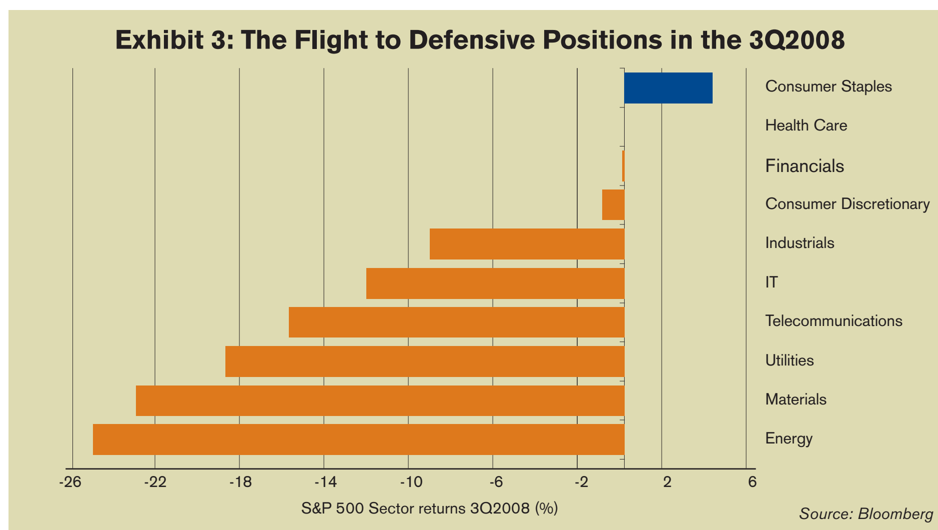
Market Review (continued from 3)

materials were the safe haven in the three quarters before last quarter, but an implosion of the commodity bubble was triggered by worldwide economic slowdown and led to a sharp disinvestment (Exhibit 3).

2. Small companies outperform. The outperformance trend that started in the second quarter of this year, continued last quarter. U.S. small cap stocks[4] declined 1.5% versus a 9.8% decline for large caps[5]. We attribute the outperformance to the larger exposure that small caps have to the U.S. economy versus the global economy.

While our review has focused on equities, fixed income markets were also severely impacted by the credit turmoil. There was an overwhelming flight to Treasuries and an offsetting flight from corporate bonds. Our taxable bond benchmark[6] declined 1.2% last quarter as Treasuries rallied. In context, fixed income investments performed as would be expected and provided a volatility dampener in such a harsh equity and commodity environment. ■

Exhibit 3: The Flight to Defensive Positions in the 3Q2008



Source: Bloomberg

[4] *Russell 2000 Index;* [5] *Russell 1000 Index;* [6] *Lehman Intermediate Government Credit Index*

The Great Unwind

With the passage of the Troubled Asset Relief Program, as the bailout package is formally known, we thought it would be instructive to take a closer look at the root of the problem the bailout package is intended to address. The current credit crisis and the resulting economic contractions and wild market gyrations all stem from "deleveraging," or the unwinding of debt. Over the past 30 years, a prolonged period of declining interest rates (with abnormally low interest rates post 9/11) and easily available credit induced households, corporations and financial institutions alike to take on increasingly burdensome levels of debt (Exhibit 4 next page). In spite of some warning signs[7], debt loads increased to unsustainable levels. With the economic system so dependent on leverage, it was only a matter of time before losses in one segment of the debt markets would be amplified and reverberate throughout the entire system.

Those losses came in the form of defaults on risky subprime mortgages, which by late 2005, comprised nearly 20% of all mortgage originations[8]. Once the low teaser rates on variable rate mortgages began to reset, some subprime mortgage holders defaulted on their loans, setting off a chain reaction throughout the financial system, exposing just how interconnected and highly leveraged the financial system had become. As losses mounted and firms struggled to raise capital, system-wide deleveraging began to take hold. What made the deleveraging process so dangerous was its self-reinforcing mechanism: trying to sell assets tends to push down asset prices, which makes them harder to sell and ultimately forces firms to sell additional (unrelated) assets.

