

# at a glance»

## DR. MARSTON ON THE MARKETS: WHERE DO WE STAND?

*This report was prepared from comments provided by Dr. Richard Marston on Wednesday, September 24, 2008. Dr. Marston is the James Guy Professor of Finance at the Wharton School of Business at the University of Pennsylvania and a long-time advisor to Smith Barney's Consulting Group. In this rapidly changing environment, please be sure to speak with your Financial Advisor for up-to-date information.*

My discussion today is geared around addressing where we stand. I'm sure that is what we've all been wondering after some of the most unprecedented events in the financial markets seen in our lifetimes. I will focus on a number of key areas including real estate; the Federal Reserve and the current crisis; the U.S. economy; and our investment portfolios.

### REAL ESTATE

Let me begin where the crisis all began – in real estate. I believe we can summarize the real estate environment with three main points:

1. Housing starts peaked in November 2005 and are now down over 60%.
2. Housing prices are down 20% nationally according to the Case-Shiller index. They may be down only 10 – 11% in places like New York, Boston and Chicago; however, there are huge declines in other cities such as Los Angeles, Miami, Tampa, Las Vegas and Phoenix.
3. The last time there was a housing boom and bust was the late 1980s. After that bust, it took over six years for California and New York to turnaround.

While we don't know what will happen this time, I would not rely on a fast rebound. Some experts believe the economy will

rebound as soon as the housing market turns around. I personally hope that is not the case because I do not want to wait that long.

### THE FEDERAL RESERVE AND THE CURRENT CRISIS

Now, let's turn to the financial crisis and the Federal Reserve. To make sense of current events, let's first take a look at the traditional role of the Federal Reserve and how it's responded to this crisis.

Believe it or not, the Fed is behaving very systematically during this crisis; it is addressing its three main responsibilities. First, it lowers the Fed funds rate. Second, it pumps liquidity into the system through discount loans. Third, it stands ready to bail out banks—but only those banks it deems “too-big-to-fail.” I'll come back to that point because it's so important.

The Federal Reserve has dealt with the present crisis very systematically:

1. It started to lower interest rates in September 2007. We now have the Fed funds rate at 2%, which is a traditional Fed response and the right one. I believe those calling for further rate cuts are misguided. If a business cannot justify a loan at current interest rates, they shouldn't be borrowing. The problem for Main Street is not the cost of borrowing, but the availability of credit. What we have is a real credit crunch and that's what we should be focusing on, not the interest rate.
2. The Fed started to provide liquidity to banks in August 2007, when the LIBOR rate went crazy. Normally, the spread of LIBOR over Treasuries is 50 basis points. In August 2007, it was 250 basis

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points (2.5%). I believe that was a sign that the inter-bank market was closing down and a sign that banks didn't trust each other. So the Fed and the European Central Bank rushed into the market last August to provide liquidity. Then, they had to do it again at year-end, then again in March and, yet again, in July. And guess what happened this past week? The LIBOR rate went crazy. The Treasury rate went crazy and the spread of LIBOR over Treasuries went above 500 basis points (5.00%). That's a sign of extreme distress in the shortest most liquid market in the world.

3. The third role of the Fed is more controversial and relates to the central bank's doctrine called "too-big-to-fail." The Fed has always been willing to bail out a bank it deems too-big-to-fail. While we don't know exactly how it makes this determination, I do believe in this policy. It is the right one because the largest banks threaten the stability of the entire system. I believe the Fed will continue to follow this policy in the future, and that may mean that some banks may be allowed to fail.

Now, let's take a look at what happened with Bear Stearns, Lehman Brothers, Fannie, Freddie and AIG.

Let's start off with Fannie and Freddie because it is a fairly simple story. Fannie and Freddie have always had an implicit guarantee by the federal government. Most institutional investors in the United States believed in this implicit guarantee and, more importantly, foreigners also believed in the implicit guarantee. I don't see any way the federal government could have walked away from these two agencies but they are special cases.

Now, what about two relatively small investment banks, Bear Stearns and Lehman Brothers? Why didn't the Fed consider bailing them out? After all, investment banks are overseen by the Securities and Exchange Commission, not the Federal Reserve.

The answer lies in the fact that securitization has fundamentally changed the financial sector in the last 10 – 15 years. Investment banks hold the same positions as commercial banks, and investment and commercial banks have become heavily involved in securities that either did

not exist, or were far less important, 15 years ago. These securities include mortgage backed, collateralized debt obligations (CDOs) and credit swaps. As a result, the failure of a financial institution with huge positions in these securities could threaten the stability of other commercial banks and financial firms.

When Bear Stearns was about to blow up, the Federal Reserve and the U.S. Treasury were caught in a squeeze; they simply did not think they could let Bear Stearns fail. In hindsight, possibly it should have been allowed to fail. After all, Lehman failed and the sun still rose the next day. But it's so easy to be a Monday morning quarterback.

