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Holland Views

What the beginning of a Credit Crunch looks like... THIS!

In short

- Do not dismiss Sub Prime as having no knock on effects
- Others effected may take weeks to come forward due to complex nature of MBS's, CDO's
- Capital is being removed from the US consumer
- Buy more insurance (put options) and improve quality of portfolio at the edges

At least the market is worrying about the right things now

I attach three reports which will help you understand the situation we are in, two of them have been my source of credit insight in the last year and they have been excellent. Annaly and Grants have brilliantly predicted this housing and Sub Prime problem way, way ahead of all other commentators. This is what they think now, so read them. They will help you understand the world of Sub Prime/MBS/CDO's and why in my opinion and theirs this may not be over. I will keep my comments brief, but will try to summarise below.

Some Facts

- Sub Prime mortgages were $625bn at end of 2005 and were 22% of all mortgage issuance in 2006
- Alt-A is the level above Sub Prime and Annaly now say that this level of mortgages is also seeing higher delinquencies as well
- Alt-A and Sub Prime combined were 40% of mortgage issuance in 2006 (only!)
- The reason this is important is because it COULD point to a slowing of the refinancing activity that has been so crucial in driving consumer spending up to now
- Importantly the third document talks of the likely risk of contagion. It suggests it is far, far, greater than many have previously suggested due to the structuring of MBS's

Implications

- MBS/CDO's are OTC products and structured in tranches. As such, once the lower tranche funding cannot be found, then the safer Tranches above it are not as safe. It therefore cannot be rated investment grade and therefore cannot be bought by most investors (the CDO's)
- Therefore the funding that has driven consumption may cease, not a given, but equally not discussed by many in the market today as a credible event
- These investments are very, very, reliant on the rating agencies and FOR MONTHS now Grants has been saying that these agencies do not know what they are doing. Recent experience of New Century and ACL suggest as such. A FED Governor also recently commented that "3 out of 4 mortgages are made by a

person who is not employed by a bank or savings and loan organization." (i.e. they are not under the protection for the FED). That is why New Century went under so fast, because there was no bank of last resort to protect them

A credit crunch is surely when those that have lent easily stop doing so (happening) and when those that equally supplied these people wholesale funding ask for it back (happening also). Also it is characterised when the central bank suggests improper lending and changes some lending criteria (I sent out details of just this a few weeks back)...

It is no-one's problem

My comments yesterday on my meeting with the HSBC Finance Director I think were telling. Each of the analysts present had their jobs to do, as do securitisation lawyers or bankers. It is no-one's problem to worry about the system, but such structures create systematic problems and by definition systematic problems only come up once in a lifetime (hence why most brokers are wise enough not to entertain the idea to their clients).

My View

I have been sanguine about China wobbles and Japanese Yen carry trades et. al., but have ALWAYS said that credit is the key. When the market worries about credit it is at least worrying about something appropriate. Therefore while this wobble may pass, we should not dismiss it so readily. That credit will now be less available to the US consumer is a given. The only debate now is how fast this credit is contracted and whether it has a tangible effect on the economy. That there will be a big financial shock because of it is NOT a given (but possible). The contagion of Sub Prime is so far seen to be very limited by most observers. BUT the structure of the products (OTC/Structured, packaged and usually off bank balance sheets) says that its full extent cannot be seen YET. Yesterday one of the world's most prudent bankers told me that other investors are unlikely to have escaped completely.

What to do?

Do not panic or sell indiscriminately, but buy Insurance and improve the quality of your portfolio at the edges (high ROCE companies are still good value and with strong balance sheet will unlikely lag a market rally). Short dated put options on Moodys/PMI US/FIC US are still not expensive and if a shock is to come it will come in the next 2 months as others come forward. Look also at those that will own CDO's (Man Group? /Allianz?/ Other insurance groups?)

As D. Flint said "Only after that period of the reflection will the market decide if it wants to re-price debt?" In two months' time the world will be clearer. You will be 0.5% of your fund worse off (having bought a few more puts) and hopefully we will see reasons to be more upbeat… or maybe not?

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