Godsey & Gibb Associates
Investment Watch
October 7, 2008

# Crisis Intensifies, Transforming Government Sponsored Entities and Wall Street Banks; Policy Makers Respond Aggressively But Economic Data Signal Slower Growth Ahead

In the third quarter, the unrelenting financial crisis intensified to the most severe levels experienced by investors in the post World War II modern era of finance, prompting an equally unparalleled policy response from U.S. regulators. Losses and write-downs related to mortgage-backed derivatives forced the two housing related government sponsored entities (GSEs) into "conservertorship", one of the five largest investment banks into liquidation and the world's largest insurance company scrambling for a government sponsored bridge loan in order to survive. As an unintended but foreseeable consequence, a money market fund lost its $1 net asset value ("broke the buck") sending investor withdrawals to record levels. In a flight to the safest possible assets, U.S. Treasury bills briefly traded with a negative yield. By most any measure, these are truly extraordinary times in the financial markets and the economy.

Investors are experiencing the unwinding of what may be determined is the largest global credit cycle in history. Deleveraging is leading to broader systemic problems and economic dislocations. Individuals and institutions are both restructuring their balance sheets to reduce over-burdensome debt levels. Banks made an estimated 15 million sketchy mortgage loans from 2004 to 2007, of which an estimated 10 million of those will default, according to Moody's Economy.com. The Financial sector also over extended itself. From 2002 to 2007, Financial sector debt levels grew from $10 trillion to $16 trillion. Federal Reserve data reveals that household borrowing slowed to a 1.3% annual growth rate in the second quarter, and Financial sector borrowing grew at 6.6% in the same period. Both measures are down from double-digit levels over the last ten years.

In what is referred to as a negative feedback loop by central bankers, the deterioration in financial conditions has led to both a decline in banks' willingness to lend and a decline in households' and firms' willingness to borrow, which in turn has led to a decline in economic activity. The decline in economic activity completes the loop by leading to a further deterioration in financial conditions. The secular decline in credit has led to a virtual stoppage of lending between financial market intermediaries, which in turn limits the availability of credit to consumers, who drive over two-thirds of economic growth. The process has decreased liquidity and increased risk spreads and financial market volatility. In September, short-term borrowing rates and equity market volatility both soared, while short-term U.S. Treasury yields plummeted as investors rushed to safety.

The overnight London Interbank Offer Rate, LIBOR, a short-term interest rate used as a benchmark for lending between financial institutions, rose to more than 6% from near 2%. The Chicago Board Options Exchange equity volatility index, or VIX, spiked to levels not seen since 1987. The VIX is referred to as the fear gauge. It tracks prices that investors are willing to pay for options on the S&P 500 Index for protection from market gyrations.

In an attempt to jump-start the credit markets, provide for the stability of the financial system and provide much needed liquidity, Federal regulators prepared unparalleled policy actions, on a case-by-case basis at first, and then on a comprehensive level later, in response to the financial disruptions. The dollar amount of the proposals total over $1 trillion, including: asking Congress for approval of a U.S. Treasury plan to buy up to $700 billion of bad mortgage securities; helping to nationalize Fannie Mae and Freddie Mac with a $200 billion investment; lending $85 billion to the world's largest insurance company; and lending $29 billion to facilitate the forced merger of an investment bank (in the first quarter). In addition, regulators announced FDIC-like insurance for money funds' balances as of September 19, a temporary halt to short sales in over 800 financial stocks, expanded lending facilities to financial firms, injections of funds into money markets and the lowering of policy interest rates. Any one of the recently announced p0licy actions would be considered large by historical standards. Together, the measures represent the largest Federal interventions in decades. However, with the prospect of a devastating credit crisis that has already transformed Wall Street, the policy response is largely viewed as unfortunate but necessary to try and minimize the overall economic impacts.

The U.S. Treasury's "Troubled Asset Relief Program" (TARP) comes as a broad, systematic approach after a number of incremental announcements failed to stop the turmoil. The program involves using a $700 billion fund to buy distressed assets from financial institutions, at what are expected to be deeply discounted prices, to provide liquidity in what would otherwise be a frozen market. The proposal calls for the U.S. Treasury to hire asset managers to facilitate the transactions. According to U.S. Treasury Secretary Henry Paulson, mortgage-related assets are choking off the flow of credit. Policymakers believe that removing these assets from institutions balance sheets will restore confidence in financial markets and enable banks to raise capital and expand credit to help support economic growth.


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The most recent example of comprehensive government regulation similar to the TARP is the Resolution Trust Corporation (RTC), a government body established in 1989 to deal with the savings and loans bankruptcies at that time. More than 1,000 specialized mortgage lenders known as thrifts failed from 1980 to 1994. Congress created the RTC to dispose of the failed thrifts' assets in a way that minimized downward pressure on financial markets. While we applaud the TARP as a first attempt at a systematic solution to the credit crisis, no plan is perfect. We will be monitoring its implementation going forward.

