VOLUME IX No. 143 **W E D N E S D A Y** **August 1, 2007**

THE MAKINGS OF A PERFECT (FINANCIAL) STORM

Many Wall Street gurus would have investors believe that, since there has been some chaos on international equity markets of late, with share prices, falling swiftly to lower levels, this is the time to buy into equities while prices are relatively cheap.

Relative to what, **TARGET (**) asks?

In this medium's opinion, this is sheer nonsense.

It seems to **TARGET** that it would be in investors' interests to allow the equity markets' dust to settle, first, before making any new financial commitment – anywhere.

Undoubtedly, this would come to mean that investors, who adhere to this investment philosophy, would never get in on the ground floor.

This is true enough.

But does anybody know what is the location of the ground floor of a key index of an equity market when investment lemmings are engaged in mass migrations?

The chaotic financial situation, recently, is the result of at least 4 factors, all of which, directly or indirectly, are related:

1. The continuing, deteriorating US housing situation;

2. The subprime, mortgage-lending spillover from the deteriorating, US housing situation;

3. The guarantee that quite a number of international financial houses will have to bite the proverbial bullet in respect of provisions for underwriting risky situations, associated with cash-raising exercises, some of which these international financial houses have been forced to eat, as well as mortgage lending; and,

4. The ever-escalating price of crude oil on the commodity exchanges of the world.

With regard to Item Number One, this situation is not about to go away in a hurry.

It is more than likely that this situation is going to be with the world for at least until the middle of 2008 … if not longer.

As the prices of homes in The Land of The Free and The Home of The Brave continue to fall, so the knock-on effects on US financial houses shall be felt.

The longer that high inventory levels of US homes subsist so there will have to be further and further provisions, made by mortgage-lending institutions which have been caught in this financial vice.

Mortgage-lending defaults are so widespread in the US, these days, that one does not need to repeat this ugly situation.

One only has to study the latest, half-Yearly Report of HSBC Holdings plc ()(Code: 5, Main Board, The

Stock Exchange of Hongkong Ltd) to realise this fact.

This bank, which ranks amongst the top 5 banks of the world, made a $US6.30-billion provision for bad and doubtful debts, mainly in respect of subprime, mortgage-lending activities in the past year or so.

In the like 2006 period, HSBC Holdings plc made a $US2.70-billion provision for this line of business.

Balance sheets of banks and finance companies are studded with provisions for bad and doubtful debts with regard to housing loans; and, many a Bottom Line has been shaved back due to defaults and delinquencies by US home-owners.

The sector of the US economy that has been hit very hard, as everybody and his cat are well aware, is the subprime, mortgage-lending industry.

HSBC Holdings plc made no bones about its situation on this account when, on February 8, 2007, it stated, officially, inter alia:

> *'The impact of slowing house price growth is being reflected in accelerated delinquency trends across the US sub-prime mortgage market, particularly in the more recent loans, as the absence of equity appreciation is reducing refinancing options. Slower repayment speeds are also highlighting the likely impact on delinquency of higher contractual payment obligations as adjustable rate mortgages reset over the next few years from their original lower rates.*
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> *'We have reviewed critically the impact of these factors in determining the appropriate level of provisioning at 31 December 2006 against the Mortgage Services loan book. We have taken account of the most recent trends in delinquency and loss severity and projected the probable effect of re-setting interest rates on adjustable rate mortgages, in particular in respect of second lien mortgages. It is clear that the level of loan impairment provisions to be accounted for as at the end of 2006 in respect of Mortgage Services operations will be higher than is reflected in current market estimates.*
>
> *'We now expect that the impact of increased provisioning in this area will be the major factor in bringing the aggregate of loan impairment charges and other credit risk provisions to be reflected in the accounts of the Group for the year ended 31 December 2006 above consensus estimates by some 20 per cent …'.*

Clearly, if one of the largest financial institutions of the world, today, is willing to admit the above, it must mean that other, financial institutions are feeling the heat, also.

Lending credence to the statements of last February by HSBC Holdings plc, last Thursday, the US Government's Commerce Department brought out a report which stated that new, single-family home sales for the month of June had fallen by about 6.60 percent, Month-On-Month, exacerbating the already bloated, US inventory levels of unsold homes.

The Commerce Department went on to state that, at the present pace of home sales, inventory levels would take between 7 months and 8 months to clear.

Obviously, construction spending in the US will be severely curtailed; this will impact the overall economy when the truth is made known.

Biting The Bullet

As **TARGET** correctly forecast, recently, there is every likelihood of a credit crunch in the offing, not just in the US, but worldwide.

As this medium recently wrote:

> *'Cerberus Capital Management, the legal owner of the Chrysler marque, had postponed a $US12-billion, syndicated loan.*
>
> *'This syndicated loan is badly required if Cerberus Capital Management intends to honour its financial commitment to DaimlerChrysler A.G. (of Germany), the giant, motor-vehicle*

conglomerate which agreed to sell the Chrysler Group, its former, US motor-vehicle division, to Cerberus Capital Management.

