

BIANCO RESEARCH, L.L.C.

AN ARBOR RESEARCH & TRADING, INC. AFFILIATE
1000 HART ROAD • SUITE 250 • BARRINGTON, ILLINOIS 60010
E-MAIL: jbianco@biancoresearch.com • WEB SITE: www.BiancoResearch.com
TOLL FREE 800-876-1825 • PHONE 847-304-1511 • FAX 847-304-1749

James A. Bianco, CMT

Volume, 12 No. 35

Last Commentary: November 19, 2001

COMMENTARY

Market Opinions And Topics Of Interest
December 3, 2001

The Enron/Argentinean Crises

"The world over, a credit implosion is unfolding, in slow motion. Sabena Group, Swiss Air, two Japanese companies on Wednesday, Bethlehem Steel, Polaroid and now Enron have all folded or are folding in just the last 90 days. This matters." – Barron's, December 3, 2001

Now that Enron has filed for the largest corporate bankruptcy ever and the Argentina crisis is widening, how will the financial markets react? That these events are being compared to Long Term Capital Management (LTCM) and the Russian debt moratorium is worry enough for many investors. With the caveat that no more "stunning revelations" are released, **we do not believe the Enron/Argentina problems are a harbinger of a wider systemic "meltdown."** Therefore, **investors should not view these problems as a reason to get defensive.**

Market Trends versus Bad Business Decisions

When looking back at the largest financial disasters in history, we can break them down into two categories: (1) those that occurred primarily from a wrong bet on the trend of a market; (2) those that occurred primarily from bad business/policy decisions.

Financial disasters that occurred by miscalculating market trends include:

- LTCM/Russian debt moratorium in 1998 (widening credit spreads)
- Orange County and Kidder Peabody in 1994 (high interest rates)
- UAL failed LBO in 1989 (high stock prices)
- E.F. Hutton in 1987 (low stock prices following the crash)
- Continental Bank in 1984 (high interest rates) and
- Penn Square in 1981 (falling energy prices).

Financial disasters that occurred from bad business/policy decisions include:

- Sumitomo Copper (Copper Derivatives) in 1996
- Barings (Japanese Stock Index Derivatives) in 1995
- Metallgesellschaft AG (Oil Derivatives) in 1993
- Drexel Burnham Lambert (High Yield Bonds, Legal Trouble) in 1989
- Texaco (Legal Trouble) in 1987
- Chrysler (Poorly Made Cars) in 1979 and
- Penn Central in the early 1971.

What's the difference between these two categories? In the case of those financial disasters that were the result of a market trend, **many other players had the same problem that threatened to cascade into a wider financial crisis.** For instance, when the LTCM/ Russian debt moratorium debacle hit, other hedge funds like Ellington Capital and many *Wall Street* proprietary-trading operations were also betting on narrowing credit spreads or "the convergence trade." Since they all had the same "bet" on the market's trend, they were all facing similar type losses. The fear in this case was not LTCM alone, but rather "who else was behind them."

In the case of financial disasters that were the result of bad business/policy decisions, there was little fear of a "cascading effect." Hence, these disasters **did not** produce the fears of widespread financial problems. For instance, Metallgesellschaft AG lost well over \$1.5 billion from oil derivative contracts. It was forced to lay off thousands and threatened with removal from the DAX index. Yet few thought its problems were the beginning of a system-wide

financial crisis brought on by too much leverage compounded by the excessive use of derivatives. Likewise, when Sumitomo copper lost over \$2.5 billion in copper derivative trades in 1996, this debacle was not considered the "leading edge" of waves of failures in the financial markets. In fact, these two incidents, along with Baring's Nick Leeson's billion dollar plus losses in Japanese stock index derivatives, helped coin the term "rogue trader" to explain these situations.

Where does Enron/Argentina fall into this mix?

So far we have not seen anything to suggest that Enron is the "leading edge" of a financial crisis. In other words, no one is suggesting that there are dozens of other "Enrons" in a similar situation. This is a major difference between Enron and LTCM.

Similarly, as the table to the right shows, Argentina's problems are **not** cascading into a "contagion" among other emerging market debts. The debt of other emerging markets has **not** followed Argentina significantly lower. Brazil's debt (which many believe would be most affected) is up 3.78% since September 10 – outperforming both the S&P 500 (3.33%) and the U.S. 10-Year Treasury (1.79%) over the same period.

