



Investing Environment



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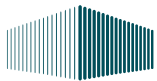
*"Some say the world will end in fire.
Some say in ice.
From what I've tasted of desire
I hold with those who favor fire.
But if I had to perish twice,
I think I know enough of hate
To say that for destruction ice
Is also great
And would suffice."*

— Robert Frost
American Poet
1874-1963

When did the financial crisis begin? Perhaps a more interesting question is "At what point did you become aware that something very serious was happening?" Some would cite the collapse of the Bear Stearns hedge funds in August, 2007. Others would cite the March 2008 collapse of Bear Stearns itself. For me, the epiphany occurred sometime in spring, 2007 during a discussion with our firm's analyst then responsible for covering financial institutions. In discussing the prospects of a certain, now deceased, mortgage company the analyst noted that the company was better positioned than its peers because it had a lower "first payment default rate" than its peers. Incredulous, I confirmed that the analyst was not joking and that the number of people who defaulted on their mortgage before making a single payment was actually a metric tracked by the industry. At that moment, I awakened from my slumber of complacency.

But as inclusion of the wonderful poem by Robert Frost hints, the subject of this essay is not how the financial crisis began, but how it ends. Before taking up that topic, however, it is worth discussing the question of how so many prominent economists, politicians and money managers missed this crisis until the financial markets meted out such dramatic punishment that the severity of the crisis was apparent to even casual observers. Several possible explanations surface:

- **An institutional bias toward optimism:** In his famous essay *In Praise of Folly*, Desiderius Erasmus (1466-1536) warned of the danger of truth telling to the powerful. Let's face it, people don't want to hear bad news. We like our leaders to be optimists. Pessimists/realists do not inspire us. Wall Street understands this. Warning signs are thusly ignored or explained away. Erasmus was right. Truth telling is dangerous.
- **Lack of skeptical, independent thought:** An underlying premise of traditional economics, in contrast to behavioral economics, is that human beings always act rationally. Countless quantitative models of great mathematical elegance have been constructed on this premise. Employment of many such models has led to significant losses. Garbage in. Garbage out. A similar lack of skepticism was employed by some investors in their unquestioning acceptance of official data from Washington statistics mills such as the Bureau of Economic Analysis and the Bureau of Labor Statistics. *Caveat Emptor*.



- **Lack of appreciation of the role of leverage:**

Markets are difficult enough to analyze under normal circumstances, but the buildup of leverage throughout the system clearly made them more unstable than at any point since the late 1920s. Since no one in the business today was a practicing money manager in the 1930s, there was no institutional, first hand knowledge of the nature of a deleveraging episode such as the world experienced in the 1930s.

Turning back to the Robert Frost question of how this ends, we must begin by reprising several past Investing Environment letters. The root cause of this crisis is the excessive buildup of debt. The ratio of US public and private debt to gross domestic product reached 358% in 2008, the highest in US history.¹ Interestingly, the composition of the debt is much different than in the 1930s. Currently, the largest increases in debt have been in the household and financial sectors, whereas in the 1930s the debt buildup was concentrated in non-financial corporations.

Once a debt bubble bursts, heavily leveraged borrowers act to deleverage by increasing savings and paying down debt. The problem, well recognized by scholars such as Irving Fisher and John Maynard Keynes, is that we can't all delever at once. Keynes coined the term Paradox of Thrift to describe situations in which saving and deleveraging is beneficial to the individual but deleterious to the general population. Irving Fisher pointed out in his famous 1933 paper² that severe deflation in a period of excessive debt can be disastrous. In Fisher's words:

"The liquidation of debts can not keep up with the fall in prices it causes." and "The more debtors pay, the more they owe."

Fisher's words haunt central bankers 75 years later.

Wise counsel from the ages aside, dealing with a debt bubble is perilous. Simply stated, there are precious few options:

1. Take the medicine now. The Depression Era Secretary of the Treasury, Andrew Mellon, famously advocated, "Liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate." There is a plausible argument that the serial bubbles we are experiencing are the result of

Central Banks, especially the Federal Reserve, lowering rates at the first sign of economic trouble, thereby short-circuiting the normal self-correcting mechanisms in the economy and promoting complacency on the part of investors now commonly referred to as moral hazard. Perhaps, but at this point considerations of systemic risk must supersede moral hazard concerns.

