MV Capital Management E-Update

The DNA of an Economic Crisis

March 18, 2008

The week of March 10-16 has already secured its place in the annals of US financial history. By comparison with what has happened over the past eight days nothing in the past 30 years – not the market shutdown after September 11, 2001, not the bursting of the tech bubble in 2000, not Black Monday in October 1987, none of these events carries the epic significance of the head-spinning sequence of events that led to the shotgun wedding of Bear Stearns into the arms of JP Morgan Chase, announced this past Sunday evening. It is important to understand the significance of what happened – not just in isolation but in the context of an unusual confluence of economic and financial market developments that continue to cloud the path to a wholesome, fundamental recovery. Make no mistake, the recovery will come. However anyone who tries to proclaim when it will come – from the top of the US Federal Reserve down to your friendly neighborhood pundit – is not only throwing darts at a board but can't even see the wall where the board is hanging.

Let's start this discussion by separating the two strands of the current woes – the credit markets, on the one hand, and the overall US economy on the other. Think of these strands in the image of the customary double helix that microbiologists use to represent the gene structure – they are distinct, yet they are interrelated and influence each other.

Take subprime loans for example. Thousands of these loans facilitated the purchase of homes by families earlier in this decade amidst soaring home prices. Last year housing prices started to go down – at the same time that the loan terms reset leaving those same families with mortgage payments two times or more higher than they had been paying before. In balance sheet terms their assets – the value of their homes – fell while their liabilities rose. Their incomes weren't going up (household incomes have been flat for a very long time) and they had all sorts of other debt accumulating at the same time – auto loans, credit cards, what have you. That's the economic strand of the subprime loan problem – rising household negative net worth.

The credit market strand arose from the alchemy of Wall Street bankers taking those subprime loans and repackaging them into exotic derivative fixed income securities whose risk characteristics were barely understood by those who concocted them, let alone the issuers and investors who borrowed and lent money with them. Through this alchemy $1 of a subprime loan could easily become $30 or more of subprime-related derivatives. One of the signature stories in last week's meltdown involved Carlyle Capital – a fund operating under the aegis of Washington-based Carlyle Group. Carlyle Capital consisted of $670 million in paid-in equity capital at year-end 2007 but was leveraged 32 times – meaning that its total risk exposure to the securities it held in its portfolios was around 32 times that of its equity base, or $21.7 billion.

It is precisely that kind of leverage that is behind the mind-numbing figures we have seen coming out of the financial institutions as they try to write down their exposures to bad debts (having gone bad in the first place because of the rising number of household balance sheet failures we described above). $10 billion here, $20 billion there – billions and billions of securities that are worthless because liquidity has dried up. Now here is the other twist to these exotic credit market instruments. In addition to turning $1 of debt into $30 of derivative securities the Wall Street magicians also turned long-dated instruments – mortgages and other term debt such as student loans and municipal bonds with 15 or 20 or 30 year maturities – into

short-term money market instruments. Through various mechanisms like auction rate notes, remarketing and repurchase facilities these derivatives became the collateral for overnight or 30 or 60 days obligations in the short-term debt and money markets. In effect the bankers involved in these deals were borrowing short-term instruments and collateralizing them with long-term securities.

When nervous investors stopped bidding for these long-term instruments or accepting them as collateral the short-term borrowers still had to come up with the cash to pay their lenders. This is what drove Bear Stearns to the edge of bankruptcy on Thursday. In a classic run on the bank that could have been acted by Jimmy Stewart, all of Bear's creditors came to the window demanding their cash – and Bear didn't have the cash on hand. Enter the Fed as Yenta and Jamie Dimon of JP Morgan as the suitor for the damsel in distress.

And here is where the credit market strand comes back and meets the economy strand. The Fed is trying everything in its power – including radical moves the likes of which have not been used since the 1930s, such as opening its lending window to investment firms as well as deposit-taking commercial banks, to try and inject liquidity into the system to get the lending markets to start flowing again. The lifeblood of the US economy is credit – business credit, homeowner credit, consumer credit. Here is a very real danger. No matter how much money the Fed pumps into the system – and Fed chairman Bernanke got his nickname "Helicopter Ben" after a paper in which he opined that dropping piles of cash from helicopters would be the remedy if the crisis so warranted – there is plenty of evidence that the measures may not take. The US consumer is tapped out. Housing prices are still going down, inflation-adjusted wages are still losing ground and consumer confidence is by some measures at a 20 year low.

This situation is eerily reminiscent of Japan in the 1990s: authorities essentially took interest rates to zero to try and stimulate the economy but nobody reacted. The Bank of Japan threw a party and nobody came, nobody that is except for the hedge funds playing "carry trade" games with the zero percent financing. Fast forward to 2008: the Fed is poised to lower rates perhaps back down to 1% while rates in the Eurozone and Great Britain remain much higher and the dollar is starting to resemble an emerging market currency. Some hedge funds are even starting to dip into the waters of a US dollar carry trade – lucrative for smart quants maybe, but not much help for the US economy.

For a fundamental economic recovery to take place this year two things have to happen. First, the magnitude of the credit strand of the problem has to be largely containable by the types of liquidity measures the Fed and others are taking. Even today nobody has a clue as to how much more bad stuff is out there. Administration and Fed officials tend to argue that it is somewhere in the $200 billion range – high but controllable – while some economic pundits and other observers see the figure as much higher - $2-3 trillion – which if true could bring us to a real worst-case scenario where foreign creditors start to junk their US dollar foreign reserves and beget a systemic global financial cataclysm. At this point nobody knows.

Second, the liquidity moves have to result in a real effect in the economy strand of the problem so that consumers and businesses resume spending at levels sufficient to restore healthy GDP growth. In our opinion this is the real crux of the problem. Japan's liquidity trap as we described above lasted for the better part of an entire decade. We don't want to make too much of this comparison because there are fundamental contextual differences – but a sustained liquidity trap is a very real possible scenario if spending and business investment fall off. Consumer spending, in particular, accounts for over 70% of our GDP and this is the real elephant in the room.

As we said at the outset of this article, recovery will happen as surely as day follows night. The question is not if, but when. Unfortunately we have a cloudy horizon that impedes the ability to make a reasoned, informed judgment as to when. In the meantime we have to stay defensive. We have made several defensive moves to our portfolios recently in a manner that seeks to provide some additional diversification-based mitigation of the risks we see prevailing in the market. To be perfectly honest these moves could work against us if the equity markets come roaring back to life tomorrow and embark on a sustained rally. That's a risk we are prepared to take as it is consistent with the view we voiced at the beginning of this year: while some years are good ones in which to seek strong outperformance, others are ones where the main goal is to resist losing money. That is what continues to drive our decisions. Rest assured we will be in continued communication with you to share our thinking as events unfold.

With warm regards,

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MVCM 2008 0006
DOFU: March 2008

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