## Foreword

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## Fingers of Instability Part III - September: Blitzkrieg of Bad News.

**Series Introduction – Click Here**

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As we move into September we must keep in mind that historically it is the worst month of the year for the stock markets. Years ending in 7 are particularly nasty as outlined in the July 15th edition of the "Crack up boom" series. With the events this year, it would argue for more turmoil. As outlined in the previous edition of 'Fingers of Instability', we are waiting for the cockroaches to emerge into the headlines and in this missive we will put a few "fingers" on them. The turmoil unfolding in the financial sectors of banks and prime brokers has a lot further to run before it will be safe to play on the long side. On the short side however, opportunities would appear to abound.

Since the financials are the largest sector of the broad S&P 500 a nice sized down move can be anticipated. It's amazing how many markets (stocks, bonds, yen carry, and currencies) are arriving at Fibonacci retracements levels at the same time. We won't have to wait long to find out if this is a bounce in longer term (2 or 3 months) unwinding/re-pricing of risk or a blip in the Bull Market. My bet is on the former. *Overconfidence by supposedly sophisticated investors, asset managers, and investment banks are the seeds of these unfolding debacles.* In fact, the confidence levels were stretched to the point that nobody bothered to ask about the exit routes if things went awry. There are very few fire exits currently available and that is the source of these problems. Until they are devised and implemented, the problems shall continue.

Here are four "Fingers of Instability" to keep in mind:

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## Banks out on a limb

The sub prime and mortgage pipelines wound down at the end of last year and left the big prime brokers and banks with no new products to securitize into CDO/CLO's (collateralized debt/loan obligations) and sell onto investors. At this point, they are now faced with a conundrum. They were addicted to the fat fees, profits and outsized bonuses they had garnered over the previous three years of residential real estate excesses. But a big new source of product had emerged last year. That new source was of course: LBO's, and Private Equity.

As fewer and fewer opportunities for growth emerge in the G8, corporations and investors look for investment opportunities in other arenas. The sheer size of these deals was as honey is to flies. Banks and prime brokers were desperate for products for their securitization operations, so it became a buyers market for the Private Equity and LBO sponsors. Since investor confidence was at *superhuman* levels, these institutions would take down products whose terms were extremely poor, switching their voracious appetites for yield at any price to these new offerings.

The terms in which these financings were agreed to by the banks and prime brokers offered the lender (buyers of the securities) very little protection in securing their interests. These lending commitments called 'covenant lite' gave much of the power to the creditors, not the lenders. In their blind scramble to get these loans for securitization, they agreed to all manners of poor lending requirements. These include: very low interest rates, no escape clauses, subordination to other debt, negative amortization and interest only payment options (including making payments with new issuance of debt or stocks in the underlying buyout candidate). It is sub-prime terms on huge amounts of new loans, insane terms. The terms they agreed to do these deals under served no one but the borrower. These deals are in excess of $300 billion and are stuck on the balance sheets of the biggest banks and prime brokers in the world such as Citigroup, JP Morgan Chase, Merrill Lynch, Goldman, Credit Suisse, BOA and Deutsche bank, to name just a few. The buffet table of fees for these deals was so large; they ate far more than they could digest. Now these investment pythons are choking on the poor investments they swallowed!

The banks are now caught out on a limb as these commitments either must be sold at a loss of 10 to 20% (possibly more) to create the terms necessary for an investor to be interested. Or they must wait for the market to recover confidence and hopefully sell them at no loss. Banking is all about managing and controlling risk. They do not want to hold these commitments and speculate on a quick debt/securities market recovery. Sometime in the next 90 days you can expect them to announce provisions to take the losses to their earnings and reserves. This could get very ugly and set the stage for the next repricing of their current and future valuations. At this point, we have not touched on the amount of bank reserves that reside in these mortgage backed securities (by some estimates it is up to 60% of domestic US bank reserves). When the ratings agencies finally do downgrade them, the amount of reserves required to insure against default will be increased. This further reduces their ability to make new loans. This is a very big shoe that still is left to drop and an emerging "Finger of Instability".

## No escape, aka "Roach motels"

The asset backed commercial paper market is basically frozen currently as no one will trust these securitized vehicles because of the potential bombs they contain. This crisis in confidence is the direct result of the structure of these products in which they offer the investor "NO OPTIONS" to exit the trade. Until a way to exit is devised, global liquidity can be expected to continue crash. Let me thank John Taylor of www.fx-concepts.com for the excellent insights below. As a long time investment manager, his handle on history is extraordinary and his clients are undoubtedly well served by his experience.

