

# Impressions

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The pessimist sees difficulty in every opportunity. The optimist sees the opportunity in every difficulty.

**Winston Churchill**

Every man takes the limits of his own field of vision for the limits of the world.

**Arthur Schopenhauer**

There are truths on this side of the Pyrenees, which are falsehoods on the other.

**Blaise Pascal**

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## Pornography is related to Geography

It is just over a year since the gods unleashed a torrent of bad news and financial disaster on American investors. It has been a time of disaster for many and at some point, we will find out it was a circumstance for great opportunity for others.

In the words of mariners there is a very confused sea running. I thought it might be a good idea to look at some of the

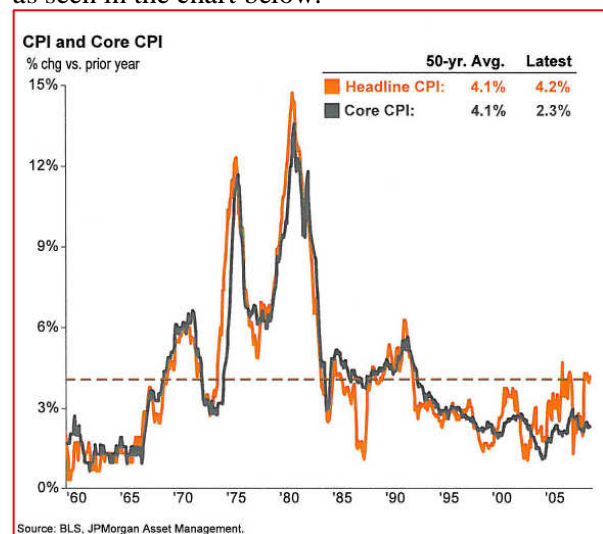
concerns and some of the counterevidence.

There are three financial concerns uppermost in people's minds: Inflation, the credit crisis and the election. There are two others of more macro scale geopolitics, and demographics. I will address those in future letters

## Inflation

The rising cost of goods and the corollary decline in the purchasing power of money is the biggest danger for investors. Inflation is insidious, compounding and largely unseen.

Since the 1980's we have experienced a nearly steady decline in the rate of inflation as seen in the chart below.

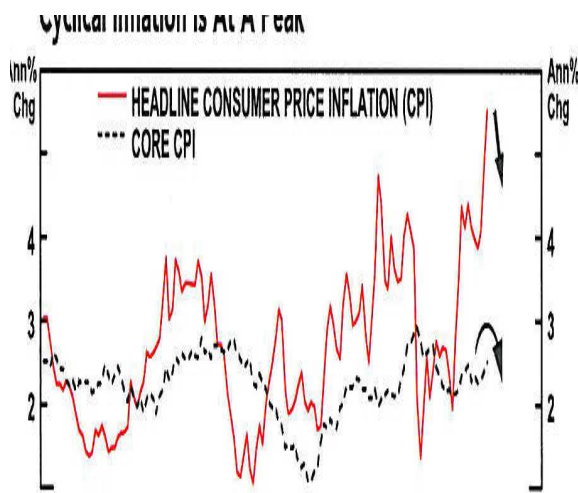


# Impressions

Economists, politicians and others who need to pass out disinformation have created various inflation measures. In the chart, you see reference to headline CPI and core CPI. The difference is that headline CPI focuses on the items that get the most news. Recently these have been food and energy.

This differentiation is useful in that it allows policy makers the option of doing nothing because inflation is really under control except for a few items. This is about as disingenuous as it comes. It is like the old line “other than that Mrs. Lincoln how did you enjoy the play?”

Like all misinformation, it contains an element of truth. As you can see below, headline CPI has been the more volatile numerical series over the 10 years shown in the chart



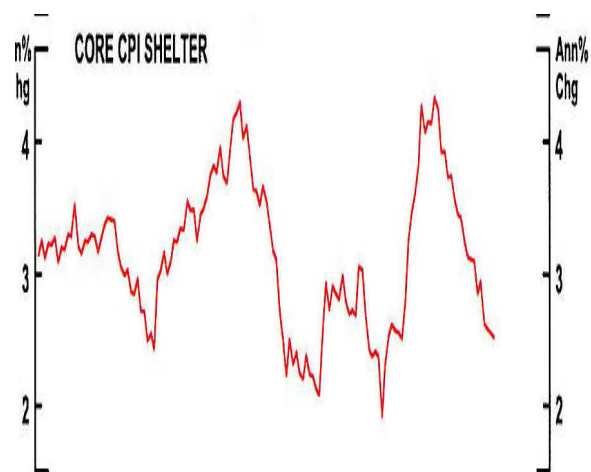
Remember that headline inflation hits a consumer every day in many different ways.

Therefore, a policy maker looking at the two series would say that inflation is un-

der control if they only looked at core CPI. Of course, that experience would not mirror what is happening to an individual.

The real reason for the two measures is that headline inflation does not require a change in behavior to occur but core inflation does. Headline inflation is generally short term in nature, but rarely reversed, while core inflation is systemic and more difficult to eliminate.

Presently, core inflation is probably understating real inflation because of this next chart:



The series for computing Core CPI includes the price of houses. House prices have been falling so core CPI has been lower. During the spike in shelter prices furthest to the right, food and energy prices were declining or stable so headline CPI was low as was Core.

