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Economics, the Government, and Financial Markets: Anatomy of a Mess

Fear and panic are driving a lot of people out of the market. Risk is seen as everywhere. But smart disciplined investors like Warren Buffet are taking advantage of the opportunities this brings by buying on the cheap. What risks are worth taking in this environment? I'll provide an interpretation of what is going on and how investors can manage real risk. We'll analyze the underlying economic issues, the government's actions, and how we can invest well in this uncertain environment.

Lots of Mistakes

Last September I covered the mortgage market meltdown which triggered the current financial crisis. There have been many side effects that have amplified the problems since then, but the underlying problem is a nationwide bubble in residential real estate. If we want to lay blame for this, we can find literally millions of culprits. Home buyers were wrong to bid up prices beyond what they could really afford. Banks were wrong to underwrite loans which the borrowers could not pay back out of income. The government was wrong in encouraging banks to lend money to people who could never pay it back and wrong in providing credit guarantees (via Fannie Mae and Freddie Mac) which caused too much money to flow into real estate. Ratings agencies were wrong to reassure investors about the quality of loans when they had no real economic basis for evaluating them.

The Government Decides Who Will Take the Losses

With all the smoke in the air, it's hard to see what really happened. As a nation, we borrowed a lot of money we can't afford to repay and we spent it. This is what drove the recovery from the last recession. Now the bill is due and someone will take the losses. First in line to take losses are those who made the biggest mistakes: the home buyers and those who lent them money. The government may try to take some of these losses away from those responsible. In any case, the government is next in line to take losses as guarantor of all the Fannie Mae and Freddie Mac backed mortgages. Losses absorbed by the government will ultimately be spread among U.S. taxpayers. It is likely that the Federal Reserve will try to inflate housing values back up by lowering interest rates and expanding the money supply rapidly. This policy will effectively shift losses to those holding dollar denominated fixed income investments. This has the advantage of sticking the Chinese, the Japanese, and the Russians with a large part of the losses since they are the largest holders of U.S. debt.

The government is intervening in the market on a huge scale with all manner of unintended consequences for investors. Besides takeovers and forced sales, the government has intervened to artificially prop up financial stocks by banning short sales – with two different sets of rule changes so as to catch people by surprise both times. This has punished investors who were managing risks via hedging strategies by forcing short sellers to buy back financial stocks in a short time frame – driving up the price. This is market manipulation by regulation – pure and simple. They probably cannot use this trick again: no one will short these stocks going forward since they now know the government can and will inflict losses on them for doing so. The result will be less liquid stocks and less market efficiency.

Because we use inverse (i.e. short) index exchange traded funds to hedge our portfolio, we were caught in the government's assault on hedging and shorting; we took substantial losses on hedges. Our financial sector hedge (ticker SKF) went from a high of $154.77 on September 18th to a low of $87.00 on September 19th thanks to the government order to buy financial stocks. Eventually we will make this money back since this manipulation is short term in nature and cannot be repeated. Short selling and hedging by investors was not the source of the problems and stopping this cannot make the real problems go away. This just distorts the market so that it takes longer for prices to reflect what is going on in the financial sector. As I write this on September 30th, the value of this particular hedge has recovered to close at $100.99.

What's Really Wrong with the Financial System

Financial companies make money by borrowing at low rates and lending it at higher rates. If they cannot borrow money at low rates they cannot remain in business. Losses on the mortgage holdings of financial companies have reduced their capital substantially. Because the actual defaults and losses take a long time to show up in the books, it is difficult to know how much a company has actually lost. If their capital is reduced too much, they lose their ability to borrow and there is a run on their assets as everyone scrambles to get their money back before the company fails. This loss of confidence is the final straw that actually causes the failure.

Because dumb lending was so widespread, the financial system has lost a very large portion of the capital that supports confidence in the companies. In addition, forced selling of some securities has caused market prices to fall far more than they would if capital were abundant in the system. We've reached a point where the cycle of price declines and capital destruction feeds upon itself. This is why the government has finally decided to act. If they don't, a large part of the financial system may fail.

The reduction in capital in the financial system reduces the capacity of banks to lend money and raises interest rates on loans. Businesses that need financing will not get it and economic activity will be forced to contract. Jobs will disappear. Incomes will decline. This is not just a Wall Street problem – it will affect everyone.

What Needs to Happen

The only way to stop the death spiral of financial companies and minimize the damage to the economy is to inject a lot of new equity capital into the financial system. The Federal Reserve has allowed banks to trade bonds for cash but this does not address their lack of equity capital. Many companies may ultimately turn out to be bankrupt. Investors are therefore reluctant to provide capital, and when they do, it is very costly for the companies that take it. Analysts are saying that over the next few years the total lost capital is likely to be in the range of $400 to $660 billion. Most, if not all, of that must be replaced. So far only about $100 billion has been raised. Thus we will need to find at least $300 billion in capital to invest in financial companies. The U.S. government is the only entity with the resources and incentive to come up with this amount of capital.

