November 25, 2009

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

Genesis of the Crisis, Policy Response, and Aftermath

By

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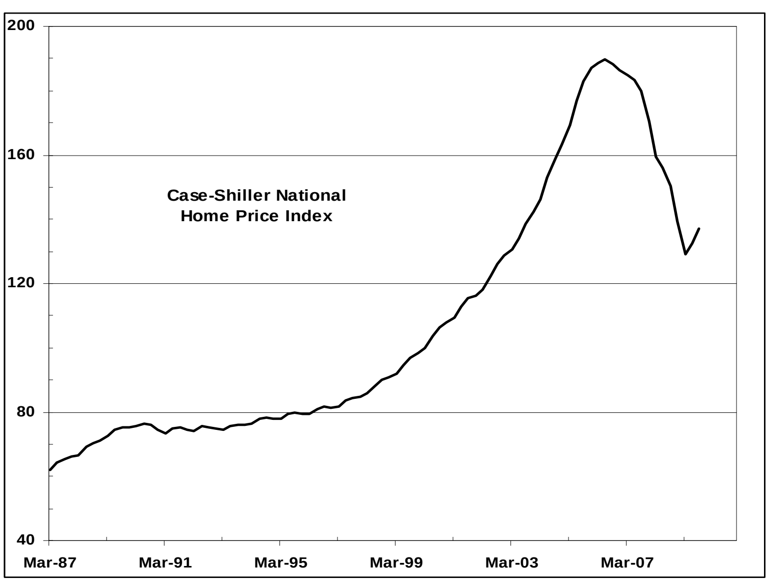
Enough time has passed to give a picture of the causes and nature of the financial crisis and the policy decisions made to deal with it. Enough time has passed for us to see some effects of these policies and to form preliminary judgments about their wisdom. In this letter and subsequent ones, we (a) examine the genesis of the crisis and its evolution, (b) consider the actions taken by governments and central banks in response to the crisis, (c) review the effects of these actions on the economy, the financial markets, the political tone of the country, and (d) put forward some ideas about what lies ahead. This letter provides a summary of these topics:

I. Introduction and Summary

A. The Genesis of the Crisis. The financial crisis flowed from a combination of factors relating to the residential real estate market in the United States and the mortgage financing practices earlier in this decade. After the bursting of the dot.com bubble of the late 1990s, the September 11th attacks, and the recession of 2001, the Federal Reserve under then-Chairman Alan Greenspan, lowered interest rates sharply and held rates down for an extended period. The aim of the monetary policy was to reflate the economy by encouraging borrowing and investment in risky assets. Residential real estate attracted a good deal of interest and investment.



Over the previous two decades, home mortgage underwriting practices had become very lax; it was easy to obtain mortgage financing to buy homes. With readily available credit, low rates, and absurdly loose lending standards, borrowed money poured into the residential real estate market. Home prices rose rapidly and steadily around the country. Wall Street's ever-imaginative financial engineers concocted new forms of securities backed by home mortgages; these securities were deemed by credit rating agencies to be of low risk. Financial institutions and investors around the world bought these exotic securities, often borrowing at low cost to buy them.

The widely-held view was that home prices, despite an unprecedented rise from the late '90s, would not suffer a year-over-year fall on a nationwide basis. Alan Greenspan took this position publicly. Respected and serious economists argued that home prices were likely to fall significantly; their warnings were given no more credence than Cassandra's. Financial incentives for banks to make mortgage loans favored the <u>quantity</u> of mortgage lending over the <u>quality</u> of loans made, so the music kept on playing--until it stopped. Housing prices peaked in 2006 and, lo and behold, began to fall. Even now, as 2009 comes to an end, home prices have barely begun to rise. As home prices fell, many homeowners

The US dollar interrupted its six-year decline during the worst of the crisis. The dollar and US Treasury bonds were seen to be safe havens as the financial system teetered.

As investors began to have confidence in the actions by the Treasury and the Fed, foreign currencies began to appreciate again against the dollar.

found their mortgage debt to be greater than the market value of their homes. As night follows day, mortgage delinquencies and foreclosures rose, followed by further house price declines. Holders of trillions in mortgage-backed securities began to suffer losses. The losses impaired the financial health of banks, investment funds, and even small countries like Hungary, Iceland and Ireland that owned these investments.

