



Weekly Market Commentary



October 13, 2008

A Bull Market for Volatility

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

The transformation of financial institutions over the last decade contributed significantly to the events that caused the seizing up of the credit markets in September. Each day the credit markets are frozen, the consequences for the economy and markets become more severe, deepening the recession and bear market.

Policy makers have introduced enormous and unprecedented policy actions to thaw the financial markets and restore funding to troubled financial institutions. In the past, it has been this type of intervention by policy makers that marked the turning point for bear markets and limited the duration of recessions.

However, there are many potentially negative unintended consequences stemming from these unprecedented policy actions that may cause markets to “retest” lows after a relief rally.

Rather than a period of rising or falling markets, we may be entering a bull market for volatility. Focusing on the types of alternative investments that benefit from high market volatility may be increasingly effective at managing risk and return.

Last week’s stunning stock market plunge of 14% may not have been the stock market’s worst week ever, but it sure felt that way. Last week’s returns contributed to a peak-to-trough decline over the past year of 42%, roughly in line with the worst bear markets since the Great Depression. This dramatic move merits examining how we got here, how we will get out, what the consequences will be, and what investors should do.

How did we get here?

Over the last 10 years, legislative changes transformed the financial services industry. The Gramm-Leach-Bliley Act of 1999 effectively repealed the Glass-Steagall Act of 1933. This Great Depression era act had separated lending (the extension of credit) and investing (the use of credit). Combining both activities in the same financial services entity had led to abuses that threatened the safety of deposits. The repeal in 1999 allowed for consolidation between commercial banks, investment banks, and insurance companies, blurring the distinctions between lines of business and regulatory oversight. As a result, the traditional roles of financial institutions changed:

- Commercial banks shifted from granting loans to being packagers and arrangers of loans which were then sold off and securitized. These companies shifted their focus from making sound lending decisions to building transaction volume to drive profits.
- Investment banks shifted from a focus on transactions such as securities trading and underwriting to a focus on buying and trading securities for the firm to drive profits through “proprietary trading”.

One outcome of this transformation was an explosion in the volume of mortgage originations. At the same time, relatively low interest rates set by the Federal Reserve Bank and other Central Banks following the 2001 recession triggered a boom in housing activity. The typical home price rose from about 3.5 times household income to 5.0 times income by mid-2006. Financing from the investment banks was abundant, mortgage rates were low, home prices were rising, and volume was the key driver of profits. So, the lending extended to less credit-worthy borrowers than traditional mortgage lending, as innovations in structured finance broadened the appetite for mortgage debt in a yield-hungry marketplace.

Tight credit spreads forced the investment banks to use high amounts of leverage through debt issuance in order to increase the profit on investments. To illustrate the problem, consider that a homeowner would be leveraged 5-to-1 with a purchase of a home with 20% down payment and an 80% mortgage. With a 5-to-1 ratio, when the price of the home



Each day the credit markets are frozen, the consequences for the economy and markets become more severe, deepening the recession and bear market.

declines 10%, the value of the homeowners' equity would be cut by 50%. Some investment banks were leveraged 20-to-1 or even 30-to-1 on their housing-related investments. With 94% of mortgage holders still paying on time, mortgage debt is not suddenly worthless now that home prices have declined 10-20% from the peak, but even a modest decline in the value of the mortgage debt can have devastating consequences on a financial institution when they are magnified 20-to-1. The investment banks relied on quantitative tools that used historical inputs to measure risk on these new types of investments, which resulted in an underrepresentation of the actual potential losses to those inside and outside these institutions.

The changes among financial institutions also meant funding for investment became more dependent upon investment banks borrowing from other banks, whereas in the past funding relied more upon commercial bank deposits. As prices began to slide, investment banks became unable to raise funds from other banks and were forced to sell their investments. With the investment banks having made up a large portion of the demand for these securities in recent years, there were few buyers to absorb the supply. This process accelerated the decline in the value in the securities and the prices entered freefall causing interbank lending to seize up in September.

This seizing up in the credit markets has made it much harder for non-financial businesses to borrow to fund their businesses. Each day the credit markets are frozen, the consequences for the economy and markets become more severe, deepening the recession and bear market.

How will we get out?

