

C *Economic & Market* Commentary

WHEN IN ROMA. . .

There has been a significant mood change on Wall Street and, as we predicted in our August 2007 *Economic and Market Commentary Perspective*, this happened sooner than many had expected. The catalyst was a mid-September, one half of one percent cut in both the Discount and the Federal Funds Rates that pulled the U.S. stock markets out of a late summer funk. When the Discount Rate was first cut in late August, Federal Reserve Chairman Ben Bernanke signaled that the Fed would do whatever was necessary to maintain liquidity in the financial markets, thus avoiding Alan Greenspan's mistake of using "once and done" language to describe the Fed's first rate cut in the early stages of the 1998 Asian liquidity crisis. The follow-up cut in both the Discount and Federal Funds rate this September was the reassurance that financial markets were looking for. Since the beginning of August, the Discount Rate has been cut by one full percentage point, and the Federal Funds Rate by one half of one percent. The resulting significant rise in the stock markets is consistent with historical precedents.

As this euphoria hit the stock market, fears of a weaker U.S. dollar and future inflation hit the bond markets, which led to a significant steepening of the yield curve (with long-term rates moving much higher than short-term rates). Largely unnoticed, interest rates on longer-term U.S. Treasuries rose almost as much as the Federal Funds Rate dropped. In addition, prices for oil, gold, and many other commodities priced in U.S. dollars rose, neutralizing the effect that a weaker dollar has on the international commodities markets. For the first time since November 1976, the Canadian Loonie (the Canadian dollar) reached parity with the U.S. dollar, and the U.S. dollar hit the lowest level ever versus the Euro (the European Union dollar). This makes doing what the Romans do when in Roma prohibitively expensive.

The dual rate cuts (Discount and Fed Funds) are not a bailout, but serve to reduce the carrying costs of all types of debt that are based on short-term interest rates. This buys investors and homeowners alike some much needed time to sort things out. Variable rate mortgages due to reset in the coming months will reset at lower interest rates than anticipated and interest rates on loans based on the prime rate and the similar LIBOR have dropped back to near pre-liquidity crisis levels. At some point, these will have a positive impact on the domestic economy.

On the subject of bailouts, there have been a few trial balloons floated in Washington, including expanding the portfolios of Fannie Mae and Freddie Mac to allowing the Federal Housing Authority (FHA) to insure mortgages with zero equity (no money down), and programs encouraging lenders to amend terms and principle amounts -- all of which are designed to keep homeowners in their homes. In principal, the concept of keeping honest, hard working Americans in their homes is good, and many of these programs have all the right soundbites.

However, there are no free lunches, meaning that someone has to shoulder the risk of these troubled loans. The notion that a homebuyer or a lender is surprised that a real estate investment can go down in value, or monthly payments on a variable rate loan rise when short-term interest rates rise, amazes me. In many business situations, variable rate loans are the norm, and one must accept the risk of a loan with open-ended interest rates. For a homebuyer, one has a choice... using the wrong kind of loan to buy more house than one can afford is like playing Russian Roulette...eventually someone loses! If a company or individual wants to be involved in that type of situation, they should accept both the risks and rewards therein.

For many years, these transactions built equity and created profits out of thin air, but when a borrower has little or nothing in the game, there is no incentive to pay off the loan should things go wrong. Once the economics surrounding a loan change (e.g., one owes more than the asset is worth or a similar living situation will cost less than paying the loan) many borrowers will default on the loan, and the lender or the lender's insurer will suffer a loss. More recently however, rising short-term interest rates, and falling real estate prices have changed the economics of many real estate purchases, creating losses and financial turmoil. If the government becomes the lender or insurer, then we, the taxpayers, will ultimately pick up the tab should things progressively get worse. Of course, if the government (read taxpayers') guarantee of home loans leads to calmer and more stable markets, then the guarantee is never cashed. Over the last decade (ending 2006), the market share of FHA -- insured homes dropped from approximately 16 percent of insured homes to approximately 4 percent, and their default rate doubled. That is not a stellar track record for a government entity in a rising housing market.

We believe there are a few more "sub-prime" and real estate related hurdles left to cross, and will continue to avoid industries and companies with more direct exposure to troubled areas of the economy. In addition, we will continue to stress international exposure through the international revenue component of U.S. companies and direct investment in foreign markets in both stocks and bonds, as this will serve to insulate us from continued weakness in the U.S. dollar, and expose us to higher-growth economies around the world.

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