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How I spent my evening

Last night there was AIG on all Channels on TV. I decided to split my time and kept zapping back and forth between CNBC, chronicling the continued mayhem on Wall Street, and the Champions League game between Manchester United (in shirts prominently displaying the logo of their sponsor: AIG) and Villareal of Spain. In the beginning I spent more time on the soccer game, even though I thought that Manchester United should have displayed the logo of their new sponsor, the US tax payer.

The Re-Nationalization of the Financial Industry

As the financial institutions are attacked one by one by short sellers and brought to their knees, a pattern is emerging. Some are clearly too large to fail (e.g. AIG) while others are unceremoniously dumped (e.g. Lehmans). How is that selection made, and by whom, and where does this pattern lead?

I am prepared to argue that we are witnessing a creeping re-nationalization of the World's banking system, where some large institutions enjoy the protection of their respective governments, while others are left to fail in succeeding waves of financial crises. At the end of this process we will be faced with a very small number of very large banks, all under the protective umbrella of their respective governments. Those lacking that protection will have disappeared.

Of course not all governments can afford to support national champions in that manner. The US can afford to lend USD 85 Billion to AIG, albeit at some 800 points above Libor and acquiring a 79.9 percent stake in AIG in the process as an equity kicker, but the Swiss government could not afford a fraction of that to save UBS, even if it wanted to. So rule number one in the race of implicit government protection: make sure you are based in a country where the government has both the deep pocket and the political will to back you.

Rule number two: make sure a significant part of your business is in a sensitive sector such as (life-) insurance or retail banking. Then you can always cry "national interest" when you seek the government's help. It also helps to simply be so big, that a collapse would seriously disrupt the markets and upset the voters. Governments don't like to upset voters, particularly in an election year. This is rule number Three: get into trouble in an election year.

Is such a trend healthy? Of course not. But it is simply the logical consequence of a rather clumsy regulatory environment, which favors the interests of the speculators over those of the

investors. Consider, for example the drama that evolved last night (on Wall street, not on the football pitch), where short-sellers were ganging up on Morgan Stanley, a company which is by all accounts well financed, competently run and which had just presented very solid quarterly earnings. Morgan Stanley is sitting on a pile of cash, and the logical response to the concerted speculative attack by the short sellers would have been to use some of this cash to aggressively buy back their own shares. This would not only have supported the stock price, but would have reduced the free float and increased the book value per share. However, buying back your own shares in that manner is not allowed under current regulations. So John Mack, the head of Morgan Stanley was forced to watch impotently how his stock price was hammered without being permitted to do anything about it.

Where is the Credit Crisis?

But aren't the short sellers right? Aren't we in a credit crunch? Isn't it a fact that banks no longer get the money back the lent to homeowners and business? Aren't homeowners all over America are losing their homes and real estate and mortgage investors their money? What about the Sub-prime crisis?

The so-called sub-prime market is tiny, compared to the overall debt market in the US and elsewhere. Under normal circumstances a whole-sale default on virtually all sub-prime mortgages would hardly have caused a blip in the balance sheets of the big institutional investors who hold most paper. It is very hard to imagine how such a mouse roaring could have cause the entire debt mountain to collapse.

We are a far way off from "whole-sale default". Most home owners, even many of the so-called sub-prime home owners, still service their debt. Mortgage default rates have risen but not dramatically. A report by the US Mortgage Bankers Association notes:

"The delinquency rate for loans on one- to four-family properties was 6.41 percent at the end of the second quarter, up 6 points from the first quarter and 129 points year-over-year. The foreclosure rate was up 28 points in the quarter and 135 points in a year, ending the second quarter at 2.75 percent. During the quarter 1.08 percent of loans entered the foreclosure process, up 7 points from first quarter and 49 points from second quarter 2007.

