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MARKET BULLETIN **October 16, 2008**

Where we are

The past six weeks have seen historically jarring events for the financial sector. What we interpreted as a major credit and liquidity cycle has transitioned into a much more significant event. In my view this was not inevitable, but rather occurred as a direct result of the specific policy decisions discussed below. We did not expect these events to occur because we did not expect policy makers to take the actions that triggered them. The policies pursued over the past seven weeks have been contradictory, and consequently have transformed a credit cycle into a credit crisis.

Policy makers have been trying to balance the objective of restoring liquidity and confidence with the objective of punishing bad behavior and instilling market discipline. Both of these objectives are legitimate at a point in time. However, they are competing objectives and work at cross purposes. Instilling market discipline and punishing bad behavior serves to curtail confidence and lowers liquidity; taking stimulative action increases liquidity and market confidence. Finding the proper balance at a given point in time represents a specific challenge for policy makers. Which one to emphasize to ensure a smoothly functioning financial system is a matter of judgment; the right response depends upon where you are in the cycle. I attribute the severity of the crisis from the first week of September forward to a mistaken effort to punish bad behavior (thereby inhibiting credit extension and liquidity) during a period where there is a stark lack of confidence and lack of liquidity.

There are indications that such policy conflicts are abating and all efforts are being focused on restoring confidence and liquidity. That would represent an important improvement. But the cost of earlier errors will make that effort much harder and more costly in terms of lost economic output, and potentially dollars. Moreover, we remain cautious for two reasons: 1) because we have seen similar indications before that have then been reversed, and 2) because neither policy makers, the financial media, or the general public seem to recognize the inherent inconsistencies in recent decisions, and their causal impact.

Background

To put these events into historical context, let's re-cap the credit cycle from the 2000-2001 time frame. At that point the stock market and general economy were starting to cool in response to the restrictive monetary policy that the Federal Reserve had put in place (specifically a Fed Funds target of 6.5%). By late 2001 the economy was cooling and the stock market was much lower. With the events of 9/11, and the start of the Iraq war, economic conditions became extremely challenging. The Fed responded by aggressively cutting rates and pumping massive amounts of liquidity into the system. It slashed its target rate to 1% and encouraged financial institutions to increase their lending and leverage. Given the conditions, this was a reasoned and reasonable policy response. This massive liquidity found its way into the real estate market, both directly and through loans that were then repackaged and further leveraged. The Fed and the Federal Government encouraged massive leverage, much looser lending standards, and were generally very aggressive in doing what they could to get the economy growing.

This policy succeeded in preventing a full blown meltdown. Consequently, by the Spring of 2004 the Fed was able to reverse course and begin draining excess liquidity by raising rates. By the summer of 2006 Fed Funds were 5.5% and the real estate market had started to cool. By the fall of 2006 the most aggressive lenders were being forced to curtail their activities. By the beginning of 2007 scores of subprime lenders were going bankrupt. By the middle of 2007 real estate prices began to fall in ways not seen in decades. The extended period of high rates properly caused an extended period of de-levering.

The cycle of tightening continued through this time last year. By then the Fed concluded it had been restrictive long enough and had taken the speculative and overly aggressive leverage out of the system. The Fed began lowering rates modestly. It was only as the economy continued to weaken, teetering on the brink of recession by early this year, that the Fed moved to a clearly stimulative stance, lowering fed funds to 3.5% in January.

From January to August, it seemed clear that the financial system was very fragile, still suffering from the earlier drain of liquidity and subsequent drop in asset values. The classic policy response under these conditions is to provide a positively sloped yield curve and wide credit spreads to allow financial companies to borrow money at cheap short term rates, lend it at higher rates, and thereby replenishing their capital and improving their financial health. A key component of this is "a degree of regulatory forbearance" whereby companies that have depleted capital levels are allowed to continue operating, benefiting from those high spreads so they can replenish their capital levels. The Fed's decision to lower rates to 2% and the federal Government's stimulus package were consistent with this framework.

We believe these conditions were playing themselves out through the beginning of September, that we were past the worst of the credit contraction, and close to a much smoother functioning system. While the equity markets were somewhat lower on the year and the economy was contracting modestly as measured by employment, the system seemed fragile but stable and slowly responding to the increased liquidity and lower rates from the Fed.

What Went Wrong

The real turmoil occurred in the months of September and into October. The classic response of engendering stability by supporting weaker institutions during fragile periods was discarded during this month. Specifically, the actions the Treasury took in respect of Freddie Mac and Fannie Mae, and the Federal Reserve Bank took in respect of AIG, had elements that were explicitly designed to punish bad behavior and served to undermine confidence. These decisions made it harder to protect the other weaker companies that were allowed to fail. A better policy response would probably have been to protect the weakest of those, in order to send a message to investors that they can be confident in and lend money to the stronger. Instead, the choice was made to actually attack investors in Freddie, Fannie and AIG.

