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Kaboom! A Primer on the Housing, Credit, and Securities Bust

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A Primer on the Housing, Credit, and Securities Bust

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TABLE OF CONTENTS

INTRODUCTION

Let's take your minds off your troubles and talk candidly about the economy. Learning economics won't make you a millionaire or keep you out of a soup line. It will give you a better understanding of how you got there (or there).

An Economist is a guy who has one foot in the oven, the other in freezer, and says: *"On the average, things are not too bad."* What's the difference between a whining dog and a whining economist at the back door? The dog quits whining when he is let in. Laugh or cry, the choice is yours.

Forecasting? There are two types of forecasters: (1) those who cannot forecast; and, (2) those who don't know they cannot forecast. The cardinal rule is to give people a number or a date, never both. Not a prophet, nor the son of a prophet, I don't want to be an optimist or a pessimist. Just being right is its own reward. I do worry about Economists who are so young they think the Great Depression was ended by *Prozac*. Really!

Keep in mind that if I really knew, in some detail, what was going on, and what will probably happen in the next 30 to 90 days, our U.S. President would make an appointment with me here in Searcy, Arkansas. But I wouldn't be here. I would be in Hawaii, which I would by now own.

No mortal has been given perfect foreknowledge. Economists do well to name the variables, put them on the scales, and try to see which way it is tilting. The trend can be our friend, if we are careful.

Let's get serious. A little poem (author unknown, but wisdom eternal):

Breathes there a man
With soul so dead
Who hasn't said
When the market fell out of bed
"Man! I wish I had quit
When I was ahead.

1. Regulating Social Action in the Market

Quite seriously now, from our Civil War to World War II, debt and credit schemes have blown up on six occasions. Today, nobody really knows how much the bundled, mortgage-backed securities (derivatives) out there are worth. We do know that being heavily leveraged globally with increasingly nonperforming debt, endangers financial institutions' capital accounts and asset values, not to mention customers, employees, and stockholders.

In a 2002 Berkshire Hathaway stockholder report, Warren Buffett referred to out of control derivatives as, *"…time bombs"* that could *"…cause a chain reaction of financial disaster."* Complicating things, those mortgage backed obligations (MBO's) have tranches (different levels of risk categories).

Being an economic historian, among other things, I know that if we don't learn from history, we are destined to repeat it (next semester). On the 1930's New Deal premise that home ownership makes us better citizens, Government Supported Enterprises (GSE's) like the 1938 *Federal National Mortgage Association (Fannie Mae)* and the 1970 *Federal Home Loan Mortgage Corporation (Freddie Mac)* were chartered; more recently, they morphed into a classic case of co-dependency.

With good intentions, the 1977 *Community Reinvestment Act (CRA)* goal was to create social good through affordable housing. The *CRA* mandated increased oversight of financial institutions to be sure loans went to all segments of society, especially middle- and low-income people (or, as a penalty, bank mergers and branch requests would be disapproved).

The *CRA* specifically required that each depository institution's record be evaluated periodically by federal agencies, in helping meet the credit needs of its entire community. Contrary to these banks' fiduciary duty toward risk assessment in the past, non-compliance with *CRA* led to fines and affected adversely banks' applications for deposit facilities, acquisitions, etc.

The Association of Community Organizations for Reform Now (ACORN) was a player at the table in helping to draft the *CRA* legislation. By one account, over the last 30 years, several hundred million dollars have been paid in fees to *ACORN* and affiliates, in part, for assistance with what are now commonly called *"NINJA"* loans--realtor jargon for "*No Income, No Job, No Assets*."

I know first-hand, as a seller of investment property in 2006, that sellers have been happy to let the subprime house buyer, and the grade B mortgage broker, inflate the sale price by the amount of the buyer's down payment and the buyer's closing costs, since frequently the buyer had neither.

Somehow, the grade B mortgage broker seemed to have an out-of-town appraiser at the ready to ratify the higher amount. Everybody involved held their breath until closing was finalized. Subprime borrowers have been essentially renting.

The *Financial Modernization Act* of 1999 ominously opened the system to more "…affordable housing," by removing investment banks, mortgage brokers, and insurance companies from the legal rules of the road, commercial banking regulations (essentially gutting the federal oversight of the 1932 Glass-Steagall Act).

Now, the chickens have come home to roost. The people we elected passed these laws and provided for enforcement, or the lack thereof. This decontrol and lack of sanctions became very similar to what caused the S & L economic crisis in the 1980's. "Affordable Housing," pushed by some members of Congress, would understandably result in greater political support from subprime neighborhoods.

Undermining traditional marketplace risk assessment, and with the sale of mortgages in the secondary market, nobody seemed to have an interest in the long term success of these subprime loans, that is, beyond originator's/broker's fee.

The resulting increased demand for houses, fed in part by Federal Reserve engineered low interest rates, led to the 2001-2006 housing bubble--a near-doubling of housing prices in that period. Houses were treated by many owners as ATM machines from which to withdraw and spend money; some owners became "upside down" (owing more than the house was worth), as a result.

