Who's to Blame?

Third Quarter 2008 Investment Review and Outlook

By Bill Hackney
October 10, 2008

"**The high flyers on Wall Street will no longer be able to jeopardize that personal economic security of Americans, again, because of the bright light of scrutiny and accountability and the attention given under regulatory reform.** "
Speaker Nancy Pelosi on the passage of economic rescue legislation, Oct. 3, 2008

"Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the . . . corporation may run into trouble in any economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s."
New York Times article about political pressure to reduce credit standards, Sept. 30, 1999

The verdict is in! Wall Street did it. In the court of public opinion and from the mouths of both presidential candidates, greedy Wall Street bankers forced an unwitting citizenry to borrow billions of dollars to buy real estate they couldn't afford. Now we're in a *heckuva* mess.

So let the blame games begin! The congressional investigations. The indictments. The regulatory reform. The wailing and gnashing of teeth about what could have been. It should be quite a spectacle--no doubt as fair-minded as the Salem witch trials of 17th century Massachusetts or the Christians versus lions of 1st century Rome. And no doubt as effective in preventing corporate shenanigans as was Sarbanes-Oxley, a.k.a., The Public Company Accounting Reform and Investor Protection Act of 2002.

The popular storyline is that the chief culprit behind today's economic problems was a small band of Wall Streeters, short-sellers and predatory mortgage brokers, aided and abetted by lax regulatory oversight. We wish it were that simple. In fact, *virtually all factions of our society played a role in getting us to where we are now.*

The great credit bust of 2008 is the culmination of 30 years of steady debt accumulation by American households and financial institutions. Between 1977 and 2007 total credit market debt outstanding in the US rose from 1.6 times gross domestic product (GDP) to 3.5 times. In other words, over the past three decades our society's debts grew about twice as fast as our ability to repay them.

ATLANTA CAPITAL MANAGEMENT COMPANY LLC
TWO MIDTOWN PLAZA 1349 WEST PEACHTREE STREET, SUITE 1600 ATLANTA, GEORGIA 30309
TEL: 404-876-9411 FAX:404-872-1672

For at least the past 15 years, economists and financial advisors have been warning Americans that they were "living beyond their means." The evidence was abundant and widely discussed. People were borrowing too much and saving too little. Since 1990, outstanding home mortgage debt has grown from 60% of disposal personal income (DPI) to 100% currently, as consumers financed multiple properties or withdrew equity from their homes through home equity loans and mortgage refinancing. Over the same period, other consumer credit (mostly credit cards) rose from 18% of DPI to 24%. The savings rate plunged from 7% of personal income in the early 1990s to below 1% today.

Consumer debt burdens weren't much of a problem with increasing real estate prices, low interest rates and readily available credit. Few consumers complained about "predatory lending" when home prices were rising at a 12-15% annual rate. Flipping real estate became a popular investment scheme, with individuals buying one or more units then quickly attempting to resell them at a profit. Nobody considered this an act of greed; rather it was a way to cash in on the American dream. Now, with home prices plunging and loans harder to get, the American dream turned into the American nightmare—consumers trapped with massive amounts of debt and real estate they can't unload.

While you'll never hear this from the lips of politicians, the American public, who binged on debt for three decades, was a major contributor to our current dilemma.

Debt pushers on Wall Street, Main Street and Pennsylvania Avenue

But if American households have become debt addicts, American financial institutions were their debt pushers. In fact, over the past 30 years, the debt of US financial institutions actually grew faster than household debt. Wall Street created and marketed the complex mortgage securities that helped fund the real estate boom. Main Street banks and mortgage brokers, many with lax underwriting standards and aggressive sales techniques, originated the mortgages. And hedge funds, mutual funds and pension funds invested in the securities.

Washington also played a largely unappreciated role in the nation's debt dilemma. Conventional wisdom holds that more aggressive regulation by government could have headed off the subprime crisis. This notion is partially true, but very misleading. In fact, Pennsylvania Avenue was, perhaps unwittingly, an important partner of Wall Street in creating subprime mortgages as well as stoking the mania in home prices.

It all started quietly in 1977 with a noble piece of legislation called the Community Reinvestment Act (CRA) which "encouraged" banks to increase their lending to low and moderate income families. In 1995 CRA was "strengthened" and the Department of Housing and Urban Development (HUD) began giving mortgage lending giants Fannie Mae and Freddie Mac explicit targets to increase their purchases of mortgages from borrowers with low incomes. In 1997 Bear Stearns did the first securitization of CRA loans, guaranteed by Freddie Mac. During the current decade, Fannie Mae and Freddie Mac—in order to meet their government mandated "affordable housing" goals—

guaranteed and/or provided funding for billions of dollars of sub-prime and adjustable-rate loans, many to marginal borrowers who bought houses with less than 10% down.

