



Global Financial Markets Perspective Fourth Quarter 2008

PERILOUS CROSSROADS

At the beginning of the fourth quarter, we hoped for Congressional action to curb the global economic downturn triggered by a mushrooming credit crisis and ongoing weakness in the real estate market. The credit crunch and falling asset prices rippled throughout the world resulting in unprecedented stress in the core of the global financial system. Plunging asset prices sharply reduced global wealth and continued to generate new losses for major financial institutions prompting governments to establish or expand a variety of mechanisms to support major intermediaries and markets. Many countries have expanded guarantee programs for bank deposits. Public capital has been invested in major financial institutions. So far, these programs have been successful in stabilizing the core of the global financial system. The most severe liquidity pressures have eased. Unfortunately, the global economy is in the midst of a significant recession. Industrial countries are likely to contract well into 2009. Emerging markets are experiencing the most significant slowdown since 2001.

A recession is a negative feedback loop. Declines in demand lead to declines in production, which lead to declines in income and wealth, and further declines in demand. Imbalances in the financial sector and the real economy can both initiate and help to propagate economic contractions. The current global recession is being driven by a variety of factors. Financial disruptions during the fourth quarter have sharply increased uncertainty and downside risks for the global economy. In response, both consumers and businesses have become more cautious in their spending decisions. In the very near-term this process is self-fulfilling.

However, these near-term dynamics are playing out in the presence of larger more durable forces. First, declines in assets prices, primarily real estate and equities, have significantly reduced the net worth of households. Since their peak over the summer, global equity markets have lost about \$25 trillion in value. This dollar amount represents about 40% of global GDP. Households are responding by limiting their spending that is depressing prospects for corporate earnings. Second, the financial sector is contracting. This process is putting further downward pressure on asset prices, and disrupting the ability of the financial sector to support economic activity. The IMF estimates that the total losses in the financial sector due to write-downs of U.S. credit instruments are likely to be about \$1.5 trillion – and that does not include foreign credit instruments!

A MAJOR SHIFT IN MONETARY POLICY

More than any one government agency, the Federal Reserve, under the leadership of chairman Bernanke, did more to avoid a greater crisis in October when credit markets “froze” and transactions among financial institutions became non-existent. The Fed’s normal role is to use monetary policy, primarily interest rates, to balance economic growth with inflation and inflation expectations. On a day-to-day basis the Fed monitors these two factors and then meets quarterly to announce any change in strategy. When there are financial disturbances, the Fed becomes a lender of last resort providing funds where necessary to avoid unacceptable financial conditions. The Fed’s latest moves in this regard went well beyond the well known reduction in the target Fed funds rate to zero. The Fed created new, unheralded loan facilities for financially strapped financial institutions, both domestically and abroad, to maintain economic stability. The addition of billions of dollars of reserves to the domestic economy was also a break with tradition as the Fed’s attempt at liquefying the economy was threatened by the downside of consumers and businesses losing faith in whether or not the system would survive. The Fed’s role in containing the credit crisis and liquefying the global economy should not be underestimated.

THE FISCAL COUNTERPUNCH

The problem is that monetary policy has its limitations. Even though governments around the world have provided unlimited liquidity, such funding cannot guarantee improved economic activity. One example of this weakness is when the Bank of Japan (BOJ) flooded the Japanese economy with money by lowering interest rates to near zero and then stepped back to wait for an economic recovery. It never happened. The problem resides in consumers’ outlook. Without a positive outlook, consumers won’t spend and the loss of that spending reverberates throughout the economy contributing to an even greater downturn. To remedy this situation, the fiscal side of the equation – government spending and tax policy – must do the heavy lifting to prompt consumers to become more optimistic.

The Treasury’s first step in this direction was the creation of the \$700 billion troubled asset relief program (TARP). Originally this fund was established as the equivalent of a bailout for financial institutions that were stuck with either illiquid or overrated securities. The potential use of these funds expanded rapidly as more and more businesses found themselves perilously close to demise. As December came to a close, the first big user of TARP was the auto industry – specifically loans were made to Chrysler and General Motors to facilitate their restructuring – that triggered lending to help stimulate a pickup in consumer spending. The loan to GMAC of \$5 billion allowed the firm to extend zero-interest financing to consumers.

As economic data continued to deteriorate, state and local government got into the financial bread line hoping for a grant from TARP to weather a revenue shortfall in 2009. Specifically, New York and California were hard hit by the financial downturn and the housing collapse, respectively. Other states were also in jeopardy of having to cut spending or to raise taxes to close budget gaps.

OBAMA'S LEGACY

Some political observers credit the abrupt collapse in financial markets during October with the win of President-elect Obama. Being handed the economic torch by President Bush, the new president certainly will have his work cut out for him. During an interminable wait between election night and Inauguration Day, the new president has to sit on the sidelines and plan his strategy for repairing a tottering world economy. Revelations of a planned stimulus package are very encouraging. The combination of major tax cuts coupled with infrastructure spending and loans to state and local governments adding up to \$1 trillion should provide enough of a kick-start to overcome the residual impact of the credit crunch. The trick for the new president will be to get that spending program through a pensive Congress – although his proposals for lower tax rates may draw more than a few Republicans to support the measure. If the first stimulus package looks like it is working, President Obama will be off to a strong start. However, if the program fails then a second and third effort may be necessary.

