STEPPING STONES MANAGEMENT, LLC

Financial Storm

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The financial storm that began last summer has taken many twists and turns since it began and since my last e-mail. In November I wrote of fears that the emerging credit crunch could lead to an investment spending slowdown which seems to have taken hold sometime between December and January. Employment statistics have weakened although the unemployment rate remains low - it seems not many workers are getting laid off but few are getting hired. Last fall the story had been the spread of the mortgage problem to the commercial paper market and last month it spread to the market for auction rate preferred securities. These are very short term, high quality debt obligations that many investors see as an alternative to money market funds (in fact most firms list these securities on their customer statements in the cash and money fund section). They ceased trading a few weeks ago and people who have invested in them find that they can't get their money out. Last week the infection was about to spread to the market for repurchase agreements, or repos, which most financial firms use to fund their day to day operations. A breakdown in this several trillion dollar market was too much for the Treasury and the Fed to bear and they stepped in with some creative actions.

The heart of the breakdown in the credit markets has been the huge amount of mortgage securities that have not been trading in an orderly market. Sellers haven't wanted to sell securities that they feel aren't priced realistically and buyers haven't been willing to step in as they see the securities getting cheaper. Last week the Fed decided that it will accept the highest quality of these securities as collateral for loans of ultra secure Treasury securities. Now financial firms can buy mortgage backed securities and turn them into the Fed in exchange for Treasuries (albeit on a temporary basis). I think this is the reason why Carlyle Capital went bankrupt last week and not prior to that time. Their creditors didn't want to foreclose on their loans and take possession of these securities before the change in Fed policy, but now they do. Similarly, I'm not so sure that JP Morgan would have wanted to takeover Bear Stearns if they would have had to absorb all these mortgage backed securities.

We can point to many reasons why this all happened. Primarily is that lenders lent at poor terms when the Fed was gushing liquidity into the system at the beginning of this decade. Also is the problem that the rating agencies marked some of these securities as prime when they apparently are not. Add to that the reiteration of AAA ratings on bond insurers MBIA and Ambac and the rating firms just don't have much credibility at this point. This is very problematic when bond transactions have always been guided by these ratings. Third is the complexity that these securities took on. As hedge funds and other institutional investors demanded more esoteric vehicles, Wall Street was more than happy to create them. This resulted in securities that Treasury Secretary Hank Paulson characterized as "CDOs squared" (Collateralized Debt Obligations) and that the upper echelon of Wall Street really didn't understand themselves. When it all began to unravel no one really knew where the risk was so investors retrenched and didn't buy anything. Alan Greenspan says defective risk models used by Wall Street have caused the worst financial crisis since World War II. Former Treasury Secretary Robert Rubin called the current crisis "uncharted waters". Not knowing how much risk one's trading partner has will lead to not trading with that party. That is what happened at Bear Stearns and it resulted in a classic run on the bank as clients pulled their accounts and the company's cash position dwindled down.

I applaud the Fed for pulling some new arrows out of their quiver besides just changing the Fed Funds rate. Time will tell if these actions are sufficient. The first test will be in a few weeks when the initial 28 day period to accept these securities at the Fed will expire. Will they need to renew it and for how long? Even if this is the end of the storm we don't know what the ripple effects will be. What kinds of capital will various financial firms now carry and how will that affect their performance? What new regulations will come about because of all this? The answers will determine how borrows will be able to borrow in the future and therefore how well the economy will be able to grow. Markets are trading better now than they have in many months and the stock market bounced off its low yesterday which was about the same level that provided support last week and in January. Interestingly, it is also the level on the Dow Jones Average that stood for over 6 years as the all time high reached in early 2000. It is reassuring to see the market trading better and I hope the storm has passed. Even if it hasn't, we know the Fed stands ready to take aggressive action. When the situation clears up we will have to deal with the other serious issues of a declining dollar and rising inflation. That will be for a later comment though.

For now, stay invested and keep your seat belts fastened.

Yours truly,

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