As the chart below shows, the Argentinean Crisis is a far different situation from 1998 when the

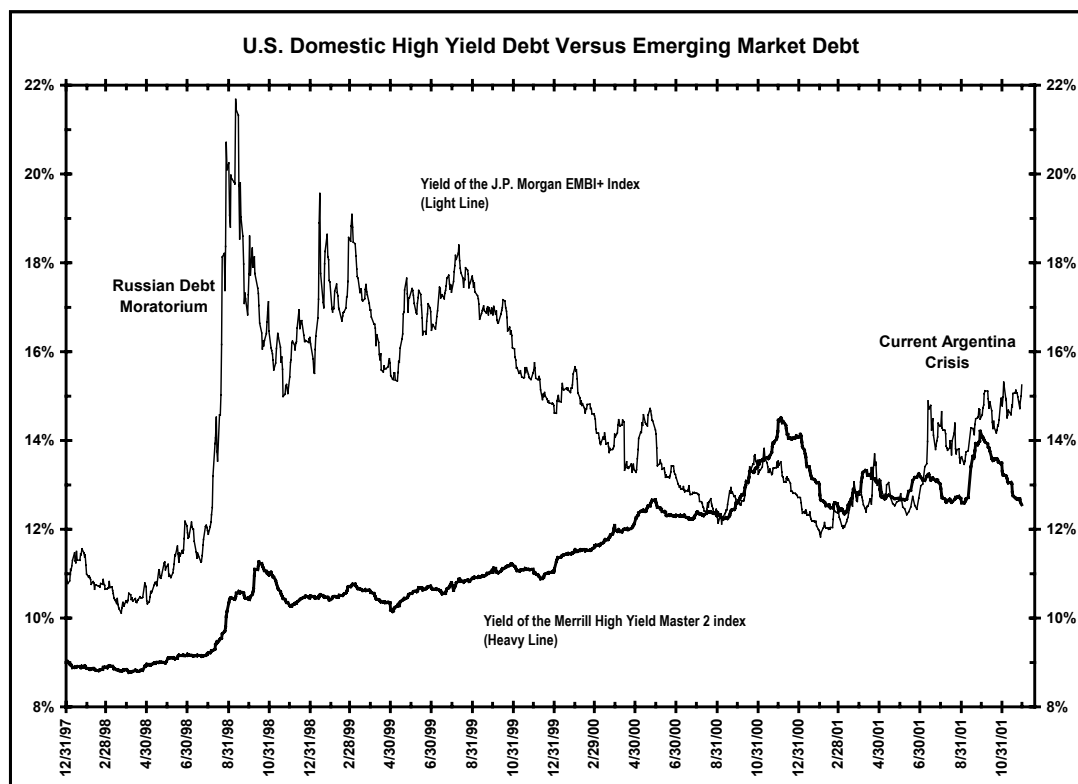
Russian debt moratorium caused a near collapse in both emerging markets and U.S. High Yield debt.

Post Attack Returns

Sorted by "Percent Change" (Best to Worst)

Benchmarks in Bold

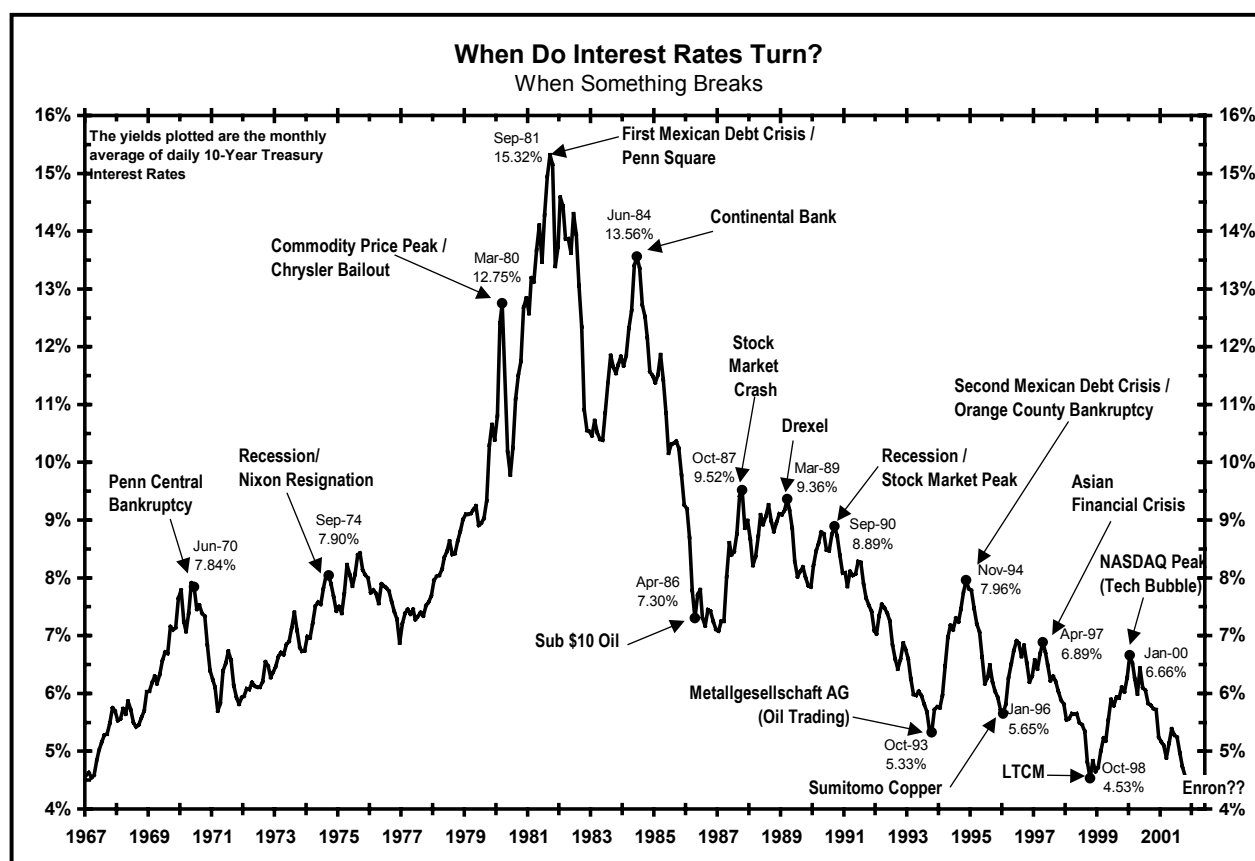
Name	10-Sep-01 Close	03-Dec-01 Close	Percent Change	Point Change
J.P. Morgan Emerging Market Bond Indices - "EMBI" (Total Return)				
Turkey	110.90	122.98	10.89%	12.08
Russia	176.93	192.88	9.02%	15.95
Non-Latin America	247.20	264.21	6.88%	17.01
Ecuador	207.10	220.56	6.50%	13.46
Bulgaria	403.36	425.03	5.37%	21.68
Philippines	112.51	118.48	5.31%	5.97
Nigeria	236.21	248.36	5.14%	12.14
Columbia	147.24	154.65	5.03%	7.40
Peru	284.46	298.30	4.86%	13.84
South Korea	149.71	155.90	4.14%	6.20
Brazil	217.96	226.19	3.78%	8.23
Mexico	208.42	213.55	2.46%	5.13
Poland	266.43	272.42	2.25%	5.99
Qatar	124.73	126.52	1.44%	1.80
Panama	349.44	351.28	0.53%	1.85
Venezuela	244.83	239.37	-2.23%	-5.46
Morocco	221.86	215.60	-2.82%	-6.26
Composite	208.78	197.50	-5.40%	-11.28
Latin America	195.22	174.00	-10.87%	-21.23
Argentina	145.49	78.54	-46.02%	-66.96