2. Grow our way out. This has been the preferred solution to past economic downturns as noted above. Yet, policy makers are likely reaping the unintended consequences of past rate cutting episodes. Still, there are important growth-friendly initiatives that we have advocated in past Investing Environment letters, such as lowering—or at least not raising—the capital gains rate, lowering tax rates on the repatriation of capital by US corporations, raising H1-B visa quotas, and raising funding for basic research, etc.
3. Replace private debt with public debt. This seems to be the policy of choice these days as one bank after another is recapitalized with public funds. But can this strategy work for long, given the impending demographic wave about to crest in the form of baby boomer retirements? Is it any wonder that the price of gold is rising in virtually all major currencies?
4. Inflation. A final path to ameliorating the debt burden is inflation. In this scenario, debt is paid back with cheaper dollars than the dollars that were borrowed. Unfortunately, history has shown that inflation is highly destabilizing to society, dating back to the Roman Empire and perhaps earlier.³ If inflation were to get out of control, the experiment with fiat currency begun in 1971, when convertibility to gold was suspended, could be in peril.

How then will the financial crisis end? Much will depend on the course of public policy. A deflation scenario is certainly possible as economic actors rush to delever. With luck, however, we will escape Irving Fisher's nightmare scenario. Our guess is that Central Bankers around the world will err on the side of avoiding a deflationary spiral at all costs. The question is whether, once we emerge on the other side of this financial chasm,

¹It is worth noting that the nature of government data series changed over the years. Accordingly, economists quibble over whether today's Debt/GDP ratio is an apples to apples comparison with the 1920s. Regardless, every economist agrees that debt levels have risen dramatically.

²"The Debt Deflation Theory of Great Depressions" *Econometrica* October 1933.

³For an excellent history of inflation I recommend [The Great Wave](#) by David Hackett Fischer.

inflation can be avoided. Steering a course between deflation and inflation is going to be remarkably difficult, analogous to attempting to land an airplane in 50 mile per hour winds. The chances of undershooting or overshooting the runway are uncomfortably high.

Will it be fire (inflation) or ice (deflation)? As Frost said, "I hold with those who favor fire," though this fire can't ignite without credit creation to ramp back up—and that may take a while. In the mean time, watch those bond durations.



John O'Connor
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Postscript

If there was ever a doubt about whether the Federal Reserve was biased to err on the side of inflation or deflation, that doubt was put to rest on March 18, 2009 when the Fed announced plans to purchase \$300B of Treasury securities, \$750B of agency mortgage backed securities and \$100B of agency debt. The Fed has now embarked on a course of debt monetization, risking—or perhaps even causing—inflation. The strategy for dealing with this downturn is remarkably similar to one

employed several times under the Greenspan Fed. The idea is to force interest rates so low that a mortgage refinance boom ignites.

Such a boom, if it happens in an era in which home equity shrinkage makes the appraisal process problematic, has the double barreled effect of lowering monthly mortgage payments for consumers and liquefying the balance sheets of owners of mortgage backed securities (i.e. banks and insurance companies, among others) as loans are refinanced.

In the short run, the Fed action is expedient. In the long run, the action is worrisome. On one hand is the concern that the Fed seems to come back to the same well every time the economy turns downward – ignite a refi boom. What happens when everyone has a 4.25% mortgage? Can the Fed keep coming back to the same well indefinitely? Of greater concern is whether the Fed will be able to gracefully shrink its balance sheet once the economy has stabilized. A great deal of money has been created. When velocity increases, to use Milton Friedman's term, and money demand moderates, the excess of supply over demand will lead to inflation unless the Fed can shrink its balance sheet. But the Fed must manage the balance sheet shrinkage so that the then presumably fragile recovery is not nipped in the bud. The degree of difficulty of this task will be daunting and the risk of human error will be high.

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