

Mutating Financial Crisis

Bill Henderly, CFA, Nvest Wealth Strategies, Inc.

The financial crisis is mutating. It is not only pulling in all types of financial institutions (banks, brokerage firms, insurance companies, and Government Sponsored Entities (GSE)), but appears to be affecting some parts of the non-financial economy. The US economy has not to this point entered a recession, but the lack of money flow via borrowing from financial institutions will most likely cause the economy to slip into a mild recession. And, the recovery from a recession may be slow.

The mutating financial crisis, that has swallowed many high profile financial and brokerage firms, has required the Fed, Treasury and government to take drastic action. The US financial markets are going through the greatest peril in 60 or 80 years. As black as the current moment seems, the \$700 billion bailout is the action needed to remove toxic loans from financial institutions' balance sheets and allow them to survive.

We are watching closely; we are monitoring closely; we are talking to many highly respected fund managers and strategists to gather current insights. We believe a terrible peril will be averted.

The "Bailout" is not a bailout. It is an asset purchase. The Treasury will buy (via a reverse purchase auction) the troubled assets from the "banks" at a significantly discounted price and later sell these assets when the markets recover, at appreciated prices. The "banks" will sell (remove) these troubled assets from their books at a discounted price (meaning they incur a loss), but they receive much needed cash to shore up their books, allowing them to make new quality loans to viable borrowers (businesses and individuals). Thus, the financial system is put back into working order.

Doing the math – if the Treasury buys a \$100 loan for \$65, the bank loses \$35 but receives \$65 cash. The Treasury holds the \$65 loan that is paying mortgage interest rates of 6%; but given their discount purchase price, the yield the Treasury earns is between 10% and 15%. The Treasury gets the money (\$700 billion) to buy the troubled bank loans from the financial markets at interest cost of 3% - 4%. That means they can earn a positive carry of 7% - 8%, maybe over 10%. In a year or two when the market for these securities recovers and improves, the Treasury will sell the loans purchased at \$65 for \$85 or \$90 (maybe higher) and make additional profit. That means the Treasury earns 10% - 15% total return (6% interest plus price appreciation). Some loans will prove to be very toxic or worthless; but many and most will perform. Thus, the Treasury will make money on the asset buyout (not bailout) and the cost to taxpayers is very low (much, much less than \$700 billion). The Treasury is just a temporary "custodian" owner of the loans, and will ultimately sell them for a profit reducing the cost to taxpayers.

When Congress approves of the asset purchase arrangement in the next few days, the bond and stock markets will rally. It will appear, and you will wonder, if it is the start of a new bull market. We don't think so. You do not need to be a quick contrarian investor and re-enter the market with cash. We do believe stocks are cheap, looking attractive to consider buying. We also believe the economy and "banking" system will take some workout time to recover. We will not have instant normal economy. There will not be rainbows appearing in the sky that all is again great. Thus, we would expect the rally (maybe lasting days or weeks) to gradually fade and retest market lows before the next new bull market begins. We are monitoring many things – government response, the markets, individual mutual funds - and are prepared to slightly adjust portfolio structures to recover in the next bull market. We look forward to recovery of values in portfolios and intend to capture that via a diversified mix of no-load mutual funds. Our approach is conservative and thoughtful. We welcome your calls to us with any questions and thoughts.

Delivering financial
peace of mind.

CONTACT US:

2310 Home Road
Delaware, Ohio 43015
740.917.9234

WWW.NVESTWEALTH.COM
Email: info@nvestwealth.com