Tim Geithner’s Speech and Plan

Markets do not initially like Geithner’s comments. There are good reasons. He gave only sketchy details that would help clarify the program. His speech was purposefully vague. Markets and the country want clarity, transparency and reliability. Instead. they got promises it would be forthcoming but they did not get facts and details that would substantiate it.

He alluded to “public-private” partnerships. This is a concept that has often failed. He offered a new “stress test.” We do not know what this is or how it will be implemented or what the penalties will be if one fails that test. And what will the reward be if one passes?

We also heard that there would be a large expansion of the Federal Reserve’s balance sheet as part of the program. This is not surprising. The Fed is the one agency of the federal government that is implementing policy to unfreeze the credit markets. The Fed is succeeding in part. We see that in the narrowing of the TED spreads and in the restoration of some working functionality in the commercial paper market. What the outcome of this monetary expansion will be out in the future remains to be seen. That comes after the economy starts to recover and then we can gauge the inflation risk.

Geithner did not address the problem of pricing of toxic assets presently held by financial institutions. He also avoided the issue of recognition of losses by those institutions. He only admitted in the post speech interview that his was being worked on.

He never mentioned the damage that has been done to the US financial system because the Financial Accounting Standards

Board (FASB) has rigidly stayed with its rulemaking that caused 30 year assets to be marked to an estimated price with the variance charged against current earnings or added to current profits. Mark-to-market works when markets are functioning, have transparency and ample liquidity for transactions. Marking-to-market when the market is broken is impossible and results in the mess we now see.

His speech did not mention his earlier trial proposal of the aggregator bank. He did not repudiate other ideas that had been surfaced and subsequently rejected. And he seemed to imply that he was consistent with President Obama's framework for government as the ONLY institution that can stimulate the economy.

The speech release was accompanied by a "fact sheet." How factual it seems we will leave to our readers to determine. The fact sheet follows:

FACT SHEET

FINANCIAL STABILITY PLAN

The Financial Stability Plan: Deploying our Full Arsenal to Attack the Credit Crisis on All Fronts. Today, our nation faces the most severe financial crisis since the Great Depression. It is a crisis of confidence, of capital, of credit, and of consumer and business demand. Rather than providing the credit that allows new ideas to flourish into new jobs, or families to afford homes and autos, we have seen banks and other sources of credit freeze up – contributing to and potentially accelerating what already threatens to be a serious recession. Restarting our economy and job creation requires both jumpstarting economic demand for goods and services through our American Recovery and Reinvestment Act and simultaneously ensuring through our new Financial Stability Plan that businesses with good ideas have the credit to grow and expand, and working families can get the affordable loans they need to meet their economic needs and power an economic recovery.

To address the financial crisis, the Financial Stability Plan is designed to attack our credit crisis on all fronts with our full arsenal of financial tools and the resources commensurate to the depth of the problem. To be successful, we must address the uncertainty, troubled assets and capital constraints of our financial institutions as well as the frozen secondary markets that have been the source of around half of our lending for everything from small business loans to auto loans.

To protect taxpayers and ensure that every dollar is directed toward lending and economic revitalization, the Financial Stability Plan will institute a new era of accountability, transparency and conditions on the financial institutions receiving funds. To ensure that we are responding to this crisis as one government, Secretary Timothy Geithner – working in collaboration and joined by Federal Reserve Chairman Ben Bernanke, FDIC Chair Sheila Bair, Office of Thrift Supervision Director John Reich and Comptroller of the Currency John Dugan – is bringing the full force and full range of financial tools available to cleaning up lingering problems in our banking system, opening up credit and beginning the process of financial recovery.

Financial Stability Plan

1. Financial Stability Trust

· A Comprehensive Stress Test for Major Banks

· Increased Balance Sheet Transparency and Disclosure

· Capital Assistance Program

2. Public-Private Investment Fund ($500 Billion – $1 Trillion)

3. Consumer and Business Lending Initiative (Up to $1 trillion)

4. Transparency and Accountability Agenda – Including Dividend Limitation

5. Affordable Housing Support and Foreclosure Prevention Plan

6. A Small Business and Community Lending Initiative

FINANCIAL STABILITY PLAN

1. Financial Stability Trust: A key aspect of the Financial Stability Plan is an effort to strengthen our financial institutions so that they have the ability to support recovery. This Financial Stability Trust includes:

a. A Comprehensive Stress Test: A Forward Looking Assessment of What Banks Need to Keep Lending Even Through a Severe Economic Downturn: Today, uncertainty about the real value of distressed assets and the ability of borrowers to repay loans as well as uncertainty as to whether some financial institutions have the capital required to weather a continued decline in the economy have caused both a dramatic slowdown in lending and a decline in the confidence required for the private sector to make much needed equity investments in our major financial institutions. The Financial Stability Plan will seek to respond to these challenges with:

· Increased Transparency and Disclosure: Increased transparency will facilitate a more effective use of market discipline in financial markets. The Treasury Department will work with bank supervisors and the Securities and Exchange Commission and accounting standard setters in their efforts to improve public disclosure by banks. This effort will include measures to improve the disclosure of the exposures on bank balance sheets. In conducting these exercises, supervisors recognize the need not to adopt an overly conservative posture or take steps that could inappropriately constrain lending.

· Coordinated, Accurate, and Realistic Assessment: All relevant financial regulators – the Federal Reserve, FDIC, OCC, and OTS – will work together in a coordinated way to bring more consistent, realistic and forward looking assessment of exposures on the balance sheet of financial institutions..

· Forward Looking Assessment – Stress Test: A key component of the Capital Assistance Program is a forward looking comprehensive "stress test" that requires an assessment of whether major financial institutions have the capital necessary to continue lending and to absorb the potential losses that could result from a more severe decline in the economy than projected.

· Requirement for $100 Billion-Plus Banks: All banking institutions with assets in excess of $100 billion will be required to participate in the coordinated supervisory review process and comprehensive stress test.

b. Capital Assistance Program: While banks will be encouraged to access private markets to raise any additional capital needed to establish this buffer, a financial institution that has undergone a comprehensive "stress test" will have access to a Treasury provided "capital buffer" to help absorb losses and serve as a bridge to receiving increased private capital. While most banks have strong capital positions, the Financial Stability Trust will provide a capital buffer that will: Operate as a form of "contingent equity" to ensure firms the capital strength to preserve or increase lending in a worse than expected economic downturn.
Firms will receive a preferred security investment from Treasury in convertible securities that they can convert into common equity if needed to preserve lending in a worse-than-expected economic environment. This convertible preferred security will carry a dividend to be specified later and a

conversion price set at a modest discount from the prevailing level of the institution's stock price as of February 9, 2009. Banking institutions with consolidated assets below $100 billion will also be eligible to obtain capital from the CAP after a supervisory review.

c. Financial Stability Trust: Any capital investments made by Treasury under the CAP will be placed in a separate entity – the Financial Stability Trust – set up to manage the government's investments in US financial institutions.

2. Public-Private Investment Fund: One aspect of a full arsenal approach is the need to provide greater means for financial institutions to cleanse their balance sheets of what are often referred to as "legacy" assets. Many proposals designed to achieve this are complicated both by their sole reliance on public purchasing and the difficulties in pricing assets. Working together in partnership with the FDIC and the Federal Reserve, the Treasury Department will initiate a Public-Private Investment Fund that takes a new approach.

· Public-Private Capital: This new program will be designed with a public-private financing component, which could involve putting public or private capital side-by-side and using public financing to leverage private capital on an initial scale of up to $500 billion, with the potential to expand up to $1 trillion.

· Private Sector Pricing of Assets: Because the new program is designed to bring private sector equity contributions to make large-scale asset purchases, it not only minimizes public capital and maximizes private capital: it allows private sector buyers to determine the price for current troubled and previously illiquid assets

3. Consumer & Business Lending Initiative – Up to $1 Trillion: Addressing our credit crisis on all fronts means going beyond simply dealing with banks. While the intricacies

of secondary markets and securitization – the bundling together and selling of loans – may be complex, they account for almost half of the credit going to Main Street as well as Wall Street. When banks making loans for small businesses, commercial real estate or autos are able to bundle and sell those loans into a vibrant and liquid secondary market, it instantly recycles money back to financial institutions to make additional loans to other worthy borrowers. When those markets freeze up, the impact on lending for consumers and businesses – small and large – can be devastating. Unable to sell loans into secondary markets, lenders freeze up, leading those seeking credit like car loans to face exorbitant rates. Between 2006 and 2008, there was a net $1.2 trillion decline in securitized lending (outside of the GSEs) in these markets. That is why a core component of the Financial Stability Plan is:

· A Bold Expansion Up to $1 Trillion: This joint initiative with the Federal Reserve builds off, broadens and expands the resources of the previously announced but not yet implemented Term Asset-Backed Securities Loan Facility (TALF). The Consumer & Business Lending Initiative will support the purchase of loans by providing the financing to private investors to help unfreeze and lower interest rates for auto, small business, credit card and other consumer and business credit. Previously, Treasury was to use $20 billion to leverage $200 billion of lending from the Federal Reserve. The Financial Stability Plan will dramatically increase the size by using $100 billion to leverage up to $1 trillion and kick start lending by focusing on new loans.

· Protecting Taxpayer Resources by Limiting Purchases to Newly Packaged AAA Loans: Because these are the highest quality portion of any security – the first ones to be paid – we will be able to best protect against taxpayer losses and efficiently leverage taxpayer money to support a large flow of credit to these sectors.

· Expand Reach – Including Commercial Real Estate: The Consumer & Business Lending Initiative will expand the initial reach of the Term Asset-Backed Securities Loan Facility to now include commercial mortgage-backed securities (CMBS). In addition, the Treasury will continue to consult with the Federal Reserve regarding possible further expansion of the TALF program to include other asset classes, such as non-Agency residential mortgage-backed securities (RMBS) and assets collateralized by corporate debt.

4. New Era of Transparency, Accountability, Monitoring and Conditions: A major and legitimate source of public frustration and even anger with the initial deployment of the first $350 billion of EESA funds was a lack of accountability or transparency as to whether assistance was being provided solely for the public interest and a stronger economy, rather than the private gain of shareholders, bondholders or executives. Going forward, the Financial Stability Plan will call for greater transparency, accountability and conditionality with tougher standards for firms receiving exceptional assistance. These will be the new standards going forward and are not retroactive. These stronger monitoring conditions were informed by recommendations made by formal oversight groups – the Congressional Oversight Panel, the Special Inspector General, and the Government Accountability Office – as well as Congressional committees charged with oversight of the banking system.

a. Requiring Firms to Show How Assistance from Financial Stability Plan Will Expand Lending: The core of the new monitoring requirement is to require recipients of exceptional assistance or capital buffer assistance to show how every dollar of capital they receive is enabling them to preserve or generate new lending compared to what would have been possible without government capital assistance.

· Intended Use of Government Funds: All recipients of assistance must submit a plan for how they intend to use that capital to preserve and strengthen their lending capacity. This plan will be submitted during the application process, and the Treasury Department will make these reports public upon completion of the capital investment in the firm.

· The Impact on Lending Requirement: Firms must detail in monthly reports submitted to the Treasury Department their lending broken out by category, showing how many new loans they provided to businesses and consumers and how many asset-backed and mortgage-backed securities they purchased, accompanied by a description of the lending environment in the communities and markets they serve. This report will also include a comparison to their most rigorous estimate of what their lending would have been in the absence of government support. For public companies, similar reports will be filed on an 8K simultaneous with the filing of their 10-Q or 10-K reports. Additionally, the Treasury Department will – in collaboration with banking agencies – publish and regularly update key metrics showing the impact of the Financial Stability Plan on credit markets. These reports will be put on the Treasury FinancialStability.gov website so that they can be subject to scrutiny by outside and independent experts.

· Taxpayers' Right to Know: All information disclosed or reported to Treasury by recipients of capital assistance will be posted on FinancialStability.gov because taxpayers have the right to know whether these programs are succeeding in creating and preserving lending and financial stability.

b. Committing Recipients to Mortgage Foreclosure Mitigation: All recipients of capital investments under the new initiatives announced today will be required to commit to participate in mortgage foreclosure mitigation programs consistent with guidelines Treasury will release on industry standard best practices.

c. Restricting Dividends, Stock Repurchases and Acquisitions: Limiting common dividends, stock repurchases and acquisitions provides assurance to taxpayers that all of the capital invested by the government under the Financial Stability Trust will go to improving banks' capital bases and promoting lending. All banks that receive new capital assistance will be:

· Restricted from Paying Quarterly Common Dividend Payments in Excess Of $0.01 Until the Government Investment Is Repaid: Banks that receive exceptional assistance can only pay $0.01 quarterly. That presumption will be the same for firms that receive generally available capital unless the Treasury Department and their primary regulator approve more based on their assessment that it is consistent with reaching their capital planning objectives.

