomenon as “liquidity” driven.
- Every irresistible credit expansion has been followed by a credit contraction.
- On the way up the boom key operators for expansion have been central banks, commercial banks, underwriters, and a number of ephemeral agencies capable of creating credit in supposedly “new” ways.
- Then all that is needed for the mania to end is prices stalling their rise and turning down. The 10-month decline in the median house price did it to the subprime.
- The power then shifts to margin clerks, or their equivalent, whose job description is vastly different to that of your basic central banker.

September 6, 2007:

## THE ROPESPINNER CONSPIRACY

*The Ropespinner Conspiracy* is a novel by Michael M. Thomas, a former investment banker who writes enjoyable novels about high finance.

The title relates to Lenin's observation the "*Capitalism will sell us the rope with which we hang it*". Published in 1987 the story is about a brilliant but insidious Soviet conspiracy to infiltrate the U.S. banking system and corrupt it to its own destruction.

The attempt starts in the late 1930s with a brilliant young economist who fell for Keynes' persuasions in more ways than one. Waldo Chamberlain becomes a Harvard economics professor and rises to pre-eminence. He is also KGB controlled. The plan is implemented through his bright and presentable nephew, Mallory, whose successful career takes him to the top of a big New York bank. Altogether, the trio introduce a number of "new" concepts to banking.

The KGB controller is knowledgeable and quotes Bagehot in describing the scheme -

***"But error is far more formidable than fraud: the mistakes of a sanguine manager are far more to be dreaded than theft by a dishonest manager."***

The young protege, Mallory, rises with his bank until -

***"There was no question that he and CertBank had been the pathfinders. Man and institution had combined to transform the face and nature of banking and, with it, the face and nature of whole economies, of nations. Mallory and CertBank had perceived markets and opportunities . . . and had grasped the business of banking might be redirected, its nature irrevocably, irresistibly altered."***

The Ropespinner plan was to take the banks, then set midway between Main Street and Wall Street, and return them to Wall Street.

The Glass-Steagall Act of 1933 separated commercial banking from investment banking. Beyond that, it was another example of post-bubble recriminatory legislation. The anti-bubble act (England) with the South Sea disaster of 1720 was taken off the books just in time for the bubble that blew out in 1772.

Glass-Steagall was passed in 1933 and repealed in 1999, which belatedly acknowledged that commercial banking had already embraced Wall Street.

***"The problems were to legally find a way around the Fed's grip: How to "dehabituate" the relationship between banks and their depositors: how to engineer a massive increase in money supply (almost impossible to have a financial cataclysm otherwise); how to destabilize exchange rates, perhaps eliminate the gold standard; how to ignite a commodity-driven inflation, each was so rich in possibility."***

This was to be implemented by Certbank's rising star, Mallory, who would -

***"Then set the Cert's shoulder to the shiny new wheel and proclaim and propagate the new gospel from the podium of the bank's eminence, other banks would follow the lead, frequently hasty, since reflection and competitiveness were ill-matched bedfellows, and within weeks the new gimmick would be as accepted and widespread***

*in American banking as if it had been proven over the years and certified from heaven by Morgan himself.”*

*Preston marveled, ‘The lad’s the best talker of claptrap I ever heard, better than FDR!’ ”*

The novelist develops the “new” banking ideas in a readable manner. Starting with negotiable CDs, EuroDollars, banks as a “growth” industry leading to the struggle for “market share”, and total commitment to “total return”, all the major changes in banking are placed in perspective.

Waldo plants the idea of negotiable CDs and, as the market for them developed, a traditional banker wonders:

*“If a short-term obligation could successfully be renewed time after time, should it not be viewed as truly long-term capital and as a legitimate source for funding longer-term loans?”*

*Waldo listened to these arguments and nodded sagely, and smiled inwardly. If ever there was a surefire recipe for banking disaster, it was to borrow short and lend long.”*

A book reviewer at the New York Times described *“Ropespinner”* as *“a sophisticated piece of work – the story generates plenty of tension, and it is anchored in a series of well-documented and well-described settings.”*

It is a parable of our era and a more timely read now than in 1987. As far as plausibility goes, it’s not too far off the mark.

Innovative banking always seems to go with experiments in currency. It’s fascinating that there are two different views on arbitrary expansion of currency. Orthodoxy claims that it is an essential tool of policy making but military intelligence has used it for destructive purposes.

