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Deciphering Recent Market Volatility

By Brian Perry

During a four-year period prior to last summer, the financial markets had been relatively calm, and compensation for assuming additional risk had been minimal. That all changed in 2007. What happened? What might come next?

This article chronicles the unprecedented period of economic and financial volatility that we continue to experience. By gaining a better understanding of recent events, readers will be prepared to effectively manage local government finances in these challenging times. Following this article's broad overview of the events of the past year, a companion article next month will discuss the impact that these events have had on local government investment portfolios, and the lessons that investors can learn from the credit crisis.

Anatomy of a Bubble. To understand what is happening now we need to step back in time, back to the aftermath of the tech bubble and stock market meltdown of 2000-2002. The precipitous decline in the stock market, combined with the accompanying recession and the events of September 11, 2001, caused the Federal Reserve (the Fed) to lower the federal funds rate to an unprecedented 1 percent. The economy and stock market did recover, but the slow pace of economic expansion prompted the Fed to maintain unusually low levels of interest rates for an extended period of time.

This sustained period of low interest rates accomplished the objectives of the Fed - economic growth rebounded and the stock market began to recover. Unfortunately, low interest rates also contributed to the huge boom in the housing market and an increased willingness among some market participants to assume higher levels of risk for less compensation. These two unintended consequences of a sustained low interest rate environment helped set the stage for the credit crisis that was to unfold.

As housing prices soared in many areas of the country, mortgage providers

offered a variety of creative products designed to allow buyers to afford more expensive homes. At the same time, lenders also relaxed underwriting standards, allowing more marginal buyers to receive mortgages. The easy availability of credit in the marketplace had a similar affect. Deals that once may have struggled to find funding seemed to have money virtually thrown at them. These deals provided attractive returns for both lenders and investors.

The Bubble Bursts. Although real estate is an extremely difficult market to summarize in statistics, it now appears that the housing market began to slow sometime in 2006. This slowdown began to affect the financial markets in February 2007, when concerns about the subprime mortgage market led to a surge in market volatility.

Subprime mortgages are issued to households with below average credit or income histories and are generally considered more risky than traditional “prime” mortgages. Although they constitute a minority of the overall mortgage market, they have become increasingly important in recent years. Many people that took out subprime mortgages did so with the hope of “flipping” their house for a large gain, a tactic that worked well when home prices were increasing. Other buyers were able to afford initially low payments, but when these “teaser” rates reset to current market rates the homeowners could not afford the new, much higher payments. As a result, subprime delinquencies and foreclosures increased. The trouble this caused went beyond subprime borrowers and lenders; many of the subprime mortgages had been “securitized” and resold in the marketplace. This dispersion of risk is generally a good thing, but in this instance it also meant that potential losses from subprime mortgages were spread more widely than they otherwise might have been.

By mid-summer 2007, concerns about subprime mortgage problems had increased, and market participants began avoiding mortgage-related risks. Although it was initially hoped that volatility would remain specific to the mortgage market; in fact, losses soon spread to encompass all risky assets, and concern grew at a wide variety of financial firms.

The crisis was underway.

The Damage Spreads. Soon financial institutions and hedge funds began reporting larger losses from their subprime mortgage and structured product holdings. Because these products are extremely difficult to value, the exact magnitude of these potential losses remained uncertain. The result was that almost every day a new rumor would circulate that a financial firm was experiencing financial difficulty. In the face of this uncertainty, many market participants simply chose to avoid all risky assets, preferring instead to place their cash into ultra-safe treasury bills.

Once investors started to shun risk, the commercial paper market nearly froze up, preventing corporations from accessing one of their most important sources of liquidity. Corporations depend upon access to short-term funding in order to facilitate their daily activities. If they are cut off from this funding, they might have

to severely restrict their operations; some might even be forced into bankruptcy, despite the fact that their underlying business fundamentals are relatively sound. Financial firms in particular are often very dependent upon commercial paper as a short-term financing source.

As access to the commercial paper market essentially evaporated, rumors swirled around a variety of previously robust companies. Countrywide Financial, once one of the largest mortgage providers in the country, teetered on the brink of bankruptcy due to a lack of liquidity before being purchased by Bank of America. Several prominent CEOs lost their jobs after disclosing massive losses on hard to value exotic bond positions.

