FINANCIAL CATALYST GROUP

Wealth Architecture™ Digest

Often people do not plan because they see only what is, and they do not have a vision of what can be. Something is always possible. We believe that, with vision, the possibilities are almost unlimited.

When Wall Street Owns Main Street Will We All Be On Easy Street?

PREFACE: At the time of this writing (on 11/25/09), the S&P 500 is up over 62% from the depressing low of March 9th. Citibank is up 312% and Bank of America is up 408% (source: finance.google.com). Wall Street is back from the precipice. But over the same eight months an additional 3.5 million people have joined the ranks of the unemployed. Main Street remains on the precipice, as foreclosures and bankruptcies grow. "March 2009 bankruptcy filings totaled 1,202,503, compared to the total 901,927 bankruptcy cases filed in the 12-month period ending March 31, 2008," (source: uscourts.gov) a 33% increase over the previous 12 month period, and up from 695,575 in 2007. Somebody is buying all the assets at a discount.

THE STORY BEGINS: It's an interesting story that began just over two years ago. The S&P 500 Index was at 1440, about 6% down from its all-time high reached the month before (source for all index/stock data: finance.google.com). The six-month T Bill had a yield at auction of 3.58% (source: treasurydirect.gov), a long-term average rate. Just five years after the devastating bear market caused by the popping of the internet stock bubble, with the US involved in two wars, with public and private debt exploding, the domestic (and many international markets) had recovered to reach all-time highs.

At the same time that the equity markets reached their highs, the US housing market was already showing signs of cooling after years of dramatic price increases caused by low interest rates and Wall Street-driven nonsensical mortgage loans. Residential mortgages were written not as a long term interest income generator for the banks and savings-and-loans, but as one-time profit boosters. The companies that originated the loan earned a nice fee up front (points and "origination fees"), and quickly sold the loans to Wall Street to be packaged as collateralized mortgage obligations, and then re-packaged into various flavors of collateralized debt obligations. Basically, the mortgage brokers, banks, and investment banks made quick, up-front profits on quick sales that were soon re-sold to unsuspecting municipalities, pension funds, endowments, etc. Oh, and the reason the end investors felt comfortable buying was that Wall Street packagers paid the credit analysts at Standard and Poors, Moodys, etc. to provide mostly AAA ratings on these debt-backed bonds.

By early 2008 it was clear that the problems in the real estate market were becoming severe. As sub-prime mortgages began to show increased rates of default, analysts began to re-evaluate the purported safety of the bonds that relied on the residential mortgages as collateral. But a funny thing had happened on the way to the bank. The investment firms like Goldman Sachs, Lehman Brothers, and others had arranged for "insurance" in the event of default from companies like AIG, MBIA, etc. Unfortunately, many investors who bought the bonds did not buy the credit default swaps (CDS), which were bought heavily by investors (gamblers?) betting that the bonds would go bad. The issuers of the swaps, largely AIG, Lehman, Bear Stearns

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and others were making huge profits collecting premiums for the insurance on which they never expected to have pay claims, and for which they were not required to establish real reserves. In March, with relatively little fanfare, Bear Stearns became the first fatality of the debt bubble as it was "sold" to JP Morgan Chase with a $29 billion Federal Reserve (taxpayer) loan guarantee against losses from toxic assets (source: wikipedia.org). By April 4th the S&P 500 was at 1370, up over 6% from the time of Bear's takeover on March 17th, and down just 12% from its all-time high.

Not to miss out on profit opportunities Wall Street was profiting off Main Street in a little understood way: commodities trading. You may not remember, but in the summer of 2008, with the recession underway – but not yet official – all commodities were going dramatically and inexplicably up. Oil hit a high of $147 a barrel and were we told it was going to $200 or more because of lack of supply. Gasoline and heating oil spiked, as did all kinds of petroleum-based products. Chemical fertilizers became expensive and food products followed. All this in a slowing global economy that we now know entered recession in December, 2007.

With a perceived shortage in gasoline (and its record price), ethanol production was ramped up and corn was diverted from food use to ethanol. Inevitably we started to see shortages of rice, corn, and wheat as more farmers produced corn for sale to ethanol plants. There were food riots in Mexico because of the price of tortillas, as well as disturbances in India because of the skyrocketing prices of rice. I remember places like Costco restricting how many bags of rice could be purchased at one time as people hoarded. But as Matt Taibbi, reporter for Rolling Stone writes in his article "The Great Ameri can Bubble Machine", the shortages were "manufactured" by Wall Street's sales of commodities futures contracts, not by actual supply-demand imbalances. But we were in the midst of brutal presidential primaries, and it was easier to simply make it a political battle cry of "Drill baby, drill."

Main Street was just starting to feel the real pain. With gas prices up people stopped buying the most profitable American vehicles, SUVs and pickup trucks. The auto companies (even the foreign ones) began to hemorrhage cash as unsold inventories increased. Consumers no longer wanted the gas-guzzlers, and Detroit did not make many small cars. But of course it was in the midst of a political season, so the blame fell on the unions for their high salaries and benefits (which were a part of the problem). People couldn't afford the $4/gallon gas to go on trips, and airline losses increased due to higher jet fuel costs and fewer customers. The snowball moved down the hill as sales of everything from cars to boats to RVs screeched to a halt. Also, with housing supply greater than demand, construction stopped, leading to more layoffs. New houses were either unfinished or unsold, leading to a drop in consumer durables like major appliances, furniture, etc. But to Wall Street it was just a slowdown – a normal part of the business cycle.

