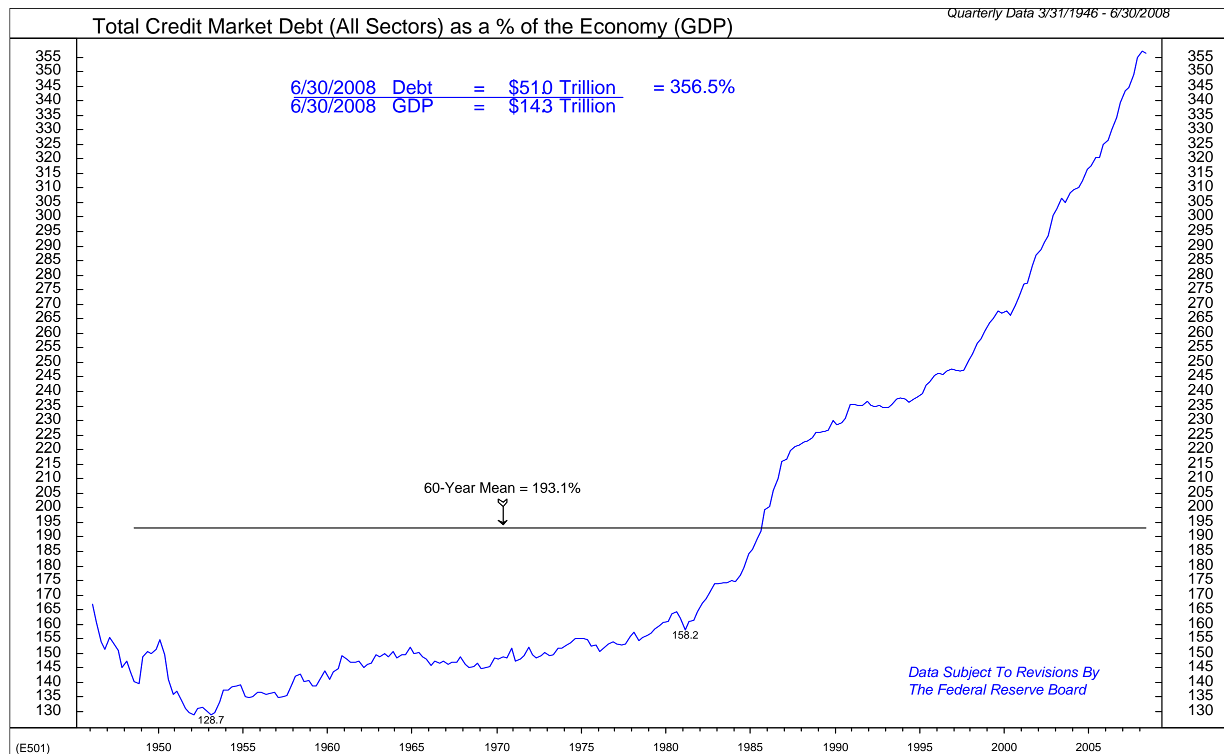
CAUBLE & HARRE WEALTH MANAGEMENT

Implications of a Changed Market

In the spring of 2007, I wrote an article discussing the significant growth of credit derivatives and the problems with credit underwriting in general (the article, "Thoughts on Derivatives" is available on our website www.caubleharre.com under *Resources, Investment Articles*). I concluded with the statement "All of this increased credit activity, however, has been occurring in a benign economic environment. Derivatives can be used to reduce risks but the effectiveness of this 'risk reducing' activity has yet to be tested in a negative credit cycle. Until we see how they react, I recommend that investors proceed cautiously."

One could argue that I correctly identified some important issues, but the true ramifications of things not working well were so outlandish, I did not correctly gauge the magnitude of the fall. Who would have thought 17 months ago that Bear Stearns, Lehman Brothers, AIG, Merrill Lynch, Morgan Stanley, Goldman Sachs, Washington Mutual, Countrywide Financial, and IndyMac would no longer exist in their current form?

