

# The Current Business Crisis

## A Letter to Clients from

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Published Since 1983

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### *A Special Edition of our Investor, U.S.A. Client Newsletter.*

- Commercial lending as “frozen” as fear of defaults plague private business.
- Treasury and Congress respond by issuing more Government Debt, and bailing out Wall Street firms
- Eleven years ago, the United States orchestrated a “stabilization” plan for Korea. But the “Bailout Bill” is exactly the reverse of what we imposed on Korea.

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Dow Jones Industrials	10,768
Treasury 10 Yr Note Yield	3.58%
CA, NY Muni Bond Yield	3.90%
Nasdaq Composite	2.040

**Scary headlines** dominate the news. As well they should. The Dow Jones has fallen back close to the 10,000 level it crossed in 1999!

To make matters worse, Congress has voted to spend \$850 billion of taxpayer money to buy up lousy mortgages sitting on the books of investment banks — and some commercial banks — all of whom received stupendous fees over the past five years for originating and packaging these mortgages in the first place. A revision of the first proposal actually added \$150 billion of wasteful spending to a bad plan, making it even worse.

You have undoubtedly read news stories about this mess, with various takes. In this political season, reports of financial news have taken on partisan colors. Hopefully without partisanship, here is my take on this.

**Behinds the scenes**, the precipitator of all this — though not the true cause — is oil. Oil rising from \$20 per barrel to \$100 per barrel and higher has drained hundreds of billions of dollars of cash from American families and sent it abroad. The drain made unbearable the mistakes and excesses of the past few years, such as the bad mortgages. We would still have had an end to the housing bubble, and still have had defaulting mortgages from unqualified buyers, but the correction would have been more easily absorbed, and perhaps stretched out over more time, if our families’ cash were not being sucked overseas by \$100 oil.

Over the past several years I have written you periodically that rising oil prices scared me; that I was worried the U.S. economy could not stand this strain. For a while, as the economy and markets marched ahead, I thought I must be wrong. But alas, the fears have proven too true — even more so than I expected. And I am still worried by oil. The price may be back below \$100 per barrel, but that is no joy. For the United States to recover her bearings, oil needs to be below \$50, and I do not see that anytime soon. Worse, every month that passes Iran makes yet more progress towards nuclear weapons. Can war be far off?

As hurtful as the oil shock has been, it really has only revealed a certain rot in our system. **Our Government lives by debt, far beyond our means.** That need not have been so. By the late 1990's, a political compromise between Clinton Democrats and Congressional Republicans had achieved a true, balanced budget after years of deficits. National finances were so solid that a few economists even worried about a "shortage" of federal debt. But then the bizarre happened.

Mr. Bush, apparently a conservative Republican, was elected in November 2000, and proceeded to spend in the grand tradition of Lyndon Johnson and the Great Society. His political adviser Mr. Rove told fellow Republicans that Mr. Bush was winning the allegiance of voting groups — the lower income middle class — in a way that would guarantee Republican majorities for a generation. Armed with that preposterous notion, Republicans in the White House and Congress embarked upon the devastation of Federal finances.

They were not alone. While Republicans were handing out cash, Democrats were handing out mortgages. Democrat holdovers in Fannie Mae and Freddie Mac, the quasi governmental mortgage promoters, ordered banks to meet quotas of loans to the deadbeat poor devoid of income, savings or any future. I followed the story because the head of this degenerate enterprise was Franklin Raines, my classmate at Harvard Law School. But I imagined that the risky lending must be simply another welfare program, and manageable. It was not until the disaster struck, and I dug further, that I discovered that my classmate had orchestrated an unbelievable hundreds of billions of dollars of doomed mortgages — while paying himself over \$90 million in compensation in the process.

At first the Bankers resisted this vulgarity, but soon they joined in. Banks like Washington Mutual and Countrywide Financial promoted the same floating rate mortgages that Fanny Mae offered the poor, and sold them to the middle class, often with teaser rates that seduced Buyers into buying a house they could never afford once the interest rate reset.

Vast stretches of poor urban districts in cities like Cleveland and Washington D.C. are polluted with bad Fanny Mae poor folk mortgages. Vast stretches of fast growing Florida and Nevada are polluted with bad

**From Editor Edvard Jorgensen...** Each year since 1983, Seahorse Financial Advisers has presented our market research and portfolio strategy .

We are professional investment counselors, managing capital for American and International families and trusts.

We are conservative but growth oriented. Our clients look to benefit from the growth potential of good businesses and well-managed properties, but value their capital as permanent wealth. Our mission is thus to preserve and then, when investment values permit, enhance our clients' capital.

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middle and upper class mortgages. Adding insult to injury is the compensation all levels of the financial industry took for generating these bad mortgages: from the \$10,000 per mortgage commission of the broker, to the bank closing fees, to the ugly millions the investment bankers paid themselves to package this junk as “investment paper.”

Perhaps if oil had stayed low, and these mortgages been foreclosed gradually over years, the problem would have been spread out, stretched out, and maybe more or less ignored. But oil shot up. Gasoline costs and heating oil costs sucked the cash out of poor and middle class pockets. So down went the mortgages, all in one fell swoop — which is where we are today.