There was an even more ominous bipartisan bill proposed in Congress in 2005, to reduce trading and increase regulatory oversight of mortgage-backed securities by *Fannie* and *Freddie*. It did not pass, in part, due to intense lobbying against it by *Fannie* and *Freddie*.

By 2006, 40% of new mortgages were subprime, up from 10% in 2001. Subprime mortgages were bundled as derivatives and sold to *Fannie* and *Freddie* and/or to hedge funds all over the world as mortgage-backed Collateralized Debt Obligations (CDO's), supposedly to spread risk. A perverse, opposite effect occurred.

After the subprime mortgage's first two years, it usually reverted to an Adjustable Rate Mortgage (ARM) which is several percentage points higher. This resulted in increased, and often unaffordable, house payments, up by sometimes 30-40%.

With a six month's interest prepayment penalty, it was difficult to refinance subprime mortgages (especially with falling prices and no equity). Subprime delinquencies and foreclosures glutted housing markets, resulting in lower prices and sending more people "*into the bucket* (again, owing more than the house is worth)." Therefore, more walked away.

2. Bailout or Workthrough?

The Federal Reserve System, the Fed, our central bank, was chartered in 1913, as a result of the financial panic of 1907. The Fed was charged to buy good debt (e.g. Treasury Bills, Bonds). The October 3, 2008 bailout legislation, the *Emergency Economic Stabilization Act*, an undoubtedly historically unprecedented intrusion into the private sector, allowed the Treasurey and Fed to buy bad debt.

The bailout did little to alleviate the credit crunch. The Fed now becomes the lender of last resort, to try to alleviate the credit crunch in the commercial credit market. However, where are the reforms to avoid future bad financial policy decisions? All this is like taking a taxi to bankruptcy court and then asking the cab driver to come in as a credit reference. Welcome to market socialism.

Today, the Federal Government is the only organization big enough to buy up the bad mortgages. And the government may, in the long run, be getting housing worth more than the discounted mortgages (a possible money-maker for taxpayers).

The government may even buy 30 year mortgages in California and Florida (by far the worst states) to keep people in their homes (and the otherwise foreclosed homes off the market). The Fed has also created a special fund to buy commercial paper and the stock of select financial institutions. With Fed help, banks may discount mortgages to present value to assist homeowners. No bank wants to be stuck with a high-priced mortgage or an underpriced house.

Here's a further irony. It was about a hundred years ago that J.P. Morgan pulled off a rescue in 1907 of a troubled financial institution, for the same systemic reason: to remove falling dominoes that could have cascaded globally.

The difference? The J.P. Morgan financial consortium in 1907 used their own money, not the taxpayers'! The 2008 J.P. Morgan purchase of Bear Stearns occurred only after the Fed guaranteed $32 billion of Bear Stearns' most risky nonperforming loans. Candidly, our financial capitol has been moved to Washington, D.C.

Although much more serious, this financial crisis is, in a way, similar to the S & L crisis of two decades ago: In the end, it was everybody's fault, therefore nobody's fault. The motto for the Resolution Trust Corporation (RTC) was this: *"Bury the Dead, Heal the Sick, Marry off the Survivors."* It took six years.

This financial crisis is much worse than even the proverbial drunken sailor on leave, squandering his paycheck. It was his own money he squandered, not ours! Go figure.

3. Follow the Money

Investment firms bundled the mortgages and resold them as Collateralized Debt Obligations (CDO's), often incorrectly rated by Moody's as AAA. The hedge funds, or *Fannie* and/or *Freddie*, saw their profits evaporate as more defaults occurred and their asset base imploded.

"*Preference,*" by the way, is a term now being discussed in legal circles. An example of *"preference"* would be a Chief Financial Officer (CFO) passing bonus money to his top executives, while knowing that the company is failing to disclose its increasingly precarious financial position.

If proven, that form of preference could be against the law. However, in the post-9/11 era, there has been a significant redeployment of FBI agents away from white collar crime toward counter-terrorism.

Insurance companies, involved in credit swaps insuring the nonperforming collateralized debt, saw their financial situation deteriorate. Stock prices of these firms spreading the risk headed sharply south, and many investors fled the stock market. The highly controversial SEC *"mark-to-market"* rule forced otherwise solvent financial institutions to artificially write down asset values to fire-sale prices created by failing institutions.

So, things happen fast in the deleveraging world. If you wait to read about it in the financial news, that may be too late. All of this is very similar to the decade-long financial crisis and deflation Japan experienced in the 1990's. It's an R & D problem; the solution will be an R & D one. By R & D, I mean nothing less than Republican and Democrat. There's enough blame to go around.

Here is a sampling of Mortgage Bankers Association 90-day mortgage delinquencies as of October 1, 2008:

Subprime Adjustable rate--26.8%
Subprime fixed rate--9.8%
Prime Adjustable rate--6.8%
Prime Fixed rate--1.3%

How do you move defaulted home mortgages off the books of financial institutions and into government-created trust accounts? Painfully. Carefully. Gradually. It was a failure of government, trying to do "social engineering" with housing (*Fannie*, *Freddie*, and the *CRA*), and not a failure of capitalism, that gave us what economists euphemistically refer to as negative externalities (bad consequences of economic activity)!

The frozen credit markets have created a disconnect from free market fundamentals, and, in the process, there has been a partial flight from, say, money market funds to Treasury Bills. New "covered bonds," common in Europe, may now become popular in the United States. They can stay on the banks' books, not be thrown onto trust accounts. Covered bonds, backed only by prime mortgages, are also paid off before FDIC claims.

4. Recession with Honor

The individual investor should be informed that the little known *Securities Investor Protection Corporation (SIPC)* is charged with identifying, securing, and returning investment instruments to their rightful owners (up to $500,000 per account), whatever the assets are worth after a financial institution fails. However, remember this: we did this to ourselves.

Concern about risk aversion, after the fact, is false economy. There is no painless way out for all who believed that housing prices, and the wealth effect, would continue to rise in perpetuity. It would be like the young man who is about to be sentenced by the Judge for bumping off his parents, saying, *"But, your Honor, I plead for mercy--I'm an orphan, you know!"*

All along, there has been too much *"Recession"* talk. The culprit? Mostly the national media, specifically the networks. They've predicted 17 of last 10 recessions, as the saying goes. If gloom and doom were nutritional, they could feed the world.

If today Edison invented light bulb, the 10 p.m. national network news would blare, *"Tragedy strikes candle industry!"* Even in normal times, typically there are eight (8) negative network stories on the economy for every positive one. If it bleeds, it leads.

Let's deal with the big question on people's minds. Is 2009 going to be 1929 all over again? No! The answer is the same in Spanish and English. There are many differences. Transfer payments (entitlement money sent to people from government, not as a result of current year production) create a purchasing power "floor" to keep a recession from becoming a depression.

The Fed isn't "imploding" money supply today as it did by 30% from 1928-1932. There are decreasing rates of interest now. There are no 5-year mortgages today with a balloon payment at the end. Furthermore, investors today have been diversified.

There is a 50% stock market margin requirement now, not 10%. There was a highly prohibitive tariff in 1930 *(Smoot-Hawley)*, triggering a trade war. Global competition has brought down our "*wall*" of isolation; we have weak neighbors north and south--fish to the east and west.

Arkansas exports approximately $10 billion each year to about 135 countries. It's 13% of Arkansas Gross State Product (GSP). For three decades, the U.S. has been applying hi-tech to lo-tech industries. They are now smaller, leaner, stronger, and more profitable.

Today, barely 20% of GDP is especially vulnerable to the business cycle (mining and manufacturing), not 44% as was the case in the 1930's. Sure, we all know some who aren't working, but most of them have jobs. There is a silver lining: we still have the *"Grossest Domestic Product"* in the world!

Never forget that we enjoy a standard of living beyond the dreams of kings. For this, we owe a great deal of credit, to those who have extended us credit, to whom we owe a great deal. So, here we are. Our money doesn't talk anymore; it just goes without saying.

Remember -- Chicken Little and Pollyanna were wrong. According to James A. Funk's "Human Action Theory" (written in 1932), *"There is a mass psychological cycle which lasts approximately 50 years (i.e. approximately three generations):*

<u>Depression</u> produces <u>Thrift.</u>
<u>Thrift</u> produces <u>Confidence</u>.
<u>Confidence</u> produces <u>Investment</u>.
<u>Investment</u> produces <u>Activity</u>.
<u>Activity</u> produces <u>Prosperity</u>
<u>Prosperity</u> produces <u>Easy Credit</u>.
<u>Easy Credit</u> produces <u>Overproduction</u>.
<u>Overproduction</u> produces <u>Fictitious Sales.</u>
<u>Fictitious Sales</u> produce <u>Fictitious Collateral</u>.
And these produce <u>Panic</u>.
<u>Panic</u> produces <u>Depression</u>, and
The more things change, the more they are the same.

5. Where Do We Stand?

Here is my take on things right now. The October 3, 2008 relief package, which became the *Emergency Economic Stabilization Act*, was not initially presented well by Treasury Secretary Paulson and the Federal Reserve. Bailing out Wall Street made taxpayers/voters furious. Think Main Street, not Wall Street, regarding credit collapse--not just mortgages, but also cars, consumer credit, student loans, with the deleveraging and credit crunch.

What about that $155 billion in miscellaneous pork, add-ons for congressional districts back home, added to the October 3, 2008 bailout legislation? Be angry if you must; worry not. Those items would have been quietly passed anyway, before Congress went home.

It’s just that the bailout package took up so much time at the end, few felt like they would stay in session beyond that already late departure date (*“…have to get home and campaign for reelection!”*).

It’s ok to be angry and resentful that some of the people who participated in the run-up to the speculative housing bubble (including former Goldman Sachs CEO Paulson) might be paid to create a Resolution Trust Corporation (RTC) type of organization to move these bad loans off lenders’ books and into a trust in an orderly fashion.

Even though they made some bad decisions (and were rewarded for it) in reselling bundled bad debt to global hedge funds, and even though Moody's should never have rated them AAA, these people do know the financial markets better than we do.