This brings up a very interesting point. Housing is larger factor in inflation than food or energy. Since house prices have been declining, the rise in prices of oil

# Impressions

and food must have been larger than any of us thought.

None of this is a discrete series. The rise in the price of energy and food and the destruction in value of real estate cause consumers to change their behaviors.

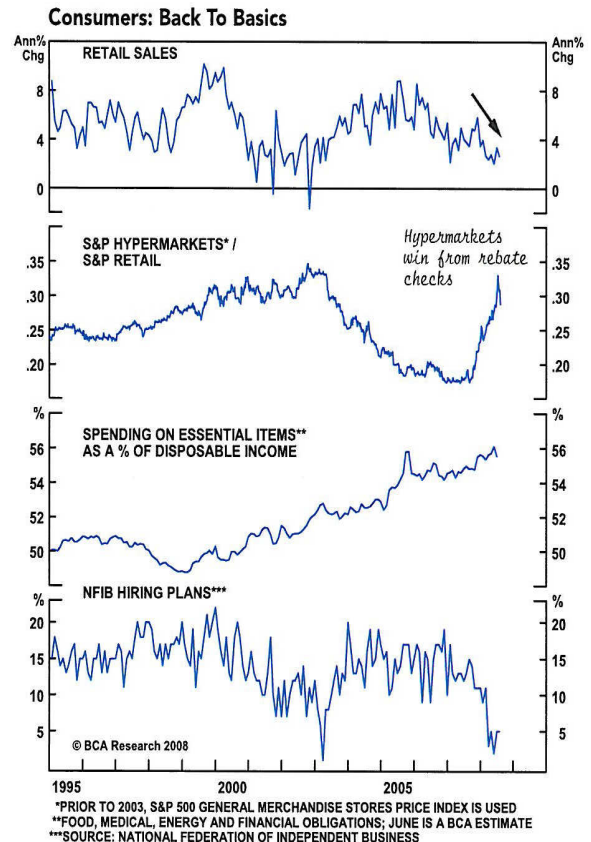
Your wages do not rise and fall with inflation so if you are making \$10,000 per month and spending \$2500 on housing, \$2500 on taxes, that leaves you with \$5k for living. If your energy costs rise 100% and your food cost double your income does not rise to cover it. If you have excess money then it is not too troublesome. However, if you are living close to the edge between cash flow positive and negative you have to find a way to offset the increased costs or you have to borrow.

To the extent that consumers cut back on purchases, demand destruction causes prices to fall. This then offsets the rise in the more volatile series. Left alone the destruction can lead to deflationary pressures.

The real issue of inflation is that the difference between core and headline CPI is the basis for monetary policy actions. The Fed and the other central banks know that inflation fighting must be their first priority. Core inflation once entrenched is very difficult to remove.

Our monetary authorities have no more prescience about the likelihood of headline inflation converting to core inflation that you or I. They can only do what they intuit and that may be wrong.

Is demand destruction underway? The following charts would indicate it is:



Retail sales are falling but the hypermarkets (Wal Mart) are getting a greater share of what spending is going on. At the same time, business is not planning big hiring binges. No job equals less spending.

The concern about inflation is determined by where you sit in regard to headline CPI or Core CPI. It is hard to believe given the intergration of monetary actions, demand destruction caused by higher prices and massive deflation in a major asset class that Core inflation will be a problem long term.

# Impressions

The press will continue to slam us with pictures of the suffering of people responding to the rise in prices and politicians and others of low degree will whip the inflation donkey for every vote it can carry. Those are just the press selling newspapers they have no idea what they are doing.

There will continue to be inflation pressures in various sectors but it is not going to be the issue it was in the 1970's. In fact, the opposite is probably more likely.

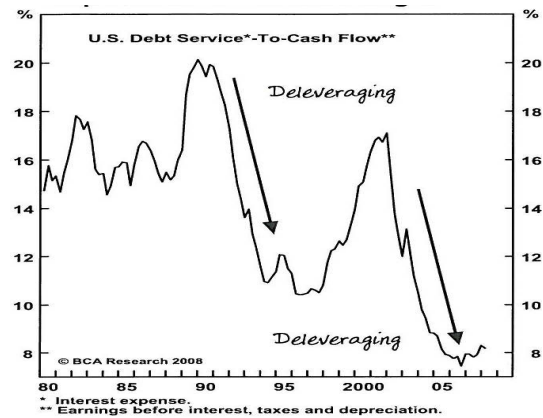
The only fly in my otherwise positive assessment of inflation is that starting 8 years ago it seems that every central bank and government began to create money at unsustainable rates. One of the biggest causes of inflation is excess money chasing limited goods.

## The Credit Crisis and Real Estate

These two issues are linked but may not be forever.

The current credit crisis has three causes: the deleveraging of balance sheets in the 1990's, the decline in interest rates resulting from the disinflation and resulting government actions and plain stupidity.

