



## **What's Going On?**

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The market stumbled and stalled in the second half of last year as the housing problem finally started affecting the capital markets. In January the stock market went through a sharp decline as fears increased about how this weakness would affect the real economy. The credit markets seized-up big time when financial institutions attempted to sell their mortgage derivative holdings. There were no bids even at egregiously low prices. Compounding this problem, some of these institutions were leveraged up to twenty to one, financing these securities with short term debt known as repos. Repos refer to the fact that the borrower hands a debt security to the lender who holds it as collateral against funds loaned, usually for just a few months. The borrower then “repurchases” this collateral at the end of the term. Banks would lend over ninety percent of the security’s value since it was typically something considered safe, such as treasury bills. But not all were so safe; often the security “repoed” was a mortgage security, perhaps a mortgage derivative where the underlying credit was not easily known. This became known as “Toxic Waste” on Wall Street. As the credit market declined, the value of the collateral mortgage security declined, making lenders nervous. They no longer were willing to lend as much as a percent of face value as before. They demanded more collateral or wanted the borrower to pay back the loan. Margin calls became common at mortgage institutions, brokers and hedge funds. One mortgage company could not sell their warehoused mortgages for anything above ninety-five cents on the dollar. They had no earnings problems, and were making all required debt payments. It was asset prices, not cash flow that was their problem. Being leveraged twenty to one, it wiped out their equity and they promptly went bankrupt. We watched in our office as the news hit they could not meet a margin call and the stock went from \$22 a share to \$2 a share in four hours. Funds that held both mortgage paper and stocks dumped their blue chip stocks to generate cash for their margin calls. The mortgage market was now forcing a decline in the stock market. The lack of confidence in the value of these mortgage securities was the root of the credit panic and culminated with the collapse of Bear Stearns.

Why was this credit panic so severe given the relative lack of weakness in the real economy? In recent years, accounting standards have required financial institutions to carry securities on their balance sheet at current market values rather than cost. The rationale was to avoid creating “walking dead” banks, like Japan had in the nineties. Back then, bad loans and paper were not written down, giving the Japanese banks a look of capital strength. They were able to put off inevitable capital raises and dilution by



simply ignoring the problem. The new rule, however, meant that Toxic Waste had to be marked down to market in financial statements, immediately eating away at the firm's book value. This held true even though a competent management team may have viewed the only available market prices as totally irrational. The unanticipated effect of this rule was to turn big banks into sellers of distressed assets instead of buyers as they attempted to mitigate future hits to their book equity.

As the mortgage market imploded, capital flocked to money market funds and treasury bills. The resultant plummet in short rates left the Fed Funds rate way above other short term interest rates, creating tight money even though the Fed was on a gradualist approach to bringing down interest rates. Fed Funds futures declined, implying that the Fed would be lowering rates more aggressively soon. Media headlines picked up on this, declaring that Wall Street was "predicting" a substantial near term rate cut by the Fed. The Fed was outraged. "Helicopter Ben", a reference to aggressive monetary easing by throwing money out of helicopters, still felt that he needed to prove his anti-inflation bonafides. "Wall Street does not dictate Fed Policy and we are not here to bail out Wall Street at the first signs of their pain", was the basic message. The decline accelerated. Pundits started rationally suggesting that the Fed should lower rates after an economic meeting or speech, making it clear it was about protecting the economy, not Wall Street. Jim Cramer went into his now infamous tirade about how the Fed "has no idea" about the magnitude of the credit market problem. A Citibank analyst drew a picture on an interest rate chart of Bernanke playing a fiddle with flames surging up all around him. About a week later the Fed, between meetings, lowered Fed Funds 0.75%, or eighteen percent of the interest rate, the biggest percentage slash in Fed Funds I have seen in my career. On January 30<sup>th</sup>, a mere eight days later, they cut it by another 0.50%. The Citibank analyst wrote: "Helicopter pilots, start your engines." Shortly thereafter, the credit markets started clearing and functioning. Through its new Term Auction Facility and Term Securities Lending Facility, the Fed has done repos with brokerage firms, a creative and unprecedented tactic that has led trading and market liquidity to improve even more. The stock market has reacted favorably.