THE FOREIGN EQUATION

The strategy of investing in foreign financial markets to diversify away from domestic market risk has resulted in favorable returns in the past. However, recent scandals that first rocked the U.S. financial industry didn't take long to spread abroad – thanks to globalization – thwarting such a strategy. Many financial institutions in Europe and Asia jumped on the “can't lose” leveraged investment bandwagon. When the house of cards caved in, Iceland was the first casualty as three major banks collapsed and took the rest of the country with them. Other non-Euro countries such as the Ukraine and Bulgaria quickly became targets of speculators likely to default on their debts. Unknown to many Fed followers, the Federal Reserve moved in quickly and put up approximately \$300 billion in loans to insure solvency in many of these countries. So far that strategy appears to have worked although the European economy is slipping deeper into recession. Fortunately, the big players on the world scene have acted in concert with the U.S. in turning to both monetary and fiscal stimulus to truncate the downturn. These coordinated efforts are a first for global economic management and if they work we will have learned an important lesson about how to manage the global economy.

EROSION OF INVESTOR CONFIDENCE

In 2006, the risks associated with the housing bubble were generally recognized by professional investors. Similarly, the risks associated with higher energy prices were factored into investors' models. What many investors couldn't assess was the speculation

and misdeeds of professionals in the investment business. It was revealed that many financial institutions used leverage of 40-50X their capital base. No wonder these companies came close to going bankrupt. Additionally, hedge funds – managed by supposedly savvy professionals who were to protect investors from risk – found themselves ensnared by securities that rapidly lost value due to the impact of rising interest rates on low quality mortgages. As these crises worsened, the economy went into a tailspin and shocked energy investors who were convinced that the price of oil had only one way to go – up. Even initial efforts by OPEC couldn't stem the slide as oil went from a high of \$147 a barrel to under \$40 within six months. This turnaround accelerated weakness as hedge funds who speculated in oil and other commodities were crushed by the magnitude of the decline. When investors watched such stalwart firms as Lehman Brothers and Merrill Lynch disappear, along with such popular firms as AIG, Washington Mutual and Wachovia Corp., their concerns about the security of the financial system eroded rapidly.

Complicating stock market declines was the revelation that two trusted professionals, one a lawyer and one a portfolio manager, had effectively stolen billions of dollars of client funds. The breadth of the fraud that these two men engaged in is mind-boggling – especially when the regulators that oversee these operators fail to catch a whiff of the scams that are taking place. The bigger criminal, Bernard Madoff, wasn't caught because of his crime. He was turned in by his two sons who learned of their 70-year old father's Ponzi scheme in December. Even though the press suggests that Mr. Madoff lost 55 billion of investor dollars, he still is not in jail since posting bail of \$10 million. Meanwhile, Marc Dreier, the other crook of lesser notoriety, is being held in jail without bail. The once high-flying New York lawyer now alleged to have perpetrated a massive fraud against a group of hedge funds has been dubbed the Houdini of impersonation and false documents. Dreier, 58 years old, has been charged with securities fraud and wire fraud in the New York case. He is also faces up to 20 years in prison on the fraud charges by the U.S. Securities and Exchange Commission.

CONCLUSIONS

The world economy is in a deepening recession triggered by a combination of speculation and failed economic policies regarding housing and energy. The risks have been magnified by speculators and hedge funds that that abused leverage and triggered an avalanche of defaults and business collapse. Investors may not realize the obvious – 2008 marked the end of the Wall Street model as we know it. We are now at perilous crossroads with the government becoming banker of the capitalist system. Politicians are already planning to oversee compensation, bonuses and other incentives that have provided businesses and individuals with the impetus for innovation and creativity. The rules of the game regarding risks and rewards may give way to a less opportunistic environment for investors. Watching the success or failure of the U.S. auto companies adapt to government oversight will be a good leading indicator of the new U.S. economic model that may help shape the new Wall Street model.

We must recognize that the world economy is traveling along a new path, a path that has not been travelled before. The financial markets have warned us that the economy may be in decline for most of 2009 and possibly 2010. Rising unemployment, weakened spending and unknown financial risks could still undermine a sustainable recovery. The experiment by governments around the world to provide both fiscal and monetary stimulus appears to us to be the only realistic way to dig ourselves out of the economic and financial hole that was created by financial leverage and speculation. In one important sense, we can benefit from the bad experiences of the Thirties. During that economic downturn, government policy embraced much higher tax rates, tight money and trade restrictions – all factors that turned a prolonged recession into a depression. The first pronouncements by the Obama economic team recognize the risks of such policies and have already renounced them. In a very short period of time, the formulation of the Obama legacy could be set in stone.

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