

## MARKET UPDATE: SEPTEMBER 25, 2008

*By John Blood, CFA, Chief Market Strategist*

September 2008 will no doubt earn a place in history books as an evolutionary period for the global financial system. The past few days have seen several new chapters written, as governmental and private sector responses have seemingly increased in both their scope and sense of urgency, culminating in a proposal for the largest governmental intervention into financial markets since the 1930s. The debate has now shifted from the confines of Wall Street and financial regulators into the harsh public spotlight of the political arena, as Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson, the key drivers behind the plan, face Congressional scrutiny this week on the merits of the Treasury's so-called Balance Sheet Relief plan.

Key developments:

- On September 19, Paulson announced a plan to treat the root cause of the financial crisis—a sweeping plan under which the federal government would purchase “hundreds of billions” of dollars worth of illiquid mortgage-backed securities. The number has subsequently been publicized at a target of \$700 billion—an amount deemed sufficient to restore confidence throughout the financial system, allow financial institutions to shore up their balance sheets, and reestablish normal functioning of credit markets.
- The drastic turn of events in recent days resulted from severe credit market stress that emerged throughout last week, but that culminated on September 17—the day after the money market Reserve Primary fund saw its net asset value (NAV) drop below \$1 per share, known as “breaking the buck.” Following the Reserve Primary announcement, which may have at first appeared as a tiny ripple, fearful investors pulled an estimated \$145 billion from other money market funds the following day; the ripple was fast becoming a tsunami. Money markets began to horde cash, fearing that they too would be forced to meet mass redemptions. The commercial paper market, which is a key source of funding for a host of other business activities and also the main investment option for many money market funds, saw activity dry up. Overnight LIBOR, the rate at which banks make loans to each other, skyrocketed above 6 percent, indicating the heightened levels of fear and mistrust that were gripping the credit market—and concerns grew rapidly that the troubles on Wall Street could immediately and significantly damage the economy at large. A more comprehensive bailout measure, which had likely been up for discussion for some time, had become a virtual necessity.
- The Treasury also announced that it will use up to \$50 billion of its Exchange Stabilization Fund to insure taxable and tax-exempt money market funds for the next 12 months. Funds must pay a fee to participate in the program, but the move should help to reassure money market investors and prevent a run on such products.

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- Additionally, the Securities and Exchange Commission (SEC) took the radical step on September 19 of requiring increased disclosure of short positions and issuing a temporary ban on short-selling in nearly 800 financial stocks, following a similar earlier move by the Financial Services Authority of the United Kingdom. The SEC subsequently softened the rule on short-selling to allow an exception for those engaged in bona fide market making or hedging activity, but the move was clearly targeted at those who might seek to drive otherwise solvent companies into the abyss of bankruptcy by creating insurmountable short-term capital demands on vulnerable firms.
- With short-sellers held at bay, the final two independent U.S. investment banks—Goldman Sachs and Morgan Stanley—each took drastic steps to remake themselves in the face of an ever more uncertain future. The firms applied for and received on September 21 expedited approval to convert from investment banks to traditional bank holding companies. The move, coming on the heels of the rescue of insurance giant American International Group (AIG) and the collapse of Lehman Brothers, allows Goldman and Morgan to seek access to more stable sources of funding, such as bank deposits, instead of relying on short-term funding from capital markets. It also brings them under the supervision of national bank regulators, however, and the reshaped organizations will be characterized by new capital requirements, less leverage, and likely lower levels of profitability than what each had experienced previously. Goldman and Morgan now join Bear Stearns, Lehman Brothers, and Merrill Lynch as having succumbed to the forces of change gripping financial markets.
- On September 23, Warren Buffett's Berkshire Hathaway, Inc., agreed in a private offering to purchase \$5 billion of Goldman Sachs preferred stock with a dividend of 10 percent. In addition, Berkshire received warrants exercisable for the next five years to purchase up to \$5 billion of common stock at a price of \$115, a discount of 13 percent from its current market price. The move by Buffett, who is widely considered a shrewd value investor, provided a boost of optimism that conditions in financial markets can present attractive investment opportunities.

So, where do we stand today? The macro debate has always been:

1. Should the government/central bank step in and perform the function of being the lender/spender of last resort to prevent more widespread financial turmoil? or
2. Does it let the free market solution play out and deal with whatever the ramifications are in terms of a deflationary cycle and potentially calamitous social conditions?

It appears that option 1 was deemed the better choice. I think, in the end, despite any feelings about moral hazards that lie at the heart of opposition to the plan, the present value of stepping in now was determined to be much less than the cost—both in dollars and social upheaval—of waiting to intervene later. Conditions were sufficiently dire that a free market solution was unfeasible; it was going to require a government solution either way—now or later. Now that imminent government intervention seems a near certainty, the debate revolves around the scope and specifics of the plan.

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To date, those details remain hazy at best. But the Treasury has initially proposed a broad authority allowing it to purchase up to \$700 billion of mortgage-related assets from ailing banks and financial institutions via an auction process. The plan will allow the financial institutions to re-access capital previously tied up in illiquid mortgage-related securities, reinforce their balance sheets, and restore a more normal lending environment. SEC Chairman Christopher Cox strongly asserted in his testimony that regulation of the credit default swap (CDS) market is a crucial component of any new regulation.

The political debate thus far has been intense, with alternate plans being proposed and many additional provisions being considered for inclusion in the final legislation. But Bernanke and Paulson have each stressed in their testimony to Congress the urgency in getting something passed quickly. The near failure of AIG and the run on money market funds brought us as close as we have come yet to financial meltdown, and we've run out of fingers to plug holes in the dike. There's no telling what shape the final bailout legislation will take, but stay tuned—there's little doubt that it will come quickly.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index.*

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