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By William W. Priest, CEO

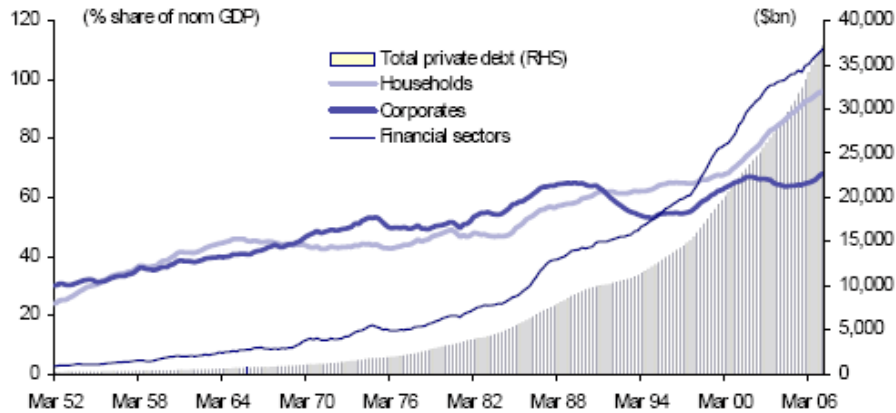
A Roller Coaster Called Credit

These days, I've been thinking a lot about roller coasters. In the dramatic ups and downs of these carnival thrill rides, I cannot help but see the centuries-long trajectory of the financial markets. I'll admit it now – this comparison isn't exactly a new one. But I present it here in the hopes of analyzing and clarifying one particular aspect of today's market dynamics: the role credit will play in any upcoming recession.

In my view, recession is analogous to the most terrifying moment of the roller coaster ride: the first big drop. According to the physics of roller coaster construction, there are two important things to remember about this drop. First, it comes about as the result of a long and methodical climb: a "wind-up," if you will. Second, every loop, dip or corkscrew that occurs after the first big drop is a direct result of the drop itself: that is, the energy that is generated during the initial climb-and-fall provides the momentum for all the twists and turns that follows. The stock market, I believe, behaves in precisely the same fashion. Recessions are the result of a gradual build-up of unsustainable growth; and a recession's fall-out is dictated precisely by the elements that led to its very creation. In this paper, we will discuss a roller coaster called "credit." We will examine the forces that fueled its remarkable climb, we will anticipate its impending fall, and we will discuss the wild ride in store for debtors, lenders and, most importantly, investors.

Credit's initial climb started nine years ago. This climb began with Greenspan's outrageously expansionary monetary policies, during which interest rates bottomed at around one percent. These low rates encouraged rampant debt-related speculation within the non-bank financial industry and households. This phenomenon is illustrated below in Figure 1.

Figure 1: US Private Sector Debt



Source: CEIC, CLSA Asia Pacific Markets

Figure 1 shows U.S. private sector debt since 1952. In 1998, U.S. private sector debt was 186% of nominal GDP, while financial sector debt was 64% of nominal GDP. Today, financial sector debt to GDP has almost doubled to 111%, and total debt exceeds 275% of GDP. Lending to the non-bank financial sector accounted for almost half the rise in total debt since 1998.

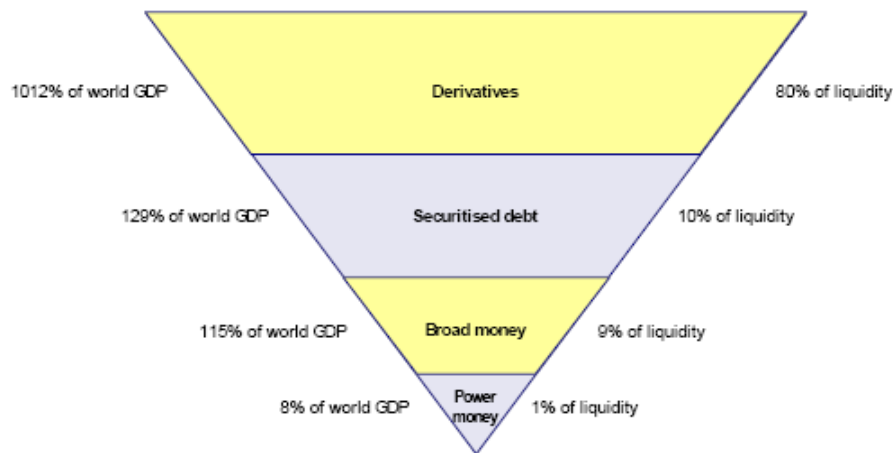
The foundational inception of the “credit climb,” therefore, was the dramatic rise in financial sector debt that resulted from the past decade’s exceptionally low interest rates. Figure 1, however, does not tell the whole story. To capture the full amount of leverage assumed by the marketplace – and to understand the momentum behind the roller coaster’s continued climb – we must acknowledge the process of securitization.

