Thoughts on the
Current Crisis in US Financial Markets

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I. The Past

- US financial markets since 1995 were dominated by high liquidity and low interest rates fueling ever increasing speculative fever in all market segments and asset classes. Indebtedness among financial institutions, as well as consumers, reached unprecedented and unsupportable levels.
- Asset valuations rose steadily based on the assumption these conditions would last forever.
- The consumer was inundated with cash from excessive credit offerings based primarily on real estate, but extending to automobiles and multiple credit card solicitations.
- Credit providers allowed underwriting standards to weaken to the point of irresponsibility. Many allowed fraudulent practices.
- **All** participants in the ever growing market for securitized mortgage backed instruments, i.e. mortgage originators, borrowers, securitizers, and investors of securitized instruments, failed to follow basic due diligence standards.
- Rating agencies failed to understand the embedded risks in these mortgage backed securities and assigned ratings which were grossly misleading.
- Regulatory agencies failed to reign in this litany of missteps.
- The US Government for most of the past 8 years has, by and large, been in exceptionally inept hands and saddled the US financial markets with huge budget and trade deficits.
- Society, led by Wall Street, succumbed to unprecedented greed.

II. The Present.

- US financial markets, since mid 2007, have taken dramatic corrective action to these failures and weaknesses leading to significant declines in valuations accompanied by high and largely unheard of volatility in most market segments.
- Successive revelations of mistakes and wrongdoing by hitherto respected market participants have severely eroded confidence in the financial market as a whole.
- Most major banks and almost all major investment banks have experienced unprecedented losses, leaving many of them with insufficient capital, which in turn forces asset sales to reduce leverage, which in turn leads to further pressure on prices and more losses. This capital insufficiency is greatly aggravated by the harsh discipline of marking all assets to market. (As an aside, it is our view, that a simple suspension of this accounting principle applicable to mortgage backed instruments, held by financial institutions to maturity, would solve the most pressing problem the US financial markets face today, namely the capital insufficiency at many of the big institutions and the resulting lack of confidence in their survival.)
- The financial failures of market participants like Fannie Mae, Freddie Mac, AIG, Lehman Bros. and Washington Mutual are truly epochal.
- The ongoing need of financial institutions to shrink their balance sheets, leads to a reluctance, if not inability, to add new loans to their portfolios.
- Consumers have less cash to spend.
- The US Government suffers from a lack of credibility with Congress and the public, aggravated at the very moment by the current presidential election campaign.
- Leadership from both the public and the private sectors seems at odds as to what to do about all this.
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III. The Future.

- US financial institutions will undoubtedly have to absorb further losses from the excesses of the past. Hopefully, these losses can be spread over the next 3 years.
- The US Government will devise more and better assistance programs to stabilize the market. Huge rescue actions, a la Fannie Mae and AIG will in all likelihood not be needed.
- Residential mortgage defaults will continue, but the market will learn to mitigate damages and, looking back in 3 to 5 years, in all likelihood, find that the current market was overly severe in punishing the valuations of securitized mortgage pools. This will help restore capital to those institutions suffering the most today.
- Tighter lending standards for corporate and consumer loans will reduce discretionary cash in the economy. The Fed will continue to provide liquidity support, and banks will resume providing credit sooner than anticipated simply because banks are in business to do so.
- Based on recent lessons, the new Administration in Washington will have a unique opportunity and attach high priority to overhaul the financial markets regulatory system and will hopefully succeed.
- Asset valuations in general should stabilize within the next year and regain lost ground over the next several years.
- The Fed will remain under pressure to combat inflationary pressures without resorting to raising interest rates.
- Most off shore markets are highly likely to follow or even lead the US markets in this general recovery outlook.
- The US financial markets are resilient and will emerge from the current crisis leaner, stronger, wiser, and in a shorter time than today's pundits might predict.

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New York, September 25, 2008

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