The Brits have been masters of “war by other than gentlemanly means”. In order to destabilize the colonial economy, the British, during the American War of Independence, invidiously introduced huge amounts of counterfeit colonial currency. American inflation was sufficient to raise short interest rates to 10,000%.

At other times inordinate amounts of currency were clandestinely introduced into an enemy’s country with hopes of destabilizing their economy and ability to fund their war effort.

It was done during World War II as well as to Argentina during the Falklands War in 1982.

In the post-bubble contraction of the early 1980’s two Wall Street economists, nicknamed by the street as “Dr. Death” and “Dr. Doom”, were pleading that the Fed should “open the taps” or something worse would happen.

Obviously the understanding of credit/currency expansion by spooks in intelligence is vastly different to that of academics and Wall Street economists.

The fictional Waldo, Mallory, and the KGB controller would be pleased with today’s “new” banking practices.

September 12, 2007:

## THE FED (Shudder) CUT

The street is getting revved up for a rate cut. This week the CIO at a large fund observed, *“Lowering interest rates will certainly help the stock market. There is no question to it.”*

Most of the investment and economic establishment would agree with this, but history is skeptical.

The problem is that it is a theoretical idea that seems without empirical evidence. Indeed some 300 years of financial history records that short-dated market rates increase with a business and stock market boom and then decline during the subsequent contraction.

This was very much the case with the tech bubble that blew out in 2000. With this the Fed raised the discount rate to 6% and then from January 2001 the administered rate was dropped in 14 steps to 0.75% in November 2002. During this interval the Nasdaq composite declined 78% to its bear market low in October 2002.

During the subsequent boom the decline in administered rates was celebrated as “emergency” policy that ended the “deflation” and created prosperity. The plunge in rates was not without precedent.

At first glance it is difficult to determine just how much of the decline post-2000 was due to policy or to market forces.

However, it is helpful to consider the old saying from physics that if you keep your data base short enough it will fit your theory. It is appropriate to review the behavior of the senior central bank through all of the great booms. Originally it was the Bank of England, and more recently it’s been the Fed, and no matter who has been in charge administered rates go up in a boom and down in a contraction.

What’s more the bigger the boom the more dramatic the subsequent decline in rates, and examples since 1873 provide the best detail. It is worth emphasizing that the sharpest declines in rates have only occurred following a bubble.

The bubble that completed in 1873 was global and with the Franco-Prussian War was accompanied by soaring base metals and mining stocks. And during the usual credit strains seen at the top of any boom the leading New York newspaper editorialized that because Treasury Secretary Richardson was not constrained by a gold standard timely discounting could prevent a contraction. In 1884 leading economists described the period subsequent to 1873 as “The Great Depression”. Although it ended in 1895 it was still analyzed under that name until as late as 1939.

However, on the 1873 boom the Bank of England raised the discount rate to 9% from which it declined during the bear market to a low of 2% in July, 1877. That bear market lasted until then and accompanied by rising interest rates the next bull market ran until 1881.

The next equivalent plunge in administered rates started in 1929. It is worth noting that with the last rate hike in that fateful August The New York Times explained that the

increase from 5% to 6% was designed to reduce the supply of funds to Wall Street speculators and that other steps were intended to accommodate Main Street.

Then during the worst stages of the infamous bear market the Fed boldly cut administered rates to 1 ½% in 1931. The Fed was not just easy with rates but the New York branch opened the discount window during the crash and exceeded its lending authority by a factor of six.

There is a little more to the pattern as in 2000 and 1929 short term market rates of interest led the change in administered rates by a few months. In the earlier example treasury bills set a cyclical high at a little above 5.00% in June 1929 and the “notorious” last hike by the Fed was from 5% to 6% on August 9. By that date the bill rate was down to 4.60% on its way to 0.08%, eventually. By the time the Fed made the first cut the bill rate was down to 3%.

With our tech-bubble, three-month bills set the high of 6.40% on November 7, 2000 and the first cut by the Fed occurred on January 3, 2001.

This time around, bills recorded their cyclical high at 5.18% at the end of February. By the time the liquidity crisis forced the unscheduled cut in the discount rate on August 17 the bill rate had plunged to 3.60% on the way to 2.45%.

