

By Michael E. Lewitt

# It Doesn't Take a Crystal Ball

History and common sense tell us where the economy is headed. So, hang on—the ride is going to be rough

**T**he bursting of the subprime mortgage bubble and subsequent market meltdown in the summer of 2007 vividly illustrate Karl Marx's adage that history tends to repeat itself: the first time as tragedy; the second time as farce.<sup>1</sup> This summer's farce showcased the collapse of the subprime mortgage market, the failure of overleveraged fixed-income hedge funds, and sharp losses by quantitative hedge funds. The sad part: these debacles were made possible by players, both sophisticated and unsophisticated, who assumed: "This time will be different." Well, this time wasn't different.

So, just in case someone actually wants to learn from these mistakes, what can the financial markets of 2007 teach?

Answer: the more things change, the more they remain the same.

Moral of the story: embrace enduring truths.

Enduring truth number one: without regulation or some other moderating influence, investors will binge until they explode. In the 1990s, unregistered hedge funds like Long Term Capital Management leveraged themselves 100-to-one until they collapsed under their own weight. This time, we had a shadow banking system of structured investment vehicles operating outside the regulators' purview that let investors gorge on leverage until the markets blew up.

Enduring truth number two: investors who think

they're outsmarting everyone else often are too smart for their own good. These days, brainiacs pursuing quantitative investment strategies spend so much time trying to uncover arcane correlations among securities that they tend to overlook the obvious: In a market panic, all securities sell off. Result: the brainiacs lose their shirts.

**Speaking of overthinking**—you can discard all the fancy Greek words ("alpha," "beta," "delta," "shmelta") that hedge fund managers have been tossing around to impress clients and substitute the only two words that always matter in the markets: greed and fear.

Unfortunately, many of the largest players in the financial markets didn't learn the last time they deluded themselves into thinking that the laws of investment gravity had been repealed. This brings us to a final enduring truth: As long as humans are human, they'll trick themselves into believing "this time will be different"—and it never will be.

## Troubled Waters

So what can we expect in 2008?

Answer: Americans will be forced to watch a divisive presidential election even as they continue to suffer weakness in the housing market, high oil prices, a weak U.S. dollar, a Federal Reserve reluctant to lower interest rates, a volatile stock market, and nervous credit markets. Economists will keep debating whether the U.S. economy is entering a recession—even as broad areas of the country experience recessionary conditions and industries (like housing) witness their worst conditions since the Great Depression.

Whatever you call it, it won't be pretty.



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Still, there are some positive signs—and opportunities. Economic growth outside the United States, particularly in Asia, remains robust and will provide a counterweight to the U.S. slowdown. Global interest rates also will trend down, because the withdrawal of credit from the U.S. and European economies will have a deflationary effect on asset prices and economic activity in general. Because nobody should misunderstand the fact that the demise of structured finance is a highly deflationary event, the financial and regulatory authorities will fight to avoid the worst consequences of the collapse of structured mortgage finance. Investors will continue to enjoy opportunities on both the long and short sides of the markets, but must tread carefully and employ risk-management techniques in a highly volatile and emotionally fragile market environment.

### The Dollar and Oil

More specifically: investors need to keep their eyes on several key investment markers. The U.S. dollar and the price of oil will be two key macroeconomic drivers in 2008. These indicia of value in turn will affect other important signposts, such as the price of gold, the

Chicago Board Options Exchange Volatility Index (the VIX) and the stock market indices.

For the moment, the U.S. dollar probably has seen most of its decline against the Euro; it already has dropped 70 percent against the European currency in the past six years. European economies will not be able to sustain much additional dollar weakness.

There is far more downside for the greenback against Asian currencies, like those of China, Japan, India and Singapore, countries that are experiencing strong growth but whose currencies have not appreciated nearly as much against the dollar as the Euro. That means, on a long-term basis, Asian currencies are the place to diversify away from U.S. dollar exposure. You won't be alone in fleeing the U.S. currency: The drive to diversify out of the dollar is broadening to include everyone from supermodels to tourist sites in India to (far more significantly) sovereign investment funds.