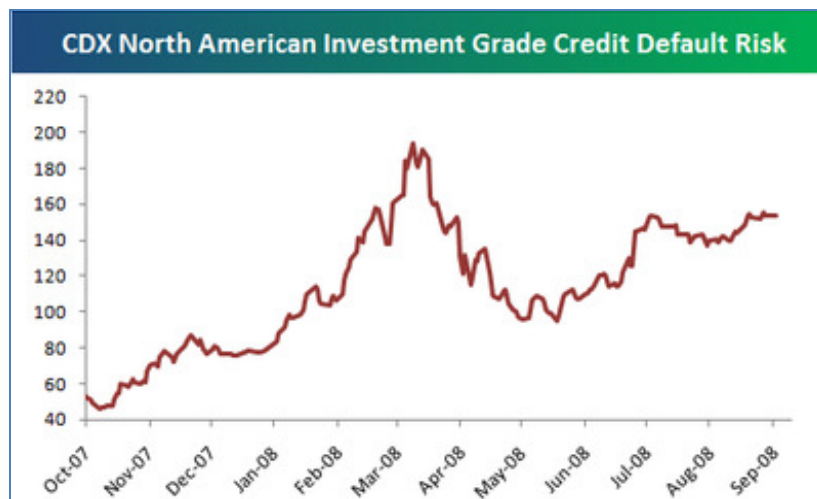
MBA Chief Economist Jay Brinkmann noted that the rise in foreclosure rates was driven by a worsening situation in the hardest-hit states, California and Florida. And the association's release said that only eight states had foreclosure start rates above the national average. In addition to California and Florida, the other six states are Arizona, Indiana, Michigan, Nevada, Ohio and Rhode Island. Brinkmann said adjustable-rate mortgages (ARMs) accounted for 59 percent of loans entering foreclosure."

In plain English: during the past year, when we were supposedly witnessing the worst mortgage crisis in decades, the delinquency rate rose to only 6.41 percent. This means that more than 93.5 percent of all home owners, including the so-called sub-prime borrowers, still make their mortgage payments regularly. Many of those that fall behind in their mortgage payments do so because they lose their job or have unexpected expenses. Most of them will be able to master their crisis and will resume payments after a relatively brief hiatus. Actual foreclosures, i.e. situations where people lose their home because the bank is not willing or able to wait any longer for payments to resume are only at 2.75 percent. These numbers are within the normal fluctuations over a typical business cycle.

Mortgage default rates tell about trouble after the fact. But the outlook in the mortgage market is not all that gloomy either. In the same MBA report we find the following paragraph:

"In a more concrete release related to mortgages, MBA reported that mortgage activity is increasing and loan rates are falling. The market composite index, which measures mortgage loan application volume, was up in the first week in September, both week-over-week and on a four-week moving average. Interest rates on 30-year fixed rate mortgages decreased to 6.06 percent from 6.369 percent, while 15-year fixed loans fell to 5.73 percent from 5.96 percent and one-year ARM rates declined to 7 percent from 7.11 percent."

Objectively speaking, the mortgage market is not in trouble. Nor are the banks and financial institutions faced with significant defaults in their credit portfolio. According to Sandy Ruefenacht, apparently a large Credit Hedge Fund manager whom I happened to catch on CNBC (the soccer game was boring, Rooney, Ronaldo and Company in their AIG shirts failed to inspire) there is no evidence of an increase in corporate default rates. According to him these rates, though admittedly very volatile, are around 1.5 percent at present, as opposed to a long-term average of three to four percent.



These are hardly signs of trouble, neither in River City nor anywhere else. The current news from the frontline of the credit markets, in particular the mortgage market hardly justify the mayhem we are now witnessing in the financial markets and, particularly, in the markets for equities of financial institutions.

It is incredibly ironic, given the absence of any obvious danger signs in these figures, that the risks spreads of solid financial institutions like Goldman and Morgan Stanley should have shot up to anywhere from 900 to 1000 BPS, if one believes the CDS market. This implies that these two financial institutions are at the lower end of junk grade. On a long-term average the risk spread paid for junk bonds, i.e. bonds with less than an investment grade (BBB) rating is around 750 BPS.

The Loss of Trust

The subtle balance between fear and greed which governs the moods and actions of stock market investors has clearly gone out of whack. Investors are fleeing in droves. At one point last night the yield on short term US treasury notes went negative, i.e. people were paying more than 100 for a treasury note that would return 100 in a month.

But if the crisis faced by banks and other financial institutions today is not a credit or mortgage crisis, and the figures above suggest it is not, what is it? I believe it is first and foremost a crisis of trust, exacerbated by a regulatory environment that forces a "marking to market" even when there is no market to mark against. This deadly combination leads to a situation where even healthy and solvent companies can be destroyed within a matter of days, if not hours.