The post-bubble pattern of senior central bank behavior is unambiguous – it performs the biggest and most extensive cuts in the history of discount rates. And as our not always amiable instructor – Mr. Market – also points out, these have only occurred during severe bear markets. Furthermore, he might wonder where the idea came from that a cut in administered rates will inspire a bull market in what obviously is exceptional credit turmoil.

The record shows that often the administered rate cut is associated with a short-covered rally.

**September 13, 2007, Pivotal Events:**

**“Signs Of The Times:**

***“Credit markets will get back to normal, as there is a lot of money that needs to find a home.”***

- John Mauldin, August 18

***“The Fed will ultimately ride to the rescue.”***

- Senior Investment Officer  
Bloomberg, September 4

***“Lowering interest rates will certainly help the stock market. There is no question about it.”***

- CIO Harris Private Bank  
Bloomberg, September 4

Recently comparisons to the panic of 1907 have been widely circulated. One of the reasons seems to be the notion that J.P. Morgan single handedly prevented the crash from turning into a disaster. The actual time line shows that this is not the case.

For some time we have considered the asset inflation era that culminated in the 1873 bubble as an appropriate illustration for our era of asset inflations. America recorded impressive immigration and within this the start of a shift of population from the country to the cities. It was a remarkable transformation to an agricultural and industrial giant. According to W.W. Rostow, in 1840 the U.S. had 5% of the world's industrial production. By the 1880s this had jumped to 29%.

As with today, the U.S. was running an experiment in fiat money, with the usual volatility in prices and interest rates, not to overlook irony.

As the boom matured during the summer of 1873 credit markets showed the typical dislocations, which inspired the leading New York newspaper to editorialize that with the policy latitude permitted by a fiat currency nothing could go wrong.

As the trading days of September advanced the credit markets became more distressed and in London, which was the senior market, central bank policy was debated.

The lead story in The Economist of September 20, 1873 conveyed conflicting forces:

*“ The State of the Money Market*

*“The continued abundance of money in Lombard Street inclines some people to doubt the necessity for the precaution lately recommended of an immediate advance [increase] of the Bank rate. It has often happened before that the Bank of England, by keeping its own rate low and discounting freely, has been able to check an impending rise [in market rates] for a time.*

*“In fact, all the circumstances which we described a week ago as calling for an advance of the rate continue . . . The New York banks have for months been in a position of chronic difficulty, and there is no doubt a good deal of difficulty arising out of the state of the currency.*

What's new?

The 1873 mania included hot action in the mining sector and the big high-tech stock was Western Union, which had completed telegraph service across North America in 1861 as well as the stock ticker in 1869, and money services transfers in 1871.

The bear market lasted until 1877. ”

**October 3, 2007:**

**When did the Greenspan “Put” become the Bernanke “Call”?**

Generally, the Greenspan “Put” has been the notion that the Fed would flood the money markets to prevent an abysmal decline from excessive highs in the stock market. Therefore, on the long term, there was no need to be concerned about overweighting the stock market – ever. Perhaps convictions about this aspect of modern portfolio theory were slightly doubted during the travails that culminated in the liquidity panic of October 2002.

It is worth noting that a few hundred years of recurring bull and bear markets suggests that

central bankers are rent-seekers mainly along for the ride. And the idea that policy makers are timing such cyclical events is expedient for those who need the comfort of the ancient notion of Plato's philosopher king, or at least in a secular priesthood, called the FMOC.

Despite evidence to the contrary, the establishment still maintains the artifice of a random walk economy, so that inspired manipulations can be written on a clean slate. The history of financial markets is an endless thread of business prosperity and subsequent recessions, bull and bear markets, as well as great financial manias and their attendant credit expansions and consequent contractions. The thread runs in the past back to the development of modern financial markets in the last half of the 1600s. This includes periods of central bank accountability and sobriety to this generation's remarkably reckless experiment in artificial currencies and interest rates, not to overlook artificial pricing and ratings of artificial securities. With little change in its resolute nature, financial history will likely continue its record of euphoria and dismay.

In the mid-1960s and inspired by Paul Samuelson the economic establishment was absolutely convinced that they had eliminated the business cycle. But as the saying went "they had a bear market anyway". Other nonsense at the time included "Operation Twist" whereby the Fed and Treasury would buy enough bonds to drive interest rates from 6% back to the "normal" of 3%. That operation was integral to long rates soaring to 15%, which was the highest ever reached in the world's senior currency.