The mechanics of securitization should be familiar to most investors. Via securitization, the risk inherent in a single investment can be spread out within a bundle of similar investments and across a group of multiple investors, therefore diffusing the original investment’s overall risk. The obvious example – and one that will come back to haunt us, not only in this paper but in real life – is that of the residential mortgage. Imagine that John Smith wants to buy a house. Furthermore, imagine that our John Smith is *not* the dashing British soldier who was instrumental in founding the Jamestown settlement in 1607. Rather, our John Smith is a financially insolvent, sporadically employed, hard-luck case (if we’re to imagine the roller coaster here, think of our John Smith as the type of character who might operate it) who, despite his better judgment, is eager to invest in real estate. There is obvious risk in providing John Smith with a mortgage, especially if the full burden of this risk is carried by a single mortgage broker. However, if John Smith’s mortgage is securitized – that is, incorporated within the “great mortgage pool in the sky”

such that its risk to the individual lender is greatly diluted – the mortgage broker feels more comfortable making Mr. Smith’s dreams of home ownership come true. And, what’s more, the broker does little or no due diligence to assess John Smith’s repayment potential because the default risk has already been securitized away!

Through this process of securitization, complex financial instruments (which we generally refer to as derivatives) have mushroomed not only within the real estate market but also within the financial economy as a whole. David Roche of Independent Strategy, a London based research outfit of genuine insight, has redefined liquidity to reflect the impact of these esoteric instruments (see Figure 2 below).

Figure 2: David Roche’s Measure of Liquidity



Source: CEIC, CLSA Asia Pacific Markets

In this simple but elegant illustration of liquidity, the reader can see how securitization has powered the climb of the credit roller coaster. The creation of derivatives has allowed the initial growth in leverage to be exponentially multiplied such that the overall indebtedness of the economy has reached record proportions. And, as informed readers are no doubt aware, the fall-out of this unchecked indebtedness is already being felt. So far, the wreckage has been largely confined to housing and housing-related financial instruments. Some highlights of this housing decline include:

- The implosion, since late 2006, of 143 major U.S. mortgage lenders.¹
- The bankruptcy of New Century Financial.
- The bankruptcy of American Home Mortgage, the 10th largest mortgage writer in the country.
- The announcement by Countrywide Financial of major write downs in *prime* home equity loans. Countrywide Financial’s second quarter earnings release also included other grim revelations: delinquency rates on conventional and subprime mortgages were up 50% from a year earlier, and home equity delinquencies overall had tripled.

¹ www.ml-implode.com, as of September 30, 2007

- The 27-month supply of housing inventory in Fort Myers, Florida. This is compared to a 3-month supply at the peak of the boom in 2005. Fort Myers, we believe, is just one regional example of a national epidemic.
- The negative effect of the housing decline on GDP growth. According to recent research from JPMorgan, “the decline in residential investment has shaved nearly a full percentage point off GDP over the past four quarters.”²

With the above points taken into consideration, it can be said that John Smith, the imaginary real estate investor, and John Smith, the 17th century explorer, have at least one thing in common: both of the institutions for which they are best known – ill-considered mortgages on the one hand, and Jamestown on the other – were founded on unrealistic expectations that had little to no chance of long-term viability. And, in the end, both of the Johns took their partners in crime – investors and banks on the one hand, early American settlers on the other – down with them.