What is a roach motel? As John explains,

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> "a box that lured the omni-present house hold pest, the roach, with tantalizing odors into its sticky interior, where it was entrapped, unable to move. Each box would catch hundreds of roaches that died slow deaths, stuck to the very stuff they desired. The catch line of the campaign was "roaches check in but they don't check out" For us, as money mangers the name roach motel soon became attached to an attractive but complex trade that was easy to enter but was illiquid- i.e. there was no market price except when the trade reached maturity or when (and if) the bank that created the product decided to buy it back. If the investment situation changed and the trade was no longer the one you wanted, you were stuck- or at the very least the hedge of the position would be very expensive and imperfect, often drastically so depending on the circumstances".

This is the perfect description for the current CDO/CMO/CLO markets as they offered the potential of higher returns than usually available on quality AAA and AA paper. The buyers jumped at them just as the roaches pile into the roach motels. John goes on to say that in the forex markets liquidity is assured. To have an illiquid currency market is to have a huge financial impact on a country's citizens.

He then says:

> "It is completely different when dealing with structured products. There is no expectation of liquidity as the institution that created the product has no responsibility for it and is not directly impacted if the price collapses – or more likely is unknown. It is not their complexity that is the primary problem – IBM is complex but it is valued thousands of times each day – it is the total lack of liquidity in all these structures. However, if you add the extreme level of model uncertainty – i.e. it is impossible to value these structures as their have been no previous transactions – together with the lack of liquidity, you end up with assets that might be worth anywhere between 5% and 95% of their original value, it's anyone's guess.
>
> "Roach motels or totally illiquid investments only appear when investors are so confident about the future that it never crosses their minds that things might change for the worse. Why else would someone totally ignore the value of his capital and only worry about the spread over the short term funding cost. Considering that there are far more that 100,000 instances of this capital uncertainty, from hedge funds to SIV's to money market funds to banks to pension funds, there are a lot of problems still ahead. Global liquidity will crash until the day that these assets can be traded and values established. Now while liquidity is shrinking faster than the Fed is pumping it out, the dollar will be strong." Thanks again John (www.fx-concepts.com).

This about sums is up doesn't it? Think of all the institutions, pension funds, banks, mutual funds, money market funds, SIV's (short term investment vehicles), hedge funds, etc. who have checked in and can't check out. The biggest money in the world and they didn't ever raise a question of controlling the risk in the trade or how to exit the investment. Now it's time to pay the piper as there is NO WAY OUT! Due to unbelievable amounts of overconfidence and hubris, the investors who placed their futures in their hands will be forced to pay the price. This finger of instability has a long way to run. However, you can expect it to be front and center in the headlines over the next several months until a market has been developed to discover the price they should have and a real marketplace for them to be exchanged.

## Juggling acts

As if the banks didn't have enough already on the table, they now have the added responsibility as substitute for the asset-backed commercial paper market. These markets will no longer accept the securities outlined in roach motel. It is clear that the president's committee on markets (plunge protection team) and the Federal Reserve (by opening the discount window, lowering rates, broadening the collateral and lengthening the terms) are asking the banks to take the paper from the market place that used to be the commercial paper market. They are then turning around and placing it in the discount window, thereby creating a single imperfect bidder

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for these impossible to value assets. In essence, they are 'jury rigging' the short term funding markets to keep the blood of the financial markets flowing through the system.

In addition to the balance sheet and reserve haircuts we can expect them to receive when they have to get the $300 billion worth of commitments off their balance sheets in the stranded bridge financing; they are moving a whole new group of "unknown balance sheet values" onto their books. It is like going from the frying pan into the fire. Keep in mind, the Federal Reserve has pledged to meet any losses with you know what: *"they will print the money"*. Since no banker in his right mind would take these CDO's with unknown value as collateral, we know that the Fed and PPT have issued guarantees to facilitate their willingness to do so. As money disappears into the maw of a bidderless market, the Federal Reserve steps in as magician and says "Abra Cadabera" and "POOF" it reappears. It is inflation defined, pure and simple. When gold takes off you can rest assured that the broad investing community has woken up to this fact. This "Finger of Instability" must be addressed before it is over. It is called a systemic risk.