How have these events affected the outlook for the stock market? The stock market still wrestles with just how weak the economy and thus corporate profits will get in the near term. Though the masses are still fearful, monetary policy is now conducive to a strong stock market rise. We have yet to report negative growth and unemployment has barely ticked up from some of the lowest numbers on record. Why does the consumer feel so bad? The average American is negative on the economy because their incomes have lagged the increase in living costs like food and energy over the last year. Food and energy costs are a large percent of the average family's take home pay. They are up substantially, not because of inflationary monetary policy but because of world growth



and demand. This lag in consumer income will mute the recovery. That being said, there are several encouraging things developing.

Housing starts have plummeted, cutting off the large new supply of houses putting downward pressure on home prices. With lower interest rates, the affordability index has recovered to normal levels. The current supply on the market is still high but even that has started to trend down. The pervasive damage the housing market has done to the economy and financial markets is mostly over. It will be some time before the prices recover, but the stock market will be up thirty five percent before that happens.

The dollar is hitting new lows but the decline has been against currencies with inflation rates either higher than ours or not much less. The dollar has been in a big trading band for decades and is at the very bottom of that range. Unless our inflation rate ramps up to over ten percent, the dollar is very undervalued on a purchasing power basis. The weak dollar has been a key variable in the mitigation of our current economic decline as it has increased our exports substantially. Our exports are up sixteen percent over last year at this time. Aerospace, software, and heavy construction equipment are quite strong, along with many other industrials. Caterpillar Tractor has created an economic boom in Peoria, Illinois.

India and China continue on a strong growth pattern, representing a third of the world's population. It is important to understand that we have just entered a thirty to fifty year period where the largest percentage ever of world population will enter the middle class. This will be the world economy's strongest growth period in history. More wealth is being created as a percent of Global GDP than ever before and every economy will benefit from this. The rise of the middle class has created a huge demand for commodities. Oil, copper, steel, grain, natural gas and fertilizer have increased in real terms. This is a change in price structure that will last quite some time.

Outside of financials, corporations have remained fiscally conservative in this cycle as debt levels are generally low and cash holdings are extremely high. Commodity costs have largely been absorbed in margins by these companies, preventing a large run-up in inflation.

To be sure, there is still plenty to worry about. The commercial real estate market has just started to decline as job growth has turned negative, the key variable in office space demand. This could start a new round of write-offs at the banks. However, there was no overbuilding of these properties, unlike houses, and current delinquency rates on payments are at all-time lows. The securitized commercial mortgage market got hit



during the first quarter but has since started to strongly recover. The economy will probably start up again before the fundamentals here become a real problem.

Politics are not looking good for shareholders as pundits speculate about the likely upward direction of taxes on capital gains, dividends and interest. There does, however, seem to be bi-partisan support for lowering the tax rate on our corporations, enabling them to be more competitive on the international scene. I consider these to have offsetting effects on stock prices. Another concern is that rising protectionist sentiment could prevent the approval of trade agreements that would enable us to benefit from this strong global growth, but Washington analysts think that ultimately these agreements will pass with few changes.

The stock market currently has a lot going for it. Psychology is so negative that many market timers overly dependent on their contrarian statistics have been prematurely bullish. They will be proven right eventually though. Cash on the sidelines is enormous and the values are very reasonable compared to real estate or bonds. New stock issuance has been subdued while stock buybacks at corporations have been strong. Insiders have also become very bullish, as measured by the ratio of buyers to sellers. More recently, we have seen stocks begin to rise on bad news. Citigroup announced a \$15 billion write-off. Equity managers, looking to pick the stock off the low, figured they would buy it on the last big piece of bad news and the weakness it presented. The buyers were so pervasive, however, that the stock rose eight percent instead of falling any further. This is indicative of a market bottom. Everyone is as defensive as they feel they need to be, this writer included. Fund managers are looking to buy on weakness.

The market is in the bottoming process with the odds favoring that the lows have been seen. We may not see an explosive new bull market, but there should be fifteen to twenty percent upside over less than a year in the not-too-distant future. The most important thing is that monetary policy is once again bullish. Fed policy is the single most powerful variable affecting the stock market. The sharp declines of Fed Funds defining the January and March lows should be the turning point. The pieces are either in place or rapidly becoming so. Sit tight and prepare for improvement.