

# Monthly Chartbook

October 15, 2008

# The Anatomy of a Meltdown

## **Banking, as it once was... BORING!**

Historically, banks borrowed money from savers and lent it out using 10:1 leverage.

They would set aside 1% of capital for loan loss reserves and earn 1% return on assets.

This 1% return on assets would become a 10% return on equity (due to the leverage factor).

Half of the return would be used for bank operating expenses and half would be returned to shareholders.

Still, though, it is not out-of-line to refer to banks (even under this model) as leveraged hedge funds.

# Banking, as it had become...

Mortgage origination with minimal credit standards.

- let your “FICO” do the talking
- no-income verification loans
- NINJA (my personal favorite) – No Income, No Job, No Assets

Housing was assumed to be a risk-less asset class (where have we heard this before?)

2 paths from there...

- loans sold to Fannie / Freddie to be “bundled” with other securities
- financial institutions then purchased these mortgage-backed securities in an effort to gain higher yield

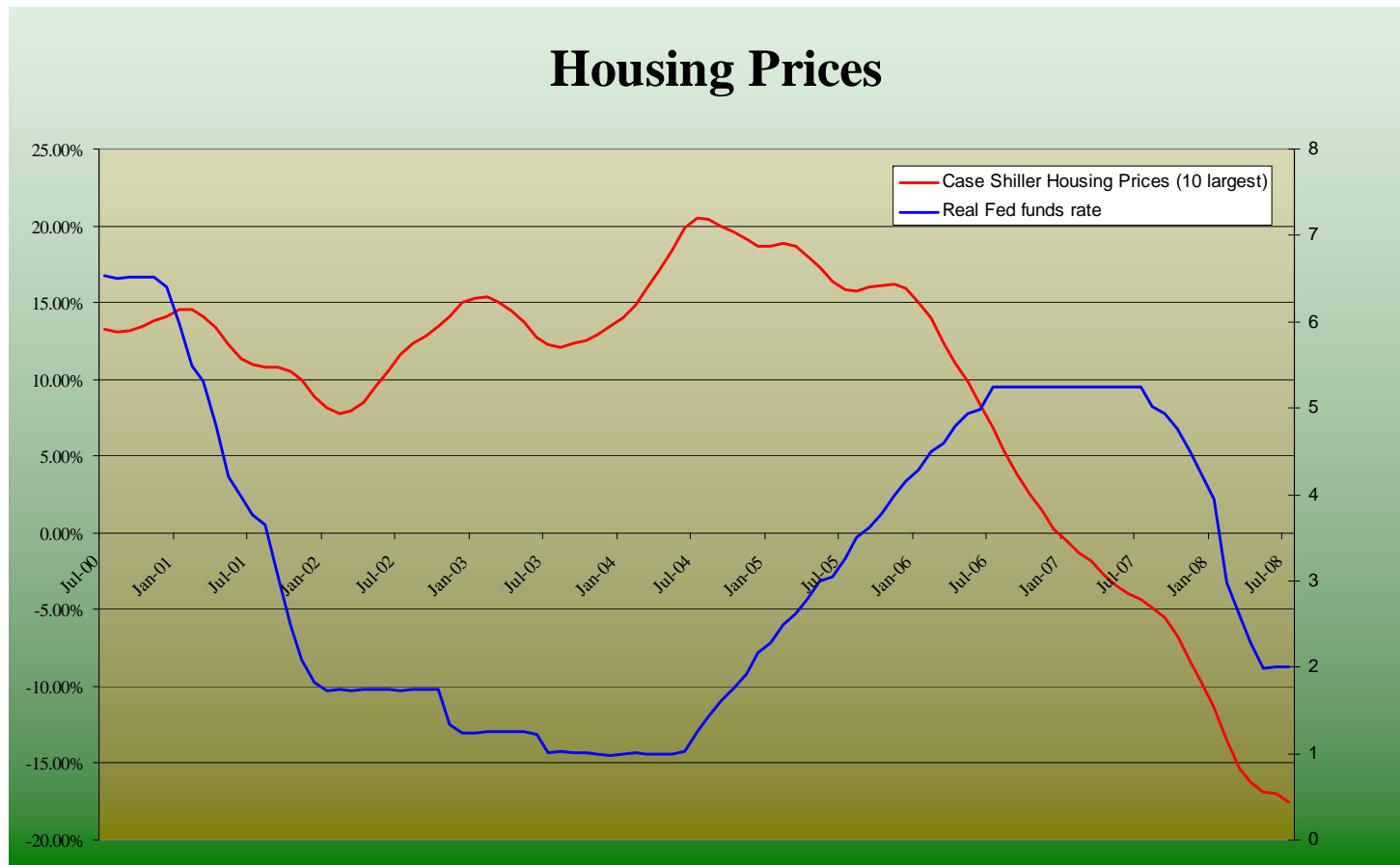
OR

- mortgages retained on bank balance sheets

Concurrently, banks (especially investment banks) increased their leverage considerably in the quest for higher yield. When you’re betting the “house’s money”, what’s the downside?

Either way, there is higher exposure partially through questionable assets and partially through increased leverage on the part of the banking institution.

# What happened when these assets begin to decline?



When interest rates rose, the bloom came off the housing market. Mortgages that had been made during the boom with dubious origination ceased to be current.

# What went so wrong?

All of the sudden, the banks that had increased leverage to historically high levels started seeing defaults on mortgage payments (or decreased cash flow from Mortgage-Backed Securities).

They then realized their assumptions with respect to the intrinsic value of the underlying loans were faulty.

Under the new FASB regulation, these assets had to be “marked-to-market”, but there was no market for the assets. So, they began to free-fall...

... requiring banks to seek additional capital and retain that which they had. The impact being

- *minimal bank lending to consumers*
- *and, more importantly, banks ceasing lending to one another*

Since they were over-levered, an asset they thought was worth \$1 was all of the sudden worth \$.65; not a good situation when you have \$.075 in capital for each \$1 in debt.

# What else was going on?

Bailouts and other failures...

Bear, Stearnes – bailout necessary due to role as prime broker for hedge funds.

Fannie / Freddie – this over-levered pair had to be dealt with as the international holders of their paper could have launched an economic war if there had been default... we don't even want to go there.

Lehman – bankruptcy, which led to the crisis in money market accounts, which led to the crisis in commercial paper, which led to another round of crisis in overnight lending between and among banks. Yikes!

AIG – would have been allowed to fail had it not been for their extensive insurance through credit default swaps (CDS); what was supposed to be a quiet little corner of profitability reached too far into the market place when we had our “six sigma event”; again, bankruptcy would have been catastrophic.

Banks, banks and more banks...

Arranged marriages – Merrill Lynch, Morgan Stanley (?), Wachovia

Outright failures – IndyMac Bank, WAMU

The good news for prudence is that equity holders in all of the above own a significantly deteriorated position.

## Is that it?!

Government bailouts – let's all join in (contrary to popular opinion, this is not just a problem for the US).

Part of the irony is that Fannie and Freddie were at the epicenter of these issues; these institutions were a hybrid between being a public firm and a private firm, which is a recipe for disaster as the worst of both models is retained.

But, this is what our entire financial system will be for the coming three to seven year time period – a hybrid between public and private. Not by choice, but out of necessity.

# What might have happened?!

**Bloomberg.com**



## **Icelandic Stocks Drop 77% as Trading Resumes After 3-Day Halt**

By Jakob Lindstroem

Oct. 14 (Bloomberg) -- Iceland's benchmark stock index plunged 77 percent, the **biggest decline** on record, as trading resumed after a three-day suspension and the nationalization of the country's largest banks.

Kaupthing Bank hf, Glitnir Bank hf and Landsbanki Islands hf collapsed this month with **debts** equivalent to as much as 12 times the size of Iceland's economy. The three banks accounted for about 76 percent of the ICEX 15 Index's **value** prior to the nationalization.

The **OMX Iceland 15 Index** fell 2,324.45 to 680.17 as of 2:07 p.m. local time. Four of the 13 other stocks in the index didn't trade, while the six that did accounted for about 8.5 percent of the index's weighting before today.

Trading was halted since Oct. 9 after the gauge lost 30 percent in nine days as the country's financial system collapsed. Iceland started talks in Moscow today to secure an emergency loan of as much as 4 billion euros (\$5.47 billion) from Russia.

The country should seek aid from the International Monetary Fund and later apply for European Union membership and adopt the euro, Foreign Minister Ingibjorg Solrun Gisladdottir wrote in Morgunbladid on Oct. 13.

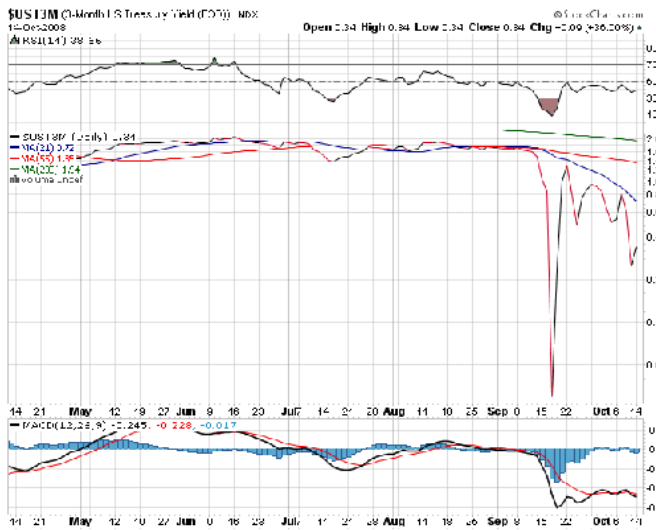
# What, exactly, has this market priced in?

	S & P	1 day	5 day	Points Daily	Cumulative
10/13/2008	1,003.35	11.58%	0.71%	104.13	(248.35)
10/10/2008	899.22	-1.18%	-14.92%	(10.70)	(352.48)
10/9/2008	909.92	-7.62%	-17.22%	(75.02)	(341.78)
10/8/2008	984.94	-1.13%	-11.61%	(11.29)	(266.76)
10/7/2008	996.23	-5.74%	-14.20%	(60.66)	(255.47)
10/6/2008	1,056.89	-3.85%	-9.26%	(42.34)	(194.81)
10/3/2008	1,099.23	-1.35%	-0.65%	(15.05)	(152.47)
10/2/2008	1,114.28	-4.03%	-8.16%	(46.78)	(137.42)
10/1/2008	1,161.06	-0.32%	-3.98%	(3.68)	(90.64)
9/30/2008	1,164.74	5.27%	-1.78%	58.32	(86.96)
9/29/2008	1,106.42	-8.81%	-6.88%	(106.85)	(145.28)
9/26/2008	1,213.27	0.34%	0.51%	4.09	(38.43)
9/25/2008	1,209.18	1.97%	-3.66%	23.31	(42.52)
9/24/2008	1,185.87	-0.20%	-1.71%	(2.35)	(65.83)
9/23/2008	1,188.22	-1.56%	2.75%	(18.87)	(63.48)
9/22/2008	1,207.09	-3.82%	-0.54%	(47.99)	(44.61)
9/19/2008	1,255.08	4.03%	5.23%	48.57	3.38
9/18/2008	1,206.51	4.33%	-3.61%	50.12	(45.19)
9/17/2008	1,156.39	-4.71%		(57.21)	(95.31)
9/16/2008	1,213.60	1.75%		20.90	(38.10)
9/15/2008	1,192.70	-4.71%		(59.00)	
9/12/2008	1,251.70				
	1,549.38				-24.55%
				1,168.99	-28.59%
	1,467.97				-20.37%
					-24.63%

Since mid-September, already over 19% off its highs, the market has provided eight days with -3.5% returns or lower.

