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Musings & Amusings

Andrew Mellon, "Gentlemen prefer bonds."

Herbert Hoover, "We have hit bottom and are on the upswing."

Jim Rogers, "People should be more concerned with the return of their principal than the return on their principal."

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Another Fine Mess:

Recent financial turmoil reminds me of Hardy's complaint to Laurel: "Well, here's another fine mess you've gotten me into."

Twenty years ago, the Dow Jones fell 23% in one day and 30% for the month. In 1998, the collapse of a prominent hedge fund threatened financial markets here and abroad.

While there's no readily identifiable trigger for the October 1987 debacle, I believe the fundamental cause was concern over the declining dollar exchange rate, which had plunged 40% in the previous two years. This had pushed Treasury bond yields up by 250 basis points. Also, people were ignoring risks after years of good economic times. Leveraged buyouts were the rage, involving heavy borrowing with "junk bonds" to buy a company's stock and take it private. Computerized program trading gave equity investors the feeling that they were protected from losses.

The Fed worried that steep portfolio losses would cause the failure of some major financial institutions – not just those who had been taking financial risks. A chain reaction starting on Wall Street would disrupt the payments system and hit Main Street hard.

Alan Greenspan, who had just become Fed Chairman in August, rose to the occasion. The Fed simply stated that it would provide sufficient liquidity to the financial system. As Tony Soprano might say, Greenspan became a "made man" that October and began building his reputation as one who could perform financial miracles.

The evaporation of huge amounts of wealth did not cause a recession. The exchange rate drop was beginning to reduce the economic drag from the trade deficit. Also, bond yields fell quickly as global financial markets calmed.

In 1997, a number of high-flying nations, such as Korea and Thailand, got into trouble over their large foreign borrowings. However, their pain turned out to be our gain! Seeking a safe haven, money poured into the U.S., driving down our interest rates. Also, the recession that plagued much of Asia helped drag oil prices down to $10 per barrel.

By 1998 the oil price plunge helped precipitate a crisis in newly "capitalist" Russia, whose government did the "unthinkable" by defaulting on sovereign debt. Risk premiums skyrocketed around the world.

In order to ease the global crisis, the Fed temporarily lowered short-term interest rates little. Then a big U.S. hedge fund, Long-Term Capital Management (LTCM), reported huge losses. The term hedge fund is a misnomer because many of these don't really hedge. Rather, they place big bets. Since hedge funds cater to wealthy individuals and institutions, they are lightly regulated. Unlike mutual funds, they can short stocks and bonds, i.e., bet that prices will decline. They can also leverage by borrowing to amplify their returns…and losses.

LTCM had a "dream team" of Nobel Prize winners and Wall Street stars. Big banks lent them large sums and asked few questions. For a while, LTCM earned impressive returns. But when the Russians defaulted, LTCM's wagers went bad very quickly. Their high leverage caused their capital to disappear.

The Fed could have let LTCM fail, but was afraid the collateral damage would paralyze the financial system and cause major harm to innocent folk. Financial firms were becoming increasingly interconnected by the use of derivatives, which were designed to spread the risk. Instead of a bailout, the Fed arranged for a consortium of private financial institutions, who were LTCM creditors, to lend enough to get over the hump. No federal money was involved.

The current "crisis," which is often called a "credit crunch," goes back to the housing bubble, but is broader based. It's what happens when complacency causes financial risks to be underestimated.

Weakening housing markets hit sub-prime mortgages hard. Sub-prime originators borrow funds short term to make loans that they intend to sell quickly. The investment banks and others who buy them will package the loans into mortgage-backed securities and sell them to investors. Sub-primes are usually too low in credit quality to qualify for purchase by Fannie Mae or Freddie Mac, who provide credit insurance when they securitize loans. Instead, the sub-prime originators themselves had to guarantee that the loans will be repaid for a stated period after they sell them. When delinquencies started rising, funding dried up quickly. Originators couldn't make new loans nor could they repurchase problem loans. Many shut down.

