

Not-So-Free Markets?

Purpose

This is a reissue of previously disseminated information.

The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

Quick Look

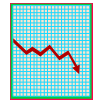
Market



- The US government's role and culpability in the current credit crisis is discussed.
- Some of the government responses to the market and credit crises are evaluated.
- Proposals for new powers for the Fed are evaluated.

Next

Expected Move



Government Created the Problem

The story begins in 2001, in the middle of the dot.com bust. Fed Chairman Alan Greenspan, believing a recession was coming, lowers the Fed Funds Rate from 6½% to 1¾% over the next year or so (hopefully) in order to forestall it. Please note this all began months prior to 9/11. While the aftermath of 9/11 factored into what happened later, the series of interest rate drops did not begin because of the terror attacks or our subsequent military responses. From that point forward, the Fed left the Fed Funds Rate below 2% for almost the next 3 years. **3 years!**

Let's examine and review what happened to our economy because of this policy.

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Real Estate

First, and most obvious, the real estate markets went crazy as mortgage rates declined with the easy credit policy that goes along with the massive buildup in the money supply required to support such a low Fed Funds Rate. The price of homes rose dramatically, but homes were still able to sell because of the low borrowing rates. Mortgage refinancing became very popular as people lowered their monthly payments. Many took out MEW's (Mortgage Equity Withdrawals) in order to buy more consumer goods or to retire other debt. Multiple financings and MEW's were common.

Times were so good for real estate that no one felt there was significant risk in *any* real estate housing transaction. Loans were made without verification of employment or income of any kind to borrowers who should not have been allowed to borrow. "Subprime" lending became a much larger part of the overall loan portfolio of the US, especially as virtually all of the prime borrowers already had homes and mortgages. After all, real estate *never* goes down in value, right? So, even if the loans default, the increase in the value of the collateral protects the lenders from any loss, right?

Instead of servicing all the loans made, lending institutions securitized (bundled together) the loans and sold them into the financial markets, providing further funds for them to lend and to make fees from loan originations, which was where the real money was. Interest rates were so low they really wouldn't make a good return on the loans themselves.

Bond Markets

Meanwhile, in the bond markets, interest rates on bonds were so low that bonds became more difficult to sell. The paltry interest rate paid on bonds were uninteresting to investors, who began favoring stocks and alternative investments such as non-bond mutual funds, ETF's, hedge funds and private equity among others.

In order to interest investors in bonds, various exotic constructs were created to generate yield. While having been around before, RMBS's (Residential Mortgage Backed Securities), CMO's (Collateralized Mortgage Obligations), CDO's (Collateralized Debt Obligations) among others became more common as they presented bond investors with additional yield. Without going into this complicated and arcane world, the important point is that these products appeared to

provide greater yield than other bond products without appearing to incur more risk. Somehow, rating agencies like Moody's and S&P were convinced to give "tranches" of BBB and below loans ratings of AAA. This obviously makes no sense and it was wrong, but that is what happened. Some people conveniently forgot that additional return couldn't come without incurring additional risk.

The markets are flooded with these securities, which have a significant percentage of underlying loans that will default. Because the exact default percentage is unknown, pricing and liquidity are huge problems.

Derivatives

As the credit markets became more arcane and complicated, privately arranged, non-traded derivatives became more common as a means of reducing investment risk for bond products. Specifically, the "credit default swap," a means of privately insuring an investment, became ubiquitous.

For example, assume you're a bond investor for a large financial institution. You buy a \$100 million CDO for yield, but you're not convinced the risk is sufficiently contained. Therefore, you approach another financial institution and arrange to pay them \$800,000 for the other party to insure the CDO. Technically, now you have no risk in the CDO, and you have diminished its return by 0.8%.

The second financial institution then tries to purchase a credit default swap from a third institution for \$600,000. Now, the second party has no CDE risk and it has realized a \$200,000 profit. Theoretically, this could go on as long as someone is willing to underwrite the risk. This creates a derivative chain of unknown length. When applied to multiple investments and multiple parties, it becomes a web instead of a chain. The financial institutions are now all linked by a derivative web.

