

Lowly Analyst Newsletter

Volume 7, Issue 9, September 2008. Free Newsletter
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The Economy and the Markets

For the long-term investor this was a good time to take a vacation. Keep your asset allocation intact, including money market funds. Sell any floating rate funds and invest proceeds in money market funds. You should get over 5% in these funds.

We must look at the recent decline in perspective. The S&P fell about 5% compared to 20% in 1998. The difference between treasury yields and 30 year fixed mortgage rates (called the spread of mortgage rates) increased to 1.9% compared to 2.3% in 1998. The spread between treasuries and Baa-rated corporate bonds increased to 1.9% compared to 3.7% in 1998. Ten-year treasury yield increased to 5.1% compared to 5.6% in 1998. Emerging market bond spreads increased to 2% compared to 16% in 1998.

Despite the scary headlines, the global and US economies remain strong because of heavy demand from abroad. Our infrastructure, best in the world, remains intact, turbulence but no crisis.

Asset Classes: For the 6 months, large growth up 7%, mid growth 5%, small growth 4%, large value 2%, mid value -2%, micro -3%, small value -4%.

Sectors: For the last 6 months, oil & equipment up 33%, oil service 38, energy 23%, steel 30%, internet architecture 27%, intrn basic materials 20%, natural resources 19%, US aerospace 18%, wireless 18%, environmental service 15%, clean energy 15%, water resources 13%, global telecom 13%, High tech 13%, global Industrials 12%, semiconductors 11%, networking 8%, commodities 9%, gold 2%.

Foreign Investing: For the past 6 months, China up 52%, South Korea 31%, BRIC (Brazil, Russia, India, China) 35%, Brazil 34%, Latin America 27%, Emerging Markets 24%, Hong Kong 17%, Canada 17%, Germany 17%, Mexico 16%, Taiwan 14%, Pacific-J 14%, Australia 14%, Singapore 14%, Netherlands 13%, Europe 11%, Malaysia 10%, Sweden 10%, France 7%, Spain 7%, S. Africa 8%, United Kingdom 6%, Russia 6%, US 4%.

Portfolio Management in Down Markets

1. Summary

The US and world economies and markets are strong. Keep your asset allocation intact, including money market funds. The current decline follows the standard pattern. It is due to subprime mortgages and excessive speculation.

2. The Current Situation

The crisis in subprime mortgages is spreading. Borrowers and investors are restricting credit to only the highest of lenders. Since subprime mortgages are not trading, it is difficult to price these securities and to know which institutions are at risk.

The current US GDP is 14 trillion. The outstanding debts, 29 trillion, are more than twice GDP, debt increased in ten years from 6 trillion. Speculation has become respectable. The government eased the restrictions on hedge funds. There are now \$2 trillion in hedge funds with leverage up to 30 times. The funds use mathematical model. These models did not work as intended since they affect the behavior of funds. Securities can be traded only if a market exists. Markets can disappear in crises, as they did for subprime mortgages. Hedge funds need a functioning market.

Unregulated hedge funds are a time bomb to explode. This could lead to severe fall in security prices. Hedge funds are usually short-term traders. There is a high degree of securitization of debts e.g. mortgage backed securities. The originators of mortgages sold them to banks which packed them in collateralized debt obligation and then sold them. Conduits, that can be kept off a bank's books are funded by asset backed commercial paper and subprimes, leverage 40-70 times.

The spread between treasury bills and commercial paper widened from 0.5% to 3.0% making it impossible to roll them over as investors flee to quality.

Security markets globalized. These developments encouraged risk modeling that in turn encouraged taking of more risk. The models assume that securities can be always traded. In

addition they neglect the fact that hedges do not work for large declines. Market neutral portfolios, investing both long and short so that value always stays the same, failed to work as intended.

There is much trend following, called momentum trading, exaggerating declines. Much of the momentum trading is done with lightning speed and large quantities on networks. For excesses in borrowing, somebody has to pay. Some institutions will fail. It is not yet known who is the most at risk.

Institutions are adjusting their portfolios getting out of any investments that could be affected by the current credit crunch, putting additional pressure on the market.

The underlying fundamental of the US and world economies and markets remain strong.

3. What the Fed Did

The Fed saw on 7/10 that the overnight lending rate had increased to 6.00% - well above its target rate of 5.25%. The target rate is the rate at which the Fed lends overnight money to about 40 primary dealers in treasuries. These are the banks and brokerage firms that maintain the largest market in treasuries.

On Friday 8/17, the Fed lowered the discount rate by ½ of a percent. The discount rate is the rate at which member banks of the Federal Reserve System can borrow from the Fed overnight. It is rarely used because it is expensive and carries a stigma of having to borrow expensive money for the short term. The duration of these loans was lengthened from 1 day to 30 days. The acceptable loan collateral quality was decreased to include nearly anything that is not in default.

Decreasing the discount rate may indicate that the Fed thinks there is the possibility that some institutions may get into difficulty and need a source of funds. It could also be simply that the Fed wanted to make a statement. The Fed also announced it will make available whatever funds are needed. It encouraged banks to borrow.

Lowering the discount rate increases the money supply; lowering the more important Federal Funds rate lowers the cost of borrowing. World stock markets responded. The US stock markets closed Friday 1.3% higher.

The Fed sets a target rate, now 5.25%, by announcing its willingness to lend overnight money

to primary dealers. The amount of money to be lent is stated daily.

The money is lent through competitive bidding for a specified amount, at a specified rate, like the bidding for longer Treasuries. The highest bids are filled until all the available money is used up. If a bank got money at a 5.25% rate, it might then turn around and lend it to its customers at 5.4%, making a profit giving the banks an incentive to bid. The overnight lending rate is lower than the discount rate, usually by about half a percent.

The Fed requires security for its loans, usually Treasuries. The Fed relaxed that requirement and also accepted high grade Mortgage Backed Securities as collateral.

The Fed injected \$24 billion on 6/24 when fund rates reached 7.00%. On 6/25 it announced fund availability three times a day and increased the amount to \$38 billion. As a consequence the overnight rate went from 6.00% to 5.00%, close to the target rate. The next day it dropped to 5.23%.

1. Historical Comparisons

There have been 6 bubbles in the last century. One of these bubbles occurred in 1987.

There was huge expansion of hedge funds. The buyout boom started, aided by derivatives aide and a decrease in government regulation. Interest rates rose. There were scandals in the financial markets.

World commodity prices were falling. Russian energy and manufacturing firms failed to pay taxes. Russia had for some time paid interest on its short term bonds by issuing new bonds. In August when it could no longer issue new bonds it defaulted. It also devalued its currency. The Fed succeeded to restoring confidence. The price of equities was excessive.

The current situation is very similar to past bubbles: relaxing regulation, excessive borrowing, and speculation achieved respectability, use of derivatives, and concentration of businesses and financial institutions. Based on their model of risks, institutions sold portfolio insurance, supposedly preventing losses. It did not work. Hedge fund Long Term Capital collapsed.

The S&P on August 28 was 33.93. On Friday October 16, it was 28.39 - 16% lower. On Monday, Oct. 19, it fell to 22.58 - 21% for a total of 34% from the high. By the end of the year, the markets were up to the previous highest level.