B. Evolution of the crisis. The drama unfolded in fits and starts, beginning in the summer of 2007 with the collapse of two large Bear Stearns hedge funds. As 2008 began, major banks began to report multi-billion dollar losses from their own portfolios of mortgage investments. In March 2008, Bear Stearns failed. The Federal Reserve and the Treasury Department stepped in to encourage (and to finance) the acquisition of Bear (the fifth largest US investment bank) by JP Morgan Chase. In the summer, the government effectively nationalized Fannie Mae and Freddie Mac, the two private, government-sponsored entities that bought mortgage-related securities. To prevent the collapse of the giant insurer AIG, which had mortgage-related obligations in the scores of billions, the government loaned it $80 billion, an amount that proved to be just the first-round of public support for AIG. In September 2008, Lehman Brothers failed. In emergency meetings over a tense period of days, the New York Federal Reserve Bank (then headed by Timothy Geithner) and the Treasury Department unsuccessfully sought to find a buyer for Lehman, the nation's fourth largest investment bank.

Lehman's bankruptcy created chaos among large banks and investment banks around the world that had contractual arrangements with Lehman. It raised the specter of the collapse of the financial system. It appeared that a number of the biggest US banks and investment banks, including Citigroup, Merrill Lynch, Wachovia and others, might have suffered losses so great as to render them insolvent.

C. Response by the Policy Makers. Well before Lehman's collapse, the world's major central banks and governments had been closely involved in the growing crisis. Suddenly, however, with financial markets collapsing and fears of bank failures rising, the Fed and the Treasury Department began a series of actions, many continuing today, designed to stabilize the system and to provide capital to the banks. The Fed and the Treasury took the view that financial collapse must be averted at all costs; the consequences of failure were thought to be a world-wide economic depression and severe deflation.

What unfolded was a stream of new programs to support the tottering capital structures of formerly mighty banks and to maintain the functioning of key credit and capital markets. The Fed and Treasury directly injected capital into various institutions, generally involving tens and hundreds of billions of dollars. Perhaps of greater significance was the extension of credit guarantees by the Fed and the Treasury. As 2008 ended, major banks were permitted to raise capital by issuing debt guaranteed by the full faith and credit of the United States. When 2008 began, the Federal Reserve held assets of about $800 billion, almost all of it in US Treasury notes and bonds. In the months after Lehman's collapse, the Fed's assets nearly tripled to more than $2 trillion, as it loaned money to banks, secured by the very mortgage-backed securities that were causing such havoc. In effect, the Treasury and the Fed took upon the public's balance sheet enormous quantities of impaired mortgage-related assets and provided banks with high-quality assets to replace the toxic assets.

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D. Public Ownership of the Banking Industry. The Federal Reserve and the administration's policy makers made another very consequential decision as the crisis deepened:

in addition to providing financial and credit support (effectively limited only by the resources of the United States), it was determined that the United States would not take majority ownership of large banks. The Bush administration in its last months was consistent about this; Congress was consistent about this; the Federal Reserve was consistent about this; the Obama administration, when it took office, remains consistent about this. In exchange for contributing hundreds of billions of direct capital and for granting the credit of the United States to banks issuing debt to the public, the Treasury and the Fed accepted small equity shareholdings, quite dodgy packages of sub-prime, mortgaged-backed securities, and warrants and other securities convertible into small equity stakes in these institutions. Banks and other private investment institutions made reckless investments that destroyed their capital bases and imperiled the world's economies. The Treasury and the Fed extended the nation's public resources to make up these losses, but, for political and ideological reasons, refused to take ownership of the banks. (There are individual exceptions to this general pattern: the United States is now the majority shareholder of AIG, for example.)

The large increase in profits of some major banks and expectations for major bonuses for many bankers has created a real backlash of political anger. If bankers caused the problems that have put so many out of jobs and homes, how can million dollar bonuses be justified?

Anger against policy makers for favoring banks and bankers makes it much more difficult politically for the federal government to enact necessary economic stimulus.

E. Effects on Financial Markets. In the month's after Lehman's collapse, through the end of the Bush administration and well into Obama's, the Fed, the Treasury Department, and Congress initiated and expanded the many and varied programs to support the financial system. For six months after the Lehman bankruptcy, financial markets were in utter turmoil. Virtually all investment assets plunged in value. (Essentially only the dollar and US Treasury bills, notes and bonds gained in value. These were the only safe havens.) There were considerable doubts about the likelihood of success of efforts by governments and central banks to forestall disaster.

The low point in major financial markets was in March. In the months that followed, came the realization that the resources of the central banks and the rich countries were, indeed, sufficient to prevent the financial system collapse. Market participants became convinced of the resolve of policy makers to restore the functioning to banking and credit markets. Investment assets had been priced for Armageddon, as the saying was, in the winter. As confidence returned, stock, bond and commodity prices rose to levels consistent with the state of the world's economy, that is, with a very serious recession. As investors absorbed the significance of the Fed's resolve to maintain exceptionally stimulative monetary conditions for an "extended period," funds have poured into risky assets and prices have risen sharply. The dollar, which appreciated in value against major currencies by 24% during the crisis, resumed its long-running decline.

