

## MV Capital Management E-Update

### As Goes the Financial Sector

August 6, 2008

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We might diagnose the stock market as being in a “static frenzy” – all hot and bothered but not going anywhere. Since the beginning of July and through the market close on August 6 there have been 26 trading days. For more than half of them we have seen the S&P 500 close 1% higher or lower than the previous day – 7 up and 7 down. On five days the magnitude has been 2% or more (3 up, 2 down). For all the stomach-churning ups and downs, though, the market has been completely directionless – the S&P 500 closed on July 1 at 1284, and a bit over a month later registered 1289 for the August 6 close – a zero percent gain or loss. The cause of this hyperactive indecisiveness can be summed up in two words: *financial sector*.

As goes the financial sector so goes the stock market. We chanted that mantra at the beginning of the year in our market outlook and it has been the defining characteristic of the US equity markets thus far. Here is the state of play: the economic environment in which the banks are dealing is terrible, but the Fed and other key policymakers have been bending over backwards to try and “rescue” the system by flooding it with as much liquidity as macroeconomic conditions will allow. Every few days Mr. Market reads about Bernanke, Paulson & Co.’s latest bag of stimulus goodies and falls in love with banks all over again, only to be followed a few days later by a jolting reminder from somewhere that things are still going down, at which point our manic-depressive friend Mr. Market unleashes hell’s fury on his fickle inamorata and sells.

The credit markets – the playing field on which banks and other financial institutions compete for lenders and borrowers – are still broken one year after the meltdown started in July 2007. On August 6 a year ago the Fed funds target rate stood at 5.25%, average conventional mortgage rates were about 6.7% and corporate Baa-rated bonds yielded 6.6%. Today the Fed funds rate is 2% - a decrease of 3.25% from last year. But average mortgage rates haven’t budged, still hovering around 6.5%, while the yield on Baa corporates is actually higher, at 7.2%. That is astonishing – the *spread* between the rate at which banks lend to other banks (which is what the Fed funds rate signifies) and the rate at which medium-investment grade corporations can borrow from the bond market has *gone from 1.35% a year ago to 5.2% today*. What that says is that all the money the Fed and the Treasury have thrown at the financial sector has had no more effect on the sector’s health than Don Quixote tilting at windmills.

Consumer and corporate borrowing rates remain stubbornly high because banks and bond investors are holding lots of bad debt on their books and don’t want to lend any more. The way credit markets work in a capitalist economy is a bit paradoxical. Lenders compensate for the additional risk of less creditworthy borrowers by charging higher rates. That’s logical, but results in the fact that those who can afford to pay least wind up paying more – like the guy who is half a step away from bankruptcy and has to pay 15% on a car loan while his neighbor with no financial worries and a sterling credit score waltzes away from the dealer with a zero percent loan in hand. The difference between a couple years ago and now is that nobody is willing to take any more risks on that near-bankrupt guy at *any* price. So the car goes unsold, as do homes and all manner of credit-fuelled consumer items that have been fuelling our economic growth – and guess what happens to that growth?

This newfound zeal against making more loans of dubious quality loans doesn’t help solve the problem of the deadweight the banks are already carrying on their balance sheets, though.

That deadweight is getting heavier. Fannie Mae and Freddie Mac, the agencies that hold about half of the country's \$13 million outstanding mortgages on their books, are reckoned to be just barely solvent with housing prices where they are today. When a financial institution holds collateral (like a home) against its loans the market value of that collateral has a direct impact on the solvency of the financial institution. That means that further declines in home prices will push Freddie, Fannie and others closer to that tipping point of insolvency. Faced with the specter of bankruptcy many institutions will likely choose to shore up their equity by selling assets – i.e. the homes, farm equipment, securities and other stores of value that make up their collateral arrangements. It's not so different from those households facing financial hardships who sell off various personal effects to pay their mortgage and credit card bills. Anyone checked out the furniture and home appliance listings on Craigslist lately?

Here's the part where we're supposed to cue up the soothing palliatives: "there's a light at the end of the tunnel", "it's always darkest before the dawn". True enough – but we have to actually *get* to the dark of night before it gets light again – we can't just skip straight from midnight to five am. In a sense our policymakers seem to be trying to do just that – to slow down the progression towards the darkest hour in hopes that some miracle happens before then – housing prices start to rebound, anything – to cause the sun to come up before we get there. Their motives are understandable – but also dangerous as they may simply be forestalling the inevitable and making it a more painfully drawn out process in so doing. *That's* why the stock market is so directionless, rather than simply collapsing and getting it all over and done with.

The sun will come out again – of that we have absolutely no doubts. In the meantime – for as long as we think it's still getting dark – we're staying defensive in our portfolios and avoiding the temptations and trappings of false dawns. Staying afloat in a down market is a tremendous challenge, but we are prepared for the challenge. The financial well being of our clients is too important – and from our kayaks we are focused on what lies around the next bend, not on the currents we have just navigated.

With warm regards,

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