THOMAS J. MCALLISTER, CFP
REGESTERED INVESTMENT ADVISOR

1098 TIMBER CREEK DRIVE #7, CARMEL, IN 46032
PHONE: (317) 571-1112 FAX: (317) 581-1261
TOLL FREE: (800) 663-3419

- ## One Man's Opinions - Winter 2008-2009

ONE MAN'S OPINIONS – Winter 2008-2009

Things have settled down in the markets in recent weeks. We are now seeing daily moves of .5 to 1% instead of "lurches" of 5, 6% or even more up and down, which were common a month or two ago. I believe it was necessary for things to settle down before a genuine recovery can begin. The credit system was indeed broken and on the verge of breakdown in September, 2008. We will examine what happened in the next few paragraphs, but let there be no doubt, the entire financial system was about to fail before the U. S. Government stepped in to fix it. This fixing has not been pretty, our three legged system of government is often messy, as it was in this case. But our government has the resources, and, I now believe, the will, to fix the problems.

Let us look at what happened. Until recent weeks, there were two kinds of banks, the commercial banks nearby in our communities, which most of us use, and the investment banks located in New York and in financial centers around the world. Most people did not know the difference, except they thought investment banks existed primarily for "the rich."

While ordinary citizens did not think much about the differences in the two, the government did. Seventy five years ago, in the wake of the Great Depression, Congress erected a "wall" between the two types of banks in legislation which became known as "the Glass-Steagall Act." It created the Federal Deposit Insurance Corporation (FDIC) to protect depositors of commercial banks and it forbade those banks from underwriting securities or acting as stockbrokers or dealers.

Beginning after the inflationary crunch of the early 1980s, Wall Street lobbied vigorously for the repeal of Glass-Steagall and, in 1999, succeeded. The banking industry immediately began to consolidate. Commercial banks could now turn loans into investment products and Wall Street investment banks were suddenly in the mortgage business.

A deregulated marketplace carries with it certain imperatives. It functions as it should only in the absence of criminal or stupid behavior. Laws can be passed to forbid and punish the former, but no regulations or regulators can prevent the latter, since traders in the markets, and even regulators themselves, are often stupid, at least in their actions. The "Law Of Unintended Consequences" often comes into play.

Two other changes had an important impact also. The Commodities Futures Modernization Act of 2000, transformed mortgage backed securities into a commodity, allowing them to be traded on the futures exchanges with little or no oversight by government regulators. Then, in 2004, the Securities and Exchange Commission waived its rules on leverage. Previously all broker/dealers were limited to a 12 to 1 ($12 of debt to $1 of equity, a ratio most would call very risky!). The five largest investment banks were granted an exemption from this rule, which they promptly used to lever up to 20, 30, even 40 to one! In retrospect this was an incredibly stupid thing to do, and many, including me, said so at the time. Hedge funds, which were exempt from any leverage regulations, compounded the problem by sometimes levering up to 100 to 1! Even more stupid, in my modest opinion! There is almost no room for human error or miscalculations with a 30 to 1 ratio, much less 100 to 1. So the stage was inevitably set for catastrophe. And a catastrophe was brewing.

After the "tech stock bubble" burst in 2001, the public recoiled in revulsion from common stock investments. But they immediately began to look for "next big thing" in which to place their investment dollars. Since home values had gone up virtually every year since World War II they settled on housing! In 1977 Congress passed the Community Reinvestment Act, which had as its goal extending home ownership to the largest possible number of citizens. Over the next 25 years an aggressive government enforcement of "fairness in lending" weakened bank standards on home mortgages and artificially inflated home values. In the meantime, the Federal Reserve Board reduced interest rates to near nothing while pouring more and more liquidity into the financial markets. Capital that had fled stocks found a home in residential housing.