At the start of the Greenspan era the Fed enhanced its reputation by "ending" the 1987 crash, which apparently successful operation is a cliché dating back to at least 1825. A period of uncharacteristic accommodation by the Bank of England when a financial bubble was due made for a huge boom. The climax of speculation was followed late in the year (1825) by a severe liquidity crisis that ran until it naturally exhausted itself. Afterwards, senior officers at the BoE congratulated themselves in preventing the panic from running forever.

The naiveté that massive liquidations will continue unless ended by policy still remains in central banking circles. Oddly enough, the concept that only policy can prevent speculative collapses is as ardently held.

Most have read Mr. Greenspan's 1966 condemnation of Fed policy during the "Roaring Twenties", and it is a supreme irony that during his watch the Fed and the Treasury outdid the recklessness that was part of the 1929 bubble. This recklessness has continued, and could continue until enough asset classes become unstable enough to end the extraordinary speculation by market participants, as well as by policy makers.

The key to this fascinating transition may be found in reviewing the action common to the culmination of previous eras of great asset inflations, or for that matter the end of any business cycle – the change shows up in the credit markets – first . Within this, the yield curve usually provides the critical signal as it reverses from inverted to steepening. Then come the problems in credit quality spreads. Ironically, the senior central bank *follows* market rates of interest.

Typically the final phase of a booming stock market runs some 12 to 16 months against an inverted yield curve, and this time around inversion started in February, 2006. This counted out to a potential top somewhere around June of this year. (Wilshire 5000 high was set in July.) Moreover, there is little need to worry about rising interest rates as they usually

increase until the boom is exhausted, and the time for concern is when short-dated market rates of interest begin to decline. Treasury bills increased to 5.18% at the end of February and the subsequent decline was an alert to possible change.

However, more precision is offered by the reversal to steepening, as short rates begin to decline relative to long rates. One explanation is that it is the intense demand for short term funds by speculators that drives short rates up, and this seems to provide a sophisticated measure of speculative abilities. Typically, as the curve reverses to steepening it is the time when the most blatant of speculations begin to fall apart. The curve reversed by the end of May, and the rest is making a data base for history books yet to be published.

Beyond providing rather good timing there are some other features of the curve. Now, most agree that on the near term the Fed can push short rates for a while. Also, most would agree that central bankers cannot intentionally influence the long end, which strongly suggests that changes in the curve are independent of Fed interest rate manipulations. This is confirmed by a review of the curve on a U. S. data base back to the 1850s, and the rule is that when the curve inverts and reverses to steepening a credit contraction and business recession follows. It is worth noting that this has prevailed during a variety of monetary systems. When the U.S. was between central banks and on the Treasury System a fiat currency was tried until 1879 and then the gold standard prevailed, but the curve actually drove the good times, or the bad. Then under the Fed, the curve has done its thing whether on a pseudo-gold standard until 1971 or a fiat currency since.

There is a little more to determining the transition from the Greenspan "Put" to the Greenspan "Call", and all that that implies.

The greatest accolade that can be laid on a financial policy maker is to be compared to Alexander Hamilton, who organized the finances of the fledgling Republic in the late 1700s. The most recent "Greatest Treasury Secretary since Alexander Hamilton" has been Robert Rubin who was President Clinton's economic advisor until taking the office of Treasury Secretary from January 1995 until July 1999. Andrew Mellon served in the position from 1921 until 1932 and during the late 1920s also received the accolade.

As best as can be determined, no other Treasury Secretary was so capable as to receive the accolade, and the common feature has been that the ones that did were in office when a great financial bubble occurred. This writer has not seen any mention of the accolade being awarded to Richardson, who was the Secretary at the conclusion of the mania in 1873, but the leading New York newspaper editorialized that with his abilities and the fiat currency there was nothing that could go wrong. In 1884 leading economists described the contraction as "The Great Depression" and although it ended in 1895 it was still being analyzed under the dreaded term until as late as 1939.

The observation is that it is the exciting prosperity of a naturally occurring financial mania that makes the reputation of the man who just happens to be in office.

