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COLUMNS

One word sums up 4th quarter: Kazakhstan

The first word most investors use to describe the fourth quarter is "subprime," but for me the word is "Kazakhstan."

One of the first casualties of the subprime meltdown was a bank in Kazakhstan. Now, how did a bank in Kazakhstan wind up holding mortgages on U.S. homes in the form of credit derivatives known as CDOs (collateralized debt obligations)? Easily. They just bought them from their friendly stockbrokers.

Traditional banking fading

No longer does the local bank lend money to a homeowner and hold the mortgage. This ties up too much capital for the bank, which found a way to charge fees for making the loan and collecting the monthly payments, while selling the mortgage and minimizing the capital required by regulators.

Here's how the meltdown happened. Many institutional money managers, like pension funds, needed investments such as bonds and mortgages because they produce a fixed income to match their pension payouts. Therefore, money managers bought the profusion of mortgages owned by local banks. This mushroomed as big brokerage firms rushed in to sell similar investments of every credit quality to retail investors such as collateralized mortgage obligations, or CMOs.

These investments were then resold and resold. This is called "securitization," i.e., turning regular home mortgages into securities that brokers can sell. Many varieties were invented, including such credit derivatives as swaps and CDOs, which proved to be even more risky.

While fourth-quarter behaviors were driven by headlines that talked endlessly of the subprime problem, longtime readers of this column know it is really a credit derivatives problem.

New phantom banking system

We look to the Fed to manage the economy by controlling the banking system, but this is becoming increasingly difficult as the traditional banking system has become less important. A new phantom banking system has developed, largely outside the reach of regulators.

A timely example is the special investment vehicles, or SIVs, which held many of the bad mortgage securities. Banks put the money of many investors into these vehicles but were not required to put those SIVs on their balance sheets. Therefore, the losses belong to the investors, not the banks. And, since there are no capital requirements for non-balance sheet assets, there was no limit on how much investor money could go into these SIVs.

This new system of banking is almost entirely beyond the reach of regulators, U.S. or foreign. This phantom banking system, according to legendary bond guru Bill Gross, has "lost its innocence."

How the markets fared

The fourth quarter is traditionally the strongest quarter each year but, for the first time in 10 years, the Dow fell 4.5 percent, while the S&P fell about 3.5 percent, and the Nasdaq fell a mere 1.4 percent. However, for the full year of 2007, the Dow was up 6.4 percent, the S&P was up 3.5 percent, and the Nasdaq was up a highly respectable 9.8 percent.

The best-performing sectors of the economy were energy (up 35 percent) and materials (up 21 percent). The worst-performing sectors were financials (down 21 percent) and consumer discretionary (down 14 percent).

The latest reading on the economy was the December jobs report, which showed a mere 18,000 new nonfarm jobs, and a huge jump in unemployment from 4.7 percent to 5 percent.

TD Ameritrade estimates unemployment will continue rising to 5.3 percent this year. I expect it could be even higher.

While the dollar finally stabilized some in the fourth quarter, it's still down about 9 percent over the past year. As a result, our current account deficit decreased from 5.5 percent of GDP to only 5.1 percent. This is good for the U.S. in the short run but hurts our trading partners. With the weak December jobs report, the Fed is under intense pressure to lower rates again, which will then lower the dollar even more. We are becoming a brake, slowing the world economy.

2008 recession?

The most popular question now is, Will we have a recession in 2008? The answer is no and yes. There are two types of recession, the traditional recession and the growth recession. The traditional definition of recession is two consecutive quarters of decreasing GDP, which is a pretty tough order. A growth recession is just a slowdown in growth, which is painful enough but hardly frightening.

Growth in the third quarter approached a "hot" 4 percent, but I expect growth in the fourth quarter was only 1 percent. The most important perspective on recessions is that they only last an average of 10 months. Take a deep breath and don't lose too much sleep over this. Even if this is a long recession, it will eventually end, and capitalism will grow again.

According to Standard & Poor's, earnings per share in 2008 is expected to fall 7.7 percent, which sounds bad but is misleading. Only the financial sector of the economy is in deep trouble, pulling down the average. Stripping out that sector, the remainder of the economy is doing great, with earnings expected to rise a healthy 11.6 percent. Unfortunately,

it is unlikely that mid-caps and small-caps will share that good health, as they are more easily strangled by the financial sector.

How we're managing it

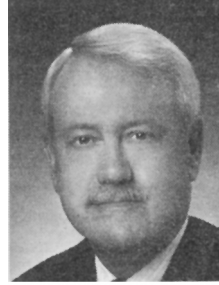
Our game plan for the first half of 2008 is to increase exposure to the sectors of the economy relatively isolated from the financial sector, such as natural resources and international technology, as well the consumer discretionary sector, which performed badly last year. Some investors don't think of cash as an investment, but we will allow cash levels to increase during the volatile first half.

While we are already under-weighted in U.S. financial stocks, we expect to briefly over-weight them in the near future, probably in the first quarter, before significantly under-weighting in the long run.

We expected the financial sector to suffer from credit derivatives, but we expected that the losses would come from credit default swaps, which could be far worse than the sub-

prime problem. Foreign banking firms will also be greatly under-weighted. Information reported by The Economist strongly suggests foreign financial firms have not yet paid the price of securitized subprime lending. The worst is yet to come for this sector.

We will also commit heresy and decrease our exposure to China. While we remain optimistic about emerging markets, good portfolio management sometimes requires taking some money off the table. The Chinese market is up an unsustainable 96 percent this year. Their current account surplus is a staggering 12 percent of GDP, but will decrease as their currency has appreciated 7 percent against the dollar. Their inflation is the highest in 11 years.



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Clearly, this century is the China Century, but hogs still get slaughtered.

Recessions come and go but capitalism always bounces back. As CNBC star Jim Cramer likes to say, "There is always a bull market somewhere," except maybe Kazakhstan.

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