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By John Mauldin

In the early fall of 1998, I remember being on a flight to Bermuda from New York. I was upgraded and sat next to a very distinguished looking gentleman. He was going to a conference about re-insurance and I was going to speak at a large hedge fund conference. We hit it off, and began a very interesting conversation, one that still burns in my mind today. It turns out that he was vice-chairman of one of the largest insurance firms in the world, and was a real financial insider, seemingly knowing every big name on Wall Street personally. After he had a few drinks (he was clearly somewhat stressed), he began to talk about the Long Term Capital Management fund and the problems in the markets. He had had a ring side seat at the Fed-sponsored bailout proceedings.

"We came to the edge of the abyss in the financial markets this week,' he told me, "and then we looked over. The world does not understand how close we came to a total meltdown of the markets."

This week we look at the similarities and the differences between the credit crisis that is going on today and what happened in 1998, take a quick look at the threat from China to the dollar and see what exotic fish and exotic bonds have in common. There is a lot of ground to cover, so let's jump right in.

China – Upping the Rhetorical Ante

Early this week the currency markets were roiled as not one but two senior Chinese officials publicly advocated using China's large dollar reserves as a political weapon should the US attempt sanctions on Chinese goods if the renminbi is not valued higher against the dollar. The two were senior officials at Chinese think tanks. Shifts in Chinese policy are often signaled through key think tanks and academics.

He Fan, an official at the Chinese Academy of Social Sciences, used uncharacteristically strong language, letting it be known that Beijing had the power to set off a dollar collapse if it choose to do so.

"China has accumulated a large sum of US dollars. Such a big sum, of which a considerable portion is in US treasury bonds, contributes a great deal to maintaining the position of the dollar as a reserve currency. Russia, Switzerland, and several other countries have reduced their dollar holdings.

"China is unlikely to follow suit as long as the Yuan's exchange rate is stable against the dollar. The Chinese central bank will be forced to sell dollars once the yuan appreciated dramatically, which might lead to a mass depreciation of the dollar," he told China Daily. (London Telegraph)

This comes as the US Congress will consider legislation that will implement tariffs on Chinese goods if China does not revalue its currency. Given the level of rhetoric from both political parties and presidential candidates, it is no wonder that China is finally responding with a little rhetorical shot of its own. After smiling at the editorial cartoon below, let's look at the likelihood of such an event.

China has an estimated $900 billion in US dollar reserves. There is no doubt that if they did decide to sell a few hundred billion here or there, they could push the dollar down against all currencies and not just the renminbi. That would also have the effect of increasing US interest rates on not just government bonds, but mortgages, car loans and all sorts of consumer credit.

Given the current state of the credit markets, that is not something that would be welcome. But it is not likely for several reasons. First, it is not in their best interests to do so. It would hurt the Chinese as much as the US, as it would devalue their entire dollar portfolio and clearly do damage to their number one export market – the US consumer.

Secondly, it is unlikely that the US will actually be able to get such legislation passed into law. Even if such legislation passed Congress (an admitted possibility) it

would be vetoed by President Bush. That means that any real change would not be possible until some time in the middle of 2009.

The renminbi has already dropped almost 10% in the last two years since the Chinese started their policy of a crawling peg. For reasons I outlined at length a few weeks ago, it is likely that the Chinese are going to increase that pace over the next two years, for their own internal reasons. A higher renminbi valuation helps them slow their economy down from its way too fast pace of growth that is evident today. (If you would like to see that analysis, you can go to http://www.2000wave.com/article.asp?id=mwo061507 .)

By the time any real legislation could get passed, the renminbi will be very close to the level where the China bashers in Congress want to see it, if it is not already floating. Hardly enough to want to start a trade war at that time.

But let's look at what the bi-partisan economic illiterates in Congress are actually advocating. First, they whine about lost American jobs. But a 25% higher renminbi is not going to bring any manufacturing jobs back. China is no longer the low cost labor market. There are other Asian countries with lower labor costs. We just will not be able to competitively manufacture products that have high unskilled labor costs.

