

# Strategy Overview

## The Crash of 2007/08

### Act 1 Scene 2

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# Meridian Investment Consultancy

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When we produced our original report on the Crash of 2007-08 (which can be viewed on our website <http://www.mips.co.uk/downloadsform.asp?id=108> ) we didn't know how fast things would move. We certainly hadn't expected that a week later there would be the first run on a British bank since 1867, and that Northern Rock would have to be bailed out by the Bank of England.

So, five weeks later, where are we? The amazing thing to us is that equity markets have recovered completely from the falls of August, and some emerging stock markets have hit new highs by substantial margins. Either there is no problem, and global economies will continue to grow, and the banks are all just fine, or equity investors are ignoring what's happening around them.

This second report on the crash will look at some more data about financial markets, and try to see what might be happening beneath the fairly placid surface of global markets.

Most of the data we shall look at will be from the US. In these days of global markets the US is still the largest and most important indicator by far, although Europe is moving up the tables. The UK is important to most readers of this note, no doubt, but what happens here will be largely a result of events elsewhere.

#### ***The Banking World***

Much of the focus of the last few weeks has been on banks. Rightly so, in our view, because it was the crazy lending policies of most banks over the last three or four years which have led to most of our problems. In the last week Merrill Lynch and Citigroup have lost their CEOs. In both cases their losses on sub-prime have increased sharply during October, after they'd already announced significant losses in the third quarter of 2007. In the case of Citigroup the losses appear to have jumped by between \$8 billion and \$11 billion (they aren't any more certain than that) in the course of October.

The underlying reasons for the new losses are in the next chart, which can be found (updated daily) at this URL:

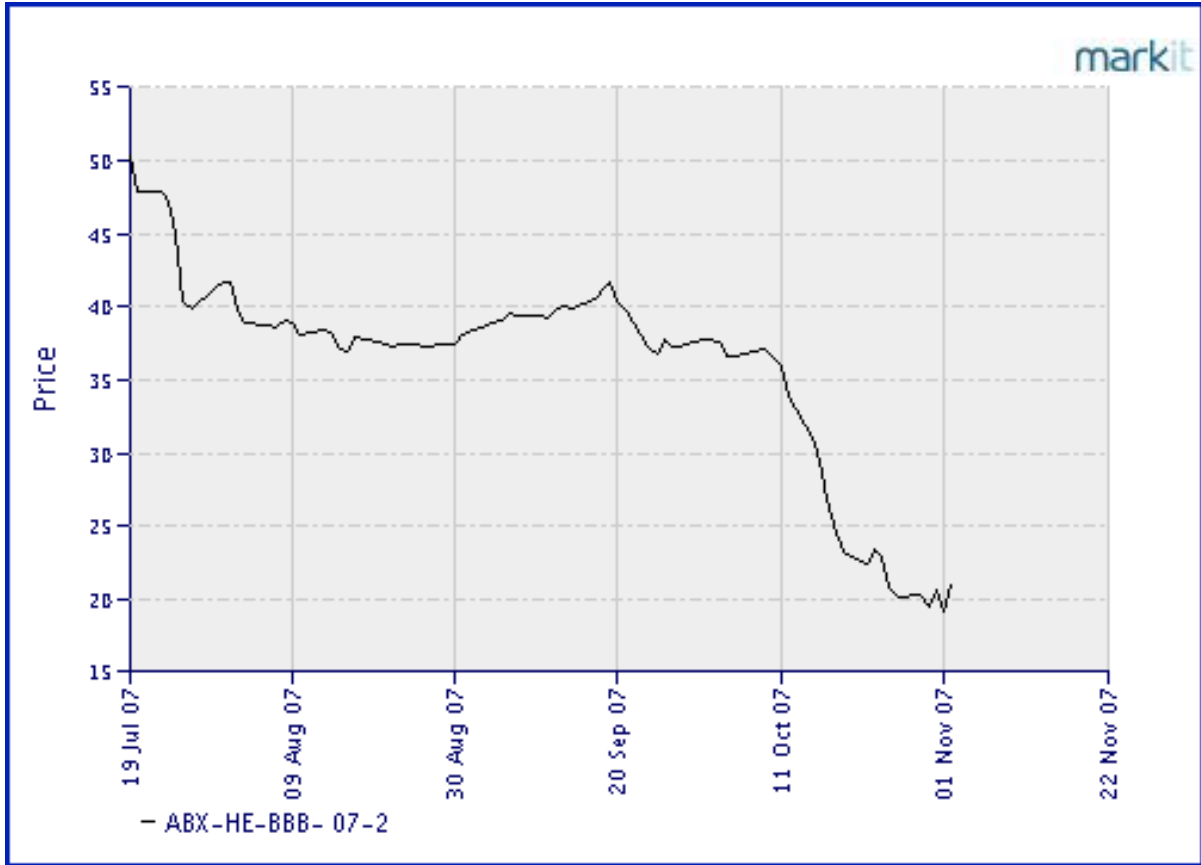
<http://www.markit.com/information/products/abx.html>