This brings us to the final component of the “credit climb.” So far, we have looked at how increased indebtedness and securitization have contributed to the leverage bubble. Now, we will examine the contribution of the “mark-to-model” phenomenon.

In an earlier paper (“The Canary in the Coalmine: Subprime Mortgages, Mortgage-Backed Securities, and the Housing Bust,” April 23, 2007) we discussed this situation at length. For our purposes in this paper, suffice it to say that marking a security to model, as opposed to marking it to market, dangerously obscures an investment’s risk profile. Remember how the mortgage lender in our prior example, lulled into *laissez faire* by the intoxicant of securitization, didn’t bother to perform the much-needed due diligence on John Smith’s mortgage? When this mortgage – and the thousands of other similar mortgages within its securitized pool – is marked to model, the warning signs that would have been revealed by proper due diligence are even further masked. This explains the recent pressure within the commercial paper market, particularly the asset-backed commercial paper segment, and the resulting flight to short-term US Treasuries.

Marking to model has also resulted in investments in these securitized, mortgage-backed derivatives by “investment grade only” institutions. With the recent “awakening” by S&P and Moody’s as to the true worthiness of these investments (too little too late, in my opinion), there is a virtual run to re-rate these derivatives as what they really are. This means that the aforementioned institutions with exposure to mortgage-backed securities will begin to forcefully disgorge these investments, resulting in a perilous ripple effect throughout the rest of the economy. As a consequence, the amount of leverage in the system is once again compounded with little or no underlying investment value to support the increased indebtedness.

The following example further illustrates the dangers of the “mark to model” system. At a Grant’s conference last fall, Paul Singer of Elliot Associates showed how mortgage loans rated BBB can be transformed, via “mark to model” alchemy, into bond products

² “U.S. Weekly Prospects,” JPMorgan Chase Bank, August 24, 2007

rated investment grade by the ratings agencies. In this instance, it was revealed that, although a mezzanine CDO might be packed with \$100 million of triple B rated assets, it could nonetheless issue \$75 million of AA rate liabilities. Alarming, these mutant bond products had higher ratings than 99% of all U.S. corporations.

But back to our main point. With sky-rocketing debt, rampant securitization, and the “mark-to-model” philosophy in place, we have acquired the final bit of momentum that will bring us to the end of the climb, to the edge of the precipice, and to the beginning of the inevitable fall.

So, what will this fall look like? And what can we expect from the rest of the roller coaster ride?

One of the first victims of the fall will be the financial sector: specifically, the investment banking, private equity and credit hedge fund industries. We’ve already discussed the manner in which securitized mortgages have put the financial sector in serious risk. The problems on the horizon, however, are likely to extend well beyond securitized mortgages and into the leveraged loan market.

First, a bit of history. Once upon a time, investment banks agreed to underwrite the loans to finance “private equity” deals (aka leveraged buy-outs, or LBOs). When the banks offered to finance these deals, there was still a window of opportunity to raise capital by selling the debt to investors via public offerings. Now, with the housing market and the economy as a whole on the brink of decline, this window has closed. The credit market has seized up and the investors aren’t buying, which means that the banks are left with the entirety of the agreed-upon financial obligation. As a result, liquidity has run away from the “private equity” party.

The statistics speak for themselves: over the last six weeks alone, an estimated 46 LBOs worth a total of \$60 billion have been postponed or cancelled. Rumor has it that CSFB offered to pay a \$1 billion break-up fee in order to walk away from its \$3 billion obligation to fund the TXU deal. Furthermore, according to Baring Asset Management, there’s now an estimated \$400 billion globally in uncompleted private equity deals; and the investment banks have their names on the IOU. Lehman Brothers, for example, has \$43 billion of commitments to finance debt-based takeovers, which is supported by only \$21 billion of stockholders equity on the balance sheet. And Lehman is not alone: among prime broker banks of this caliber, it is common to lever equity 10 to 20 times. Until recently, Bear Stearns was 17 times levered. All of this has had a regrettable impact on *real*, as opposed to *reported*, book values: it has been suggested that balance sheet write-downs for the investment banks are in the \$100-150 billion range.