With their behavior over the past decade the banks have gambled away the trust of investors, clients and, particularly ironic, other banks. The trust has been replaced by fear, fear that the banks first and foremost look out for themselves and certainly not for their clients. Unfortunately this fear is often justified.

In a commentary last October I compared banks to sausage factories who processed all sorts of debt, some of it quite unsavory, into debt products. These derivatives were given glamorous names such as "Structured Products", "Reverse Convertible Bonds", "CDO" etc. and were then fostered onto an unsuspecting public. And like consumers who don't know what is in their sausages that are meat derivatives with glamorous names such as "Andouillette", "Salami" etc., the unsuspecting purchasers of these financial products had no clue what was in them. They simply trusted their banks in the same way as the housewife trusts the local butcher.

But very few local butchers still make their own sausages and can thus vouch for their contents and very few banks structure their own products. Both are little more than retailers, who supply themselves on the world market and then sell to the consumer. And there they do not

necessarily buy what is best for the consumer, but what sells more easily and allows them to realize the largest profit.

The sub-prime crisis revealed that some of the packagers had packed some rather unsavory bits into their products and the investors reacted in the way sausage consumers react when they find out what their sausages really contain: they stopped buying. They no longer trusted their banker, who in turn no longer trusted his or her supplier of product. Demand for such products collapsed leaving many financial institutions stuck with a large inventory of financial "sausages" with dubious content.

Marking to a Market" that no Longer Exists

It is normal that when counterparts in financial markets no longer trust each other, and especially when investors no longer trust the financial intermediaries, the system freezes up. All note and bond issues, even those who are not contaminated, are met with suspicion. In the absence of trust there are no trades, and thus no market. In this situation the rules forcing banks to "mark their portfolio to market" become insidious time bombs. The rules demand that if there is no market price for assets, these assets have to be written off or at least provisioned against. In other words, if there is no market now, the asset is "worthless".

If one contrasts the enormous write-offs banks had to take in the application of this rule with the essentially health condition of the debt and mortgage markets, where the problems forcing these write-offs are supposed to lie, one quickly notices a disconnect. It is simply not possible that all these write-offs are economically justified in a generally healthy credit environment where most loans are still serviced normally and default rates are no higher than average.

The write-offs are necessary, however, to comply with the rule that an asset which cannot be traded right now has to be considered "worthless". That the underlying credit may still be healthy, may still be serviced normally is almost irrelevant. The accounting and audit profession is dancing around the golden calf of "marking to market" and loses sight of true value. I am pleading here for a "fair value" approach that allows establishing a fair value for an asset, even if it is not traded right now. The distinction is at least as important as the distinction between valuing a company as an ongoing concern or at liquidation prices. Why an otherwise healthy financial company should be forced to value its portfolio at liquidation prices is beyond me.¹

If you surmise from this that I see value in the beaten down stocks of financial companies, you are right. I am of the contrarian belief that in the short- to midterm financial stocks are a good

¹ Barclays played this distinction brilliantly. It is now set to acquire Lehman's North American operations at liquidation values (Around USD 250 million), about one tenth of what it should have been worth as an ongoing concern.

buy. In the long run, however, I am seriously concerned about the nationalization trend which distorts the financial sector, as I explained above.

I am convinced that in not too long a time we will look back to this current period as the buying opportunity of the decade. Remember that Prince Waleed of Saudi Arabia purchased a solid junk of Citibank at the last major financial crisis and that his adjusted acquisition price is today somewhere between USD 1.00 and 1.50. This, by the way, is something that could happen again. Investors from the oil exporting countries could seize the opportunity of putting some of their oil money to work.

In the medium to long term, however, I see more value in the natural resource sector than in Financials. The shares of commodity producers have been battered by the double whammy of an extremely unfriendly stock market environment and falling commodity prices. This trend, however, is being reversed. Oil is off its low and approaching USD 100 again and in the general flight to safety gold posted its biggest one day gain ever yesterday. In the stock market 21 out of the 43 companies in the S&P 500 index that did post a gain yesterday 21, i.e. almost half, were natural resource companies.

Even the housing sector appears to have turned the corner. Both, housing permits and mortgage applications are up, a much hoped for sign of life in a market that has been moribund for almost a year. It will take some more time yet to work off the inventory of unsold homes that built up after the housing bubble burst, but it does appear that in this sector as well the worst is over.

By the way: the football game ended nil-nil. Both teams also might look back some day to this date as a missed opportunity.

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