



The Worst Ever? When Will It Ever End?

Anyone who thinks this is the worst economic situation ever is either not very old or has a very faulty memory. However, it is an interesting moment in history, as substantial risk simultaneously exists politically, economically and in capital markets. These risks are reinforcing each other, creating abnormal levels of uncertainty.

Capital Markets Update

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In our Fall 2007 Capital Markets Update, we stated that the Great Capital Strike would take 18-24 months to resolve. We are now about nine months into this time period, and pundits like Lou Dobbs claim that this is the worst economic mess ever, that we are years from recovery, and that a long and deep recession is inevitable.

But anyone who thinks that this is the worst economic situation ever is either not very old, or has a very faulty memory. For example, the prolonged stagflation of 1973-1981 was much worse, as was the collapse of the S&L industry in 1989-1993. The combination of the collapse of the Dot-com Bubble and 9/11 destroyed far more wealth relative to GDP, as did the October 1987 stock market crash. No, today's rhetoric is a combination of poor memory and politically motivated, media-fueled verbiage.

But it is an interesting moment in history, as substantial risk simultaneously exists politically, economically and in capital markets. And these risks are reinforcing each other, creating abnormal levels of uncertainty. The wide open nature of the current political landscape is extreme as there is no incumbent telling you that "everything is all right and you need me to keep it that way."

Securitization is not the problem. People describe the current capital market crisis as if no loan had ever defaulted prior to securitization. How quickly they forget.

Have they forgotten how Brady bonds came to the rescue of the horrific bank balance sheet lending to Latin America in the 1970s? Or how the S&Ls were destroyed by balance sheet home mortgages and housing finance was rescued by RBS in the 1980s? Or that commercial real estate balance sheet loans brought the western world's financial system to its knees, only to be rescued by CMBS in the 1990s? Need we mention the disastrous balance sheet loans by Japanese lenders in the 1980s?

In each case, securitization provided liquidity where none existed and improved, though imperfect, credit underwriting via better transparency. Securitization spread the risk of poor underwriting more broadly across the financial system, reducing, though not eliminating, the risk of financial system lock-jaw. Capital costs were reduced by the more efficient risk allocation across investors.

But now securitization is being labeled the root of all evil, while balance sheet lending represents all things good. Bad underwriting, whether buried in a bank's vault until the guilty parties are safely promoted or retired or pawned off on naive fixed-income investors, results from hubris, greed and poor risk analysis conducted by fallible human beings. It is the singer, not the song; it is the book, not the cover.

Many blame the rating agencies for the current capital market mess. But the rating agencies' opinions are rightly protected by freedom of speech. Investors, not the rating agencies, are ultimately responsible for their investments. Ratings constitute just one part of a smart investor's diligence process, and it is widely known that they are paid for their opinions by the note issuers. It is up to investors to discount this phenomenon.



1970s Gas Crisis

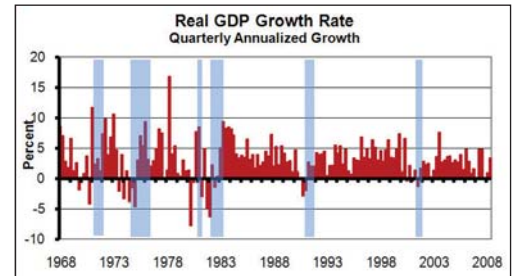


Investors who rely solely on the opinions of rating agencies are sure to lose, as these agencies do not possess the manpower or detailed data necessary to form perfect opinions. Plus, as humans, they have an uncanny record of predicting meltdowns only after they occur. The blame for poor investment decisions always lies squarely with the investors who sought extra yield without doing any extra work.

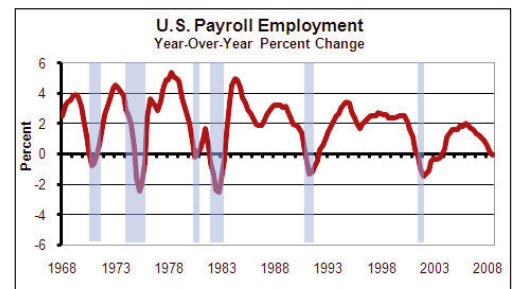


As with science and medicine, we must remind ourselves that in 10 years, today's current financial structure will be viewed as hopelessly primitive, and in 40 years, it will be considered laughable in its simplicity. This evolution is the product of constant trial and error, with each solution leading to new problems. But the financial system slowly evolves into a more efficient and liquid apparatus, and the current crisis is but another bump. It is only "the worst" because it is happening to us, rather than our ancestors. And our problems are always worse (at least to us) than those of others.