But we will continue to manufacture high value added items in a host of industries where skill and talent are required. Even though manufacturing as a percentage of US GDP is down, our actual level of exports and manufactured products is up by any measure. It is easy to write about the closing of a plant, and it makes the headlines, but the fact is that free trade has created more jobs by far than we have lost.

Secondly, if our cost of imports were to rise by 20-25%, that cannot be understood as anything but inflationary. And it would not just be Chinese products, but the products of all developing countries. Many Asian countries manage (manipulate) their currencies to keep them competitive against each other and the Chinese. You can bet that if the renminbi rises another 20%, there is the real prospect that they all will.

And much of what China and the rest of Asia produces is bought by those on the lower economic rungs of the US ladder. So, if Congress gets its way, they would be advocating putting pressure on those least capable of paying higher prices. But no one lobbies for the little guy. Congressional members can pander to their local unions and businesses without having to answer for what would be higher prices.

And higher prices means more inflation which means that interest rates have to be higher than they should, which means higher mortgage rates, etc. Protectionism has a very high cost. Free markets create more jobs everywhere.

Finally, we should hope the Chinese continue to allow their currency to rise slow and steady. Neither country needs the turmoil a rapid rise would induce. The world needs a stable China. We are watching world credits markets freeze up because things went

very bad very quickly in the relatively small subprime world. A 20% drop in the dollar in a few months would be even more catastrophic. Senators Lindsey Graham and Chuck Schumer are competing to be this century's Smoot and Hawley that creates a depression from trade wars where none should be.

The danger in all this is that politicians who have little economic literacy create a hostile environment with their rhetorical poison, with both sides feeling the need to play to their "home crowd." That is a very dangerous environment.

It won't happen, but I would like to see the following question asked in the presidential debates to those (like Hillary Clinton, Obama and Dodd, etc.) who basically advocate a weaker dollar.

"Why are you advocating a weak dollar policy? Why do you want American wage earners to pay 25% more for the goods we buy from foreign countries? Do you really think there is no connection between the value of the Chinese currency and the rest of the currencies of the world? Do you think American consumers need to send even more money overseas and get less for our dollars? Do you think the American consumer is so well off they can afford to pay more and that it will have no affect on the US economy? Do you realize that a 25% lower dollar will mean a rise in world oil prices? Do you think there is no connection between the value of the dollar and US prosperity?"

I won't hold my breath.

Back to 1998

Let's get in the Wayback Machine and revisit 1998. (For reference for my foreign readers, the "Wayback Machine" originally referred to a fictional machine from a segment of the cartoon *The Rocky and Bullwinkle Show* used to transport Mr. Peabody and Sherman back in time.)

First, there was the Asian currency crisis and then Russia looked like it would default on its debt, causing a crisis in the credit markets. A hedge fund called Long Term Capital Management had leveraged their bond positions about 80 to 1 based upon the relationship between certain types of bonds always, emphasize always, converging upon a certain price. They diversified on bonds throughout the world as an "extra" protection.

Except that the markets in the fall of 1998 were not acting as they had in the past. The relationships changed just a very small amount, but if you are leveraged 80 to 1, then small is enough to wipe you out. The Nobel Prize winners who designed the system overlooked the possibility that the market could become irrational.

Fast forward to 2007. Again, the credit markets are in turmoil, and the subprime mortgage problems are spreading, as predicted here last January. Let's look at some things that are similar to 1998.

First, normal relationships between certain types of bonds have been turned on their head. For many companies who go into the credit markets, there are different types of debt they sell. Certain types of bonds or loans are considered "senior" because in the event of the company going bankrupt, they get paid first. Then debt that is subordinated to the senior debt gets paid, and lastly the shareholders get to split what is left over, if anything.

