STILL THE BEST GAME IN TOWN

> *In a move that could help increase home ownership among minorities and low-income consumers, the Fannie Mae Corporation is easing the credit requirements on loans that it will purchase from banks. ". . . .another thrift industry growing up around us," said Peter Wallison, a resident fellow at the American Enterprise Institute. "If they fail, the government will have to step up and bail them out . . . ."*
>
> Steven Holmes, *New York Times,* September 30, 1999

This quarterly commentary is the 4th version. I began over a month ago and have had to start again now four times. It seems pointless to dwell on what we've all been reading and hearing so I'll try to take the longer view that I frankly prefer.

DENIAL, ANGER, BARGAIN, REALITY, ACCEPTANCE – We've experienced all but the last in less than a month. During the DENIAL phase we thought a few firms would be helped and that would be about it. Anger grew from both the size of the "help" and the growing number of firms. The two presidential duffusses (duffi?) figured a bit of political BARGAINING would help until a global credit crunch arose and that was the REALITY check. ACCEPTANCE is here . . . . I think.

I'm still in the BLAME mode, which fits some place between DENIAL and BARGAIN. Barney Frank, still in DENIAL, and his smug support of Community Reinvestment and Fannie Mae offends me . . . . as does a Nancy Pelosi inability to marshal her own party – where is Tip O'Neill when you need him – that man could herd cattle.

Alan Greenspan told Martha Seger a few years back – when she raised the leverage/credit quality issue – "not a problem – we have it under control." Still think he's overrated, she's not appreciated.

We had an okay economy – meaning earnings, sales, employment, inflation, etc. – going. There was no economic "boom" going, no market "boom" going. We did have an over-levered credit boom going and that went bust. To my mind, then, we need to now separate our thinking into two elements:

- How is the credit element fixed? and . . . .
- Can the economy survive?

The credit element is in all the media – beef up the banks so they will trust each other and have the capital to attract depositor trust and thus be able to lend. Of late, the government temporarily buying bank stock warms my heart – we taxpayers have a shot at getting some of our money back when they cash out. (Did you know that when the government backed Chrysler's I.O.U.s, we taxpayers made $400 million and never lent out a dime – and Lee Iococca tried to renege on the deal?) This idea of buying in is global now and a huge step that isn't necessarily a long-term liability to the Treasury, but is critical to restoring confidence.

Rather than beat it to death, it seems to me that the tools are in place, the coordination is global (unlike '29), the lessons learned will be reflected for years to come in more rules, regulations and restrictions, each of which will spawn a new generation of circumvention. The single most valuable thing to happen was to finally debunk something I have railed against for years: Markowitz and his Nobel Prize-winning(!) Efficient Market Hypothesis which, by the by, is still being taught to impressionable CFA candidates. (Talk about a program in need of total overhaul.) With it went the "normal distribution" – the bell curve, 6-Sigma events, "once-in-a-hundred-years" thinking, all the science of any financial "engineering" that contains a human component wherein risk was said to be known and planned, down to how often it would appear. Okay, a bit overstated but it was thought to be "under control." Toss the stock charting group in also, although I'm sure one of them "predicted" all this.

I wrote previously that normal distributions apply to physical elements – the range of heights in a room full of school children, for example – but dial in the element of human behavior and welcome, Black Swan. For those of you with real lives and productive days, the Black Swan reference speaks to a time when Black Swans were thought not to exist – until one was found. Our over-levered credit environment was thought to be unable to fail – until it did – not once in a hundred years or one chance in a million, but when the human element (confidence) changed – which can happen again tomorrow, statistics be damned.