What about AIG? Why would the Fed rescue an insurance firm? After all, insurance firms are not the responsibility of the Federal Reserve; instead, they are overseen by 50 separate state insurance commissioners.

Once again, we need to return to how much the financial markets have changed in the last 10-15 years. Securitization has replaced the traditional banking model and AIG insured a lot of these firms. AIG was also one of the most aggressive players in the credit swaps market—a market that did not exist 10 years ago and has never been tested by a financial crisis. AIG was so heavily leveraged and so heavily involved in these new markets that the Fed and Treasury did not want to see what effect its failure had on the financial system.

What we have now is a new Fed doctrine: the Federal Reserve helps rescue an insurance company, not a bank. This forces us to throw out the rule book about regulation.

But that's not the end of the story because none of it worked. The day after AIG was rescued, the markets went berserk. The LIBOR rate, as I said, soared above treasuries. There was a run on money market funds and the commercial paper market basically dried up.

In this scenario, the Treasury developed a new plan: a super-fund bailout plan to buy up debt. The problem with the current financial crisis is not simply one of competence. It's also about the huge losses that banks, investment banks, insurance companies and hedge funds have suffered in the mortgage-backed market, as well as many other fixed-income markets.

Under the bailout plan, the Treasury will bolster the securities, which are at the root of the financial sector's problem. Banks that are on the margin of collapsing will survive; banks that were really bad off will fail. The market, not the government, will pick the winners and losers.

### U.S. ECONOMY

What about the U.S. economy? First of all, the economy, so far, has been quite robust—surprisingly so. GDP grew over three percent in the second quarter of this year. Growth was kept high by two factors. The first factor was robust foreign exports, which boosted the economy, and the second was the tax rebate program.

I believe the economy will slow down, and perhaps slow down significantly, for three main reasons. First, exports are falling. Germany, Japan and some other industrial countries may already be in recession. Second, the tax rebates have ended. Third, most importantly, the banking sector has cut-off credit and there is a genuine credit crunch on Main Street.

We don't know how bad the credit crunch will be so we don't know how much the economy will slow down. Much will depend on the pricing of the debt purchased by the bailout plan, if there is a bailout plan, and how much support will be given to the banking system.

### INVESTMENT PORTFOLIOS

Now, let's look at our investment portfolios. A lot of the damage to our portfolios has already occurred. The time for hand-wringing about equity positions was back in 2006 or mid-2007 after the first hedge funds failed.

Let's look at the facts about past recoveries. When the market turns around, it will turn around like a rocket. If you start to play games with your portfolios at this juncture, you are likely to be burned. Please keep these points in mind:

1. In the past nine recessionary environments since 1950, the S&P rose like a rocket once it hit bottom. The minimum rise in the first 12 months was 30% and often times quite a bit more.
2. In all but one recession the market started rising before the end of the recession, typically about three to eight months early. The exception to this rule was the last recession. We had to wait from November

2001, when the recession ended, to October 2002 to see the bottom.

My point is that even if we hit a recession this coming winter, we better not be caught flatfooted by the stock market recovery. When the market does turn up, historically, the assets that outperform earliest and the best are the riskier ones, which was the case in 2002, 2003, 2004 and 2005. In past recoveries, small caps have often done better than large caps. In almost all recoveries, riskier bonds start to shine earlier.

### CONCLUSION

At this point, I am most worried about the credit crunch; I'm worried that the market has not yet factored in the credit crunch and the slowdown of the U.S. and world economies. The steep volatility in the markets recently has been driven by the financial crisis not by the economy.

With patience, we will have a rebound in stocks and an opportunity to earn results on our portfolios. I believe it's absolutely imperative that investors remain focused on their long-term asset allocation plans.

*Dr. Marston took several minutes to address questions from his audience:*

**Q: WHAT ARE YOUR THOUGHTS REGARDING ALTERNATIVE INVESTMENTS, PARTICULARLY LONG / SHORT HEDGE FUNDS? DO YOU ADVISE INVESTORS TO SLIGHTLY INCREASE THEIR HEDGE FUND EXPOSURE OUT OF EQUITIES TO HELP PROVIDE DOWN-SIDE PROTECTION IF WE CONTINUE TO SEE FURTHER DETERIORATION IN THE MARKET?**

**A:** You may know that I'm a strong supporter of hedge funds. I believe, at least in the short run, that hedge funds will experience some real difficulty. I believe what you are really asking about is option positions—rather than hedge funds – in order to create downside protection on equity portfolios. Yes, that can be done with options and also with a long-short strategy. But the time to consider downside protection strategies was earlier on.

I counsel investors not to limit the upside. I believe investors should participate on the upside and use hedge funds and options as alternatives to limit the downside. That said, I don't believe investors should consider a big shift right now because of the possible downside of the equity market.

Take a look at the Yale University endowment. In its latest report, the Yale endowment reduced its hedge fund position by 2% and put the money into private equity positions. It's very interesting to see one of the smartest investors in the institutional world, David Swenson, Chief Investment Officer of the Yale endowment, only marginally reduce his hedge fund positions.

Typically, tactical asset allocation changes are nominal adjustments – often in the range of 5-10% adjustments. If asset allocation committees had a crystal ball, they would have told you to sell on October 9, 2007. Then, they would have told you exactly when to get back into the stock market. But asset allocation committees, unfortunately, do not possess crystal balls to “time the markets.”

That's why Yale University, which after all has been around since 1702, doesn't play games with asset allocation by going in and out of the markets. They have a long-term strategic asset allocation strategy, properly positioned to align with their long-term objectives and they don't make large interim tactical adjustments. That's the same policy that private investors should have in any kind of market environment.

**Q: HOW DO YOU PERCEIVE THE DOMESTIC EQUITY MARKET'S REACTION IN A TURNAROUND VERSUS THE FOREIGN MARKETS?**

**A:** You really need to distinguish which foreign market. The Europeans and the Japanese entered into a recession before we did; that presumes that they're probably going to emerge from recession earlier, so there's a possibility their local currency will give us a boost. On the other hand, the big secular movement in the European currencies is over. I believe there is now downside risk on European currencies, which we've seen over the last few weeks. That means that even if the European economies come out earlier than we do, we do have to worry about the currency element.

In Asia, we have less concern over currencies because there is a lot of upside on Asian currencies over the next few years. Having said that, Japan is definitely in recession and it's difficult to play the domestic versus foreign right now. It was so easy to play over the last few years because we knew the European economies were doing well. And we knew we had the wind at our backs, with the

euro and the other European currencies so under-priced. Now, it's a much tougher call. I wouldn't be leaning one way or the other.

**Q: DO YOU THINK THAT DOWNWARD ADJUSTMENTS TO THE SPENDING POLICIES OF NOT-FOR-PROFIT ORGANIZATIONS IS APPROPRIATE AT THIS TIME?**

**A:** That is a very good question, not only for those of you who work with institutions, but also with retired private clients. Typically, most spending rules are tied to a weighted average of assets. That's the process used by Yale and most large institutional investors when establishing spending rules. Consequently, if there is a downturn in the portfolio, spending policies are definitely cut-back.

Yale doesn't do it dramatically, but if there is a downturn in the market, they tighten their belts. The same would be true of a 70-year-old who's already retired. If a retiree's spending policy is 4 1/2% of his or her portfolio and their spending policy is tied to some sort of weighted average of their assets, that retiree will inevitably be cutting back. And that's a sensible policy. Foundations have to cut back in a downside environment, and that's the nature of the beast.

**Q: WHAT IS THE RISK OF THE U.S. LOSING ITS “AAA” CREDIT RATING AND HOW WILL THAT AFFECT INTEREST RATES AS A RESULT?**

**A:** I think the possibility of a reduction in the U.S. credit rating is something fun for journalists to talk about, but I would be absolutely shocked if the U.S. lost its rating. The basis for this credit rating is two-fold: good government and the ability to raise taxes. Major industrial countries like the U.S. have triple “A” ratings for good reason. They have the quality of their governments, safety in terms of political risk and, in addition, the ability to bring in tax revenue, which has not been impeded in this environment.

The U.S. has a very rich economy – that's one of the reasons everyone around the world wants to invest in the U.S. economy during a crisis. We are the safe harbor – even to a great extent than Switzerland. Again, the lowering of credit ratings is a fun topic for journalists but I don't think it's a realistic possibility.

**Q: HOW DO YOU ADVISE RESPONDING TO CLIENTS WHO ARE CONCERNED THAT IT'S DIFFERENT THIS TIME AND LIKEN THE CRISIS AS A PRECURSOR TO ANOTHER GREAT DEPRESSION? DOES OUR GOVERNMENT HAVE THE CAPACITY OR THE RESOURCES ULTIMATELY TO DEAL WITH THE CRISIS?**

**A:** I think there are two issues here. First, does the government have the capacity to deal with the current crisis? As I've said, the American economy is very wealthy and we do have the right policies to clean up this mess.

The second issue though deals with whether we have competent policy makers. It takes a great deal of expertise and skill to respond to a financial crisis of this magnitude. I believe we currently have some of the best people we possibly could in the Treasury—people who know where the bodies are buried in the financial markets. There's nobody better in this kind of circumstance than our present Treasury Secretary, Henry Paulson.

In addition, the current Federal Reserve chairman, Ben Bernanke, spent his academic career studying what went wrong during the Depression. Again, I believe the combination of Paulson and Bernanke is just about perfect in terms of facing up to this crisis.

I'm so glad that we have these people in place as it's an ugly situation. It's going to be a little bumpy, but we have competent people in place and we have the strength of the American economy banking on them.

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