To be sure, financial intermediaries have lost lots of money because of the decline of Enron's stocks and the drop in Argentina's debt. Thousands of jobs both related and unrelated to Enron/Argentina are at risk. However, the lack of follow-through by the markets to these disasters suggests this situation is **not** the "leading edge" of some wider systemic problem.

What Happens Next?

Below is our version of a chart that has been popularized by Ed Hyman of ISI Research. It shows that interest rates often turn when a big financial story "breaks."



Interestingly, it does not matter if a disaster is a wrong bet on market trends or a bad business/policy decision. They often mark a turning point in interest rates regardless. Why? We believe the answer can be found on the next page.

Bankruptcy Lags The Economy

The chart on the next page shows the percentage of debt that defaulted in the previous 12-months for both non-investment grade (top panel) and investment grade (bottom panel) bonds. The shaded areas are official recessions.

Bankruptcies or defaults are **lagging indicators**. The greatest amount comes **after** a recession has ended. This makes sense, since bankruptcy is the culmination of months, if not years, of problems. Bankruptcies or defaults mark the **end** of a process,

not the **beginning**. They also mark a "capitulation" that is needed for a market trend to reverse. To put it in market parlance, "a market trend will continue until that trend forces a change." Bankruptcy/default is certainly a "forced change."

For this reason, we view the quote leading this commentary differently from how it was intended. It was supposed to be a warning that credit instruments and the stock market face further risk, given the rash of bankruptcies over the last 90 days.

We believe this rash of bankruptcies marks a "capitulation" phase in the current economic downturn. Bankruptcies and financial crises are usually the recognition of a problem that has existed for some time. When the problem is recognized, the market has usually "capitulated" to the belief that the

situation will not get better. Thus, all the “bad news” is fully priced into the marketplace. This appears to be the case with Argentina. Furthermore, its financial problems are not exactly a secret and no other emerging market debt is behaving like Argentina.

As the chart below shows, the high number of bankruptcies/defaults is also consistent with a recession that is nearing an end. The greatest number of bankruptcies occurs **after** the worst of the economic downturn/recession is over.

Conclusion

The Enron/Argentina financial disasters do **not** appear to be the start of a systemic financial crisis. Many financial intermediaries have lost lots of money and thousands of jobs both related and unrelated to Enron/Argentina are at risk. However, we believe these events **will not** lead to a financial crisis. Enron/Argentina's problems **do not** appear to be the result of a market trend that has “trapped” many other players.

Even though we believe the Enron/Argentina disasters will **not** lead to a widespread financial crisis, this does not mean their “problems” have no meaning for those not directly involved. Often bankruptcies/ defaults are the culmination of months, if not years, of troubles. They often act like a form of “capitulation,” as the signal that all the “bad news” is out and thus occur near a turning point in a market.

We do not believe investors should view the problems at Enron and Argentina as a reason to get defensive. Unless evidence comes to light that many other emerging markets are in a similar position to Argentina, or other corporations are in the same financial position as Enron, we believe these episodes are best viewed as those that occur when an economic downturn is either over or close to over.

