



Global Financial Markets Perspective Third Quarter 2008

Restoring Confidence in Financial Markets

One would be hard pressed to come up with a financial market scenario that is the equivalent of the greatest financial market crisis since the Great Depression in the 1930s. Yet, the third quarter of 2008 will go down in history as an equivalent. Hopefully, Congressional leadership decisions can be made that will moderate an economic crisis that would undermine long term growth and damage financial markets further.

How did this crisis happen? Blunders in regulation coupled with errant monetary policy set the stage for the panic we are experiencing in financial markets. While the focus has been on a bailout or rescue package for holders of defaulted mortgages, there is a lot more to this crisis than meets the eye. Behind the failure of the mortgage market there have been speculators and gamblers who have undermined the basic principles of buying stocks and bonds for growth and income. These speculators have used financial leverage and hollow promises to promote risky securities to unaware investors. The collapse of these markets followed by failing brokerage firms and major banks has resulted in a loss of confidence in the normal functioning of financial markets.

At the beginning of the third quarter, the energy crisis was the major concern where \$147 per barrel oil was threatening the economy. The focus turned quickly to the surprise takeover of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac) on Sunday September 7th. Due to an increase in defaults on sub-prime mortgages, the government had to take these government-sponsored agencies over leaving shareholders with less than 10% of the value of their stock. One week later, a second shoe fell, or maybe two shoes, as a major Wall Street investment banking firm, Lehman Brothers, declared bankruptcy. The almost simultaneous report that the "Bullish on America" Merrill Lynch was being purchased by Bank of America for a measly \$50 billion sent the markets into a tailspin. Then the Fed agreed to lend up to \$85 billion to American International Group for two years in exchange for an 80% equity stake in the company. These institutions were deemed "too big to fail," meaning that their collapse would have generated much wider problems within the financial system. Shortly thereafter, Washington Mutual, a major national bank, filed for bankruptcy and Wachovia Corp., another major financial institution with both banking and brokerage

facilities, was almost forced to file for bankruptcy but agreed to be acquired by Citigroup. (This purchase hasn't taken place yet since Wells Fargo stepped in and offered to buy Wachovia at a higher price. This tug-of-war continues at this writing.) These unprecedented failures due primarily to a combination of bad loans and falling equity prices triggered a government bailout response whereby a \$700 billion pool was established to buy mortgages from illiquid financial institutions.

The primary cause of these events started way back in the Seventies under Jimmy Carter with the implementation of the Community Reinvestment Act which was meant to provide credit to underserved populations, improving home ownership in inner cities and providing loans to small businesses. The subprime mortgage market provided such people an opportunity for home ownership sooner rather than later. The excesses came as subprime lending expanded well beyond its scope. Mortgage originators, interested only in a fee, had little incentive to make sure that the borrower would be able to pay if, for example, adjustable-rate mortgages were to reset at higher levels. Moreover, financial engineers caught on to the opportunity of creating fancy no-down payment, and no-or-low interest rate loans that triggered a surge in mortgage demand followed by a boom in home building. Not only homeowners but also speculators decided to get in on the easy money-making real estate business and the term "flipping" became a common expression. Mortgage securitization has been an important success over the years, expanding homeownership and providing opportunities for investors worldwide. The problem was leverage. Fannie and Freddie got greedy. Investment banks levered up, borrowing to buy higher-yielding securities backed by subprime debt.

When the Federal Reserve began to raise interest rates in 2005, the wheels began to come off these fast moving real estate transactions. When rising energy prices and rising mortgage rates on adjustable mortgages collided, the sub-prime meltdown began in earnest. The first real casualties were hedge funds: two Bear Stearns funds that had leveraged up by borrowing substantial sums to finance a massive mortgage portfolio of – you guessed it – sub-prime loans. The next casualty was Countrywide Credit, a major mortgage lender, followed closely by their bank subsidiary, Indymac Bank. These failures were the tip of the iceberg and by March Bear Stearns was bailed out by J.P. Morgan with the help of the government. The equity holders of Bear Stearns were left with little – if anything.

Sub-prime loans were a critical part of the credit crisis equation but were not the only problem. There were other factors that don't get as much attention but they add a gambling element to the scenario. The first regulatory decision that created a few sparks was the elimination of what is known as the Uptick Rule. The

Uptick Rule required that any short sales be accomplished after the stock went up in price. When this rule was in place, speculators and hedge fund managers could borrow stock and then sell that stock hoping for a decline in price. A subsequent sale would yield profits. If these speculators could make such sales any time they wanted, a falling stock price would be a self-fulfilling prophecy. When the Uptick Rule was rescinded, the doors were wide open for continuous shorting of stocks.

The second regulatory snafu came out of the Sarbanes Oxley Act that required Mark-To-Market accounting. Financial institutions were required to change the prices on their securities – primarily bonds – to be priced as though they were trading in the marketplace like stocks. The problem is that bonds don't trade like stocks. They trade very infrequently and their prices are usually set by a formula or by pricing agencies. Under normal circumstances, such a regulation isn't too harmful. However, in a financial crisis where there are no buyers, the situation can become catastrophic as it has done. Let me give you an example. When Tom managed a large high yield bond fund during a mini-crisis in 1991, he carried a bond at a price of \$73. When he went into the market to sell the bond, he got a price of \$13. He ultimately sold the bond for \$53 but setting the price at \$13 along with similar pricing for the balance of bonds in his portfolio would have caused a run on the fund he was managing and a run on other high yield bond funds. The Mark-To-Market Rule has probably caused 70% of the real crisis that we face today. A simple, decentralized system of temporarily eliminating the Mark-to-Market Rule would help restore financial markets. Companies would not have to face a fire-sale of their assets and would get to play on a level playing field with the government and private equity funds.