I would attribute the large recent market gyrations to the policy decision of punishing bad behavior in a fragile period. That context is important to understand because it helps inform how the market and economy may respond to future policy actions. I would expect a significant rebound in financial company shares (and the broad market) if these punishing policies are reversed, and continued turmoil if they are not. At this point there are conflicting indications of where policy makers are headed so we remain cautious in our exposure to financials, and are instead building exposure to securities that could perform better in a continued period of turmoil.

This period of bad decision-making began on Sept 7th as the Treasury Department announced it had placed FRE & FNM into conservatorship. The decision to issue the government warrants to purchase 80% of the equity for a nominal value was the explicit move to punish bad behavior and instill market discipline described above. Predictably, this served to reduce confidence and liquidity. The decision to halt preferred dividends had the same explicit intention. Moreover, that latter decision had the important additional impact of draining a non-trivial amount of capital from the system. Banks that held those preferred shares suffered a direct loss of capital. And when banks lose capital, they need to decrease the amount of assets they hold by 5-15 times what they lose. I estimate banks lost $20-35 billion in capital through that decision. That would put pressure on them to sell $100-250 billion in assets in an environment where there were few ready buyers.

The decision to halt dividends had the further impact of reducing investor confidence in preferred shares issued by other financial institutions. In fact, much of the capital that had been raised by financial institutions earlier in the year had been raised through those type securities. Once the government announced its intention to impair the value of those securities, it closed that market to other companies looking to raise capital.

Even if one accepts the notion that placing the companies into conservatorship was necessary, which I find a hard-to-defend argument, the punitive elements of the plan were not necessary in any economic sense. Rather, they served to undermine confidence and drain liquidity at a point in time when the system was quite fragile.

Parts of the Treasury's plan may have been designed to enhance confidence and liquidity, but the way in which the plan was implemented – specifically issuing dilutive warrants and halting preferred dividends — served to undermine those efforts. The Treasury Department under Henry Paulson was the principal entity that managed the Freddie and Fannie debacle.

Two weeks later the Federal Reserve Bank, under Ben Bernanke, included similar elements in its approach to AIG. As AIG became unable to fund itself – more as a result of earlier policy actions than its own decisions – the Fed stepped in with similar punitive measures. In order to help the company continue functioning, the Fed extended AIG $85 billion in credit (arguably the Fed or other government agencies' proper role in a period of crisis). However, it did so at highly onerous rates of 11.5% or higher and took warrants for 80% of the company's common equity. These terms allowed AIG to function, but they also served to curtail any further investment into financial companies that individual investors might have considered making. Again, those elements were designed to instill market discipline, in other words, to scare off investors. When we as investors see that the government takes over 80% of our company in its actions regarding Freddie Mac, and see them do the same in regards to Fannie Mae and AIG, we are exceedingly hesitant to provide capital to that sector. Other investors react the same way. Punishing those companies through these actions serves to starve the entire sector of capital. It transforms a liquidity cycle into a crisis.

Under what terms will investors put money into this sector? Clearly the government's pronouncements that companies are well capitalized cannot be relied upon. In July Henry Paulson stated unequivocally that the current status of Freddie and Fannie did not warrant takeover. Little changed between then and his takeover of those companies in the beginning of September. In fact, he predicated his takeover of them on non-public information the Treasury gained from getting an inside look at their books. Basically that is a message to investors that the published financial statements of these companies are inadequate to make informed decisions regarding their condition. That undermines investor confidence.

As a result, the Treasury is being forced to invest hundreds of billions into the sector because other investors are justifiably too scared to do so. Why aren't other investors willing to invest? It is not for lack of ability. The amount of cash on the sidelines is off the charts. But earlier this year the government encouraged Washington Mutual to find more investment capital. The company found investors willing to put up $7.5 billion dollars to invest in the company. Last month the government took the company over and wiped out those investors. A similar situation occurred with Fannie, and those investors are facing massive dilution as "punishment." Freddie sold billions in preferred shares over the past year. Investors who accepted the government's prognostications that the company was adequately capitalized and bought those shares may-or-may-not ever get paid.

We are in the midst of a crisis of confidence that has been caused by bad policy. The good news is that most of corporate America is fairly well capitalized. Once confidence is restored the underlying fundamentals could become very positive very fast. Equity valuations are also extremely attractive, providing investors with very compelling risk/reward. The government's commitment of roughly $1 trillion to create a stable environment is more than enough if used decently. There are many indications that such could be the case. But there do remain many mixed messages coming from all sides (including Congress and both Presidential Candidates). Specifically, Secretary Paulson has stated that he will only use the $700 billion allocated by Congress to aid "solvent" financial companies. The implication is that there are non-solvent companies currently operating (whose regulators have up to this point deemed sound). Such an approach only encourages investors to seek out the weakest and anticipate their failure. Policy makers must make the alternative case that those companies that meet their regulators requirements will by definition be deemed credit worthy – at least during this period.

The fix for the current crisis is instilling the confidence that those financial companies that have survived to the current point were well-enough run that the government will support them (and not punish them and their investors) until this crisis passes. That was the right fix seven weeks ago, and it remains the right fix now. The only question is how soon policy makers will understand it.

—Charles Lemonides, CFA

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