MARTIN
CAPITAL MANAGEMENT, LLP

FIRESIDE CHAT

Chat No. 7
Among the Last Skeptics Standing

December 11, 2009

"On March 3, 2008, the first of what has become a series of Roosevelt-esque "Fireside Chats" was broadcast by the undersigned. It, along with the six that followed, have been intended to assuage fears of what looked like a financial crisis in the making. Less than two weeks after the inaugural broadcast, Bear Stearns, pioneer of the securitization and asset-backed securities markets, collapsed and moved quickly toward bankruptcy. In an unprecedented move, the Fed deemed Bear "too big to fail," coughing up $29 billion in a non-recourse loan collateralized by toxic mortgages in Bear's portfolio. With the Fed's backing, Jamie Diamond of J.P. Morgan Chase bid $2 per share for the remains. The phones of protest started ringing off the hooks, so he quickly raised his bid to $10, and the deal was done. An overwhelming sense of urgency, bordering on chaos, coupled with *ad hoc* decision making characterized the response to the financial crisis from that point forward.

Federal Reserve Chairman Ben Bernanke defended the bailout by stating that "a Bear Stearns bankruptcy would have affected the real economy and could've caused a 'chaotic unwinding' of investments across the U.S. markets." For the next six months he looked prescient: The Dow Jones average, often an anxiety barometer, remained relatively steady around 11,500 on light volume. To most observers, the storm had passed.

A second Fireside Chat was broadcast on June 5, three months after the Bear debacle. It took issue with the complacency, issuing a dire warning instead.

> Although I have no illusions that what's happening today will be a replay of the 1930s—history, after all, is seldom so accommodating—I do think what is occurring in the financial system and the economy has the potential to become so unsettling that I consider it necessary to risk offending my listeners by sounding a warning (with such strong emphasis by historical association [with the 1930s]) that some might call it fear-mongering. You won't hear such cautionary alarms from anybody in high political or economic places any more than those in the same shoes felt inclined to issue storm warnings in the late '20s and early months of 1930. To the contrary, what people were hearing and reading then—and what

> is being served up in sound bites now—are little more than palliatives from the presumed pundits.

Three months later, on the weekend of September 13, all hell broke loose. It was Lehman's turn to exercise the "Bernanke (formerly Greenspan) put," but this time the Fed and the Treasury weren't buying. After all, the senior officials of both agencies were convinced that Lehman posed far fewer real risks than Bear Stearns. According to the *New York Times* on September 12, the confidence by Washington officials stemmed from the fact that, after the Bear Stearns collapse,

> they obtained stronger regulatory powers that gave them the ability to peer into the activities and risk exposures of institutions on Wall Street, to gauge the firms' exposure to hedge funds and other big players, as well as their positions in financial derivatives and other opaque markets. Fed and Treasury officials have also been taking the daily pulse of executives and traders on Wall Street for months, and much of that discussion has been about Lehman.

No matter how much the Fed and the Treasury thought they knew, Lehman's blowup could not be contained. The "moral hazard," the asymmetry between Wall Street's and the regulators' understanding of the systemic risk exposure was starkly revealed. The regulators' ignorance became the taxpayers' expense. Investment banks, cajoled to step up to the plate like they did under similar threats when Long-Term Capital Management threatened to roil the financial world back in 1998, refused to budge. Lehman was the weakest and, therefore, was sacrificed. The stronger of those left standing knew that, united, Bernanke and Paulson couldn't let them all fail. Investment banks were granted bank holding company status overnight. This arrangement allowed them access to the Federal Reserve's discount window and benefit from the Troubled Asset Relief Program (TARP). Through contagion, the financial pandemic spread like wildfire. That same weekend one of the marginal players, Merrill Lynch, defaulted to Bank of America in a hastily arranged shotgun marriage. On the following Monday the AIG bombshell hit Ground Zero. The Fed's first infusion into the giant insurer of $85 billion (ultimately $182.5 billion) dwarfed the Bear Stearns bailout.

