

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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Historic Times

High schools pep their football teams, Space Shuttle Endeavour moves to the launch pad, Democrats and Republicans head to Orlando to tackle tough healthcare issues, and all over America folks go about their daily routines, while dire radio and television forecasts for Wall Street's brokers and huge banks ring in their ears. They are understandably worried and confused. Until just hours ago, government regulators seemed equally confused.

In the last dozen or so days regulators have been operating on multiple levels, putting stamping out one brushfire after another. From Freddie and Fannie, to Lehman and Merrill, to AIG and then Goldman and Morgan Stanley; each received its own treatment. As the clock ticked and maturities tied to some of these institutions came and went without payment, it became clear that even money market instruments were being affected. Bank of New York managers distributed emails to clients telling them the value of some of their funds had dipped below a dollar or 'broken the buck.' On this news President Bush authorized Treasury to tap up to \$50 billion from a Depression-era fund to insure the holdings of eligible money market mutual funds. The Federal Reserve announced it will expand its emergency lending program to help support the \$2 trillion in assets of the funds.

Yesterday it became apparent that efforts were becoming more planned and coordinated. Early in the morning it was announced that the Fed, the European Central Bank, the Swiss National Bank and the Bank of England had all offered up more cash to provide liquidity to global markets. Yesterday afternoon, administration officials and every member of Congress who was on a finance committee stood before the cameras to promise quick legislation to give Treasury sweeping power to buy up toxic unmarketable debt that is clogging up the financial system.

The largest market applause came in the afternoon when it was made clear that the Securities and Exchange Commission was serious about an emergency ban on short-selling of financial company stocks. Contemporary headlines also announced that three of the nation's largest pension funds had stopped lending shares of Goldman Sacs and Morgan Stanley to short sellers. The news sent stock averages up almost 4% within minutes.

The Fed is likely going to be given the authority with the creation of a new government agency to buy bad, unmarketable debt from institutions akin to the Resolution Trust Corp. set up in 1989 to absorb losses from savings and loan associations. The government has already taken control of Fannie Mae and Freddie Mac. And they have stepped in to save some homeowners from losing their homes. Congress recently adopted a new FHA program to insure as much as \$300 billion in refinanced mortgages for 400,000 borrowers at risk of losing their homes.

Not everyone is happy about so much government intervention. Numerous Wall Street Executives, former Federal Reserve Officials, and lawmakers are saying that too much has already been done. They say that every time they intervene, they do more harm than good. They say the bailouts by the Fed and Treasury encourage future reckless risk-taking by investors. The markets should be allowed to work. Trouble is, many markets weren't working at all. What was working very effectively and profitably was the short-selling market. Hedge funds were having a feeding frenzy.

Short selling in and of itself is not bad or evil. It provides leverage to the markets and helps to keep prices rational. However the reality is that in markets where panic and uncertainty rule, the opportunities for abuse abound in a huge way. The last few days provide a glaring example. Goldman Sacs and Morgan Stanley have business models that work and their capital structures are sound and well managed. Yet in the chaos, short-sellers were able to drive their prices down 50% to 70% respectively. As much as \$3 trillion has been erased from global stock prices this week.

In answer, the Securities and Exchange Commission halted short selling of 799 financial companies. The move comes too late for Lehman Brothers Holdings Inc. and American International Group, but perhaps Goldman and Morgan Stanley will survive as independents, as alternatives to the huge money center banks in the capital markets.

Much work has to be done to re-build investor confidence in financial institutions as well as to restore the efficient operations of markets that are now slow to frozen. We have confidence the measures will be taken and the government will go too far. But better to avert the crisis that was surely ahead and work out the regulatory burdens later. Capitalism made this country great. Greed and abuses bring it all into question every so often, but no one can argue that it is the greatest wealth-building system known. The challenge ahead is that the temptation to regulate is balanced against a recognition that the greatest challenges so far lie ahead for the US economy – global competition. I'm confident we will get it right.

Have a good weekend