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Uncertain But Not Uncharted

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It's hard not to accept that the current financial crisis and its economic repercussions are unprecedented when so many credible – and not so credible – researchers, journalists, and television commentators now characterize most any development as unprecedented. Last month alone, we counted about 4000 reports or articles describing some economic news as "unprecedented." With so much reinforcement, how can one resist the fear and panic?

It seems to us, though, that "unprecedented" and its equivalents have been overused; a little jog to the memory, a dusting off of old reports, and some research were called for. First, we approached our 93-year old private wealth advisor, Al Feld, who has worked at Goldman Sachs for 75 years and has witnessed a cycle or two or three. We then met with Jim Grant of *Grant's Interest Rate Observer*, who has written about the financial markets with great clarity and perspective for over 25 years. We dug up our old Salomon Brothers, Inc. *Analytical Record of Yields and Yield Spreads*. We reviewed the list of the big financial bubbles all the way back to the Dutch Tulip Bulb Bubble of 1636 and the South Sea Bubble of 1720 in an excellent book by Charles Kindleberger and Robert Aliber first published in 1978, *Manias, Panics, and Crashes: A History of Financial Crises*. We brushed up on our understanding of the "Minsky Moment" (named after the economist Hyman Minsky) when the virtuous cycle of easy credit, greater leverage, and greater risk and higher returns turns to a vicious cycle of de-leveraging, a free-fall in speculative assets, and further drop in the value of all assets – good and bad.

We concluded that while the use of such terms as "unprecedented" make for captivating press, much of what we have experienced in the last year or so has, in fact, been *with* precedence (and much of it within the last 40 or so years), notably the level of volatility, the "seizing" of capital markets, the rapid and sizable downdraft in equities, the hit to high quality corporate bonds, the complexity of mortgage-backed derivative securities, the fall of several Wall Street firms, the leverage in private equity, the drop in GDP – the list goes on.

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What *is* unprecedented today is the scale and speed of monetary policy response by the Federal Reserve (a zero to 0.25% interest rate policy, 12 different liquidity facilities, and the expansion of the Federal Reserve balance sheet to about $2.3 trillion), and the scale of government action so far and in the coming months through the Troubled Asset Relief Program and an expected $700 billion-plus fiscal stimulus.

In light of significant similarities between this and prior cycles, we feel that history does provide some guidance as to the range of probable outcomes for 2009.

Let's start with the epicenter of this crisis: easy credit to the residential and commercial real estate markets and the subsequent carving up of mortgage-backed securities. We dug up press reports on this topic. From *The New York Times*: "Derivatives are complex securities whose returns are based on – or derived from – other investments. In this case, these derivatives

started life as everyday home mortgages…. But in Wall Street's derivative laboratories, they are diced and sliced and reassembled into what can turn out to be a Frankenstein's monster." Likewise, in an article in *Barron's*, certain fund managers were reported to be too greedy, investing in "kitchen-sink bonds, instruments collateralized by mortgage derivatives." Wait a minute: These articles appeared not in 2008, but in the summer of 1994!

These "kitchen sink bonds" led to the blow-up of several mortgage-based hedge funds. Such complex derivatives, including COFI floaters (floating rate securities based on the Federal Home Loan Bank's 11th district cost-of-funds index), also led to significant problems in the money market sector at that time, and one fund after another was kept whole by sizable capital infusions from their sponsors. In 1994, BankAmerica injected $67.9 million into its funds, and PaineWebber spent over $268 million on its short-term funds. Others with smaller infusions included Merrill Lynch, First Boston, Piper Jaffray, and Fleet Financial.

Esoteric mortgages, in fact, date back to the mid-1880s when various railroad companies enticed settlers to Kansas, Nebraska, and the Dakota Territory by offering a menu of mortgages including, for example, an 11-year mortgage with interest only for the first three years and only 10% down. Sound familiar? Such easy credit led to a peak in land prices in 1887; in real dollars, those prices are still 5.5 times higher than the price of farmland in the region today after 110 years.[1]

This is not the first time that mortgage derivatives, hedge fund debacles, or the bursting of a credit bubble have taken down major financial institutions.

The easy credit of the 2004-2007 period and the subsequent global boom in real estate, as well as in public and private equities, emerging markets, and commodities, among others, is reminiscent of the easy credit of the mid-to-late 1980s that led to the savings and loan crisis with somewhat similar repercussions. Several banks and insurance companies were brought to their knees in 1990 and 1991, and investors were debating which banks were too big to fail. At the time, Citicorp, the predecessor to Citigroup, was at the top of the list of banks that were deemed "too big to fail." In late 1991, Citicorp's share price hit a trough of $8.50, which in split-adjusted equivalent shares, is a mere $0.93. In August 1990, the *American Banker* reported that the then-director of the Cato Institute suggested that "you have to sit the Fed and the Treasury and the FDIC down and say, 'How do we deal with a Citi or Manufacturers Hanover failure? You have to have a plan in place.'" Well, 18 years later in November 2008, the Fed, the Treasury, and the FDIC did put a plan in place to avert a crisis at Citigroup. The parallels are uncanny.

