

What to do?

Obviously, everyone's circumstances are different, so there is no one answer that fits. However, for anyone who is using investments as opposed to earned income for lifestyle, I suggest that a minimum of one year's expenses be set aside in banks or money market funds. Spending should come from this account so as not to draw money from volatile assets. Dividends and interest from investments should also be used for lifestyle instead of being reinvested. Assets invested for the long term should not be moved to cash, so long as it is emotionally possible.

In my opinion, no one really knows how long it will take for the global economy to begin sustainable recovery, nor what things will look like in the interim. It was only a few months ago that many financial "experts" said that there was no real threat to the broad economy. But with the major collapse in confidence that happened with Lehman Brothers' bankruptcy on September 15th, credit dried up and global leaders are struggling to get things under control. I do believe that the U.S. and global economies will recover, so even though the current situation is disconcerting, we should focus on the future.

Big Number

Just for fun I decided to look at a really big number: our national debt. In round numbers it is 10 trillion dollars. I wondered how to put that number in the context of both time and distance. The calculations resulted in mind-bending figures.

First, if one were to try to count to ten trillion, one second at a time, how long would it take? Well, there are 78,840,000 seconds in a year. At first it would seem that it shouldn't take too long. Wrong. It would actually take 126,839 years. So then I wondered how far it would be in a line of dollar bills laid end-to-end. With a dollar bill being about six inches long the calculation was based on 10,560 dollars per mile. How far would it stretch? The answer is **946,969,696** miles. In case you are interested, that is a distance of .68 *light years*.

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Gross Domestic Product (GDP) is the total market value of all final goods and services produced in a country in a given year.

The Merrill Lynch Corporate Master Market Index is a statistical composite tracking the performance of the entire U.S. corporate bond market over time. It is capitalization weighted and is re-balanced on the last calendar day of each month.

*Fitch Ratings is a global rating agency providing the world's credit markets with credit opinions. Similar companies include Standard and Poors and Moody's.

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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.

It's Credit, Stupid

Sixteen years ago Bill Clinton won his bid for the presidency during a fairly severe recession caused, in part, by the real estate collapse and the S&L failures of 1989-90. One of his most memorable one-liners was, "It's the economy, stupid." The current crisis facing the U.S. and the world can also be summed up in one word-- credit.

Years of easy credit helped global economies grow. Money was made by lending money. To be able to lend more money, commercial banks, investment banks, mortgage banks, and other institutions borrowed money. So long as there was money to borrow, more credit could be advanced to consumers (credit cards), homebuyers (mortgages), homeowners (home equity loans), private equity firms (leveraged buyouts), etc. Record profits were made, in part by the power of leverage created by credit. And then the music stopped.

The one thing that underlies the willingness of lenders to lend is the *confidence* that their loans will be repaid. For example, lending money to the 150-year-old Lehman Brothers seemed a good bet, as it had always repaid its debts. In January, 2008 Fitch Ratings* affirmed Lehman Brothers Financial Products (LBFP) as "AAA," both as to the Issuer Default Rating and the Counterparty rating. They considered the outlook as "stable" (source: Fitch Ratings 1/25/08.) The press release said "LBFP is a bankruptcy-remote entity..." If we cannot trust a 158-year-old, AAA-rated company to meet its obligations, who can we trust? While the housing crisis and the related sub-prime lending issues began in the summer of 2007, it was the bankruptcy filing of this once-venerable company that knocked the legs out from under the global economy. Fear took hold and began to freeze the credit markets around the world.

I recently learned about what some consider a fear indicator within the global credit markets. It is called the TED Spread. "*The TED spread is an indicator of perceived credit risk in the general econ-*

omy. This is because T-bills are considered risk-free while LIBOR reflects the credit risk of lending to commercial banks. When the TED spread increases, that is a sign that lenders believe the risk of default on inter-bank loans (also known as counterparty risk) is increasing. Interbank lenders therefore demand a higher rate of interest, or accept lower returns on safe investments such as T-bills. When the risk of bank defaults is considered to be decreasing, the TED spread decreases" according to the entry in Wikipedia.org. The LIBOR rate mentioned is the London Inter-Bank Offered Rate.