A weak dollar has important investment implications for stocks and bonds. Many U.S. companies incur a significant percentage of their sales outside the United States, so these companies' earnings will benefit in the next year from non-dollar earnings. This phenomenon can be seen already in the stock prices of many multi-



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national companies and is one of the factors that supported stock prices through an otherwise difficult 2007.

But the larger, sadder fact is that we are in the beginning of the end of the dollar supremacy. The economies of China, India and even Russia are growing at twice the rate of the United States and those of the core European Union countries. Middle Eastern nations are enjoying the benefits of high oil prices and investing their oil wealth abroad in a manner that will extend their influence and wealth. The American proclivity for spending over saving (from Congress to Main Street) is sounding the death knell of U.S. economic sovereignty in the 21st century.

As for the world economy's 800-pound gorilla, oil: it did not require a hurricane in the Gulf of Mexico to force prices up to the feared level of \$100 per barrel in 2007. Instead, strong global demand, a lack of new

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oil discoveries and fears about supply did the work. A consensus is emerging that most of the low-cost, easy-to-access oil has been discovered and that future oil output is likely to level off. At the same time, projections show demand significantly outpacing supply. Like it or not, the West is under enormous pressure to find alternatives during the coming decades. In the near-term, U.S. and other Western consumers will face high oil prices, which will divert their money from other expenditures. Combine higher oil prices with a real estate recession or depression (depending on where one lives) and there'll be lower consumer spending.

In other words, the news is bad for investors in many sectors—except for investors in energy and related sectors.

### The Stock Market

Meanwhile, the equity market has gone on a roller coaster ride, swinging wildly because investors are reacting to every news headline as if the future of Western civilization hung in the balance. Gargantuan write-offs by financial institutions that drank the subprime mortgage Kool-Aid caused investors to sell financial stocks and boards of

directors to jettison Wall Street chieftains who'd lost touch with their businesses. To a large extent in 2008, fallout from the collapse of the mortgage business will impair the profitability of several important Wall Street businesses, including leveraged and structured finance.

Indeed, we've seen the crumbling of the entire edifice of structured finance, where individual loans were packaged and sold to institutional investors who had no relationship with the underlying borrowers. Because structured finance was a major profit center for Wall Street, its disappearance will hurt the financial sector's earnings in 2008. Moreover, the collapse of the mortgage market and structured mortgage finance will mean credit withdrawn from the economy, impacting other areas of consumer finance, such as automobile and credit card loans. Consumer credit in general will be more difficult to obtain.

Translation: investors should avoid companies in the consumer finance space in 2008. Instead, they should gravitate toward oil, resource and building/infrastructure stocks, which should continue to experience strong growth in 2008. The global building boom is unstoppable; just read the financial reports of multinational companies active in these sectors. Although the price of oil will likely retreat from \$100 per barrel as the U.S. economy slows, the price will likely average above \$80 per barrel throughout 2008 as global demand remains strong. This means that oil-rich countries in the Middle East and elsewhere will continue to mint money—and fund enormous building projects.

We can only hope that presidential candidates will address America's energy future in a meaningful way during the campaign instead of engaging in a mud-slinging contest.

### Credit Markets

The credit markets are likely to see higher default rates than in previous years.

Some of the predictions out there are too dire, however. Moody's Investors Service seems unduly pessimistic in its prediction of an increase from October 2007's default rate of 1.1 percent to a mid-year 2008 default rate of 3.4 percent. Goldman Sachs has issued an even grimmer 12-month trailing default prediction of 4.0 percent for high-yield credits and warns that a recession could push the default rate to 6.0 percent. Goldman Sachs places the odds of a recession occurring during the first half of 2008 at above 30 percent.<sup>2</sup>

One reason I doubt there'll be such a sharp increase

in the default rate is that many structural features have been built into the latest generation of leveraged transactions that give borrowers many ways of avoiding defaults (for example, the so-called “toggle” notes that give the borrower the option of paying interest in cash or in additional notes.) Absent a serious recession, which is unlikely because of global economic health and continued healthy demand for U.S. exports, defaults likely will stay below 2.5 percent through 2008. This means that spreads on corporate bonds are unlikely to widen to levels that truly compensate investors who assume the equity-like risks implicit in owning unsecured, subordinated debt in highly leveraged companies.