So, clearly, it stands to reason that senior debt is more valuable than subordinated debt. Why would you pay more for the riskier debt? So, if you want to put on a hedge, you can "go long" the senior debt and "go short" the subordinated debt. And in the past, that works.

Except not this time. There are a number of funds that are having real problems and are being met with high redemptions because they are exposed to the subprime markets. But no one is buying the subprime debt, so they have to sell what they can to meet redemptions. And what sells? The quality senior debt. At a discount, of course.

So, if you are another fund holding that debt instrument that just traded down, you just saw the value of your high quality loan or bond drop. But because the subordinated debt you sold as a hedge is not trading, there is not a price for it, so you can't show the profit there should be on the pair trade. Your fund is down for the month. Bummer.

Now, if you are not over-leveraged and forced to sell, you can wait a few weeks or a month and the normal relationship will come back. And you may even benefit as quality will rise even as the riskier instruments fall. But until there is a price made on your hedges, you cannot just make up a price based upon normal rational markets.

And if you are in the lucky position of having cash, you can go in and buy very good debt at a fire sale price today. There are a lot of debt instruments of very good and profitable companies that is on the market for much less than what it will be in a few months when things get back to normal. And if you are a company with cash, you may be able to go back in and buy your debt at a discount.

The End of the Quantitative World

I should first note that the average hedge fund made money in July, and some did quite well. There are a number of hedge fund strategies that have the potential to benefit in this type of environment. That being said, if a fund has invested in the subprime mortgage space (unless they are short), they are losing money. It is easy to see the relationship between the subprime mess and the funds that invested in it. But there are other funds which are losing money, and the connection to the subprime markets is less clear.

There are any number of statistical relationships which have simply not functioned as they have in the past. Large quantitative hedge funds that employ teams of mathematicians and physicists to develop complex "black box" trading programs to

computer trade on these relationships are finding themselves losing money. As Spencer Jakab writes:

"Quantitative hedge funds running 'black box' models are primarily market neutral, seeking to exploit small inefficiencies in valuations and historical volatility between similar securities. A period like the last few weeks would have typically seen such funds outperform most of their peers in the hedge-fund community, but they have instead shocked investors with steep losses.

"Because risk managers were able to demonstrate that they were less risky, on paper at least, they were allowed to use far more borrowed money than other leading hedge fund strategies. Some are clearly overextended. 'The inherent leverage is killing them,' said a broker at a major investment bank who deals with hedge funds."

"Analyst Matthew Rothman of Lehman Brothers wrote that the models are working in exactly the opposite way they should to protect a black box fund in an up or down market. 'It is not just that most factors are not working but rather they are working in a perverse manner,' wrote Rothman. 'The names that are short are outperforming, often notably, while the names that are long are underperforming, although less severely.'"

Goldman's Global Alpha, which has been losing money for two years, is down 26% for the year and down almost 40% since the end of July. It is not surprising they are being hit with redemptions. And that forces them to sell. Many of the largest hedge funds are the very quantitative funds that are being forced to sell, putting pressure on the markets.

In 1998 problems in Asia and Russia spread to the rest of the markets, affecting Norwegian bonds and US stocks. It took a few months to sort out, and a lot of people lost money. Today, problems in the subprime mortgage markets spread to other credit markets and the affect is spilling over into stock markets.

But there is a difference. Today, instead of one fund that was at the epicenter of the problem, the problems are spread around the world among scores of funds and permeate the largest institutional and pension funds. While that means the losses are spread among thousands of investors, it also means that central banks can't bring everyone to the table to "fix" the problem.

The problem of the last two days was triggered by BNP Paribas telling investors in three of their funds that they would not be allowed to redeem. This simply froze the European markets. The European Central Bank has injected $211 billion into their system. Central banks have put $339 billion into the world system in the last 48 hours. And you should be very glad they did, by the way.

I heard on TV that some are saying the Fed is bailing out banks. Not they way I read it. They are simply taking short term "repo" paper for a few days to inject liquidity.