The TED Spread had generally been under 0.5% from 2004 (source for TS data: Bloomberg.com) until the subprime crisis began in the late summer of 2007. It then rose to between 1% and 2% for a year. On September 5th of this year it was 1.04%, but with the collapse of Lehman Brothers on September 15th, the \$700 billion rescue package and the global panic in credit markets, the TED Spread rose to an all time high of 4.64%. The only trusted borrower became the U.S. government. Banks would not lend to each other, much less to businesses around the world.

This may seem esoteric and of little importance to you and me as individual investors, but this fear is proving extremely important as it spreads like a cancer. The ramifications of fear in the credit markets include both greater difficulty in obtaining credit, and higher costs due to the perceived higher risks. Remember that if Lehman can go from AAA-rated to Chapter 13 in a matter of weeks, no borrower is considered *safe*.

On November 4th Fitch Ratings issued its most recent Global Economic Outlook. It was the first such report since July. It reduced projected GDP growth by -2.7% to -0.8% (Source: Fitch.) They say it will be "the steepest decline in GDP since the Second World War." I think one particular paragraph in the report says it best.

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The rapid intensification of the global credit crisis in the last two months and clearer evidence of household retrenchment, declining corporate investment intentions and falling world trade growth explain the sharp deterioration in the outlook since the summer. These factors far outweigh the benefits to income growth in the advanced economies from the decline in commodity prices.

Fitch does opine, however, that the fiscal injections of the past month “will head off the worst -case scenario of widespread deflation.” But while Fitch and others recognize the sharpness of the recession and the likelihood of recovery over the next couple of years, global markets remain extremely nervous because of the unprecedented evaporation of credit.

On November 24, 2008, the 3-month T-Bill was at 1 basis point (bps) or 1/100%, all related to panic in the credit markets. In the first auction of this year the 3-month T-Bill yielded 3.25%, and that was down already from 5.06% at the beginning of 2007 (source: treasurydirect.gov.) By contrast, the yield on a AAA 1-year municipal bond is 1.93%, almost double that of the 12-month T-Bill (source: online.wsj.com.)

In more normal times when an economic slowdown begins and stocks drop, investors move to bonds. The reason being bonds are generally less volatile than stocks, and when the economy slows, interest rates go down. Not so this year. Other than the move to short term treasuries mentioned above, bonds have been hit hard as well. As of November 25th the U.S. Corporate MAster Bond Index had lost 12.40% this year and is currently yielding 8.74%, up from 5.52% at the beginning of the year (source: wsj.com.) The yield spread is 636 bps (6.36%) above treasuries, up from 170 bps. The high yield index shows a yield of over 21%.

In these uncertain times lenders want to be paid an extraordinary premium to take credit risks. The normal risk premium of stocks over T-Bills is about 5%. Now we are seeing the bond premiums greater than would usually be required for investments in stocks. Companies that need money to stay in business either cannot get a loan or, if they

can, pay a very high price. The same is true for states and municipalities. This creates the double trouble of lower revenue and higher debt-service requirements, making the risks even greater.

The global economy runs on credit. Profits are magnified by leverage, as are losses. If a bank hopes to make a 6% return, it can try to maintain a spread of 6%, or it can live with a spread of 1%, with a 6:1 leverage ratio. Unfortunately the major financial institutions were racing along with leverage ratios in excess of 25-to-1, which brought them to their knees when asset values started their downturn with the subprime problems almost 18 months ago.

Now, as the financial system works to de-leverage, the banks need to bring in capital, but not make as many new loans. Instead of investing in new loans, they are trying to pay down existing debt. They make no money doing so and the general economy suffers from the unavailability of credit. Consumers are doing the same thing by using any extra money to pay down debt, not buy new things. Less consumption leads to layoffs, which leads to fewer people with money to spend – a difficult negative feedback loop.