These mortgages sit in the portfolios of banks, insurance companies, investment houses. No one knows how many will default. No one knows what value to put on this sewage today. But post-Enron “mark to market” accounting rules require that risky mortgages be assigned some market value, even “written down” far beyond the cash delinquencies experienced to date.

As banks and brokers began to take write-offs, the financial system quaked. Familiar names began to fail. And in the panic, even some solid names crashed. You know I have always had soft spot for American International Group. Well, it is now a Government orphan, thanks to insurance policies it wrote guaranteeing that this fiasco wouldn't happen, and a market panic that destroyed the best insurance franchise in the world.

**I doubt a “Bailout” is possible.** This past winter scared Treasury officials, led by Mr. Paulson, formerly of Goldman Sachs, began to bail out Wall Street for its losses. That charity for old friends didn't work. Each bailout has only increased the fear among sound banks and investors that there must be more losses hidden somewhere, so the normal trading and funding of business is grinding to a panicked halt. Now Mr. Paulson wants \$700 billion more money for him to assist his friends. But the Federal Government is already sunk by Mr. Bush's version of the new great society, together with bills for the Iraq war. There is no \$700 billion, except deep in the printing press recesses of Government determined to emulate the Weimar Republic.

**There is an answer, but I just can't imagine any politician offering it.** It was only eight years ago we had a balanced budget, and we could do it today. Just end all the extra new spending of the past few years, and put a tax on foreign oil to pay for the Iraq war. But Republicans will not tax for their war, and Democrats will not cut back on their Evita Peron-like social programs. So what will happen?

Some countries in debt ended up like the Weimar, with severe inflation. More recently, massive bad bank debt in Japan led to just the opposite: 0% interest rates for 15 years. In a way, inflation and 0% interest on savings are two ways of making the productive middle class pay for Government degeneracy. In the United States during the late 1970's, a much milder case of oil shock and economic woes led “only” to high unemployment and 16% interest rates. I remember my office mate in our law firm joyfully reporting to me that he had been approved for one of those 16% mortgages to buy a house for his wife and newborn baby. That “misery index” world ended in the 1979-1982 recession that was the nastiest since the 1930's.

In 1997, Korea suffered a banking crisis remarkably similar to ours today. It began with the bankruptcy of a large industrial conglomerate, Hanbo Group. But quickly investors sensed that this one bankruptcy was merely a warning of massive bad loans made by Korean banks to the politically connected industrial cartels that ran the Korean economy. Investors began a run on the banks, both as depositors and as stock market investors. Banks stocks plummeted. Bank deposits fled. International depositors simply exited the country. And the Korean economy faced overnight collapse, as the entire credit system of a market economy froze and failed.

I thought of the Korean crisis of eleven years ago the other day, as word hit Wall Street that General Electric was having trouble selling its commercial paper. Commercial paper is very short term borrowing a corporation does to buy inventory in anticipation of receipts later. For example, if General Electric is selling an \$80 million generator to an overseas customer, General Electric must first buy the steel to make the generator. So it sells commercial paper, raises cash, uses the cash to make the generator and then repays the commercial paper when their customer pays.

If General Electric can't sell its commercial paper, then the generator doesn't get built. And the American economy comes to a halt. Is there money in the economy to fund General Electric's commercial paper? Of course there is. But seven months of Government bailouts and seizures of private firms, particularly the seizure of giant American International Group, have taught investors that "the only good debt is Government debt," so they are afraid of all private debt, including General Electric's commercial paper.

That is why industrial leaders like General Electric lobbied Congress to pass the bailout, even though the bailout's design is ludicrous. These industrial giants need a functioning private market, and they want to "try anything" to get that private credit market going again. We have had short term panics before: in 1970, the once great railroad Penn Central collapsed, freezing the commercial paper market as has happened today. That panic was solved by lowered interest rates; today's panic reflects system wide bad debt that dwarfs the isolated case of one railroad.

So the bailout has passed, even in its miserable current form. And Mr. Paulson gets his authority to buy all the bad investments of his friends — even his own firm — on Wall Street. To me, it is an astounding and disgraceful spectacle. What's more, the politicians are deluded to try to solve bad debt with more debt.

Eleven years ago the United States, and the International Monetary Fund, which intervened in Korea to stabilize that failing economy, did not permit such a bailout. They insisted that the corrupt bank lending end. They insisted that the corporate cartels either reform and compete honestly, or go bankrupt. They closed down the Government agencies that promoted the bad loan cover-ups. They cut Government spending. And, months later, after a recession, the Korean economy recovered. In the ensuing ten years, the Korean economy has been among the world's strongest. Did you notice that as Lehman Brothers was failing, it sought capital from the Korean Development Bank? Korea said no, quite rightly. I saw an interview with a Korean official who participated in the 1997 Stabilization of his own country. He asked, "Why should we invest in America when America won't take the steps they made us take?" He is right. That is our crisis. I will shortly write about portfolio steps we'll be taking. Sincerely,

*Edvard Jorgensen*

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