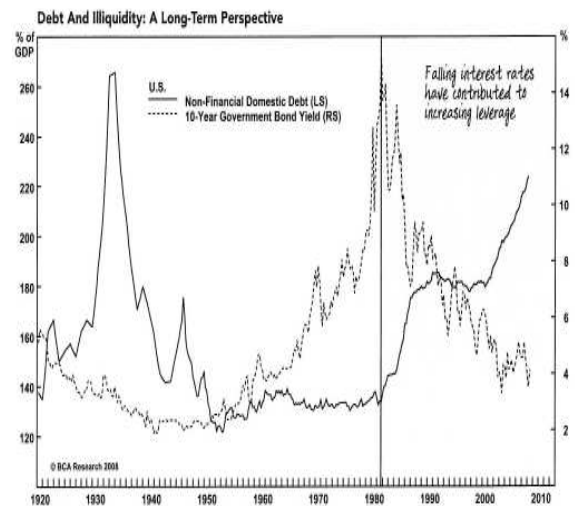
After peaking in the late 1980's and early 1990's debt service to cash flow at corporations declined for 15 years:



Corporate deleveraging reduced the amount of bonds in the markets. At the same time, the US Treasury changed the mix of debt it issued reducing the amount of 30-year debt that was much loved by pension funds.

There was also an upsurge in the demand for debt from European state operated pension plans who were allowed to purchase foreign debt for the first time.

It is helpful to remember that the perfect scenario that was the bull stock market of the 1990's was a perfect storm for those who needed to purchase bonds. Rates on the 10-year Treasury declined from 14% in 1982 to 3% by 1999!



# Impressions

If you were trying to fund a known future obligation (that is what pension funds do), you no longer had as many options. The lack of bonds reduced the amount of income that could be generated from the same amount of money. The solution was to invest more money, which had to come from increased taxes, or find higher returns.

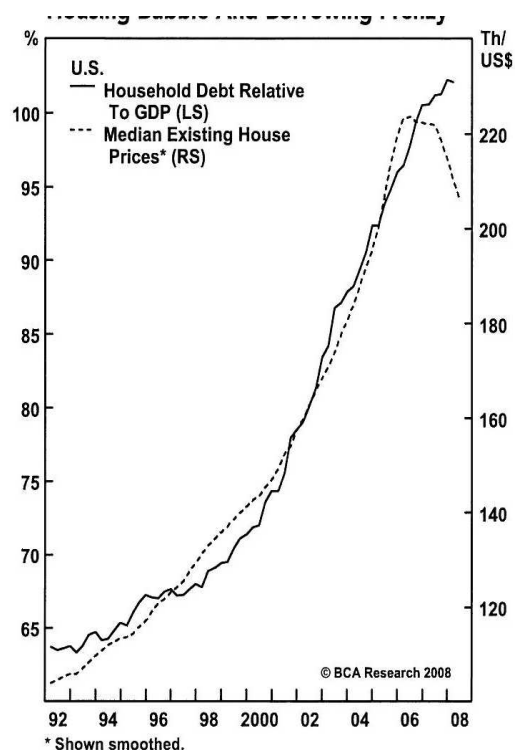
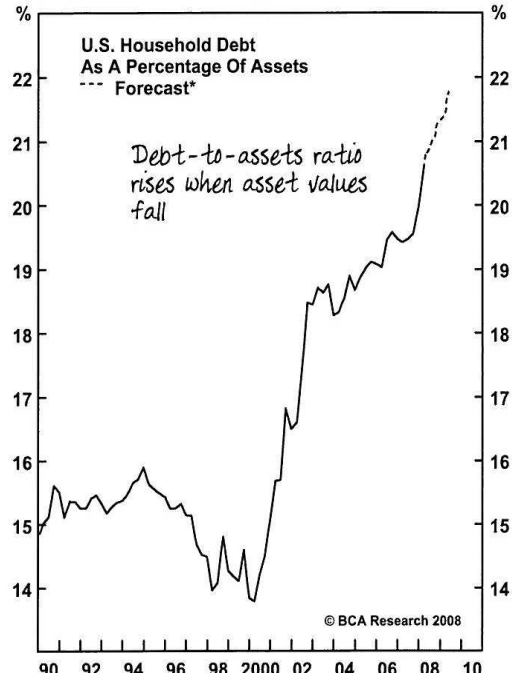
This conundrum was exacerbated following the tech collapse of 2000 to 2004. Now the equity portion of the pension investments had taken a major hit but the obligations were intact. This increased the pressure on the managers to get higher returns from the bond markets.

Wall Street exists to satisfy three aspects of human behavior, fear, hope and greed. Wall Street knew that the pension funds and others needed higher returns but needed a secure investment. Interest rates declined in the wake of 9/11 and the losses in the stock market had fostered interest in residential real estate.

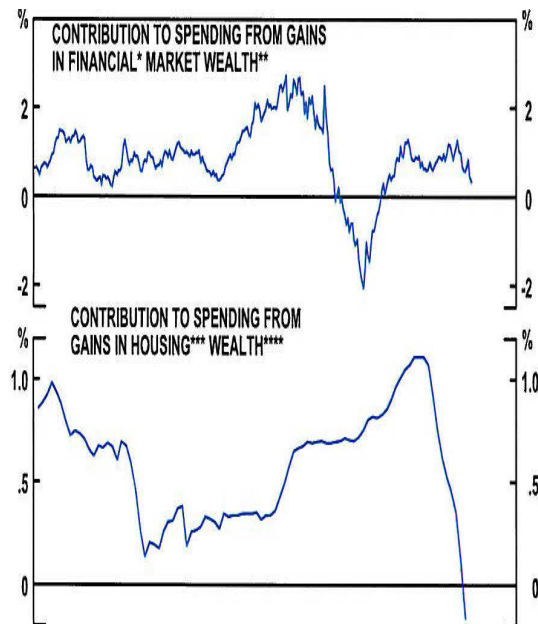
The geniuses on Wall Street created something called a Gaussian copula model that showed how to structure residential mortgages to produce a return superior to the interest rate being paid by the underlying mortgage. In addition, the model said this structure diversified the risks increasing safety. Then wonder of wonders it also solved two problems for the banks.

