Crossing the Rubicon

These past two weeks have been extraordinary in that the Federal Reserve has had to take actions that have not been used since the Great Depression and a few that heretofore have never been used. There have been several crises in the capital markets that lead us to comment on what they appear to mean. During the last year, we have conveyed a growing concern, through several prior commentaries, as to the dangers and implications of an absence of fear toward various types of increasing risks in our financial system. We believe the culmination of these risks forced the Federal Reserve to take the recent extraordinary actions of creating two new lending facilities for primary dealers and facilitating a merger of Bear Stearns with JPMorganChase to prevent a liquidity and solvency crisis from potentially toppling the U.S. capital markets. The partners of First Pacific Advisors, LLC (FPA) discussed these events on March 21 and came to several conclusions about what the long-term implications of these actions might be and we will share them with you in this commentary. Fortunately, over the last two years, our preparations for potential financial market disruptions have meant that FPA and most of our product areas have essentially avoided the calamitous effects of this credit crisis.

We have been in disagreement with the Federal Reserve's policy actions since this credit crisis began. In FPA New Income's September 2007 shareholder letter, we argued that future Fed policy actions, the lowering of the Federal Funds rate, may prove rather ineffective in dealing with the unfolding credit crisis. The Fed proceeded under the assumption that this was a liquidity crisis, whereby lowering the Fed Funds rate would resolve the credit problems and return stability to the capital markets. However, with each lowering of the Fed Funds rate, there appeared to be very few positive responses from the U.S. capital markets. Even with a record 125 basis point cut in the Fed Funds rate between January 22 and January 30, liquidity and stability in the financial markets did not return by any appreciable degree.

As the Fed Funds rate declined, a growing flight to quality, as reflected by the rush into Treasury securities and away from any security that might have credit risk, began to take hold. Despite the decline in Treasury interest rates, these declines did not spread to other areas of the capital markets, as exemplified by the 30-year Agency mortgage-backed securities market, where yields rose while Treasury yields declined. At one point, FNMA and Freddie Mac yield spreads increased to over 300 basis points above the Treasury curve versus a more normal 150 basis point spread. Our capital markets were shutting down since participants did not trust the counter parties with whom they were trading.

From the beginning of this credit crisis, we were of the opinion that deflation in the value of assets would create widespread balance sheet impairments within corporations, consumers and other involved parties; therefore, counter party solvency risk was likely to become an important issue. It appeared that the Fed might be starting to realize this when they announced their first move on December 12, 2007, with the establishment of the Term Auction Facility (TAF) to provide greater liquidity to the system by accepting a wider array of qualifying securities for term funding to depository institutions. This facility was increased in size on January 4 and again on March 7 of this year. Subsequently, on March 11, the Term Securities Lending Facility (TSLF) was created to provide Treasury securities to primary dealers in exchange for a wide array of qualifying securities for a 28-day term. On March 16, the Primary Dealer Credit Facility was created to provide overnight funding to primary dealers in exchange for qualifying securities that include corporate bonds, municipal securities, mortgage-backed securities and asset-backed securities. These last two programs provide liquidity assistance to primary broker/dealers and are the first of their type since the Great Depression. This is a fundamental change in the policies of the Federal Reserve and may place its balance sheet at risk because of the potentially risky nature of the securities pledged. The Federal Reserve did not regulate broker/dealers since this was the responsibility of the SEC. Now it appears the Fed has become the lender of last resort to a borrower that had not been regulated or subject to review by the Fed. In essence, the balance sheet of the Fed, and potentially U.S. taxpayers, is being placed at risk for institutions that increased their balance sheet leverage and risk, during good times, so as to enhance their firm's profitability but now, during a time of difficulty, they are looking to the Fed to be the savior, despite their previous business mismanagement practices. In our opinion, this is a strategy of heads they win, tails the U.S. taxpayer loses. These recent Fed policy changes have taken place without a full public discussion with Congress. It appears the Fed saw fit to do this since there was a vacuum in the capital markets and the risks were beginning to spiral out of control.