Thanks to the Fed, commercial banks were awash with cash and started lending it to virtually anyone who asked, even those with bad credit, low income, and/or no down payment! Boy did things look rosy! The U.S. homeownership rate went from 62.1% in 1960 to 68.9% in 2006, and prices began to skyrocket, especially in California, Florida, and the east coast. Speculators "flipped" houses like crazy, often several at a time. And homeowners, encouraged by those cash rich lenders and by Congress, which took away tax deductions for all interest, except for loans against residential real estate, borrowed more and more against their rapidly rising home equity. There was no risk right? Home values could only go up, right? There was not a single down year for home prices from 1970 to 2006!

Of course the bubble had to burst, and burst it did, pricked by unrealistic prices, overbuilding, and interest rates rising as the economy heated up. Prices began to drop, while at the same time a lot of those adjustable no and low interest loans began to reset. The jig was up! Commercial bankers are not known as a reckless bunch. As mortgage standards dropped they found themselves making loans to shakier and shakier recipients. They did what any prudent conservative person would do, they hedged their bets! They moved most of their mortgages off their balance sheets.

The big Wall Street investment banks, with all that borrowed money available to them at low interest rates, had begun to "securitize" (bundle up) mortgages and other consumer debt into packages for sale to institutional and individual investors. Thus the mortgage business was largely uprooted from local commercial banks and transported

into the investment houses, which had far less restrictive requirements for reserve capital, far less regulatory oversight, and huge markups on the pools of mortgages they created (called Collateralized Mortgage Obligations or CMOs). These, in turn were sliced, diced, and repackaged into a bewildering array of securities (called "tranches") which supposedly more closely matched the risk tolerance of the investors buying them. The effect of all this was that the original mortgage was often tossed from buyer to buyer, or even split into parts. Totally gone was any local oversight of the actual market value of the underlying properties.

Wall Street decision makers are not known for their low IQs. On the contrary, these are normally extremely bright people who have a tendency to be blinded by greed and arrogance into making some very stupid moves. In this case the creators of all these various and wonderful artificial securities recognized the risks they were taking. So they invented still another entity to assume these risks called credit default swaps (CDSs). These are, in effect, an insurance policy, a way of dealing with fear, and a device for assuming the risks inherent in trading products the buyer (and the seller perhaps also) may not fully understand. Those buying the protection pay an upfront amount and yearly premiums to the protection sellers, who agree in return to cover any loss to the face value of the security. These are private two party contracts utterly devoid of any regulatory oversight. There are more than a few caveats to these nifty little documents. For one, the holder of that security, now "protected "by a CDS, may sell it to a third party, who might then protect it and sell it, and so on, creating an impossible chain of complex ownership and obligations. For another, the CDS itself might be traded in an over the counter market. And the underlying assets at some point may be partitioned into different tranches. Lastly, short sellers could and did operate on any part of the incredibly complex structure. Eventually there evolved $43 TRILLION worth of CDSs! To put this in perspective, the entire U.S. Government's annual budget is less than $4 Trillion, and the U.S. National Debt is $10 Trillion.

Now, here is the problem with this incredibly large overhang in our economy. Suppose the party providing the initial protection, having collected its upfront fee and "premiums," does not have the money to pay the insured buyer when a default occurs. Or perhaps they have gone bankrupt. The buyer finds himself left naked and alone with his loss. AIG was the biggest player in writing this protection and it is here they got in over their heads, not in their many insurance companies

When the housing bubble inevitably burst, defaults hit the relatively small sub-prime sector (less than 20% of mortgages) starting a chain reaction that raced through the derivatives market, compounding geometrically until, in the end, our entire world financial structure was facing collapse. The following are two blogs I wrote some weeks ago explaining what happened.

Blog #10 (September 20th, 2008) RULES GONE WRONG

As the Music Man would say, "We've got trouble, trouble, trouble". Much of the trouble in the U.S. financial markets has been attributed to the sub-prime mortgage meltdown. But, as a financial planner and stock market observer for more than four decades, I know that at least two other factors are weighing very heavily on financial stocks now. Both these factors have to do

with rules. In my opinion, one set of rules is too strict, the other too lax.

