SLAYING THE BEAR

The thud (and screams) when one of the most storied firms on Wall Street hit the floor last week echoed throughout the world's financial halls. It was, at minimum, an unsettling event for investors, already on edge after witnessing a stream of negative news over the previous twelve months. It was, also, far from unprecedented.

Just ten years ago, at the encouragement of the Federal Reserve Bank of New York, roughly a dozen firms provided $3.6 billion to bail out Long-Term Capital Management and keep the giant hedge fund alive long enough to liquidate its positions. In 1994, the once vaunted Kidder Peabody sold for just $70 million. In 1991, Salomon Brothers was taken over by Warren Buffet, held for ten months, and then sold to Travelers. A year before that, Drexel Burnham Lambert collapsed in the wake of the junk bond market's steep downturn. And, slightly more than twenty years ago, people stopped listening to E.F. Hutton and the firm negotiated its own rescue from Shearson Lehman Brothers.

Bear Stearns? Creators of their own demise. They made massive bets in their business model and overexposed themselves to questionable underlying assets—mortgages and sub-prime mortgages. A strategy that has run its course. The deteriorating capital markets and the credit squeeze therein has frozen the ability to get capital to maintain the desired daily liquidity.

Others will continue to take some hits from the decreased liquidity and their exposure to sub-prime and other mortgage debt, but this is not the end of the financial system as we know it. Not by the longest of long shots.

JP Morgan, with the Fed's help, came to the rescue this time...and they will be rewarded handsomely. They are picking up a firm with significant top quality businesses, including their merchant banking and retail investment services, for just $236 million originally, now up to $1.2 billion. Bear is a firm that is worth about $7.5 billion. Their midtown Manhattan offices alone are valued at $1.2 billion. JP Morgan picks up these assets for next to nothing. They are now paying just roughly $7 for each dollar of annual earnings from Bear.

This rescue story is not finished. As seen from the renegotiation over the weekend, it will continue to evolve.

Over the past year, rising delinquencies on sub-prime mortgages have triggered a cascade of anxieties, culminating in deep concerns about the wherewithal of the global financial sector and prospects for the US and global economies. Since last summer, investors' fixation on the sub-prime crisis has made them increasingly anxious about two issues. The first, banks' sub-prime-related losses will make them virtually unwilling to lend. The second, falling US home prices will curtail residential construction and cause consumers to spend less. (For more on this, click here.) Because of these concerns' potential impact on growth, investors have become fearful that the US economy will slide, causing global growth to slow and worldwide stock markets to decline. This has been reflected in heightened risk-aversion and the resulting volatility. Despite this, and the sense we're on a never-ending Matterhorn ride, market volatility is still roughly aligned with the long-term pattern.

Although sub-prime losses at financial institutions will be large—current estimates put them at $200 billion to $250 billion—banks around the world are well capitalized, with more than $4 trillion in book value, to withstand the losses. Net of all 2007 write-downs, every major US bank, was profitable for the year. And there has been a rapid response by the central banks in this crisis—in terms of both providing liquidity to bolster the global financial system and in lowering interest rates aggressively in the US. On January 22, the Fed reduced its benchmark Fed funds by 75 basis points, or three-quarters of a percentage point. They followed by reducing it another 50 basis points on January 30, and 75 more this past week. What's more, for those banks that have had the largest losses, some $60 billion in capital has flowed in from a diverse group of investors, including so-called sovereign wealth funds. However, no one was willing to help Bear, just as Bear chose not to participate in the bailout of Long-Term Capital ten years ago.

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The Fed's interest rate cuts should work to temper losses from sub-prime mortgages. Many such loans will reset in 2008 at somewhat lower—and more affordable—rates than they otherwise would have. Lower borrowing costs will make housing more affordable since mortgage payments for new homeowners will be lower, stimulating demand for housing. Finally, qualified existing homeowners will be able to refinance their mortgages at lower rates, giving them more disposable income to spend on goods and services.

To be sure, the US housing crisis has hurt the health of the US economy. Too many houses were built over the past few years, and we are now experiencing a slowdown in residential construction. House prices could drop an estimated 10%–15% more before bottoming out. Things may get worse before they get better since foreclosures will likely rise before settling. Nevertheless, the broad US economy is being bolstered by increases in commercial construction and—more importantly—dramatic growth in exports, aided by a weaker dollar. Significantly, the housing sector represents just 4% of America's GDP, while exports make up 12%.

In fact, in the US, where we've seen slow growth in early 2008, we expect growth to pick up later in the year, driven largely by continued strength in exports due to the decline of the dollar. We expect after-inflation growth in the global economy to be in the 3% range in 2008, supported by the robust growth in emerging markets.

We're fully cognizant of the danger in today's tumultuous markets, but we also see significant opportunity across the capital markets. We compared the expected return for equities with the yield of 10-year Treasury bonds—the equity risk premium—and the extra return that investors can expect for investing in stocks was roughly 5% at the end of 2007, well above its long-term average. Even better, the equity risk premium has risen further in 2008, making stocks look all the more attractive relative to bonds.

A classic example of the opportunity emerging today is financial stocks. They were by far the worst performers in 2007's second half, when investors fled companies with even remote connections to sub-prime loans, in a prima facie case of guilt by association. Financial stocks are generally so beaten down that they currently make up close to 60% of the most attractively priced quintile of S&P 500 stocks, versus 32% at the end of 2006.

After researching potential hazards for financial firms (above and beyond mortgages), such as credit cards, auto loans, and commercial real estate, we concluded that select financials embody tremendous long-term value. The market appears to be ignoring that many large financial players around the globe have strong balance sheets, and are well diversified by geography, business lines, and sources of potential risk. But timing here is crucial. We remain cautious about the near-term risks so we are approaching financials in a measured fashion. Still, it's well worth noting that it is in unsettled times, very much now, that investment discipline can uncover opportunities.

The urge to flee to the safety of Treasury bonds when stocks plunge is understandable, but not necessarily wise. Risk aversion has run rampant among investors, and impeded their ability to earn return. If you purchased a two-year Treasury bill at the end of 2006, your real—after inflation—yield was 2.5%; at the end of 2007, it was a mere 0.6%. Extreme risk aversion equals virtually no return.

We believe that both the stock and bond markets offer exceptional opportunities. And, as we've often pointed out, stock market gains tend to come in bursts. These facts get lost in times of duress.

As always, the best defense in times like these is to adhere to a methodical asset allocation strategy—one designed to contend with a period of high volatility and, crucially, to take prudent advantage of it.

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