If you are going to have a central bank, then this is a proper action. The fact that the excess liquidity which produced the bubbles can be laid at the Greenspan Federal Reserve's feet is a topic for another day.

And while we are on the topic, I think BNP Paribas probably did the right thing. They have funds which have invested in all sorts of credit vehicles. Nothing is trading, so if they tried to meet redemptions, they would have to sell assets at much distressed prices, and then guess at what prices the other assets should be valued at in the absence of a market price. If they guessed to little, then those exiting would lose too much, notice their losses were too high and sue. If they guessed too high, then those remaining would notice that they lost more than they should have and then sue. BNP was in a no win situation. To be fair to all investors, they have to wait until the market prices the assets in their portfolio.

They have not said what those assets are. If they are not US mortgage related it is likely they will turn out ok. If there is subprime in the mix, they will take significant losses.

Subprime for a Long Time

And one last difference between 1998 and today. Back then, the problems in the markets became known and were priced into the markets in relatively short order. It is going to be several years before we know the extent of the subprime losses. Remember the table that I used last week which showed the bulk of subprime mortgage interest rate resets was not until the first half of 2008. It is going to take years for the markets to know what the losses on the subprime will actually be.

And it is not as if it should be a total surprise. Any investor can go to their Bloomberg and pull up a listing of subprime Residential Mortgage Backed Securities. There are 2,512 of them. If you sort by the ones with the most loans over 60 days past due, you find that the average RMBS has 12.39% of their mortgages over 60 days, and 2.39% have already been repossessed (REO in the next table), with almost 5% in foreclosure.

The table below shows the RMBS with the highest level of 60 day past due (or worse) mortgages in them. Yes, the worst two offenders are the 2006 vintage of RMBS. But notice that a lot are from 2000, 2001, 2003 and earlier, well before the supposedly lax standards of the past few years. The third listed RMBS, the INHEL 2001-B is selling at 18 cents on the dollar (you can't see this from the table), and has been dropping since 2003. Over 25% of the mortgages in that portfolio have already been repossessed or are in foreclosure, with another 25% past due for over 60 days. Can you say ugly?

But you can also find paper from 2001 that is not doing badly. It should be clear to anybody who did a little due diligence a few years ago that there were problems in the subprime RMBS markets. There was a great deal of difference in the quality of various

offerings. So it paid you to do some homework. If you could not get transparency, then you were taking a gamble.

That being said, many of the European and Asian institutions who bought this paper relied on the credit rating agencies. They relied on the models built by the investment banks that put this paper together. As I have written, they sold their AAA rating but put legal language buried in the documents that basically said, "OK, this is not what we mean by AAA in our other ratings." The document for the RMBS mentioned above was 300 pages of fine print. I will bet you that the vast majority of people buying this paper did not read it or understand what they were reading if they did.

You can bet lawyers all over the world will look at this same screen I show below. They are then going to ask the bankers and credit agencies how they could put such a high rating on the paper seeing the problems in these securities? "Really, you didn't look at the lending standards?" It's all hindsight, of course. But that's what lawyers do. And in front of a jury, it will be a tough day for the banks and credit agencies.

