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2008 Third Quarter Review: How Strong are the Fundamentals?

These are truly historic times. In our 2008 market outlook we mentioned that the banking crisis was looking more and more like the Great Depression. We never thought it would be like this. The past month has witnessed the collapse of some of the largest financial institutions in the world and the global economy faces massive paralysis. The ultimate repercussions of this credit crisis are anything but clear. What is clear is that global financial markets are more connected than ever before and more cooperation is needed between central banks and regulators worldwide (as witnessed by the coordinated global rate cut). Too much has happened in the past month, especially the past two weeks, to dissect it all in detail in our newsletter, so we thought we would give you the "Cliff Note" version of what happened and how this will affect the investment outlook.

September 15: Lehman Brothers, America's fourth largest investment bank, files for Chapter 11 bankruptcy with over $613 billion in debt. Merrill Lynch, the third largest U.S. investment bank, looking to avoid bankruptcy as well, sold itself to Bank of America for $50 billion in an all stock deal. The repercussions of Lehman's collapse are felt in the CDS (Credit Default Swap) market where Lehman was a top ten counterparty. The Reserve Primary Fund became the first money market fund in 14 years to fall below a $1 a share after writing off $785 million of Lehman debt.

September 16: AIG, which had recklessly overexposed itself to the CDS and MBS (mortgage backed securities) markets, looks to the Fed for a loan to avoid bankruptcy. Less than a day after letting Lehman Brothers fail, the Federal Reserve authorizes a loan of up to $85 billion to AIG to keep it solvent. The loan is collateralized by the assets of AIG and the U.S. government acquires 79.9% of the company and reserves the right to suspend dividend payments as AIG proceeds with an orderly sale of its assets. The Fed and Treasury felt the global effect of its failure would have been catastrophic.

September 19: In response to the Reserve Primary Fund losses, the U.S. Treasury Department establishes a guaranty program for all U.S. money market funds that choose to participate. For the next year, the Treasury will insure the holdings of any eligible public money market fund, retail or institutional, that pays a fee to participate in the program.

September 22: U.S. Treasury Secretary proposes a $700 billion "bailout" whereby the government would purchase mortgage backed securities from struggling banks. The plan is an attempt to stop the massive systemic de-leveraging by the financial sector. The three-page proposal by Henry Paulson is debated by Congress. By the end of the week the bill is significantly restructured to include provisions that make the bill more palatable to both parties.

September 25: Washington Mutual, on the 119th anniversary of its founding, was placed into the receivership of the FDIC. With assets of over $300 billion, it is by far the biggest bank failure in U.S. history (Continental Illinois is second at $40 billion in 1984). JP Morgan Chase buys the functional assets of Washington Mutual for $1.9 billion.

September 29: Over the weekend, Congress works to find a compromise and bring the "Emergency Economic Stabilization Act of 2008" to a vote in the House of Representatives. In Europe, three governments (Belgium, the Netherlands and Luxembourg) agree to a $16.4 billion bailout of Fortis, Belgium's largest retail bank. The British government nationalizes mortgage lender Bradford & Bingley. Early in the morning, Citigroup reaches an agreement to acquire the banking operations of Wachovia for $2.2 billion. Federal regulators helped orchestrate the deal with some key provisions: Citi will assume the first $42 billion on losses from Wachovia's riskiest assets and will pay the FDIC $12 billion in preferred stock and warrants. The FDIC will in turn absorb all losses above $42 billion. At 1:00 pm, the House votes against the bill, mostly along partisan lines, but with reservations amongst most congressmen, especially those facing re-election. In a matter of minutes, the DJIA plunges 500 points. The DJIA closes the day down 777 points. The decline marks the single largest one-day point decline ever. The S&P 500 drops nearly 9%.

September 30: Markets rebound from the failed vote and the DJIA vaults almost 500 points. Investors are hopeful another attempt at the bailout bill will eventually pass.

