

Market Flash: Financial Sector Unrest

Shana Orczyk
Research Analyst
Peak Financial Management

How did we get here?

The events of the past few days are a result of changes that have occurred throughout the past decade. In the late 90's we experienced a tremendous bull market. This bull market led to exuberance in the credit markets. U.S. fiscal and monetary policy loosened during this period, lenders were far more willing to extend credit because most assets were increasing in value, and they weren't concerned about the ability to recoup their investment. After the market peak in March of 2000 we saw a significant decline in the stock markets and the events of 9/11 further magnified the market correction. In an effort to provide a stimulus for consumers the Federal Reserve cut rates to their lowest levels in over 50 years. The Fed action resulted in extremely low mortgage rates. The problem with this action is that the Fed failed to react when the economy began to turn around in 2003. The Fed chose to delay any rate increase for almost 2 years. The result was that rates stayed artificially low and there was a lot of free cash around that banks were more than willing to lend even to people with risky credit. The housing bubble only magnified the issue. The result was a massive leveraging of consumer and corporate balance sheets. 18 months ago the credit markets began to show cracks in their foundation and the process of deleveraging began. This process requires the sale of assets and the ability to raise capital, which have become exceedingly difficult as the value of assets have declined and the credit markets have dried up.

Why did the government take action with Fannie and Freddie?

Fannie Mae and Freddie Mac are Government Sponsored Entities (GSE). These organizations were primarily responsible for securitizing mortgages and selling them in packaged products called Mortgage Backed Securities (MBS). Fannie and Freddie held more than 60% of this market. The government involvement should not come as a surprise to anyone, as these organizations have always had some form of government oversight on their actions. Additionally, on July 23, 2008, Congress passed the Housing Economic Recovery Act, which allowed the U.S. Treasury to make direct investments into the GSEs. The U.S. Treasury department felt it was necessary to step in and help stabilize the companies and the MBS markets resulting in 4 actions.

First, the Federal Housing Financing Authority (FHFA) acting under their congressional powers put both companies under conservatorship. This means the FHFA assumes the power as Chairman of the Board of Directors, and now has the power to control the companies' future actions.

Second, the U.S. Treasury entered into an agreement to invest up to \$100B in Senior Preferred Securities of the GSEs. It is important to note that this investment is only triggered if the GAAP (Generally Accepted Accounting Principles) net worth of the company were to go negative. At this time both Fannie and Freddie are positively valued. This agreement exists in perpetuity and is designed to ensure the stability of capital flows into the companies.

Third, the U.S. Treasury announced that they would become a direct purchaser of MBS, supplementing the activities of the GSEs and providing a stabilizer in the MBS market.

Fourth, the U.S. Treasury established a liquidity facility for the GSEs, allowing them to come to the treasury with collateral if they needed to receive emergency liquidity. The penalty rates on these loans are very high and were established as a lender of last resort.

Why did Lehman Brothers file for bankruptcy?

Lehman Brothers held over \$60B in declining real estate assets. The sale of these assets was difficult in the current market environment and resulted in huge losses for the company. Lehman was unable to raise additional capital due to the tightening credit market. Unable to raise the cash they needed to meet their debt obligations, Lehman was forced to file for bankruptcy protection.

What's going on with AIG?

As the world's largest insurance company AIG was heavily involved in the business of guaranteeing mortgage investments. The subsequent events in that market resulted in billions of dollars of losses and an inability to raise cash. In an effort to stabilize its balance sheet AIG is seeking to raise approximately \$100B in capital. They have received a \$20B "bridge" loan from the State of NY and given the systemic risk its failure presented the Federal Reserve bailed out the firm by offering \$85B and received an 80% stake in the company.

What's going on with Morgan Stanley?

This is a perfect example of a self-fulfilling prophecy. Tuesday night Morgan Stanley beat street estimates and announced better than expected earnings. However, the turmoil on Wall Street and investor panic is resulting in a sell-off in the stock, and as of this moment the stock is down almost 50%. The problem is that a company that is as healthy as Morgan Stanley can still be taken down by the steep decline in their stock. Remember a company can raise capital in two ways: issuing debt (through bonds) or issuing shares of stock. The value of the stock effects the Shareholder's Equity portion of the balance sheet ($Assets + Liabilities = Shareholder's\ equity$) and thus a self off of this magnitude can still effect the company's ability to pay its outstanding obligations as the E part of the Debt/Equity ratio declines in value.

Are my FDIC insured accounts really in trouble?

Earlier this week many headlines warned of the impending danger that FDIC could not fulfill its obligation on the accounts it covered. In our opinion this report was incredibly irresponsible. FDIC was established in 1933 to preserve and promote consumer confidence in the U.S. banking system. It insures up to \$100,000 per account (\$200,000 per couple) per participating bank. Since it was established in 1933 no depositor has ever lost money in FDIC insured accounts. The major news organizations reported yesterday that the FDIC account balance was not sufficient to cover the failure of the banking system. While this may be true it is important to note that most depositors hold their accounts with major banks like Bank of America or JPMorgan. These banks are not experiencing the cash crunch of other financial firms, as illustrated by their recent purchases of Merrill Lynch and Bear Sterns respectively. In addition, if the worst-case scenario was to occur and all the FDIC insured deposits were to be in danger the U.S. government would provide the additional funds necessary to cover the shortfall. FDIC was established as a promise by the U.S. government to the U.S. people. Our elected officials understand the ramifications of its failure; they would not allow that promise to be broken under any circumstances.

So what now?

We completely understand the concern investors feel today, like you, we also have money invested in the stock market. Now is not the time to be emotional. Remember we've been through these types of crises before. Many people are suggesting that we are heading for another great depression, but our current climate is nowhere near as dire as the one that existed in October of 1929. Today our economy is fundamentally stronger than that of the great depression. Today we continue to see positive earnings from 8 of the 9 GIC sectors in the S&P 500. We are far less reliant on the manufacturing sector today, and companies did not allow the market exuberance affect their own spending policies. Inventories are at low levels, we have not

seen a sharp increase in capital expenditures over the past 5 years, and hiring levels remained stable during the most recent market peak. In contrast to 1929 we have the safety measure provided by the FDIC and the Treasury department and Federal Reserve are far more engaged in the financial markets. Its easy to get emotional about the events of the past few weeks, but remember throughout its nearly 100 year history, the stock market has gone up far more often then it has gone down. Also remember that with every market decline comes incredible opportunity. The markets are very cheap right now and many stocks are being sold indiscriminately due to the panic. As with any purchase we want to buy what is on sale. This means that as investors we should be buyers of quality companies at bargain prices. Historically buying during periods of volatility and turmoil results in the best returns for investors, but most investors fail to experience these gains because they trade on emotion. Stay disciplined when you invest, remember to stay diversified, and take a deep breath. The road ahead may be rocky, but for the investor who views this market as an opportunity the future should be very bright.