Then there are those who stayed too long. Andrew Mellon was an outstanding banker and industrialist before taking over at Treasury and was widely praised during the good times. In not leaving the office until 1932 he became the focus of the animosity typical of the usual post-bubble recriminations. This turned to outright hostility when in the face of socialist New Dealers he advised that it would be best to liquidate the "rottenness out of the system".

The end of the artificial prosperity of the 1920s financial mania was signaled as treasury bill rates turned down and the curve started its reversal to steepening in the early summer of 1929. It also signaled the eventual demise of Mr. Mellon's reputation as an outstanding financial officer of the U. S. government.

As with 1929 and the 1873 examples, the tide of speculation turned with the yield curve in the early part of the summer of this year. More specifically, the curve completed the transition to steepening by the end of May, and that could be considered the time when the Greenspan "Put" became the Greenspan "Call".

What a posterity.

**October 16, 2007:**

## **GLOBAL WARNING**

- The Chinese market (FXI) is generating an "Upside Exhaustion" reading on both the daily and weekly numbers. Representing the oil play, Schlumberger (SLB) is also registering the same highly speculative condition. On the techs, RIMM is also at this Icarus altitude.
- On the financial side, our proprietary Bank Trading Guide has significantly deteriorated since Thursday.
- Today's 3% drop in base metal prices is interesting.
- Although quiet, this week's action in the dollar index has been constructive. That is for students of the market – for the nattering nabobs of interventionism the worst of all worlds would be a sound dollar.
- Recent work on the gold/silver ratio suggests that rising above 56 would resume the uptrend. The recent low with market rejuvenation was 53.8 on September 28. Today's close was 56.
- As noted last week, the BBB subprime bond is setting new lows. The old low with the initial panic was 41.42, now it is at 33.78, and this melancholy fact with the absence of the likely touts about "containment" is eerie.

The widely discussed \$100 billion "liquidity" pool arranged by Treasury Secretary Paulson along with Citigroup, Bank of America, J P Morgan and others reveals a weak hand and an inadequate understanding of the credit markets in today's condition. Moreover it will take some 90 days to implement.

But for those who prefer the brighter side, the bailout pool is going to be called the "Master Liquidity Enhancement Conduit" or MLEC. Sounds like more artificial credit to us.

**October 17, 2008, Pivotal Events:**

**“ Signs Of The Times:**

***"The Existing Home Market is in Freefall"***

- Bloomberg, October 3  
Chief Economist, High Frequency Economics

***"Exorcising Ghost of Octobers Past"***

***"Despite Housing Slump, Crashes, Such as in 1987 Likely to Stay Memories"***

- Wall Street Journal, October 15

***"I think the Fed has taken care of the Summer's harrowing turbulence by cutting short-term interest rates, pumping money into the system and seeming determined to prevent recession."***

- Wall Street Journal, October 15

As we like to say, so long as prices are rising the street will ardently believe the most preposterous stories. This week's harvest of convictions seems to be doing just that – prices are up and it is due to the immense wisdom and influence of policymakers.

However earlier in the summer, these pages reviewed the usual policymaker options as trying to use more credit to solve a liquidity crisis that is eventually consequent to any binge in easy money. As the saying goes, "When the Fed is the bartender, everyone drinks until they fall down".

The recuperative powers coming out of the initial plunge have been impressive, but it has been mainly a rebound from a serious deterioration of liquidity. The other Fed tool that we thought would be dragged out would be the "first" cut in fed funds, which would prompt a short squeeze. As with conditions following the great booms since 1873 – the senior central bank is typically behind the change to market rates of interest declining. This has been the case this time around, and we have been noting that during a big boom treasury bill rates go up and when they turn down it provides a warning on the longevity of the boom.

This has worked out with the rebound as the bill rate has increased from 2.60% to 4.31% on Monday, and the drop to today's 4.00% is signaling that the next phase of the credit contraction is starting. On the big picture, short-dated rates have always declined until the contraction is over, and it is ironical that the first cut was very briefly celebrated in early January of 2000. This time around the celebration has been outstanding, making the stock market all the more vulnerable to a long series of cuts in administered rates.

As most stocks, corporate bonds, and commodities begin their next slide the establishment will again seek solace in the "durability" of the economy.

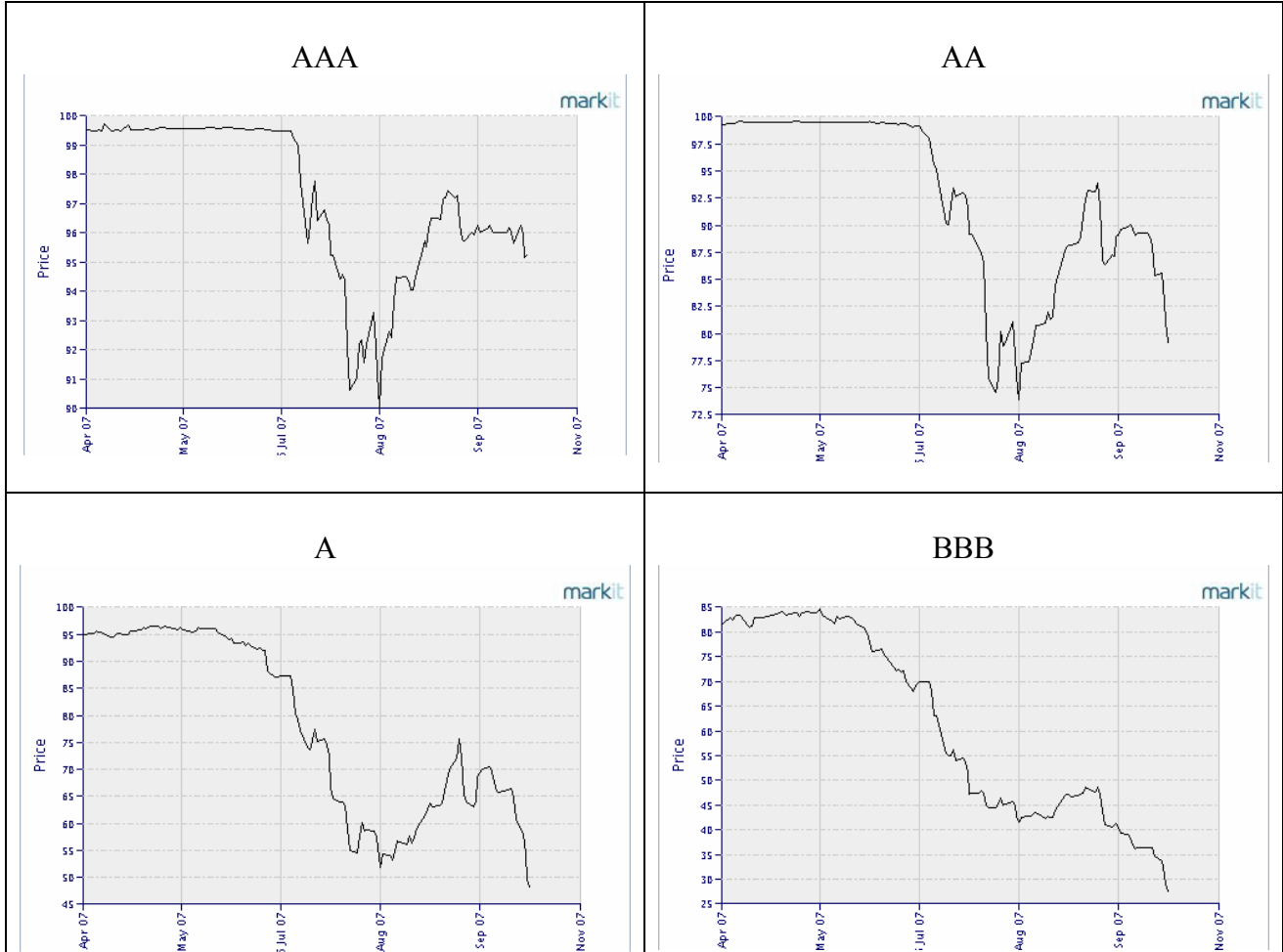
The problem with this is the usual sequence of events. In this case, as in June, the subprime bond turns down, then traditional corporate spreads take to widening, the stock market declines, and then some time much later the economy begins to weaken.