Nevertheless, the 1999 *Financial Services Modernization Act* allowed them (investment banks, mortgage brokers, hedge funds, etc.) to do these things. Taken away was most of Federal Reserve, Treasury, and FDIC oversight, regarding being heavily leveraged globally with nonperforming debt and endangering their capital accounts, asset value, stockholders' investment, and employees' livelihood. Thus, the grim consequences.

This is very serious, and we need to look past elected officials' pandering to their constituents about how offended they are on our behalf. Again, it's important to think *"Main Street,"* not just *"Wall Street."*

"Exonomics" also compounds the picture as well--significant outside, unpredictable events exerting real influence over economic facts of life as we know them: financial crises, terrorism, third world debt default, changes in availability of resources, crop failures, national security issues, faulty statistics, etc.

6. Dire Questions Abound

Will financial institutions' loan exposure (nonperforming loans) get better or worse? Will record personal bankruptcies continue? What direction will unstable economies and the globalization of risk go? Will there be a possible repatriation of funds (i.e., pulled out of U.S. economy)?

How low will consumer confidence go (and for how long)? How large are the amounts of short-term external debt? How badly have importers have been hurt by weak dollar? How long will it take the weakest sectors of manufacturing (autos and housing) to recover?

How much capital flight will be triggered by low interest rates? Are there prospects globally of cascading currency devaluations and systemic shockwaves? Do major lenders still fail to appreciate dangers of hedge funds? Does anyone fully know how much leverage is deployed in global markets?

What about rising nationalism colliding with retreating global finance (less control, more fear)? How many fragile young democracies and fragile old regimes are out there? Can businesses continue to structure cash flow through loans' securitization (bundling into bonds)? Was Moody's AAA rating of subprime mortgages grossly unmerited? Why did the financial markets believe it?

We can always plan on election season policies to pander to taxpayer/voters. Beyond that, credit rationing by banks will continue to neutralize, in part, any Fed easy money policy. What direction will oil prices go (most 2005-2008 production growth was in natural gas which is not feedstock for other petrochemicals such as gasoline, jet fuel, and diesel)?

Strong demand for oil by China and India (very large populations) suggests higher prices in the long run ($4/gallon might actually be referred to as the *"…good old days"*). There are stagflation possibilities (usually a long term phenomenon, so not yet).

7. Is Anything for Sure?

Ever present geopolitical events, the Mideast turmoil, for example, hover over us. The weak dollar is only half the picture (it makes exporters more competitive). The weak dollar also creates upward bias on import prices (especially petroleum).

Housing market inventories still hold at approximately 11 months, due, in part, to foreclosures. Shopped-out consumers are a drag on the economy. Conversely, quicker supply chain management adjustments by businesses have smoothed things out in recent decades, resulting in fewer, more shallow recessions.

Government spending, in general, and tax rebates specifically, can result in a phantom increase in GDP growth statistics. What we produce and sell to each other in terms of real, physical goods could be flat or declining. However, if government spending is up, GDP figures show a rise. Incumbents love it!

Can we ever assume no further terrorist attacks? Are successful military campaigns a certainty? Is “soft landing with successful war completion” a realistic scenario? Will global energy markets be interrupted again? Will appropriate and timely monetary and fiscal policy applications be the key? Pay your money; take your choice.

Uncertainty is hard on markets; it's a difficult time to be a risk-taker. The domestic economy revival could be later and slower than expected. There is only so much Fed leveraging that can be done with one major tool: interest rates. So, the Fed will throw everything possible at the problem.

It's possible that government bailouts, to try to ease the pain of the economy imploding, might, in fact, postpone a healthy recovery. Hear now the haunting words of Thomas Jefferson, *"The principle of spending money to be paid by posterity, in the name of funding is but swindling futurity..."* We still live on the same planet. However, it is indeed a very new world.

8. Federal and State Budget Economics

The word on the street: the unemployment rate (at this writing 9.0%) could bump to 11.0% at the depth of the '08-'10 recession. That rivals the '81-'82 recession (10.5%). However, the labor force is 50% larger today, so that's significantly different in terms of numbers of people and families affected.

The tax base for many states has also been eroding for a decade. Unemployment figures and state revenues typically lag the economy. The federal government has not been reimbursing states for post-9/11 security costs. Every dollar spent on anti-terrorism security by the states must come from other programs, creating a fiscal crunch.

Any cuts in Medicaid are also scary. Medicaid accounts for roughly 20% of our Arkansas state budget. Further, rising unemployment is sharply boosting demand for Medicaid. As a general rule, for every one dollar cut in state Medicaid spending, the state would lose another three dollars in federal matching funds.

Of concern is when we talk about budget cuts and percentages of programs that are dear to peoples' hearts going unfunded in the Health and Human Services area. In Arkansas, we realize that, in times of revenue shortfalls, most of the cuts come from

Category B priorities, after Category A programs are fully funded.

