

What's Next for the Credit Crisis?
I'd Rather Be a Hammer than a Nail.

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"I climbed in the ring with Robert Duran and the punches began to rain down.

He hit me with a dozen hard upper cuts and my corner threw in the towel.

I asked him why he had to knock me out and he summed up real well.

"I'd rather be a hammer than a nail."—Paul Thorn Band, Hammer and Nail, 1997.

This article comes fresh off a trip from visiting my son in Chapel Hill, North Carolina, where we had the good fortune to take in a live show of The Paul Thorn Band, one of my favorites. Paul is an ex-prize fighter that once lost in a title bout against Roberto 'Hands of Stone' Duran. For those of you not familiar with Paul Thorn, he is a native of Tupelo, Mississippi and his lyrics are wonderfully folksy and sometimes downright hilarious. His style is a splendid mix of blues, rock, and a bit of country. When listening to a Paul Thorn CD on the way home today, I thought of this song that he calls his 'theme song'. And it reminded me of how I feel about today's investment environment—**I'd rather be a hammer than a nail.** (For a clip of the audio –

<http://www.paulthorn.com/store/cd/clips/hamnail.mp3>).

Now that this investment environment is here, we must ask ourselves if a) it is fully discounted and b) what other sectors of the stock market and economy will be hit next?

There are a couple of basic trading disciplines that I live by. First, 'what the market knows isn't worth knowing'. By the time I see thoughts I wrote about several years prior make their way to the cover of my local newspaper, I know that most people are now aware of the problem and likely already positioned for it.

Second, I was taught at a young age (the hard way) that no matter how intriguing an investment opportunity appears the balance of risk and reward must be squarely in my favor. Most seasoned traders and investors like to have risk/reward somewhere between 2:1 to 3:1 in their favor before establishing a position, long or short.

Lastly, we must 'plan for the worst and hope for the best', a difficult position for most anyone with even a moderate sized ego to take. The markets seem to find a way to sniff out crowded positions and crush the crowd at extremes, otherwise known as the 'Pain Trade'. Having been on the wrong side of the Pain Trade enough times, I try to avoid the crowd as often as is practical.

With this in mind, I think that the easy money has been made on the short side of financial stocks. By no means does this mean that they cannot decline further, it just means that the balance of risk and reward just isn't there, as a group, to be short. There are most certainly isolated instances that offer excellent risk/reward characteristics, notably weakly positioned broker/dealers and regional banks that have not yet 'fessed up to the real value of the esoteric securities that remain on their balance sheets, but this is more of a 'rifle shot' approach as opposed to the broad 'shotgun approach' that has worked so well since the crisis began in earnest last summer.

I would note that the fundamentals of the housing industry are nowhere close to turning, and in fact, are worsening. Recent reports show foreclosures soaring 50% year-over-year which will certainly force more write-downs, and eventually write-offs, both at housing companies and banks. Other reports estimate that nearly 2/3 of all sub-prime and Alt-A loans¹ originated in 2004 - 2007 will be in a 'negative equity position', which makes refinancing all but impossible for many years to come.

Does this make us suddenly bullish on the equity market as a whole as a result of our more neutral attitude towards financials? Not in the least. In fact, this is where I believe the next stage of the crisis really takes hold—in sectors that one might think are not correlated to banks and brokers.

I have read recently that technology stocks are a 'safe haven' in the equity market. The rationale, I am told, is that you should buy Microsoft, Cisco or Apple because 'at least you can understand their balance sheets'. I cannot disagree that Apple's balance sheet is much easier to understand than the labyrinth of leading investment banks and regional banks. If this is an investor's sole reason for buying a stock, I would be wary of letting them manage my money. If this is what the market has become, the best of the worst, then we had better start worrying as this is behavior of an equity bear market that is about to shift 'into gear' to the downside.

Think about who buys I-Pod's, P.C.'s and routers for a moment. On the corporate side, many of the largest buyers are those in the financial industry, the very ones that are being forced to raise capital just to stave off bankruptcy or the many smaller institutions that I fully expect to be merged into larger organizations in coming months and years. From the consumer side of

the ledger, most consumers are stretched beyond their means. We also know that the majority of homes purchased with Alt-A and sub-prime mortgages now have negative equity. Not to mention the nearly \$100 it costs to fill up a tank of gas.