The last two weeks of the quarter were extremely volatile and the market's disappointment with the bailout was understandable. In particular, credit markets have seized up and banks have no confidence to lend to each other or businesses that need credit to function. The EES (Emergency Economic Stabilization) Act was not a perfect bill, but the changes made to Paulson's three page proposal from the prior week were sufficient to merit its passing, especially given the gravity of the situation. Congress had rightfully asked for more oversight through an Oversight Board and asked for the release of funds in several parts: $250 billion immediately, another $100 billion subject to Presidential certification and another $350 billion subject to Congressional disapproval. The bill will allow federal agencies to modify foreclosed loans it owns or controls to help keep families in their homes. The need for taxpayer protection was addressed both through curbs on executive compensation and warrants on the companies that participate should they experience future growth as a result of the program.

The blueprint of the plan is similar in theory to the Resolution Trust Corporation that was used to resolve the savings and loan crisis of the late 1980s and the Home Owners Loan Corporation of the 1930s. The plan would help stabilize markets by buying debt, primarily MBS, which are currently not trading and are clogging the credit pipeline. By taking these assets off banks' balance sheets, it would free them up to extend credit to businesses that are in dire need of financing. Further, the flexibility to keep people in their homes will slow defaults in the same MBS the government would be buying, thereby increasing the likelihood of a profit for the taxpayer. The resolution of the problem will likely take years, but the government's balance sheet is large enough and its investment time frame long enough to potentially sell those assets back into the market at higher prices when markets have stabilized. There are significant risks to the taxpayer, but if the asset pools are administered by the right professionals (Bill Gross from PIMCO is waiting by the phone), the potential for profit exists. In the absence of the bill, the Federal Reserve and Treasury continue to work with the private sector by drawing a line around several institutions (JP Morgan Chase, Morgan Stanley, Goldman Sachs, and Bank of America) that it will not allow to fail and is counting on for help stem further bank failures. For example, in the case of Washington Mutual, the FDIC was able to move those deposits over to JP Morgan Chase rather than having to manage that failure itself.

What is most clear in the aftermath of the failed vote (and subsequent positive vote) is that the American people did not understand what the bill was about. It is difficult to fault them. It has been presented as a "bailout" and not a "rescue". No one has attempted to explain why it is truly necessary or how the current credit crisis will hit "Main Street", not just "Wall Street" in the coming months. In that regard our government has failed us. In a time of economic crisis, Americans look to their represented leaders to understand what is at stake. That is the least they can do. The President failed to adequately muster support for the plan, both publicly and privately in negotiations with Congress. The first vote in the House had everything to do with politics. The second vote had everything to do with fear. As the President is mired in the worst approval ratings of his administration, many representatives chose to distance themselves as much as possible. Amongst representatives up for re-election in the next month, over 75% voted against the bill. Whose interests are they really serving? The partisanship that has been a hallmark of President Bush's administration was evident here as well, although surprisingly, it was the majority of Republicans that rejected his proposal. With the polls very tight, Barack Obama and John McCain chose to sidestep questions about the bill in their debate.

It appears our elected officials know even less about what is actually happening with our economy than the average citizen. Over the past year, the credit crisis has steadily gotten more severe and many congressmen seemed oblivious to what was actually happening. Perhaps they should read John Mauldin's recent newsletter (the newsletter is titled "Who's Afraid of the Big, Bad Bailout?" and is available in the Market Commentary section of our website) to understand what is at stake and how to best explain their difficult vote to their angry constituents. In the coming months there will likely be several more difficult and unpopular decisions to make.

It is clear that the U.S. economy will be hard pressed to move through this recession quickly. The revision to the second quarter GDP number showed growth was only 2.8%, significantly less than the original estimate of 3.3%. Consumer spending, already slowing in recent months, is likely to slow even further. Lack of credit is severely impacting sectors like autos, housing and retail spending. September auto sales were down about 30% across the board. Bill Heard Enterprises, the nation's top selling Chevrolet dealership group, just filed for bankruptcy protection. Housing will continue to suffer if consumers can't get funding. With a huge inventory of unsold homes already, the construction sector will suffer further. Credit card companies are tightening credit limits and increasing rates, student loans are more difficult to obtain and short-term financing costs in all categories have skyrocketed.