DQRP　　　P271 EquityDQ

Sector: Residential　Res BC　　　Delinquency Re

Issuance Year: All　Ticker:　Series:　　2000 records displayed of

Deal	Rep. Date	30Day	60Day	90Day	Forecl.	REO	60D+ ↑	WALTV	FIC
Weighted Averages		3.98	2.05	2.89	4.99	2.43	12.39	76.91	6
ACE 2006-SD1	07/2007	7.95	5.93	24.58	18.40	8.87	57.78	75.68	5
GSAMP 2006-SD2	07/2007	4.12	4.26	29.41	12.13	6.35	52.15	79.36	
INHEL 2001-B	07/2007	8.63	16.11	9.87	15.91	10.13	52.02	80.38	
OOMLT 2000-1	07/2007	0.00	0.00	37.60	10.69	0.00	48.29	79.84	5
MSDWC 2001-NC3	07/2007	4.77	3.72	25.42	9.15	9.95	48.24	77.57	
INHEL 2001-A	07/2007	15.07	6.98	14.12	16.73	10.35	48.18	80.61	
CDCMC 2001-HE1	07/2007	4.44	4.02	24.15	8.01	11.50	47.68	78.65	
ACE 2006-SD2	07/2007	5.70	3.30	22.04	16.83	5.26	47.43	75.10	5
MSDWC 2001-NC4	07/2007	4.99	5.16	21.70	11.93	8.43	47.22	77.13	
SASC 2003-GEL1	07/2007	6.65	1.95	24.43	14.30	5.09	45.77	92.21	
INHEL 2000-C	07/2007	18.16	7.51	15.54	12.66	9.97	45.68	77.85	
RFSC 2002-RP2	07/2007	7.93	3.88	8.76	25.44	6.89	44.97	72.73	5
CSMC 2006-CF2	07/2007	44.83	8.77	35.70	0.00	0.00	44.47	75.62	5
RFSC 2003-RP1	07/2007	9.25	3.57	8.21	27.26	4.91	43.95	75.04	
SBM7 1998-NC4	07/2007	0.68	1.43	36.13	5.68	0.71	43.95	77.61	
MSDWC 2001-NC2	07/2007	7.57	5.37	25.23	4.24	9.09	43.93	76.24	
DELHE 2000-4	07/2007	8.11	3.81	17.03	9.30	13.45	43.59	71.29	5
CSMC 2006-CF3	07/2007	50.27	9.27	24.83	8.04	1.25	43.39	76.10	5
RASC 2003-KS6	07/2007	5.02	4.01	12.75	17.73	8.52	43.01	82.18	6

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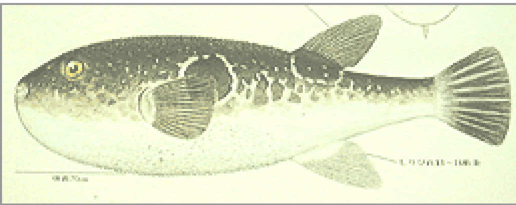

Takifugu Rubripes（学 名）

Source: http://www.suinoko.or.jp; Accessed 8/3/07

The Fugu Ultimatum

And let's close with a few paragraphs written by my friend and partner Jon Sundt of Altegris Investments. I think this is one of the better pieces I have seen looking at the complex environment we are in today. Most of the press tends to greatly oversimplify and lump all funds, banks and bonds into one category, when the truth is there is a lot of difference. Full disclosure, Jon and I and the rest of my international partners are in the business of finding hedge funds for clients, so we have both an inside view into what is going on, as well as a clear bias. I am proud of the job that Jon and his team have done and happy to be associated with them. That being said, let's read Jon's take on the situation.

The Fugu Ultimatum

"Indeed, if you look at the indices for different hedge fund strategies out there, you will find a large dispersion of results for July, with some strategies gaining money and some losing money. The differences between a long/short US manager, a multi-strategy Asia manager, and a leveraged CDO manager are too numerous to mention in this article, but the press would have you believe that these managers are all bound together.

"Let me reinforce my point with a basic but very appropriate analogy. In Japan, there is a distinctive puffer fish called the Fugu. It is served in special sushi restaurants by master chefs. Fugu tingles in your mouth when you eat it. It is supposed to be an exotic aphrodisiac in Japan, where diners spend hundreds of dollars a serving to eat it. The problem is that eating Fugu can kill you. There is an old saying in Japan, 'I want to eat Fugu, but I don't want to die.' People have been known to literally drop dead in sushi bars from cardiac arrest and pulmonary failure if the Fugu they ate wasn't prepared correctly. You have to be a specially trained and licensed Fugu chef to prepare and serve it. Personally, I would want to see the stats of the chef before eating Fugu…just a simple 'number of customers killed' would work for me.