From September 15, 2008, through March 9, 2009, the world's markets upchucked, with the Dow free-falling 5,000 points, shedding more than 43% of its value in the panicky, relentless, and high-volume selloff. All manner of other financial fallout and makeshift remedies transpired during those turbulent days. The shadow banking system was shuttered, and the rating agencies were shamed by their negligence. The bank-based, credit-generating system became largely dysfunctional. Collateral damage forced the Treasury to provide FDIC-type insurance for money market funds after the $65 billion Reserve Primary Fund—the nation's oldest money fund—"broke the buck" as part of the fallout from the Lehman bankruptcy. Fearing a run on other money market funds in the $3.5 trillion industry, the Treasury was forced to step in. Money market fund investors take note: The insurance was lifted in September 2009. Likewise, in a *quid pro quo* for the bankers, the FDIC insured limit was temporarily raised to $250,000. The list goes on.

The financial and economic Shakespearean-like tragedy onstage and ongoing around the globe cannot be fully understood apart from its principal U.S. actors, complete with situational and dramatic irony. They are Ben Bernanke, appointed by George W. Bush as chairman of the Federal Reserve Board in early 2006 and reappointed by President Barack Obama in December 2009. Hank "Henry" Paulson, Bush's secretary of the Treasury, served from the summer of 2006 to January 20, 2009. Finally, Timothy Geithner, Paulson's successor, was appointed by Obama on January 26, 2009.

Bernanke, a highly credentialed academic, left his post as department head in the School of Economics at Princeton to enter public service as a member of the Board of Governors of the Federal Reserve System in 2002. Bernanke's speeches, soliloquy in form, were most revealing. In a rambling professorial speech on May 17, 2007, fifteen months after he was appointed Fed chairman, he made this fateful statement: "We believe the effect of the troubles in the subprime sector on the broader housing market will be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system." As noted above, after the Bear Stearns failure, he was confident that the risk of a financial meltdown had been greatly ameliorated because of greater regulatory oversight. Most recently, Bernanke, in testimony December 3 before the Senate Banking Committee, said that the recession was "very likely over…at this point we are in recovery." Bernanke also told lawmakers he didn't see any "bubbles" at this point in the U.S. The Fed is keeping watch, monitoring major credit and stock markets to look for "misalignments," he said. True to form, in response to a question about lax regulation of the investment banks when they went on a 2004–07 leverage rampage, the ever-contrite Fed chairman rued: "We should have required [banks to hold] more capital, more liquidity. We should have required more risk management controls." As this chat is being written, right under the chairman's nose, thanks to the Fed-sponsored "carry trade," other bubbles are forming (see subsequent analysis).

Time Magazine, in selecting Paulson as runner-up for its Person of the Year 2008, said, with reference to the Global Financial Crisis of 2008: "if there is a face to this financial debacle, it is now his."Whether history will record Paulson's endeavors as part of the solution is questionable; there is not a scintilla of doubt that he was part of the problem. In 2004, Paulson, then CEO of Goldman Sachs, led a parade of Wall Street titans to Washington with the intent of pressuring the SEC to release them from the net capital rule, the requirement that their brokerages hold reserve capital that limited their leverage and risk exposure. The European Union regulators, who threatened to derail the process through their oversight of the European operations of the investment banks, acquiesced on the condition that the SEC agreed to supervise. During this repeal of the net capital rule, SEC Chairman William Donaldson agreed to the establishment of a risk management office that would monitor signs of future problems. This office was eventually dismantled in late September 2008 by new SEC Chairman Christopher Cox, after discussions with Paulson. According to the *New York Times*,

> While other financial regulatory agencies criticized a blueprint by Treasury Secretary Mr. Paulson proposing to reduce their stature—and that of the S.E.C.—Mr. Cox did not challenge the plan, leaving it to three former Democratic and Republican commission chairmen to complain that the blueprint would neuter the agency.

Thus freed from capital and regulatory restraints, Goldman's balance sheet exploded from $400 billion to $1.12 trillion over the five years ending November 2007, with financial leverage reaching 26:1. The other investment banks, in a high-stakes game of chicken, enthusiastically joined a rigged dice roll that would eventually put the financial system in jeopardy.

The third tragicomic character, appointed as Paulson's successor, is 48-year-old Timothy Geithner (who looks 38). The only explanation that seems palatable for his appointment as Treasury secretary is that the crisis threatening to engulf us at the time of his selection by Barack Obama in November and confirmation by a harried Senate in late January 2009 was so overwhelming in its urgency and fear that it pre-empted the normal deliberative process. Geithner's inexcusable personal tax foibles nearly derailed the confirmation. On a clearer day they would've been considered fraud. Of course, in just another minor irony, the man who fudged on his taxes is now *de facto* head of the IRS.

