Investment Watch

3rd Quarter, 2008

Credit Crisis or Collapse?

A major blow of the credit crisis hit us last Monday, September 29th, when our equity portfolios buckled, along with the DOW's loss of 777.68 points, the largest ever! The House of Representatives defeated the White House's $700 billion emergency rescue plan for the nation's financial system. This startling turn of events set shock waves around the world and compounded the uncertainty of our economic future here at home.

An ill fitting end to a month which was marked by domino-like collapses of our two mortgage behemoths and numerous long-established, stalwart investment banks. But, at this time, whether this ***Credit Crisis*** ends as a crisis or deteriorates into a collapse has yet to be resolved and may yet be determined by congressional action or inaction. At this moment, the U.S. Senate is scrambling to finish its version of what will be the historic $700 billion financial-rescue package.

The Wall Street Journal's headlines over the last month have echoed our fears and have chronicled the carnage in our banking system-


September Headlines

U.S. Seizes Mortgage Giants 9/8
Government Ousts CEOs of Fannie, Freddie; Promises Up to $200 Billion in Capital

9/15 Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash

AIG, Lehman Shock Hits World Markets 9/16
Focus Moves to Fate of Giant Insurer After U.S. Allows Investment Bank to Fail; Barclays in Talks to Buy Core Lehman Unit

9/17 U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up

Mounting Fears Shake World Markets As Banking Giants Rush to Raise Capital 9/18

9/19 U.S. Drafts Sweeping Plan to Fight Crisis As Turmoil Worsens in Credit Markets

Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis 9/22

9/23 Doubts on Rescue Plan Spur Fall in Dollar, Leap for Oil

Buffett to Invest $5 Billion in Goldman 9/24

9/26 WaMu Is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History

Crisis Hits Europe's Banks As U.S. Seals Bailout Deal 9/29

9/30 Bailout Plan Rejected, Markets Plunge, Forcing New Scramble to Solve Crisis

The headlines for September tell the story and detail the rapid deterioration of our nation's financial system.

- The U.S. government seized **Fannie Mae** and **Freddie Mac** who account for three-quarters of new home mortgages, the most dramatic market intervention in years.
- Bank of America with only 48 hours of frantic negotiating acquired 94 year-old global financial services firm, Merrill Lynch & Co.
- Lehman Brothers, founded in 1850, is shunned by the Federal Reserve and with no suitors, files for Chapter 11 bankruptcy protection.
- The government seized insurance titan American International Group, Inc. (AIG), one of the world's biggest insurers in an $85 billion deal.
- Goldman Sachs and Morgan Stanley, two of Wall Street's premier investment banks agreed to the Federal Reserve's conversion into traditional bank holding companies.
- Warren Buffett invests $5 billion in Goldman Sachs to help the venerable investment bank navigate the global credit crisis, exhibiting a sign of confidence.
- WaMu, with insufficient liquidity to meet its obligations, was shut down by Federal regulators resulting in the largest bank failure in U.S. banking history. Its banking operations were sold to J.P. Morgan.
- Wachovia was rescued by Citigroup in another government backed deal.

The nation's banking system has gone through a lifetime of consolidation within the last month aided and abetted by the U.S. government. The old model of specialty brokerage firms and independent investment banks is being supplanted by the old traditional, more highly regulated bank holding company model. Instead of being overseen by just the Securities and Exchange Commission (SEC), bank holding companies are also governed by the Federal Reserve, Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC). Even though they will have tighter oversight and lower profitability, becoming a bank holding company allows them to organize their assets and potentially acquire smaller banks with insured assets.

Wall Street will never look the same again! The Credit Crisis exposed the weak institutions forcing consolidations that have resulted in three bank behemoths. According to The Wall Street Journal, these *"Big Three"* have about equal market share amounting to almost one-third of the total U.S. bank deposits. Bank of America, J.P. Morgan and Citigroup will dominate the banking landscape for years to come.

Because these big banks have such diverse products lines, it is hoped that they are better equipped to sustain economic shocks.

Credit is built on trust. The ultimate fear is that our financial system will lose trust and the credit markets will freeze. If the credit markets freeze, our economy, and those of the world, may come to a grinding halt.

Dr. Ben Bernanke, Chairman of the Federal Reserve, after using all the tools at his disposal, teamed up with Treasury Secretary Henry Paulson to try to hold our financial system together. Although extraordinary, the patchwork measures over the past year have not averted the **Credit Crisis**. A more organized approach is needed to stop the credit downgrades and tumbling stock prices both of which contributed to the fall of venerable Wall Street brokerage firms and investment banks.

Banks are becoming unwilling lenders even between themselves. The toxic loans creating this uncertainty are the target of the rescue bill in the Senate today. By buying these mortgages at a fair price, it will remove some of the uncertainty and allow more rational lending patterns.

Fear and uncertainty have resulted in unprecedented and gut wrenching volatility in our markets. The Fed and the government must work together to structure a comprehensive approach to the **Credit Crisis** to restore some certainty and some semblance of order to our nation's financial system.

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