October 3, 2008

Greetings,

We are in uncharted territory. Many people including myself thought that the failure (or as I referred to in a recent report as the shot gun marriage) of Bear Stearns last March was the end of the worst financial crises since the stock market crash of 1929. I was wrong. It was just the beginning. During the last three months; Freddie Mac, Fannie Mae and American International Group were taken over by the U.S. government. After deciding that AIG was too big to fail (one of the very few things the government did right over the last eight years), Lehman Brothers collapsed. Lehman Brothers had been in existence for about 150 years. Lehman failed mostly as a result of a crises of confidence. After driving down the price of AIG from $25 to $4 (less than a year ago, they were a $70 stock) within a matter of days, the hedge funds needed another carcass to pick apart. Lehman was vulnerable so they ganged up on them like a gang of wolves. The hedge funds selling Lehman short (that means that they sold shares that they didn't own) wasn't the only reason that Lehman went under. They just basically put the nail in the coffin. Lehman dug its own grave by making dumb decisions based on its own greed. Once Lehman failed, the hedge funds needed another carcass to pick apart so they focused on Merrill Lynch. As a result of the short selling, Merrill's stock dropped like a rock. Fearing a fate similar to Lehman's, Merrill sold itself to Bank America. I am no fan of Merrill Lynch, believe me on that one. However, there is no way that Merrill should not have been able to survive on its own. What is interesting is that if Bank America would have waited another few weeks, they could have purchased Merrill at 15-20% of the price that they paid for it. This was after Bank America purchased Countrywide Financial a few months ago. If they would have waited a few more months, they could have purchased Countrywide for the same price that JPMorganchase purchased Washington Mutual which was nothing. Washington Mutual was seized by the FDIC because they wanted to prevent a bank run, something that hasn't happened since the early 1930's. The FDIC didn't want to be on the hook for $ 20 billion or more, so instead of playing George Bailey (from the classic Christmas move It's a wonderful life), they delivered the bank at a zero cost to the 21st century version of Mr. Potter (also from It's a wonderful life), Jamie Diamond, the brilliant CEO of Chase. Washington Mutual was not a bank that was insolvent. They were suffering from being temporarily illiquid. There is a huge difference between being illiquid and being insolvent. During the two weeks prior to its seizure, its customers withdrew 15% of WM deposits. With WM having access to the Fed window (this means that WM can borrow from the Federal Reserve whenever it needs to), the withdrawals should not have caused this action by the Federal Reserve.

Another resource that the banks have to help liquidity is that they regularly borrow from each other at low interest rates. With the panic in the credit market, the normally low interest rates were doubling overnight. In addition to that, the banks were not lending to WM, essentially cutting them off from life support. Up next was Wachovia, another one of the largest financial institutions in the country. A few days ago, its banking operations were taken over by Citigroup at a near bankruptcy price. Now, just this morning, Wachovia voided the deal that they had with Citigroup to get a better deal with Wells Fargo, which is 9% owned by Warren Buffet. I expect a big lawsuit over this as well as an investigation of insider trading since the Wachovia stock rose well past the original takeover price after the deal was announced.

I am as angry as I have ever been over the destruction of our capital. It would be unprofessional to put down in this letter my true and candid feelings. For 4 ½ years, the people on Wall St. had a money party. For several years, we benefited indirectly since we did well with our investment returns. Of course our benefits paled by comparison to those who caused this disaster. It was like those at the cause ate Surf and Turf while we ate pizza. What is disgusting is that those who caused this calamity get to keep most of their ill gotten gains while we have given back all the money that we have made over the last couple of years plus more. The man in the White House said recently that Wall Street got drunk. Well, if Wall Street got drunk, then the present administration along with the Congress were the bar tenders! They were the enablers. The greedy, at times stupid CEO's (along with its top henchman/upper management) of all these financial institutions could never have pulled this scam on the American people without the help of our government. They not only passed laws that allowed all this to happen, they encouraged this behavior. Believe it or not, Congress has a lower approval rating than the President and IMO, deservedly so and I am no fan of the Prez. Congress encouraged Fannie Mae and Freddie Mac to take on more risk. When some people pointed out years ago the risks of sub prime lending, option arms and giving out (I won't even start with the influence of the financial services lobby in all this) mortgages with zero down payments so that the home owner had no stake in their own home, they were shouted down by the people in charge and accused of being anti minority and against low income people being home owners. Once these outlandish laws were passed which basically allowed the housing industry to act like the Wild West, the House Financial services committee along with the Senate Banking committee were supposed to be the watchdogs to make sure that things went as planned. The job they did was comparable to the job that the accountants at Arthur Anderson did while auditing Enron. Arthur Anderson was disbanded. Most of the members of Congress will be re elected next month because even though they have a 14% approval rating, most people feel their own representative is ok, it is the others that are bad. By being re elected, it means that they get away Scott free just like the Wall Street people.