Many of the risky assets that have been the cause of concern, such as SIVs, CDOs, and other structured products, are extremely complicated and difficult to price. They are also rarely traded, making an accurate value difficult to determine. Market participants dislike large losses at financial firms, but even more than that they dislike *not knowing what those losses might be.* Many of the largest banks and brokerage firms in the world have repeatedly stated that they believe they are done taking losses, only to be forced again and again to take further write-downs. This inability to accurately ascertain the true extent of losses has eroded confidence in the strength of many financial firms, and in the financial system as a whole.

During the month of March 2008, Bear Stearns, a Wall Street investment bank, collapsed, and was purchased by JP Morgan in a forced sale brokered by the Federal Reserve. In the span of 72 hours, Bear Stearns went from a *profitable* entity to the verge of bankruptcy. This was due to a lack of liquidity and a loss of confidence that resulted in a refusal of many counterparties to conduct business with Bear. Fearful that a Bear Stearns collapse would severely damage the entire financial system, the Fed orchestrated a purchase of Bear by JP Morgan, even going so far as to guarantee some of Bear's liabilities.

A Category Five Storm. A potentially more serious situation began to unfold in July 2008 when Fannie Mae and Freddie Mac, the two giant federal housing agencies, began experiencing larger losses in their mortgage portfolios. Although rumors of trouble had circulated for some time, events reached a critical point as the two companies' stocks declined nearly ninety percent from their highs. While the government is not inclined to help stockholders minimize their losses, Fannie Mae and Freddie Mac are seen as vital to the recovery of the housing sector. Their debt issuance is also massive, and its widespread ownership and implied government guarantee placed an onus on the government to take action to protect bondholders, or risk a broad based financial and economic meltdown.

On September 7, the Federal Housing Finance Agency (FHFA,) in conjunction with the Treasury Department placed Fannie Mae and Freddie Mac under conservatorship as part of a four-part plan to strengthen the housing agencies. In addition to conservatorship, the Treasury pledged to: inject up to $100 billion in each agency if needed to maintain a positive net worth; provide unlimited short-term liquidity if needed; and purchase mortgage-backed securities in the open

market. The government took these actions in order to provide stability to the financial markets, support the availability of mortgage finance, and protect taxpayers from excessive losses.

It was hoped that these government actions would restore confidence to the marketplace and help mitigate recent volatility. Unfortunately, while the credit profile of Fannie Mae and Freddie Mac improved, the broader markets moved from bad to worse. In fact, the month of September witnessed an unprecedented reshaping of the financial landscape and some of the highest levels of financial market volatility on record.

Shortly after the housing agencies' situation was resolved, confidence in a number of venerable financial institutions began to evaporate. On September 14, Lehman Brothers (the fourth largest Wall Street investment bank) declared bankruptcy following 158 years of business and Merrill Lynch (the third largest Wall Street firm) agreed to be purchased by Bank of America. On September 16, American International Group (AIG), once the largest insurance company in the United States, received an $85 billion emergency loan from the federal government in order to prevent the company's bankruptcy and the chaos that might have ensued in the financial system.