Every Arkansas Governor is no doubt very thankful for the Revenue Budget Stabilization Act. Some states, like Oklahoma, do seem to fare better in times of general revenue shortfalls by appropriating only 95% of anticipated revenues (rainy day fund), thereby protecting, in part, against shortfalls.

Then there is the issue of perceptions vs. reality. For example, in the mid 1990's, the Clinton administration won the budget cuts battle over the Republicans. While the Republican leadership talked about *"…percentages, stats, deficits, and debt,"* the Democrat leadership announced adeptly that the Republicans wanted to *"…toss Granny out in the snow."* Game. Set. Match. The world operates not only on what is true, but also on what people believe to be true.

Most recent key assumptions of typical U.S. and Arkansas economic consensus forecasts are probably too optimistic. They hinge in great part on the consumer as the key, bank on Fed rate cuts, assume that no more terrorism will occur, that the war on terrorism will be successfully concluded, and that global energy markets will be undisturbed. However, there is good news out there.

Each year, projected from 1995 to 2015, four million Baby Boomers turn 50. Overall, that's 80 million Boomers in a 20 year period. The affluent of this number were piling on, paying more for stock than ever before (until the meltdown). Twice as many families were investing by, say, 2005, than 20 years ago.

Equities replaced houses as a family's largest asset (what goes up can come down). Some in the market failed to distinguish between investing, speculating, and gambling. Now, in the current climate, many investors are on the sidelines. Others are bottom fishing and shopping for bargains.

The drumbeat from most of the financial professionals during the Bear Market meltdown (at this writing in mid-October) was this: *"Hang On! Don't Sell! Be in there to take advantage of the bargains in the next Bull Market" "Stay with dollar cost averaging!"* It's not that simple.

There are other factors: age; retirement date; taxes; income goals; growth plans; and risk averse attitude. Why would some brokers be willing to lose transactions' fees? Because if investors moved to the safety of the sidelines, the brokers might not lose just fees, but also customers.

Why? Some investors ended up being steamed at brokers (rightly or wrongly) for not staging the customers to be more risk averse and move to the sidelines along the way, say, through stop-loss orders in times of fear and panic (e.g. automatic sell order when stocks drop a predetermined percentage, say 15%, beyond a 10% technical correction), etc.

It has been said that, *"…a Bull can make money on Wall Street, and a Bear can make money on Wall Street, but not a Hog."* When fear and panic trigger a meltdown beyond fundamentals, this is the ultimate loss of purchasing power. Ironically, uninitiated investors have tended to show a historical pattern of buying high and selling low.

There were a few financial advisors who were willing to admit that if investors didn't flee to safety before or early in the meltdown, a drop of approximately 42% for the first 10 months of 2008 (mostly in October/November), that those investors' chances and abilities to take advantage of a rally, after those huge losses, were somewhere between slim and none (and Slim has already left town).

9. The Scorecard

In a broader sense, it is not *"…written in the stars…"* that we have to lose markets to overseas competitors, or that their quality is better. What's the lesson? Automate, emigrate, or evaporate; it has happened to the family farm, the corner soda fountain, and the mom & pop grocery. Joint ventures are a growing trend, to reduce risk, build expertise, and penetrate markets, using the people and resources of many countries.

We are more interdependent now than ever before. With 4% of world's population we produce nearly 25% of world's GDP (and use about 25% of the world's energy production). Barely 2% grow enough food to feed 200% of us; we export 50% of what we grow. Our poverty level income is greater than the average income in Eastern Europe.

Our workweek is 20% shorter than it was in 1900. Over 90% of us are working in the present economy. Some 50 years ago, incomes in South were 2/5ths national average. Today, it's 4/5ths. And 80% of today's millionaires are first generation. They got it the old fashioned way; they earned it!

Today, more Americans are connected to Internet than were hooked up to electrical power, a water line, or sewer line 100 years ago. Our average lifespan has increased about 60% in the last 100 years (average age of death in 1900 was 48).

Thanks to better fuel economy and gains in per capita income, motor fuel would have to stay at $3.50 a gallon to cost family budgets in real terms what it did 25 years ago (the early 1980's price spike). An average factory worker's pay today (approximately $17.50) buys five gallons of gas. Seventy years ago, it was three gallons. It is Eastern Europe that has been inefficiently consuming three times the energy per dollar of GDP.

Heavily subsidized ethanol, by the way, has ruined feed lot prices and global food prices, hurting the poor (2 billion people for whom food costs are 60% to 70% of their budgets). It makes little sense to expend petroleum at all those stages of farming, to try to distill food into fuel. Why should, say, 30% of our corn crop go to distill 3% of our fuel? Is it worth all that to salve our consciences for driving SUV's? The question answers itself.

10. A Reach Beyond Grasp

Might The Fed be reaching beyond its authority to help the economy avoid the dominoes falling--systemic failures globally? Possibly. Few are complaining, because of the greater downside risk (global depression).

And yet, swings in commodity prices are also a consequence of global demand and supply and will not readily respond to federal monetary policy. Banks' credit rationing to customers has resulted, in part, from mortgage defaults and asset deterioration. Lack of credit robs the economy of the necessary lubricant to keep commerce moving without friction.