This is not a prediction, but if we have a bear-market rally 30% from the low through the end of the year, the S & P is priced between 1150 and 1200. This remains 25% down from its high and 20% lower than the start of the year, so it is not heroic (but it would return the index to its pre-calamity end-of-September values).

# Are we oversold?



The VIX (volatility index) hit an uncharted intra-day high above 75, and the US 3 month Treasury bill – a measure of risk aversion - has offered tremendously low yields (but not as low as we saw around the time of the Bear Stearns collapse).

We continue to believe this is a massive credit cycle, but one that has reacted in the extreme due to the following:

- over-leverage by households, governments and financial institutions
- government-subsidized risk
- a lack of regulatory oversight for an increasingly complex financial system
- poor decisions made on Main Street, on Wall St. and in the nation's capital

# Where do we go from here?

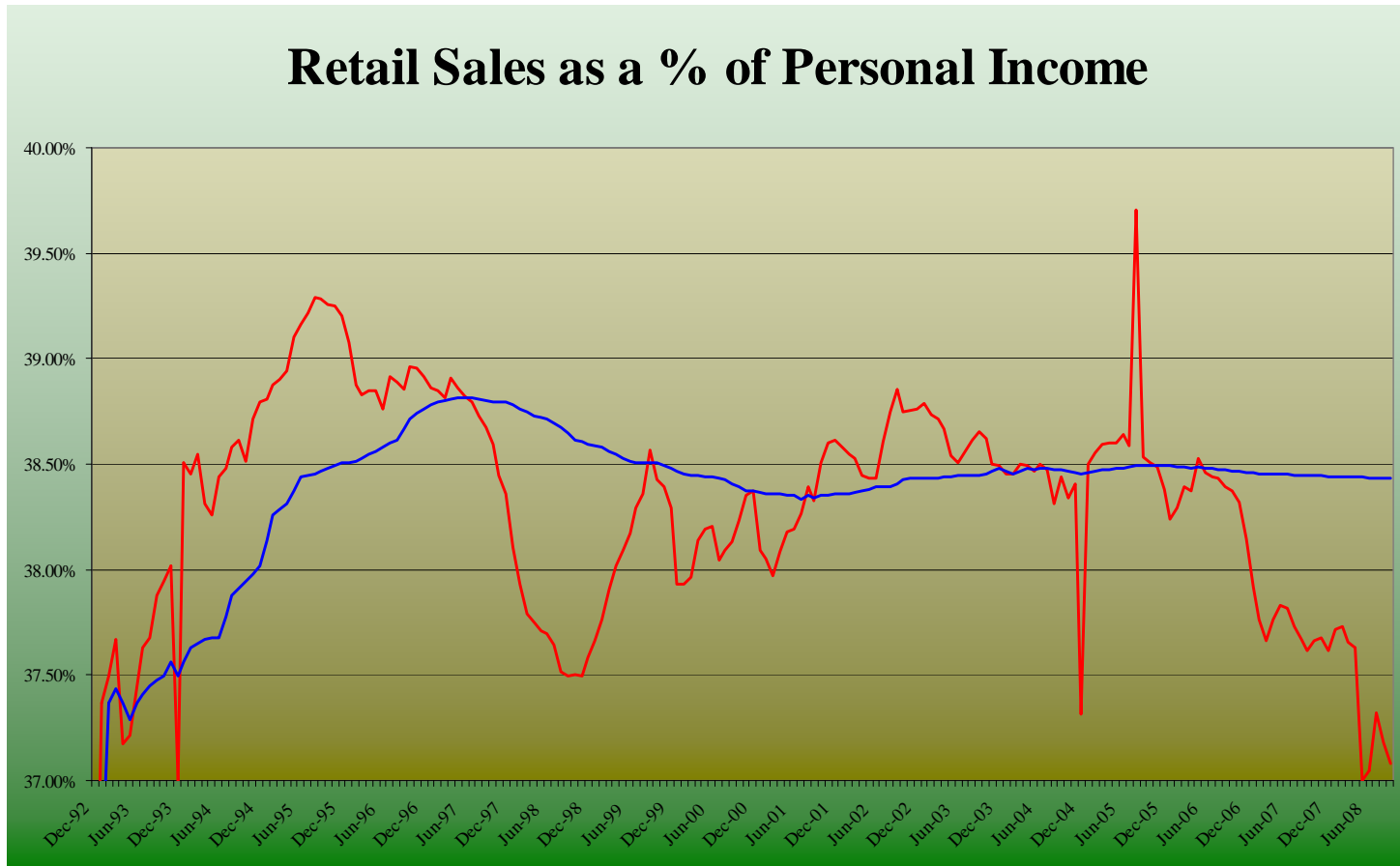
We are in the midst of a consumer recession, one in which households will change their behavior and spending habits. This will result in less “conspicuous consumption” and higher savings rates. Modify your investment portfolios accordingly.

We are also likely to experience a bear-market rally.

