

## Quarterly Critique

September 2008

At the beginning of the September quarter I imagine few would have thought that the world's troubles would increase so markedly in three months, volatility would soar and financial markets would seem so grim. Surely things cannot get any worse? During the bull market we seemed to have quarter after quarter of price appreciation, accompanied by bullishness all the way up. Usually a lot of bearishness would be a signal to buy, but the signal has not worked so far, in the same way the pervasive bullishness was not a contrarian indicator in the good times.

The finance industry has a low median age. I'm not quite sure where the greyer hair ends up but it always seems to me that the median age of professionals involved with the financial markets is under thirty. For almost all participants, the early 90's recession was "before my time", and for many the shallow recession of 2000 would barely register. There is also a perception that "history is for wimps" – wimps, presumably, in the gladiatorial pursuit of risk taking and the embrace of financial innovation. Although company management is generally older than the analysts in our sector, few would have had to steer their enterprises through a severe downturn, and may be similarly unprepared for the conditions we may find ourselves in.

One of the key tenets of current popular investment thinking is that we have made progress in the way the economy is managed. It is often thought that the Fed (the US Federal Reserve Bank) was staffed by incompetents in 1929 who

allowed the Great Depression to happen by not providing enough liquidity. This is contrary to a Fed memorandum following the 1929 crash which explained: "**The drain upon bank reserves was met in the classic way with a policy of free lending**". That same school seems to overlook the questionable management of monetary policy that has got us to this point, and feels the current financial authorities somehow have the panacea for all the pain the credit crunch is causing. I am only sure of one thing: the Fed was very good at providing the liquidity that fostered an explosion of credit as reckless lending and speculation took place. There is no particular reason to believe that they can clean up the mess.

Bernanke in particular is keen to avoid the money supply and credit contraction that was associated with the Great Depression (association and cause are different matters entirely of course). However, I imagine the problem for the Fed in 1929 was that available liquidity and low rates did not induce people to borrow: this tends to happen in a period of deleveraging and we may be entering such a period now.

The unravelling of the bubble has reached a point that several financial institutions in the US and Europe are either insolvent or close to it. Lehman was left to go to the wall as the Fed dealt with the even bigger crisis enveloping the financial services division of AIG which was threatening the once great insurance company. Merrill Lynch fell into the arms of Bank of America, Washington

Mutual appears to be insolvent, Wachovia was hastily taken over by Citigroup, Fortis has been “nationalized” as has Bradford and Bingley, while Lloyds TSB is taking over HBOS.

In the midst of this a grand rescue plan is before Congress (Troubled Asset Relief Programme, or TARP), allowing the Treasury Secretary power to buy troubled mortgage paper from banks for which there may be no market. The problem of course is there may then be no market price, and certainly the market may be a lot lower than the paper is carried at on banks’ balance sheets. “John and Jane Public” in America probably think TARP stands for something like “Taxpayers Are Real Patsies,” such is the disgust at the mismanagement of the financial corporations that have helped to create the mess and the huge sums paid out to executives of failed banks. According to US press reports, in the last two years the CEOs of Lehmans and Bear Stearns took home USD62 and 50 million respectively, while the three week CEO of Washington Mutual could pocket 18 million. Our March critique foreshadowed that a groundswell would emerge against executive pay and it is interesting to note that executive compensation limits had to be part of the TARP bill before it was presented to Congress.

The falling market requires a scapegoat. The august institutions who permitted excessive credit expansion (probably the real source of trouble) apparently wish to be credited with averting a crisis. Poorly performing companies have been targeted by short sellers, and in September many countries around the world imposed bans of varying ferocity on short selling. ASIC imposed perhaps the strictest regulations in what Chanticleer described as “a bit of an amateur hour exercise”, where market participants did not know where they stood and the market opening was delayed an hour. Having created a more favourable environment for some of the ASX’s least fundamentally attractive companies, it is surprising they did not all leap to raise equity at favourable prices.

Although many people believe the short selling was “getting out of hand,” I think if one reflects on whether short sellers have driven fundamentally good companies to insolvency, it is instructive to look at Lehman brothers. Despite access to Fed liquidity, Lehmans was in some trouble and was looked at by several banks. None wanted to buy at any price – surely if the shorts unjustly sold the stock there would have been some value to an acquirer.

An essay ran in the New York Times (Oct. 6, 2006), written by a former SEC lawyer who had actually studied short sellers and their trades. The following excerpt is food for thought:

***"As an enforcement lawyer at the S.E.C., I received from short sellers early warnings on certain companies that led to the capture and return to investors of hundreds of millions of dollars taken by stock frauds. Such information came from no other source — certainly not from institutional stock analysts, whose failures of objectivity were made notorious by the Attorney General Eliot Spitzer of New York. Representing short-biased hedge funds as a part of my practice as a private lawyer, I continued to be impressed by their ability to spot stock frauds in the early stages.***

***"But if short sellers are friends to the S.E.C., the commission has been no friend to short sellers. The agency has saddled short sellers with trading restrictions and has looked the other way when companies have taken potentially illegal actions to silence short sellers’ criticism."***

If the root cause of our current global malaise is excessive credit expansion, the trigger was the collapse of US housing. Collapse seems too mild a term. According to Gerard Wright, writing in the Sydney Morning Herald on September 27, a ***“well kept five bedroom Kansas City house was auctioned for US\$5,500, the price of a used car.”*** Stories of similarly low prices in

industrial Midwest cities and towns abound. Even in cases where property values have not plummeted to such a degree, many have no equity in their homes (five million people, on top of the seven million who face foreclosure). If such a low price can be recorded in the USA, why is it inconceivable that houses in, say, Kellyville in outer Sydney or Rockingham near Perth could have last sold for \$500,000 (and more), but might only find buyers at \$200,000 or less in the coming year or two?

Unfortunately the problem of falling property prices in the US has been compounded by housing equity withdrawal. Many American homeowners took out second mortgages (or increased their mortgage) because of the rising home values, spending the money on yachts, plasma TVs, holidays and so forth – while making the cushion of the equity in their home very thin. This was great for the retail economy, not so wonderful for the personal balance sheet. In Australia the ever competitive banks have also pushed their customers to take advantage of the housing boom so as to keep the banks' balance sheets growing at a fast pace.

Australian debt levels are high, and house prices are extended relative to average incomes and also relative to rents. Will Australia somehow remain an oasis of prosperity and economic growth while so many similar countries suffer? The common belief, reflected in the share prices of our banks, is that no major upset to the economy or property values will occur. Readers of this commentary can make up their own minds.

**Hugh Giddy,  
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