NBZ Quarterly Review

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On July 19, the Dow Jones Industrial average closed at a record high of 14,000, a 12.33% increase for the year. Economic growth had resumed in the second quarter, retail sales were rebounding, unemployment was low and inflation seemed to be in check. Less than a month later, the Dow lost 1,154 points (8.24%), the world was in full panic mode, and commentators (Jim Cramer especially) were begging / demanding that the Fed do something. Finally, on Friday August 16th the Fed did do something. They lowered the "discount" rate and extended the time banks could borrow money from the government from one day to 30 days. The markets came roaring back and investors took a deep breath.

In this special report, we'll explore what went wrong, what the Fed's actions mean and what you should do now with your investments.

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A Minsky Moment

Stability breeds instability. So said Hyman Minsky, a little known economist who died in 1996 at the age of 77. Minsky taught that the longer times are good, the more risk investors take on. Eventually they take on too much risk and too much leverage. When an outside event occurs that reduces the value of their assets, lenders call in their loans and customers demand redemptions. Investors and funds are then forced to sell both speculative and non-speculative positions to meet their cash requirements. This puts downward pressure on the value of all assets until markets crash and the public panics.

This situation has been called a "Minsky moment". The world's financial markets had a Minsky moment last week. As the table below shows, there were few places to hide. Asset allocation and diversification could not protect most investors from the panic emotion. Bonds were a safe haven, relatively speaking, but large-cap stocks, small-cap stocks and international stocks all fell by 8% to 12%. Economists who knew Minsky said that he would have approved of the Fed's rescue efforts, but that he would have worried that speculators would return to the market too soon.

Index	Type	Return at high of year	Return from high to low
New York Stock Exchange	Broad market	11.84	-11.09
S&P 500	500 large US companies	9.52	-9.40
Dow 30 Industrials	Industrial blue chips	12.33	-8.24
Nasdaq Composite	Index with large tech exposure	12.63	-9.89
Russell 2000	Small company stocks	8.63	-12.21
Morgan Stanley EAFE	International stocks	14.20	-11.58
Lehman Govt / Corp Bond	Intermediate term bonds	1.51	-0.84

What Went Wrong?

Everyone knows that the "subprime mess" is the cause for all the financial turmoil. But how did some bad mortgage loans in the US lead to a liquidity panic and a worldwide stock market collapse? There are many pieces to the puzzle, and we'll start at the beginning. (John Mauldin's weekly newsletters were an invaluable resource in researching this article. I encourage you to sign up for his free newsletter service at frontlinethoughts.com/subsribe.asp.)

Asset Based Securities

In simpler times (pre 1990s), homeowners borrowed from their local bank or savings and loan. Corporations also borrowed from banks or sold bonds. This worked well, but was limiting to the financial institutions and the economy. Banks could only lend up to their total deposits. In the early 1990s, though, a new type of security called an Asset Backed Security (ABS) was created. Investment banks would pool a group of mortgages or car loans or business loans and create a security. The security could then be sold to individuals, pension funds and other institutions. The buyers of the security received a higher rate of interest than they could from government loans or deposits at the bank. The banks were able to keep the fees on the loans but not take any credit risk or tie up their deposits. This concept worked very well and is partially responsible for the growth in our economy and the world.

There was only one catch. Before anyone would buy an ABS, they had to know the likelihood of repayment. Enter the ratings agencies like S&P, Moody's and Fitch. Based on the underlying loans in each security, the ratings agencies would determine the credit quality and issue a rating. Risk averse buyers would stick to AAA rated deals and aggressive investors would buy the lower rated deals. So far, so good.

In any group of several hundred loans, some would default. In order to preserve an AAA rating, an investment bank divided the overall deal into smaller chunks called tranches. The first tranch might consist of the first 50% of principal paid on the entire group of loans. In order for an investor to lose money, 50% of the loans would have to default. This tranch would get the coveted AAA rating and also receive a relatively low interest rate. The next tranch might get the next 30% of principal payments and receive a lower credit rating but a higher interest rate. Buyers could choose exactly what risk level and return they wanted.

Stretching Too Far

In the early part of this decade, housing prices began to rise and then accelerate. Real estate appreciation seemed endless and everyone wanted a piece of the action. Some borrowers had bad credit, however, and couldn't get a traditional mortgage. They had to get a "subprime" loan. These loans generally carried higher interest rates and monthly payments, but so what? The underlying real estate could only increase in value and as long as you could afford the payments you would come out ahead. At first subprime loans required sufficient downpayments and proof of income like any other mortgage. In 2004-2005, lending standards began to change. New "no doc" loans became prevalent where no documentation of your income was required. Exploding ARM's also were created. A low teaser rate was offered on a mortgage that reset in two years at a much higher amount. Monthly mortgage payments could rise 25% or more in the third year. Even worse, buyers' approval for these loans was made on the low initial rate. Next, "piggyback" loans were created that eliminated most downpayments.

So now we have a large group of people borrowing 100% of their home's purchase price, with monthly mortgage payments that will rise sharply and with no proof they have the income to repay the loans. As long as the rating agencies classified these loans properly, no problem would exist. Buyers would know they were purchasing very risky securities and pay much less than face value. Here's where things started to go terribly wrong. Somehow, no one told the rating companies that

these type of loans were more risky than the normal subprime loan with a 20% downpayment, a fixed interest rate and a source to repay (or they did tell the agencies and were ignored). The ratings agencies rated most of the loans as AAA and buyers paid AAA prices.