The chart shows the price of an index based on a basket of BBB-rated home equity loans originated in the first quarter of 2007. The contract fell sharply in the early summer, was fairly steady through August and September, but has fallen by another 50% during October.

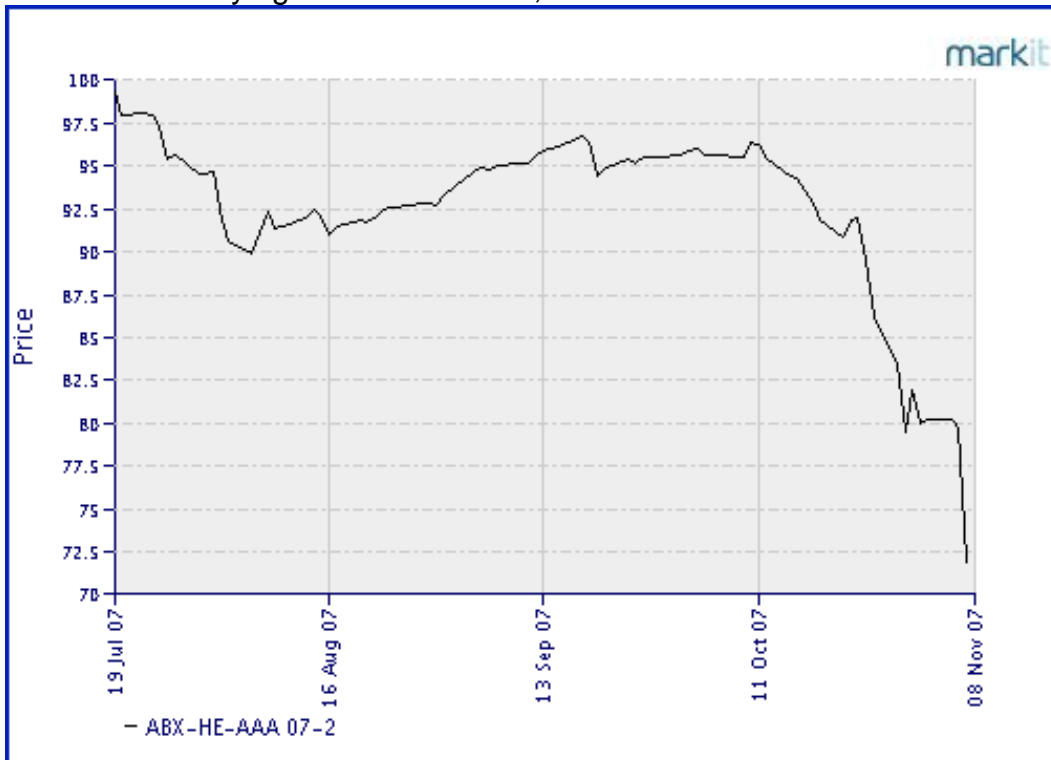
This fall is not unique to BBB-rated bonds, the A rated ABX index has also fallen by 50% in the last month, the AA rated index from 85 to 50, and the AAA version from 95 to 80. So the problem is spreading all the way up these structures, and the banks are having to recognise this. This means that all the banks who announced losses on sub-prime for Q3 will soon be back to announce new losses, and for many banks (Citigroup and Merrill for a start) the losses in October will exceed those for the whole of the third quarter by a substantial multiple.

