

Fiscal Quarterly: 3Q 2008

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The third quarter of 2008 saw losses in all major categories, except cash. US stock fell 8.88%, while international equities fell an alarming 20.5%. Bond markets declined slightly, off 0.48%. With interest rates so low, (as well as rumors of a sub 1% Fed Funds Rate), cash accounts could only edge up slightly, 0.45%.

This of course is old news. In the first few weeks of the quarter, US equities marched down another 20% with the banking industry in meltdown. All of us asked the same question. Why? To point fingers and politicize this is not germane to didactically examining these events. There are answers, and many of them. Here is the reasoning with which I follow and agree.

There was a strong sense that homeownership was good for America. The concept is: if people own their homes, they will be more productive members of society and strengthen the overall economic resolve of the country. I don't disagree. The push was on to get more people, who otherwise would not be able to purchase a home, financially onto step one of the American dream. The vehicle was sub-prime lending.

This lending was an incentive to buy a home. There are other public policy incentives for homeowners. The big one is the ability to write off mortgage interest. There is no other reason for the Federal government to allow citizens to write off the interest of home mortgages than it being "good public policy." This makes homeownership easier, financially, and if people own homes and land they are more likely to stay in a certain area and strengthen the local economy. These local economies are the building blocks to our national economy. Subprime lending was the added sweetener to this public policy.

The housing boom boomed. According to the Bureau of Labor and Statistics (www.bls.gov), new home construction from 1956 – 2000 swelled and ebbed between 400,000 and 900,000 new homes constructed per year. In the last eight years, the resistance line was broken and new home construction rocketed up to 1.4 million new homes constructed per annum. Almost four times our historic low, and almost twice our historic high, in just eight years. That is a lot of inventory. That's a lot of supply.

The supply, however, was pacing demand. Subprime was helping that. And for a few years all was well – or so we thought. Homeowners worked to pay the mortgages, but the mortgage underwriting process had been flawed. Income verification was lax. Brokers could augment the stated income for the soon-to-be homeowner, and thus get the deal done, creating their commission. This placed people in mortgages, assuming they could whether a rise in their interest rates, i.e. their monthly income could bear an increase to the monthly mortgage payment. It could not.

Meanwhile, these mortgages (the paper contracts) were being sold. Under normal circumstances, the mortgage is typically sold as a security to various investment institutions and, based on ratios like debt/income or equity/debt, pricing would be established. Mortgage companies sell the paper in tranches or "quality buckets" to the investment firms, and the

investment firms then create financial products based around them, like the XYZ Co. Mortgage-Backed Mutual Fund.

So the financial products are sold to municipalities in Norway, and school boards in Kansas, everyone expecting a monthly or quarterly interest distribution or dividend. But suddenly the income slowed. The homeowners weren't paying on time. A blip in the system? Business as usual? The notes, these mortgages, look great on the balance sheet of the banks and investment companies. "Sell more to create more income," said the banks, now leveraging their bad investments with more bad investments. When the new mortgages failed to produce sufficient income, the cycle of failure began. Whether in Norway, Kansas, or Hartford, the effects were unavoidable.

The tipping point may have been when Fannie Mae and Freddie Mac decided to purchase, for their own investments, some of these sub-prime loans. It legitimized the practice, and also gave the mortgage industry a quasi-governmental clearing house for the products. This is debatable, but to this amateur economist, seems to be the point of no return – I can't see what could have been done after this point to avoid where we are now.

It's tempting to read into these facts and see the problem as simply US homeowners not paying their bills. In fact, the problem was more epidemic – lending for business, big and small, also contributed to this handsomely, and not just in the US but abroad as well.

Similar business lending fiascos occurred, and continue to occur around the world. From Pakistan, to Iceland and Russia and China, monetary lending engines are ceasing. To use these examples, both Pakistan and Iceland are requesting IMF (International Monetary Fund) relief make liquidity in their national financial systems. Russia is so nervous about the value of the ruble it is removing other currencies from ATM's to avoid fiscal expatriation. China's economy has slowed considerably, in part due to the factory shut downs for the Olympics but also because of the slowing of exports to the US and European Union. We can examine many other nations struggling through this, Canada, France, England, Brazil, Venezuela, Australia, but tacitly, we are not alone.

Let's add perspective. The comparisons to the Great Depression are simply ridiculous. Unemployment is just over 6%, the historical average. During the 1930's, unemployment floated between 25% – 30%. The 1929 crash had to do with stocks of companies being overvalued – some 100% over valued, and investors margining, or borrowing against, their portfolio values. When the crash hit, people realized there was no underlying value to the investments. Houses have value. Land has value. This is ultimately the core difference between the crashes of 1929 and 2008. Foreclosures on homes during the depression peaked at 50% - half of all the mortgages! We're at 7% now, with the average about 2%. A good news story would be about the tripling of foreclosures, but not how we're at "Great Depression" levels.

Lastly, let me touch about the "bail-out" before pontificated on the market in the near future. The \$700 billion bail-out number is simply enormous. Federal tax revenues from 2007 were \$2.674 trillion. Ergo, the bail-out is about 25% of all tax dollars collected last year (www.irs.gov). The purpose is to buy the worst of the debt off of the 9 largest banks that went

under or merged/sold. This creates a backstop to the lending crisis. We will likely, as tax payers, see the Federal government recoup that amount, but not for several years. The issue is: what regulation can be put in place to prevent these loan practices from occurring again? None so far, but I suspect it may be coming soon. It will be interesting to see what the new president and congress will come up with.

Heading forward, the fourth quarter looks to be similarly volatile, and normal swings in the market are not likely until the third quarter of 2009. The September 29th report on GDP growth stated a rise of 3.3%. This next report in 10 days will probably show GDP down. These reports are lagging indicators, just as market swings are leading indicators. The real recession begins in January 2009. I don't believe we will experience several quarters of this though. My contacts with Goldman Sachs, Crawford, and the Treasury Department see a lateral movement through at least the first quarter of 2009. We fight not inflation now, but deflation. Governor Bernanke seems prepared to move rates lower still, and continue to buy commercial and treasury paper to keep liquidity for the US economy. We are in for some bad financial weather, but storms always pass.

I was encouraged to hear from many of you in the last few weeks, and certainly I am ready to stay by the phone to field more calls. The staff and I feel very fortunate to have you as clients and as always look forward to adding value to you lives. If you have a spin on the recent events I'd love to hear it; do call.