The banking sector lacks confidence as the risk of counterparties failing is extremely high. The result has been tighter lending standards, higher short-term interest and a grinding halt in short-term lending. State and local governments are a direct victim, with higher lending costs and lower tax receipts straining budgets. To see how Wall Street and Main Street are connected, look no further than New York City. The securities industry accounts for 25% of the wages paid in the city and generates 27% of its direct tax revenue. The city's

Independent Budget Office estimates some 40,000 of the city's 185,000 Wall Street jobs will be lost. For every 1,000 jobs that are lost, the city estimates a loss of $50 million tax revenue. The city was already facing a budget deficit before the crisis started. To many, the Big Apple may not exactly be Main Street, but Washington Mutual, Wachovia and Indy Mac aren't based on Wall Street either. The crisis is a national crisis and when business slows down it trickles down to everyone, the food vendor on the corner in New York, the farmer in the Midwest who can no longer finance his operations, the car dealership that can't sell cars without good financing and has to lay off 3,200 workers. The nebulous effects of credit will be felt by everyone and that needs to be explained to Americans. Congress was not voting on a bailout bill. They were voting on a economic rescue bill. It may turn out to be one of several.

The rescue plan is essential to stabilize the markets. The U.S. and Europe are in a recession, while China and other emerging economies will see their growth projections slow. The Asian Development Bank has trimmed its forecasts for 2009 GDP growth for every country in the region as demand for exports is slowing. Every major market index in the world is down double digits for the year, with many down over 30-40% for the year. As investors reign in risk, emerging economies that were very reliant on foreign capital will suffer even more. As we mentioned in our last newsletter, we are now facing the prospect of deflation rather than significant inflation. This increases the likelihood of further rate cuts by the Fed. The ECB (European Central Bank), ever vigilant in the fight against inflation, may have to cut rates even further. At the government level in the U.S. and Europe, a combination of government deficit spending, tax incentives or subsidies for businesses and tax cuts for consumers to help increase discretionary income are needed to stimulate growth in a recession. The economic policies of both presidential candidates will be impacted dramatically. Barack Obama will have to make difficult decisions about how to allocate resources for all of the initiatives he has promised and in many cases reconsider on those that are expensive. John McCain is reconsidering his own tax cuts and given the $12 billion the U.S. spends in Iraq each month, both candidates need a clear strategy for resolving a war that continues to drain resources.

The crisis has broader long-term ramifications that will change the political and economic landscape across the world. A new regulatory environment will emerge from the current turmoil. Most importantly, the $55 trillion CDS (Credit Default Swap) market will be regulated, most likely through an exchange. Credit-default swaps are insurance-like contracts in which buyers make regular payments to sellers, who agree to make payouts if a company defaults or files for bankruptcy. As defaults have spread through the system, many counterparties are now unable to make payments on the swaps they have written, further stressing balance sheets. The story of the past 30 years has been one of deregulation in the U.S. (please see the February 2008 newsletter for more on this). The next several years will see a shift to stricter regulation across all capital markets, possibly through a central regulatory body.

Over the past five years, the Iraq War has eroded the political capital of the U.S. worldwide. Our allies have questioned our motivations and our enemies have renewed confidence. The world is questioning our global leadership more then any period since the end of the Cold War. The current crisis will have the same effect on the U.S.'s global economic leadership. Wall Street's dominance as the center of global finance will likely shift to London and Hong Kong. Foreign countries will likely diversify their currency holdings away from the dollar as U.S. government debt skyrockets and the emergence of multiple poles of economic power will exist around the world. Developing countries will be less likely to use our laissez-faire approach for their own markets and are likely to structure a managed form of capitalism, a compromise between China's mercantilist system and the American free market approach. This does not mean that the U.S. will lose its status as the leading political and economic force in the world, but it will give the rest of the world second thoughts about following our lead.