Another trend purported to be unprecedented today is the high debt-to-equity leverage ratios and size of private equity deals. But it might surprise you to know that the amount of leverage in the late 1980s was significantly greater than the peak leverage ratios of private equity deals in 2006 and early 2007. In 1988, equity as a percentage of total capital in leveraged buyout deals averaged a mere 10%. The lowest level of equity contribution in the most recent credit cycle was 32%, reached in 2005. Similarly, the size of deals in the late 1980s certainly rivals the size of deals done in the last couple of years. Kohlberg Kravis Roberts & Co.'s leveraged buyout of RJR Nabisco Inc. for $25 billion in February 1989 was achieved with $2 billion of equity (i.e., only 8% equity); in today's equivalent dollars, the RJR deal is still the second largest leveraged buyout deal in US history.

What about the unprecedented collapse of several Wall Street firms and the merger or acquisition of financial institutions such as Lehman Brothers, Bear Stearns, Merrill Lynch, Wachovia, and Washington Mutual? This is not the first time that mortgage derivatives, hedge fund debacles, or the bursting of a credit bubble have taken down major financial institutions. Where are the likes of Kidder Peabody, Manufacturers Hanover, Bank of New England, First Executive Corp, MCorp, Financial Corp of America, and Drexel Burnham Lambert? Financial Corp of America ran the largest savings and loan operation in the US. At its height, Drexel was the fifth largest investment bank in the US and had a 75% share of the high yield market. At the time of its demise, high yield securities were not only referred to as junk bonds but as "toxic waste."

Neither is the volatility nor the rapidity of the equity market downdraft unprecedented. On October 19, 1987, known infamously as Black Monday, US equities dropped 20.47%, and shortly thereafter, 30-day volatility reached 92. For the two months ending in November 1987, the equity market had declined 28.4%, and for the three months ending in November 1987, the market had declined 30.2%. In the current cycle so far, the peak in 30-day volatility has been 88.7, the worst two-month return is negative 24.5%, and the worst three-month return is negative 30.1%.

What about the seizing up or freezing of credit markets? Is this unprecedented? During the 1973-74 period, the credit markets fared much worse. While we are amazed by the recent high levels of the TED spread, (the incremental yield between 3-month Libor and 3-month Treasury bills, which peaked at 4.64% on October 10, 2008), these spreads pale in comparison to 1974 levels. After the Arab Oil Embargo of October 1973, the TED spread reached 6.22% and stayed above 5% for four months in 1974. Longer-dated corporate securities also exhibited worse performance in 1974 than in 2008. Our best estimate of the price drop in BBB-rated long corporate utilities and industrial bonds from peak to trough in 1974 is about 23%, while BBB-rated long corporate bonds have dropped about 16% in price so far in this cycle.

In the 1973-74 period, the US economy had a cumulative decline in GDP of 2.7 percentage points, equities dropped 48%, and unemployment increased from a low of 4.6% to 9%. Interestingly enough, unemployment troughed at 4.4% in this cycle, and is expected to peak around 8.5-9.5%. But to really compare the current crisis to the early 1970s, you may want to envision cars lined up at gasoline stations, big "no gas" signs plastered over hundreds of gasoline stations, and depending on the state you lived in, having to check your license plate because motorists with even-numbered license plates were allowed to buy gas only on even-numbered dates and those with odd-numbered plates were allowed to buy gas only on odd-numbered dates. Now that was unprecedented!

Federal Reserve concerns about the seizing up of the commercial paper market and subsequent intervention to prevent a breakdown of the financial engine are also not without precedent. It is well known that Federal Reserve Chairman Ben Bernanke is a student of the Great Depression and the Lost Decade of Japan; but judging by his recent actions, he must have also studied the commercial paper crisis and eventual bankruptcy of Penn Central Transportation Co. in 1970. At the time, Penn Central was the largest transportation company in the world and a major issuer of commercial paper. As Penn Central's financial condition deteriorated, there was an appeal to the federal government. The Nixon Administration was supportive. Congress, however, opposed a $200-million loan guarantee (they didn't call it a bailout then) and the Federal Reserve Board denied a loan to help Penn Central roll over the firm's commercial paper.