**Return of the resolution trusts**

It is clear that the Federal Reserve wants to clear the financial system of mal investments as much as possible before the next reflation really commences. This crisis may be met with lower interest rates to minimize the "keys to the house" from being collected and distributed to the investors in CDO/CLO/CMO investments. But a resolution trust is going to be part of the work out. A 'resolution trust' is an organization that takes these properties and disposes of them just as was seen after the Savings and Loan debacle of the late 1980's. Then once the poor elements are removed from the quality ones, they will be repackaged and put back into the marketplace. This process will offer many opportunities, so get ready!

The securitization of risks is not going to die here, but a solid set of regulations, clearing arrangements and marketplaces will have to be created to prevent a repeat of the unfolding debacle we now face. The unregulated, over-the-counter affair that it has been up until now cannot survive under the current structure. It will be a painful birthing process but the incentives to do so are enormous. Before it is over you can expect a complete overhaul of the ratings agencies and their complicity in facilitating these frauds on investors. As the rating agencies ratings come into question, expect major turmoil in anything their ratings rest upon. It's going to be an interesting near term future and we sincerely hope Senator Chris Dodd along with the mandarins of Washington DC are up to the task of this bailout. It appears the Bush administration does not have a clue as to the solutions. As always, the people left holding the bag will be the little guys.

**In conclusion:** We are just waiting for the dead bodies to rise to the surface; you can count on them doing so. September will be the month of SURPRISES! Nasty ones. "Fingers of Instability", BANG, BANG, BANG! The prime brokers and banks have to reveal the problems with their earnings reports which are set to begin right at the beginning of September. Look for earnings warnings starting RIGHT NOW! As bank balance sheets are further impaired, lending will be curtailed as well to reflect the weakness in their balance sheets.

As these huge sums of money unwind in the market place look for wild gyrations in many markets: stocks, interest rates, currencies, etc. as it attempts to exit (markets going down) or find new homes (markets going up). Many of these CLO/CMO/CDO securities that must be unwound are on the buy side of the carry trade and it is trapped in this side of the trade as they have no place to sell the securities. NONE. They can't exit even as the yen rallies. The carry trade is not over, but it will continue to correct the most foolish excesses of those employing it. Worldwide the "Crack up Boom" is set to continue after these fingers of instability run their course. It is the financial authorities' job to see that the bombs hitting Wall Street and Lombard Street don't hit Main Street. For now, we do not have the answer as to how this will be accomplished.

Volatility will provide opportunities for the prepared investors and pitfalls for those that are not. These are the times where you must observe, learn and be prepared. By doing so, these pitfalls become your playground and profitunities. What do we take from this? Liquidity and risk control are all important, as Mohamed Al Arian, investment manager of the Harvard endowment said on CNBS, err CNBC this week. Take note, he is

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making money overall in these challenging markets. This man knows how to make money when markets GO DOWN! Do you?

There are plenty of dollars out there looking for a home. They just require that when they are invested they can be returned in short order if needed and risk can be managed. You need to put together your investment plan just as Warren Buffet has done. In recent interviews he was positively gleeful as we can see he has done his homework. He is waiting and positioned to pick up the pieces at BARGAIN prices. This is a classic example of strong hands taking from the weak as they lose their shirts from poor planning and execution. This is how you thrive during "Fingers of Instability". The prescription that the central banks must implement is centered on one theme at this point "MONEY AND CREDIT CREATION". What else?

Stay on your toes, you will find out the quality of your investment plan and your investment advisor. Do not make or accept excuses. If either have failed you and haven't asked the questions that John Taylor speaks of (i.e. can I exit the investment if I don't like it anymore?). Give this a careful thought. Then find new ones who have done their homework, know where to play, and how to get out of the playground if necessary. A good example of this is John Taylor! These are the periods where you learn how well you prepared, learn your lessons well. Is your diversification working? Do you have winners in your portfolio as well as losers? If the answer is 'no', you are not properly diversified. The key to successful investing is risk control. Volatility is opportunity, take advantage of it, don't be a victim of it. Thank you for reading Tedbits. If you enjoyed it send it to a friend and subscribe for free at: www.TraderView.com . Don't miss the next exciting issue of Tedbits, where the "Fingers of Instability" continues and we cover the "Amen" corner, where you can look to kiss your a** goodbye!

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