Under normal circumstances the interrelationship of supply and demand works. When a business has excess supply, it cuts its prices until the buyers feel the price is low enough to where they are willing to buy, hence, increased demand. That works fine so long as the buyers have enough cash or credit with which to buy. Most of the time companies finance their inventories because the profit margin on the finished goods is greater than the cost of money (interest on debt) tied up in the inventory. But without the ready availability of credit, it is currently difficult for companies to get the credit they need to finance their activities.

On the consumer side of supply and demand it is the same thing. People may want to buy something that is on sale, but if their credit cards are maxed-out, they can't buy regardless of the price. Many credit card issuers have reduced limits or closed inactive accounts, further limiting consumer buying power. Credit is the lubricant of the financial system, and right now there is not enough to allow the system to run smoothly.

The Free Market

There has been a great deal of discussion regarding what to do about all the problems we face, from tumbling home prices, evaporating retirement values, failing banks, failing automobile companies, and drowning local governments. Something *will* be done, as the consequences of total inaction are too scary to contemplate, even for free-market conservatives. China, with GDP growth slowing, has announced a \$586 billion stimulus program wherein the government will spend money employing people to build infrastructure (source: latimes.com.) Fortunately China has the surplus reserves to do so without borrowing from other countries. The U.S. will likely stimulate with a large put-people-to-work program, but must borrow the money to do so. I've read cost projections of over \$600 billion. We taxpayers will likely bail out other companies as well, but is there a reasonable alternative?

I do not believe that anything is truly free. If I take you to lunch and pay the bill, you still have to “pay” by listening and spending your time with me. I may believe that GM really screwed up over the years. After all, they did kill the electric car they created in 1990. For the purpose of this discussion, let's assume that the company has made a series of critical mistakes. In a true free market we would let GM fail. Shareholders would be wiped out. Bondholders would lose a lot (I guess they were fools in lending to GM.) Employees would lose their jobs, their health benefits, and likely a good part of their pensions.

Of course it's not just GM. Suppliers would not get paid, and would no longer need the production capacity, so they would lay off many of their employees. The stores and restaurants that the GM's and vendor's employees supported would lose business as the terminated employees move away or have no money to spend. Many would lose their homes, and the banks would fail as the employees and local businesses could not pay their debts. But the free market, being Darwinian, assumes that this would all be better in the long run. In the meantime tens of billions of dollars of potential tax revenue would be lost as neither the closed companies, nor the unemployed workers, would pay taxes. No income, no tax liability. Would this be free?

A large part of the financial/credit crisis we are in is a result of a free market financial feeding frenzy. Just eight years ago in December of 2000, Congress authorized the creation of sophisticated financial derivatives that would be *unregulated*. Under the Commodities Futures Modernization Act of 2000 the financial services industry was granted a regulation-free market. Title IV of the Act was aptly named “Legal Certainty for Bank Products Act of 2000.”

Section 407 provides “No provision of the Commodity Exchange Act...shall apply to, and the Commodity Futures Trading Commission shall not exercise regulatory authority with respect to, a covered swap agreement.” Essentially this would be a free market product because those who promoted these instruments believed that the market would self regulate.

To make sure that no one would interfere in the market, Sub-section 408(c), the final paragraph of the act states: “PREEMPTION: This title shall supersede and preempt the application of any State or local law that prohibits or regulates gaming or the operation of bucket shops (other than anti-fraud provisions of general applicability) in the case of (1) a hybrid instrument that is predominantly a banking product; or (2) a covered swap agreement.”

When I read this I almost fell over— gaming or bucket shops? Congress understood these would basically become unregulated gambling contracts. “The term bucket shop is a defined term under the criminal law of many states in the United States which make it a crime to operate a bucket shop....Bucket shops specializing in stocks and commodity futures flourished in the United States in the late 1800s and early 1900s” (source:wikipedia.org.)

In my opinion, the free market approach to credit, especially credit derivatives, destroyed the very market that derivatives were created help. Originally meant as a way to hedge credit risk, they became the explosive ingredient that speculators used to wreck the world's credit markets. The free market cost has been over 10 *trillion* dollars in lost stock market capitalization – and counting (source: mscibarra.com.)