The Panic of 2008

Credit: to believe; put confidence in; trust; have faith in. Latin, credere: to believe.

The global stock markets have plunged since September 1st, causing sickening anxiety and stark fear, as investors have rushed to dump shares and shunned risk. The drop in the S&P 500 Index from its all-time high of 1576 in October, 2007 to 860 on October 10, 2008 was 46%. This decline in the U.S. stock market ranks as one of the three worst bear markets in the last fifty years (the other two were 1973-1974 and 2000-2002). As the selloff has continued day after day, many investors have panicked, selling shares at almost any price. Others have been forced to sell due to margin calls and fund redemptions. Investors have lost confidence in their key institutions. The VIX Index chart below, which investors use to track the level of volatility (risk) in the stock market, shows the highest level of fear since this index was instituted:

VIX Index
CBOE Volatility Index

This alarming bear market had its origins in the crisis in the credit markets, which led to the government takeover of Fannie Mae and Freddie Mac, the rescue package of AIG, and the bankruptcy of 158-year-old Lehman Brothers. As collateral damage from these events spread, liquidity dried up in the banking and global financial systems. The most recent blow was struck in October, as investors realized that this financial crisis would cause a recession in the U.S., which would likely bring a global economic slowdown. This quarterly commentary seeks to review briefly the causes of the credit crisis and the U.S. government’s steps to deal with it, why the recession which we are entering will be nothing like the Great Depression, and how investors can ultimately benefit from this worrisome bear market, which has brought stock prices back to their 2002/2003 lows.
Panics

History books inform us about the runs on U.S. banks (and the national panics that they engendered) which took place every twenty years or so during the 19th century and the first third of the 20th century. The famous panic of 1837 threw the country into a serious depression which ultimately resulted in numerous U.S. states defaulting on their bonds. Except for the “greatest generation” who can well remember the depression years in the 1930s when President Roosevelt declared a four-day Bank Holiday in March, 1933, few of us in the U.S. have lived through a panic. Ultimately 9,000 banks failed during the 1930s. The rest of us have only experienced a bank run vicariously through movies such as It’s a Wonderful Life, when Jimmy Stewart saves the Bailey Savings & Loan with the money he had set aside for his honeymoon. However, we are surely living through a panic now. The major difference from the panics of previous centuries is that the government now knows what to do in order to prevent runs on the banks. All banks (and money market funds) are illiquid if most of the bank’s clients seek to withdraw their deposits at the same time. This is the reason for the Federal Reserve’s and Treasury’s proactive steps to guarantee money market funds and increase deposit insurance at the first sign of panic.

How Did We Get Into This Mess?

It is not possible in this brief commentary to explore the many ways in which U.S. consumers and institutions accumulated excessive leverage (debt) over the past decades in instruments which included credit cards, auto loans, student loans, home equity loans and mortgages. Financial institutions are now struggling with high delinquencies and losses in each of these categories, but it is residential mortgages which brought us the panic of 2008. In brief, the story of the residential mortgage debacle is as follows:

- The Community Reinvestment Act (CRA), passed in 1977, was originally designed to ensure that banks lend in their own community. In the 1990s, it was used by regulatory authorities to force banks to lend to low-income borrowers. By 1996, HUD required that 12% of all mortgages purchased by Fannie Mae and Freddie Mac be “special affordable” loans, typically to borrowers with 60% of their area’s median income. By 2000, that number was increased to 20%.
- After the 2000-2001 recession in the U.S. was over, the Federal Reserve kept the Fed Funds rate at 1%-2% for several years, resulting in individuals and institutions borrowing more than would have been the case if interest rates were at higher levels.
- Housing prices (as tracked by the Case Shiller Index for 20 major U.S. metropolitan areas) increased 126% during the period 2000-2006 and encouraged riskier mortgages.
- As housing prices peaked in 2004-2006, many billions of dollars of subprime and Alt-A mortgages were made to borrowers with poor credit. Alt-A mortgages are loans where the borrower is not required to provide the lender with documentation about assets and income.
- Between 2000-2005, Fannie Mae and Freddie Mac met the HUD goals, buying hundreds of billions of dollars of subprime and Alt-A loans, many to borrowers with less than 10% down.
- The securitization of mortgages produced Collateral Debt Obligations (CDO) which were rated AAA by the credit rating agencies because of their geographic diversification and collateralization. CDOs often mix subprime loans with better quality loans, and because of the AAA rating, they were easily sold to financial institutions and investors around the world. CDOs have so many permutations that it is hard to calculate the value of these securities if many mortgages in a security are in default.
- With little or no equity in their homes, many homeowners have defaulted, as interest rates adjusted upwards or declining housing values left them with negative equity in their homes.
When the media refers to toxic securities on banks’ balance sheets, they usually mean these CDO securities. Analysts have estimated that $1 trillion in subprime and Alt-A mortgages were underwritten, funded and sold during 2002-2007. And it is primarily these securities that caused such damage to the banks, Fannie Mae and Freddie Mac, insurance companies and institutional investors around the world.

