

"Hurricane Subprime"

... continued

The Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets." The Fed Funds target rate was not changed and no mention was made about inflation. Many on Wall Street criticized the Fed for not going far enough.

By late August, LIBOR (London Interbank Offering Rate) rates had risen relative to other money market rates. This was particularly significant because LIBOR rates serve as the base rate for many types of loans that have little or no connection to the ongoing subprime mortgage problems. Observers worried that the market for inter bank lending was "seizing up". Then on September 7, the Labor Department reported that jobs had declined 4,000. Other recent economic indicators were also on the weak side and inflation appeared contained.

On Friday September 14, just two business days before the FOMC's September meeting, the British government effectively had to guarantee the deposits of Northern Rock, the

fifth largest mortgage lender in the UK. Northern Rock had fallen into difficulty by trying to enhance earnings with subprime CDOs. Nervous depositors withdrew their funds and by the second week in September the lender was reeling from an old fashioned "bank run."

In light of all these negative developments, the Fed at its September 18 meeting finally cut its Fed Funds target by 1/2 %. It also cut the Discount Rate another 1/2 %. The press release noted, "...the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally." The cut of 1/2 % instead of the anticipated 1/4 % was a surprise. The FOMC did not give any indication that it was leaning towards further rate cuts, but said it would act "as needed to foster price stability and sustainable growth."

While no FOMC member formally dissented, a number of officials remain worried about inflation. Perhaps rightly so since the dollar reacted by hitting a record low against the Euro and a 31 year low against the Canadian Dollar, which reached parity with the US dollar. In addition, gold hit a 27 year high, and crude oil broke \$80 per barrel for the first time.

The next scheduled FOMC meeting is October 31 (which some might think is appropriate). Current market thinking expects a 1/4 % cut in the Federal Funds target rate. Of course that could all change if some other significant funding problems surface. Furthermore, the economic indicators released during the month will be scrutinized carefully to see whether housing problems are spilling over into the broader economy.

The hurricane season officially ends November 30th. Wall Street, the banking industry, and the central banks certainly hope that "Hurricane Subprime" turns out to be only a category 2 or 3 rather than a catastrophic category 4 or 5.

The Panic of '07

A major New York financial institution's questionable investments and high leverage prompt nervous investors to withdraw their funds. This in turn triggers a tightening of the short term credit markets and forces some overly leveraged investment firms to jettison securities, almost regardless of price. Chaos reigns on Wall Street as indiscriminate waves of selling drive prices down over 10%. Rumors circulate that some large collateralized loans are at risk due to the precipitous fall in securities valuations.



by Bill Miller
Patton Albertson & Miller, LLC

Frightened bankers and speculators hope nervously that a "lender of last resort" will intervene to stanch their financial losses. Fortunately for them, the greatest financier of the Gilded Age, J. P. Morgan, steps forward and cobbles together an emergency program that halts the Panic of 1907. As Yogi Berra so eloquently said, "It's déjà vu all over again".

We spotlight the Panic of 1907 because of its obvious parallels with the turmoil we have seen so far in 2007. Where 1907 had the Knickerbocker Trust, 2007 had the Bear Stearns hedge funds. 1907 had skyrocketing call money rates, 2007 had severe tightness in the LIBOR and asset-backed commercial paper markets. 1907 had collapsing stock prices undermining call money collateral, 2007 had dubious "mark-to-model" prices for sub prime mortgages evaporating when tested in the real market.

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2007 has not come close to the level of panic and dismay
which swept financial markets a hundred years ago.*

Despite the amazing technological and financial advances since 1907, human nature remains largely unchanged. Greed and fear still roil the market from time to time because "the market" is just shorthand for the collective actions of millions of individual investors. When it comes to money, we're no different than our great grandparents.

Today's investors, for example, are still as loss averse as those a century ago. This means they perceive a monetary loss much more acutely than they perceive a gain. Behavioral scientists actually have attempted to quantify the degree of loss aversion and their studies consistently find that a \$1 loss has about 2-2.5 times as much impact as a \$1 gain. Perhaps this explains why stock market declines tend to be more rapid than stock market advances—investors' fear of losses drives panicky emotional selling.