The change in consumer spending and saving patterns may be a long-term effect of the housing price collapse and the recession. Americans may spend less and save more for a long time to come. Because consumer spending has been such a large part of the US economy, we may see slower growth than in previous years.

The composition of the US economy may change: with a lower value to the US dollar, US exports may rise and the industrial side of the economy may become larger.

F. Effects on the Economy. In addition to support for the banking system and the credit markets, a series of public initiatives was undertaken to provide support for the stricken economy. As prices of homes and investment assets fell, individuals in the United States changed their spending and saving practices on a dime. By the middle of this decade, US individuals were spending more than they earned. Consumers used borrowed money, often from mortgages, to fund purchases. In a short time during the crisis, the US savings rate ran from negative 2.1% of gross domestic product to positive 6.2% of GDP, a remarkable 8.3% swing to frugality. The private sector in the United States cut spending to repair balance sheets impaired by falling home prices and declines in securities portfolios. With the concomitant loss of jobs, consumer spending contracted. The corporate sector hoarded cash as well, by cutting capital spending and reducing payrolls. The demand for credit from that private sector shrank. Into this void stepped the federal government. The stimulus package enacted in the early months of this year is to provide some $700 billion in new federal spending. This $700 billion in new federal spending, stretched over more than a year, will not nearly make up for the decline in spending by people and businesses, but it is only the Federal Government that can act on this scale to restore economic growth.

The revised third quarter GDP report indicated that the economy expanded over the summer by 2.8%. However, it appears that the private sector's contribution to economic activity was essentially flat; federal stimulus spending accounted for all the economy's growth. It is quite likely that without significant emergency federal spending, the economy would shrink further into deep recession with terrible human consequences. Thus, although the collapse of the banking and financial system appears to have been averted by extraordinary actions by the Fed and the government, the real economy is still in very grim condition. We are a long way from self-sustaining economic growth.

The Fed's extraordinarily stimulative monetary policy provides real support for financial markets. Although the real economy remains quite weak, financial market conditions are strong.

G. Political Effects. Bank profits in the last months have been very strong, flowing from two sources: Trading profits have benefited from consistent and large price changes in many tradable assets. Additionally, banks have used funds borrowed from the Fed (at essentially no cost) to purchase higher yielding securities. Given the very low cost of funds and the significant leverage banks can employ, their profits have been high. In effect, banks' high profits meet one of the explicit goals of Fed and Treasury support for banks, namely the rebuilding of bank balance sheets after the losses of the last two years.

Of course, the principal public function of banks--and a principal reason for their rescue in the last year--is their lending to private businesses. Banks' provision of capital to the nation's private businesses permits businesses to maintain and develop their activities. The unhappy fact, however, is that bank lending is far lower now than it was before the financial crisis arose. Underwriting standards are much more rigorous than previously; it is far tougher for all but the biggest and financially strongest business to obtain financing from banks. It is also the case that loan demand is lower now in the recession, than during the mid-decade period of expansion. It is unclear whether it is tighter lending standards or reduced loan demand that is the primary cause of the decline in lending. The result, however, is that bank capital is being used less for lending and more for trading and leveraged investment in high yielding securities.

The effects of rising bank profits in our still-private banking system and high compensation and bonuses to bankers during this grinding recession, with its growing ranks of jobless and homeless, are politically toxic. The acute financial crisis may be over, but the political consequences of the decision to rescue the banks without taking control of them may give rise to a different, but serious crisis.

H. What lies ahead? The resolve, imagination and resources of the central banks and governments will probably suffice to recapitalize the banks. The credit markets, which had essentially stopped functioning in September 2008, have come back to life; their crisis appears to be over. Stock markets have recovered from the depths of the late winter, encouraged by the exceptionally favorable monetary conditions provided by the Federal Reserve Board. Because the Fed has promised to maintain these very accommodative monetary conditions, investment assets will have support for an extended period. The dollar will probably continue to decline against foreign currencies, another consequence of the Fed's monetary policy and the administration's efforts to stimulate the economy.

The timing of the economy's recovery to sustainable growth in the private sector, of the resumption of strong employment growth, and of stabilization of housing prices are all quite uncertain. Because tax revenues have fallen while federal spending has been rising, federal deficits have grown to hitherto unimagined levels. When the private sector grows and borrows once again, federal borrowing must fall, or rising interest rates and inflation will be at hand. Timely action by public officials has averted the collapse of the banking and financial system, but complex problems are still before us. Their resolution is unclear.

Future letters will discuss these matters further.

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