Consumers are now officially tapped out and this helps explain why nearly 20% of all Americans have borrowed against their retirement accounts, a clear sign of financial stress. Consumers have become so programmed that their assets will rise in price since the stock market bull market began in 1982 and the real estate bubble that began in 2003, they are used to borrowing against these assets. Now that debt has piled up, savings are depleted, and inflation in the 'things that we need' like gas and food have exploded up into their own bubble you might say that the 'Perfect Storm' has now formed for the median wage earner.

Anecdotally, I sense that spending habits are changing for the upper class as well. As producers face higher price inputs, they then try to pass the costs along to consumers. Retail sales numbers may have risen this past week, but most of it was as a result of more money spent on gasoline and higher prices paid per item purchased. This is not a harbinger for future growth; rather, it is a recipe for a deep and prolonged recession, which explains our caution.

So if you believe that technology companies are immune to the mess that began with banks and brokers, you may wish to re-consider. Earlier on, I mentioned that I need the balance of risk and reward to be squarely in my favor. I now believe that the next sector that could be the new downside leadership, if the market decides to have another leg down, is technology. It is as close to being a safe haven as I am to being as good a golfer as Tiger Woods.

There are a few other reasons we believe tech would lead another leg down in stocks. Namely

¹ An Alt-A mortgage is a type of U.S. mortgage that, for various reasons, is considered riskier than "prime" and less risky than "subprime," the riskiest category.

that the short interest in the largest companies in the NASDAQ 100 are at very low levels, which would suggest a dearth of buyers, should a down move develop. Further, insiders are selling in droves and valuations are hardly inspiring. Mutual fund cash as a percentage of assets remains at very low levels (as it has since 2000) and the best potential outcome for the stock market would be persistent sector rotation as opposed to broad market strength. More likely I expect large net redemptions from mutual fund investors that need to get cash from somewhere as they have exhausted all other avenues for liquidity. Consumers have already tapped home equity extraction and credit card advances which in turn could lead towards a self-fulfilling prophecy of lower equity prices that lead to more redemptions, and so on.

Also, let us not forget the hedge fund industry, where returns have been better than long-only investing, but nothing to write home about as a group, which could also prompt redemptions in that space as well. Considering the leverage that many funds employ (present company excluded as we utilize limited leverage), it has the potential to set off quite a dramatic sell-off. This scenario seems more likely to me these days as the markets seem more random (everything from equity futures to bonds to commodities) on a daily basis in terms of unexpected volatility.

Other industries that I find susceptible to a move lower include transportation, commodities, materials, and manufacturing concerns. The concept of a Black Hole that I mentioned in my last piece (a concept that I borrowed from a good friend of mine) seems to want to play out.

Black Holes basically absorb anything in its path and now that banks and brokers have been absorbed, it should now spread to other industries. Let's not forget about retailers in general. I know that some companies have benefitted from the economic weakness, like

discounting giant Wal-Mart; they are not immune to a general economic slowdown any more than Costco is (I recognize that Costco is a well-run organization but is hardly the bargain at nearly 30 times trailing earnings). I realize that they are expanding into China and other developing nations, but those nations are not immune to our macroeconomic issues; rather they rely on our consumption and deficits to recycle our dollars into our assets.

Speaking of foreign investors, Sovereign Wealth Funds were early buyers of brokers and banks seeking fresh capital to cover their mortgage backed securities write-downs, but they have seen their purchases fall by 25 to 50%, and they were notably absent from Lehman Brother's capital raise done last week. Speaking of Lehman, they have temporarily managed to stay out of the hands of a suitor (rumored buyers have been everyone from Goldman Sachs to BNP Paribas), but that will prove temporary in my opinion. Let's face it; it took a savvy hedge fund manager to undress Lehman's inability to price their own assets, and the obvious lack of ability for top management to assess its own portfolio, all in a span of days when the COO and CFO are unceremoniously dumped.