Policy makers have introduced enormous and unprecedented policy actions to thaw the financial markets and restore funding to troubled financial institutions:

- **Investment banks become bank holding companies** - In September, the remaining investment banks converted to bank holding companies, allowing access to the Federal Reserve's emergency lending facilities, subjecting them to greater scrutiny by regulators, and imposing new capital requirements that limit leverage.
- **TAF created and expanded** - Commercial banks can borrow \$150 billion from the Federal Reserve's Term Auction Facility (TAF) for a term of 28 or 84 days secured by other securities as collateral, including mortgage-backed securities.
- **PDCF created and expanded** - Investment banks can borrow from the Federal Reserve's Primary Dealer Credit Facility (PDCF) to provide daily funding to investment banks in exchange for a wide range of collateral that includes mortgage-backed securities. The amount borrowed currently totals \$134 billion.
- **TSLF created and expanded several times** - The Federal Reserve introduced the Term Securities Lending Facility (TSLF) in March, which provides loans of \$200 billion of Treasury securities to primary dealers secured for a term of 28 days by a pledge of other securities, including mortgage-backed securities.



- **Currency swaps established and expanded** - The Fed established \$620 billion in currency swap lines with other central banks around the world to calm money markets.
- **Commercial Paper program established** - The Federal Reserve lends directly to corporations. This program is designed to reduce concerns about non-financial companies that are dependent upon the commercial paper market for short-term funding of operations. Through the program, which has no size limit, the Fed will buy commercial paper directly from the issuer. This course of action avoids issuers having to draw on bank lines of credit and further crimp banks' capital.
- **TARP established** - The Treasury's Troubled Asset Relief Program (TARP) is designed purchase up to \$700 billion in mortgage-backed securities from troubled financial institutions. This program has not yet been implemented, but is expected to begin within the next 2–4 weeks.
- **Interest on reserves** – The Fed also announced a program in which it will pay interest on required and excess bank reserves, providing more cash for banks.
- **Direct purchases of mortgage-backed securities** – As part of the rescue of Fannie Mae and Freddie Mac, the Treasury originally announced in September it would buy \$5 billion of mortgage-backed securities, but then increased the amount to \$10 billion. Additional purchases could be announced.
- **Global rate cuts** – Central Banks in countries around the world have cut interest rates, including those in the United States, United Kingdom, Europe, China, Canada, Switzerland, South Korea, and Taiwan.
- **Fed interventions** – In March, the Fed guaranteed \$29 billion of Bear Stearns liabilities to facilitate a sale to JPMorgan Chase. In September, the Fed provided an \$85 billion loan to AIG. The effective nationalization of Fannie Mae and Freddie Mac came shortly after legislation approved in late July 2008 that also contained a tax break of as much as \$7,500 for first-time homebuyers, created a new regulator to oversee Fannie Mae and Freddie Mac, and allowed the Federal government to insure up to \$300 billion in refinanced mortgages.

We expect that there are likely even more dramatic announcements on the way, including direct equity injections and guaranteed bank lending in order to restore confidence in the interbank lending market. Last week, UK Prime Minister Gordon Brown allocated \$87 billion to recapitalize UK banks in exchange for shares. The British rescue package also would provide a guarantee of about \$430 billion to help banks refinance debt. Other countries, led by Germany and France, pledged to take equity stakes in distressed banks and vowed to guarantee bank lending. In the United States, Treasury secretary Paulson said such action by the Treasury would be in nonvoting stock to avoid the appearance of nationalization and a governmental role in decision making. This effectively would leave U.S. financial institutions with sufficient capital, while leaving the government with a recently enhanced regulatory backstop to protect taxpayers.



The trillions of dollars being marshaled to stabilize the global financial markets are likely to prove to be successful, with signs of progress evident in the coming weeks.

Bear markets of this magnitude nearly always pull back after an initial rally. This “retest” is often the result of lingering uncertainty over the potentially negative unintended consequences of policy actions, in addition to the reassessment of the depth and likely duration of the recession.

Intervention by policy makers has consistently marked the turning point for bear markets and limited the duration of recessions, in the past. While this financial crisis is more severe than most, the scope of the policy response is unprecedented. And while key policy actions are taking precious weeks to implement, the trillions of dollars being marshaled to stabilize the global financial markets are likely to prove to be successful, with signs of progress evident in the coming weeks.

What are the consequences?