Investors also tend to extrapolate recent market trends well into the future. When the stock market has been performing well, most investors expect it to continue and they invest accordingly, often chasing recent hot performers regardless of price.

Office Update:

We are pleased to announce that we have moved into new office space in both Macon and Atlanta. Please make note of our new address in each location. Also, please make note of our new phone numbers in Atlanta.

Atlanta Office

Patton Albertson & Miller, LLC
Fourteen Piedmont Center, Suite 210
3535 Piedmont Rd., NE
Atlanta, GA 30305

Telephone Number: (404) 917-2727
Facsimile Number: (404) 917-2728

Macon Office

Patton Albertson & Miller, LLC
231 Riverside Drive, Suite 105
Macon, GA 31201

Phone numbers in Macon remain unchanged.

Conversely, when the market turns lower, most investors react negatively which tends to accelerate movement to the downside. As a result, the stock market is much more volatile (both on the upside and downside) than can be justified by the underlying financial fundamentals. That creates opportunities for investors who can discern when the market is pricing stocks incorrectly.

Finally, like most people, investors are susceptible to what is called "moral hazard". If they believe they have a safety net to avoid potential adverse consequences, they are tempted to engage in more risky behavior.

In 1907 the trust banks overextended themselves in the call money market believing
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that the New York commercial banks would provide “lender of last resort” funding in times of financial stringency. The leading commercial banks had done so in earlier crises, so the trusts felt confident they would do the same in the future. Unfortunately for some of the trusts, the crisis of 1907 was different. The commercial banks allowed a number of trusts to fail before Morgan decided to take action.

In 2007 hedge funds, investment banks, and private equity firms engaged in a variety of leveraged activities confident that the Federal Reserve (established in 1913 primarily to prevent a repeat of the 1907 Panic) would intervene if market conditions got unstable. After all, under Alan Greenspan the Fed responded to the Crash of '87, the Mexican crisis (1994), the Asian crisis (1997), the Russian/Long Term Capital Management meltdown (1998), Y2K (1999), and the Dot-com crash (2001-2002) by cutting the Fed Funds rate and flooding the financial markets with liquidity. Wall Street wags called it the “Greenspan put.” After the Federal Reserve’s rate cuts on August 17th and September 18th it now appears we have the “Bernanke put.” So moral hazard is alive and well in the American financial system.

Without radical monetary reform (perhaps the subject for a future commentary), the Federal Reserve’s disregard for moral hazard is a recipe for further financial and economic instability. That is just a fact of life for today’s investors and one they must keep in mind when evaluating investments. We have chosen to maintain above average money market positions in part to reduce the overall market volatility of our clients’ portfolios. In addition, keeping some powder dry should enable us to exploit any extraordinary buying opportunities. Unlike some, however, we continue to believe that it is too early for purchases in the homebuilding, building supply, or investment banking industries. We expect to see enticing long term bargains among some of those stocks in 2008 or 2009.

One glaring contrast between the crises of 1907 and 2007 bears mentioning. In 1907 the dollar literally was “as good as gold”, being defined by Congress as 23.22 grains of pure gold. That made one ounce of gold equal to \$20.67. Back then a one dollar bill carried the words “United States Note” rather than “Federal Reserve Note” and it promised to “Pay to bearer on demand one dollar” meaning one dollar in gold. Because all our major trading partners also defined their currencies in terms of a specific weight in gold, no one worried about exchange rates. If a country defined its currency as 46.44 grains of gold, then its currency would trade for \$2.00. Dollar, pound, mark, or franc were just names for varying weights of real money ie. gold. No one speculated in foreign exchange and no “carry trades” such as we see today in the Japanese yen or the Swiss franc tempted investors to leverage their investments. So unlike the financial conditions today, there was little risk that the Panic of 1907 could become global.