Then there are other non-regulated securities' markets such as credit default swaps, one of many derivatives (an instrument that derives its value from another security) that can have an enormous impact on financial markets and the economy. Even in this crisis there is little, if any, move to regulate or eradicate these instruments that serve only to enrich the speculators who use them. In our opinion, the misdirected or lack of regulation is the primary reason for the financial mess we are in today. Fortunately, the Federal Reserve under Chairman Bernanke and the Secretary of the Treasury Henry Paulson are making a difference in increasing liquidity to get funds flowing in the frozen money markets. The Federal Reserve began rewriting the playbook last December, creating a number of special liquidity facilities, each designed to substitute Treasury securities for riskier, less liquid assets. Financial problems have continued, but that does not mean that the Fed's efforts have been ineffective. Rather, conditions would have been much worse if the Fed hadn't taken action.

The bottom line in this brief history of the current global financial crisis is to emphasize that politicians and regulators have the power to “write the check” that can solve near-term problems. Permanent solutions will require the abolishment of bottom feeders that use the financial markets as a gambling casino. The securities that we invest in for your long-term benefit should not be abused and undermined by these speculators and hedge fund managers who either take home compensation in the seven figures or who leave their investors with worthless shares in a defunct hedge fund.

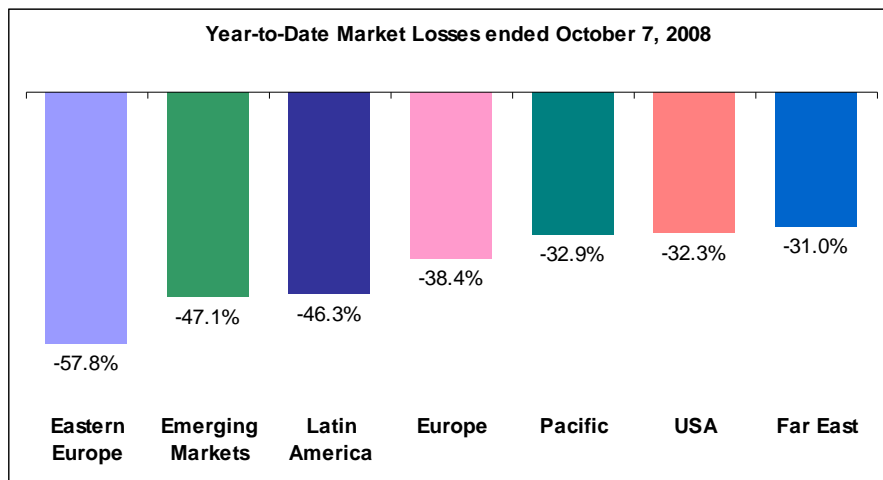
The financial market crisis is broadening to the global economy as banking institutions fear lending money to anyone. Car dealers, who borrow heavily to finance their inventories, are on the front line since they haven’t been able to secure loans even if they have good credit ratings. It is estimated that more than 700 dealers will be forced out of business this year due to the credit crunch. Shipping companies are also feeling the pinch and cannot secure financing for their cargo. They cannot even load the containers so the cargo doesn’t get moved.

In the past few weeks global economic statistics have shown notable deterioration. The need is growing for a massive fiscal stimulus package to mitigate all of these residual events that can have long-lasting economic consequences. The Congress has loaned \$25 billion to the auto industry to help keep it afloat and the housing industry continues to deteriorate as prices plummet (16% last month alone) and many builders are nearing bankruptcy.

In our last Financial Markets Perspective we warned about rising inflation due to high oil prices. Since that time, global economic weakness has produced a veritable collapse in commodity prices and oil has fallen in price by more than a third. This drop is good news for consumers but bad news for commodities markets as a whole. This decline in oil prices has triggered another round of selling in the industrial sector driving those stocks down well below their fair value. In one short quarter, we have shifted from being concerned about inflation to being concerned about deflation. The markets cannot tolerate such dramatic short-term swings and this change in prices will take a toll on the smooth functioning of the economy.

In times of crisis the government has to play a major role in restoring confidence yet the latest battles in Congress suggest divisiveness rather than leadership. We are on the brink of a national election whose outcome could determine the direction of our country. Hopefully the winner will have the power and skill to make decisions that get the economy back on track. Such success would also provide relief for global markets that have been contaminated by our financial crises.

Global financial markets are forecasting a serious global recession. The following chart reflects the year-to-date performance of major equity markets around the world. These unusual losses can be attributed to a combination of the expected effects of prolonged high oil prices and the loss of confidence in financial institutions. On the other hand, the most expensive securities are U.S. government bonds, notes and bills. During the past two weeks, in the midst of the crisis, one month Treasury bill yields fell to zero percent, an event that last occurred in the Thirties. Even though the Federal Reserve has been providing hundreds of billions of dollars to the global financial system, the interest rates on government securities remain below the average rates of the past century. As a result of this barbell market structure, investors have no place to hide except very low-yielding government securities or insured bank certificates of deposit.



We are in the midst of an environment that is experiencing unprecedented movements. We have had over sixty financial runs, bank and market crises over the last 300 years. Though the current environment is every bit as severe as any of the other crises, it is essential to remember that time and economic persistence has risen above each prior crisis. Government intervention through increased spending and tax rate cuts could reverse the downtrend just as it did in 2003 when the Bush tax rate cuts provided the basis for a major stock market rally. Such stimulus would also spill over to foreign markets and prevent a global recession.

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