The Fed also resorted to a Depression-era clause, Article 13 (3) of the Federal Reserve Act that is to be used only in "unusual and exigent circumstances," to deal with the Bear Stearns crisis. The Fed initially guaranteed $30 billion of Bear Stearns assets so that JPMorganChase could acquire the company for $2 per share. This is the first time since the Depression that the Fed will be taking brokerage firm collateral onto its balance sheet and placing itself at risk because of the excesses and unsound business practices of a brokerage firm. In an earlier era, Bear Stearns would have been left to fail. This is not the case today since there was apparently a deep fear on the part of the Fed that a failure of Bear Stearns could create a domino-like crisis infecting a wide array of financial institutions, thereby accelerating and deepening the current credit contagion. As Steven Romick said in our FPA partner meeting on March 21, "I'm more concerned about what I don't see. Why is it that we are not being told about or seeing another bidder for Bear Stearns other than JPMorganChase? Might JPMorganChase be playing defense so as to protect its $91.7 trillion dollar derivative exposure (according to September 2007 Office of the Comptroller of the Currency data) that is supported by just $123 billion of equity? How much counter party exposure did JPMorganChase have to Bear Stearns?" In our opinion, the Bear Stearns transaction looks very suspicious. If the situation were so precarious, why shouldn't shareholder ownership have been entirely wiped out because of the excesses and mismanagement by their firm? Why should the Fed's balance sheet be placed at risk while shareholders are receiving some type of compensation? A week later, the bid was raised from $2 to $10 per share, increasing the value conveyed by approximately $1 billion.

Again, why should there be any compensation to shareholders? This compensation is being conveyed to owners of a firm that had derivative positions, with notional amounts as of November 30, 2007, totaling $13.4 trillion. Warren Buffett has, on several occasions, described derivatives as potential “weapons of mass destruction.” Apparently, the collapse of Bear Stearns might have triggered a financial market nuclear meltdown and this potential outcome forced the Fed to intervene.

We have written about the growing risks inherent in the derivatives market on several occasions. Within the greater derivatives market, there is a segment, referred to as credit default swaps (CDS), which has grown from $900 billion in 2001, to $45.5 trillion in 2007. These swaps offer bankruptcy protection to a corporate lender or a chip on the gaming table to a speculator. We would guess more of the latter, given that the size of the CDS market is several times larger than the corporate bond market. We witnessed an earlier derivatives market meltdown with the collapse of Long Term Capital in 1998. Despite its collapse and the emergency creation of a rescue group of companies (Bear Stearns declined to participate), the derivatives market was allowed to explode in size, while various regulatory agencies did little to control or moderate the potential risk that was developing. It looks to us that market participants and regulators learned very little from this near cataclysmic event. In the case of Bear Stearns, it held $2.5 trillion of swap contracts, according to the March 23, 2008, The New York Times article, “What Created this Monster?” Apparently, the risk of a CDS contagion helped to force the Fed’s hand to create a bailout of Bear Stearns. The lack of supervision and control by the SEC that allowed this expansion in risk to develop, and the Fed’s bailout of Bear Stearns, are highly disturbing to all of the partners at FPA.

Treasury Secretary Henry Paulson, Jr. has said that the actions taken by the Fed are of only a temporary nature. On March 26, 2008, in remarks delivered to the U.S. Chamber of Commerce, he said, “the Federal Reserve's recent action should be viewed as a precedent only for unusual periods of turmoil.” All of us have witnessed governmental proposals that have been enacted into law that were supposedly “temporary,” but they continued to exist many years after their enactment. Pardon us if we are skeptical of such statements made by governmental officials.

In our opinion, a new financial system is in the process of being created. This is the beginning of a new era. Some may refer to it as Pre-Bear Stearns and Post-Bear Stearns. It is inconceivable to us that the Fed can place its balance sheet at greater risk without having some type of regulatory authority over those financial institutions that now have access to its liquidity services. In essence, new and increased levels of regulations are a likely outcome from this series of events. We believe that primary dealers and the rest of the brokerage industry will be subject to greater regulatory oversight, with a concomitant reduction in firm flexibility and financial leverage. These new regulations will also likely limit customer financial flexibility and, thus, they may potentially lessen the availability of credit. Furthermore, the consolidation of regulatory authority into a central regulator does not, in and of itself, ensure that systematic risk to the U.S. financial system will be reduced. Unless the Federal Reserve or the new central agency that is established have the regulatory authority and courage to act, nothing will have changed. As an example, the Federal Reserve had the authority to influence or control the excesses that developed in mortgage loan originations by its regulated depository institutions. The Fed did not act, despite Federal Reserve data showing that mortgage lending was getting out of control. Over the last three years, we have addressed this growing risk. Furthermore, we took measures, within FPA New Income and our fixed-income separate accounts, to reduce mortgage credit risk exposure that we saw exploding. With the limited resources we have at FPA compared to the Federal Reserve, how could we see this mortgage risk developing and the Fed not? We have to conclude that the Fed was aware of the growing risks in the mortgage and derivatives markets; however, it was unwilling at that time to take appropriate risk-reduction measures. In all likelihood, exogenous political pressures were a likely contributor to this inaction. We also believe these elements were in existence in other governmental agencies as well. Because of this poor record of inaction, we have more confidence in capital market discipline, if it is allowed to prevail, than in governmental regulatory agency discipline.

