Stock Market Perspective: Financial Crisis and Bailout

YOUR INVESTMENTS ARE NOT IN DANGER FROM THE CRISIS. Before getting into the main discussion, I want to reassure you that the accounts I manage are not in danger due to the current problems banks and other financial firms are having. My managed accounts are held at two custodians: Rydex mutual funds and brokersXpress (bX). Mutual funds are strictly regulated, more so than banks, and they do not have loan portfolios that leverage their assets as banks do. Rydex has only one money market fund, which I use as a parking place when not in the market. It owns only treasury securities, so it is as safe as possible. The returns may be anemic now, which is a small price to pay for avoiding some of the problems other money market funds have had recently.

Cash in retirement accounts at bX is swept into FDIC insured accounts, and is protected up to $2 million. All customer accounts at brokerage firms are separate from their corporate trading and investment accounts. That means unless there is illegal activity (and that is protected up to half a million by the independent Securities Investment Protection Corporation, SIPC), problems of a firm such as Lehman or Merrill Lynch do not affect individual accounts. Non-retirement accounts at bX have their cash swept into their proprietary money market fund. The head of bX has sent out a letter saying their money market has not had exposure to Lehman, which was the cause of the one money fund's "breaking the buck." The letter also says that bX does not borrow operating funds and has a strong balance sheet. In short, I have confidence in the safety of our holdings with them, and I have considerable assets with their parent company, optionsXpress.

▶How Did We Get Into This Mess? You have heard and are going to hear a lot of reasons given. Many of these will be finger pointing at one action or policy, quite often to support an agenda, which may be political. You should ignore all such ranting no matter how much you like or agree with the propounder. Just about all of them will have an element of truth to them, but none will be even close to the full story. In effect we have had a "perfect storm" resulting from quite a few factors. Some are deliberately risky behaviors such as using too much leverage. Others are victims of the law of unintended consequences. For example, the Fed lowered rates in 2002 and 2003 to help bring the economy out of recession. The rates were so low, higher paying alternatives to typical fairly safe investments were being sought. At the same time, the low rates encouraged a tremendous amount of building, quite of bit of it being housing. That led to a need to provide mortgages to marginally qualified or unqualified buyers, which led to further shenanigans. I'll let you read about the gruesome details elsewhere.

I believe that steps will be taken to make sure this particular storm will not ever happen again. However, given the propensity to search hard for extra investment returns, which sometimes can be greed run amok, and all the clever people looking to exploit niches and weaknesses in the financial system and legal and regulatory loopholes, it would be shocking if there are not "bubbles" in the future. Given that most things tend to happen faster these days, that day may not be all that far off.

▶Is Government Action Really Needed? The "man in the street" or the so-called "Main Street" seems to think that those who caused the problems should be allowed to stew in their own juices. Put another way, why should the taxpayers ("Main Street") bail out the rich bankers on Wall Street? Enough House members reacted to that overwhelming consensus from feedback from their constituents to defeat the first bill on September 29. That caused a minor panic in the stock markets resulting in a Dow drop of almost 800

points that day. The next day saw some more reflective thinking and the Dow bounced back almost 500 points.

Although such thinking might sound and feel good, it is more like "cutting off one's nose to spite one's face." The crisis has already caused credit markets to come close to seizing up. Much of our economic activity is lubricated by credit. Commercial paper, short term borrowing by businesses, is critical to many companies. If they can't find someone, often a money market fund, to buy the commercial paper, they may not be able to obtain inventory to sell or to pay their employees in a timely manner.

Some steps by the government were needed to prevent an economic calamity, but what has been done so far may not be enough.

It is not only businesses that will be hurt. An article in the October 2 *Wall Street Journal* reported that over a thousand colleges and universities had cash parked in a short-term fund run by Wachovia. Although the fund had retained its value, Wachovia was worried about too many withdrawals too soon causing forced liquidation at unfavorable prices. They decided to terminate the fund and liquidate its assets on an unforced schedule. That resulted in the schools being able to withdraw only 33% of their money right away, 57% by the end of the year, and the rest coming installments through 2011. Some colleges will have to scramble to meet their payrolls, possibly tapping into their endowments.

The credit lubricating the economy analogy is apt. If your car's engine loses too much of its oil, it will literately grind to a halt. So will much of economic activity leading to a severe recession or even a genuine depression. Unfortunately, we are left to choose a lesser evil, some sort of bailout.

▶Does the Bill Passed Take the Right Steps?
I don't know! It will take a little time to see if the credit markets loosen and lending gets back to normal levels. The reactions of the stock markets in the first days after the bill passed suggest that more government actions may be needed in the near future.

Several alternative rescue plans have been proposed by various parties. From what I have read, most, if not all, have been considered by the "team" (Treasury Secretary Paulson, Fed Chief Bernanke, the senior members of the appropriate Congressional committees) that worked out the plan that passed. In short, it appears that every tactic, including the up to $700 billion purchase of "toxic" debt by the government, is far from perfect, can fail to achieve its goals, and has the potential to create new problems down the line as the law of unintended consequences again rears its ugly head.

My guess, and it is only a guess as I claim no particular expertise in this area, is that we have not seen the last of what the governments, ours and those of many developed countries, will need to do to prevent a freezing of the credit markets worldwide. Although there are those who claim the $700 billion will be mostly or completely recovered or even possibly produce a profit once the loans are settled over the years or sold back into the markets, I suspect that is overly optimistic. I would not be surprised to the see the costs to the U.S. government eventually exceed a trillion dollars as additional steps are taken.

To summarize, I am afraid that the "cockroach theory" applies here. That is there are always a lot more than you see and it is quite difficult to exterminate all of them.