Crises call for individuals whose character and experience inspire confidence. Sadly for the nation, Geithner doesn't move the needle much on either account. Sometimes one finds significance in the trivial. When Geithner was selected in late November, Paulson endorsed him lavishly: "I have great confidence in his understanding of markets, his judgment and leadership, and his ability to meet the challenges that lie ahead." The following is a factoid to reflect on. Geithner bought his home in Larchmont, New York, in 2004 for $1.602 million and, in 2009, when he left for Washington and the Treasury Department, he put his home on the market for $1.635 million—*after* the U.S. real estate market had collapsed. Would Paulson still say Geithner understands markets? Finding no buyers for his house, Geithner later rented it for $7,500 a month. Using a rough rule of thumb that monthly rent should be about 1% of the home's value, the worth thus inferred was more like $750,000. As for "judgment and leadership, and his ability to meet the challenges that lie ahead," only the future will tell. In the meantime, here's what's on Geithner's plate. He continues to play a large role in directing the federal government's economic response to the financial crisis. He is currently dealing with multiple high-visibility issues, including the survival of the auto industry; restructuring of banks, financial institutions, and insurance companies; recovery of the mortgage market; demands for protectionism; President Obama's tax changes; and relations with foreign governments dealing with similar crises. If you're not frightened by now, you haven't been listening.

Beyond the three men described above, the rest of the government of the United States also was gripped by fear and panic. The $700 billion TARP bailout was ramrodded through Congress in early October 2008 by Treasury Secretary Paulson. Within a month of his inauguration President Obama's $787 billion American Recovery and Reinvestment Act of 2009 was enacted. Lesser (after all, everything is relative) *ad hoc* measures like nationalizing General Motors and Chrysler—and the whole panoply of interventions in the private sector—were unleashed. Independently, "Helicopter Ben" was living up to his name. Ballooning the Fed's balance sheet with whatever assets were needed to engineer the desired effect (and in the process driving short-term interest rates down to zero), the Fed chairman was adamant about jacking up prices of everything from distressed debt to stocks—anything to avoid the scourge of deflation. Unfortunately, real estate prices, so crucial for reflation, proved stubbornly resistant to Fed manipulation.

And then on March 9, 2009, the sun came out from behind the clouds. That was the day the U.S. market began its celebrated ascent, as of this date regaining all the ground lost since Lehman threw in the towel and almost half of the losses since the peak in October 2007. The resurgence of risky assets (equities and low-grade debt among marketable securities) as presumed leading indicators stand as the only compelling evidence that the financial crisis and economic contraction are behind us.

Even the idea that markets are a leading indicator must be considered suspect in once-in-a-lifetime crises. (Other indicators are foreclosures and unemployment, which I address later.) Since March of this year the heretofore unimaginable amounts of money the Fed created did not find their way into the real economy. Rather, the Fed, no doubt unintentionally, underwrote a massive worldwide speculative bubble in oil and other commodities; a narrowing of high-yield and high-grade credit spreads; and an even bigger rally in stocks, bonds, and some currencies, not including the dollar. Iconoclastic economist Nouriel Roubini concludes that this "mother of all carry trades faces an inevitable bust."

The question before us is not whether to jump aboard the bandwagon of government-engineered reflation of risky assets. As the Shiller price-earnings ratio makes clear (updated in the last Fireside Chat in August and confirmed by the other valuation metrics profiled in the 2008 MCM Annual Report), to expect much more than we've already received is to defy both history and the rudiments of security valuation.

Rather, the question that should be on everyone's mind is whether the reflation in the prices of stocks and lower-quality bonds is a false-positive error, one born of excessive credulity. If the markets in risky assets are correct in forecasting a sustainable economic recovery enabled by a smoothly functioning financial system, that prospect has already been priced into the markets with the Shiller PE pushing a "bubble territory" 20 times earnings.