To make matters worse, housing prices quit rising and started to fall. As mortgage payments reset to amounts they could not afford, borrowers tried to refinance their nifty exploding ARMs to fixed rate mortgages. Most could not qualify for the new loans because their reduced house value would not support a loan large enough to repay the ARM. Many borrowers started to default on their loans. As defaults rose, banks and mortgage lenders suddenly tightened their lending standards making it even more difficult for borrowers to refinance and increasing the rate of defaults on subprime loans.

Run on the Bank

Many hedge funds, mutual funds and investment firms bought the subprime loans. In many cases, investment companies borrowed money from banks to buy the loans using the loans as collateral. When the defaults started in earnest, lenders began to reduce the value of the collateral and demanded the investment companies pay some of their loans back (a margin call). The investors were forced to sell some of their subprime loans to pay the margin call which reduced the value of the loans even more. Then one day, the subprime loans couldn't get a "bid". (When a financial instrument is for sale there is a bid and an ask price. The seller sets the ask price and the buyer sets the bid price. If no buyers set a bid price, the sellers can't sell their investment.) The liquidity crunch had begun.

It's funny how sometimes you don't know you want something until you're told you can't have it. (Free music downloads come to mind.) Sophisticated hedge fund investors suddenly wanted to redeem their investments when they learned that the hedge fund assets weren't liquid anymore. This caused a crisis for several hedge funds starting with two Bear Stearns funds. The crisis spread gradually through the subprime market, the normal mortgage market and then to all holders of asset backed securities. Banks tightened their lending standards to all borrowers including corporations. In order to provide liquidity to meet margin calls or redeem investors, investment funds began to sell any assets available. This included stocks, real estate and commodities.

All Out Panic

The purchase of subprime loans was not limited to the United States. Investors worldwide had bought billions of dollars of these loans. Once the crisis began, international investors reacted similarly to US investors. This caused disruptions in the financial markets worldwide. Corporations who funded their short-term operations with "commercial paper" (short term loans) couldn't find buyers. Nor could investment banks that had funded huge leveraged buyouts. Real AAA loans that should have yielded 6% interest were instead priced to yield 10%. Sellers wouldn't discount their bonds that much, and buyers would hardly buy anything except the safest US, German and Japanese bonds. Stock markets worldwide were tanking even though central bankers were trying to inject funds into the system. This is the situation the Fed saw on Thursday August 16th. Something dramatic had to be done or things would get really ugly.

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The Fed Steps In

On Friday August 16th, the Fed made a surprise announcement. It lowered the "discount" rate from 6.25% to 5.75% and extended the time banks could borrow money from the government from one day to 30 days. The discount rate is the interest rate that the Fed charges banks to borrow money. The more widely known "Fed Funds" rate is the interest rate that the Fed sets for money lent between banks. Normally when the Fed raises or lowers interest rates the Fed Funds rate is involved and many other consumer interest rates are affected. Immediately after the announcement the Dow Jones Industrial average jumped 300 points. While it retreated from that high by the end of the day, it still managed to gain 234 points.

Does this mean that the crisis is over and the markets will quickly rebound? Probably not. The Fed's announcement was more symbolic than substantive. It served to assure the markets that the Fed was on the case and would step in as much as necessary to restore liquidity and confidence. The Fed said in their statement, *"the Committee ... is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in the financial markets."* This suggests that if conditions do not improve quickly, the Fed may cut the Fed Funds rate. In 1998 when the world economies had a Minsky moment similar to what we've just been through, the S&P 500 dropped 19% from July 18th to August 31st. The Fed subsequently lowered rates three times in a month and a half. By the end of 1998, the S&P 500 had increased 28% from its low. The odds are that the Fed will have to cut rates before the economy and the markets regain their strength.

Should you Buy, Sell or Hold?

Even though the Fed has committed itself to mitigating the adverse effects of the disruptions in the financial markets, the market may decline even further. I don't think this is the beginning of a 2000-2002 downturn, however. The economy is generally in better shape now than it was in 2000. The market was also valued much higher in 2000 when the P/E ratio on the S&P 500 was 29.41 at the time of the market peak. Today the P/E ratio is 17.00. Remember that the Fed increased rates for the first half of 2000 and did not begin cutting rates until January 2001. There are definite good news/bad news ways to look at the markets and the intermediate term outlook (two to six months).

First the bad news. With the financial markets shaken so badly, banks have less money to lend and have suffered losses on their loan portfolios. Their earnings, which account for 26% of the S&P 500, will be sharply lower. With less to lend, the banks will constrict other economic growth causing at best a severe slowdown and at worst a mild recession. The scores of private equity deals and mergers that were responsible for a large part of the market increase over the past year are over. With mounting foreclosures and dropping house values, consumers will have less to spend and retail sales will plummet.

Now the good news. With the Fed willing to lend money to banks at a decreased rate, banks' lending operations will not be severely hurt. Payrolls are still rising as are real incomes of consumers. Since 1990, the P/E ratio of the S&P 500 has been lower than today only 13% of the time. The last time the P/E ratio was this low was the third quarter of 1995. Once confidence has returned (not if, because this is the good news section), investors will realize that the selling has been way over done and speculators will rush in to buy discounted mortgage backed bonds and beaten up stocks.

Which version of events will unfold? I think the Fed has signaled that if conditions worsen, they will cut rates which will pump liquidity into the economy and stabilize the financial markets. The next several months could be dicey though. Now is a good time to evaluate the risk in your portfolio. If you have suffered losses too large for your comfort level, you should increase your fixed income exposure and lighten up on aggressive stocks or funds. If you have cash to invest, don't try to be a hero. Dollar cost average into the market over the next few months. *Bottom line—the stock market at the end of the year should be higher than the low on August 15th.*