**Sector Comment:** After plunging to 172 on August 16 our Bank Trading Guide rebounded to 186 at the end of September. With this the huge sector of complacency, banks (BKX) rebounded from 101 to 112 on September 19 and as noted last week, the subsequent rise only made to 111. This week the BKX and our Guide are both weakening, reaching 104 and 180, respectively. Key breakdown points are 101 and

178. Also it is worth noting that the Guide has had rather a quick move, which is suggesting a return of the bad kind of volatility. ”

October, 2007, ChartWorks:

### ABX Indices



October 30, 2007:

## **CREDIT IS THREE-DIMENSIONAL**

**The Fed has little influence on the curve, or credit spreads,  
and the concept that credit markets are national 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.

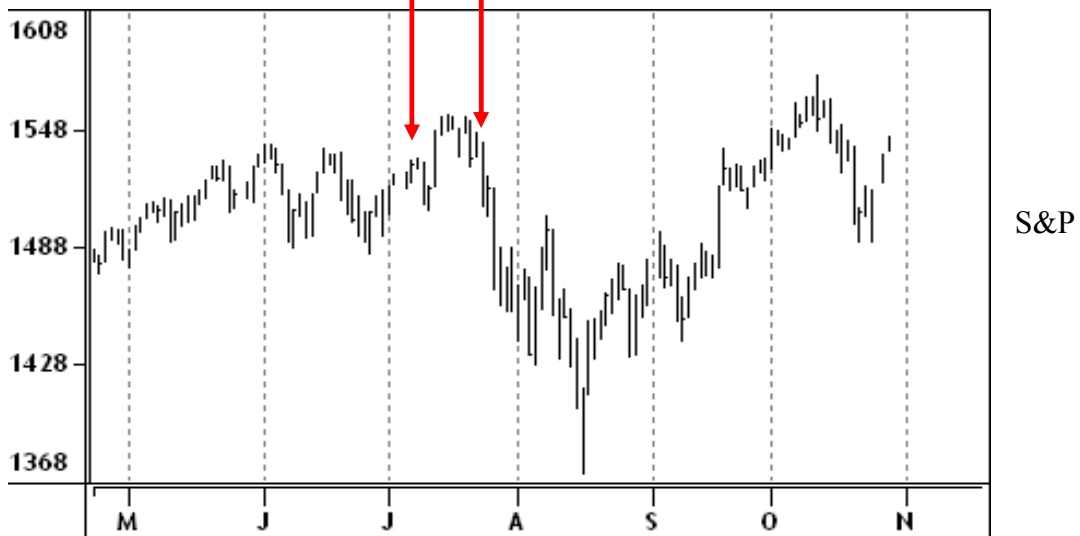
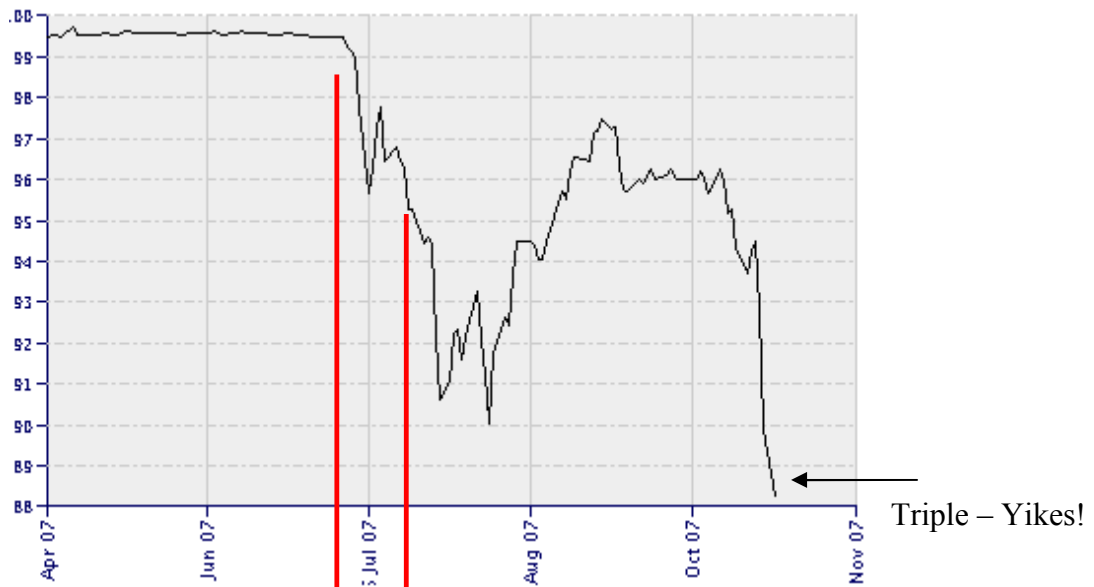
However, the event that provided an outstanding warning on the August panic was the initial signal as the BBB subprime mortgage bond turned down in June and the killer was when the AAA subprime bond plunged from 99 ½ to 91 in the first two weeks of July.