Is it the worst ever? Highly unlikely. In the 1973-1975 recession, the stock market fell by nearly 40%, real GDP fell by 3.5%, bonds tumbled as inflation soared to 12.2%, wage and price controls were widespread, banks and thrifts ceased lending, a sitting President was about to resign due to scandals and we would soon have a President elected by a handful of Michigan voters.



In 1981, the Fed Funds rate stood at 17%, bond prices were crushed by runaway inflation, the stock market had fallen by 23% (from already low levels), real GDP plummeted by 2.5%, unemployment peaked at 10.7%, and lenders had virtually ceased all lending, while in 1987 wealth equal to 10% of GDP was lost in two days in October as the stock market fell 25%.



In the 1990-1991 recession, the U.S. housing finance system had been effectively nationalized, inflation topped 6%, a war was under way as the real price of oil went to \$54 a barrel, unemployment stood at 6.8% and GDP growth was -1.4%. And in 2001, Wall Street lay in smoldering ruins along with the Pentagon, the Tech Wreck had wiped out wealth equal to a third of GDP and a recession was under way.

"Worst Ever" U.S. Recessions Over the Past 40 Years

	Dec 1969- Nov 1970	Nov 1973- Mar 1975	Jan 1980- Mar 1980	July 1981- Nov 1982	July 1990- Mar 1991	Mar 2001- Nov 2001	Jan 2008- July 2008
Duration in Months	12	17	3	17	9	9	6
Change in GDP (%)	-0.4%	-3.5%	1.3%	-2.7%	-1.4%	-0.2%	1.3%
Change in Payroll Employment (%)	-1.2%	-1.6%	0.2%	-3.1%	-1.1%	-1.2%	-0.3%
Change in Real Household Net Worth (%)	1.7%	-10.1%	-1.8%	-1.4%	-3.5%	-3.4%	0.2%
Change in Auto Sales (%)	-29.2%	-30.4%	-15.9%	-12.5%	-15.2%	-6.2%	-5.9%
Change in Industrial Output (%)	-7.1%	-15.0%	-0.8%	-8.5%	-4.4%	-4.0%	-1.4%
Change in Real Sales by Retail Stores (%)	-2.1%	-9.5%	-4.9%	-5.1%	-5.2%	-1.3%	-1.9%
Change in Construction Contracts for C&I Buildings (%)	-37.6%	-52.2%	-21.1%	-41.3%	-25.0%	-33.6%	-28.6%
Percent Real Return in S&P 500	-23.2%	-39.9%	-12.9%	-23.2%	-16.5%	-11.3%	-10.1%
Change in Real Median Home Price (%)	-15.8%	-4.0%	-3.1%	-8.7%	-6.2%	-1.1%	-3.2%
Change in Real After Tax Profit (%)	-13.3%	-30.4%	-12.7%	-6.8%	-12.3%	-8.3%	0.5%
Lowest Consumer Confidence Level (Monthly)	72.4	57.6	62.1	65.7	65.1	88.6	59.1
Change in Housing Starts	-17.5%	-30.5%	-32.7%	-25.1%	-31.6%	2.1%	-13.7%
Highest Inflation Rate (Monthly)	6.4%	12.2%	14.6%	11.0%	6.4%	3.6%	4.9%
Highest Unemployment Rate (Monthly)	5.8%	8.3%	6.3%	10.7%	6.8%	4.8%	5.7%



Commercial real estate markets are clearly in better shape today than the early 1990s, with lower vacancy rates, higher real rents and much smaller construction pipelines. Commercial mortgage delinquency rates are miniscule, though will certainly rise if we have a recession. While real estate capital markets are hardly robust, at least loans are being made (rather than called). This litany of past woes hardly makes you nostalgic for the "good old days."

This is no way meant to lessen the severity of the Great Capital Strike. Debt markets are barely functioning, while equity values struggle under the weight of capital market, economic and political uncertainty. The imbalance between the supply and demand for housing is resulting in declining home prices, much as we predicted in 2006. At that time, we pointed out that on a national basis, home prices were 10-12% too high. We explained why it would take roughly two years for housing equilibrium to return, and that in the meantime there would be greatly reduced housing starts and little in the way of existing home sales.