The first set of rules relates to banks, requiring them to do “mark to the market” accounting. These rules, launched just a few months ago, force banks (both investment and commercial banks), on their quarterly statements, to show all assets, including long term holdings, at current market value. That means that even long term home mortgages on which payments are current must be priced quarterly (as if the homes were being sold right now!). Of course such long term assets were never meant to be priced quarterly, and since home prices in general have fallen, the mortgages show up as losses on income statements. The irony is, no cash losses have occurred, because the mortgage payments are up to date and the homes are not all being sold right now! The same unreasonable rules apply to commercial real estate holdings by banks. The new regulations (part of the Sarbanes-Oxley legislation) that require this "mark to the market" are triggering unintended consequences by making the financial statements of investment banks and commercial banks appear to be in much worse condition than they truly are. In my view, Congress should immediately pass legislation suspending these “mark to the market", pending review and modification of accounting abuses. This set of rules is too strict and is hurting, not helping matters.

Just as Sarbanes-Oxley rules are "too strict", a second set of rules, this set perfectly sensible and effective, was changed last July by the SEC, regulators of the stock market. Now we have a situation where the rules are too lax, inviting some of the abusive practices that are helping drive stock prices down. This second set of rules has to do with "short sales" of stock. By way of background, a short sale is one made by a person or entity with borrowed stock. The seller borrows shares from a broker and delivers them to the purchaser's broker. The seller is betting the price of the stock will go down. (If I'm a short seller and ABC stock is now selling for $50 per share and I believe it's headed downward in price, I sell borrowed shares at $50, with the intention of buying shares at $45, delivering them to cover my sale and keeping the $5 per share profit.)

Until July of last year and going all the way back to the Great Depression, short sales could be made only on a “up-tick.", meaning at a price higher than the last transaction price. This rule kept short sellers from driving down the price of a stock by repeatedly selling it short. In the year since these very effective restrictions were removed, hedge funds and other speculators have deluged already troubled financial stocks with continued and repeated short selling. In my opinion, Congress should immediately pass legislation reinstituting the up-tick rule. In fact, as proof of what I'm saying about the need to limit short selling, just a couple of days ago the SEC put a temporary ban on short selling (whether on an up-tick or not!) on 799 different financial stocks.

Yes, we've got rules, rules, rules. Some are unreasonably strict, some overly permissive And, my friends, maybe that's the reason we've got troubles, troubles, troubles….

Blog #12 Oct. 3, 2008 What Happened?

Steve Forbes agrees with me, I was gratified to learn. And, since the CEO of Forbes Magazine is #1 among the few journalists I respect and whose work I’m careful to read thoroughly, that’s quite a compliment. Forbes’ lead comment in the Oct 6th magazine issue included five paragraphs virtually identical to my Blog #10 posted Sept. 17, in which I discussed the two underlying cause of our credit crunch. I cited the “mark to the market” rules introduced last year, and the suspension of the “uptick” requirement for short sales, and Steve Forbes thinks those

two rules are at the root of the current troubles as well.

Since my blog was posted, the US. House of Representatives had one of its worst hours in history, voting down the President's plan to rescue the credit markets. Then, on Oct. 3, the House reversed itself, but only after the Senate had attached enough "goodies" to sway sufficient representatives to switch their votes.

No economist I, but as a student of the markets and a financial planning professional in my forty-sixth career year, I am ashamed. I'm ashamed of the House, its leadership, and the members of both parties (including my own Representative Dan Burton), for voting against the rescue. Instead of doing the right thing for the country, I feel, they put their own re-election concerns first. Yes, I understand that comments from constituents were eight to one against the bill. But, remember this: in a republic, Representatives are sent to Washington to determine, collectively, what is best for the country. Secretary Paulson, Chairman Bernanke, and many other experts had clearly outlined the imminent danger facing the U.S. credit system, explaining that if our system shut down, that would shut down the world's credit system. (In fact, two large European banks have already failed as a result of our lack of rescue action.)