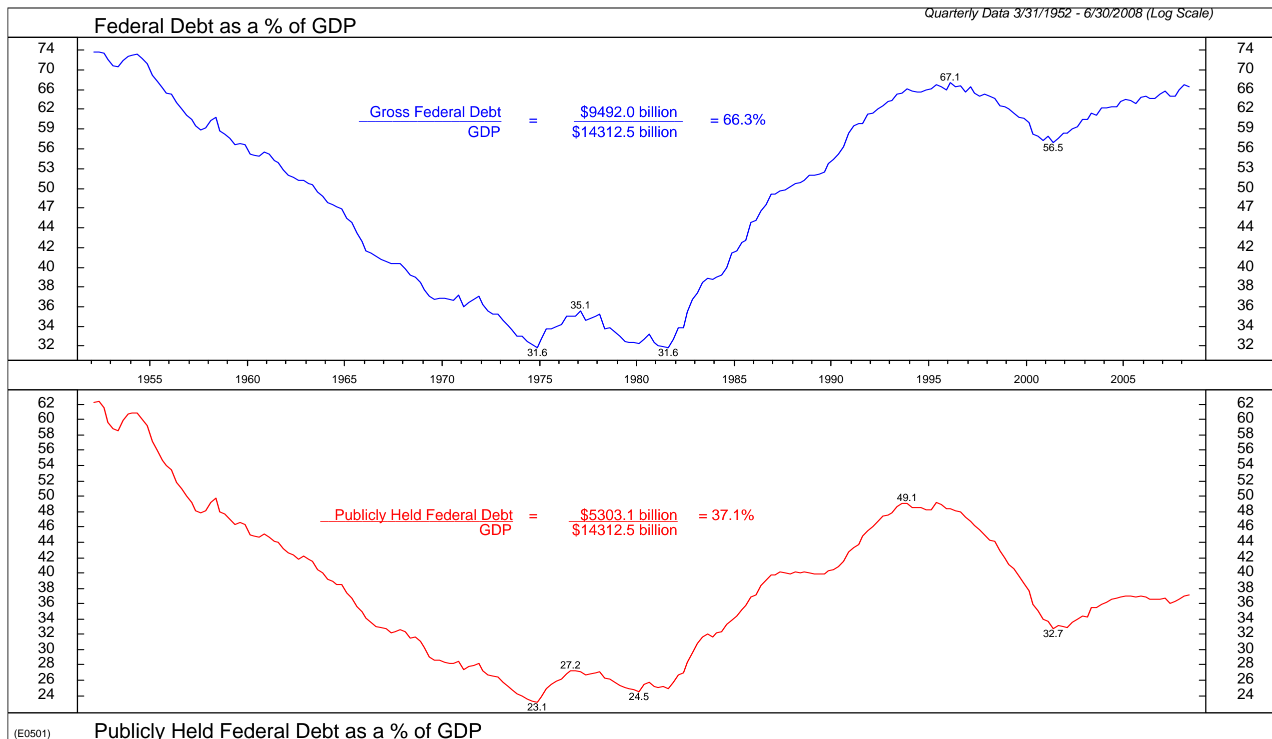
At the time I wrote the article, a chart from Ned Davis Research caught my attention. I include that same chart here updated through June 30, 2008.



The chart shows total credit market debt which can be broken out into debt of financial service firms, household debt, business debt and government debt. As you can see, there was a significant

rise in this debt over the last 8 years. It now stands at 356% or 3.5 times our Gross Domestic Product (GDP).

A lot of this debt is found in financial services firms including hedge funds. Of the $51 trillion, roughly $18.6 trillion is from these firms, $14.5 trillion is from households, $9.4 trillion is federal government debt and $8.5 is business and state and local government debt. The chart of household debt looks the same as this chart of total credit market debt. Interestingly, the chart for gross federal debt is different (Ned Davis Research)



While it shows an increase during the last eight years, rather than setting new records, it has reached levels last seen in the mid 1990's, and is still below levels of the late 1950's.

It is not hard to conclude that current levels of debt are unsustainable. We have heard this before, so what makes this time different? Debt or credit is affected by supply and demand forces. Over the last 20 years, demand for credit from consumers has been strong. Perhaps more importantly, this demand has found willing partners (financial service firms) to supply this credit. Arguably, this increased supply of credit in the last few years was enabled by weaker oversight and regulation from government, and irresponsible management on the part of financial service firms.
I believe that the demand for credit will likely change, but more significantly, the supply of credit will change materially. The source of this supply, financial service firms, will be going through fundamental structural change. As a result, the amount of leverage they are allowed to operate with and the amount of credit available to businesses and consumers will decline.