On June 21, 1970, Penn Central declared bankruptcy, which, at the time, became the largest bankruptcy in US corporate history. To prevent widespread fear and panic in the markets and the consequences of further failures, the Federal Reserve, under the chairmanship of Arthur Burns, announced four measures:[2]

1. It explicitly allowed member banks to go to the discount window to borrow funds for the purpose of helping clients roll over their maturing commercial paper;
2. It suspended Regulation Q ceilings on interest rates on large-denomination CDs to encourage the flow of funds into commercial banks;
3. It expanded its balance sheet to increase the money supply; and
4. It committed that it would use standby procedures if necessary to make loans, directly or indirectly, to worthy borrowers who were otherwise unable to secure credit.

Again, the parallels to the liquidity measures undertaken by the current Federal Reserve are astounding. In July 1970, *Time Magazine* wrote: "The nation's largest railroad succumbed last week to a lethal combination of politics, tight money, mismanagement, and fumbled Government rescue." This sounds like some recent press coverage about Lehman Brothers, now the largest bankruptcy in US corporate history. We should note that prior to the current crisis, Al Feld, our 93-year-old private wealth advisor, thought that the Penn Central crisis was the worst experience of his financial career. He now

believes that the current crisis, post the Lehman bankruptcy, holds that dubious honor.

We also question the claim that this cycle is unique because of the global contagion of the crisis. All financial crises, wherever they emanate from, have a pattern of transmitting to all corners of the world through trade, financial flows, commodity prices, and panics that beget panics. After the Arab Oil Embargo, while the US had a peak-to-trough drop in GDP of 2.7 percentage points, world GDP growth declined from a peak of 6.1% to a trough of 1.2%; US equities dropped 48%, and other developed equities (as measured by the MSCI EAFE Index) dropped 41%. In the 1980 through 1982 downdraft, the US had a peak-to-trough GDP decline of 2.3 percentage points and global growth reached a low of 0.6%; US equities dropped 27% and MSCI EAFE equities dropped 25%. The 1998 crisis that emanated from emerging markets – more specifically, Russia and a handful of Asian countries – similarly dragged down returns in all markets. Ditto in the 2000-2002 bursting of the Internet bubble; while the economic impact was muted, US equities fell 49%, other developed equities fell by 51%, and emerging market equities as measured by the MSCI EM Index were down 50%. In an April 2008 National Bureau of Economic Research working paper, *This Time is Different: A Panoramic View of Eight Centuries of Financial Crises*, Carmen Reinhart and Kenneth Rogoff demonstrate how "shocks emanating from the center countries" have often led to financial crises worldwide over centuries.

And finally, for those who are now sounding the death knell of American capitalism, the end of the US dollar as the reserve currency of the world, and the end of the American century, we offer the paragraph below. It appeared in *The Economist* in 1908 following the panic and crash of 1907, courtesy of Jim Grant's 1992 book, *Money of the Mind*: "From one point of view, credit may be defined as the power to attract gold; but public credit really depends on public confidence, just as private credit depends on private confidence. The financial crisis in America is really a moral crisis, caused by the series of proofs which the American public has received that the leading financiers who control banks, trust companies and industrial corporations are often imprudent, and not seldom dishonest. They have mismanaged trust funds and used them freely for speculative purposes. Hence the alarm of depositors, and a general collapse of credit."

Nearly 100 years later, in the December 16, 2008 issue of *The New York Times*, Thomas Friedman wrote: "we don't just need a financial bailout; we need an ethical bailout." We are reminded of Jean-Baptist Alphonse Karr's quote: *plus ça change, plus c'est la même chose* – the more things change, the more they stay the same.

All financial crises, wherever they emanate from, have a pattern of transmitting to all corners of the world through trade, financial flows, commodity prices, and panics that beget panics.

Our goal here has not been to minimize the depth or breadth of the current crisis. On a global basis, the value of public equities alone has dropped by over $30 trillion. Banks have recognized about $850 billion of losses, and our Goldman Sachs bank analyst estimates that total losses may reach $1.7 trillion over a full cycle. This has been a seismic shift; it feels even more drastic after a period of moderation in economic cycles and a lull in corporate and sovereign debt defaults.

But while serious challenges remain and uncertainties abound, much of what we see in the current market environment is not unprecedented. We've experienced financial market dislocations, collapsing asset prices, and wild swings of panic before. What history tells us, and what we've learned from steering through such treacherous waters in the past, is that opportunities are often created during just such times. This one, we believe, will ultimately be no different.

[1] See *Grant's Interest Rate Observer*, November 4, 2005, for a more detailed discussion on railroad bonds.

[2] For further details on the Federal Reserve measures, please see the National Bureau of Economic Research working paper by Charles Calomiris: *Is the Discount Window Necessary? A Penn Central Perspective*, December 1993.

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