

Economic & Market C o m m e n t a r y

Perspective

As of this writing, most major stock markets around the world are by-and-large well below the highs reached just weeks ago. The decline has not been a result of expected earnings disappointments but, rather, of market participants facing a liquidity crunch that has created a buyers' market. It doesn't matter if it's real estate, the futures markets, the commodities markets, the stock markets or the bond markets, the need for liquidity creates selling, and when there are more sellers than buyers, prices decline. The length and depth of this shift depends on many factors that occurred both before and after the realization of liquidity problems.

Recent events look a little like the heavily-leveraged real estate market's liquidity crunch in the late 80's. While different factors caused each situation, liquidity was a common thread as it was, and is, necessary to keep projects alive and loans current. Monetary policy was being tightened leading up to, and after, the real estate market peaked in 1986. Fiscal policy changes that drastically affected real estate holdings ultimately pushed that market over the edge, and it took federal action in the form of the creation of the Resolution Trust Corporation to help provide liquidity, then, sparking a mid-90's turn around in that market. Financial markets had a liquidity driven crunch in 1987 and again in 1998. In 1987, a combination of tight monetary policy and liquidity pressures in the financial system led to the "Crash of 87" (a three day, 31 percent drop in the Dow Jones Industrial Average that culminated with a 22.6 percent drop on October 19 – better known as "Black Monday"). Immediate monetary policy easing the following day sparked a 4.5 percent rebound, leading to a positive return for the year. In 1998, the Asian currency crisis had a similar backdrop in that uncertainty and global liquidity pressures drove the S&P 500 down approximately 13 percent from its July 1998 highs. With worse news in many international markets, the Federal Reserve (Fed) announced a minor easing with "once and done" language at the end of September, which was met with another round of selling that drove the S&P 500 down a total of 22 percent from its recent highs. Fifteen days later, more accommodative language from the Fed and another round of easing sparked a one-day, 5 percent advance which put the icing on a huge year for stocks. In both instances, the liquidity crunch pushed stock prices down for only a short period.

The main difference between the real estate and financial markets is the relative liquidity of the financial markets. Financial assets are priced by competitive bids and offers on a minute-by-minute basis. Pricing real estate assets can take weeks and months due to the time involved in getting credible bids and offers for the specific piece of real estate. This difference in liquidity is the basis for the short-term volatility of the financial markets.

The current reversal in the real estate market first affected real estate investors and had a residual impact on complementary industries. As the markets eroded further, aggressive loans made to buyers with substandard credit ratings or substandard projects were the next area to come under pressure. This "sub-prime" debt debacle has expanded into many areas related to construction, real estate, and the

finance companies associated with real estate and construction. If the fallout remains limited to those related industries, as we expect, it should not affect other parts of the markets. If, however, the fallout widens, there will be collateral damage as the ripple effects of falling real estate values will affect many other, non-related, industries. Concern over the extent of the collateral damage is driving the stock market's current volatility.

Another current phenomenon is that sometimes a high-quality asset is sold because it can be, while a low-quality asset is held because it can't be sold. This is where quite a few hedge funds find themselves. Some have employed elaborate schemes to stretch returns that involve probability and statistics, currencies, interest rates, and the stock markets. If all goes as planned, all is well, but when reality falls outside of the expected range, the equations deteriorate. As this plays out, positions have to be unwound and investments must be sold to create the liquidity needed to remain solvent. Certainly, the situation has many moving parts, but it is clear that it is driven by liquidity and not earnings concerns.

Liquidity driven corrections in the financial markets are usually fast and furious and can turn on a dime. Exiting quality investments at this point could be either brilliant (if there is wider fallout) or a huge mistake (if there is only limited fallout). For now, we believe that this storm in the financial markets will subside, and it may be sooner than many expect.

There are three reasons that we hold this belief:

1. Companies operating in industries not directly related to real estate, building, and the financing of those activities are experiencing quite healthy business conditions. Concurrent with this, market valuations for many of those quality companies seem inexpensive, based on expected earnings trends and historical valuation levels.
2. The Federal Reserve has cut the "discount rate" from 6.25 to 5.75 percent. Prior to the cut, the discount rate was a full percentage point above the Fed Funds rate, and the repurchase agreements that had injected liquidity into the system by the Federal Reserve were limited to U.S. Treasuries, Government Agency bonds, and Agency backed mortgage collateral. At present, they will accept non-Agency backed mortgage collateral, and allow institutions to borrow for as long as 30 days, which is a change from the usual overnight terms. This action is consistent with historical Federal Reserve action when faced with similar situations, and looks to be providing targeted liquidity for those institutions struggling with illiquidity of mortgage holdings.
3. While the markets have dropped below short-term technical "support" levels, there is longer-term technical support in the S&P 500 stock index about 4 percent below the market close on Friday, continuing the uptrend that began in 2003, and shorter-term technical support about 2.5 percent lower, continuing a flatter 3-year uptrend. The speed, rather than the extent of this correction since the July highs has made it feel greater than is actually has been. The S&P 500's turn-around on Thursday, recovering from being down 35 points (-2.5 percent) to closing up 4.5 points (+.32 percent), and Friday's up almost 35 points (+2.5 percent) is a significant change in direction of the markets, reminiscent of the reversals of 1987 and 1998.

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