

Overview

The perfect storm

August, Friday 17, 2007, is the date to be remembered as the "Perfect financial storm." The Fed decision to lower to 5.75 percent, down from 6.25 percent the discount rate, the interest rate that the Fed charges to make direct loans to banks, is the right one in this dramatic situation. The Fed did not change its target for the more important federal funds rate, which has remained at 5.25 percent for more than a year but it sent a strong signal to markets.

The problem started in the beginning of August and it was triggered on August 9, and 10, by BNP Paribas telling investors in three of their funds that they would not be allowed to redeem. This simply froze the European markets. The European Central Bank has injected \$211 billion into their system. Central banks have put \$339 billion into the world system between August 9 and August 10. This has been the result of bad mortgage underwriting practices, bad rating agency practices, a destruction of confidence, excessive leverage of hedge funds and investors, and then the withdrawal of that leverage by banks, the need for high-yield, just plain stupid greed.

Bear in mind the size of the total subprime market is estimated by the Fed to be about \$500 billion. This is the total asset pool, not nonperforming loans. The GDP of the United States today is about \$14

trillion. That means this crisis represents about 3.5 percent of GDP diluted in two to three years.

Many of the European and Asian institutions who bought this paper relied on the credit rating agencies. They relied on the models built by the investment banks that put this paper together. Rating agencies sold their AAA rating but put legal language buried in the documents that basically said, "OK, this is not what we mean by AAA in our other ratings." The document for the RMBS mentioned above was 300 pages of fine print. I will bet you that the vast majority of people buying this paper did not read it or understand what they were reading if they did. Difficult to understand wording always create confusion in most people.

Events like these and potential losses should not come as a surprise to knowledgeable and well-educated investors, whether in Bear Stearns' funds or other funds. According to one Citibank report, the Bear Stearns fund at one point was leveraged 80:1! In March of this year, the subprime story was all over the news. At a time when most news sources were already talking about interest rate increases hurting subprime borrowers, Bear Stearns appears to have been marketing a fund that invested in illiquid/exotic mortgage credit instruments with high levels of leverage. While I don't personally know the full details behind the reasons Bear sponsored this fund, it is clear in my mind that investors seem to have been taken by surprise as to

what they had invested in. Investors appear to have not seriously considered what could, and in fact did, go wrong. This is nothing new in my experience. I remember the petrodollar frenzy between 1979 and 1983, the precious metal frenzy of 1979-1982, the stock market crash of 1987, the risky banks investments in emerging markets such Brazil and Argentina in the 1990, with the debt default of Argentina, the dot.com bust of 2000-2001, and so on. History repeats itself, and it is amazing that investors do not learn from previous history. When an investment in fixed securities or any security it seems very attractive, it is better to do due diligence and find out what could go wrong. Eventually it would be wise to buy some insurance, even if it means to lower the return. I never understand risky bonds. I never bought high yield bonds, with the exception of preferred convertible shares in good managed REIT's at discount. I never understood risk/reward investments rationale in debts that pays two or three percentage points more than the market of "real" A, AA, or AAA rating bonds (such as the U.S. treasury) would pay. If I have to choose more risky investments I choose to buy stocks.

Greenspan, the man behind the subprime debacle.

Alan Greenspan ex Chairman of the Federal Reserve, between 1998 and 2005 created huge amount of excess liquidity in the financial system. In turn banks started to issue high risk mortgage loans to subprime borrower. This situation developed into the well known real estate bubble. This in turn created a large secondary market in bundled mortgages -- huge numbers of mortgages grouped together and sold and traded as if they were simply financial instruments. As a result, banks began to view mortgages less as long-term investments than as

transactions. They made their money on closing costs, rapidly selling the mortgages to aggregators, which in turn passed them on to others. The more mortgages banks racked up, the more money they made. **The risk was transferred to others.**

In the past few years, two new groups of players entered the scene. The first group comprised mortgage companies and brokers, nonbanking institutions whose business model was built primarily around the transaction. The brokers in particular had no skin in the game. Every time they executed a mortgage, they made money. The second group was the final buyers of bundled mortgages – institutional investors, pension administrators, and hedge funds. The final owner of the mortgage, of course, is the loser. The assumption that subprimes could be refinanced if needed failed to take into account that higher interest rates priced these people out of the market. But the worst part is this: Many hedge funds leveraged their purchase of mortgages by using them as collateral to borrow money from the banks. Sometime the leverage was sky-high, with a ratio of 10 to 1 or 20 to 1.

The perfect storm that followed, has divided the world of finance into two camps. In the first camp you will find those who want to bring back the man who is seen as the friend of easy money. I mean Alan Greenspan, of course. **His tenure at the Fed brought the interest rates into negative territory and Greenspan has favored packaging of these subprime mortgages sold to pension funds and hedge funds.** In the second camp you will find all those who feel the time has come to draw a line against gambling and wild speculation trying to pass as investments. These are the folks who back the current Chairman of the Federal Reserve – Dr. Ben Bernanke.

Greenspan had endorsed these super-leveraged and high risk loans, and had ridiculed people who had opted for fixed-rate long term mortgages, saying that they were wasting a lot of money. Then after realizing it was too late, Greenspan and his cohorts began to build the federal funds rate back up again, boosting the rate to a one quarter point every six weeks. Fed funds rate had reached 4.75% when Dr. Bernanke took over the Fed. I believe Bernanke by the end of this year will return Fed Funds to a 4.75% rate, and it will stay there for the entire 2008. Creative financing with high leverage can destroy your finance. To be more conservative in investing is the rule of the game. Remember: there is not such a thing as free money!

I think this is not a market meltdown; it is a downturn with additional risk. I also believe (and hope) the subprime crisis will bring about a new paradigm that could result **in a fundamental shift in how the U.S. or the international financial system works.** There is no one major central bank that can deal with a market meltdown where the trust in the currency system is shaken.

Easy money is gone, and now is the magic moment for investors that patiently waited for this to happen. They will reap the benefit of this market volatility by buying up good stock or companies at discount. Remember the glass is always half full. In this market volatility gold and silver will soar to new high. I believe that gold will reach \$750 per ounce between the end of this year and beginning 2008.

Currencies

With the scenario above I remain with the following model portfolio: US Dollar 35% to 40%, Euro 19% to 23%, Danish Kroner about 7%, CAN Dollar about 18%, AUS dollar between 14% and 18%, British Pound about 5%. I closed the carry trade position in Yen in the month of May. There is a maximum of 20% leverage on the model portfolio, which means if you invest \$ 1 million, you borrow no more than \$200,000.

Have a Great day

Dario A. Bianchi

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