

The Pain Report

From the desk of HFA Asset Management's Jonathan Pain

WELCOME TO THE U.S.S.A

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Saturday 20th September, 2008

It is tempting to use the words, historic, unprecedented, incredible, unbelievable and any other superlative to describe the events of last week. On Thursday 18th September, the news broke that the US government would create a Resolution Trust Corporation (RTC) type entity that would purchase mortgage related securities from banks. US Treasury Secretary Paulson stated: "The federal government must implement a program to remove these illiquid assets that are weighing down our financial institutions and threatening our economy... I am convinced that this bold approach will cost American families far less than the alternative – a continuing series of financial institution failures and frozen credit markets unable to fund economic expansion".

In a week that changed the world we saw Lehman Brothers declare bankruptcy on Monday, Merrill Lynch acquired by the Bank of America, with the very visible hand of government marching Merrill's down the aisle. We then saw a government takeover of AIG, the world's largest insurance company and by Wednesday it looked like Morgan Stanley would not make it to the end of the week. It was the breathtaking speed of the process of disintegration that meant that the US government had to step in to avert a 'systemic' failure of the American financial system.

Do not for a moment think that we were not just hours away from financial Armageddon. On Wednesday 17th September, the mother of all safe havens, US 3-Month Treasury bills traded at 2 b.p, yes, two basis points, and the credit and money markets effectively seized up! So what is next?

Equity markets around the world saw some of the strongest two day gains ever witnessed and it is fair to say that the 'relief' rally underway has further to go. My macro view is that the actions being proposed (we won't know all the details until possibly next week) have averted a 'systemic' failure but will not prevent the inevitable and painful process of credit contraction, that we have been talking about for a year. As we have said before, we have commenced the 'Mother of all credit contractions'.

The greatest threat at present is deflation, not inflation, and hence central banks such as the RBA, ECB, BOE and others need to cut rates. The proposed action by the US government should be applauded. I personally feel they took rather a long time about it and in fact we recommended such action on the 20th August 2007 in a Pain Report entitled 'Born in the USA'. The RTC-style proposal does not stop house prices falling but it buys some time and serves to 'soften' the speed of the de-leveraging process, but certainly does not stop it.

A couple of issues which intrigue me about all of this are; if the jolly clever financial engineers at the world's investment banks, who created all these nasty toxic mortgage-related securities, do not know how to value them, how does one expect the government employees of the U.S.S.A (United Socialist States of America) to put a price on them. Since they are about to acquire many, many hundreds of billions of securities, I am fascinated to see the process by which they price them. Another thought is; if the current capital write downs and credit losses, since the start of the crisis, amount to US\$519.3 billion then surely as the securities are purchased by the government, the price at which they are 'sold' will constitute a market price and hence have to be accounted for. Given the majority of these problem assets have, to date, been classified as Level 3 assets and too difficult to price then surely we are looking at the potential for a significant escalation in losses.

Anyway, maybe such thoughts are not appropriate right now as we celebrate the 'Mother of all financial parties' and I certainly do not want to be the one to have to ask the awkward questions about government deficits and the like. So much easier to simply pay the investment banking executives vast amounts of money as they lose unprecedented billions and billions, and leave the trillions and trillions of debt to the next generation to sort out. Why ruin a good party?

However, now is not the time for moralising and philosophizing. Now is the time to recognise that there are some outstanding valuation opportunities. We have seen a stunning decline in oil prices from their US\$147 peak and our short term target of a decline to US\$100 was, in fact, exceeded and we now feel oil will move higher. The underlying fundamentals have not changed, namely, the motorisation of the world's two most populous nations and the 'crude reality' that supply cannot satisfy the inevitable rise in consumption. Good quality, diversified resource companies such as BHP are currently trading at insane valuations. Regular readers of this report will know that I am a long-term believer in this company and have been for several years.

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Markets like China and Hong Kong look like exceptional long-term value (This is the first time I have ever recommended Chinese stocks despite the fact that I have been a big believer in the Chinese economic story). I still cannot get excited about the US stock market and given the current P/E ratio is 24 times, it is not exactly cheap and since I just do not believe the E in the forward P/E, I cannot bring myself to recommending it. The broad macro view is that most of the economic pain will be in those countries that have seen the biggest housing bubbles and the highest levels of household debt.

On the currency front, the situation is somewhat more complex. We have just seen a dramatic rise in the US Dollar as investors ran for the 'risk exit', but in fundamental terms, debt, deficits, etc, the US Dollar must be viewed as a 'high risk' currency. I also feel that many countries in Arabia and Asia have, quite frankly, been shocked by what they have just witnessed in America. If you were responsible for \$1.9 trillion worth of foreign exchange reserves at the People's Bank of China, wouldn't you want to start reducing your 65% exposure to the world's most indebted country? In this regard, the continuing diversification away from the US Dollar, which was so rudely interrupted over the last few months, will now recommence. Our parity forecast for the Australian Dollar was similarly interrupted by the contagion of risk reduction and, yes we got, oh so close, reaching .9850 on 15 July. It will be a long road back to parity but, that, I think, is the long-term direction.

That is enough of forecasting from us for the moment. Just one more and then I must go as it is Saturday night! History shows us that moments of chaos and panic present wonderful opportunities. Now that the US Treasury appears to have averted a systemic failure, there are some extraordinary opportunities in the credit markets, currency markets and selective equity markets. Those who have best preserved their client's capital through these extraordinary times will best be able to participate in these opportunities.

Sunday morning, 21st September 2008.

We now have the text of the plan. The US Treasury has asked Congress for authority to buy as much as US\$700 billion in mortgage related assets from the nation's financial institutions. 'Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or an administration agency.' The Treasury plans to hire managers to purchase the assets through so-called reverse auctions, seeking the lowest prices, a person briefed on the proposal said.

It is believed that the House of Representatives will pass legislation to implement the plan by the end of next week, and the Senate will act soon after. In response to questions about the package, George Bush said the following, 'I'm sure there are some of my friends out there that are saying, I thought this guy was a market guy, what happened to him. My first instinct was to let the market work until I realised, while being briefed by the experts, how significant this problem became.'

Not just your friends, George, not just your friends.

Comrade George, welcome to the U.S.S.A

All the best,



Jonathan Pain

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