CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 28, 2009

Deepening Recession And Insolvent Banks

Financial markets reflect deep pessimism about the economy, the credit system, and investment assets. All are in poor shape now and worsening by the week.

We expect a good outcome in time, but we will keep clients' capital out of the path of this avalanche of selling. Cash and high-grade bonds are fine for now. Opportunities will be at hand when things improve. Your investment capital will also be at hand.

This extraordinary recession is worsening. Housing prices continue to fall; job losses rise; much of the banking system in the United States and Europe is insolvent. The optimism that prevailed in the weeks before President Obama's inauguration has been replaced by fear that the scope of the problems may overwhelm the efforts, imagination, and resources of the Federal government and the Federal Reserve. The result has been a relentless, weeks-long erosion in stocks. In recent sessions, the Dow and the S&P fell below the low levels of the 2000 to 2002 bear market, and now trade at levels last seen in 1996, as shown in the nearby chart.

As 2009 began, Core's portfolios held very small equity investments, and large cash and high-grade bond positions. We have sold more of our equity positions this year and have added to bonds. As discussed in our last letter, at this stage of the economic cycle--that of a severe and still worsening recession--it is safe to invest in high-grade bonds issued by credit-worthy companies, and in bonds of the United States and its agencies, which now include Fannie Mae and Freddie Mac. When we see real signs of economic improvement--stabilizing prices in housing, a slower rate of job losses, for example--it will be a sign that we can invest again in riskier assets, including high yield bonds and stocks.

It is unknowable when economic improvement may come--perhaps in six months, perhaps in twelve, perhaps in a longer time. We are certain that the economy will recover in time and that the banking system will become unstuck, but we do not know when these will happen. Rather than guessing, we will observe the flow of economic reports and make our investments based on reality, rather than hunches and hopes.

By

Jack Mayberry

Solvency, Liquidity and Patience. Traders in the financial markets, the financial press, and television commentators on the scene are an impatient lot, quick to criticize the federal authorities, including the Chairman of the Federal Reserve, the former and present Treasury Secretaries, the chairs of the Congressional committees with responsibility for these matters, and the former and current Presidents. There is certainly much to criticize about policy decisions over the last decade and over the last two years. But here we are. Private investors and foreign investors, including the Sovereign Wealth

Funds, have stepped aside--for good reason. The need for capital for the banking system is far greater than can be provided by the nervous private sector. The Federal Reserve and the Treasury are the only players with sufficient capital. The press and market participants are desperate for the Fed and Treasury to put things right, but too impatient to give time to see results.

Financial markets have greeted every announcement by the Treasury with disdain and more selling. Our initial reading of last week's announcement about bank capitalization persuades us that it is comprehensive in addressing the banking and credit crisis.
Complex problems lie ahead, but the Treasury plan sets forth realistic steps to manage these matters.

It is worth considering, as one listens to the strident criticism, that some of the significant actions taken by the Fed and the Treasury have worked very well, as can now be seen. Recall the abyss into which we stared after Lehman Brothers collapsed in September. Lehman was, like most big companies, a big issuer of commercial paper for the funding of its short-term needs. Money market mutual funds were the biggest buyers of commercial paper. When Lehman failed, its commercial paper was 'impaired'--to say the least. Money funds had to write down their holdings of Lehman paper and a couple of big funds were unable to maintain the $1.00 per share net asset value of their portfolios; they 'broke the buck'. Within a few days, the commercial paper market dried up and investors began massive withdrawals from money funds. (Core joined in the exodus: we sold your holdings of Schwab's commercial paper money funds and swapped into a fund that held US treasury bills only.) The Federal Reserve, within days, guaranteed all money market fund holdings and began to buy commercial paper for the first time in its history. In short order, the commercial paper market began to function again and the stampede out of money funds ended. (We then moved back into Schwab's regular commercial paper market money funds, with their lush 1% yields.) The Fed's unprecedented and rapid action worked almost immediately and fully accomplished its purposes. Not only that, but it appears that the Fed has so far earned $1 billion on the tiny fee (about 0.01% per year) it charged money funds for its back up guarantee.

Restructuring the banking system will take time. Meanwhile, the recession spirals deeper and asset prices slip further.
As this unfolds, our investment approach is straightforward: we will stick to the safest investments--cash and high-grade bonds--until we see external and real evidence that things are on the mend. Opportunities abound. We will do very well when things turn. Until things turn, we will take very little risk with your capital.

The Fed and the Treasury have solved much of the liquidity problem: The Fed has flooded the system with dollars and, through its swap lines with foreign banks, met the demand for dollars in Europe and some other countries. (Because of the interconnectedness of the world's financial systems, things have to work outside the United States, as well as here.) The liquidity crisis has subsided--at least for now--thanks to timely and creative action by the Fed and the Treasury. The problem that remains is the solvency of the banking system. It is not an exaggeration to say that much of the banking system in the United States and Europe is functionally insolvent. And further erosion of bank capital is a certainty as housing prices continue to fall and the mortgage-backed securities on the banks' books decline further.

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There is no question of the commitment of the Fed and the Treasury to solve the solvency problem; my expectation is that the balance sheets of the Federal Reserve and the United States Treasury are big enough to provide the needed capital to our insolvent banks so that our credit system can revive itself and so that the we will have, in time, a functioning private banking system again. The elaboration of Treasury's plan, announced this week past, appears to address the problems comprehensively. However, even assuming the will and the resources to restore solvency to banks, the complexities are staggering. The derisive criticisms hurled at the officials considering and discussing approaches to square this fantastic circle are unseemly. But ours is a democracy. Full-throated criticism, responsible and irresponsible, is the way we stumble towards public resolution of complex problems.

Things will improve. Because we have very large holdings of cash and bonds, we will preserve your capital while things are bad and then earn very good returns when markets recover.

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