The Paulson Proposal is Inadequate

Although the headline number is $700 billion, the solution proposed by the secretary of the U.S. treasury, Henry Paulson, replaces only a fraction of the $300 billion needed. While the media refers to the plan as a bailout, Mr. Paulson has proposed no injection of capital into the banks. Instead he proposes that the U.S. government set up its own bank with a balance sheet of $700 billion. Perhaps he intends a backdoor injection of capital by purposely overpaying when buying assets from banks, but he has assured congress that this will not happen. The reason that this seemingly big number is not enough is that banks can hold risky assets of 10 times their capital. Therefore, by buying away $700 billion in assets at fair market value, the proposed government bank will be implicitly freeing up just (700/10 =) $70 billion in equity capital for the financial system – but risking losses far more than $70 billion. No wonder this didn't pass.

The Central Bank Can Finish the Job

Paulson is a former Goldman Sachs banker so he knows the math. He knows his current proposal alone won't do it. But it will buy time. So it seems likely there is another part of the plan which he is not talking about that will take time to materialize. Here's where I see the inflation strategy coming into play. If the Paulson plan can keep financial company balance sheets from falling apart for a year or two we might muddle through this crisis by engineering enough inflation to reduce the losses and thus put the capital back into the banks. This may also have the benefit of depreciating the dollar and helping to soften the recession with increased exports.

Alternative Scenarios

Given the rejection of Paulson's plan by congress, it is possible that the government may decide to address the problem more directly by injecting capital directly into the banks via expensive senior debt and/or preferred stock. This has many advantages and would require no more than $300 billion to implement. Politically it would be tough to do because it would be perceived as a bailout and because it would prevent the politicians from giving the money to their supporters.

The house republicans offered an alternative, called the Cantor plan, which may turn out to be more palatable politically. Rather than the government buying securities directly or injecting capital directly, they would put a floor under mortgage assets by selling default insurance to the holders. This could possibly work if the government insures say 80% of the principal – giving the banks an incentive to try to collect as much as possible. Then, if these assets are carried on the books at the insured value, banks would not need to hold capital against them because there would be no risk of losses. This scheme could potentially free up all the necessary capital to resume lending without a large up-front money commitment by the government. In fact, the government would actually collect premiums from the banks at the start of such a program. If the percentage of principal insured and the insurance pricing are set appropriately, this could end up not costing taxpayers anything. Or it could be structured as a hidden giveaway to the banks.

If the government doesn't do something, many financial institutions will fail and we'll have a deep recession. The government will end up owning of lot of failed banks and mortgages anyway. My best guess is they will adopt some combination of the solutions described here but first there will be a fight over who controls the money.

Analyzing Risk

It is possible that congress will be unable to pass a meaningful bill to address the problems. In this scenario, prices of financial assets will continue declining which will cause more bankruptcies and, in turn, further declines in asset prices. The contraction in credit will lead to a deeper recession and the Federal Reserve will have to cut interest rates to near zero and pump up the money supply in the process. In this situation, U.S. stocks would likely fall another 30% or more and the contraction in economy could offset the increased money supply - keeping inflation from taking off for another year or two. The dollar would likely decline along with the economy.

If congress passes the Paulson proposal with some minor adjustments, it will probably be enough to stop the downward spiral of financial asset prices but the banks will still recognize losses as defaults build up over time. Without raising house prices with monetary policy, this policy will lead to a prolonged recession. Therefore the Federal Reserve will probably increase the money supply to increase inflation – but they cannot admit that this is their goal or they will cause an even worse crash in the value of the dollar. Inflation and interest rates will rise slowly and the economy will slowly grow its way out of the problems. It will probably take a long time for stocks to bottom out in this case because it will take a long time to see positive results.

If the government injected capital directly into the banks there would be a relatively short but large decline in stocks – especially financials as the implications would be much easier to see quickly. We will still have a recession for the next 9 months but, assuming house prices are allowed to reach their natural bottom, we could see an economic recovery emerge by the second half of next year.

Assuming the final plan is a combination of mortgage/bond insurance and asset purchases, it will put a floor on asset prices and free up needed bank capital. Then, the recession will be rather mild and stocks will not fall as far before they stabilize.

Managing Long Horizon Investment Risks

Given the significant risks of stock price declines, investors should avoid taking full equity market risks until there is clarity as to when the economy can start growing again. Our portfolio remains fully hedged to economy wide demand risk and we expect to maintain this position over the next few months at a minimum. The very substantial chance for inflationary policy implies that investors should stay away from long term fixed rate bonds and have some portion of their portfolio in resource stocks and gold to benefit from such trends. By focusing on stocks paying substantial dividends and hedging against market wide declines, investors can earn reasonable returns while waiting for valuations to get in line with the new economic realities.

The risks worth taking are those of holding undervalued real assets that long term economic trends will likely bring back to favor over time. Specifically I suggest buying assets that provide earnings and/or dividend rates of 8% or more on the investment and where general inflation and economic recovery would increase those earnings. This is what Warren Buffet was doing by investing in Goldman Sachs at a 10% yield. He got his upside from a call on Goldman's common stock which he can cash in when the financial markets recover.

Conclusion

Uncertainty about the economy is producing wild gyrations in stocks and causing panic among investors. There are risks worth taking but investors need to be both smart and disciplined in their approach. We can help you manage risk in the near term and earn great returns over the long term. Please contact us to discuss details of our investment management services.

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