



# Bushell's Signature Report



## Sub-prime goes global: Credit crunch puts the brakes on world growth

Globalization led to cheap debt and inflated asset prices in the past few years. But this cycle is now reversing as the credit crunch and deleveraging put downward pressure on asset prices.

How did this happen? A global savings surplus, fuelled by OPEC and Asian countries' trade surpluses, developed between 2003 and 2007. This money was recycled into government bonds, depressing global interest rates. Low government bond yields presented a problem for savers, who responded by migrating into riskier income investments in search of a better return. These investors were gladly greeted by innovative financiers, who had developed high-yielding structured debt instruments comprised of risky mortgages, among other things. A broad-based compression of risk premiums in debt markets continued as investors reached for yield. Leveraged buyouts and overheated commercial real estate markets were other symptoms of this environment of mispriced credit.

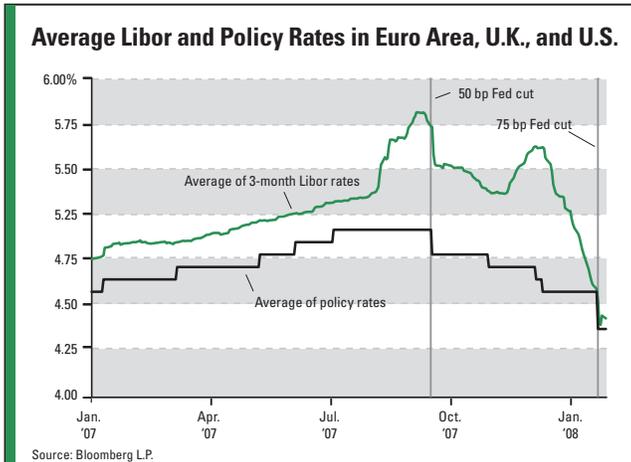
This debt frenzy reached its zenith in March 2007 and now, nearly a year later, we have entered into a deleveraging cycle that has brought asset price deflation. Poised to suffer most are assets that are most sensitive to leverage – which, fortunately, does not include most equities. But housing, commercial real estate, heavily indebted equities and infrastructure all fit the bill.

Structured debt and sub-prime mortgages pricked the debt bubble – although if it wasn't sub-prime, it would have been something else, such as the failure of a large leveraged buyout or real estate deal. As it turns out, structured debt products are

complex, illiquid investments. The buyers did not understand them, nor did the financiers who assembled them. The disturbing reality was that structured finance experts were taking individual, low-grade assets and magically turning them into “high-quality” securities. Buyers included financial institutions, hedge funds and pension funds, not just in the United States but also abroad. We dubbed this practice “financial alchemy” in December 2006 and warned that the situation was going out of control.

Cracks in the structured debt markets began to show during the first quarter of 2007 with HSBC's sub-prime write-offs. But things began to fully unravel in mid-June when a Bear Stearns credit hedge fund collapsed due to a margin call. Assets that its managers considered to be investment grade proved to be completely illiquid; this was the warning shot for all risk managers around the globe. By August, the credit contagion had shut down every aspect of the securitized debt market, which had profound implications for the rest of the financial system.

The system relies heavily on securitization of credit and on financial institutions' access to debt markets for funding. For several months last summer and fall, banks were unwilling to lend to each other, as seen by the spike in interbank lending rates (See Chart 1). Equally problematic was the freeze-up of money markets, which had investors boycotting any commercial paper related to securitized bank assets (See Chart 2).



*Chart 1: Last year's credit crunch can be seen in the spike in interbank lending rates (LIBOR or London interbank offered rate), which showed that banks were unwilling to lend to each other and preferred to conserve their capital. The rate has since returned to normal levels, following the U.S. Federal Reserve's rate cuts in January and bank efforts to rebuild capital bases.*

Ultimately, central banks around the world responded as lenders of last resort. In December, they provided hundreds of billions of dollars in emergency lending to troubled institutions in a successful bid to restore normalcy to money markets. But a bigger problem had emerged during the fall, as a global banking crisis – and, by extension, a massive credit market shock – had begun to take hold.

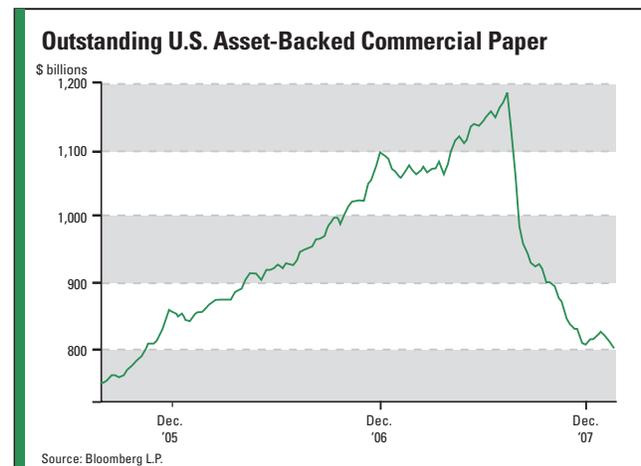
The banking system will right itself. Already, capital injections, takeovers, dividend cuts and asset sales are bringing solvency ratios back to acceptable levels and stabilizing the interbank lending market, as shown in Chart 1. Later this year, greater transparency and simpler structures will bring sophisticated lenders back to securitized debt markets. Lending standards will correct themselves.

