

Cales Investments, Inc.

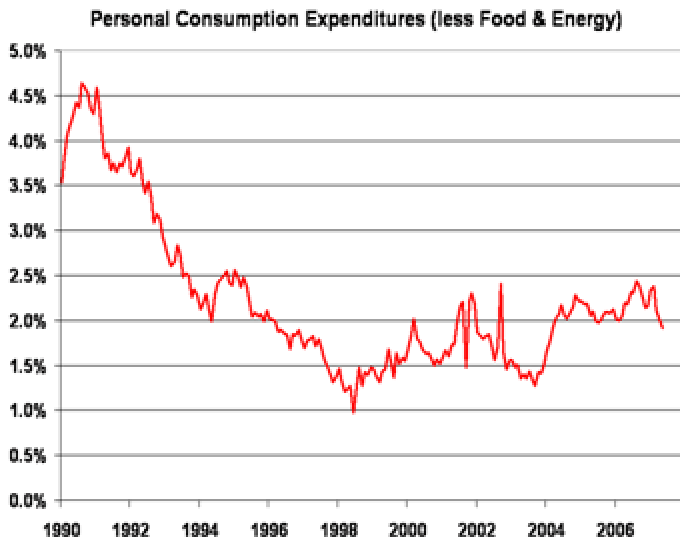
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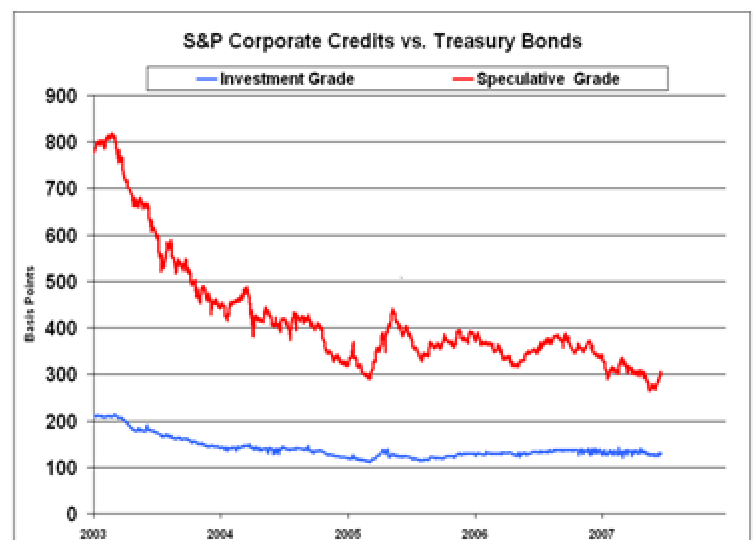
The Price of Risk

Thursday's Federal Open Market Committee statement didn't mention the credit market's recent turmoil, except for the "ongoing adjustment in the housing sector." It said furthermore that "... economic growth appears to have been moderate in the first half of this year ...and a **moderate pace of growth** seems likely...over coming quarters." Our readers know already, that thus far at least, inflation was not the force that drove Fed policy or interest rate movements in the credit markets. The imaginary threat of inflation might have raised some eyebrows in one or the other ivory tower and it probably made good headlines for the mainstream media, but it certainly did not cause the recent turmoil in the credit markets. Inflation continues to subside but credit markets continue on their rollercoaster ride. The housing recession and the related subprime-mortgage mess have forced Bear Stearns to embark on a bailout that could cost as much as \$3.2 billion for one of its two troubled hedge funds. That occurrence jolted investors and put sub-prime borrowers and lenders and investors on notice. So now, we have to deal with this problem for the **second time in 4 months**: Did anything change since February? Let's first look at bonds and inflation to make sure we understand the backdrop before we hazard a guess at the future.

Inflation is Falling



Credit Risk is Falling



The left chart above shows that inflation is falling. The right chart above shows falling (or stable) credit spreads. Credit spreads are measuring the extra yield investor's demand for low quality bonds (junk bonds) versus investments in "riskless" bonds such as Treasury Bonds. The difference is called the spread and is expressed in yield percentages. The current spread is the lowest it has ever been, some 3% above T-Note yields of 5%. This amounts to an annual 8% that low quality borrowers have to pay if they want to borrow money. Is this expensive or is it cheap? If we consult the right chart above, it is the cheapest since 2003, when junk bonds were paying 12% total or 8% over Treasuries, which in turn were trading at around 4%. Clearly those yields 5 years ago incorporated a lot of default risk. Today's yields are priced for perfection and incorporate almost no risk of default." I have been skeptical of the sensationalism and dire predictions that have been anticipating the doom of this nation as we know it for the past 2 years. For the past 2 years I have made some money shorting housing stocks, as well as buying mortgage companies. The housing/mortgage sector was a two way market and depending on the phase and the cycles, it paid to be long or short or both. The question always was, whether the housing boom and the subsequent housing bust would remain a **portfolio event** or whether it would eventually turn into an **economic event**. So far, declining home prices and declining home equity values did not restrain the consumer to any great degree. This might change of course, but up to this point in time, the burden of proof rests still with the negative crowd like Bill Gross. The Bear Stearns episode might give everybody reason to reassess their risk