This market for securitizing existing mortgages reliquidified the banks created a vehicle for banks to grow earnings. Ain't American great.

The effect of this was to shift the American home from shelter to an ATM. As you can see from the chart above borrowing was increasing but the charts below show that it was being driven by consumer borrowing:



# Impressions



What occurred was an unvirtuous cycle. Wall Street was able to package and sell all the mortgage paper they could find. They exhausted the supply. Supply dried up but demand increased so there was a need to increase supply.

The investment banks bought and/or funded mortgage banks who hired mortgage brokers to find new borrowers and they paid the brokers lots to do their magic.

The result was nearly constant, relentless advertising for refinance, cash out loans, lower payments and other dodges. This was paired with advertising showing beautiful happy people on boats, airplanes and travelling to fabulous resorts all financed by your house and the helpful folks at the local bank.

Banks got used to the growth in earnings and lowered their underwriting standards knowing that they could sell anything

they could write. Buyers including the pension funds mentioned above bought with both hands as Wall Street convinced them that the risks inherent in lower quality mortgages could be controlled by financial innovation.

The demand for mortgage paper created a bid for residential real estate that pushed prices higher and higher. The increase in prices was used as justification for purchasing mortgages creating a self-fulfilling prophecy.

The seeming relentless rise in house prices also became the impetus for increasing speculation in residential real estate.

A person who is a mortgage lender ends up in possession of a secured investment that produces a decent, if unspectacular return over a long period.

If however, the purchaser of a mortgage can be convinced that the loan has somehow been supercharged to produce higher returns at no additional risk, then owning a mortgage can become a spectacular investment.

This is only possible if four things happen: real estate prices continue to rise, interest rates stay low, the assumed default and delinquency rates are correct and leverage can be applied. We don't know which one of the three failed first but one of them did.

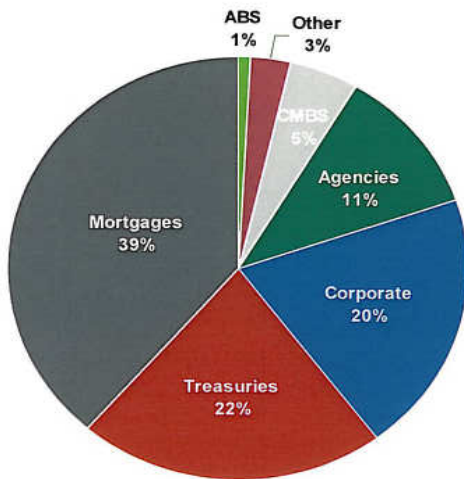
The borrowing boom was not isolated to mortgages it spread to credit cards, car loans and leases, student loans and credit

# Impressions

card receivables and other borrowing. Look at these next two charts:

Mortgages are a big part of the total debt outstanding in our society. The next chart shows the breakdown of debt in the US. Mortgage debt is larger than the sum of US Treasury and Government Agency debt! We carp on the government issuing too much debt but they look like model citizens next to the mortgage markets!

Lehman U.S. Aggregate by Sector



However, none of this explains the credit



crisis. After all not all mortgages are in default and not all mortgages will default so what happened?

Only about 26% of all mortgages are in the two now infamous classes of Alt-A and subprime. Most of the other mortgages are still sound.

Of that 26%, not all of them are in trouble. The latest figures show that about 14% of total mortgages are in default. This would indicate about 4% of the total is in the two trouble classes. So how can 4% losses cause all this trouble?

About 50% or more of defaults are in Alt A and subprime. Most of this paper came to life between June 2005 and the first half of 2007.

The reason this has caused all the problems is leverage effect. Look at this chart:

Total Mortgage debt outstanding	9,000,000,000,000
Amount of sub-prime and Alt A mortgages (26%)	2,340,000,000,000
Assumed defaults in Subprime Alt A (25%)	-585,000,000,000
Less recovery from sale of property (25%)	146,250,000,000
Realized losses	438,750,000,000
Leverage effect implied by 8% tier one capital ratio	12x
Total shrinkage of bank balance sheets or new capital needed	5,265,000,000,000

# Impressions

A commercial bank's capital is less leveraged than either the investment banks or Freddie Mac or Fannie Mae. A good portion of the crappy late issues paper is in the hands of the investment banks. Is there because they could not sell it or they believe their own hype.

In the banking world, a loan is an asset. To the borrower it is a liability but to the bank, a loan is an earning asset.

To maintain their capital ratios banks taking losses have to either raise capital diluting the existing shareholders or they have to reduce the assets on the balance sheet that are secured by the bank's capital. This is shrinking the balance sheet. Shrinking the balance sheet means not making loans or not renewing existing loans. Any combination reduces the stimulus to the economy.