For the informed investor, it is probably shocking to realize that the risks associated with the private equity industry went unnoticed for so long. While the roller coaster was still in mid-climb, it seems that none of the banks ever stopped to consider the realities of the fall. Today, however, the dangers of this over-leveraging are becoming hugely apparent:

the corporate loan market has been suddenly and completely paralyzed, leaving the banks with large potential liabilities.

The private equity situation is just one characteristic of the upcoming fall. In addition to saddling themselves with debt obligations related to LBOs, investment banks have also lent capital to credit hedge funds and to funds-of-funds that invest in hedge funds on a leveraged basis. Christopher Wood, an equity analyst at CLSA, has stated in his subscriber newsletter (“GREED & fear”) that this little-understood feature of the financial sector represents great potential for systematic risk.

The source of this risk resides in how these funds are managed. Unlike most equity hedge fund managers, credit hedge fund managers do not invest personal capital in the funds under their supervision. Consequently, these managers are much more willing to engage in risky leveraged strategies that would have been unthinkable if their own money was at stake.

What’s more, a growing number of credit hedge funds have been staying afloat by acquiring leveraged loans directly from the banks. The underlying value of these loans is nearly impossible to establish: there is no stock market exchange quoting their price, and, unlike asset-backed securities, they are not rated by credit rating agencies. As a result, the value of these loans is now plummeting; and, for the investment banks, the wake-up call is clear. The demand for these leveraged loans, be it from hedge funds or from manufacturers of collateralized loan obligations (CLOs), is on a precipitous decline, similar to the decrease in demand for all other structured finance products. This credit freeze, in turn, reinforces the aforementioned stagnation in the “private equity” environment and the collapse of the hedge fund game. Margin calls have been triggered and funds are closing up shop: Sowood, a U.S. hedge fund, recently shut down after losing more than 50% of its assets (over \$1.5 billion) in the course of just one month.

And these problems are not limited to our shores. In Europe, the financial sector is already in an advanced state of deterioration. France’s Oddo Asset Management, for example, recently closed three of its funds, which, combined, claimed \$1.3 billion in assets. Axa Investment Management came to the rescue of two of these funds; but Daniel Boulton, a senior French banking official, was still compelled to assert that an “extremely sizable credit bubble has burst” within his nation’s economic landscape. And, as we have already learned from witnessing the demise of other such bubbles, the effect of a credit deterioration will be protracted and multinational. In Germany, for instance, a consortium of leading German banks has put up nearly \$4.8 billion to cover losses at IKB Deutsche Industriebank. Jochen Sanio, head of BaFin, Germany’s financial regulator, said the potential losses could have caused ‘the worst banking crises since 1931.’”

In summary, the “credit coaster’s” big free-fall will be characterized by a collapse within the financial industry. Fred Hickey, editor of the “High-Tech Strategist Newsletter” had it right: “Extremely easy money conditions, unregulated new financial products, mark to model pricing, huge incentives to speculate with other people’s money and massive use of leverage has been a recipe for disaster.” In our recent book published in January by

John Wiley, Free Cash Flow and Shareholder Yield: New Priorities for the Global Investor, we highlighted similar concerns: “The main source of vulnerability in the period ahead continues to center upon the concern that a global search for yield, which began in 2003, may have led investors...either to underestimate or to take on too much risk...And when people lose their appetite for risk, they often lose their appetite for consumption, which has immediate and meaningful effects on liquidity...This brings us to what is in our opinion, one of the most worrisome indication that we are headed for a major economic punctuation.”³ And a final quote from Christopher Wood: “If the catalyst was subprime mortgages, the end game is likely to be intensifying focus on the solvency or otherwise of certain financial institutions.”

So, after this first big drop, what will the rest of the roller coaster ride hold in store? Will we be thrown asunder by an endless series of bone-jarring peaks and valleys? Or will we glide effortlessly to a stop once the sins of the financial sector have been repented?