parameters and thus might turn the “**Bear Stearns portfolio event**” into a “**hedge fund industry event**”. It might do this because it becomes clear now that risk has been miss-priced by the risk pricing experts. Who are they? The risk pricing experts are:

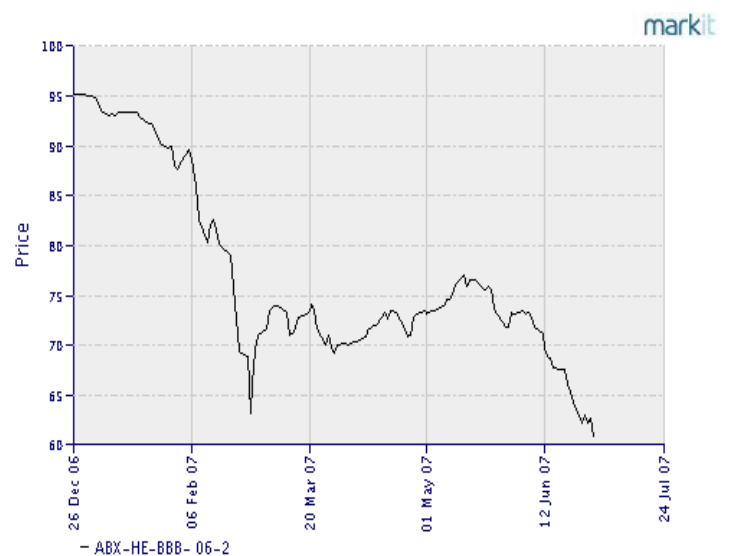
1. **Hedge fund managers** and their rocket scientists, whose models direct and redirect cash flow from mortgage pools into certain tranches, which are labeled depending on their priority within the cash flow pecking order: AAA, AA, A, BBB, BB, B, etc.
2. **The rating agencies** Standard & Pools, Moody’s and Fitch, who assumed (or where told and believed) that a pool consisting solely of deadbeat borrowers can be turned into something resembling a prime loan with an AAA credit rating.
3. **The customers** who insist on low volatility and high returns, both at the same time. This can only be achieved by using extreme leverage. Customers are sometimes just too greedy and they may pay a high price for that. No tears, please. They were all big institutions or accredited investors, meaning they all had a net worth of at least 1 Million and annual income of at least \$200,000. They were big boys, who could take care of themselves.

Mark Pittman opens his [June 29th article](#) for Bloomberg with the following paragraph: “Standard & Poor’s, Moody’s Investors Service and Fitch Ratings are masking burgeoning losses in the market for sub prime mortgage bonds by failing to cut the credit ratings on about \$200 billion of securities backed by home loans.”

Asset Backed Index BBB- (2007 issued)



Asset Backed Index BBB- (2006 issued)



What will turn these portfolio events into economic events? Bill Gross is on record predicting that declining home prices will cause the consumer to retrench which then will lead to recession. So far I see no evidence for this. I see evidence of a coming hedge fund shakeout. I can see the hedge fund industry engorged on too much leverage and that the banks were like drug pushers, selling the stuff on the streets to anybody who asked. I agree with Mark Hard (Currency Fund) who wrote that this willingness by the banks to ignore risk has led to low volatility and little reward for risk in the marketplace. He says: “Markets need risk to properly price assets. ... The Bear Stearns debacle highlights that the industry has gone too far, and that it is high time that credit be reined in.” This re-appreciation of risk is taking place right now. Several low-credit quality, high-yield bond deals to finance buyouts were struggling after hitting a wall last week. Risk adjustments will take place and dislocations may not be avoided, but I still doubt that these adjustments in portfolio pricing will lead to an economic event or a recession. Stick with what worked before and you will do fine. What worked for the first half of 2007?

Construction, mining, railroads, technology, and other beneficiaries of a global economic boom led the market. On the other hand, sectors reliant on the American consumer have lagged, with homebuilders, casinos and apparel retailers suffering. The message is to stick with what works. Ensure that the cyclical part of your portfolio retains a global reach, and the domestic segment overweighs the defensive-growth sector and you will weather the storm.

Hermann Vohs