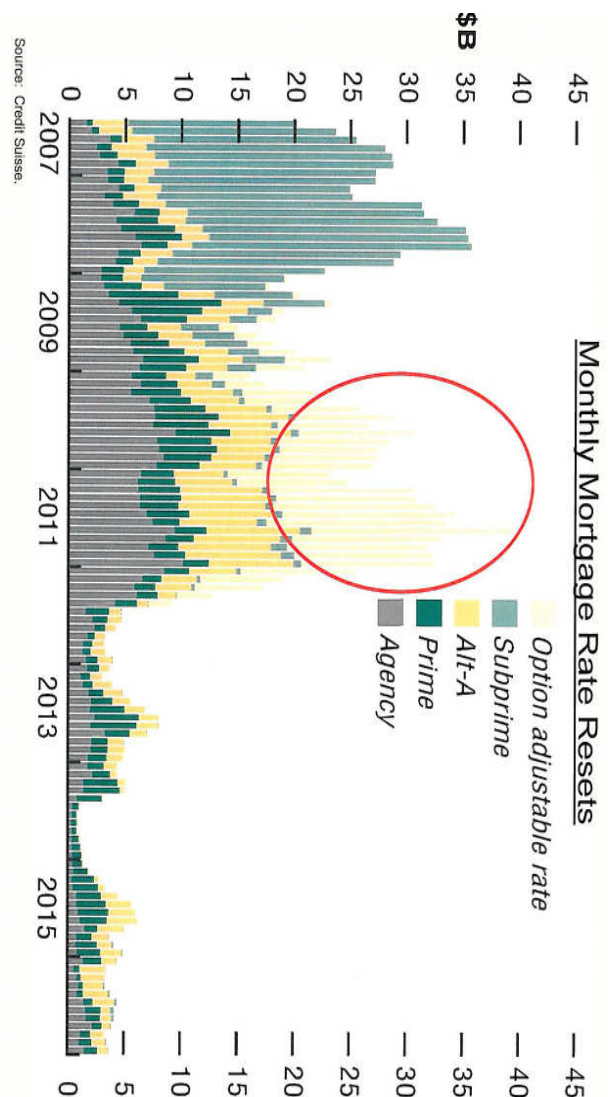
To the extent, they take losses it is first against the equity capital of the bank. Because of leveraged, a relatively small amount of loss can wipe out the equity making the bank or mortgage entity insolvent. This is what happened to Indy Mac (thank you Sen. Schumer).

The higher the leverage, the smaller losses needed to destroy equity. This is what happened to Bear Stearns.

Before you all throw yourselves off a cliff not all the mortgage are in trouble and not all those in trouble will result in losses. Not all the banks and brokers are leveraged at 30 to 1 or even 20 to 1.

Leverage is good when things are good but horrid in the obverse.

Is the crisis in credit or real estate over or even close to over? No, we are about 50% of the way. Here is why:



Sorry, big chart small space. Many of the mortgages made in the last years of the boom were option ARM (adjustable rate mortgages with options that allowed smaller payments) with 5-year time-

# Impressions

frame. At the end of the 5 years, the options would end and the rates would reset. Why would anyone get into that sort of a deal- because they were convinced they would be able to refinance the mortgage before the resets. That the price of the house would go up so it would not be problem to get the money. Whether these assumptions are true or not, remains to be seen. Currently, the market says it is not going to happen.

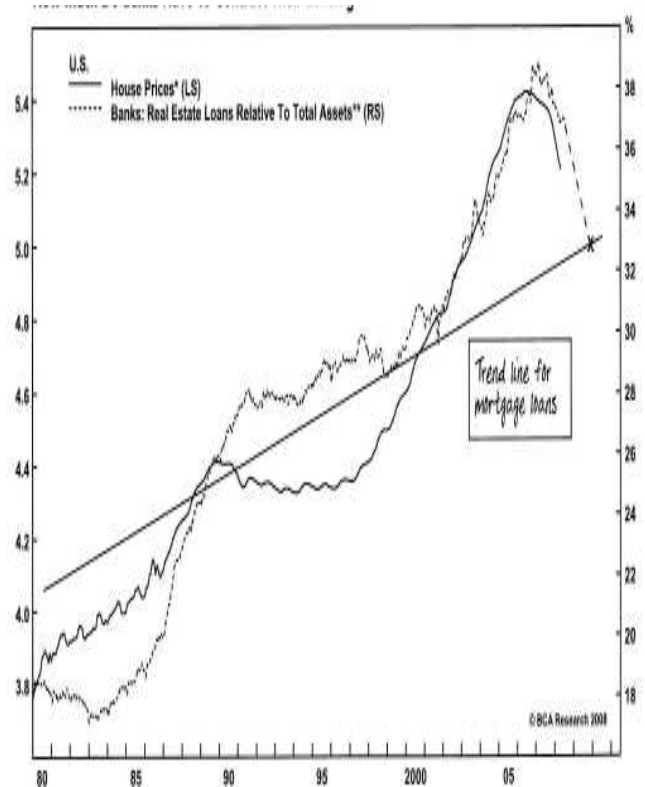
When these securities were put into the various categories of CDO and sold to investors, representations were made. One was that a good portion of this stuff would be refinanced so the average life of the mortgages would be shorter than stated. When it became apparent that house prices were falling, refinance activity declining and foreclosures raising the nature of the securities changed and the prices adjusted.

