DJC
THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

MONDAY
April 13, 2009
www.djcOregon.com

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The Fed's bold Ben rides to the rescue

Federal Reserve tackles the housing crisis by purchasing long-term treasury bonds

SUMMING IT UP

William Rutherford

After President Barack Obama took office in January, we initially saw a market rally based on optimism. This was undoubtedly inspired in part by the election of a president offering so much hope in a time of despair.

The hope and the rally were short-lived. Punctuated by the testimony of the new Secretary of the Treasury, Timothy Geithner, it was soon obvious that the new president had no silver bullet.

With hopes dashed, a market rout began and President Obama gained the distinction of being the first president to preside over a bear market in his first 60 days. The Dow plunged more than 20 percent, and the Obama administration failed to execute a plan to aid the economy. Consumer confidence fell, retail sales weakened, and the U.S. economy continued to shed jobs at an unrelenting clip. Total job losses since the start of the recession exceed 5 million. Nonfarm payrolls dropped 663,000 in March alone. Unemployment jumped to 8.5 percent. Banks continued to hoard money and limit credit lines, exacerbating the slowdown.

The S&P 500 Index in the first quarter of 2009 fell 11.7 percent, its sixth consecutive quarterly drop. That string ties the record six quarters of decline over 1969 and 1970. The Dow, which fell 13.3 percent in the quarter, was down 53.8 percent from its high on Oct. 9, 2007 and had retraced over half of its gain from its Great Depression low on July 8, 1932. In other words, it had given up one-half of the gains of 76 years. However, in March, the Dow rose 7.7 percent, its biggest monthly gain since October 2002, which turned out to be the beginning of the last bull market.

The Federal Reserve cut interest rates to near zero. An alphabet soup of programs was introduced to free up the credit markets, aid bank lending and housing markets. The president unveiled his stimulus package and housing relief package; however, while there was an occasional uptick in the economic outlook, the trend was generally down.

Finally, the Fed did what had become inevitable and about the only thing it had not tried: buy long-term treasury bonds. Neither congressional approval nor political gymnastics was needed. Federal Reserve Chairman Ben Bernanke made perhaps the boldest decision of his career; the Fed began buying back U.S. Government debt by simply printing money.

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The purpose of this move was to lower long-term interest rates, make home mortgages more affordable and do what had been needed to be done since the beginning: solve the housing problem. Better late than never.

The markets immediately responded to the Fed action and began the biggest rally since 1933, eventually rising more than 20 percent. Not only had President Obama presided over a bear market (down more than 20 percent) but also over a bull market (up more than 20 percent) – all within the first 90 days of his administration.

There are still many risks in the market, including some macro issues (some international and some domestic) that are quite disturbing. But the appetite for risk has been increasing, and with the recent good feelings emanating from the G-20 summit, tiny signs of optimism are beginning to appear.

Buying long-term treasuries should help clear the housing markets, and progress is being made; however, many commercial loans are encountering problems and many companies have debt to roll over. It remains to be seen if the credit markets and the banks are receptive to lending; if not, we can expect more problems.

The U.S. Treasury is about to begin stress testing banks. There will be less stress now that the Financial Accounting Standard Board has relaxed the so-called mark to market rules, allowing institutions far more latitude in the pricing of their holdings. While the rule change will result in fewer markdowns, it also should lessen bank interest in the government's effort to clear bank balance sheets of "toxic assets."

Banks are even considering borrowing money from the government at low rates, to buy loans of other banks, eventually profiting from the bank-caused mortgage problems. No doubt, more bonuses will be paid in celebration and CEOs will be able to return to the normal business of flying in private jets and getting extravagant office remodels.

In the meantime, some banks and credit card companies are

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reducing credit lines for small business and individuals, which reduces the borrowers' FICO credit scores, which causes other card issuers and lenders to further reduce credit lines or raise interest rates, all of which are causing further cutbacks by business and consumers. Bankruptcy rates have soared. The result is that some of the beneficiaries of the bailouts provided by taxpayer money are pushing those same taxpayers to the wall, and the economy with them. Can a backlash be far off?

And, there may be more Madoffs in the weeds. It has already been reported that one national bank was operating a branch in the office of a newly discovered Ponzi scheme.

We need the banks to be strong to lead us out of this mess. So far, with a few exceptions, we have been disappointed.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a five-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.