Now that the stock market is down nearly 21% YTD and numerous major financial institutions have already failed, Treasury Secretary Henry Paulson (who is basically running the domestic side of this country, which IMO is not a terrible thing) who is a former CEO of Goldman Sachs, has devised a bail out package. While Mr. Paulson is a smart man, the problem is that making deals with a partisan Congress is vastly different than making deals on Wall St. He has learned that you can't just slam down the Congress's throat a $ 700 billion taxpayer funded bill with the tact of an army drill sergeant. He did a poor job of selling the package to the Congress as well as the American people. It didn't help that the President is a lame duck with a 28% approval rating who has little influence with his own party. I have heard from many Congressmen (from watching CNBC 9 hours a day) who were dead set against the plan because their constituents were letting them know that they were against this by a 100-1 margin. That is all well and good except for some things that are very important. First, the NBC/WSJ poll states that 1/3 of the American people are for this plan, 1/3 against and 1/3 unsure. Using deductive reasoning, I conclude that only people who are against this are contacting their representatives. People who are for it were staying quiet until the DOW dropped 777 points on Sept. 29. On Sept. 30, the day after black Monday, all of a sudden some of the constituents are letting their representatives know that they are for the plan. It looks like either the Congress isn't aware of the polls or if they are can't figure out that the most of the people making noise are those against the package.

I want to make this clear. I am disgusted with the fact that the government needs to spend our money helping the same financial institutions that got us into this mess. It would be great if the government could just do nothing and have these companies get us out of the mess that they got us all into. While that is a nice thought, it is not realistic. I truly wish it were but it is not. I can understand why so many people are against the greatest government intervention since the New Deal of 1933. The problem is that the vast majority of people either doesn't understand the ramifications of doing nothing or are just so angry that they don't want to try to understand. It is also possible that the government down the road could make money on this plan.

What is going on now is that the credit markets have frozen up. The economy works on credit, from the top down. Banks can't lend now because they are so loaded up with bad loans as a result of its greed and stupidity. Banks are required by law to keep a certain amount of capital. With its asset values deteriorating, the capital ratios are reduced. This means that they can't make more loans because if they do, they will be in violation of Federal banking laws. Since the banks are also scared to make more bad decisions, they are reluctant to lend money with what they do have available. If the bailout package were to pass, it would take bad loans off the books of the banks and theoretically allow the banks to start lending again. What so many people don't realize is without some sort of significant intervention; we could be looking at best a prolonged recession. At worst a lost decade similar to what happened to Japan in the 1990's. It is

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regrettable that when Wall St. benefits, Main street does not, at least not to the same degree. However, if Wall St. goes down the drain, it will take the rest of the economy including many innocent middle class individuals who have very little if anything invested in the market along with it.

The economy is in bad shape. I doubt that you need me to point that out. I think that it is possible that it will get worse before it gets better. When you have a crises of confidence like we have now, things just don't turn around overnight. The U.S. economy is resilient. Things will improve. I am just not certain when. I will be pleasantly surprised if things improve before the spring. I have always been straight with you as well as the rest of my clients. I won't change now just because things look bleak for the time being.

I do think the stock market has seen the worst. The stock market is forward looking. A year ago, the economy was in decent shape but the market did not do well since it saw the storm clouds gathering. The stock market isn't always right but this time it was. This recession was the most widely predicted recession ever. I think that at this point in time, most if not all of the bad news is built into the prices of stocks. I look at the valuation of so many of the companies that we own and it is beyond belief at how cheap most of them are. For the time being, fundamentals mean nothing. Earnings ultimately determine stock prices. For now, no one believes that so many of these solid companies will ever grow its earnings. If they do believe it, it doesn't affect their decision making because they are simply focusing on the falling stock prices. What we have now is the ultimate buyers strike. Very few people want to buy anything now, no matter how cheap the companies are because they are either so overwhelmed with fear or they figure why buy anything now when I can buy it cheaper a month later. Once there is even a sign that the economy has hit bottom and could be turning around, then the short sighted traders will all of a sudden see how cheap so many of these companies are and start putting this mountain of cash on the sidelines to work.

I must thank you for your incredible patience that you have had during this dreadful market. Even though we have a long term outlook, no one in their right mind wants to take this kind of a hit in the short term. If you feel the need to call me or send me an email, in case you have any questions or if there is anything that you want to discuss, then by all means please do so. I have heard from a few clients recently and I am glad that they called.

Sincerely,

Michael Weinstat, RIA, CPA