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CAPITAL MANAGEMENT, LLP  
Regions Investment Assets

# FIRESIDE CHAT

## Chat No. 2

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“Good evening, friends.” With these words Franklin Roosevelt greeted his radio audience during “fireside chats” beginning in March 1933, only days after he was inaugurated as our 32<sup>nd</sup> president. Almost 3½ years after the stock market crash that began on the day of financial infamy, October 29, 1929, during which the Roaring '20s flip-flopped to become the Repentant '30s, a commercial banking collapse was spreading like wildfires in a high wind. Although credit was ample and at low rates in 1930, consumers did not behave as economists had predicted. Remorseful as their ill-placed bets on stock prices with only 5% down underwent an overnight reversal from unearned riches to margin calls they could not meet, erstwhile speculators were overcome with remorse, bravado giving way to a new and harsh reality: an immediate and contagious aversion to risk and the spendthrift ways of the 1920s, choosing to curtail spending as sort of an act of contrition, and a vicious downward economic cycle ensued. The banks were among the last dominoes to fall, and Roosevelt’s first chat sought to restore

confidence in the organizations that greased the wheels of commerce.

Seventy-five years later, almost to the day, the first Martin Capital Management fireside chat was broadcast—on March 11, 2008. Exactly five days later, the fifth-largest investment bank in the world, Bear Stearns, was gripped by panicky chaos as counterparty claims were presented that the company simply could not honor. The Federal Reserve swiftly interceded, invoking the “too big to fail” doctrine—or what is more cynically known in financial circles as the Greenspan (or now Bernanke) “put.” During that weekend of behind-the-scenes machinations the less-than-battle-tested Fed chairman, hearing real bullets whiz over his head for the first time, resorted to instinct. A rescue package was hurriedly cobbled together that included a takeover by J.P. Morgan Chase and an unprecedented non-recourse loan to a non-commercial bank of an astounding \$30 billion by the Fed. In defending his actions to Congress in the cold light of day, Bernanke testified that most likely there would have been “severe

consequences” to the default of Bear Stearns, leading to a possible systemic financial crisis.

The monetarist Bernanke’s decisions were greatly influenced by the classic Milton Friedman and Anna Schwartz book, *A Monetary History of the United States, 1867-1960*, published in 1963, which transformed the debate about the Great Depression. The Fed chairman, ostensibly attempting to avoid the monetary policy miscues he believes exacerbated the Depression, reacted to the Bear Stearns threat by opening the monetary floodgates to avert a liquidity crisis threatening to infect the commercial banking system in this latest iteration of what economist Hyman Minsky, whom, interestingly, Bernanke does not cite as a reference, would have described as reckless and ultimately self-destructive financial innovation.

Parenthetically, it would be reasonable for the listener to ask why I am framing the current upheaval with the contextual backdrop of the crumbling 1930s. First, there doesn’t appear to be any comparable episode in the post-World War II period. Second, 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) that some might call it fear-mongering. Third, 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. For one current example among many, it may be enlightening for the listener to Google the Federal Reserve Board’s website and read Vice Chairman Don Kohl’s fresh-off-the-press May 22, 2008, speech, then wind the clock back 18 months and compare it with the speech he gave on October, 11, 2006. His Pollyanna bromide conclusions are conspicuously at odds with the facts he presents. No doubt well-meaning, Kohl’s “forecasts” were indicative of a thinly disguised and potentially destructive false-positive error.

Three-quarters of a century after what is remembered as the Great Depression, a different set of challenging financial and economic circumstances, perhaps requiring an atypical response, is upon us. Allow me, for the record, to briefly chronicle some of these circumstances:

- The unprecedented 14% decline in median home prices over the last 12 months.

- A tripling of gas prices in five years to \$4 a gallon.
- More immediately, four consecutive months of shrinking payrolls concurrent with consumer confidence falling “out of bed” to 28-year lows.

How these factors, among other contractionary forces, will impact consumer’s willingness to spend on goods and services—and to save and invest—cannot be known with any reassuring degree of confidence at this point. The lagging secondary effect on employment and corporate profits, along with the growing burden of debt on consumers and corporations, is likewise unclear. What is known is that the balm that, according to the Fed chairman, would have mollified the consequences of the economic upheaval of the early 1930s is being vigorously applied today. The markets have greeted the extraordinary steps to restore some semblance of order to the credit markets with palpable, if not nervous, relief. The S&P 500, as a crude bellwether of investor sentiment, has haltingly regained half the ground lost since its peak last October. Perhaps like the emotional impact of falling stock prices on financially handcuffed speculators in the ’30s, the great reversal in home prices that began in the summer of 2006 (that could easily reach \$6 trillion nationwide in lost market value by the end of this year), as well as the other

aforementioned maladies, might consumers once again be overcome with speculators’ remorse? Even as data released in late May indicated that house-price declines accelerated in the first quarter, the Conference Board’s consumer-sentiment research indicated that consumers’ desire to buy a house in the near future surprisingly declined from 3.4% to 2.1% during the same three months. Having played virtually every trump card in his hand to lead this horse to water, surely Bernanke’s greatest fear is that it will defy the central banker’s logic and refuse to drink.