Under the accounting rules, the banks and brokers have to mark any paper held on their books to market each quarter. When Bear Stearns' now infamous hedge funds, which owned the crap of mortgage market, got in trouble in April of 2007, it was discovered that the market for selling this stuff was very thin and prices fell. This then caused everyone to have to reduce values and the drumbeat of disaster got louder.

You all know the story after that. The real question is how long will this last and how far will house prices decline.

The numbers on the right side of the next

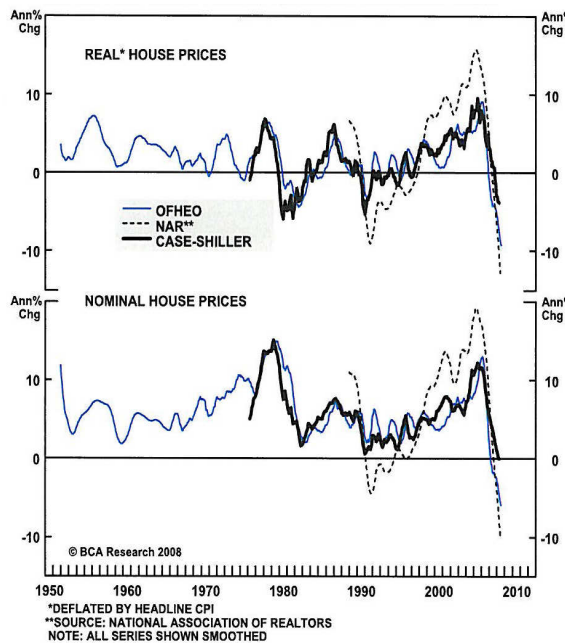
bank assets. The darker diagonal line is the trend line of the percent of assets.



As you can see to get back to trend, the banks are going to have to write a lot less mortgages for a while. At the same time, banks are reducing assets to maintain capital ratio so the percentages are moving targets.

This need to reduce mortgage-lending means that house prices will continue to fall until there is a way to borrow money to buy a house.

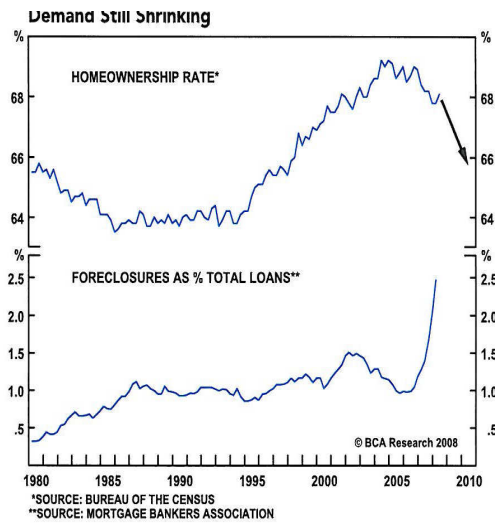
# Impressions



The charts above lay out the problem in a nutshell. Real house prices are minus inflation but no one prices a mortgage or a house that way. They price on nominal house prices.

If inflation rises, real house prices decline. If the credit windows do not open and buying returns nominal prices must fall until a clearing point occurs at which inventory is destroyed or moves. This is immutable.

Demand is falling and foreclosures rising so the squeeze is developing. Inventory must be reduced and that is only going to happen if building stops, houses are destroyed or prices fall, as witnessed by this chart:



The conclusion is that residential real estate prices must continue to decline for the near future. Will they decline equally in all areas? NO. The real tragedy of this is where the decline is most likely to be felt.

This is where the stupidity comes in. It is a sad fact of life that a good number of people in the US would be better off not owning a home. A good number of homebuyers do not get the benefits of homeownership.

Those benefits are:

1. equity build up from paying down the mortgage
2. Tax reduction from deductible mortgage interest and property taxes
3. Appreciation of net worth
4. Community stability

For a good number of people and particularly a great number of the buyers in the last couple of years this litany is all BS.

# Impressions

Almost all of the option ARM and teaser rate loans had negative amortization so equity was declining! When the loans became fully amortizing, the owner could not afford the payment.

Almost 50% of the people in the US do not pay any income tax and these are not the richest Americans. This is a fact. If you pay no tax, or if you do not have sufficient income to itemize deductions, mortgage interest and local taxes are not deductible. No benefit there. Without a tax offset, the real cost of the mortgage is the stated cost less inflation. The real cost of a mortgage under those conditions is very high in historic terms.

## Your principal residence is not an investment! You have to live somewhere!

Thinking of a house as an investment is self-delusional. Houses do not appreciate at the same rate. Some don't rise in value at all. While houses in places like Atherton, CA or Redmond WA or Round Rock Texas or Beverly Hills might skyrocket houses in other places stagnate. Places like Flint, MI, Fargo, ND or Marion, Ohio. Even within communities, not all houses enjoy a rise.

