
Strike Three Becomes Phase Three

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It's been an interesting year this week. The boldface front page headlines are historic:

"Day of Reckoning on Wall Street" *Tuesday September 16 London Financial Times*
"Worst Crisis Since the Depression" *Thursday September 18 The Dallas Morning News*
"Credit Panic Hits Historic Levels" *Thursday September 18 London Financial Times*
"Worst Crisis Since 1930s With No End in Sight" *Thursday September 18 NY Wall Street Journal*

Credit cycles are not as well studied as business cycles because they occur much less frequently. The liquidation of excessive debt or weak credit in this cycle has proceeded with

- a "strike one" realization that mortgages and credit quality were weaker than advertised,
- a "strike two" recognition that mortgage finance was a symptom to a deeper problem of overconsumption -- consumers struggling with debt and impacting the broader economy, followed by
- a "strike three" loss of confidence in the broader levels of debt, derivatives, and counter-party risks at the most senior levels of investment banks and governments.

In reaction to these events, the United Kingdom and United States Treasury Department, Federal Reserve, and SEC are taking historic actions. These actions likely change the potential downward "spike" of the US stock market and "strike three" impact on credit into a "phase three" elongated period of dealing with the crisis. Excessive levels of weak debt took a long time to build up, and the government wants the unwinding phase to occur over a gentler longer downslope. The following actions are designed to get us off the double black diamond slope and on to the blue or green ski runs:

- The UK Financial Services Authority banned short sales of financial stocks yesterday, effective into January 2009.
- The US SEC today announced it will be illegal to sell short the equity shares of 799 US financial stocks from Sept. 22 to Oct. 2, and that list may grow to include other stocks.
- The US Treasury will guarantee publicly available money market mutual funds, for a fee, and the US Federal Reserve will fund bank purchases of weak assets from money market funds.

- The US had to provide capital this week to the world's largest insurance company, AIG, and could now control 80% of that company.
- The US had to back the ownership transfer of Bear Stearns to avoid an avalanche of counter-party risks in derivative securities, and that was back in March.
- The US had to explicitly guarantee the credit of Fannie Mae and Freddie Mac this month.
- The Federal Reserve flooded the financial system with liquidity beyond imagination in joint operations with the central banks of Canada, Switzerland, EU, Japan, and Britain this week.
- A plan will be submitted for Congressional action next week for the US government to buy illiquid mortgage assets from financial institutions, which effectively completes an unthinkable government takeover of the US mortgage industry.

On top of that, Treasury Secretary Henry Paulson's golf game has been severely neglected.

The balance sheet of the United States, which was a little heavy on debt to begin with, is now ... it's so large I can't even complete the sentence. The Marines are looking for a few good men, and the US government is looking for a few good portfolio managers -- it's hard to keep track but I think we are long AIG, long mortgage-backed securities, and short the US Treasury yield curve. Where to from here?

Ralph Wanger, the long-time accomplished manager of the Acorn Fund (though his fund business has been sold and changed greatly in recent years), is the person I'll credit with the great quote:

"The only practical way to survive an avalanche is to be somewhere else when the mountain decides to have one."

It's been snowing a long time, and we've tried to be on solid ground but are not completely unscathed either. One would expect the swings between deflation (from asset liquidation) and inflation (sacrificing fiscal prudence and currency value to avoid a panic) to become more extreme than would otherwise have been the case. This interesting combination of inflation and deflation can be thought of as biflation, a situation where debt-financed assets decline in value and then essential consumer goods influenced by money-supply experience inflation.

As this is written, the stock market has rebounded about 1000 points from noon Thursday to noon Friday... the ultimate short squeeze and an exuberant reaction.

Today is not a joyful day.

We said on March 3rd that the stock market would move decisively under 11,000 this year. That happened. Now that the only sales of financial stocks will come from those who have first purchased the stock, and the government intends to assume the risk of so many questionable credits, the stock market lows of this week are likely to hold on an intermediate basis. That's important to traders, but the ramifications may be different for investors.

Markets under such government control are a new experience and the rules are changing quickly. We had been operating with a pretty clear strategy over the past couple of years, but frankly the outlook seems foggier now. This avalanche is large enough to have after-shocks. We may be off the double black diamond ski slope for the moment, but there's still a large and long mogul field ahead of us.

-Brian

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