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Even more worrying is the AAA index, which has done this:



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This is beginning to have an impact on the banks' capital ratios. Citigroup's ratio fell by nearly 1% from the beginning of the year to the end of September, and it will have fallen further since, probably to below 7% (for comparison UBS is about 10.6%). With the near-certainty of more losses yet to be recognised the banks need to raise new capital, or move more risk off their balance sheets. They can hardly do the latter, because there's nobody out there who would buy risk from banks at present, at least not at a price the banks could accept. And raising new capital won't be any easier.

And that is probably why the main US banks spent so much time in October trying to create a new "super-SIV" to take a lot of their riskier assets off their balance sheets and put them in yet another structured investment vehicle. To nobody's great surprise there were no takers for the idea (outside the banks). Who in their right mind would put up \$100 billion to buy a package of bonds (of unknown quality) from a group of banks desperate to lighten their balance sheets?

The other problem the banks are sweating over is their regulators. The regulators may be slightly sympathetic, but they are also very concerned that the big banks have been using risk models which (like the Rating Agencies) were overly optimistic about large numbers of structured securities. The regulators are mainly concerned about protecting depositors, but they also have a duty to keep banks functioning. At present they will be encouraging the banks to dig deeper into the complicated vehicles they own, and have sponsored, to assess what the damage actually is. The news is probably not good.

So what will the impact of this all be on investment markets?

### **Bond Markets**

As we said two months ago, credit risk is a big concern, and we don't think credit spreads are yet wide enough to discount the increased risk of default, especially in financial borrowers. We'd still be in favour of reducing allocations to credit as we outlined last time.

Duration risk has paid off well, especially in government bonds. In the UK the Bank of England has resisted calls to cut rates, but we expect a downward move quite soon. In the US the Fed has suggested that there will be no further cut until the picture is clearer. That may be, but if the credit crunch pushes more banks into difficulty, and also causes the economy to slow then the Fed has no choice but to continue to cut.

Stay long of benchmark duration. It may be a volatile ride, but we think it will pay off in the next twelve months.

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### Equities

Global equity markets seem to be on another planet. The banking system is under severe stress, leveraged buyouts have stopped for lack of funding, and the global economy is likely to slow rapidly next year. So what happens? The Hang Seng index in Hong Kong is up 50% from the August lows, as is Shanghai. Most emerging economy equity markets have hit new highs. Even the boring S&P 500 and FTSE 100 are up by 10-15%.

The only explanation for developed markets being up is that the Fed has cut interest rates. So it has, but only because of the severity of the credit crunch. It's a bit hard to see that as good news, overall.

Emerging markets seem to have benefitted from repatriation of funds from the US. Global financial flows suggest that emerging countries have been big sellers of US bonds and equities, and have taken the money home. That's clearly paid off so far, but if the US economy slows seriously in 2008, as we'd expect, then the rest of the world will suffer too.

We'd reduce equity allocations sharply at or near present levels.

### Hedge Funds

After a bad August hedge funds bounced back in September, mostly ending the quarter slightly up. October was another good month.

We'd be keen to cut back on equity long-short funds with any sort of long bias, and to avoid event-driven funds hoping for a recovery in buyouts. If the credit crunch spreads further then highly geared hedge funds could be in trouble too.

We'd aim to reduce overall gearing, and to move towards funds trading in liquid markets. We'd look to add to credit specialists, and experts in debt reconstructions. It may be a little early, but there will be lots of opportunities in 2008.

### Commercial Property

In the UK commercial property unit trust markets prices have fallen by about 10% since the end of 2006. About half this fall will be a switch from offer price to bid price, but the other half is a real fall in values. Much of the UK property boom has been based on borrowed money, and the banks won't be lending much for the next twelve months.

Overseas property markets are more difficult to read from here, but none will look very attractive as the credit crunch bites.

### Summary

The banks clearly still have no idea how much money they've lost. Citigroup's latest estimate has a range of \$3 billion. That is the whole of the losses they declared in

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Q3.

Stay conservative, reduce risk, except for duration risk, of which most people should be taking more.

David Osborne

5 November 2007

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