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.

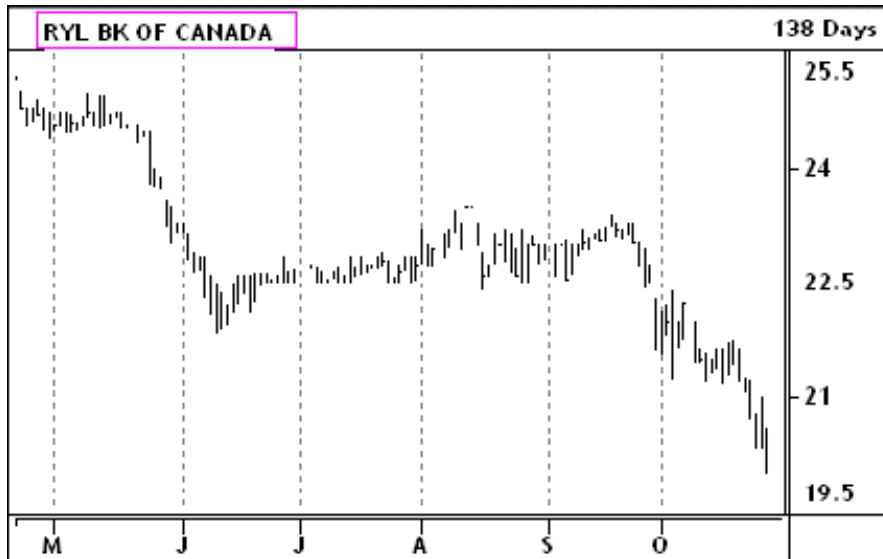
Although we have been discussing price it should be emphasized that the plunge also reflects severely widening credit spreads and one chart shows the crash in the "A" subprime bond and the slump in the S&P.

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

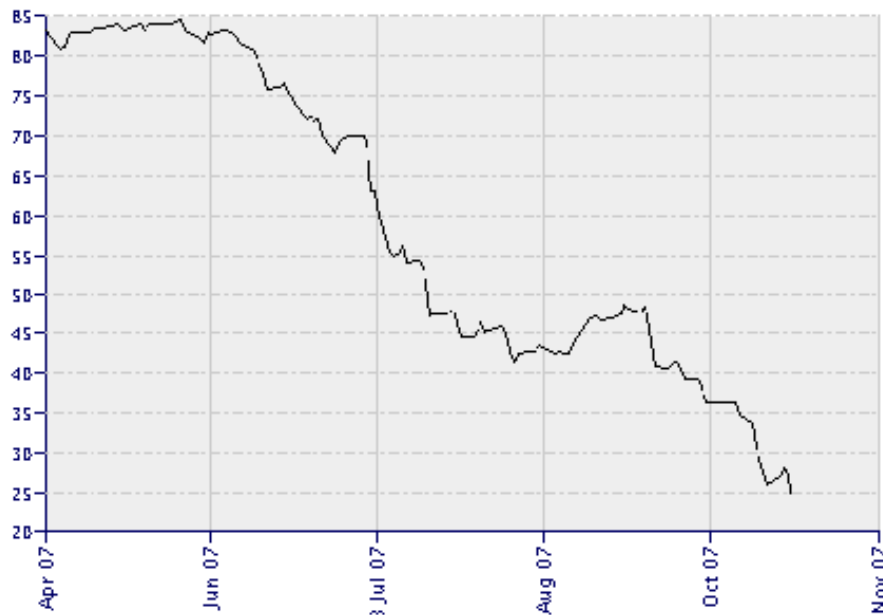
### AAA Subprime Bond



## 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

**November 1, 2007**, Pivotal Events:

*“Today the next crisis seems to have started.”*