

Banks Go Back To Basics

Marc Hendriks

Chief Investment Officer

April 2008

International Overview

The sub prime crisis has resulted in two problems for the international banking system. The first is the need to replace at least \$500 billion of capital as a result of the losses sustained by the banks on their holdings of asset backed securities. The second is for the banks to learn again how to act as 'principals' rather than 'agents' as bank lending replaces asset backed securities as a source of capital. The latter is a significant change to the functioning of the financial system and the transition will delay the recovery from the current credit crisis. Slowing global economic growth and a prolonged period of adjustment in the financial sector may seem to support an easing in monetary policy in those economies experiencing the most stress. However, there are powerful secular factors exerting upward pressure on inflation to which easing monetary policy and the transfer of credit risk from the private to public sector will add.

Sub prime crisis not just about write-offs

The banks have lost an estimated \$500bn of capital through losses on asset backed securities. If this capital were not replaced the banks would need to contract the asset side of their balance sheet by calling in loans. When banks contract their balance sheets long term profitability is reduced and the value of their shares decline. Therefore it is in the interests of both the banks' management and shareholders to replace the lost capital. This explains the huge capital raising exercise currently taking place in the form of rights issues to existing shareholders and the attempt to find new large investors of which sovereign wealth funds are obvious targets. In order to prevent further write-downs some central banks, such as the Federal Reserve Board and the Bank of England, have agreed to swap non-performing assets held by the banks for government securities. This allows the banks to use the capital and stems the need for replacement capital. The governments of the central banks offering these swap arrangements hope that it buys time for the financial markets to recover and the price of the swapped assets to recover. If not then the taxpayer will pick up the bill, but that will be a problem for the next administration!

Banks need to become Bankers Again

Aside from the capital replacement problem, the sub prime crisis will have another profound effect on the financial system. Over the past decade bank lending as a share of total capital raised has declined and replaced by asset backed securities. This changed the role of the banks from 'principals' to 'agents'. A 'principal' ensured that the loans made commercial sense and the collateral was adequate in order to avoid losses. Acting as an 'agent' meant that the banks acted as a go between the borrower and the lender. The incentive to become an 'agent' was the prospect of increasing returns with less capital. This change in the roles goes a long way to understanding the root cause of the current credit crisis.

The growth in asset backed securities has contributed significantly to economic growth by unleashing a huge expansion in liquidity based on increased leverage. The shrinkage of the asset backed securities market will now reverse the trend of the last decade and this has a number of implications.

Firstly, the decline of the asset backed market has caused a dramatic widening in spreads paid by borrowers for loans over the past six months. This provides a powerful motivation for banks to return to traditional bank lending as the return on capital has increased sharply. This is one reason why there is currently an urgency by the banks to raise new capital in order to take advantage of the current market opportunities. The scramble for capital will crowd out banks that come later to the capital markets which in turn will make them vulnerable to take over. This will precipitate a period of consolidation in the banking sector where the large banks will take over the mid-sized banks.

Secondly, it is often noted that the US non financial corporate sector is currently in a financially strong position with record high holdings of cash and, until recently, positive cash flow. The financial strength of the corporate sector is in stark contrast to their usual position of financial weakness heading into an economic recession. However, this picture overlooks the gross financial position of the corporate sector. In gross terms the corporate sector has a very large programme of asset backed securities issuance. In 2007 the corporate sector raised a record \$630bn through the credit markets. Over the previous 12 years the annual average raised was \$250bn. The slowing economy means that corporate profit growth will slow and external funding needs will increase. In addition, the closure of the credit markets means that companies will have difficulty in replacing existing sources of capital and a contraction in outstanding corporate debt will occur. Seen from this perspective the financial strength of the corporate sector is not as great as it first appears.

Thirdly, the banks will be seen as a source of capital but they are constrained by first the shortage of capital and second by a skill shortage. Old fashioned bank managers and credit officers were thought to be redundant in the new financial world of securitisation. Now they will be in high demand but in scarce supply.

Fourthly, the combination of a decline in banks' capital and the closure of the asset backed markets will force all sectors of the economy to de-leverage. This process has already started in the housing sector with the value of outstanding mortgages expected to decline. This will spread to the consumer sector as access to credit to support auto loans and credit cards is withdrawn. The corporate sector will be affected as already discussed above. Quantifying the effect of financial de-leveraging on real gross domestic product is pure guess work. Given the size of the de-leveraging, however, it will be a significant number and it is likely to occur sooner rather than later as the financial sector tends to adjust rapidly.

Governments are seeking to smooth out the adjustment process by offering swap arrangements, directly supporting the housing market or expanding fiscal policy. If this were only a banking crisis these policies might be successful. The loss of the asset backed securities market, however, makes the problem too large for these measures to be successful. In fact the measures currently being taken may result in worse problems later.

Weaker economic growth does not mean lower inflation

The current rise in inflation is a combination of both demand-led and cost-push factors. The recent additional demand of an extra 2.5 billion people joining the consumer classes has resulted in exponential increases in all basic commodity prices, both hard and soft. Demand and supply projections for just about any commodity show them to be either in deficit or near balance. The reasons for this current state of affairs range from poor government policies to market failure. However, it is clear that supply limits have been reached in a wide range of commodities and new investment and technological solutions are required which will not be available in the next few years. A tipping point has been reached in the supply and demand for commodities.

The argument that increases in commodity prices do not matter because monetary policy cannot control them gave rise to the notion of a core inflation measure. However, the recent evidence is that commodity prices are now feeding through into other prices in Europe, US and most worryingly China. China is a concern because the transfer of production to China over the past decade has been a significant factor behind the secular decline in inflation in developed economies over the past decade. The spreading of inflation in China is an indication that this source of deflation may now become a source of inflation.

The belief that the corporate sector will absorb higher commodity costs by reducing profit margins is a specious argument. The corporate sector's ability to reduce margins is already greatly weakened by the credit crisis and slowing economic growth. Slowing economic activity will do no more than pause the secular rise in inflation.

Cost of Capital to Rise

US interest rates are priced for a period of slow economic growth, possibly recession, and stable inflation. This is the best possible outcome. The low yield on government securities reflects the flight to quality by investors who are more worried about protecting the nominal value of capital than the risk of inflation. This will gradually change as the central banks shore up the banking system. While global economic growth may weaken as the developed economies slow over the next year, it is a fact that economies generally expand and periods of contraction are short. A rebound in economic growth, which most analysts expect to start in the second part of 2008 in the US, carries the risk of a further surge in commodity prices. Coupled with the additional inflation risk of the current policies put in place to rescue the banking system, treasury yields are unlikely to remain at the current distorted levels for very long. This also means that while the Federal Reserve Board is fighting one battle at the moment its attention may have to shift to a very different one.

Thomas Miller Investment Ltd
International House
26 Creechurch Lane
London
United Kingdom
EC3A 5BA

invest@thomasmiller.com
www.tminvestment.com

Thomas Miller Investment is a trading name for Thomas Miller Investment Ltd; which is part of the Thomas Miller group of companies. Thomas Miller Investment Ltd is authorised and regulated by the Financial Services Authority to conduct investment business.