

November 27, 2009

The Dubai Default

So far more of a Family Feud than a financial crisis

A \$50 billion real estate development in Dubai has cried “uncle” on debt owed to European banks. (The only US bank with some exposure seems to be Citi---they never miss one, do they.)

This is being portrayed as a “sovereign” default since the development is owned by the Dubai government. But that government is really more like a very large family business and has behaved just like any other over-leveraged real estate developer.

The following note comes from GaveKal Research, based in Hong Kong and our newest source of independent research:

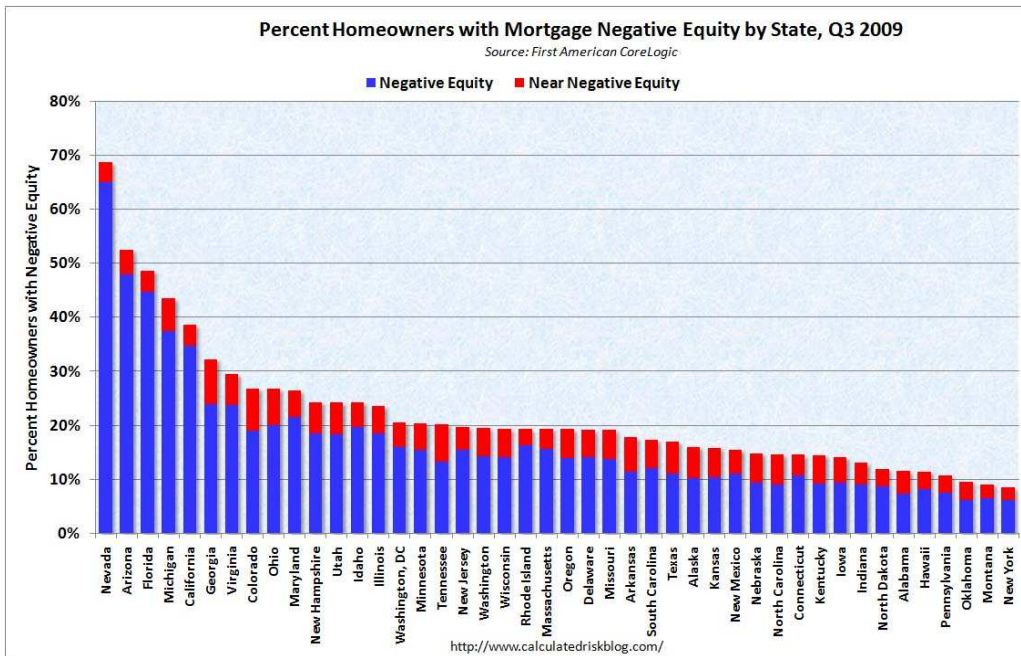
The first point to make here is that the Dubai situation is singular, because the UAE is dominated by two families. The family that runs Dubai has been very successful in building up the city despite the **lack of oil revenues**; however from time to time, they have had to be bailed out by the family that runs Abu Dhabi (indeed, the iconic sail-shaped Burj Al Arab hotel, which is a symbol of Dubai, is actually owned by Abu Dhabi due to a previous bailout).

Dubai World has drawn down only a portion of the current financial lifelines provided by Abu Dhabi institutions, as it scrambles to find other sources of funds rather than effectively hand most of the “city-state” to the rival family. Thus this is not a case so much of the cash not being there – but of emotions and politics twisting the saga into new proportions. That said, clearly this event is spilling over to other potential default stories.

So the most likely outcome here is that the Abu Dhabi family (with the oil) forecloses on some property in Dubai owned by their cousins. It’s all between Sheiks.

But this mess is a reminder of how shaky banks remain. Commercial real estate loans will take a big toll on bank balance sheets in 2010 and while residential real estate has stabilized, the foreclosure cycle has not peaked and more loans promise to go bad. We will continue to avoid the financial sector in our portfolios.

Take a look at this chart showing the percentage of mortgages with negative equity by state:



The number of homeowners with negative equity keeps climbing and continuing job losses aren't helping. Sales activity has picked up, but prices remain near their lows so it's likely that these underwater mortgages will show up on some bank's bad loans list.

We think the crisis in Dubai will pass, but world-wide real estate remains fragile even for guys in the Persian Gulf!

Fortunately we are not flying blind. Between GaveKal in Hong Kong and Bank Credit Analyst in Montreal we have a pretty good picture of what's happening in the world. We believe they will be helpful in detecting a repeat of last year's financial crisis and allow us to avoid serious loss.

Best regards,

Daniel A. Ogden