### Leveraged Finance

The outlook for the leveraged finance markets in 2008 is subdued. We were supposed to see the first \$100 billion leveraged buyout (LBO) in 2007. Instead, we saw investment banks stuck with more than \$300 billion in LBO loans that, because of the credit market meltdown, they could sell only at sharp discounts.

The culprit was the collapse of the structured credit markets and two types of structured credit vehicles: structured investment vehicles (SIVs) and collateralized debt obligations (CDOs), particularly the CDOs that owned subprime mortgages. The financial media reported that collateralized loan obligations (CLOs), that is, large pools of corporate loans, were the primary purchasers of the bank loans used to finance mega-LBOs.

But most missed the story-behind-the-story: that CLOs were being financed by SIVs. And SIVs were operating in an economy that was entirely opaque and accountable to nobody except institutions that were willing to finance them with short-term commercial paper. Big problem: SIVs were using short-term funding to purchase long-dated illiquid assets such as mortgage CDO and CLO obligations. When the subprime mortgage market collapsed, leading mortgage CDO paper and CLO paper to plunge in value, commercial paper lenders balked at financing these heavily leveraged SIVs, which naturally collapsed under their own weight.

Here's another enduring truth: Borrowing short-term to lend long-term has always been a recipe for disaster; the SIV stew was no exception. When the SIVs could no longer borrow money to purchase additional assets, the CDO market came to a grinding halt during the summer of 2007.

The second half of 2007 saw a much-reduced number

of CLOs completed, but their cost of capital increased from the London Interbank Offer Rate (LIBOR) + 50 basis points in the first quarter of 2007 to LIBOR + 130 basis points after the summer. CLOs will continue to attract institutional capital, only because spreads on the underlying bank loans that CLOs own have also increased significantly. These changes are not necessarily a bad thing; just look at what havoc the complacent credit environment wrought. Too many deals were done that served no business purpose other than lining the pockets of the LBO firms sponsoring the transactions. In fact, an unhealthy amount of overall financial market activity has been purely speculative in nature, meaning that it has contributed little or nothing to the productive capacity or capital stock of the global economy. Instead, private equity funds did deals because they generated fees and were doable due to the flood of global liquidity and artificially low interest rates that resulted.

Hopefully, higher funding costs will limit the number of speculative deals in 2008, while offering lenders higher and more appropriate compensation for the risks they assume in financing leveraged transactions. At the same time, the new environment should open the door for strategic buyers to add assets to their businesses without having to overpay to outbid LBO firms motivated to complete deals simply to generate fees.

### Buckle Up

The bloom came off the rose in 2007. Financial models ran aground, as the best-laid assumptions of quants and men proved flawed—again. The markets in 2008 will have to cope with fallout from the bursting of the biggest credit bubble in history. The subprime mortgage debacle seeped into every corner of the financial markets and produced hundreds of billions in losses. Investors who move too quickly to pick the bottom in financial and housing stocks are likely to experience more pain. It's going to take all of 2008 and longer to repair the damage to confidence and balance sheets that was wrought by the collapse of the housing market, as well as the mortgage and structured finance markets that grew up around it. **TE**

#### Endnotes

1. “Hegel remarks somewhere that all facts and personages of great importance in world history occur, as it were, twice. He forgot to add: the first time as tragedy, the second as farce,” Karl Marx, *The Eighteenth Brumaire of Louis Bonaparte* (New York: International Publishers, 1972), originally published in 1852.
2. Goldman Sachs, 2008 Investment Grade Credit Outlook, Nov. 21, 2007.