Many equity investors are concerned about the spread of non-performing loans into other areas – including credit cards, leveraged loans and commercial real estate. However, we believe these risks are much better understood than were asset-backed securities, collateralized debt obligations, and

other forms of last year's distressed debt. As such, we are positive on financial stocks, and will become much more so once financial insurers are recapitalized.

Throughout much of last year, equity investors remained confident and stock markets, outside of financials, managed to produce some gains. Markets were underestimating the severity of the credit problem and how widely its effects would be felt on Main Street, USA, and what the impact might be on foreign markets, particularly China and other fast-developing economies.

That situation is now changing. The consensus economic outlook is being revised downward and with it expected earnings growth. Concern is mounting over tighter lending standards and lower capital ratios that may choke off credit availability to sound borrowers. If this comes to pass, the stimulative effects of monetary policy may be muted. Policy responses of all sorts are forthcoming, and fiscal, monetary



*Chart 2: The freeze-up in money markets brought on by investors shunning anything related to structured finance is best illustrated by the contraction in the asset-backed commercial paper market. Outstanding U.S. ABCP quickly declined from nearly US\$1.2 trillion to \$810 billion at the end of January 2008. That \$400 billion in ABCP, along with another \$200 billion in other vehicles, was forced back onto banks' balance sheets.*



and housing-specific measures dominate the headlines – all are aimed at re-establishing some stability.

Looking ahead, the central question is not whether the United States suffers a slowdown – consumer deleveraging ensures that – but rather what the effects will be on emerging market economies. Investors have great expectations for emerging market growth and resiliency. This is a conviction that has developed over the past five years against a backdrop of unprecedented global growth. Sovereign risk premiums have compressed dramatically as confidence in monetary and fiscal policies strengthened. Local equity markets have boomed.

But how much of the improvement in emerging economies has been cyclical and how much has been structural? This year will provide the answer. We expect that tighter credit and weaker exports will result in lower growth expectations. However, developing economies should provide a healthy global offset to weakness in developed markets. We believe China has the internal momentum to withstand all this, as do a number of other developing economies.

More specifically, the credit crunch is serving up four challenges to emerging markets:

1. It has triggered a U.S. and Eurozone slowdown, which will lead to lower exports.
2. It pushed down the U.S. dollar and forced up prices for oil and agricultural commodities, which are seen as hedges against a weak greenback. Commodity price inflation is a significant chink in the armor of emerging economies.
3. U.S. interest rate cuts are forcing all countries with currency pegs to follow suit. But how can countries with overheating economies and rising inflation, such as those in the Gulf region, cut rates?

#### Food Commodity Prices (in special drawing rights)



Source: Credit Suisse First Boston

*Chart 3: Rising food commodity prices, as well as higher energy prices, are the twin drivers of inflation in emerging markets.*

4. Weaker employment in developed countries has impacted emerging market incomes as remittances from immigrant workers fall.

An additional challenge is the potential flight of capital and repricing of sovereign risk. However, this is likely to arise only in isolated situations.

The second point – the impact on the U.S. dollar and oil and agricultural products – deserves more attention because it aggravates the problem of wide income gaps in developing countries. With the dramatic increase in food commodity prices (See Chart 3), governments from Russia to China to Indonesia are instituting price caps across a range of staples. Food and energy costs comprise a huge proportion of these countries' price index consumption baskets, and government wages are often linked to those indexes. In India, for example, food prices comprise nearly one-half of the country's inflation rate.

One potential outcome is that inflation forces interest rates higher and chokes off domestic demand. Given that inflation already is running between 4% and 10% in many developing

### Inflation in Developing Countries

	CPI (year-over-year change %)	Central Bank Rate (%)
Ukraine	19.4	10.0
Latvia	15.8	6.0
Vietnam	14.1	N/A
Russia	12.6	10.25
South Africa	9.0	11.0
Argentina	8.2	N/A
Turkey	8.2	15.5
Chile	7.5	6.25
Hungary	7.4	7.5
Indonesia	7.4	8.0
Egypt	6.9	11.0
China	6.5	7.47
Saudi Arabia	6.5	5.5
Iceland	5.8	13.75
India	5.1	6.0
Brazil	4.5	11.25
Thailand	4.3	3.25
Qatar	3.9	N/A
Morocco	2.0	3.25

Source: Bloomberg

*Table 1: Developing countries are facing high levels of inflation relative to the past decade. Investors have been willing to accept low real interest rates, but that may change as economic growth falters. Developing world central bankers face unusual policy risks in 2008.*

countries, as shown in Table 1, any added pressure could force an upward spike in rates.

Last January's Mexican Tortilla Crisis, which saw corn flour spike in price, served as a timely reminder of the political and social risk embedded in food scarcity and pricing. With the price hikes leading to demonstrations, the Mexican government jumped into action, working with food companies and retailers to establish temporary price caps. The Bank of Mexico supported the government action by tightening monetary policy. Our visit in May to Mexico City confirmed that the country's economy had felt the effects as consumption fell. This sort of scenario is likely to be repeated throughout developing economies in 2008.

The U.S. sub-prime credit crisis is becoming everyone else's problem. The policy responses are triggering new challenges for developing countries. The keys to successful investing in 2008 lie in deciphering the complex interactions and transfer mechanisms that have taken hold in our globalized economy.

The good news is that valuations are cheap. Equities did not participate in the euphoria that credit markets experienced from 2004 to 2007. In fact, many companies are trading at levels they were at in 1998 despite years of growing their business. Looking forward over the next three to five years, it is clear to us that equities will outperform other asset classes. Patience will be rewarded.



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