To answer this question, we must contemplate its origin: that is, we must understand the climb and fall of the credit market if we hope to understand its future trajectory. In looking back at the past decade of unprecedented indebtedness, it is safe to say that this is not just another credit spasm. The collapse of the subprime market has caused the CDO market to virtually evaporate, thus breaking the backbone of liquidity for a whole host of other asset classes for which hedge funds and other leveraged players were the primary buyers. We are also seeing first-hand the downside of our new and complex global financial system: the strain of the credit situation has been felt not only in the US, but overseas as well.

What’s more, the recent economic expansion was financed almost entirely by debt. So, unlike the relatively benign fall-out of Long Term Capital’s demise in 1998 – which represented a well-identified and temporary disruption of the derivative and currency market – the risk to liquidity today could extend into the long term. Our five-year equity bull market and protracted economic expansion was more reliant on credit than any other cycle in modern history. But now the borrowers have decided to stay home; and the leverage that created the liquidity boom has disappeared.

Based on the above discussion, it seems the economy is in for the ride of its life. Maybe, maybe not. In any case, I believe this is still a one standard deviation event. The system, in other words, can handle it. Opportunities will continue to arise for the alert and informed investor. But – and here’s the important part – it is too early to be certain of anything. Absolutely no one knows what those vast quantities of collateralized, mark-to-model debt are actually worth. There is also far more leverage among the investment banks and hedge funds than there is comprehension of the dimensions of the problem.

What I believe will determine the nature of our remaining ride is the likelihood of a slowdown in US consumer spending. After all, the U.S. consumer is 70% of our GDP,

³ Free Cash Flow and Shareholder Yield, New Priorities for the Global Investor, by William W. Priest and Lindsay McClelland, John Wiley, 2006, p.111.

and, by inference, about 30% of world GDP. If the U.S. consumer stops consuming, our problems will only get worse. Unfortunately, things do not look promising in this regard. Delinquency rates for all types of consumer loans are at their highest level in six years. In addition, there is a significant amount of mortgage debt – nearly \$800 billion in aggregate – that will come up for resets over the next year. 17% of all mortgages (\$2.3 trillion) are ARMs, and half of these will reset in the next two years, driving monthly repayments up by more than 25%. Of the U.S. ARMs that are due to reset next year, one-quarter is estimated to have negative equity. And all of this spells bad news for the U.S. consumer: JP Morgan has estimated that up to 45% of the borrowers facing resets will not be able to refinance in the more restructured lending climate that now exists. And if home prices continue to decline, it will only exacerbate the current problem in the structured credit markets. This will also put the banks in jeopardy, as non-performing loans and foreclosures will inevitably accelerate.

My view is this: even if we don't have a full-blown recession, we will still come very close to one. The first sign of imperiled economic growth will be weakness in commodities, which will foreshadow the slowdown resulting from the escalating distress in the world of credit. As a general rule, equity bull markets are driven by news from earnings statements whereas bear markets are driven by news from balance sheets. Considering the recent credit implosion – which is balance sheet news – it's safe to say that we are currently tilted toward a bear market. Credit spreads should continue to widen in the next several weeks. Earnings news should continue to be positive, but at a decelerating rate. And should consumer spending slow – which seems all but predestined – next year could be a down year in the stock market. As for the financial sector, which will bear the brunt of this slowdown, balance sheet news is just beginning to emerge. So, in general, this sector is far too early to play. When balance sheet negativism ends, however, the bottom should be near.

I have been an investment manager for forty-plus years. And, over the decades, I have often found myself in a position that is both exhilarating and frightening: like a passenger in a roller coaster, I understand that every climb is followed by a fall, and every fall is followed by a series of additional movements that are shaped by the forces of history and precedent. Today, an asset class called credit is unwinding. Largely the creation of the past six years, this asset class is in the process of imploding as the edifice of structured finance becomes discredited along with the illusion of liquidity it once provided. Simply put, we're in for a few bumps.

And, although I'm fond of the analogy, the stock market is not, after all, a roller coaster. A roller coaster, due to the laws of physics, will always return to the altitude at which it began. The stock market, however, need not succumb to a similar fate. The simple and encouraging truth about the stock market is that there will always be companies that generate free cash flow and have shrinking or nonexistent levels of debt on the books. These companies will be the winners in the next several years and beyond. In the meantime, my advice is this: sit back, relax, and try to enjoy the ride.

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