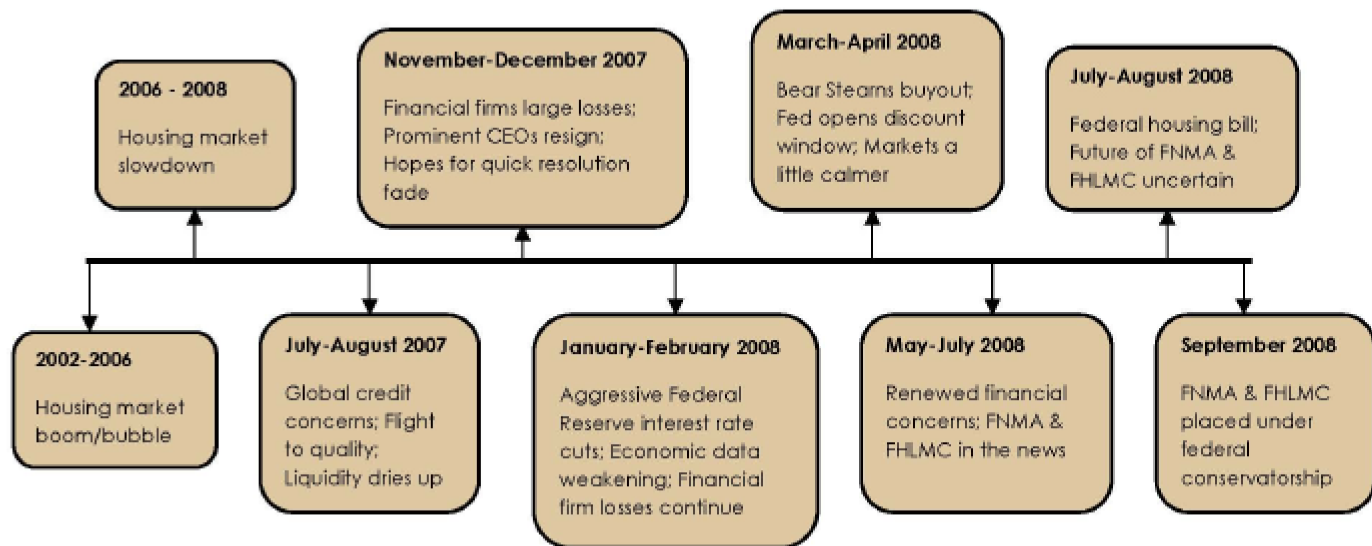
Over the course of the next several days fear of bankruptcy continued to swirl among a wide variety of financial firms. These concerns caused Goldman Sachs and Morgan Stanley, the two largest and most prestigious investment banks on Wall Street, to change their regulatory status in order to become commercial banks. Although this change may result in lower profitability for Goldman and Morgan, the ability to depend on relatively stable customer deposits was seen as essential to the companies' survival.

On September 25, Washington Mutual was seized by the Federal Deposit Insurance Corporation (FDIC) and its assets were sold to JP Morgan in what is officially the nation's largest bank failure. On September 29, the banking operations of Wachovia (at one point the nation's fourth largest bank) were purchased by Citigroup in a deal that included the backing of the FDIC.

In addition to these failures and takeovers of very large financial institutions, the markets demonstrated extreme turmoil. At one point, demand for Treasury securities was so great that the one-month Treasury bill was actually *paying negative interest* as investors fled to the world's safest asset. Credit spreads (the additional compensation required for investing in risky assets) reached all-time highs and many fixed income and short-term loan markets essentially ceased to function.

Faced with the possibility of a systemic collapse of the financial system, the Treasury Department and the Federal Reserve used every tool at their disposal in order to navigate the crisis. In addition to essentially nationalizing several large firms and facilitating the takeovers of others, the Federal Reserve provided unprecedented levels of liquidity to the marketplace. The Treasury also proposed a $700 billion plan that would involve the government's purchase of impaired

assets from the balance sheets of banks and investment firms. It is hoped that by purchasing these assets the government can restore liquidity to the balance sheets of banks, repair their credit standing, and reinvigorate their willingness to lend to businesses and consumers. The Treasury would hold the impaired assets until the market improves and then resell them, perhaps even earning a profit. Many market observers feel that at this point the Treasury's plan provides the best chance for a financial sector recovery and a limit to the damage caused to the broader economy.



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From Main Street to Wall Street and Back Again. The difficulty on Wall Street began with housing weakness on Main Street. This process has now come full circle as financial market volatility has contributed to a slowdown on Main Street. National economic reports reflect this, and the slowdown is even more evident in certain regions of the country such as the industrial Midwest, Florida, Arizona, Las Vegas, and California. Housing market weakness has been exacerbated by high energy and food prices, a weakening job market, and a difficult credit environment.

Many economists believe that the economy is currently in a recessionary period and even economists that are not forecasting a recession are predicting a protracted period of slower economic growth. While second quarter 2008 Gross Domestic Product (GDP) showed growth of 2.8 percent, this relatively strong number was due in part to the effects of the tax rebates and increased exports from the weak dollar. Forecasts for the remainder of the year call for much slower growth, and consumer confidence remains very poor. Since recent economic indicators do not yet reflect the impact of September's financial market events, the potential exists for growth to slow even more than previously predicted.

Conclusion. The ongoing financial market volatility and economic slowdown have affected all Americans. However, recent events have also had more specific implications for local government investors. In next month's follow-up article, we'll take a closer look at the impact recent events have had on local government investment portfolios and the lessons that can be learned from these difficult

times. We'll also examine the outlook for financial markets and the economy.

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