It soon became clear that the risks had been grossly underestimated. Problems were few as long as house prices were rising rapidly since borrowers could readily refinance or sell their homes at a profit. But prices started to fall. Furthermore, many borrowers had taken out adjustable-rate loans, which began to reset with dramatically higher monthly payments. There are also allegations of deceit by originators, but it is often difficult to tell whether the borrower was duped or just plain dopey in taking big risks.

The sub-prime problem spread to "jumbo" mortgages, which are those larger than the $417,000 limit on loans purchased by Fannie Mae and Freddie Mac. Interest rates on jumbos jumped, while rates fell a little on the mortgages purchased by Fannie and Freddie.

By mid-August, a broad "flight to quality" was taking place. Yields plummeted on Treasury securities as investors sought safety. This return to recognizing risk took its toll on the stock market and even municipal bonds.

Overseas financial markets were hit by the fallout, and central banks around the world started pumping reserves into their banking systems to combat a growing credit crunch. As worries about risk spread, financial institutions were becoming less willing to extend credit.

On August 17, the Fed took the highly unusual step of cutting the discount rate but not the fed funds rate. This came between FOMC meetings, which is also rare. Just the week before at the August 8 meeting, the FOMC had left interest rates unchanged and stressed that inflation was a key concern.

The discount rate is normally a minor policy tool. Banks can borrow at the Fed's discount window but usually don't because this is often viewed as a sign of weakness. A reduction in the fed funds rate is more important since most other short-term interest rates, such as the prime rate, move in lockstep.

The Fed wanted to encourage borrowing at the discount window in order to address growing problems in the commercial paper market. Commercial paper is an important source of short-term financing for companies who use it for working capital. The Fed was afraid that commercial paper problems could spread further and decided to break the logjam by encouraging banks to use it as collateral at the discount window. Just having that option available to banks makes commercial paper more attractive.

So how did this fine mess happen? Financial markets got caught in the housing bubble, as they did with LBOs, junk bonds and dot.coms. Regulators were slow to react. In a February 2004 speech, Chairman Greenspan praised the benefits of variable-rate mortgages just four months before he started raising interest rates! The spread of securitization (the packaging of individual loans into securities resembling bonds) has reduced the discipline that existed when lenders knew their borrowers. While many recent innovations helped diversify the risk, they also helped spread the problems when they have surfaced.

The process of re-pricing of risk is inevitably painful. In order for interest rates on existing securities to reflect higher risk, their prices have to fall so that new buyers will get the higher returns that risk requires. This is painful for the existing holders. Furthermore, markets can become very "illiquid" while trying to find the new equilibrium. Prices often fall too much as sellers panic and buyers sit on the sidelines waiting for bargains at even lower prices.

Many argue that cutting interest rates under these circumstances or opening the discount window amounts to a bailout for bad decisions. They say that these Fed actions give rise to "moral hazard" whereby participants take on too much risk knowing that they'll eventually be bailed out. They contend that the Fed should "let the chips fall where they may."

The problem comes when the chips start hitting people who had nothing to do with the problem, such as the homeowner trying to sell his house in order to move to another job. There's also a significantly increased risk of recession when the Fed takes a tough stance.

Where do we go from here? By late August, financial markets seemed to be calming. The stock market has been less volatile; and short-term Treasury yields have risen somewhat, indicating that the flight to quality may be abating.

But to quote Yogi Berra, "It ain't over until it's over." More adjustable-rate mortgages will reset in coming months, and problems are developing in condos where new units are being completed in some very soft markets.

I think the most likely outcome is slow economic growth, with 2% or less real GDP growth. Recent events have raised the odds of recession but not made one inevitable. Slow growth and lingering financial problems reinforce my view that the Fed will be cutting the fed funds rate several times later this year. This is the only way of providing some modest relief for those many adjustable-rate mortgages that are poised to reset.

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