If, on the other hand, the current financial and economic episode is not a run-of-the-mill, post-World War II business contraction but rather the aftershock of a massive credit bubble that went into overdrive post-2000 , a Shiller PE of 10 is not out of the question. Having read daily summaries for the last seven months of the feature stories in the *Wall Street Journal* for the corresponding day in 1930, two conclusions jump off the pages: First, for every pound of wheat there were 10 pounds of chaff and, second, the focus was so much on the short term and so deeply influenced by the herd instinct that virtually no one saw (nor did the market discount) the onrushing Depression tsunami until it overwhelmed them. The ongoing exercise is almost surreal—like reading a murder mystery having already seen the end. You turn page after page, incredulous, as the characters miss clue after clue. It reads so much like today.

Anecdotally, the retail investor is behaving atypically. Since the mid-'90s the mutual fund investor has bought every rising market and sold every falling one. In this rally he is forswearing risky assets, preferring bonds to stocks. Will he finally capitulate or, after 10 years of looking in a rearview mirror and seeing nothing but disappointment, adopt a new mindset: twice burned, forever shy? Another trivial detail?

Not readily apparent in the myriad statistics with which we are inundated on a daily basis is the undercurrent of a secular change in attitudes toward risk, the American dream, and at root, the American psyche. These perceptions are absorbed by mental osmosis, being assimilated almost unconsciously. The word secular, meaning "of indefinite duration," is contrasted with situational or cyclical change, which in economic terms is more closely tied with the business cycle.

The question I rarely get comes from the soft science of human behavior. How are people responding in the aftermath of the epic (and ongoing) credit collapse and implosion of household net worth? Seldom am I asked about attitudes toward debt, savings, discretionary spending, and homeownership—and whether they are undergoing a secular transformation. Is, I'm hoping someone will ask, the harsh reality that one of eight Americans, and one in four children, are openly accepting the once-stigmatized food stamps program a sign of a deeper, more profound malaise or is it merely situational or cyclical? What do parents talk about behind closed doors when they know that one of every four of their mortgaged neighbors is underwater? Indeed, the number of U.S. homeowners now "upside down" on their mortgages has swelled to 10.7 million households—or 23% of all U.S. property owners (40% of those who have bought a home since 2006 now have a mortgage balance exceeding the property value). How much overlap is there with the burgeoning ranks of the unemployed, now at 15.7 million, more than double the number in January 2008? Will there be a contagion effect? When you add the Bureau of Labor Statistics total for "underemployed" workers (known as U6), the number of Americans idled in some fashion during this job-disgorging recession, the total jumps to 26.7 million—or 17.5% of the 153 million-member workforce. After a horrific three-month period in which foreclosure filings have approached a total of 1 million, data on "negative net equity" point to even more pain going forward.

There is no doubt that the unemployment rate will stop rising. The burning question is how fast will it fall?

Knowing the limitations of any grassroots perceptions I might have about changes that might be under way in the country's collective mindset as a consequence of the financial and economic travails, I read Dr. Frank Luntz's just-published *What Americans Really Want...Really: The Truth About Our Hopes, Dreams, and Fears.* Luntz's credentials are as impressive as is the degree of difficulty of anyone capturing the national mood.

Luntz sees a secular shift.

> The financial meltdown has devastated our trust in institutions, shattered our confidence in the future, and thoroughly undermined our economic and emotional equilibrium. This book had to be completely rewritten because we're just not the same people today that we were in October 2007, and we don't have the same priorities. Ask Americans, and most will tell you they're worried, anxious, even angry about the world around them and angry with America. Our financial system now has the dubious distinction of weathering the worst slide since the Great Depression. And in this economic deluge, the average working American has less than 60 days savings put away for a rainy day—and one-fifth of us have no savings at all. That's a lot of people in a lot of pain.

Luntz continues:

> Americans are a mess of contradictions, an amalgamation of angst, driven by what we don't have now and what we want tomorrow. Living, working, playing at breakneck speed from dawn to dusk, we are seekers engaged in a twenty-four-hour quest for balance between home and work, friends and family, the need for money and the desire for free time. Truth is, we want it all. The American tradition of "living large" worked when we had a competitive advantage over everyone else, when we were the unchallenged global superpower. We bought big houses, big SUVs, big televisions, big speakers, and rang up big credit card bills. Everything was big, and yet we wanted it even bigger. But as the United States begins to lose some of its swagger, even if only temporarily, everything is starting to get slightly smaller—including our dreams. The specter of economic collapse casts a pall over a people who have rarely known want. In their own lives, the vast majority of Americans are financially worse off than they were a few years ago, and they fear their family income is falling behind the cost of living. Nationally, Americans are more pessimistic than at any time since pollsters started tracking pessimism. This isn't a deterioration of confidence. It's a collapse of confidence—and it has become intergenerational in scope and magnitude.

