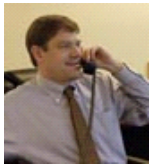




DECEMBER 2007



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## Liquidity versus Solvency, and a Broader Notion of “Subprime”

I toyed with calling this month’s letter “The Last Christmas” but my own sentimentality forbade it. Even so, I believe this may be the last holiday season for a while that Americans get to spend the way they like to spend, buying ephemera not out of need or even deep desire, but out of habit.

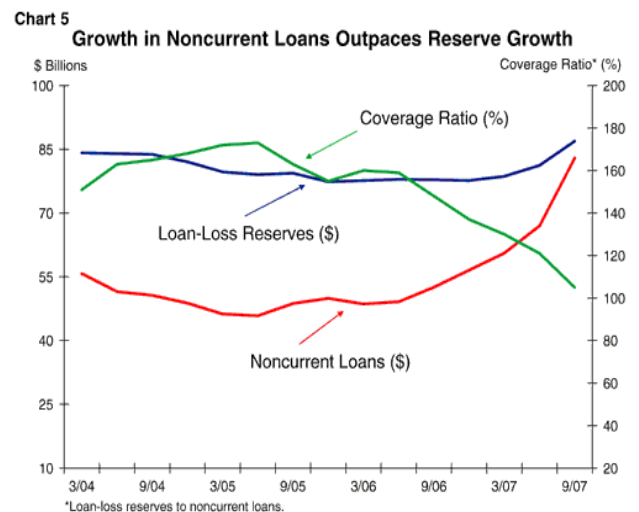
Let’s take a moment to distinguish between liquidity and solvency. Liquidity describes the readiness with which an asset can be converted to cash without significantly discounting price, whereas solvency refers to the ability of an entity to pay its debts. The former is largely process-oriented; it greases transactional efficiency and enables the orderly operation of markets. Solvency, on the other hand, is of a more fundamental nature; it describes the ability of ownership to sustain itself on an ongoing basis. At heart, solvency is about survival.

Certainly, the two can intersect – for instance, a company which has liquidity enough to convert its assets to cash will be better able to meet its obligations and stay in business – but they differ in how tractable they are to top-down intervention.

To keep liquidity flowing, global central banks have employed their usual rate cuts, open market operations, and palaver, and added new flourishes such as the Global Coordinated Liquidity Injection (a discount-rate-cut-by-another-name), and the Fed’s Term Auction Facility (the term? “for as long as necessary” reads the latest official language), and last week’s half-trillion \$ auction by the European Central Bank (an innovation if only for its lump-sum theatricality). Intervention has thus far kept the system running – process remains intact – but there’s a fundamental problem with pushing debt as a remedy for debt. Mid-mudslide, the central banks are trying to rebuild by scooping the muck right back into place, piling still more on top as the base continues to give way.

While liquidity intervention makes for an orderly settlement of obligations (a fine thing), it cannot cure disproportion in the magnitude of debts, nor can it generate real wealth with which to service or pay them down. It can promote solvency where assets exceed liabilities, but it cannot substitute for solvency when asset values are eroding even as debt levels stay fixed and their “cost of carry” sticks or climbs higher.

Consider how US banks have seen their Goldilocks epoch sour, with noncurrent loans and leases spiking 23.8% in the Third Quarter, the greatest increase in 20 years, and coverage ratios hitting their lowest level since the post-S&L workout days of the early nineties:



It would be nice if we could dismiss this as just a matter of subprime mortgages going bad (and indeed, third-quarter delinquency increases were worst among residential loans), but it was commercial and industrial borrowers who triggered the highest level of actual charge-offs, and non-credit card consumer loans the next highest. Meanwhile, recent SEC credit card data show defaults up 18%, and balances on 90-day delinquencies up 50%+ from October 2006.

We’ll be watching closely to see how these numbers shake out when December’s shopping bills come due. Insolvency may yet supplant liquidity in the headlines, and there may yet dawn the realization: Subprime, it ain’t just for houses anymore!