The triumphant return of greed is now only nine to 15 months away. But why does this adjustment take so long? First, it takes time to collect, disperse and evaluate the relevant economic and financial data. It took several quarters before excesses were apparent. For example, most observers failed to appreciate the fact that once the Fed pushed the Fed Funds rate to 5.25%, up from 1% 18 months earlier, the required returns for long-term risk positions had to rise. Lenders responded to the artificially high short-term rate by reducing their inordinately large long-term risk positions induced by four years of a 1-1.5% Fed Funds rate.

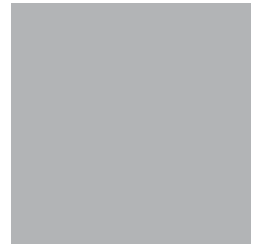
It subsequently took several months for the Fed to realize they had pushed the return for short-term safe investments too high. As a result, the Fed's interest rate cuts came far too late, beginning only in late August. These rate cuts are important as they buy time for floating rate borrowers by reducing interest burdens and recapitalizing lenders, who lower their lending rates only with a lag. Finally, low short-term rates make it diffi-

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Rank Order (7 is Worst; 1 is Best)							
Duration in Months	5	6.5	1	6.5	3.5	3.5	2
Change in GDP (%)	3	7	4	6	5	2	1
Change in Payroll (%)	4.5	6	1	7	3	4.5	2
Change in Real Household Net Worth (%)	1	7	4	3	6	5	2
Change in Auto Sales (%)	6	7	5	3	4	2	1
Change in Industrial Output (%)	5	7	1	6	4	3	2
Change in Real Sales by Retail Stores (%)	3	7	4	5	6	1	2
Change in Construction Contracts for C&I Buildings (%)	5	7	1	6	2	4	3
Percent Real Return in S&P 500	5.5	7	3	5.5	4	2	1
Change in Median Home Price (%)	7	4	2	6	5	1	3
Change in Real After Tax Profit (%)	6	7	5	2	4	3	1
Lowest Consumer Confidence Level (Monthly)	2	7	5	3	4	1	6
Change in Housing Starts	3	5	7	4	6	1	2
Highest Inflation Rate (Monthly)	3.5	6	7	5	3.5	1	2
Highest Unemployment Rate (Quarterly)	3	6	4	7	5	1	2
Total Rank Score	62.5	96.5	54	75	65	35	32
Number of Worst	1	10	2	3	0	0	0
Number of Best	1	0	4	0	0	6	4





cult for investors to remain “on strike” by simply jamming their money profitably into safe short-term investments.

As lending for long-term risk tightened, risk spreads rose, reducing the values of long-term risk assets. This caused asset sales to meet margin calls, which triggered subsequent rounds of asset sales and margin calls. In addition, underwriting errors visibly led to higher than normal early delinquency rates for sub-prime residential debt. This reinforced rising risk premiums as debt buyers worried if other long-term risk instruments were as poorly underwritten by lenders.

Exploding risk spreads reflect a capital buyers strike as traditional fixed-income investors are refusing to buy debt unless the return is so high that either no diligence is required (a steal) or until they can substantially increase their diligence efforts. But ramping up diligence takes time due to the illiquid and idiosyncratic nature of debt, particularly highly structured debt.

Meanwhile, lenders are unable to securitize their existing debt holdings, which would allow them to recycle their debt holdings for cash and permit them to make new loans except at enormous losses. But typical executives won't accept such losses on debt holdings, particularly if they believe the Great Capital Strike has caused excessive risk spreads on their loan portfolios. This situation has created lender constipation, as lenders have little capacity to issue new debt until they sell their warehoused paper, even though there is a lot of capital sitting on the sidelines.

