market update

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So far in 2008 we have had two periods of significant market decline: one in mid-January and most recently in late February into early March. Both periods have been associated with problems with certain companies and parts of the financial markets. The January drop was related to concern about debt insurance companies including MBIA and Ambac. Most recently the collapse of Carlyle Capital and of course Bear Stearns were at the center of the decline.

While seemingly unrelated, both episodes and the associated corporate downfalls were related to the on-going problem of the quality, trading and valuation of mortgage debt. Described by many as a disease, symptoms of the problem have been visible in many different parts of the financial system. Bond insurers such as Ambac that provided guarantees on poorly underwritten mortgage debt, bond funds and municipalities that relied on the bond insurers guarantees, various types of pooled funds that invested in long maturity mortgage bonds using short-term funding, and brokerages that had their credibility questioned due to large holdings of mortgage product are all casualties. The disease acts on the flow of money to parts of the financial system by increasing the level of fear. Those parts of the system that are thought to hold the problem loans and bonds are denied the flow of money and thus wither.

The disease is caused by declining house prices. Many of the loans that are behind the mortgage bonds were made at 100% or more of the value of the house and to borrowers with questionable ability to repay the debt. Underlying the lender's willingness to make what now look like foolish loans was the assumption that home prices could not decline. With falling home prices, the inclination of the owners to repay the debt is questioned and the collateral of the value of the house is unknown causing great uncertainty in valuing the debt.

The cure has been elusive, but is proceeding down two paths. The first is to enhance the flow of money. Much of what the Federal Reserve has done in the past few months has been to provide greater access to funds for banks, and in conjunction with the Bear Stearns sale to J. P. Morgan, to primary brokers as well. This has been achieved by accepting a broader range of collateral for loans and by lending for longer periods of time. The second approach has been to find ways to stabilize home prices. This has been done by trying to improve the affordability and availability of mortgage money. Lower interest rates, greater lending capacity at government agencies such as FHA, FNMA and FHLMC and tax rebates are key parts of this approach.

Our view is that there is no one action that will cause fear to subside, money to flow and prices of real estate to firm. However, taken together and over time the changes that have been implemented will have an impact on the problem. We commented after the January decline in the market that additional financial crises would likely have the market retest the January lows. The Bear Stearns episode of the past week was just such an event. Our view that the current market would favor larger companies over small and domestic over international is so far correct. We have not yet seen a break in the price of energy and the dollar has failed to rally as we hoped, although recent market action in both is more supportive. These would be important stimulants to the market. Volatility in the markets will persist, but valuation in the equity market and increasingly in parts of the debt market looks compelling. Quality and growth are on sale and we will continue to try to take advantage of the bargains.