"Now imagine a family in your town called the Griswolds. (You may remember them from the National Lampoon 'Vacation' films.) Suppose for their next trip, the Griswolds decide to travel to Japan and pursue some gastronomical thrills and eat the infamous Fugu. So they do some cursory research, march into a Tokyo Fugu restaurant, plunk down $1,000 and order a huge plate of Fugu. And die on the spot.

"The next morning as you sit at your breakfast table sipping coffee, you read the following headline:

"LOCAL FAMILY DIES EATING EXOTIC POISONOUS FISH IN TOKYO"

"You think to yourself, no problem... you continue sipping coffee... and maybe mutter... 'They should have known better.'

"Now imagine instead that you read the following headline:

"LOCAL FAMILY DIES IN FISH RESTAURANT"

"Your reaction may be very different. You are likely going to cancel your reservation at the local sushi bar until you hear more. What if all fish are tainted? Or is it just that restaurant? Or is it a specific type of fish? You'll have lots of questions, and you might assume, until you know more, that no fish are worth eating.

"My point is that events like these and potential losses should not come as a surprise to knowledgeable and well-educated investors, whether in Bear Stearns' funds (the current focal point of media attention) or other funds. The name of one of the Bear Stearns' funds was 'The High-Grade Structured Credit Strategies Enhanced Leverage Fund.' If this name alone didn't suggest possible concentrations in potentially high-risk investments, I don't know what would. According to one Citibank report, the fund at one point was 80:1 leveraged! In March of this year, the subprime story was all over the news. At a time when most news sources were already talking about interest rate increases hurting subprime borrowers, Bear Stearns appears to have been marketing a fund that invested in illiquid/exotic mortgage credit instruments with high levels of leverage.

"While I don't personally know the full details behind the reasons Bear sponsored this fund, it is clear in my mind that investors seem to have been taken by surprise as to what they had invested in. As I see it, and to return to my analogy, this fund may have been serving up large plates of Fugu to investors clamoring for a bite. The 'diners' appear to have either been unaware of the risks, or more likely, had not seriously considered what could, and in fact did, go wrong.

"Not all CDOs have danger written all over them, but those backed by subprimes would, with the benefit of hindsight, seem to have been quite clearly headed for trouble. It is a very narrow and specialized breed of hedge fund that trades in such a space. Like a sushi 'Fugu' bar, such investing is not typical of all hedge funds. That doesn't mean there aren't billions of dollars exposed to it... it just means it isn't your everyday long/short hedge fund."

90 Years and Still Going Strong

It's time to hit the send button. Tomorrow is my mother's 90th birthday. She is still going strong, with two new knees and two new hips. She had an amazing and difficult life. Born on a Mississippi cotton farm, she joined the Women's Army Corp (yes, my mother wore combat boots) and met my Texan Dad in Europe. Dad became an alcoholic when I was young and mother had to assume the responsibility for many years to support three kids until Dad joined AA and was able to work steadily again.

She never complained. She just met her life with a simple faith and trust. I remember getting up every morning in Bridgeport, Texas. In the winter we would stand

shivering in front of the Dearborn gas heater while she read the daily bible passage. I learned to work watching her, and learned to love to read when our TV died and we were too poor to have it fixed. Life was good.

I leave for Europe in ten days. After meetings in London and a speech in Copenhagen for Jyske Bank, I am going to visit Poland and the Czech Republic, two countries that I have wanted to visit for a long time. It will be fun to be tourist for ten days and lots of new friends to meet.

I usually like to read sci-fi when I am on vacation, but there is not a lot that interests me now that I have not already read. So, I will do some more serious reading. I will pack The Black Swan. I am going to look for a biography of George Washington. And I am looking for another biography or two to take as well. I am open to suggestions.

Have a good week. And remember that family and friends are the most valuable credit you can have.

Your planning on making it to 90 and beyond myself analyst,

John Mauldin