The thing that bothers me is that I don't think Lehman is alone, in fact I think they are the poster child of the financial system-I DO NOT BELIEVE THAT MOST INVESTMENT BANKS AND OTHER FINANCIALS HAVE ANY CLUE HOW TO VALUE MANY OF THEIR ASSETS. Pile 25 to 40 times leverage on top of this mess and I have to admit, it gives me the shivers.

I find it interesting that so many companies from General Electric to Merrill, Keybank to National City and Lehman, have such lack of risk controls that they act surprised when the values of their securities suddenly drop and they have to write down assets. We need to be on the lookout for more of this activity as the assets held from

everyone from hedge funds to mutual funds to financial institutions are about to face Phase 2 of the credit crisis when loan performance continues to worsen as the stretched consumer pulls back from purchasing all but necessities and corporations find their inventories rising, which in turn leads to less manufacturing and finally higher unemployment. This will go on and on until the painful de-leveraging process is completed. This train of thought should help explain our cautious, and sometimes downbeat, view of equities and credit risk.

There has been considerable jaw boning by the European Central Bank and the Federal Reserve about inflation of late. The jaw boning has been so severe that Treasury notes have sold off violently. So violent that I suspect some large market players like macro hedge funds were taken off guard. The markets have taken on an almost surreal, random intra-day feeling on some days, frustrating many, present company included, which has led us to trade smaller and play closer to the vest until the market takes on a more rhythmic feeling.

When yields of 2 year Treasury notes can move 40-50 basis points in a day or two with nominal yields in the 2.5% range, it is easy to see how prudence will likely be rewarded. As rates have risen into the 3% range in 2 year notes and closing in on 3.75% in 5 year notes, we have taken a strategic long position as we feel that fears of Fed tightening will prove unfounded; in fact, we are leaning heavily towards the deflation camp over the coming year or two as debt destruction leads to deflation.

It seems that we are facing an 'inflationary recession', which is not the best of propositions when one considers the debt that has piled up in nearly every part of the system, both here and in other parts of the world. Higher rates in an over-leveraged system are a self-fulfilling prophecy in our view. While I believe that the financial sector,

as a whole, has been hit hard, credit issues from other parts of the economy, both domestic and abroad, are yet to be heard from and we believe that Treasuries will once again be in favor after this bout of weakness.

Don't forget, 'buy when you can, not when you have to'. I find flight to Treasuries all but inevitable in coming months. Recall that Chairman Bernanke is known for being one of the most educated regarding the period of the Great Depression, when the Fed made the mistake of raising rates which led to a more prolonged period of economic duress.

In summation, it is my opinion that we need to continue to respect the credit crisis and its potential impact on other parts of the economy. Frankly, I cannot come up with a sector that isn't either 'damaged goods', overvalued, or in many cases, both. As a result, we continue our cautious view in general, but will begin to focus on groups of equities and debt that will likely come under attack as the credit crisis makes its way through our markets and economies worldwide. We cannot forget a few valuable investment management commandments:

- ***The key to making money is not losing money.***
- ***Buy from the fearful, sell to the greedy.***
- ***Keep volatility of return low and avoid large draw downs.***
- ***Buy when you can, not when you have to.***
- ***Do not burn through 'emotional capital'.***
- ***When in doubt, play small until the trend becomes obvious.***
- ***Better to lose opportunity than capital.***

As we head into what may arguably be a tough couple of years, the seasoned investor with risk controls will likely come out on top. Those that have lived through credit crisis before will emerge intact and hopefully some solid gains. That would then allow us to take risk when others are not in position to do so.

While I know I have sounded a bit like a broken record these past 7 or 8 years, warning about

the likely winners. At Atlantic Advisors and in the Harbor Pilot Fund, we are looking forward to the challenges ahead and hope to come out on top with both our investor's capital

high equity valuations, the monstrous buildup in debt not to mention the leverage in the financial system, I suppose I would rather sound like a broken record than go broke. Or like Paul Thorn aptly put it, I'd rather be a hammer than a nail.

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