Imagine a pile of sand in a box. Each grain is represents a financial institution. As long as they are grains of sand, you can pound away on the sand and maybe a few grains break, but the box of sand sustains essentially no damage. Now heat up the sand and atomically link all the silicon molecules together into a pane of glass. When a blow is struck to the pane, one of two things will happen: nothing or the pane of glass shatters, destroying the entire pane. Because of the linking, the entire structure could be shattered, just like the financial industry today.

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Asset Allocation Percentages CJ Current Suggested Ranges

Dow Theory Market Phase: BEAR
Appropriate Current Allocation: DEFENSIVE

<u>Asset Class</u>	<u>Conser- vative</u>	<u>Aggres- sive</u>
Money Market Funds	70-10%	55- 5%
<i>Long Positions:</i>		
Bonds & Bond Funds	30-60%	40-60%
RD Stocks	0-10%	0-10%
Growth Stocks	0%	0%
Gold Equities/Funds	0-20%	10-30%
Bear Market Funds	0- 10%	5-20%
<i>Aggressive Positions:</i>		
Shorts and/or Options	0%	0- 5%

Notes:

Income generating portfolios may not conform to the above guidelines. If income is the primary purpose of a portfolio, income needs are met *first*, then other allocations are made.

Up to 50% of bond/bond fund positions should be in international (non-US) bonds. Such bonds will provide higher interest paid on the face due to the additional *perceived* risk of foreign bonds, as well as providing hedging gains as the dollar declines against foreign currencies due to Fed monetary policies.

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What has happened is that through this derivative web the financial industry has transformed individual company risk into systemic risk. Individually, a firm would not appear to have risk as it is all “covered” by the derivatives it holds. However, if one of the other institutions in the industry goes under for any reason, the risk gets transferred back through the web of derivatives and the entire industry could topple over like dominos – or shatter like a pane of glass.

It’s not too hard to understand why The Fed would go to such great lengths to preserve the financial industry, as most recently shown by brokering the Bear Stearns purchase by JP Morgan Chase. Their fear is entirely justified. *The subprime meltdown is the blow that may shatter the financial industry like a pane of glass.* It’s hard to believe that, just two years ago, Fed Chairman Bernanke was telling us how the danger was “contained” and didn’t present a major systemic risk. What did he base that on?

What the Fed doesn’t want you to realize is that they are culpable for the entire problem by lowering the interest rate below 2% and leaving it there for three years. This could be a textbook example of how (at least in one industry) interest rates below the natural rate of interest create malinvestments, further creating the expansion phase of the business cycle and how capital is destroyed in the recession phase, as theorized by Austrian economics.

The Wrap-Up

So, in light of the Fed’s culpability in the current market and credit crises and the impending recession, what does Treasury Secretary Hank Paulson propose today? He wants to give the Fed even more power! He wants the Fed to become one of three new regulators, the one in charge of “market stability!” That’s like giving a promotion to someone who severely messes up her current job.

First, the Fed already has a focus problem. They have to try to balance the often-contradictory responsibilities of “maximum employment and protection of the value of the dollar.” See last month’s *CJ Newsletter* for more on this. The “mandate” of maximum employment should be removed. Other central banks do not have this mandate. Their jobs are to keep prices stable, the currency solid and their banking systems liquid enough to operate efficiently. That should be our Fed’s jobs, too. Their only jobs.

Second, what does “market stability” mean? In the context of the phrase used more than once by Paulson, “prevent market failures,” does this mean markets shouldn’t go down? Shouldn’t go down more than how much? Talk about a slippery slope... Market declines, even crashes, are not “market failures.” They are the repricing of securities to reflect a new, lower value based upon new information or anticipated changes. Without markets’ abilities to decline, some of the “creative destruction” coined by Joseph Schumpeter necessary to the improvement of capitalist economies would be stymied.

Markets are the most efficient device ever created to place capital where it needs to be quickly and efficiently. Do we really think regulation destroying that characteristic is better than letting them work freely? If we do, let’s not bother to call this a free-market capitalist country anymore. It won’t be. Who wants to be the first to tell the founding fathers and those who died to keep a capitalist America free that we don’t want that kind of America anymore?