Investors in 2007 face a much more challenging investment environment due to floating currency exchange rates. Volatile exchange rates impact the value of their foreign investments and the revenues of their U.S. companies which sell abroad. Therefore investors must monitor the monetary policies of the major central banks such as the Bank of Japan and the European Central Bank as well as business conditions abroad. Problems in one country can spread disorder globally through disturbances in exchange rates and credit markets. We saw that this summer when America’s sub-prime mortgage crisis triggered problems in financial institutions from Europe to Australia. We have kept our clients’ exposure to financial stocks relatively low because of concerns about potential “financial contagion”.

The severe Panic of 1907 led to “reforms” of the U.S. financial system, in particular, the creation of a central bank, the Federal Reserve System. Despite the Wall Street angst prominently displayed in the media, 2007 has not come close to the level of panic and dismay which swept financial markets a hundred years ago. Odds are we will muddle through as in recent crises because of the resiliency of our capitalist system, not because of the Fed’s misguided interventions in the credit markets.

Remember Webvan?

Whenever the stock market gets unusually choppy, it’s always helpful to review history and gain perspective. Today’s sub-prime mortgage mess isn’t exactly new. The phenomenon of easy money creating asset bubbles and eventual losses has occurred countless times before. For instance, just as mortgage lenders fueled the rise in real estate by offering generous terms, the irrational exuberance of the last decade did much the same for internet companies like Webvan.

Webvan was a start-up funded in 1999 through an initial stock offering of \$375 million. Operationally, through the power of the internet, and financially, through the power of Wall Street, Webvan was going to revolutionize grocery shopping, beginning with cities like Atlanta. Superior software and highly automated distribution facilities expedited a Fed Ex-like team of check-out clerks in delivery trucks. Customers raved about the convenience of the online ordering, the responsive service, and the wide selection of high quality items at competitive prices. Webvan was wonderful!

But just like a beautiful new home financed with a subprime mortgage, the problem wasn’t the house. It was the money. The business would only survive if everything went perfectly according to plan. There was no margin for error. The only back-up plan was either to issue more stock or to borrow. Webvan counted on investment bankers being impressed with its stellar sales growth, allowing it to raise more money. But with so many tech companies following similar strategies, the banks finally got skittish and funding dried up. When the window of easy money closed, Webvan’s demise was sealed.

In similar fashion, the “sophisticated” technology of pooling and repackaging mortgage loans for Wall Street consumption opened the floodgates for mortgage lenders. On the most aggressive and profitable end of the spectrum were sub-prime lenders who convinced borrowers not to worry about the future. As the market for mortgages became saturated, some lenders even falsified mortgage applications to qualify marginal borrowers for loans. While it was likely that most subprime borrowers would never be able to afford more than teaser rates, optimism trumped reason. Many mortgage brokers either ignorantly or fraudulently convinced people that the existing



by John Healy
Patton Albertson & Miller, LLC

“Hurricane Subprime”

The Tropical Meteorology Project at Colorado State University predicted that the 2007 hurricane season would be very active with “...land-fall probabilities for the United States coastline ... well above their long period averages”. Fortunately the hurricane season passed September 10th (historically the date of peak activity) without any serious destruction to the U.S. mainland. The season still has time to run, however, and October has brought some serious hurricanes in the past.

While perhaps there is some optimism for getting through this hurricane season safely, another type of storm has developed, this time in the financial markets. Like a meandering low-pressure system, this storm developed from the problems in the subprime mortgage loan market and quickly intensified into a major “seize up” in the credit markets.

We will attempt to explain briefly what happened and what to look forward to in the near future. To begin, the Federal Open Market Committee (FOMC), despite Jim Cramer’s celebrated meltdown on CNBC (“They know nothing!!”) and other analysts’ more restrained pleas to ease, did not lower the Fed Funds rate at its scheduled meeting on August 7th. It did acknowledge that credit problems stemming from the collapse of the

climate of low floating rates would persist and that they would be able to refinance their mortgages under similar terms. Either way, most did just about anything to justify making more loans.