As government sponsored enterprises (GSEs), Fannie and Freddie used their low borrowing costs and their highly leveraged balance sheets to substantially expand their purchase of subprime mortgages and thus help fuel the 1998-2006 surge in housing prices. At mid-year 2008, Fannie Mae was the nation's fourth largest financial institution with assets of $886 billion. Freddie was close behind with $879 billion in assets.

The increasing credit risks undertaken by the GSEs have been publically debated since the late 1990s. (See quote above). Earlier in this decade, former Fed Chairman Alan Greenspan frequently warned Congress about the systemic risks posed by these giant quasi-government lenders. Representative Richard Baker (R-La) held public hearings about the GSE's questionable accounting practices, excessive executive compensation and excessive risk taking. He and a few others eventually introduced legislation to rein in their growing market power. But not much was accomplished because of the GSEs' ability to counter more aggressive regulation through effective lobbying efforts and their powerful Republican and Democratic supporters in Congress.

As a sign of the times, Representative Maxine Waters (D-Ca.), during a 2003 hearing about GSE regulation, seemed to sum up the feelings of many in Congress, ". . . I have sat through nearly a dozen hearings where, frankly, we were trying to fix something that wasn't broke. Housing is the economic engine of our economy and in no community does this engine need to work more than mine."

Last month, weighed down by their huge subprime mortgage portfolios, both Fannie and Freddie failed and were put into a conservatorship.

Another unwitting culprit

Beyond an unwitting Congress, an unwitting Federal Reserve also played a role. In 2003-2004 the Fed pushed short-term interest rates down to 1%, creating an ideal environment for those super-low teaser rates on adjustable rate mortgages. What's more, many mortgage lenders qualified borrowers on their ability to pay an artificially low teaser rate, not the higher interest rate to which the mortgage would eventually reset.

Our purpose in examining "who's to blame" is not to absolve Wall Street of its culpability in creating this mess. From our perch here on Peachtree Street, we share much of the public sentiment that the worst practices of Wall Street should be investigated and regulated. Our only point is that Wall Street was not the only culprit: the worst practices of government and consumers should be considered also.

At this writing, global stock markets are declining sharply as the credit markets here and abroad have seized up. Nobody wants to buy anything but the highest quality government paper. Until mid-September, we believed that the US stock market was in the process of making a bottom. Many broad market indexes appeared to be tracing out sideways trading patterns and in mid-September were trading around the levels of other crisis

points in the market this year; i.e., the "Bear Stearns" low of mid-March and the Fannie Mae/Freddie Mac insolvency of mid-July.

In mid-September, Lehman Brothers failed and shortly thereafter, a large money market fund "broke-the buck." After that, a global financial panic ensued, the end of which may be more a question for psychologists than investment professionals.

Our view is that recent massive government actions to provide liquidity to the financial system—The Emergency Economic Stabilizations Act of 2008 and the coordinated 50 basis point rate cut by the Fed and European central banks—will have a salutary effect on the markets over the next month or so. The recent panicked fall in asset prices—whether houses, stocks, high yield bonds, oil or other commodities—is the result of a rush to de-leverage by the most egregious users of debt—securities firms, hedge funds, banks and insurance companies. (By "de-leverage" we mean reduce debt by selling assets and/or raising equity.)

This deleveraging process will take time. The good news is that it will rapidly reduce inflation pressures in the economy. The bad news is that the US economy will probably experience a protracted recession lasting well into 2009.

Our equity strategy during 2008 has been to increase emphasis on domestic companies and reduce emphasis on multi-national companies whose earnings could be negatively impacted by a strengthening dollar. The US was the first major world economy to enter a downturn and should be among the first to recover. Emerging market economies, a key driver of US multi-national earnings, will slow markedly in the months ahead.

During a bear market that precedes a recession, an important leadership change generally occurs in the stock market. Who this new leadership will be remains unclear. But our belief is that it probably won't be the energy and materials stocks which led the market over the past six or seven years. Our view is that new leadership may occur in the technology sector, where the US has many world class competitors with strong balance sheets, or in the consumer sectors of the economy, including health care. In general, the world economy is sputtering because US consumer spending is weak. So a healthier US consumer is probably a pre-condition to improved global growth. ♣♣♣