Bill Gary's

PRICE PERCEPTIONS

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Creative Destruction

Four years ago, I was dumfounded at the preponderance of mortgage firms offering home equity loans up to 125% of appraised value. Who in their right mind would buy these mortgages? Over the past two years, I have been equally amazed as the financial media reported average credit card debt climbing to $20,000 per user. How could these people ever pay off their credit card debt with interest rates of 18%? Even recently, I was astounded that car dealers were still offering to finance trades for those owing more than their old car was worth. Who are the willing buyers of this paper?

In recent weeks, answers to these questions have been revealed. Wall Street packaged and dissected these loans into attractive packages. They sold them to banks, pension funds, endowments, foreign governments, mutual and money market funds and others. Buyers of these loans bought insurance against default in the form of derivatives called credit default swaps (CDS). Therefore, they were able to value these loans at full cost on their balance sheets because they were protected by credit default swaps.

Financial derivatives were originally designed to reduce risk. When Alan Greenspan was Chairman of the Federal Reserve, he indicated this new Wall Street tool would permit greater credit access for the masses and promote a strong economy. He was steadfastly against regulation of derivatives, as market forces would protect both buyers and sellers.

However, the fatal flaw overlooked by regulators and holders of derivatives was ability of offsetting parties to pay. There was no exchange to determine the value of these financial instruments. There were no margin calls if the value of packaged loans deteriorated. In fact, the only way to value these instruments was through arcane mathematical models designed by each individual firm. In some cases, both the buyer and seller would book profits on a transaction, as their models were valued differently.

The illusion of value began evaporating when banks were forced to value assets mark to market. Assets such as commodities, stocks, and bonds are marked to market each accounting period to maintain transparency for investors and regulators. However, the value of derivatives were difficult to establish. When they were sold in distressed situations, the price was below book value. The market value of these assets became well established when Merrill Lynch dumped several billion dollars of derivatives to a hedge fund at 20% of book value. This forced other banks to value holdings at similar prices and the downward spiral of assets began to accelerate.

To date, the US government has bailed out Bear Sterns for $25 billion, Fannie Mae and Freddie Mac for $200 billion, AIG for $85 billion and shifted $50 billion from forex reserves to protect money market funds. Now, they are asking Congress for an additional $700 billion to buy toxic assets owned by a multitude of financial companies.

Whether or not these massive bailouts will stabilize financial markets is unknown. However, one thing is clear... *The US will face more creative destruction in months and years ahead.* Excessive risk taking will become a thing of the past... Consumer credit will tighten, reducing purchasing power... The dollar's credibility will continue to be questioned... And, politicians will eventually ask Americans to tighten their belts rather than promising more of everything.

Many traders view massive bailouts as bullish for commodities. They point to excessive money printing as bullish during the Seventies and in recent years. However, this bout of money printing is not designed to spur growth, but to offset massive banking losses and support a declining economy. Therefore, expanding money supply will be readily absorbed by bad debts and add nothing for expanding consumer income or expenditures. Rallies in most commodity markets in response to bailouts should be viewed as temporary and utilized as selling opportunities.