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Market Outlook

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The $700 billion rescue plan intended to stabilize financial markets, stem the credit crisis and avert an economic recession was endorsed by leaders of both political parties, the Chairman of the Federal Reserve, and highly respected individuals like Warren Buffet. Yet the House of Representatives, fearful of the political backlash in an election year, failed to pass one of the most important pieces of legislation in recent history. Markets around the world plunged in response to the bill's failure. The Standard & Poor's 500 (-8.9%), Dow Jones Industrials (-6.0%) and Nasdaq Composite (-12.1%) all plunged in the month of September.

As the list of corporate casualties continues to mount, the crisis our economy and markets face today is one of fear and a lack of confidence in our largest financial institutions. This rescue plan is not a taxpayer bailout of Wall Street! It is an investment of taxpayer money in artificially depressed assets, and it is necessary to prevent the disaster on Wall Street from spreading to Main Street. We come to this conclusion by analyzing the timeline of events that led to where we are today, identifying the sources of the crisis, and determining the only viable solution that is in the best interest of the country.

> We believe the $700 billion rescue plan will resolve the credit crisis, restore confidence in our markets, and lead to significant gains for the taxpayer.

The root cause of this crisis is the housing market. Many Americans bought homes they could not afford in anticipation of rising prices. Mortgage brokers facilitated these home purchases with exotic mortgage products that offered teaser rates and limited documentation to qualify borrowers. These loans were then sold to lending institutions. The lending institutions (commercial banks), working in concert with Wall Street investment banks, packaged thousands of these loans into securities that could be sold to investors. Many securities combined home loans with other types of consumer loans, further complicating the structure of the investment product. The investment banks then paid ratings agencies to provide the securities with a credit rating. The rating agencies assigned erroneous credit ratings to these securities, misrepresenting the quality of the loans in the product. These false ratings enabled the investment banks to sell the securities to other institutions that believed their potential for loss was limited, based on "pristine" ratings. Many Wall Street firms attempted to increase their returns on investment by using leverage to purchase these securities.

Home prices began to fall as the economy slowed and the unemployment rate rose. Delinquencies and foreclosures started to rise, and the value of the mortgage-related securities declined. Those institutions employing the most leverage were forced to sell their investments at depressed values. Because of the complexity of the many loans pooled into these investments, it became increasingly difficult to value each security held on the balance sheets of every financial institution. To address this issue, an index called the ABX was created in early 2007. It was intended to serve as a benchmark, similar to a stock market index, for securities that held home loans issued to borrowers with weak credit. The problem with the index was that it did not track the performance of the securities. It was comprised of derivatives called credit-default-swaps (CDS) used by traders to speculate on the securities. As the housing market declined, speculators drove the index down to extremely unrealistic levels. The market value of the securities the index was intended to represent plummeted in response, irrespective of the performance of the loans the securities held.

The Financial Accounting Standards Board instituted a new rule for financial companies at the end of 2007. Security values would be determined by what sales price could be obtained from a buyer in the current marketplace. This became known as mark-to-market accounting. The consequences were devastating. When leveraged institutions were forced to sell mortgage-related securities in an illiquid marketplace, values were determined by the ABX index, which had been manipulated to depressed levels by speculators. When a transaction occurred at fire sale prices, other institutions holding similar securities were forced to mark down the value of their assets to similar prices. A negative feed-back loop developed as the ratings agencies began to lower the credit ratings of these securities on the basis of the declining value of the ABX index, which further depressed values and forced sales.

The paper losses resulting from mark-to-market accounting rules on the balance sheets of financial companies soared into the hundreds of billions. This eroded the available capital base which financial companies use to lend. The final chapter of this saga, which led to unprecedented government intervention, was the rampant speculation on the demise of our largest financial institutions in the unregulated credit-default-swap market. A credit-default-swap (CDS) is an insurance contract originally created to allow the owner of a debt security to insure against loss in the event of a default. As balance sheets deteriorated, speculators began to purchase these insurance contracts on the debt of financial institutions, despite their not owning the underlying debt security. These speculators would sell the company's stock short, driving down the stock price, in hopes of creating fear and panic. Other institutions and individuals, fearful of what they did not know, would pull assets from the speculator's target, creating a "run on the bank."

All of these events culminated in the bankruptcy of Lehman Brothers, the bailout of AIG, the government takeover of Fannie Mae and Freddie Mac, and the government-brokered acquisitions of Merrill Lynch, Washington Mutual and Wachovia. The ban on short-selling financial stocks until October 2 was imposed by regulators in an effort to stop this death spiral until the $700 billion rescue package could be implemented. The crisis on Wall Street is now infecting Main Street as the remaining financial institutions are dramatically limiting credit availability to businesses that depend on it to operate.

We believe the $700 billion rescue plan will resolve the credit crisis, restore confidence in our markets, and lead to significant gains for the taxpayer. Treasury Secretary Hank Paulson has proposed using taxpayer funds to buy these undervalued securities from financial institutions at prices above where they are currently valued, but below their fair market value. This would result in marking up the value of all related securities not being sold that still sit on the balance sheets of financial companies. That in turn will increase available capital and credit availability. The Treasury can finance the cost of these purchases at an interest rate of 3-4%. The securities it would purchase are yielding a substantially higher rate of interest. The plan then proposes to facilitate loan modifications within the securities they acquire to prevent avoidable foreclosures and stabilize the housing market. This should serve to further increase the value of securities purchased above the market value paid by the Treasury.

We expect Congress to approve a revised rescue plan within the week, because there are no alternatives. The markets should respond positively to the final outcome. We are all now paying a high price for speculation and greed that was able to flourish because of a financial system devoid of regulation and oversight. Everyone from homeowners to the largest financial institutions is culpable in this meltdown. The only institution left standing to address this crisis is the Federal government. ■

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