There’s a not-so-subtle difference between Ben Bernanke’s conclusion that an unaccommodating monetary policy was the cause of which the Depression was the effect 75 years ago and another explanation that comes from Austrian school of economics, a persuasion that has been of great intellectual appeal to the speaker for many years. Austrian theorists who wrote about the Depression include Friedrich Hayek, Ludwig von Mises, and Murray Rothbard, who in 1963 wrote *America’s Great Depression*. In their view, the key cause of the Depression was the expansion of the money supply in the 1920s that led to an unsustainable credit-driven boom. According to the Austrian coterie, the Federal Reserve, created in 1913, shoulders much of the blame for pouring monetary fuel on the flames of asset price appreciation in the ’20s.

The public-policy response that differentiates the early '30s from the current economic climate is that while easy and cheap money gave birth to the problem children of both eras, this time the Fed is fighting the conflagration with what purportedly caused it in the first place: too much monetary gasoline. Bernanke's policy responses reflect a Friedmanesque belief that the cause of the 33% decline in the money supply between 1929 and 1933 was a reluctant Fed and not the "once burned, twice shy" lenders and borrowers. Moreover, as he voiced in a March 2004 speech on the subject, the strict adherence to the hard-money gold standard until 1933 further crippled the economy. To be sure, reasonable doubts exist regarding the fragility of the gold standard in times of crisis. However, the lack of external discipline (the scourge of all fiat currencies) may pose a greater threat to long-term consumer price and social stability. To paraphrase Sir Isaac Newton, for every action there is an equal and opposite reaction. A Fed chairman who, even hyperbolically, proposes to cure economic ills by dropping "dollars from helicopters" is about as uncoupled from the restraints of a gold standard as one can get. (In fact, the rebate checks from Uncle Sam this spring and summer are remarkably reminiscent to Bernanke's "pennies from heaven" strategy.)

The political advantage of systematically debasing a fiat currency is that the process is

almost undetectable. Few Americans at the gas pump, to say nothing of some of our political candidates when speaking to a crowd anxious for simple answers, realize that the convenient scapegoats, "big oil" or the oil-producing states, represent only the supply side of the equation. The growing worldwide physical demand for oil and the proliferation of U.S. currency-backed IOUs coursing in ever-greater quantities around the world have combined to drive the price upward in dollar terms. But few are pointing to what is by far the biggest reason for today's \$60 fill-ups. The collapse of the dollar exchange rate alone explains at least half of the increase in the pump price of gas over the past five years. If it weren't for the falling value of the dollar, the price of gasoline would scarcely be an issue. Economic and financial decisions are never without trade-offs. Whether more and more monetary and fiscal stimulus will restore consumer and business confidence—and their willingness to borrow and spend and stop a self-reinforcing debt-liquidation cycle—remains to be seen. In the short term, the untimely risk that thrift will reappear as a virtue could throw macro policymakers into a cocked hat.

Returning to the subject of Roosevelt's first fireside chat, the migrating banking crisis, like the '30s, is spreading outward from Wall Street. Nearby Cleveland, the epicenter of Midwestern conservative values and a Rust Belt economy to boot, doesn't seem a likely

place to find those willing to take risks without commensurate rewards. One of few cities in the nation that is home to the headquarters of *two* top-20 banks, National City and Key Corporation, Cleveland is quaking from the aftershock as its two bank holding companies are crumbling from ill-advised attempts to maintain market share. National City, having disclosed \$25 billion in bad loans, is on the ropes and looking for a white knight, its CEO pilloried by the press and driven into exile in Florida. Key was a potential buyer of its troubled sister until it just announced, on May 28, its own burgeoning loan problems.

While not major players in the originations of structured-finance products like their big-city brethren, the occupants of the two largest buildings in Cuyahoga County found other more mundane ways to lose money in the housing market as they struggled to keep pace with their competitors inside and outside this proud, rebuilt city that overlooks Lake Erie. Given their checkered pasts as consumer lenders, it's unlikely that either bank is ready for an onslaught of corporate loan losses should the recession begin to expose the dark side of the surge in less than investment-grade corporate lending in recent years. Earlier in this chat it was noted that the Federal Reserve chairman justified his intervention at Bear Stearns as a necessary step to avoid "a possible systemic financial crisis," most likely a run on an investment bank by other investment and

commercial banks. But what about the depositors who fund the assets of commercial banks? Are they protected against systemic risk, or are they, to coin a phrase, "too small to save"? I'll leave you with this thought. The \$52 billion in funded reserves at the FDIC is enough to cover approximately 50% of the deposits—at the two biggest bank holding companies in Cleveland.

If Congress can keep its legislative pen out of the ink well and if the Fed can regain its lost composure, this will be the gloomiest of the fireside chats. Obfuscation from those who are in denial and leveraged financial structures that defy description have made getting to the truth of the matter exceedingly difficult. This is one of those times that if you're going to err, you are strongly encouraged to do so on the side of excessive caution. There is a time for heroes, but that time has not yet arrived. A steely, focused temperament, along with the patience of Job, will likely see you through. All ordeals come to an end, and this too shall pass. Those who make it through with their propensity to seize opportunity intact will be the very ones who lay the cornerstones of a new era of economic opportunity in the most resilient nation in the world.

Until we chat again,

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