We are also fearful that the Fed's recent actions have increased the likelihood of an increase in moral hazard risk or the socialization of risk. By this we mean that there is a movement at various levels of government to stem the tide of mortgage foreclosures while trying to increase the level of liquidity available in the mortgage market. FNMA and Freddie Mac recently had their special capital requirement reduced from 30% to 20%. That previously higher capital requirement had been put in place because these two agencies had engaged in reckless and questionable accounting and management practices. They were not in a position to address this mortgage crisis, for which they had originally been created, because their balance sheets had become impaired by unsound profit motivated activities. They were just too financially leveraged. With this new lower level of required capital, subject to raising a non-disclosed amount of new capital, they are now being placed in a position that would allow them to acquire $200 billion of additional mortgage securities. Should this new flexibility lead to their balance sheets becoming overextended again, there is the potential risk that taxpayers may be forced to ride to their financial rescue. In addition to these actions, the Federal Home Loan Bank is being asked to increase its purchases of mortgage-backed securities by $160 billion. Finally, Senator Chris Dodd and Congressman Barney Frank are in the process of crafting legislation that would possibly create a new entity to help deal with a prospective flood of potential foreclosures. This new entity could buy as much as $300 or $400 billion of mortgages under various types of aid packages. They are not referring to this as a bailout but rather as a "rescue" package. Because of the recent Federal Reserve action that bailed out Bear Stearns and their counter parties, we can expect to hear the argument that, if Wall Street can be bailed out, why should there not be some help given to Main Street? We believe it will be difficult to defeat this type of an argument. These measures may prove more dangerous than many realize as they can result in unintended consequences. As for FPA, we will likely require a higher compensation, through an increased mortgage spread, for us to deploy capital into the mortgage market because of the growing risk of governmental interference into the sanctity of the mortgage contract.

We believe that one of these unintended consequences will likely lead to the Federal Reserve becoming even more politicized. With the taxpayer's purse being placed at greater risk by these governmental entities' increased financial risk, the process by which the Federal Reserve conducts monetary policy may be placed in jeopardy. Will the Fed be as willing to raise interest rates to fight economic excesses or inflation if it means it could cause losses for these governmental entities or place the American mortgage borrower at increased financial risk? Given the extreme measures that are currently being contemplated, we believe this is a serious risk consideration. If we are willing to "rescue" borrowers and financial institutions that have been reckless or unwise in their financial decision making leading up to this crisis, how can we expect a different outcome in the future? Why should individuals and financial institutions conduct themselves in a financially prudent manner, knowing that the government will likely ride to their rescue? Why shouldn't they take increased risk with the expectation of short-term gain, while laying off long-term risk to the government? The Federal Reserve's recent policy changes, federal agency enhanced risk taking and possibly new consumer mortgage "rescue" plans, all have the potential of increasing future unsound business and consumer decision making.

Ever since the government bailout of Chrysler in 1979-80, this country has been on a course of raising the safety net so that the market's discipline, in a capitalistic economic system, has been truncated. We have witnessed a growing level of decisions that are based upon expediency rather than sound long-term decision making. Each time these expedient decisions are made, the level of risk within the U.S. economy has been increased. The market's discipline is not allowed to work for fear of the potential economic fallout.

In light of the above comments, the partners of FPA came to a unanimous conclusion that the recent Federal Reserve actions and the potential new Congressional policies under consideration are likely to lead to a significantly higher level of long-term inflation in the U.S. We are more than disappointed in the substandard decision making that has taken place within the Federal Reserve and other governmental entities these last several years. The misguided monetary policies of the former Chairman of the Federal Reserve, Alan Greenspan, created an era of "too big to fail" that has led to two major asset bubbles. With each successive bubble, the policy actions available to the Federal Reserve to reduce financial system risk have been systematically reduced. The extraordinary actions taken by the Bernanke Federal Reserve reflect acts of desperation rather than long-term policy solutions. The rapidly changing events within the capital markets are forcing the Fed to adopt policies that have the potential of long-term negative consequences. These recent events, and their fundamental changes to the U.S. financial system, are forcing the leaders of FPA's product areas to reassess their present portfolio allocations. In essence, we believe we have "Crossed the Rubicon" into a new financial era.

Sincerely,

Robert L. Rodriguez

Chief Executive Officer

First Pacific Advisors, LLC

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