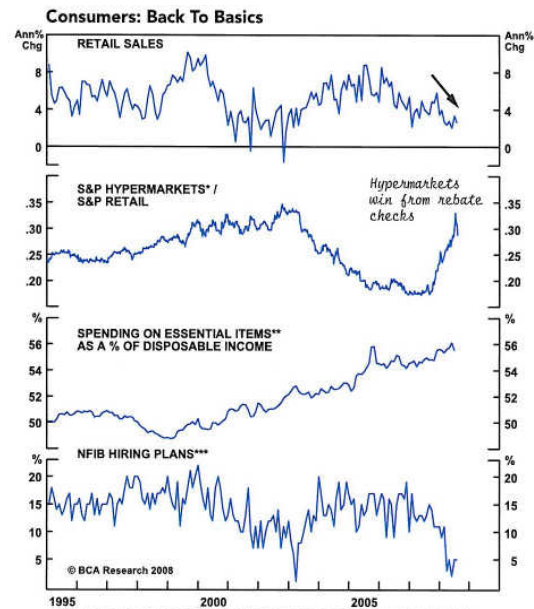
Many of the people sucked into the last gasp of this mortgage madness bought older houses or houses in less desirable areas that would only fulfill the needs of the financing if stupidity continued. The best solution for many of these properties would be to bulldoze them.

Therefore, from this description we should all go out and open our veins since it is useless to continue. Nothing could be further from the truth.

Everything I have said above is already known. The only thing left to happen is for the issue to play out. No great collapse has failed to create great opportunity.

It is very possible that the government seizure of Freddie and Fannie will mark the bottom of the mortgage crisis.

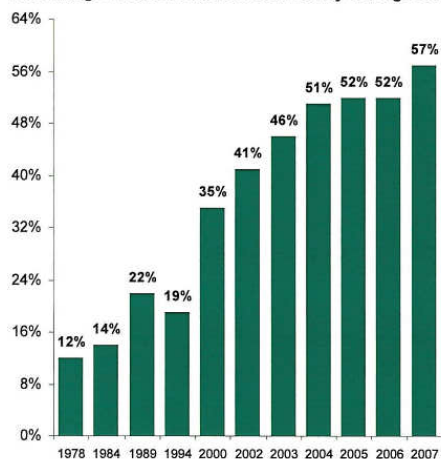
The deleveraging of the economy will make it stronger long term. It will reduce if not eliminate inflation; it will reduce excesses in all areas. When capital is easy to get and cheap it makes people do stupid things. Conversely, the shortage of capital will force folks to use money more wisely. It is already happening as shown below:



# Impressions

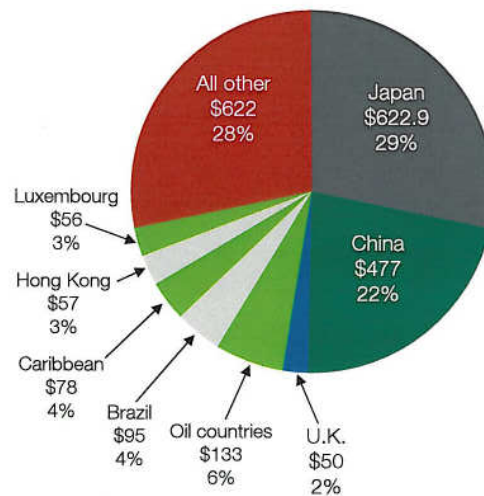
So the logical question is won't the world collapse if the US does? Yes but it won't happen because it can't be allowed to happen. Here are the reasons why:

Percentage of U.S. Treasuries Owned by Foreigners



Note that the rate of ascent has increased right along with the rise in consumer debt and mortgage madness. This is only Treasury securities foreigners are also up to their keasers in mortgage, corporate and agency debt.

Here is the breakdown of holding by nation.



The politicians wail about our dependence on the Arab oil producers, but the music at the dance of the future is likely to be Chinese.

The US can not collapse because the rest of the world cannot afford it. Therefore, some solution will be imposed on us and it will not come from John McCain or Barack Obama. They do not have a clue. The solution others come up with will not be in the United States' best interest. While we are not as dependant on others for energy as Europe, but our overseas debt burden provides others leverage.

Europe cannot and will not intervene to stop the Russians from retaking the former Soviet republics because of their dependence on Russian gas. We will not be able to stop other nations without risking irreversible damage to our economy.

## *The Election*

# Impressions

The founding fathers visited upon us the curse of a four-year Presidency. Thomas Edison crucified us with television. Therefore, every two and half years the business of government stops so we can engage in a contest of who can preen their feathers the best. What the election has turned into is contest to see who has the best spin-doctors.

There is a great deal of consternation this year because of the hatred (and that is not too strong a word) for President Bush and the dismay that Congress has done nothing. It is rare that the President has a 30% approval rating but Congress has one only half as good!

Our choices now are between a Republican war hero and long time legislator and a Democrat Senator from Illinois with limited experience in leadership and government.

There are those who believe this is the most critical election in the history of the country but I doubt that. It is an important election however.

I could come up with charts showing that when the president is Democrat the markets actually do better than with the Republicans. However, that is not the issue.

There are three significant issues in this election: restoration of our national competitiveness, the war on terror, and regaining the ability to govern.

All three are going to require a need for every American to sacrifice for the greater good. While being pro choice or pro life may seem important, it will not be an issue if Sharia law rules us.

If our corporations are not able to compete because they are hamstrung by high taxes and stupid rules about where they produce

their products we all lose. If the nation cannot produce workers with basic skills, we will not produce the earth shaking innovations like the computer chip and the internet.