As the credit crisis intensified in 2008, many financial institutions began to record losses. As investors began to understand the complexities of assets on financial institutions’ balance sheets (and in cases such as AIG, off their balance sheets) and the degree of leverage taken on, the weakness of some of the biggest banks and insurance companies increasingly became apparent. Then, starting with Bear Stearns in March this year and spreading like a virus to other financial institutions, a vicious downward spiral occurred, bringing many banks to bankruptcy or a takeover, and leaving shareholders with virtually nothing. The process of bringing a financial institution to its knees often unfolded like this:

1. Mark-to-market accounting forces CDO writedown
2. Complexities of CDOs cause illiquid market
3. Cost of insuring the bank’s debt (via credit default swaps) soars
4. Stock sells off sharply
5. Absence of uptick rule helps short sellers drive stock further down
6. Illegal naked shorting (selling short without borrowing the stock) causes stock to drop more
7. False reports and rumors passed around market
8. Inability to raise capital due to low stock price
9. Rating agencies downgrade debt
10. Clients stop trading with bank, pull business or ask for collateral
11. Full-scale institutional run on the bank ensues
12. Government arranges takeover or bank fails, i.e. Lehman

No Repeat of the Great Depression

The events of the past months make it unmistakably clear that the entire banking and financial system depends on trust – on the belief that a depositor’s funds in a money market fund or a bank are safe. Unlike companies which sell tangible products such as toothpaste, computers, or tools, a bank’s critical product is confidence. When people lose confidence in a bank or in the safety and soundness of the system, a panic ensues. The difference between this panic and panics in the 19th century and in the Great Depression is that the government understands the fragility of the system and has taken extraordinary steps to intervene to prevent further runs on banks. To date, these steps include: the takeover of Fannie Mae and Freddie Mac; guaranteeing money market fund deposits; increasing FDIC insurance on bank deposits to $250,000; allowing banks to pledge unconventional loans and securities as collateral to the Federal Reserve; the U.S. Treasury buying commercial paper; arranging the takeover of two of the largest U.S. banks (Washington Mutual and Wachovia) and the largest insurance company in the world (AIG) without losses to depositors or lenders; and finally the $700 billion rescue package recently enacted (including $250 billion of government investment in bank preferred stock). In short, the U.S. government has made it crystal clear that it will do whatever is necessary to create more liquidity in the financial system and ultimately restore it to full health.

Stock Market Forecasts Deep Recession

Why did the stock market plunge 20% after the rescue plan (known as TARP) was passed? Once the soundness of the U.S. financial system was no longer the dominant issue, investors began to focus on the likely damage to corporate earnings that a nasty recession would cause. And with irresponsible comments by media pundits about a depression, investors decided to sell stocks at any price. This second bear market since 2000 has caused the first 8¾ years of this decade to be the worst decade for stocks in the last 80 years, as the chart on the following page shows:
We believe that those who forecast that a coming recession will be as severe as the Great Depression do not know their history very well. During the Great Depression, the Federal Reserve let the money supply contract by about a third, leading to crushing deflation. Taxes were raised dramatically, and the punitive Smoot-Hawley Tariff helped to strangle global trade. The result was that over 25% of the work force was unemployed for most of the 1930s. Currently unemployment is 6.1% – lower than it was in the 1991-1992 and 2000-2001 recessions. The Federal Reserve is injecting massive amounts of liquidity into the financial system to ensure that the money supply does not shrink, and Congress and the President undertook a fiscal stimulus package earlier this year.

The storm that has ravaged the financial system has now done major damage to the stock market, as pessimism and despair abound. Sir John Templeton once said: “Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.” We experienced the euphoria in 1999-2000, and now we are living through the pessimism in 2008. As investors pull in their horns and shun risk, bargains abound. Recently, Standard & Poor’s Compustat research service calculated that out of a total of 9,194 stocks which they track, 3,518 are trading at less than 8 times their earnings over the past year. This is roughly half of the stock market’s average valuation historically.

At Bradley, Foster & Sargent, Inc., we cannot foretell the future. We do not know the severity of the current economic downturn. We do not know who will win the upcoming Presidential election. But we do know several things: 1) the U.S. government will continue to put its strength behind the financial system so that we ultimately have a sound and functioning system; 2) the U.S. government has the time-tested tools to moderate a recession; and 3) investors will regain their confidence as the current problems are overcome and stock valuations will rise. Accordingly, we believe that it makes sense for investors with cash reserves and the appropriate risk/reward profile to take advantage of these bargains in high quality growth stocks over the coming months. P/E ratios for most of these stocks are at the lowest levels in two decades, and we think that investors can do worse than to act like Warren Buffet (who has been buying stocks recently) and recognize the wisdom of Sir John Templeton.