

OVER BUILT, OVER BORROWED, OVER LENT

Some economic and financial metrics are only meaningful at extremes, and then they mean everything. Examples include debt, leverage, liquidity, stock valuation measures, mismatches between borrowing short and lending long, and trust between counterparties. We reached many of these extremes in housing, consumer, and subprime debt; in investment house leverage, liquidity, and trust. All of a sudden the financial markets and business lurched from excessive optimism to pervasive pessimism. Besides the poison of the subprime problems working its way through the arteries of the economic system, stocks declined sharply. The decline particularly hit financial companies, builders, technology, and foreign markets. Areas of strength were in such sectors as consumer staples, export oriented industrials, commodities, and high quality bonds. The Standard & Poor's 500 average was down 8.6% in the first quarter.

For those of us who did not win school spelling bees, we now know the meaning of the word "contagion." Contagion is the communication of disease by direct or indirect contact, carrying or spreading a contagious disease. The heart of our economic problems are centered in the housing market; the most highly leveraged and monetarily significant asset owned by American consumers. Approximately seventy percent of American households own their own homes. When home prices fall there is a sizeable ripple effect, this time in unexpected areas particularly due to the securitization of subprime mortgages and a more leveraged financial system. It caused the fall and bailout of an important investment banking house, Bear Stearns, huge losses for major financial institutions holding subprime debt (i.e., Citigroup, UBS, AIG, Countywide Financial, etc.), and a slowdown in consumer spending. To stabilize the economy and financial markets, the Federal Reserve has reduced interest rates and injected significant amounts of liquidity into the financial sector. For you personally, if you have money in short term cash equivalents, your part in funding the bailout is seeing the interest rate on cash instruments quickly go from five percent to two percent. The decline in interest rates could also lead to a greater risk, higher inflation.

Swoons in the economy and stock prices are regular events, but long term the performance of each has been excellent. We all remember the effects of the September 11, 2001 terrorist attack, the market declines set off by the bursting of the dot-com/technology bubble, fears surrounding Y2K, and corporate accounting scandals like Enron and Worldcom. Some negative events do more damage than others but, so far, in our entire history the long term has been good for stock investors. The current unknowns are how long will the economic doldrums last, how well will the consumer hold up, will the leveraged sectors of the financial system reduce debt and get back to normalcy, and can we avoid other possible problems like derivative turmoil? Can we avoid stagflation or a trading-range environment? No one knows the answers to these questions over the short term, but we have strong convictions about the long term.

Given the events of the last nine months, we are likely to see significant regulatory changes. There will be limits to the leverage ratios permitted for investment houses, more in line with those that exist for commercial banks. It is likely that financial structures for mortgages will be simplified and there will be some return to the old relationship between lender and borrower. Compensation schemes in the brokerage system need to be examined and incentives rationalized. Of particular importance is the need to address the problem of "financial illiteracy." People need to be taught how to think about their financial situation and make rational decisions.

Investing, and much of life, involves navigating through the tempestuous seasons. Besides the credit crisis, there are other items for investors to consider. Elections will influence economic, fiscal, monetary, and regulatory policy. A big item is taxes where rates on dividends, capital gains, and income are likely to increase. If you are ever going to sell a business or take a capital gain on an appreciated stock about which you have long term concerns, 2008 is the time to act. Commodity prices have been strong and need to be considered. For example, the price of rice has more than doubled in the past year. One third of the world uses rice in almost every meal. This has implications for trade and agricultural policy (ethanol). Gold is another commodity that bears watching, particularly its impact on fiat currencies. Most important, investors need to separate themselves from the news, noise, and short-term thinking coming from Wall Street and CNBC. A better use of time is trying to buy into a business at a bargain price.

We live in a resilient world and for all the negatives to be considered, lots of good things are happening and market declines create opportunity. Lots of cash is on the sidelines waiting to be invested. The world's central banks have provided huge amounts of liquidity, running their printing presses overtime to ward off recession and bring back prosperity. Stock market indices have built large bases off the July 2007 highs and recently have shown a strong inclination not to go down. If people become more optimistic, lots of money is available to pour into the world's stock markets. There are always conflicting pressures on the stock market, but cheap prices and good companies are always a reason to consider adding to stocks.

Turmoil makes investor psychology an important factor to monitor. Where do you believe investors are in the spectrum between fear and greed, euphoria and depression?