Hundreds of mortgage brokers have already declared bankruptcy as have scores of mortgage lenders such as HomeBanc and NetBank. The true extent of the losses from the subprime mortgage bubble remains unknown. Some analysts estimate the losses will exceed those of the S&L crisis in 1989-1991. In today’s dollars that would represent losses in excess of \$400 billion. The impact on select industries will be quite negative (see Bill’s comments for specifics). As always, our goal is to position clients’ portfolios so they can take advantage of any opportunities which are bound to arise in the coming quarters.



by Charlie McAnally
Patton Albertson & Miller, LLC

subprime market were spreading in U.S. financial markets and were posing a downside risk to the economy. The FOMC’s decision came just a few days after the CFO of Bear Stearns, which had disclosed in June that two of its hedge funds faced huge losses due to subprime mortgage exposure, warned investors that the turmoil in the fixed income market was the worse he had seen in 22 years. Nevertheless, the FOMC reiterated that its “predominant policy concern remains the risk that inflation will fail to moderate as expected.”

Meanwhile, conditions were also worsening in Europe. IKB Deutsche Industriebank, a small German lender, required a messy bailout by larger German banks and its state-owned parent. IKB’s predicament was typical of firms that utilized leverage to expand earnings and then got into financial trouble. Starting in 2002, IKB had built up a large portfolio of asset backed investments including US subprime loans that were bundled into collateralized debt obligations, “CDOs” (see last quarter’s Insight and Outlook). To get around international bank capital requirements, these assets were held off the bank’s balance sheet in a special purpose vehicle known as a conduit. In turn the conduit, named Rhineland Funding Capital Corp, funded itself in the short term commercial paper market. Illustrative of how global and circular finance has become, investors buying Rhineland’s commercial paper included the city of Oakland, California, a suburban school district in Minneapolis, and the Montana Board of Investments.

A few days later an investment arm of BNP Paribas, France’s largest bank, added fuel to the fire by suspending withdrawals from three investment funds because “the complete evaporation of liquidity in certain segments of the US securitization market has made it impossible to value certain assets fairly regardless of their quality or credit rating.” Although a few other European mutual funds had suspended redemptions in the prior two weeks, the BNP Paribas announcement precipitated a dramatic change in market perceptions.

Investors began to worry about where else such problems might crop up. The immediate consequence was a dramatic divergence in interest rates, with the rates on riskier assets rising and those on safer assets safer falling. The European Central Bank (ECB) responded to the money market pressures by offering unlimited funding, and the market availed itself of the Euro equivalent of \$130 billion in overnight money. The next day the ECB supplied over \$84 billion. In the US, the Fed injected \$24 billion on that Thursday and \$38 billion on Friday after issuing an uncommon formal statement that it was “providing liquidity to facilitate the orderly functioning of financial markets.”

The following week was characterized by flights to quality and immediate liquidity. For instance, 90 day U.S. Treasury Bills moved from about 5% earlier in August to just 2.35% for a brief time in mid August. The market for asset backed commercial paper (short term corporate IOUs backed by assets such as subprime mortgages as contrasted to traditional commercial paper issued for short term working capital needs) began to contract. A casualty of that contraction was a Canadian finance company, Coventree, Inc., which announced on August 13 that it could not roll over its maturing debt. Several days later a group of banks and pension funds agreed to convert \$35 billion of debt into notes maturing out to 10 years. Terms won’t be made public until mid-October. Until then, investors won’t know when or if they will be paid. In the US, Countrywide Financial Corp announced that due to funding problems, compounded by a Wall Street analyst who abruptly changed his buy rating on the stock to a sell, it was drawing down an \$11.5 billion credit line. So now major U.S. banks were drawn into the credit storm.

In response to the waves of risk aversion and the strains created by rolling the asset backed commercial paper into the banking system, the Fed opted to make sure the mechanism of credit extension would work. On Friday morning, August 17th, the Fed cut the Discount Rate—the interest charged on direct loans to banks – by 1/2% and lengthened the term of such loans to 30 days from the usual one-day. Such changes were described as “temporary” and “designed to provide depositories with greater assurance about the cost and availability of funding.” Its accompanying statement said “Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward.