



Does the US affect us?

by Graham Brown (LoveProperty.org)

3 key developments and questions in finance that BMV investors need to be aware of.

- * How will the meltdown affect my ability to make deals stack?
- * Is it going to become cheaper or more expensive to borrow?
- * Is it going to be business as normal in 2009?



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The Money Supply Meltdown - who cares?

The good news is the Credit Crunch is over. The bad news is that it has been replaced by a more malign beast - Global Meltdown.

But then, why should we care about the plight of the financial markets? The plight of the world's money men seems far removed from the world of BTL.

"Does the US affect us?" wrote one curious investor on a forum thread today I occasionally monitor but pay little heed to because it precisely is populated by these kind of BMVers.

On second thoughts maybe I shouldn't be so harsh because there are plenty of investors who haven't even got to the stage of asking that question yet. Having worked in finance for some time I take a keen interest in global developments but I can understand why the vast majority of investors take little note of these overpaid fools (I mean the greedy money men, not the BMVers).

Contempt for investment bankers is deep rooted in history, ever since their founding father, Rothschild, made the profession the power-base it is today. Rothschild was a wise man. Not necessarily a good man but a wise man.

"Give me the control of the money supply and I care not who makes the laws of the land".

He knew the golden rule; he who has the gold, makes the rules.

It's precisely the very fact of drawing the connection between money supply and BMV that will separate the men from the boys in coming months.

Money supply is everything. It controls the fortunes of the economy, determines the success or failure of administrations and ultimately pens the fate of the property market.

In the UK we call them the government in the US they are the "administration". The semantics are more than a red herring. Administrators are merely custodians for more controlling forces - the money brokers.

Consider this; Hank Paulson - the US treasury secretary has sought a blank cheque and (importantly) no administrative review from the House to spend in excess of \$1 trillion in the form of a bailout that will lance the toxic debts of our infected system.

The chief beneficiaries of the bailout will be those who stand the most to lose - the money brokers i.e. Goldman Sachs and company, the high flying fat bonus investment bankers whose convoluted system of leveraging and securitized debt got us precisely into this mess in the first place.

So does it come as no surprise that Paulson who professes to act on principal in the interest of the taxpayer is himself the ex CEO of none other than Goldman Sachs?

It seems when their financial muscle is made impotent by a climate of fear they need to take over the executive framework.

It's precisely the climate of fear that will soon stifle the property sector. Everyone understands the bit about falling property prices but that's about as far as the understanding goes.

I'm reminded of the Seinfeld skit where Jerry explains the pharmaceutical industry's visualization of the diseased patient.

Consider the human body conceptualized as the mouth, no eyes, the tube (the oesophagus) leading to the circle - the stomach. Day one of medical school the medical professor addresses the doctors elect: "here we have our patient characterized by the two main areas of concern - the circle and the tube... and that's about as much as we know right now, come back tomorrow when we'll train you to make them wait in that little room with their pants off".

A mild diversion, but the seriousness of the situation is that as an industry we've only specialized in the circle and the tube so when things start going wrong we're overwhelmed by the complexity of the organism's machinations.

One such commonly misunderstood aspect is the process of lending so let's start by addressing question #1

*** Q1) How will the meltdown affect my ability to make deals stack?**

Here's a commonly held belief (read *myth*): Banks borrow from the Bank of England at the "base rate" on top of which they charge a small markup when they lend to us in the form of mortgages.

We rely on the *wholesale market* more than the BoE for BMV funding

The fact is that very little of our mortgage business arrives in our hands through that channel. The vast majority stems from the "wholesale" finance market. Wholesale is essentially a cobbling together of grey market mechanisms that have sprung up in the last decade to service non traditional lending - eg Buy to Let. And it's the very ability of the high bonus money men to be able to channel funds outside of the traditional financial vehicles that has allowed BTL to flourish.

2/3rds of our lending, maybe more in the higher risk BTL market, comes from the wholesale tap a large proportion of which originates in the States. Hopefully by now you're starting to see the breadcrumbs lead back to Wall Street for reality bears little resemblance to the simple Bank of England model we first mooted as reality.

Most of our mortgages have roots in the US

So there are 2 fundamentals to understand when trying to get your head round how the mortgage market works

- 1) We are highly dependent on the US for our requirements
- 2) In the current climate Liquidity, not the Base Rate, determines the cost of our mortgages and ultimately whether deals stack.

In relation to the first point I've already outlined the basics. The wholesale market relies on a complex chain of "securitization" whereby "high risk" BTL mortgages are converted into lower risk "portfolios of debt", sold on to investment banks, transformed into bonds and finally buried in the system through insurers such as the fated AIG or the monolines.

It's one complicated beast

Sound complicated? Sure is. So much so in fact that not even those that set it up understand who owes who what. That's been half the problem - preempting who's next to disclose an unpalatable raft of exposure to toxic debts.

*** Q2) Is it going to become cheaper or more expensive**

to borrow?

The second point has the greatest bearing on our sector. Liquidity is best visualized as a tap. When lenders are confident of lending they turn it on, fear turns it off.

BoE base rates have little bearing in a dysfunctional market

So let's consider a further widely held myth. When the BoE lowers interest rates it becomes cheaper to borrow. This assumption holds true insofar as the financial system works. That scenario stopped when Northern Rock was jettisoned down the S bend some time back.

Right now investors are keen to identify "who's next"? in order that financial institutions that demonstrate any signs of wobbling can be cut off before they bomb. The investment community is currently stalking the waiting room with a shotgun looking for signs of sniffles or sneezes.

In the meltdown, banks would rather borrow than lend

The bank with the worst balance sheet will become the next Northern Rock or HBOS, primed for takeover. Quite how B&B has held on for so long remains a mystery, but then logic is out of fashion. No bank CEO wants his brand top the list of the "weakest link" so all banks are focusing entirely on 2 strategies

1) eliminate all risky exposure from their portfolio and 2) maximize reserves and deposits to shore up the balance sheet

Expanding BTL lending precisely compromises both strategies and puts any bank onto the hit brigade's A list.

That's why any move from the BoE to increase money supply or lower rates will have little or no effect on the overall supply to the mortgage market. In the patient analogy it's like trying to feed the chronically constipated Pop Tarts in the hope you eventually shift the goods.

In short banks are too scared to lend. In fact most would rather you lent to them not because they want to make money but because their primary motivator is surviving and surviving means not being bottom of the pile. That's why you'll start seeing noticeable increases in high interest saver accounts as a measure to improve their short term liquidity.

*** Q3) Is it going to be business as normal in 2009?**

The third commonly held assumption is that we'll have weathered the storm in maybe 6 to 12 months after which it's business as usual, or maybe on slightly less favourable terms.

12 months isn't enough to work this through the system

I would have concurred 12 months ago when we were still in a "crunch". What has transpired since then is a full scale meltdown of unparalleled scale. The world's biggest insurer and the top 4 biggest investment banks have all been brought to their knees by contagion.

When the administration try to push through \$1 trillion in a desperate bid to squander even more of their taxpayer's money before their rivals cross the proverbial Rhine into the White House you can be sure that in whatever form the bill lands on the taxpayer's plate it comes with a significant ticket of legislation.

Expect the oncoming regulation of lending practises to slow BMV down

Let me put it this way: it's precisely the deregulated highly leveraged environment backed by huge rewards for risk taking in the investment banking community that facilitated the financial vehicles which ultimately enabled us as BMV investors to entertain creative financing options.

And, it's precisely this environment that is not only dead in the water but positively going backwards. Yet, it still has to come home to roost because the mortgage market in the UK is potentially 3 to 6 months downstream of that tap.

In short, the mortgage environment in the UK will not only be a more expensive one but substantially less flexible.

We could feasibly go back 20 years in our lending practises

With the pendulum swinging fully back towards a risk averse regulated environment we could quite feasibly find ourselves as BMV investors operating in a financial environment more semblance of the pre-BTL of the 80s or early 90s where large deposits, credit checks, inflexible remortgage windows and excessive fees were the norm.

You only have to consider that the two biggest BTL lenders - B&B (who most of us know in the guise of MX) and HBOS (TMB) are in dire financial straits and it's precisely these brands that enabled BMVers to go about their business in they heydays.

Sadly their days are numbered as independent entities and any acquiring CEO certainly isn't going to begin a rash course of extending their exposure to risk.

So in short, even if we miraculously make it out in 12 months (which by historical precedent is very unlikely) the landscape of the UK's mortgage market will have changed irrevocably that's why not only do our expectations need to change but the very business models on which we are operating also need to change.

Does the US affect us?

Most certainly but few investors are sensibly adding two and two together to get four because it's 2 today, 2 tomorrow and 4 a half year down the line.

I hope you now draw the connection between money supply and your BMV business.

So we can rejoice in the plight of the apparent masters of the financial universe pack their belongings into that ignoble brown box as they depart the ivory towers of the investment bank for the last time but remember this - it is exactly these organizations that made BMV possible and now their world has changed irrevocably so will ours.

About Graham Brown

Author Graham Brown has business interests in 3 fields - telecoms, real estate and the Internet. Part time property investor, part time director of a marketing consultancy for mobile telecommunications service providers and angel investor in Internet and telecoms concerns.

Graham founded Love Property and is the host of the Inside Property Radio Show as well as the Radio Love Property Breakfast Show with investor John Lee. The broadcasts are available on their respective sites as well as syndicated on I-tunes.

Recent speaker engagements include presentations to Vodafone in Ireland, Telenor in Norway as well as conference addresses in various countries. Featured on the Richard Quest show (CNN), Power Lunch (CNBC Europe), BBC breakfast as well as published in the FT, Sunday Times, The Telegraph, Wall Street Journal and the Economist.

More information, making contact

<http://www.GrahamDBrown.com>

<http://www.LoveProperty.org/profile/GrahamDBrown>

<http://www.InsidePropertyRadio.com>

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