Regardless of who assumes the Oval office in Jan of 2009 the United States is going to be forced to make some hard decisions and to have some of its freedom of action curtailed.

## The Stock Markets

Everyone is worried about the stock market and that should be the least of the worries right now. Here is a chart that shows the long-term trend of the markets:

Dow Jones Industrial Index, Price Return (since 1900)



As you can see over the 20<sup>th</sup> century, we faced many challenges and the markets have continued to do well. The current debt crisis is more complex but it is not unique. This is America after all.

# Impressions

Every time there is a bust in some bubble, everyone wrings his or her hands and claims this is the end of the world as we know it. It might be this time but I doubt it.

The chart below shows that we have had a number of bubbles unique to the US and we have been the victim of some that started overseas and the contagion spread here.

As long as there are people investing in markets there will be bubbles. Nothing grows to the sky not even trees so for every bubble there must be a bust. This is not the first housing boom and bust. The last one took the market down 50%. Of course, there was this thing called the Great Depression under way at the time so that might have contributed to the decline.

**Table 1: Selected stock market busts**

UK boom and bust events	Boom (stock market increase in %)	Correction	Decline from peak in %
Latin America mania	1822-1824 (+78%)	1824-1826	-37.3%
American boom	n.a.	1835-1839	-23.4%
Railroad boom	1840-1844 (+52%)	1844-1847	-34.1%
European financial crisis	n.a.	1874-1878	-31.0%
Roaring 20s	1920-1928 (+137%)	1928-1931	-60.3%
Housing boom	1931-1936 (+110%)	1936-1940	-50.1%
Go-go years	1965-1968 (+67%)	1968-1970	-18.9%
Tech boom	1994-2000 (+89%)	2000-2002	-24.8%

US boom and bust events	Boom	Correction	Decline in %
Railroad boom	n.a.	1853-1859	-50.6%
Railroad boom	1875-1881 (+51%)	1881-1885	-26.7%
Rich man's panic	1899-1902 (+30%)	1902-1904	-16.3%
World financial crisis	1903-1906 (+52%)	1906-1907	-19.4%
Roaring 20s	1920-1929 (+168%)	1929-1932	-73.4%
Post war slump	1941-1945 (+90%)	1946-1949	-10.8%
Go-go years	1965-1968 (+31%)	1968-1970	-15.7%
Tech boom	1994-2000 (+130%)	2000-2002	-27.7%

Source: M. Eordo (2003), UBS WMR, as of 25 July 2008

What I am saying is that the credit cycle and the housing crash are part of, to borrow a phrase, “the circle of life”

There are a couple of important things to remember. This crash occurred because of the imprudent use of money.

For all the wizardry and genius on Wall Street, there are several immutable facts:

1. Financial innovation does not reduce risk it merely disguises it and moves it to a different source or location.
2. Each generation can and usually will repeat the mistakes of the past. This is borne out by the history in the previous chart. Busts occur every 20 to 40 years a generation of life span. It that regards

# Impressions

the current credit crisis and housing boom might not be a new bust but an extension of the tech bust of 2000.

3. If total risk seems lower it is because it is misunderstood or the sources of the risk are misunderstood.

4 There is nothing as disturbing to one's well being and judgment as seeing a friend get rich.

The fact remains that a bust in the market or an asset class is like the Supreme Courts definition of pornography;" what is obscene in Alabama might not be seen as obscene in California." Therefore, pornography like a bust in the market depends on where you are when it happens.

There are two options available for investors here, try to trade through the markets or to invest for the long term and sit tight. I think the first is foolish.

What are we to do, we have a credit crisis, we have an election with unknown effects, we have a falling real estate market. Chicken Little would be proud!

In times like this, it is helpful to look at what great investors have done or will do in a crisis.

Bernard Baruch was the Warren Buffett of his day. One of his maxims was, "if you can't make sense of the market sell everything and go away for 30 days." However, I will pass along some wisdom from an old sage I worked with

years ago. "I would rather be out wishing I was in that in wish I was out."

The second thing great investors will do is to look for opportunities created by the crisis. For example, if the credit crisis continues there is going to be a need for people to help the banks dispose of foreclosed houses. There is also going to be a need for firms and organizations to secure and maintain the houses until they are sold or bulldozed.

This is also a good market for those nasty bastards that run collection agencies. If the credit crisis spreads beyond home loans as it has to car leasing then companies that provide valuation services for cars and trucks will get more business.

The third thing great investors will do is to maintain their discipline. If Ben Graham were alive, he would be scouting for companies selling at less than their liquidation value. Warren Buffett will be looking for companies that will be able to take a toll from customers all the time. They will also be companies that have products that will always be in demand.

Knowing that capital flows to the largest company's first small cap companies unusually have the best capital discipline and the lowest capital risk. The only reason Citicorp is not out of business is that it is so big!

The risk of volatility is less important at times like this that the risk of total capital loss. Focus on the correct risk.

# impressions

Finally, great investors will continue to look for the bargains. They know the characteristics of what they like. They will stalk the prey like a lioness until the time is right and then they will strike.

This is the time when great fortunes are made.

Sorry to be so long winded but there is a lot of important stuff to say.

Good Luck,

*Dennis Gibb*

**Impressions**