Regarding Fannie Mae and Freddie Mac, deteriorating financial market conditions prevented sufficient capital from being raised to continue normal operations. The institutions, which date back to the 1930s and 1970s respectively, had grown too big to be acquired by another company and too interconnected to the global financial system to fail. Together, the two GSEs hold more than 40% of all U.S. mortgages. The collapse of the housing bubble proved to be too great a shock for these two organizations, which were ultimately unsuccessful in fulfilling the dual roles of trying to both facilitate home ownership and generate earnings for public shareholders. Under a rescue plan announced in the third quarter, regulators will run the GSEs. The Federal Housing Finance Agency, and the U.S. Treasury will provide up to $100 billion to each entity for capital needs. The U.S. Treasury and Federal Reserve also established an unlimited lending facility for both entities and the Federal Home Loan Bank and the U.S. Treasury intend to buy GSE guaranteed mortgage-backed securities in the open market to boost liquidity. While the rescue plan allowed the agencies to continue functioning and increased liquidity in the mortgage credit markets, and led to a decline in mortgage rates to near 5.78%, from 6.34% a year ago, it did not address the historically high inventory level of unsold homes currently available on the market which continues to pressure home prices.

In the cases of the investment banks, the business model based on borrowing short in the overnight funds market and lending through long maturity deal structures, often with the use of significant leverage, suffered as trading partners became more scarce due to the credit turmoil. Unlike commercial banks with stable deposits from client accounts, the operations at investment banks were predicated largely on confidence. Given deteriorating financial market conditions and without the much needed trust of trading partners, known as counterparties, the investment banking model was ultimately unsustainable due to: increased funding costs, as well as low levels of liquidity due to the reluctance of trading partners and withdrawals from clients, at best; and at worst, totally unavailable credit. The remaining Wall Street investment banks have either merged with commercial banks or have filed for re-regulation and plan to continue operating as commercial bank holding companies going forward. Late in the quarter, the nation's largest thrift became the 13th FDIC seizure this year. Given the magnitude of the crisis, more bank failures are possible and Financial sector consolidation is expected to continue.

Data points from the current cycle continue to point to an economic slowdown and potentially an official recession. Unemployment rose to 6.1% in August and is likely to continue climbing as the labor market has lost jobs every month this year and unemployment claims are making new highs for the current cycle (since the 2001 recession). Annual changes in retail sales are also at the weakest levels of the current cycle. The level of both unsold homes and delinquencies continue to rise. The aggressive policy response could also increase the Federal government's budget deficit and the country's overall debt level, which could negatively impact the value of the U.S. dollar. Large amounts of government borrowing could also crowd out private investment and increase market interest rates.

The crisis has exposed regulatory inadequacies with regard to containing systematic risk. For example, the Securities and Exchange Commission, the lead oversight agency of Wall Street firms, has seen two investment banks collapse and a third sell itself to avoid similar problems. We are hopeful that the current cycle will lead to an end to the fragmented system of oversight and to more transparency and supervision of financial giants that are "too big to fail" and too interconnected. Regulators may also consider systemic enhancements such as an exchange-clearing house for derivatives and a return of the so-called "up-tick rule" which prevents a short sale unless the share price is higher than the last trade.

Regardless of future regulatory modifications, business cycles and market cycles will always be with us. Since 1948, there have been 12 bear markets that lasted an average of 14 months, which experienced an average decline in the S&P 500 Index of 22.4%. After each of these periods, economic conditions improved, with 12 bull markets lasting an average of 45 months that experienced an average gain in the S&P 500 Index of 123.9%.

Godsey & Gibb Associates continues to believe that the design of a customized, balanced and prudent asset allocation is the most important determinant of long-term returns. We advocate optimal exposures to cash for short-term spending needs, preservation and stabilization of assets and flexibility, bonds for income generation and stability and equities for appreciation of principal over a full market cycle, typically at least three- to five- years. After allocating assets and implementing solutions we realize that markets are constantly changing so it is therefore important to review progress and periodically rebalance allocations to maintain appropriate targets. While stocks can dive in a day, they can surge too, and while no one knows when this market will turn, if investors are not exposed to it, they will miss it when the time comes. Just as we would not recommend buying stocks in times of irrational exuberance, we would not recommend broad based selling into the current environment. If the purpose of the funds being invested, the time horizon, the risk tolerance or the need for short-term withdrawals has not changed, we recommend staying the course with the conservative, defensive strategies currently being employed across equities, fixed-income and cash by Godsey & Gibb Associates.





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