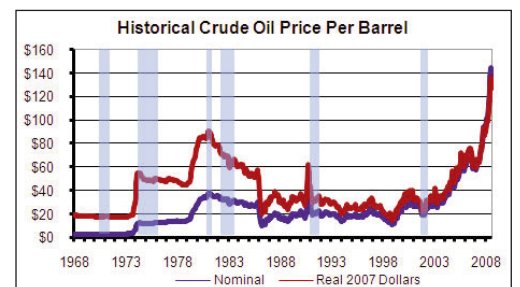
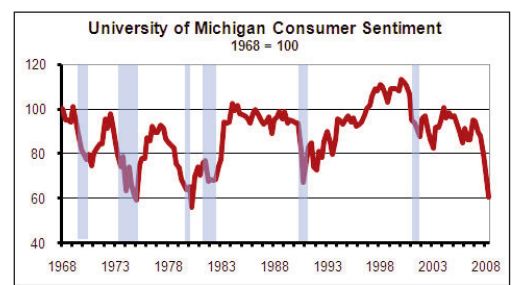
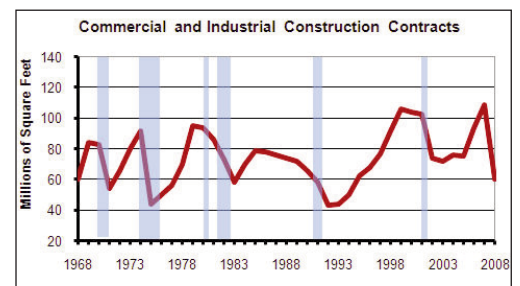
In time, this lender constipation will be relieved by a combination of:

- narrowing risk spreads as buyer diligence occurs;
- accountants forcing debt write downs (frequently to inappropriately low values), at which point the paper can profitably be sold from an accounting perspective;
- the appointment of new CEOs at debt holders, as these new CEOs will write down and sell everything possible in order to assure that accounting profits are recorded in the first couple of years on their watch;
- reducing the Fed Funds rate, which will slowly recapitalize lenders;
- lenders recapitalizing via debt, stock and preferred sales.

Each of these adjustments takes many months to occur and is necessary for lenders to have new capital for new loans. In this light, it is easy to see why we originally believed the return of greed would take 18-24 months.

Some have suggested that the Great Capital Strike will drag on, as it has for some 17 years in Japan. But more demanding U.S. corporate governance standards are causing much quicker CEO replacements. Also, far more aggressive lender recapitalization is being demanded by the U.S. regulators and shareholders than in Japan. In short, the U.S. system is far more oriented to sowing the seeds for new fortunes than to protecting the vested interests of failed borrowers and lenders.

As we feared, political efforts are saving careless borrowers at the expense of the rest of society. These efforts are not only wrong, but will also delay the adjustment process by inducing uncertainty about which ill-conceived solution will be enacted. Political





efforts to save roughly 2% of all U.S. households with delinquent mortgages are an affront to the conscientious efforts of the other 98%. Renters, who understood that they were economically unprepared to become owners just 18 months ago were called fools for renting. And homeowners, those with no mortgage at all, and those who prudently took on the additional payment burden of an amortizing fixed rate mortgage and a substantial down payment, were mocked saying, "my floating rate mortgage payment is much lower than yours." Why should anyone be forced to subsidize the "get rich quick" speculative home purchasers who are delinquent on their "can't miss" flip properties? Stated most bluntly, it is a massive mistake to bail out delinquent homeowners.

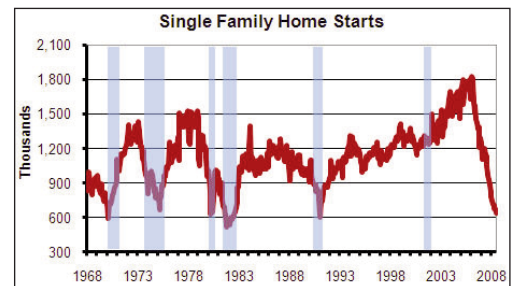
But what about the poor mortgage delinquents in Greater Ohio (Ohio, Michigan, eastern Indiana, northern Kentucky, western Pennsylvania and western New York) who are delinquent because of a severe regional recession? There are welfare programs to assist those experiencing recessionary pain. This assistance may be deemed inadequate, but the conditioning of recessionary welfare relief for a mortgage delinquent is bizarre public policy, particularly given the fact that renters (not homeowners) are the most negatively affected by recessions.

What should the government do to speed the end of the Great Capital Strike? The Fed should slash rates to 1% while simultaneously pronouncing that effective July 1, 2009, they will restore their collateral standards and increase the Fed Funds rate to 3.75%, for example. This would proclaim that the Fed remains committed to fighting inflation, and will not repeat the disastrous error of the Greenspan Fed. This policy would also tell shareholders of major debt holders that they have a year to get their houses in order before they are on their own. Of equal importance, the Fed must re-adopt a policy of public silence. Their incessant public chatter during the Bernanke era of openness is reminiscent of a faculty meeting (perhaps of the Princeton economics department) where everyone needs to demonstrate their cleverness. This openness undermines market confidence. Imagine the damage wrought by similar openness at your firm, much less the CIA, NSA or Defense Department. Fed members should remember that they are public servants, not public orators. It is essential to resume the golden silence of the Volcker and Greenspan Feds.

It has also been half jokingly suggested that Congress pass a bill that the 100 largest debt holders have 24 hours to replace their CEOs or else all board members will be publically crucified. While the new CEOs may (or may not) be better executives, they will speed asset write-downs and sales, promoting the recycling of lender capital and help end the Great Capital Strike. Of course, this policy would be unfair to most of the 100 dismissed CEOs, but even if each departing CEO received a federal severance payment of \$10 million, such a program would cost a mere \$1 billion, a small price to pay to get capital markets functioning a year sooner.

In the near term, the government should provide substantial liquidity without allowing runaway inflation to take hold, while simultaneously demanding swift lender recapitalization. Sensible policy must avoid bailing out the very small group (of above average income) mortgage delinquents. Saving "the financial system" must not be confused with subsidizing the 2% of foolish U.S. households who are not paying their mortgages.

A healthy financial system is a long-standing governmental commitment via federal deposit insurance. When this status was recently awarded to investment banks, moral hazard was created. This is because investment decisions made by banks and allowed to lever 12 to 1 are occasionally going to be wrong. No historic evidence suggests that





regulatory oversight can realistically prevent these errors. After all, both bankers and regulators make mistakes. And with high leverage, such errors mean that the government must either bail out lenders or nationalize large swathes of the financial system. While neither alternative is appetizing, bailouts are far superior to nationalization, which would lead to highly politicized lending delivered with the efficiency of the postal system. Not a pretty image.

It is important to realize that lender bailouts and the "Fed put" do not create moral hazard, they are the result of the moral hazard created by federally insured deposits. What is really needed is a prohibition of high leverage rates at insured depositories, irrespective of buyer portfolio assets.

The Fed has made up with audacity what it lacked in timeliness during the Great Capital Strike. Instead of lowering rates in February 2007, they waited until late August 2007. Even then, the cuts were too little, and rates remain higher than we prefer. But in terms of broadly extending credit, they have been both creative and aggressive. Their boldest move, which helped calm markets, was its bailout of Bear Stearns. Without Congressional action or a Presidential order, the Fed extended federal deposit insurance to an investment bank that was leveraged at least 30 to 1, and perhaps 80 to 1. Furthermore, the Fed became an equity investor in \$29 billion worth of former Bear securities. And the Fed keeps the excess yield over \$29 billion setting a dangerous precedent. Allowing Bear equity owners to realize \$1.25 billion, bails out not only Bear debt holders, but also its equity holders.

While we do not presume to second guess the Fed's decisions, they have set the stage for a troubling set of further regulatory decisions. Specifically, it is impossible to federally insure entities with debt-to-equity ratios such as Bear's, as the margin of investment error is too small. We fear that after some 60 years of slowly repealing Glass-Steagall, we are heading back to the world of the (non-economic) separation of banking and non-banking activities a mere nine years after its legal abolition. This would be a sad legacy of the Bear affair.


When calling for new and improved lender and mortgage regulations, we urge you to remember that the S&L collapse was caused by Reg. Q, the regulation of acceptable S&L investments, poor Fed inflationary policy and FIRREA. And the Great Capital Strike is attributable to the Fed's excessively low interest rate forcing lenders to take greater long term risks. Each is a vivid example of the government helping us. In short, more regulations rarely make things better.

Some readers claim that we believe that markets can do no wrong. This greatly mischaracterizes our position. We do not believe that markets function perfectly. Far too often greed, dishonesty, imperfect information and improper incentive structures (frequently created by government actions) cause markets to malfunction. But government action is not a magic wand commanded by an all-knowing, benevolent and omnipotent bureaucracy. Instead, government actions are the outcome of self-interested lobbying activity interacting with all too human government officials. A good physician knows that you do not do gastric bypass surgery just because a person is overweight. "First do no harm" should guide our approach to financial "reform." Unfortunately, we fear that election fever will make this impossible.





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