'Cerberus Capital Management put on a stoic face, last Wednesday, stating that it was confident that it would be able to come up with the required cash in the current quarter.

'That being the case, one may well ask: Then, what was the reason for the postponement of the syndicated loan?

'Then, there is the case of Alliance Boots plc.

'This British-based company, which is engaged in the sales of medicines and health and beauty products, has been trying to arrange the sales of some £9-billion worth of its loans (about $HK145 billion).

'A total of 8 banks are (or, perhaps, were?) engaged in this mammoth task in order to pull off the biggest management buyout in the history of the United Kingdom.

'It has turned out to be a daunting task, by all accounts – because the 8 banks have been unable even to place £5-billion worth of Boots's Senior Loans (about $HK80.65 billion).

'In spite of very favourable interest rates in respect of the above-mentioned, much-needed loans, and in spite of all the sweeteners, suggested by the respective banking syndicates, there was a decided paucity of takers for the offerings, at hand.

'Investors are, clearly, averse to the risks, associated with these syndicated loans.

'Size matters, of course, but the name of Chrysler and Boots are, both, well-respected, internationally.

'But these names, it is obvious, mean nothing to the potential investors, lobbied by the respective investment bankers, when it came to picking up the shekels at the end of the day.

'The chances, now, exist that the international appetite for underwriting might well be curbed in the very near future.

'It has been confirmed that a number of international banks have sent memos to staff to the effect that all new financial commitments of materiality must pass through a management sieve.

'According to ***TARGET****'s confirmed information, some of the biggest investment banks are keeping their doors ajar, but there is stop on their doors, preventing them from opening too far, inward.*

'What this all boils down to is that the days of wine and roses may well be coming to an end as far as underwriting massive amounts of money is concerned.

'When the above becomes widely known, the key indices of major equity markets could well start to collapse, quietly at first, but leading up to a major fall.

'The US housing market is facing a terrible situation, with The National Association of Realtors (of the US), reporting that sales of homes, during the month of June, hit a 5-year low.

'And sales continue to fall.

'And there is, still, the matter of the subprime, mortgage-lending crisis which is, now, confirmed to have spread to The Land of The Rising Sun where some $US8-billion-plus is at risk.

'Meanwhile, there is a decided slowdown in economic growth in the US.

'It does not bode well, does it?'

Turning To Crude-Oil Prices

According to the database of **TOLFIN** () (The Computerised, Online Financial Intelligence Service and Web-Based, Credit-Checking Provider), from the beginning of this year until last Monday, the price of light sweet crude oil on The **N**ew **Y**ork **M**ercantile **Ex**change (NYMEX) has put a decided dent in many a profit and loss account of all kinds of companies, engaged in a wide variety of financial endeavours.

TOLFIN's records indicate that there has been an increase in the price of light sweet crude oil, as quoted on The NYMEX, during the first 7 months of 2007, of about 32 percent, rising from $US58.32 per barrel to about $US77.02 per barrel.

It seems only a matter of time before the price of light sweet crude oil will hit $US80-plus per barrel – which will be a record level, of course.

Cathay Pacific Airways Ltd () (Code: 293, Main Board, The Stock Exchange of Hongkong Ltd) has, for more than 2 years, now, been loading the price of its air tickets with larger and larger fuel surcharges, making the travelling public pay through the nose for the pleasure of flying on the company's aeroplanes.

The cost of a return, Business-Class seat aboard a Cathay Pacific flight, Hongkong-Toronto-Hongkong, includes a fuel surcharge of about $HK1,000, today – and that surcharge continues to climb – and, no doubt, will continue to climb.

Oddly, thus far, this fuel surcharge does not appear to have dented Cathay Pacific's Bottom Line, but that may well be the future as the flying public baulk at the fuel surcharges and determine not to fly aboard a Cathay Pacific aeroplane: There are alternative airlines.

As energy costs continue to rise, most corporations will, definitely, not be able to absorb all of the added operational costs and, if these corporations are unable to pass them down the line, as has Cathay Pacific Airways Ltd, then, the profit and loss accounts will suffer, accordingly.

Late last week, the key indices of equity markets started a full-scale retreat as investors came to the realisation that *'Something is rotten in the state of Denmark'*, to quote William Shakespeare in his immortal play, *'Hamlet'*.

The big questions are whether or not the contagion, which the world enjoyed, last week, will continue, internationally, and, if so, to what extent will that contagion be upgraded to be a full-blown pandemic?

Some international investment houses claim that last week's sell-offs were overdone.

TARGET cannot agree: It could well be just the beginning of a flight from equities when cash, once more, will be king of the (financial) mountain.

Whether or not this could lead to, or assist in bringing about, an economic recession, **TARGET** cannot foretell, but there is, always, that possibility.

It has been stated, umpteen times, that World War III has never been very far away and, so it seems, a US economic recession has never been far away, also.

Conclusion: *'Put your trust in God, my boys, and keep your powder dry'*. [Valentine Blacker (1778 - 1823)]

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