Let's consider for a moment instead the remaining doomsayers who don't believe we can fix and cycle out of this. If it's all over, what do you do – I mean it either is, or it isn't. If it isn't, prepare now for eventual recovery (when it's clear, it's way too late). If it <u>is</u> all over, your T-Bills are worthless; gold will be an impossible medium to carry/store/value/use and <u>nothing</u> you can do now will matter. Cash – in any form – will be worthless with no government to back it. (Oddly enough, your stocks, but not your bonds, may have value in this event as they represent ownership of property. Germany bore witness to this anomaly in the 30s.) The probability of it being all over, truly over, is too low for me to abandon treating these times as a severe cycle through which we will progress. In 1987, we had down days in the market – 22% as I recall one day; back in '87-'91, we had over 2,000 banks fail. (We also had inflation, high unemployment and no global coordination.) The point is simple – the doomsayers are dominating the press, but the economic cycle is dependent on, but different from, the credit cycle. I don't believe the de-leveraging of the credit cycle will cause a depression, much less a flat out "it's over." It has triggered an unnecessary recession which is the fault of Congress and their stumbling, blaming, self-serving laziness.

What I <u>do</u> worry about is a Democratic President and Congress. That, to my mind, will lead to typical Democratic solutions – protect unions, teachers and give-away programs, raise taxes on the "rich" and create new trade agreements, tax rebates that aren't the new social engineering policies – you get the idea – think the "70s.

There are reasons to be mildly optimistic about the economy – the other issue. To list a few, we have 1) low interest rates, 2) a rising dollar vis-à-vis the Euro, 3) plenty of cash stashed and plenty of money in circulation, 4) falling oil prices (gas under $3 by year end) and thus a removal of the "tax effect" of high gas and oil prices, 5) a mild reduction in immigration to help employment numbers, 6) falling commodity prices, 7) cheap stocks, 8) a falling trade deficit as oil prices decline, 9) gold that did not go to $2,000 or whatever those whack jobs were calling for, 10) the oil despots of the world watching oil revenue fall as they try to convince their citizens the demon is the U. S., not the despot at the helm, 11) oil and gas subsidies to citizens falling in India, China, Russia, etc. and even, I think, a wiser U. S. consumer – if only for a little while.

Consumers are frightened – frightened for their jobs, their 401(k)s, their gas costs and their house values. Consumer spending will need time to fully recover – but remember, please, the much larger number of people who <u>are</u> prudent, <u>do</u> make mortgage payments on time, <u>can</u> invest and wait for recovery and <u>do</u> have some savings. Emphasis on the irresponsible sells newspapers, but should not influence your view of the whole population.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

I am not enjoying the stock market volatility, but it is an opportunity to buy real companies with real, <u>necessary</u> products at a discount. I hear from friends who tell me of folks they know in a "told-you-so" mode – folks who buy Treasuries or farm land as if that will be the last decision they ever have to make – and for their sake I wish it was. The idea, however, that cycles have ended, that the end is here and it's all over is a dangerous idea – as dangerous as assuming 1,000-point days in <u>either</u> direction mean anything.

It's the economy folks – it's 120 million homeowners who do pay their bills, it's 150 million working Americans who do show up everyday and work and feed their families and educate their children to do the same. I, for one, am weary of what is a serious credit wind-down, very pleased that it is happening, worried it is being "fixed" by the same people that caused it and confident the citizens of this country are, finally, seeing some of the errors of their leaders – of all stripes.

In my gut, I suspect the recession will be shorter than most expect, albeit a slow economy to follow, and we'll elect the same group of losers again, see a mild round of inflation next year and see stocks rebound way too fast. I am a buyer, selectively, and have been since the 20th of September. Did I catch the absolute bottom? Nope – but like the good Cub Scout I was, I want to be prepared. Thank you Doc, Jim, Phil, Rod, Bruce, Ron – you know why.

October 2008

P. S. The European Union cannot and will not work together to solve their individual problems, i.e. British banks with too many Russian assets, Austria exposed to the Balkans, German banks way too tied to Corporations, etc. So – Euro/Dollar parity – how about 12 months? I retain serious doubts the European Union itself can survive – we can't get adjoining <u>states</u> to agree, much less the mix of languages, cultures, grudges and egos of 27 some-odd <u>countries</u>. At the end of the day, we're still the best game in town and better now for this purge.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568