Great damage has been done, and it will not all be cured by this reversal. We are probably now in a recession in this country, one which could have been avoided in the same manner as the economy escaped recession last winter and spring. In fact, we have just barely avoided a depression!

In addition to the two causes Steve Forbes and I pointed out earlier, a Sept. 30 article from The New York Times shows how the problems started. (click here for the New York Times article) The Times spells out how Fannie Mae and Freddie Mac heavily promoted sub-prime lending and guaranteed risky loans. (The article is posted on my website tommcallister.com.) I'm sure you'll agree, sometimes it's hard to put sense into our Representatives!

So where are we now, and where do we go from here? The most dangerous words in Wall Street are supposed to be, "It's different this time!" I have tended to agree. Near the end of the "Tech Bubble," we heard repeatedly that "this is a new paradigm" (meaning, "it's different this time."). In previous market bubbles during my career we heard the same thing over and over: "It's different this time!" When this topic came up I always had the same answer: "Maybe you (or they) are right! Maybe human nature has changed. But it has not changed in 6000 years of recorded history, so I am betting it is NOT different this time!" And time and again this position has proven to be the correct one. The markets and the economy sorted themselves out, and stocks advanced to new highs.

Well, now I am hearing the same thing at the bottom of a very serious and deep decline. "It's different this time!" "The market and the economy will never recover from this serious failure of the U. S. financial system, it is going to drop another 50%, or more!"

Well it IS different this time! Their concerns are justifiable and understandable. We have not had a systemic failure of our credit system like this in most of our lifetimes. Major financial institutions have disappeared; still others have been swallowed up by stronger firms. It is turmoil and volatility like none of us have ever experienced. But I am betting that human nature has not changed, that stock prices have been driven down

to unsustainable levels by fear and panic on the part of investors and speculators, especially the latter. But the full power and credit of the United States government has been pledged to correct these market extremes and reenergize our financial system. It won't be pretty and it won't be efficient, but it will be done!   If human nature has changed, then perhaps the pessimists are right. I am betting it has not! I believe things will sort themselves out as they always have done; the stock market will come back to life; and the economy will resume it's long term growth over the next several years.

We are certainly in a deep recession, probably at or near the deepest part of it. Observers disagree as to when it started, but we are in it now! I anticipate a return to positive growth in the U.S. economy no earlier than the second quarter of 2009, more probably the third quarter. A grim prospect indeed, and you may rest assured the media will report every single piece of bad news in headlines. We will hear and read about more layoffs, higher unemployment, more claims, etc. etc. The incoming Obama administration will deny any fault for the situation, conveniently forgetting the year-long campaign when they, and their media supporters, talked down the economy at every turn. But they and their Democrat allies in control of the Congress are fully responsible for getting us out of this whole mess beginning Jan. 20.   The initial cabinet appointees who will execute their new policies are quality people who appear to have the necessary experience and knowledge to resolve our problems. The "fly in the ointment" is Congress. In the last two years, since they assumed control, Democrat leaders have not demonstrated a great grasp of the problems the country is facing, nor any leadership in solving them.

So far as the stock markets are concerned, I am, as usual, optimistic about the long term, two years or more. Traditionally the market discounts economic events six to twelve months in advance. If my premises are correct and the economy returns to positive growth this coming summer, the stock market should reflect this potential improvement very soon. Stocks are at bargain levels rarely seen since the Great Depression. Every money manager I know of has funds in cash waiting to be committed.   Evidence of buyers coming in the market abounds every time we see a dip.

I wish all my readers a much more Prosperous and Happy New Year. My blogs will resume Jan. 2.

Tom McAllister   800-663-3419