Therefore, the Fed is extending short-term bridge loans and taking some equity interest in some major banks. We will probably have to see at least an overall 30% drop (from the high in 2006) in housing prices, to put us back on the long run trend line of 2000. This double bubble, housing and credit, has been a long time coming; there are no quick fixes.

In the Spring 2008, stimulus checks (really advance rebates on next year's tax filing on this year's earnings), and totaling $168 billion for families, went mostly into gas tanks. The weak dollar and rising speculation fueled, in part, the rising commodity prices (including petrochemicals). Remember, however, that exports of goods, services, commodities, etc., thrive and are more competitive with a weak dollar.

Again, no one knows how much collateralized, nonperforming debt is leveraged globally. There is a scary disconnect here. So, central banks around the globe are throwing hundreds of billions of dollars, etc., out there. The great fear is a systemic failure (again, think dominoes), and banks conversely try to ration credit as asset values decline.

Inflation-linked Treasury Bills (TIPS) are an option for some during these times. The purchaser of TIPS at, say, the start of calendar year receives a fixed interest rate above inflation (CPI benchmarked semiannually). In deflationary times, par value at maturity or an inflation-adjusted principal is guaranteed with TIPS, whichever is greater. More on that later.

11. Where Do We Go?

Is the worst still ahead of us? Quite possibly (don't shoot the messenger). Candidly, a new round of foreclosures could be triggered by rising unemployment, glutting the market, and depressing housing prices further, until they can get back to the long term trend leading up to 2000 (again, probably a 30% drop overall). Who knows the timetable? Not we mortals.

Many participants in the marketplace are in denial; it's not just a river in Egypt. Remember the Chrysler bailout/loan guarantees in 1981? Chrysler surprised everyone by paying back the loan early. Few remember that the Chrysler loan guarantees artificially put Chrysler ahead of the more creditworthy borrowers. Never mind the bad decisions and shrinking market share that led them to that point.

Welcome to state-regulated capitalism. *"Too big to fail*" is the mantra now. It's all very interconnected, and yet there have been some systemic disconnects. For example, Lehman's landlord in London had a renter's insurance with AIG.

Yes, I do wonder if the Fed used more power than it legally has. Someone speaking about the crisis recently said, *"…the rascals snuck out the back way, ran around to the front, and joined the crowd demonstrating and shouting, 'Throw the rascals out!'"* Sadly, an untold number of innocent people have been hurt along the way.

12. The Conservative--Liberal Debate

Many issues in life seem to have "conservative (rightist)" and "liberal (leftist)" spins to them. In election years, there may be more (or less) clarity on this, as each side is tempted to pander to the other's base. Additionally, on either side of the barricade of issues are some who have neither understood nor cared. Confusing matters, few of us are consistently in just one camp or the other.

Winston Churchill put it this way (paraphrased): *"Anybody who is under 25 and not a liberal has no heart, because he can't feel the pain and suffering of the people. Anybody who is over 25 and is not a conservative has no brains, because in 25 years he has not learned what people are really like."* Ouch!

Conservatives believe that each person should be compensated according to his contribution to the marketplace, as valued by customers, and that capitalism has solved the poverty problem better than any other economic system. Liberals would not want a capitalism in which some are rich while others are poor, because wealth-causes-poverty, don't you know.

Conservatives are sometimes content to follow the plans their grandfathers made. Liberals may pass laws and then go on their way to pursue other noble causes to pursue with other people's money. Conservatives believe that, in clashes between good and evil, duly constituted governments are ordained by God to mete out justice to those who harm the public good.

Neither is for locking up criminals. Liberals claim it's society's fault, and conservatives say it costs too much money. Liberals say that country clubs should be more fully integrated and that prisons should become more like country clubs.

Complicating the debate, several recent studies confirm, often by self-reporting, that American academia and media members are, on balance, markedly to the left of center. Do unbiased scholarship and balanced news reporting become potential casualties? The question answers itself.

Conservative people of faith, who want to be *"salt," "light,"* and *"leaven"* in this life, tend to actively participate in our representative democratic process by voting their cultural values. Some liberal people of faith believe that they should not take their personal convictions into the polling booth and in some cases even refuse, by abstaining from voting, to support the body politic.

Conservatives usually regard moral values as "*mainstream middle America issues*" in elections, and believe that religion can provide moral values that not only make a country great, but also that nations prosper when governments work well and honorably. Liberals often regard moral values as "*wedge issues*" in elections, deriding those who are drawn to the polls by just moral or cultural issues.

The conservative jurist literally intends to *"…support and defend the Constitution of the United States…,*" by enforcing the Constitution and time-tested laws passed by elected public officials. The liberal jurist tends to favor personal politics, activist social agendas, and sometimes interprets other countries' founding documents into his own circuitous judicial rulings.

Well, what do conservatives and liberals have in common? They all want more laws. They have different goals; however, they both agree that they want to control the kind of power that can be wielded to achieve their respective goals. They live in blue and red states all across the map, states predominately blue around the perimeter in large, metropolitan areas and mostly red everywhere else.