Luntz's conjectures are backed up with harsh realities. Moody's, the much-maligned but still top rating agency, advises that under the most pessimistic scenario the U.S. would lose its top rating in 2013 if economic growth proves anemic, interest rates rise, and the government fails to dent the deficit or recover most of its assistance to the financial sector. Moreover, Moody's expects the interest-to-revenue ratio to climb to 13% by 2012 in its most likely outcome. In its worst-case scenario, the figure could spike to 18%, a level seen only in the 1980s. As for the burden on the flagging economy of total public and private debt combined, as of the second quarter of 2009 it was at an all-time high relative to GDP: 370%. Going into the 1974–75 and 1981–83 recessions it was around 160%. There is far too much debt chasing way too little income. There are solutions; however, none is without enormous, unwanted consequences.

When Luntz surveyed the toughest, hardest-hit communities, they all had the same question: "When will it end?" He continues:

> They knew the CEOs who made the mistakes that created the crisis were being rewarded. They knew the Wall Street guys were still collecting (or trying to collect) multimillion-dollar bonuses. They knew the corporate leaders were still attending lavish retreats as though nothing had happened and were still spending millions on naming rights to sports stadiums. And it was—and is—all bought and paid for by the government in Washington and, by extension, us.

If we flash back to the 1930s and read Amity Shlaes, *The Forgotten Man: A New Story of the Great Depression*, we find striking parallels in sociopolitical attitudes, if not events. The "forgotten man" of the 1930s was "Joe the plumber" of 2008.

The big question that Shlaes raises about the Great Depression is not whether war with Germany and Japan ended it, rather "It is why the Depression lasted *until* [emphasis added] that war." According to Shlaes, "1929 to 1940, from Hoover to Roosevelt, government intervention helped to make the Depression Great." The period was not one of a moral battle between a force for good, the Roosevelt presidency, and forces for evil, those who opposed Roosevelt. It was a period of a power struggle between two sectors of the economy, both containing a mix of evil and virtue. The public sector and the private sector competed relentlessly for advantage. At the beginning, in the 1920s, the private sector ruled. By the end, when World War II began, it was the public sector that was dominant."

Roosevelt fomented class warfare. In his 1932 convention speech, the future president quickly targeted the scapegoats. The Depression, FDR said, was the result of "lack of honor of men in high places" and "crooks." More generally, he assigned blame to a moral failing: national greed. "Let us be frank in acknowledgment of the truth that many amongst us have made obeisance to Mammon, that the profits of speculation, the easy road without toil, have lured us from the old barricades." But it was Roosevelt's finale that struck everyone most. "I pledge you, I pledge myself to a new deal for the American people." This routine of targeting class enemies in the name of reform would become Roosevelt's trademark.

Taxation became onerous. Continued FDR: "It was time for the 'princes of property,' the wealthy, to share their resources. Growth would not provide for the poor; only redistribution could."

Summary

The future hinges on forces not easily seen among all the news clutter. Like the 1930s, the "experimenters" in Washington are unquestionably bright but so inexperienced as to often be inept. Their mental models have proved time and again to be too small for the huge task at hand. The factors that make headlines—growth vs. stagnation, inflation vs. deflation, the cost/benefit trade-offs of multiple monetary and fiscal stimulus packages, fiscal budget and trade deficits, dollar devaluation—fall substantially into the realm of the unknowable. Those factors that get little public attention (*Will the growing segment of the population that feels disenfranchised be made to once again feel empowered? Will business shake off the burden of leftist government intervention and higher taxes and become spontaneously optimistic?*) are the ones that will determine whether employment and the economy generally rise or whether they stagnate. Will the "great moderation" be followed by the "great malaise"? I wish it weren't so, but I wouldn't bet against it.

Until we chat again,
Frank Martin, CFA
Senior Partner