- oversold conditions – we will be led out by strong earnings from non-financial companies
- continued strength in the US \$ - risk premiums will increase, making the US (seen as a global safe-harbor) relatively more attractive
- looser monetary policy – as world markets (not just stock markets) have weakened, there is less potential inflationary pressure which allows for less restrictive monetary policy

*But, we are in the early stages of de-leveraging the entire economy, and this will not be a short-term process.*

*Consumption is declining*



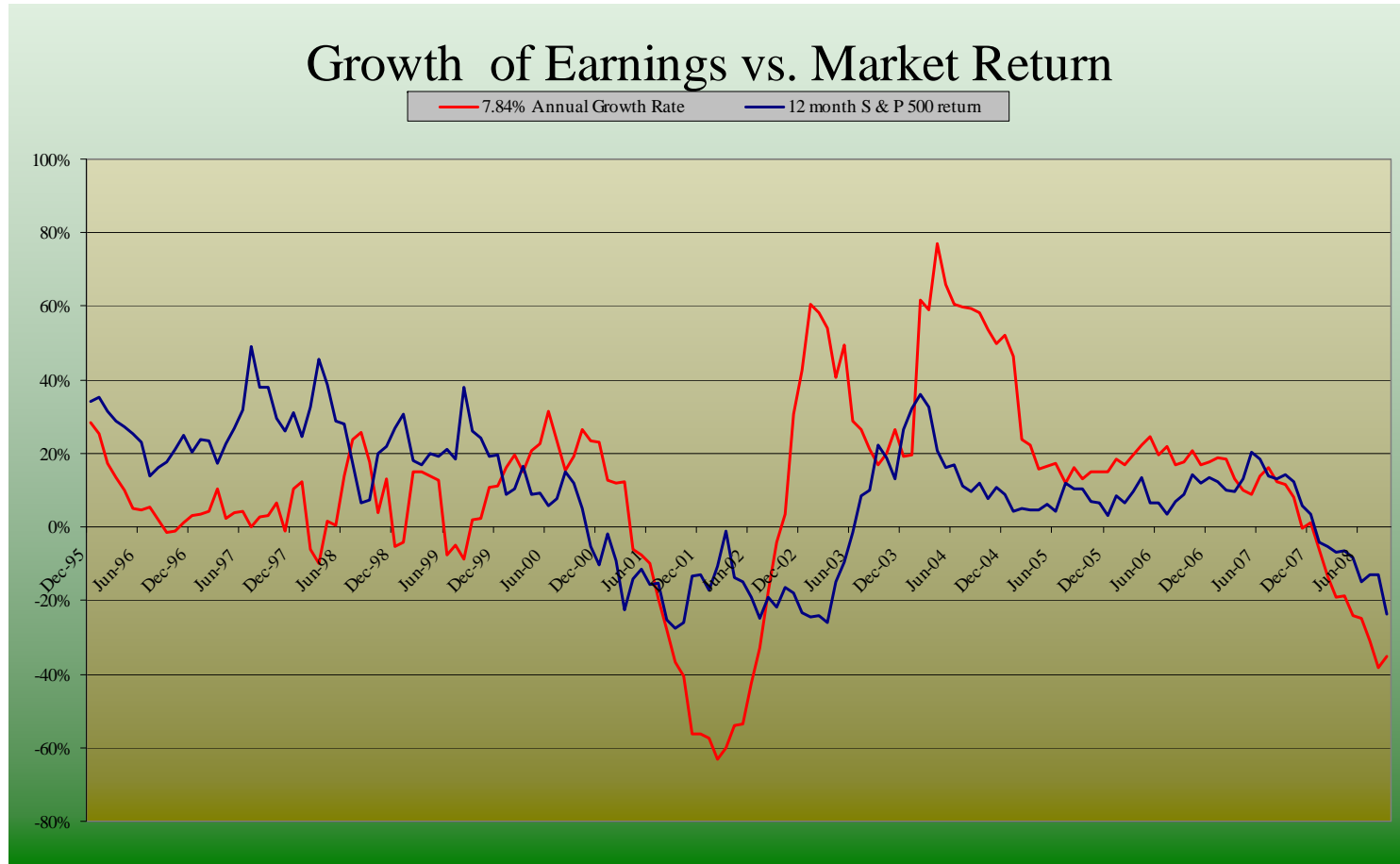
Slowing trends in consumption will move us towards the overall goal, and this is part of what is required as consumers re-calibrate their personal balance sheets. Of course, part of the trend hi-lited in the chart is no longer being able to use home equity to finance lifestyle.

*Savings rate must increase over time, but it will not be a stimulus short-term*



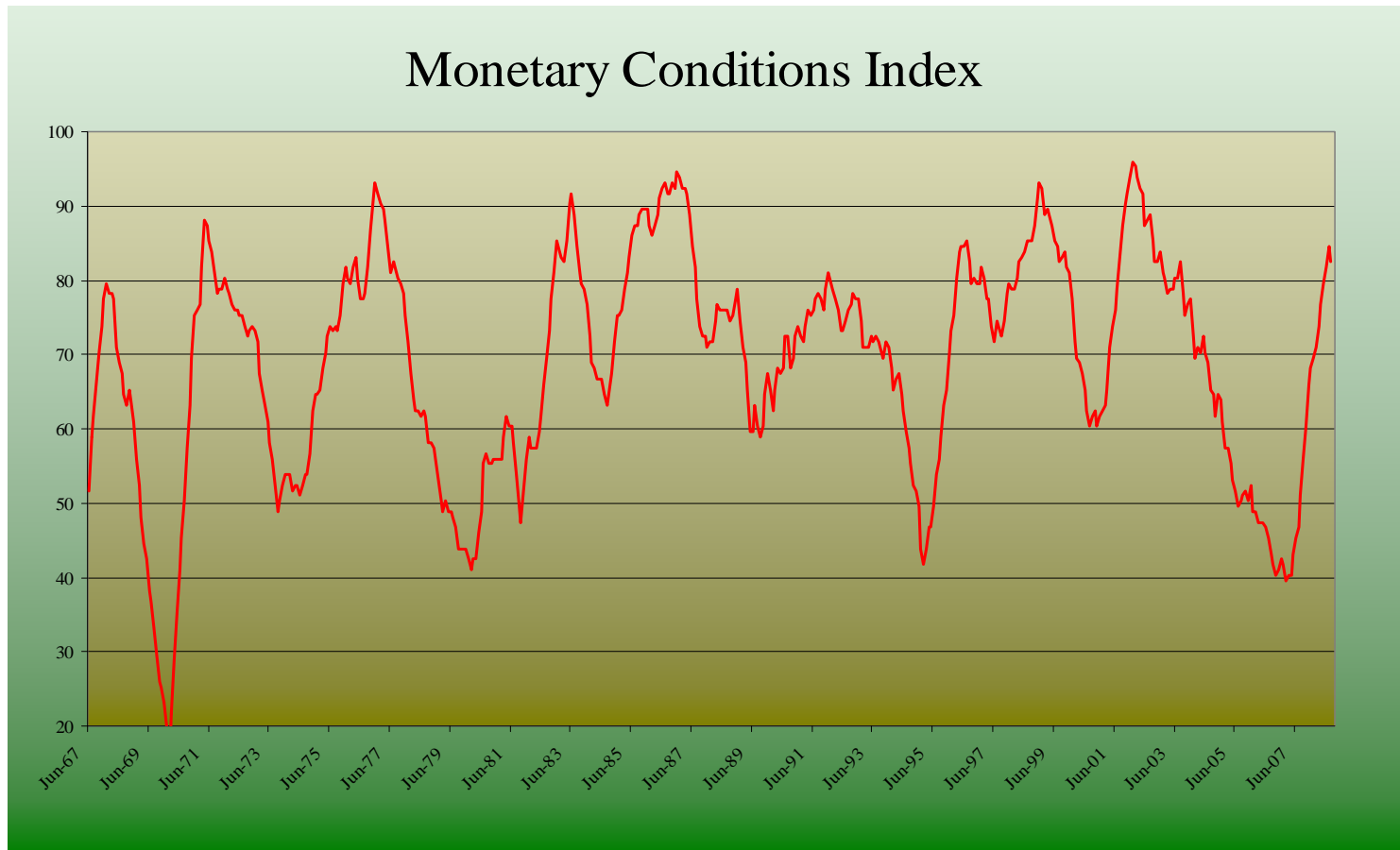
Compare the present 1% savings rate to the historical averages of 3.7% (20 year) and 6.53% (40 year).  
If it takes ten years to return to a 5% savings rate, though, that is only .5% additional savings per year which is equivalent to another \$5 billion a month being used for savings instead of consumption in aggregate. Of course, this amount has to grow over time, but it is not insurmountable.

## S & P 500 Earnings



Earnings for the S & P are down 38% from their high of \$86.90 last July to a level of \$54.09. This earnings season may lead us out as non-financial firms have posted reasonable earnings thus far this quarter.

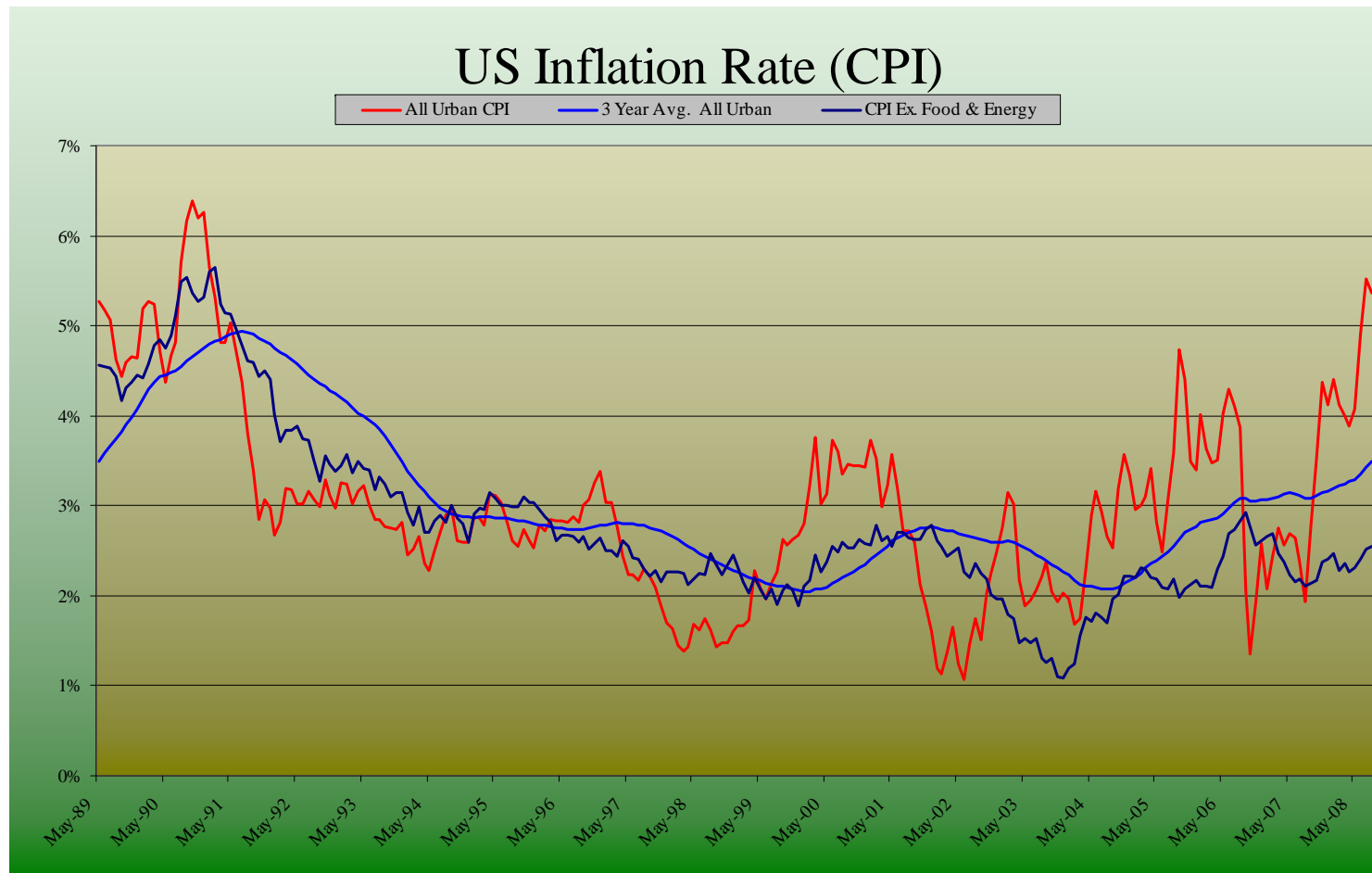
*Monetary policy – the Fed’s running out of tools.*



Monetary policy is loose, but there are few tools the Fed has left at its disposal. Year over year growth in the Adjusted Monetary base is almost 10%, and the Fed funds rate cannot go below 1%, can it?

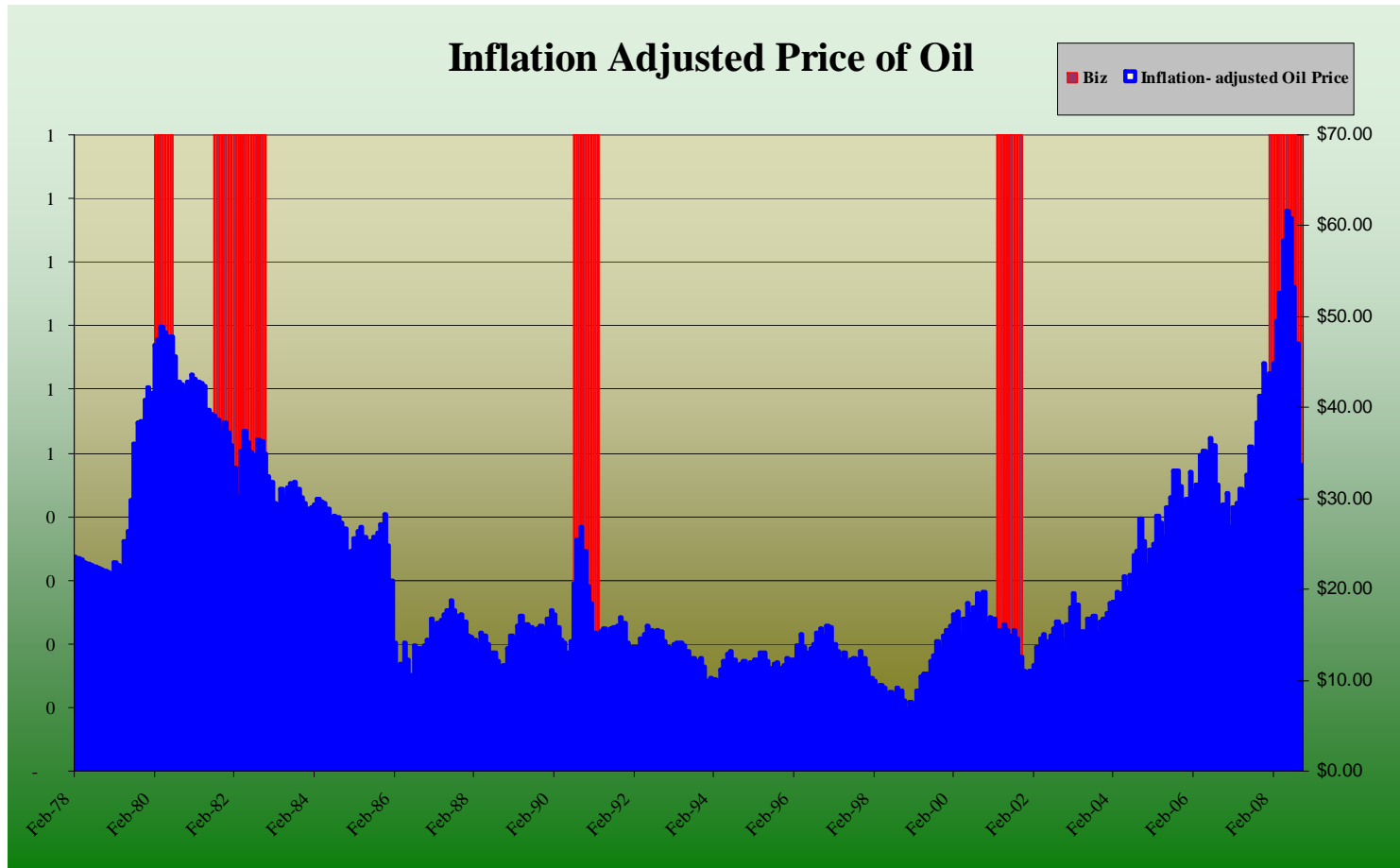
But, is some of this money recently created simply replacing money the economy has destroyed?

## *Inflation expectations*



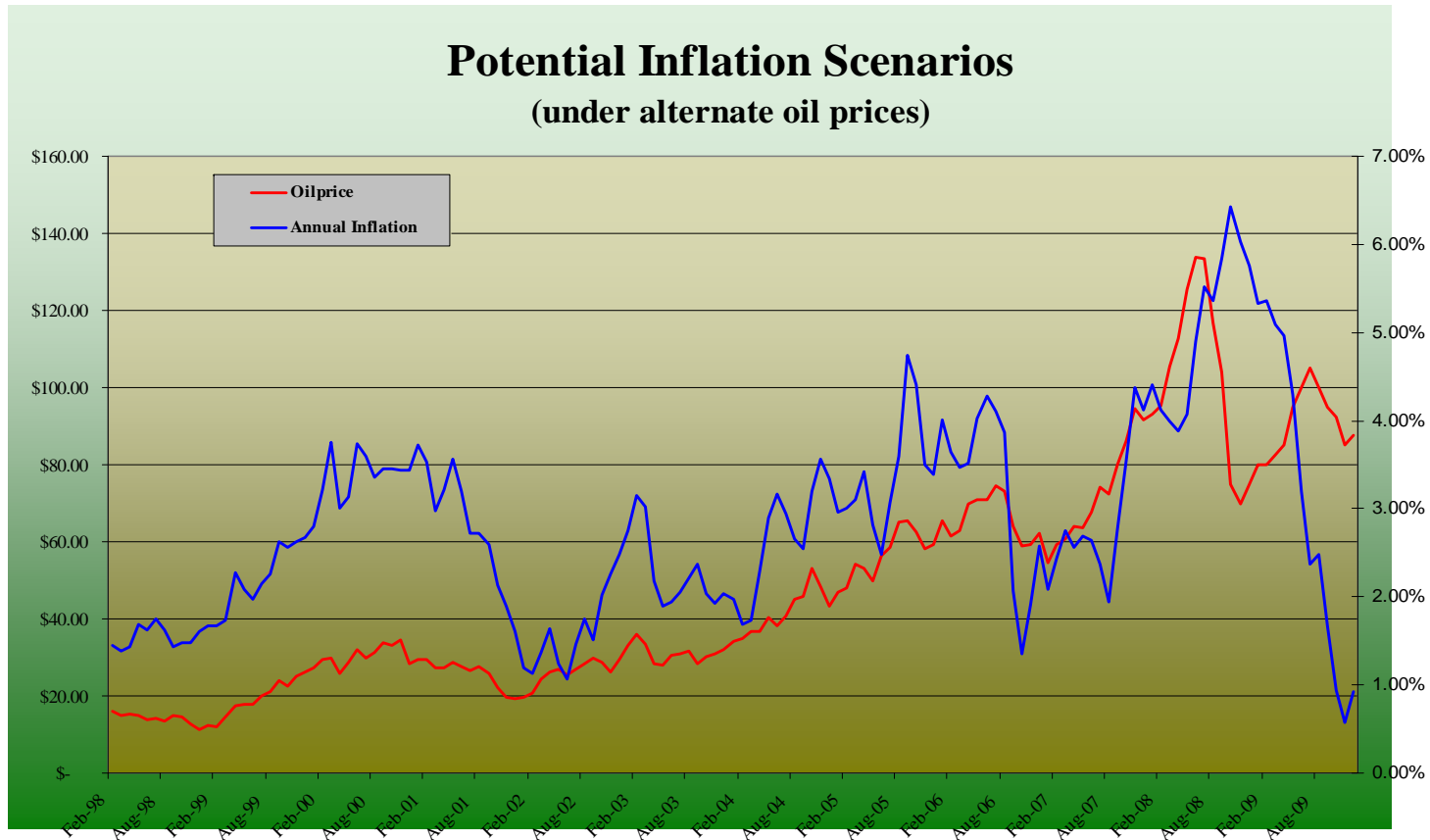
Inflation appears worse than it is, but some of these pressures should abate as petroleum prices decline.

## *Inflation expectations*



Oil is down over \$65 from its peak, and it is now within a reasonable (but still elevated) inflation-adjusted range.

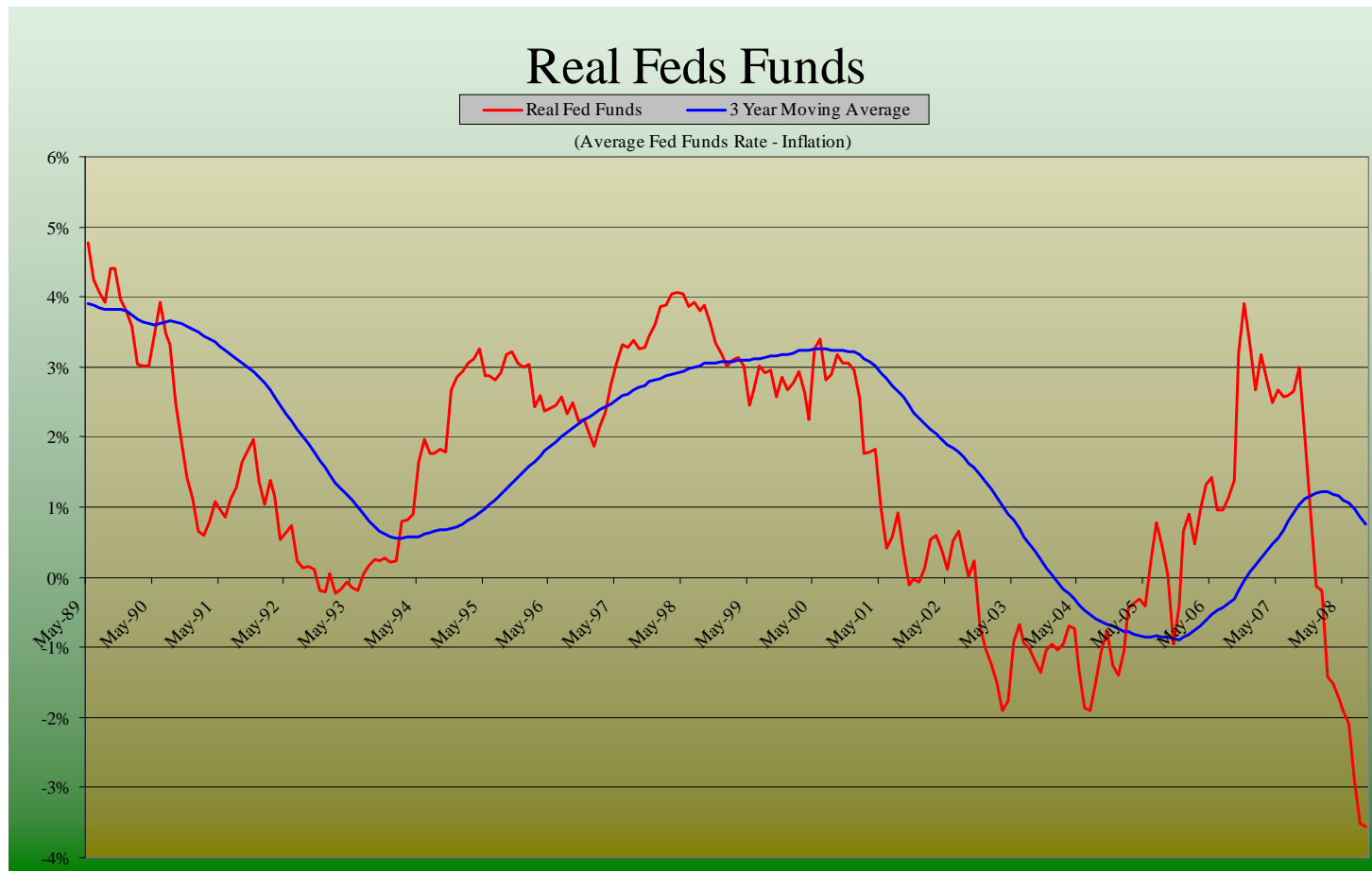
## *Inflation expectations*



Inflation has probably peaked out due to lower future petroleum prices – not necessarily a positive, since they were partially brought on by fears of a global contraction.

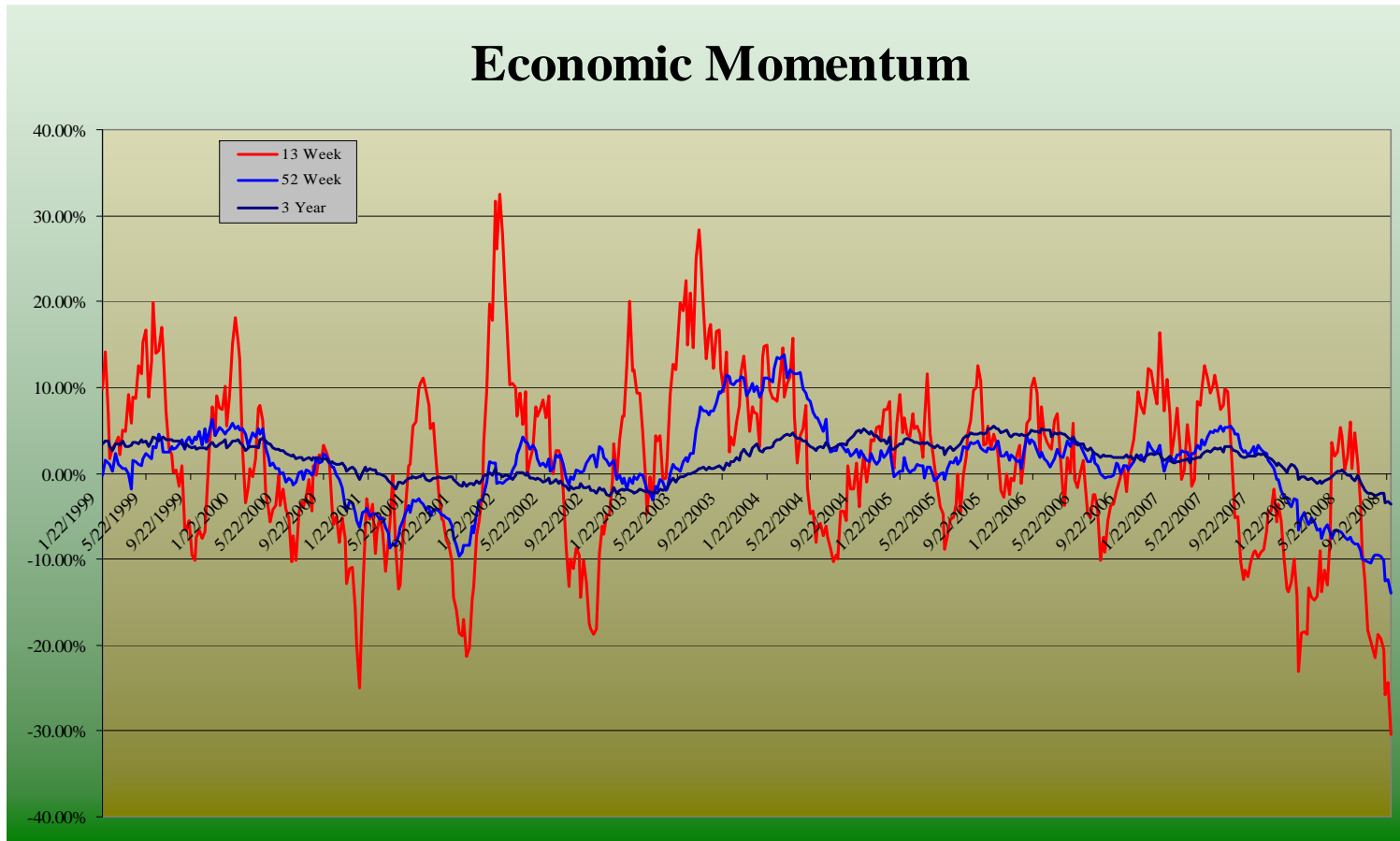
Under this set of assumptions (forecast oil prices and assumed 3.13% core rate), we are through the worst inflation. The good news is that this relieves policy makers of fear of future inflation *near-term*.

## Federal Reserve Watch



Even if inflation is over-stated, though, we have got to put some real yield on the curve and stop punishing savers before we can convince them that it's the right thing to do.

## Outlook



The worst of the crisis *may* be over, but there will likely be residual shocks that continue to impact headlines for some time.

This chart is as ugly as I've seen in my career, but realize that a heavily weighted component of the leading indicators is stock prices.

# Potential Outlook

Many challenges remain, and we will likely re-test the market lows.

But, at this point, most challenges are psychological as the market has already priced in a cataclysmic event.

My final thought is a comment I read from John Hussman, manager of the Hussman funds –

Word to the wise - don't accept advice or analysis about this crisis from anyone who *failed to anticipate it* in the first place. The people warning about Depression now (or even talking about it casually on the financial channels) are the same reckless jackasses who told investors that stocks were cheap and “resilient” at the highs.