This list could be longer; however, we get the idea. Two schools of thought are locked in battle, and that's good. As history demonstrates, when there is no active political opposition, there is always the danger of the suppression of liberty in the name of liberty.

For example, the former Soviet government excused tyranny by saying that inasmuch as the Communist Party was the party of the *"…liberated people,"* there would be no sense in having another party to oppose the *"…will of the people."*

"Opposition is so important, that I wish it would always exist, even for its own sake. It will sometimes be wrong, but it performs a valuable function nevertheless," said Thomas Jefferson (paraphrased).

As Disraeli put it, *"No government can long be secure without a formidable opposition."* Opposition by the "outs" makes the "ins" careful to avoid actions that invite criticism and to promptly correct the mistakes that they do make.

How shall we all get together? John Milton penned it this way: *"When there is much desire to learn, there, of necessity, will be much arguing, much writing, many opinions; for opinion in good men is but knowledge in the making."*

And sometimes, yes, being liberal or conservative comes down to the issue at hand and next to whom we are standing at the time. In the meantime, is this a great country, or what?

13. Interesting Time to Study Economics

The following is an excerpt from my 2007 monograph titled "*CHAMPION OF CAPITALISM: A Tribute to Nobel Economist Dr. Milton Friedman, 1912-2006*":

> *A child of working class immigrants from eastern Europe, Friedman's father died while Milton was in high school, and his mother worked as a seamstress in the New York City garment district. Friedman arrived in 1928 at Rutgers University with a rare and coveted scholarship in mathematics.*
>
> *Friedman was wanting to become an actuary, but then decided that it was a fascinating time to be studying economics, as the Great Depression was unfolding. He turned down his scholarship, changed his major to economics, and took on several part-time jobs (clerking, waiting tables).*
>
> *One account has it that, on the eve of our Great Depression, Friedman took his first Economics class by accident, taught by Arthur Burns, future Federal Reserve Bank Chairman. After that semester, Friedman was addicted to what I like to call, "The Only Game in Town."*
>
> *Graduating from Rutgers in 1932, Friedman stated later that, "…under the circumstances, becoming an*

economist seemed more relevant to the burning issues of today than becoming an applied mathematician or an actuary." So, off he went for graduate work in economics at the University of Chicago, followed by post-graduate work at Columbia University.

14. Moving Past It All

Excessive and negative chatter about the economy is not wholesome, except to achieve clarity. Why all this self-flagellation? Why do the networks dwell on it? Horror movies attract large crowds. Nevertheless, there are some things that reasonable and prudent people just don't do. You just don't stand up in a crowded theater and yell *"fire!"*

It is possible to be a short term pessimist, and yet a long term optimist. That is where I find myself. In fact, one reason I became interested in capitalism is that, even flawed, it solves the problems of society better than any other economic system known, by solving the problems of the individual.

The application of freedom to the marketplace allows people to achieve much more than under other systems. When America's profit-incentive system is working well, profits (or business savings) provide steady jobs, higher wages, more jobs, worker benefits, better working conditions, safe and modern equipment, rising standards of living, opportunities for the future, and social progress.

Even right now, the dynamic triad of corporate restructuring, quality improvement, and spending on research and development are fortifying our economy during our financial crisis.

Losses also provide a valuable function in the American incentive system. Losses are the market's way of sending a signal to businesses to reallocate their resources more efficiently, according to the price- and quality-conscious customer's demanding standards.

Capitalism, therefore, contains its own built-in checks and balances. People are required to exercise sound judgment, or suffer the consequences of their own folly. The American incentive system doesn't carry any guarantee.

One risks failure along with the prospect of success. And if we are honest, we know that there are no real guarantees possible in life--not in theory, not in reality.

15. Soldier On

According to the Greek mythology, Pandora, the first woman on earth, was given gifts by all the gods. One gift was a box which they warned her never to open. Not being able to resist her curiosity, Pandora raised the lid and all of life's troubles, sins, vices, and diseases immediately escaped. Pandora quickly closed the lid, preserving only "hope," mankind's last refuge.

With worldwide bloodshed taking up most of the headlines, it's reassuring to ponder the words of historian Will Durant. *"Civilization,"* he said, *"is a stream with banks. The stream is sometimes filled with blood from people killing, stealing, shouting, and doing the things historians usually record, while on the banks, unnoticed, people build homes, make love, raise children, sing songs, write poetry and even whittle statues. The story of civilization is the story of what happens on the banks."*

Beyond the storm clouds, and in the economic recovery, the American economy will continue to be foursquare in the middle of a rebuilding binge that could run for two more decades. During this era of restructuring, implementing of new technologies, and yes, probably more regulation, we will, in both goods and services, continue to be able to compete with any other nation in the world.

One hundred years from now -- 50, 25, 10, 5, years from now -- America will remain the place to be. People all over the world will still look to us for growth, stability, and the good life.

The past is prologue. Just what is at stake for the future of our land? Josiah Bailey said it best years ago:

> *The American Republic and American Business are Siamese twins; they came out of the same womb at the same time; they are born in the same principles, and when American business dies, the American Republic will die. When the American Republic dies, American business will die.*

16. The Bottom Line

Right now, fear and panic are driving the market, not just fundamentals. At this writing (mid-October 2008), the S & P 500 has dropped 33%, and the Dow has dropped 39% in calendar year 2008.

Beyond this cataclysm, rather than a V-shaped recovery, it may look like a U-shaped upturn (moving sideways for awhile) from this Bear Market.

Better clean up your balance sheet, because if all this carnage doesn't spin your wheel, then your hamster is already dead! Read on. Help is on the way. In the meantime, Strength and Honor.

APPENDIX

“50 Valuable Actions You Can Take *Right Now* to Make Your Enterprise Leaner, Stronger, and More Successful Than the Competition”

by D.P. Diffine, Ph.D.

Managers who take these 50 Valuable Actions will come out of any economic downturn and into the recovery stronger, leaner, and, yes, more profitable than the competition.

1. Manage the details of the business each and every day.

2. Stay nimble and flexible; do study the competition — they're watching you.

3. Become prepared to respond quickly to competitive opportunities.

4. Conduct business impact analysis for operational continuity.

5. Create partnerships with customers and suppliers, remaining in close contact.

6. Collaborate with other business owners on purchasing strategy.

7. Consider an acquisition of another company with a strong cash flow to the bottom line.

8. Keep costs under control, especially before times are bad.

9. Have a new respect and passion for liquidity and working capital.

10. Lock in credit lines early and often; be on lookout for new capital sources.

11. Make bankers information partners and part of

a strategy-making process.

12. Treat vendors as a type of banker; aging payables can improve cash position overnight.

13. Keep your legal counsel well informed at all times. Listen and learn.

14. Concentrate on markets in which you have a distinct advantage.

15. Think long and hard about both product abandonment and product development.

16. Take advantage of small company agility to enter and exit markets.

17. Develop market segments that your larger competitors consider too small.

18. Do everything possible to be a hero to your customers.

19. Boost sales to existing customers through offering add-ons.

20. Use after-sales service to solidify your relationship with customers.

21. Develop contingency plans for a significant reduction in sales.

22. Keep sales revenue profitable; the goal is profits, not market share.

23. Eliminate excessive inventories through just-in-time manufacturing; don't over do it.

24. Carefully implement pricing strategy with an eye toward ongoing cost-benefit analysis.

25. Be sure that investment in info-tech doesn't lag behind, even for old-economy companies.

26. Trim those insurance costs by eliminating overlapping coverage wherever possible.

27. Cut travel costs by instituting a per diem travel allowance incentive plan.

28. Analyze and pare back utility costs, without sacrificing the mission.

29. Initiate a capital audit to learn where idle capital is tied up in the business.

30. Stop capital projects unless operational efficiency or cost reduction would be greatly impaired.

31. Depreciate assets aggressively and to the maximum allowed by accounting methods.

32. Sell underused assets, refunding proceeds to shareholders through stock buybacks.

33. Convert your budget process from a bottom-up to a top-down, fast-tracking the outcomes.

34. Review the company's tax planning strategies in light of a weak economy.

35. Improve your cash flow by consistently annualizing estimated taxes.

36. Take advantage of government-sponsored employment incentives for business.

37. Get out of a bunker mentality, and get more involved than ever.

38. Make sure to communicate the CEO's presence and commitment to any plan.

39. Communicate to employees in a climate of mutual respect and consideration.

40. Regularly ask your people for advice, and follow through whenever possible.

41. Encourage and reward new ideas and suggestions from your employees.

42. Integrate your key personnel directly into company operations and strategy, to reduce turnover.

43. Keep confidential list of employees ranked by contribution. Categorize A, B, or C. Tough decisions may await you.

44. Keep a list of past applicants who would have been hired if openings had existed.

45. Never lay off people in any department who are key players in customer service.

46. Fully staff key positions to give added strength to compete.

47. Shorten the work week, to warehouse a trained work force for the coming recovery.

48. When absolutely necessary, make salary reductions across the board, to try to keep morale from deteriorating.

49. Provide stock option plans for effective and loyal employees who tough it out.

50. Never underestimate what your employees can do for you or to you.

Remember — Do not ever forget these 50 Valuable Actions during the next round of good times!

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It is hoped that the reader will think about the points laid out in the publication, and then decide for himself. Hopefully, the material herein will motivate people to further study and also toward a greater understanding of God's will on life's stewardship issues here on Spaceship Earth.

In this expository monograph, many sources have been consulted in the preparation of this material. The References section enables those who desire to so further study to consult these sources. If any such acknowledgements have been inadvertently omitted, the author would appreciate receiving information, so that proper credit may be given in any future printings.

Special thanks go to Office Manager and superb English teacher Dana Jones, along with student worker Kate Hale, for their perseverance with me, especially on matters of form and style on this project. May their tribe increase. Care has been taken to trace the details of specific events and trends.

Every effort has been made to include only reliable information, and yet present it in a way that will not quickly date this publication. The author would welcome knowing about any possible errors in content.

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