



The Credit Crisis – Where Are We?

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With the turmoil in financial markets reported in the newspapers, radio, and TV, I want to give you an update on what I see happening in the markets and what you can do to help protect your financial future.:



Background

- In his 2007 Annual report the manager of the Julius Baer International Equity Fund, Rudolph-Riad Younes, stated that we have been living in “The Age of Decadence”. “During this period we saw America continually make the wrong decisions, lose its industrial might, damage its national balance sheet, and erode the reserve status of its currency. We also created structural imbalances and excesses in our economy that led to one bubble then another—the least painful way to contain one bubble is to create another; hence postponing the day of reckoning. In this period, we made useless financiers fly-by-night billionaires, destroyed most American's living standards by depressing their wages and sinking the dollar against most currencies known to man—with few exceptions such as the Zimbabwe dollar.”
- For a view of the increasing debt situation of American consumers, see this chart of household debt as a % of disposable income for several countries over that last 20 years.

The Credit Crisis and the Economy

- I believe that the Fed, Treasury, Congress, and White House will take action to limit the fallout from the growing credit crisis. I hope that the steps they take will be effective, timely, and help stabilize the financial system before too much damage is done.
- Dr. Christopher Thornberg in a recent presentation stated that the credit crisis has more steps to play out. With \$500B in acknowledged losses to date, ultimate losses could reach \$1 to \$2 trillion. The financial sector will have to reorient itself around a meat and potatoes business model like old-fashioned banks. Dr. Thornberg is an economist from Beacon Economics and former leader of the UCLA Anderson Economic Forecast team.
- Even if the financial system issues are stabilized in the near future, consumer spending will tighten and lead the overall economy in a longer recessionary path,

perhaps through 2009, according to Dr. Thornberg. The weakening job market, housing price declines, and consumer debt will put a damper on consumer spending (70% of the economy) for quite some time.

- Warren Buffet is a firm believer that the American way of life will continue, unlike some bears. "The genius of the American economy, our emphasis on a meritocracy and a market system and a rule of law has enabled generation after generation to live better than their parents did... We unleash human potential and will continue to do that in the future. American ingenuity will tend to surprise on the upside much of the time."

The US stock market

- The major indexes are down more than 25% from last year's high, very volatile, and reacting to every financial headline.
- However, stock markets typically rebound in advance of the turnaround from a recession. We're never sure when the turnaround might come, but it's not wise to be totally out of the market when price growth returns. Some investors believe that they are finding values now, such as Berkshire Hathaway's recent purchase of Constellation Energy Group and Chinese battery maker BYB.

International stock markets

- Some thought that international markets could decouple and continue to grow, even if the US was slowing. This scenario doesn't look likely as there are signs of slowing economies and markets in Europe, Japan, and other regions.
- However, you do need international exposure in your portfolio for long-term growth and diversification. Some markets will rebound faster than others.

Bond markets

- Bonds are a tale of two markets – investors flee to safety in US treasury securities when fear jumps, lowering yields. Many other bond such as corporate and high-yield bonds have jumped dramatically in yields, consequently dropping prices.
- International bonds have had a tailwind with the declining dollar, but are now more volatile as the dollar has rebounded recently.
- It is important to have exposure to bonds as part of your portfolio, partly to diversify from stocks. There will be opportunities to buy riskier bonds at a discount as the credit crisis plays out.
- Municipal bond funds have seen increases in yields due to credit crisis concerns, and may be a good value for tax-sensitive accounts

Commodities

- Many commodities have been through a sharp bubble from global demand as well as investor speculation. As the economy slows, fundamental demand may slow for a while, but volatility may persist.

Housing and mortgages

- We may have a ways to go as housing prices drop to more generally affordable levels. In San Diego, the median house cost 40% of gross median income in 1999, and rose to 74% in 2006, per Dr. Thornberg's data. Obviously, prices had to drop for affordability for a large number of residents.
- The conventional mortgage market is frozen. Over 90% of mortgages now are government sponsored, according to an experienced local broker.
- Jumbo mortgages are difficult and expensive to obtain. There is a short window to refinance/originate mortgages between \$417K and 697K before December 31 of this year under conforming government programs.
- There is some good news for first time homebuyers – prices are dropping, rates on government sponsored loans are good, and a new \$7,500 tax credit is available.



What you can do

Cash Flow

- Spend less than you make. Set a goal of saving at least 10% of income (retirement and other savings). Some have said that the current crisis will be over when the US returns to a savings rate of 10-12% that we had through the 1980s.

Balance Sheet

- Reduce your debt wherever you can. This is critical to your long term financial health.

Your skills

- If you are still in the workforce, hone your skills. As Warren Buffet said recently, "Develop your own talent. I mean, if you are the best doctor in town, if you're the best teacher in town, if you're the best salesman in town, you'll do well no matter what the currency does."

Your Investments

- We do not know what the performance of specific investments may be in the short term. Things can change dramatically over days, weeks and months. The best defense is diversification among assets classes. If you are concerned that your portfolio is too exposed to market volatility, we should review your current investment allocation.



Our governments

Federal

- See the movie “I.O.U.S.A”. This paints an in-depth picture of the challenges facing our federal fiscal future. We clearly need to address Social Security and Medicare, as they will take more than 100% of the total federal revenue in the future without any changes. We need to tell our elected officials that they need to work on long-term fiscal issues, not just reacting with short-term tactics such as the stimulus rebate, gas tax holiday, etc.

State and Local

- The state has a budget “fix” for this year, but the future still looks challenging. Our representatives need to change our process to be able to reach a responsible balanced budget in future years with less partisan bickering.
- Our local governments will be grappling with their budgets as well, with the housing price declines impacting property tax revenues.

Call to action

- I encourage you to contact your elected representatives at all levels of government, and encourage them to focus on the larger issues that will impact our long-term financial viability. Whatever your political beliefs, we need a combination of tax revenues and managed spending to balance the books. The alternative is to watch the US lose its leadership in the world economy with a declining currency and standard of living.



Please let me know if I can help you in any way!