As the crisis begins to ease, the first sign will be firms becoming less reluctant to part with their cash. The spread between the three-month LIBOR, or London interbank offered rate, and the expected federal-funds rate over the next three months has soared. This spread shows the difference between what firms charge each other for short-term cash and what they expected to pay in the relatively risk-free overnight fed-funds market. After averaging 100 basis points for much of this year, the spread suddenly tripled in September to about 300 basis points, indicating a major financial crisis erupted. As LIBOR begins to fall and the crisis begins to fade, stocks are likely to rally. However, an initial rally stemming from relief that the crisis is no longer worsening may not be sustainable. Bear markets of this magnitude nearly always pull back after an initial rally. This “retest” is often the result of lingering uncertainty over the potentially negative unintended consequences of policy actions, in addition to the reassessment of the depth and likely duration of the recession.

There are many potentially negative unintended consequences stemming from these unprecedented policy actions.

- **Sweeping regulatory changes** – A tremendous amount of uncertainty results from the likelihood of broad changes including consolidation of regulatory agencies, expanded oversight by the Federal Reserve, and new rules covering everything from predatory lending practices to short selling. This uncertainty may weigh on the markets.
- **More political oversight** – With all of Washington closely involved in the new regulatory framework, it is likely that more “politicized” overseers may be appointed, which may introduce a new philosophical dimension to enforcement.
- **More conservative consumer financing** – Consumers will find borrowing harder due to tighter lending standards combined with less capital and higher rates. It has been a long time since consumers have been without easy and abundant credit, and the degree that this tightening will impact spending is uncertain.
- **Insurance regulation** – The government’s loan to AIG raises the issue of whether the insurance industry should come under some type of federal regulation.
- **Changes at rating agencies** – The business model of the credit rating agencies may be forced to change to separate conflict of interest between consulting with issuers and rating them.



- **The future of Fannie and Freddie** – Congress must decide what to do about the future of the companies that help provide capital to 50% of the mortgage market. The potential for a breakup and re-introduction to the private markets has raised a lot of questions.
- **Lower leverage for financials** – Further deleveraging and lower returns on capital are likely, for enhanced safety for the financial system. We also expect higher borrowing costs and less risk-taking to result from policy actions.
- **Global coordination** – Effective regulatory and economic policy-making increasingly requires integration across borders, adding another complicated dimension to efforts to achieve financial stability on an ongoing basis.
- **Inflation fears** – Market participants may fear that these policy actions pumping money into the financial system may reignite inflation pressures, as policy makers opted to address the risks to growth at the expense of potentially higher inflation. Another fiscal stimulus plan to boost the economy is likely next year under the next administration and Congress, which may raise concerns that weak demand and more money supply could lead to higher prices. Rising inflation would be bad news for financial assets.
- **Changes of legal form to avoid regulatory backlash** – In response to the reforms stemming from the Sarbanes-Oxley Act of 2002, many companies opted out of the public markets. A drain of value from the public markets might result as healthy financial firms choose a partnership structure or re-mutualization.

What should investors do?

First, do not panic and sell all of your investments. While the markets may continue to fall in the coming days, they are currently extremely oversold by those forced to sell. All the policy actions discussed are very likely to limit the duration and depth of the recession and turn the stock and credit markets around after a record-breaking plunge. The investments you do not need to use for living expenses in the coming year or two should remain invested.

Second, these interventions leave lingering uncertainties surrounding their unintended consequences, which are likely to foster a high volatility environment and may warrant a shift in your portfolio. The focus on whether markets will go up or down is misplaced—they will go up AND down. Rather than a period of rising or falling markets, we may be entering a bull market for volatility. From early 2003 to late 2007, the stock and bond markets exhibited unusually low volatility. While in general, stock and credit markets marched steadily upward, investments that benefit from volatility languished. The market environment ahead is likely to differ. Rather than investing purely directionally for either a rising or a falling market, focusing on the types of alternative investments that benefit from high market volatility, may be increasingly effective at helping manage risk and return.

Rather than a period of rising or falling markets, we may be entering a bull market for volatility.



IMPORTANT DISCLOSURES

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise and are subject to availability and change in price.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in alternative investment may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, potential liquidity. There is no assurance that the investment objective will be attained.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial, UVEST Financial Services Group, Inc., Mutual Service Corporation, Waterstone Financial Group, Inc., and Associated Securities Corp., each of which is a member of FINRA/SIPC.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit