

INSIGHTS ON FRONT STREET



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Our Early Take

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Last week's extraordinary market gyrations have validated our excessive conservatism of late. The US Treasury has announced an *outline of a plan* to try to stabilize chaotic financial markets. It is important to note that the details of the reported \$700 billion plan are still being developed as we speak. However, we do have some early views about the plan's effect and how it relates to our strategy going forward.

By all accounts, the panic we detected in money market funds on Wednesday morning reached a crescendo on Thursday afternoon. Our action to move our clients' considerable cash holdings to safer ground was vindicated. The wave of fear of a "bank run" precipitated a bold reaction by the US government. It will have many ramifications.

Before delving into our views of the Treasury's plan, here is a short, simple summary of what got the US markets to this point.

Banks lent money to consumers and real estate developers and packaged them into "loan pools". The pools of loans were then sold off to investors. These investors were basically other banks, some huge agencies of the government (Fannie Mae and Freddie Mac), and also private investors. The loans were, as they say, "backed" by the value of real estate.

For years, the value of housing and land kept going up and up and up. The rising value led to extreme confidence and extremely easy lending standards. These are the ingredients of a classic boom waiting to go bust.

Because the banks basically sold off the soon-to-be-crappy loans to seemingly unthinking investors at happy and high prices, nobody seemed to care about the possibility of future losses. What could go

wrong if the collateral they lent against always went up? Didn't we all read that real estate never goes down? Well, real estate did go down and down and down and now the government is worried it will go down some more. So, they've decided to step in. Or should we say, they've decided to step "in it"?

Of course, it is more complicated than this because the bad loans were mixed into very complicated pieces and slices and turned into highly-rated investment securities. These securities go by a lot of acronyms that are mind numbing to most people (e.g. MBS, CDO, CDO² etc...)

The really odd thing is that a lot of banks originated the junky loans and successfully dumped them off with their seasoned loan officers probably wiping the sweat off their brows in total relief. Then, quite remarkably, banks proceeded to buy back other's packaged loans as investment securities for their own balance sheet. It was kind of like throwing a boom-a-rang and wondering why you got smacked upside the head a few seconds later!

As banks have felt the affects of bad investments going bad, they've had to raise capital from new investors to offset the losses. They've been doing this just to keep their bank afloat. And, *naturally*, bank stock prices fell. Rarely do forced sellers get to negotiate high prices.

Since the fundamental condition of many banks was deteriorating rapidly by the mortgage loan losses, astute investors felt quite comfortable betting against them. We think blaming this whole situation on "short sellers" is a bit overdone, by the way. They've simply been taking advantage of the poor lending standards of the past and the falling collateral values of real estate of the present.

Sure, games were being played, but that is almost always the case and diverting attention away from the core problem by finding a scapegoat to blame isn't helpful at all, in our opinion.

As these stock prices have fallen and as the government has taken over institution after institution (mostly by wiping out the old owners of these companies) it has made it nearly impossible for banks to raise new capital anymore. We all know what happens when there is no new capital to be found and more losses are on the horizon. We see more bank failures in the near future, plan or no plan.

However, something "bold" had to be done to try to slow the speed of an uncontrolled downward spiral. And, voila, "the plan" was hastily announced last Thursday. Unfortunately, as of the following Monday morning, the details are few and far between.

We know that the US Treasury plans on buying the problem loans from banks. The goal is to "clean up" their books to entice them to lend again. The price the US Treasury is willing to pay for the troubled loans is unknown at this time.

When it is all said and done, the US Treasury will have accumulated a huge pile of bad loans that they will likely have paid too much for. Otherwise, what would be the point be for banks to sell them to the US Treasury now? So, they'll overpay no doubt.

The pile of loans will be "rehabilitated" in some fashion. Eventually, renegotiated mortgage terms will likely be arranged with troubled borrowers. Unfortunately, this mortgage modification process will take a lot of time and will cost a lot of money.

Once the modifications are done, the US Treasury will take the loans they were able to repair and package them up into new pools for the financial markets to digest again. They'll probably have to wrap the pools with some kind of a government guarantee and the loans will go off into the private market again. We can be certain that proceeds the Treasury will receive will be lower than what they paid for the loans at the start. In other words,

they'll lose money. The question, exactly who will benefit from the aggregate losses; banks and/or consumers and to what degree? Congress is fighting over this right now.

The reason they are willing to do all of this is twofold. First, by buying the mortgage-related loans from the banks at higher than current market prices, the banks might not have to feel the full losses on their watch. The lower losses for banks means they'll need to raise less capital to stay solvent. This means fewer bank failures than otherwise expected and less generalized consumer fear. And, it could mean banks will become more willing to lend money to consumers again. And then...the credit crunch ends and we have a happy ending. That's the theory, at least.

The second reason is this all might, *might*, allow "on the edge" homeowners a chance to modify their mortgages and stay in their homes instead of handing in the keys. The fewer keys handed in, the fewer foreclosures on the market and the less downward price pressure we'll see on housing prices. They hope this will slow down the housing price correction in order to buy banks some more time to earn back their losses back in the meantime. All of this is meant to relieve our banking system's looming need to raise capital in order to survive. Again, this is the theory.

Admittedly, without having seen the details of the plan yet - and nobody has - we cannot know for sure its overall effect on the economy. But, to us, the path of the economy is what matters right now.

The key consideration is whether or not these actions increase the financial world's *ability and willingness* to lend to consumers and business. This is far from clear. Further, even with banks willing and able to lend again, when all is said and done in this down cycle, we seriously wonder if consumers will be willing to borrow enough to get growth going again soon. We have our doubts. Painful memories affect future behavior for a long time.

Confidence is a necessary condition in a capitalist society. This is especially true of our leverage-based capitalist system. This huge government plan was hatched in quite a hurry. As they say, the "devil's in the details". We will gladly stay hunkered down for the time being. Patience will pay.



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