Households too, on the demand side, will likely reduce their demand for credit as they strive to repair their balance sheets. The net worth of households has been hit both from declines in real estate prices and the fall in stock markets. We are already seeing some evidence of this repair process in the recent declines in retail sales which fell for the third straight month in September as reported by the Commerce Department, and a slower rate of growth in household debt, which grew by only 1.4% during the second quarter (Ned Davis Research). This was the slowest rate of growth since the fourth quarter of 1995.

How far do debt levels have to decline? Total credit market debt is 356% of GDP. In order to get back to 2001 levels of 275%, we need to remove about $11.5 trillion dollars of debt. This assumes that GDP remains flat, which over the next two years could be an aggressive assumption. What does reducing 20% of your debt look like? No one knows, but we are about to find out.

In order to pay down debt, you have to do one of two things: You sell assets and use the proceeds to pay down balances or you redirect cash flow/earnings from consumption to debt reduction. The first process can cause falling asset prices. We witnessed this last year as banks tried to sell mortgage paper held in their off-balance sheet investment vehicles, and found an unwilling market. Today, we are witnessing hedge funds and other leveraged firms selling assets to raise cash in order to meet redemption requests from investors, margin calls from brokers, or for operating funds since they cannot borrow from the public markets anymore.

Leveraged entities are in a forced sale position, and many will not survive this process. Central banks have stepped in to make sure that the core of our banking system will not fall into this same forced sale position. This action will shift a portion of the total credit market debt from the financial services chart to the federal government chart, perhaps pushing it into record territory. Hopefully, this forced sale stage of the deleveraging process is nearing its end. The volatility in the stock and bond markets during this stage is historic.

The next stage will involve households, businesses and governments redirecting cash flow from consumption/investment/services to debt reduction. This stage will result in lower earnings growth for companies and slower economic growth in this country. Consumer spending accounts for more than two-thirds of our economy. The impact will be felt.

What implications does this have for investors? With the knowledge that there is a great deal of forced selling occurring today, it is difficult to reduce equity exposure down to zero. Recoveries from this selling can be swift and material. Generally, though, we are underweight our long term equity allocation targets. Rather than using this time to increase equity exposure by buying a lot of stocks that might be at a bargain, we are shifting funds into companies with certain attributes. Stocks that we favor right now are those that are in good financial shape and are not dependent on the credit markets for their growth. Also, companies that have exposure to international markets are at an advantage in that many other countries do not have the debt overhang that our market does. There are many larger corporations that meet these requirements that also pay healthy

dividends. Dividend growth will likely slow, but if companies are in good shape financially today, they should be able to maintain their current dividends and grow them in the future.

One issue that gives us concern for ramping up equity exposure right now is the status of the credit default swaps market. These instruments were discussed in the "Thoughts on Derivatives" article. At that time, the notional value of these securities $34.5 trillion. Currently it is $55 trillion. These securities act like insurance for bonds against default. Unlike insurance, the market is not regulated. There are no restrictions on the amount of insurance taken out, or that someone purchasing a 'policy' has an economic interest in the 'insured'. For Lehman Brothers, the amount of 'insurance' taken out was about twice the value of their bonds outstanding. This $300 billion plus bill comes due the week of October 20, 2008.

No one knows the extent to which a particular firm has exposure to this potential liability. There might be offsetting transactions making the net exposure less than $55 trillion. Market participants are trying to devise a system to improve transparency. This is important. In theory, if all the bonds covered defaulted, the sellers of these securities would have to come up with $55 trillion dollars. Good luck. While we wait for transparency, anytime a firm declares bankruptcy, or a bond defaults, it could create additional selling pressure in the markets as firms that sold this protection have to raise funds to make good on their bets. And again, the amount of protection could be much greater than the value of the bond that defaulted.

A lower allocation to equities means a larger allocation to fixed income. There are larger risks in the bond market as well. Slower economic growth will affect tax revenues of many municipal entities. We believe that the credit crisis has yet to fully impact the municipal bond market. With our economy likely to experience a recession, the credit quality of any bond becomes more important. We believe that it is too early to consider investing in high yield bonds. High quality corporate bonds are a good value right now as the demand for U.S. Treasuries have caused the relative price of these bonds to fall.

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October 2008

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