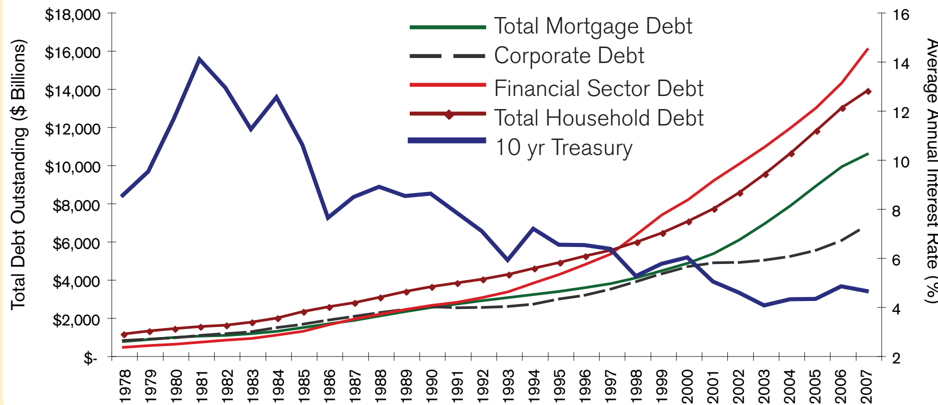
In this way, the problem quickly spread beyond securities linked to subprime mortgages to other types of loans, and triggered massive losses in credit default swaps (CDS), or contracts that provide insurance for securities losses in case of default. It was massive losses in these contracts, combined with a lack of short-term funding that forced some of the weaker capitalized investment banks to go under or, in many

(continued next page)

[7] *The Household Debt Ratio, which is calculated as Total Household Debt (including mortgage and consumer debt) as a percentage of Total Household Disposable Income, surpassed the 100% mark in 2001, meaning that the average debt load per household was in excess of the average annual income. Flows of Funds Accounts of the United States, September 2008. U.S. Federal Reserve.*

[8] *From essentially zero in 1993, subprime mortgage originations grew to $625 billion by 2005, representing one fifth of all mortgage originations that year, a 26% annual increase over the twelve year period. Mortgage Market Statistical Annual for 2005; Inside Mortgage Finance Publications.*

Exhibit 4: Declining Interest Rates Led to Widespread Borrowing



Source: Flows of Funds Accounts of the United States, September 2008. U.S. Federal Reserve, Bloomberg

Over the past 30 years, a prolonged period of declining interest rates (with abnormally low interest rates post 9/11) and easily available credit induced households, corporations and financial institutions alike to take on increasingly burdensome levels of debt.

cases, into the arms of stronger capitalized commercial banks. The net effect has been a seizing up of the credit markets, as banks have become increasingly reluctant to lend to one another as well as to their commercial and industrial customers. This hoarding of capital has created its own self-reinforcing loop, as companies unable to find financing put further downward pressure on the economy, which only makes the banks even more reluctant to lend.

What Needs to Happen

In order for the economy to stabilize, that self-reinforcing loop has to be halted, which will only happen once banks start lending and confidence is restored to the short-term funding markets. While the bailout is certainly a necessary step in that direction, it is by no means sufficient. Rather, a couple of additional steps need to be taken in order to restore confidence.

First, financial institutions have to come clean about their past mistakes by either selling or writing down the value of those distressed assets to a "true" market value. While the bailout package is intended to help in this process by making a market for these securities, the ultimate success of this program will be determined by the price paid for these securities, which presents the Treasury with a conundrum: If the price is too low, banks may choose not to sell; if the price is too high, the losses will ultimately be borne by taxpayers. Given these deals will be negotiated on a bank-by-bank basis, this puts additional pressure on Treasury Secretary Paulson and his team to get it right.

Second, financial institutions need to build up their capital base. While this can be achieved through a variety of ways (including recapitalization, a decrease in dividends, and/or a slowdown in loan growth), how banks ultimately choose to build up their capital can have material unintended consequences for the overall economy.

Post-Bailout World

Over the short term, much will depend on how well the bailout is received and whether it achieves its goal of restoring confidence to the short term funding markets and to the banking system. Our own view is that restoring confidence will require additional resources beyond the $700 billion, as well as a coordinated easing of monetary policy on the part of central banks around the world. The problem is that even if these do work, the effect of these actions will not be immediate, and may not be felt for quite some time. That is a dangerous proposition, especially when time is of the essence, as it is currently.

Looking out over the medium term, things are likely to get worse, before they get better. Contractionary economic forces have already been set in motion, and as the deleveraging process enters a new phase, we are likely to see a couple of additional bank failures as well as a few corporate bankruptcies. If anything, the sheer complexity of the underlying securities, not to mention the marked increase in counterparty risk, will ensure that the ultimate resolution will be long and complicated.

That said, the government's willingness to step in as the lender of last resort and provide a backstop on several different occasions has certainly kept the current credit crisis from snowballing into a more severe economic contraction. The bailout package is also indicative of a major shift in government strategy, as it adopts a more comprehensive approach to addressing the systemic problems caused by the credit crunch. The severity and duration of the current economic downturn will ultimately be determined by how quickly domestic and foreign governments can restore confidence to the financial markets and dampen the side effects of the deleveraging process. ■