The reason I go through in some detail the myriad of issues that were separately but simultaneously taking place is that they are important to understanding the oft-misunderstood affect of Wall Street on Main Street, and how misaligned their respective interests have become in the post credit-bubble world. The events of the past 14 months illustrate this very well.

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September 15th was the day the financial world started spinning out of control. The news from the residential mortgage market had been getting worse for some time, and the financial system was showing ongoing stress. With the collapsing value of its portfolio, capital calls on its loans, and nowhere to raise new capital, the 158-year-old Lehman Brothers filed for bankruptcy protection and closed its doors. It was one of the biggest counterparties in the global derivatives market and its failure froze the credit markets.

The next day, American International Group (AIG), which had been one of the biggest providers of credit “insurance” (credit default swaps) had been downgraded below AA levels (source: wikipedia.org) creating a catastrophic liquidity crisis. With AIG at the center of a $60 trillion CDS market and Lehman gone, the Fed was forced to step in as the lender of last resort and provided an $85 billion credit facility to avoid AIG being forced into bankruptcy.

The credit crisis caused by the problems at AIG and Lehman spread rapidly and the government, along with the Federal Reserve, made rapid and dramatic changes. The FDIC increased the amounts they would guarantee in depositor accounts. We had the “bailout” known as TARP, and an expansion of government guarantees for a variety of financial transactions aimed primarily at helping banks whose balance sheets were devastated by the cratering value of mortgage-backed securities, credit default swaps, etc. The federal funds rate, which had been 4 ½ % at the end of October, 2007 was cut to 0.25% by mid-December last year (source: treasurydirect.gov).

In the early days of the credit crisis Goldman Sachs rushed to acquire a commercial bank (source: NYDailynews.com 9/21/08) giving it access to the Federal Reserve’s lending facilities and low cost money from consumer deposits in addition to normal credit markets. These sources became cheap and reliable sources of borrowing for Goldman Sachs’ trading operations. Its cost of money decreased dramatically.

Over this past year interest rates have remained extremely low, and with Goldman Sachs (GS) deemed by many to be “too big to fail” it has implicit government backing resulting in extraordinarily low borrowing costs. The Motley Fool, an investment advisory publication and site (fool.com) pointed out on November 6, 2009 that GS had an average borrowing cost for long term debt of just 0.92%, while Johnson & Johnson’s average cost of money is 5.42%.

With much of its competition gone and its cost of money virtually nil, profits at GS have exploded since the crisis peaked last November. Its stock is up 156% over the past 12 months (source: finance.google.com), and according to its own quarterly filing, its quarterly net revenue is double that of last year. Interest expense for the quarter (with liabilities similar to last year) were $1.3 billion this year, versus $7.5 billion last year. This year’s nine-month interest expense is down almost $21 billion. Note 17 of their report shows “interest expense on customer credit balance and other interest-bearing liabilities shifted from last year’s nine-month cost of $9.9 billion to a *profit* this year of $271 million. The minimal cost of money has provided GS with great flexibility, powering its trading and principal investment revenue to explode to $23.8 billion from $12.5 billion.

So where did this money go? Did GS help the economy by lending to needy businesses or funding new mortgages? No. Did it go to shareholders in significantly increased dividends? No. Did it create jobs through investments on Main Street? No. It went primarily to bonuses and other compensation to the tune of $16.7 billion for the first nine months, and an estimated $20 billion for the year ending 12/31/09 (source: finance.google.com.) That is an *average* of over $630,000 per employee – and we know that is not what the secretaries and mail-room clerks will get.

Putting this bonus number in perspective (just for fun), let's benchmark it against other things. It is 23% of the total $87 billion market cap of GS, and is 27 times the annual dividends paid to shareholders (source: finance.google.com). It is greater than most recent 12-month profits of Apple, Intel, and Google combined. It is almost 3% of the stimulus money to be spent by the federal government over two years.

There is no question in my mind that over the long-term capitalism has provided a better life for most people, and a robust global economic system. But the system can get out of balance, and with the crisis last year the government decided it needed to make sure that Wall Street did not completely implode. The bailout (TARP) and the other programs to support the banks were successful in doing that, but while our government *hoped* that the programs would allow Wall Street to help Main Street, that was not to be. As the Goldman story illustrates, it is far more profitable to use cheap money to be a trader than it is to use it to loan the money in longer-term, lower-margin "retail" transactions.

Wall Street (along with its hedge funds, etc.) may soon own Main Street as companies buy up mortgages, loan packages, etc. at steep discounts. When this last happened in the early 1990s with the failure of the S&Ls, the Wall Street firms profited handily as they bought up foreclosed properties in bulk and flipped many for significant profits. For a while, when real estate and the stock markets took off again, many on Main Street thought they would be on Easy Street, only to find after many years they were in a Dead End. Let's hope this is not a repeat.

FINANCIAL CATALYST GROUP

4030 Moorpark Avenue, Suite 105
San Jose, California 95117
Phone: 408-261-7600
Fax: 408-273-6399

Financial Catalyst Group was founded in 1977 to help successful people articulate their goals, and realize their dreams to protect and preserve their hard-earned wealth. At Financial Catalyst Group we provide Wealth Architecture™ services that result in the implementation of value-added plans for the responsible transfer of wealth through the generations. We specialize in working with families that desire to provide a legacy to their families and their communities, making gifts instead of paying transfer taxes. We work closely with these families and their advisors to form a strong, results-oriented team.

Unless otherwise noted, market statistics and data used in this newsletter were obtained from finance.google.com, and interest rate information was derived from www.treasurydirect.gov.