· Restricted from Repurchasing Shares: All banks that receive funding from the new Capital Assistance Program are restricted from repurchasing any privately-held shares, subject to approval by the Treasury Department and their primary regulator, until the government's investment is repaid.

· Restricted from Pursuing Acquisitions: All banks that receive capital assistance are restricted from pursuing cash acquisitions of healthy firms until the government investment is repaid. Exceptions will be made for explicit supervisor-approved restructuring plans.

d. Limiting Executive Compensation: Firms will be required to comply with the senior executive compensation restrictions announced February 4th, including those pertaining to a $500,000 in total annual compensation cap plus restricted stock payable when the government is getting paid back, "say on pay" shareholder votes, and new disclosure and accountability requirements applicable to luxury purchases.

e. Prohibiting Political Interference in Investment

Decisions: The Treasury Department has announced measures to ensure that lobbyists do not influence applications for, or disbursements of, Financial Stability Plan funds, and will certify that each investment decision is based only on investment criteria and the facts of the case.

f. Posting Contracts and Investment Information on the Web: The Treasury Department will post all contracts under the Financial Stability Plan on FinancialStability.gov within five to 10 business days of their completion. Whenever Treasury makes a capital investment under these new initiatives, it will make public the value of the investment, the quantity and strike price of warrants received, the schedule of required payments to the government and when government is being paid back. The terms of pricing of these investments will be compared to terms and pricing of recent market transactions during the period the investment was made, if available.

5. Housing Support and Foreclosure Prevention: There is bipartisan agreement today that stemming foreclosures and restructuring troubled mortgages will help slow the downward spiral harming financial institutions and the real American economy. Many Congressional leaders, housing advocates, and ordinary citizens have been disappointed that the Troubled Asset Relief Program was not aimed at ending the foreclosure crisis. We will soon be announcing a comprehensive plan that builds on the work of Congressional leaders and the FDIC. Among other things, our plan will:

· Drive Down Overall Mortgage Rates: The Treasury Department and the Federal Reserve remain committed to expand as necessary the current effort by the Federal Reserve to help drive down mortgage rates – freeing up funds for working families – through continuation of its efforts to spend as much as $600 billion for purchasing of GSE mortgage-backed securities and GSE debt.

· Commit $50 Billion to Prevent Avoidable Foreclosures of owner-occupied middle class homes by helping to reduce monthly payments in line with prudent underwriting and long-term loan performance.

· Help Bring Order and Consistency to the various efforts to address the foreclosure crisis by establishing loan modification guidelines and standards for government and private programs.

· Require All Financial Stability Plan Recipients to Participate in Foreclosure Mitigation Plans consistent with Treasury guidance.

· Build Flexibility into Hope for Homeowners and the FHA to enable loan modifications for a greater number of distressed borrowers.

6. Small Business and Community Lending Initiative: Few aspects of our current financial crisis have created more justifiable resentment than the specter of hard-working entrepreneurs and small business owners seeing their companies hurt and even bankrupt because of a squeeze on credit they played no role in creating. Currently, the increased capital constraints of banks, the inability to sell SBA loans on the secondary market and a weakening economy have combined to dramatically reduce SBA lending at the very time our economy cannot afford to deny credit to any entrepreneur with the potential to create jobs and expand markets. Further adding to this frustration is the sense that community banks – which still engage in relationship lending that serves their local communities – have been overlooked not just during this crisis, but over the last several years.

Over the next several days, President Obama, the Treasury Department and the SBA will announce the launch of a Small Business and Community Bank Lending Initiative: This effort will seek to arrest the precipitous decline in SBA lending – down 57 percent last quarter from the same quarter a year earlier for the flagship 7(a) loans through:

· Use of the Consumer &Business Lending Initiative to finance the purchase of AAA-rated SBA loans to unfreeze secondary markets for small business loans.

· Increasing the Guarantee for SBA Loans to 90%: The Administration is seeking to pass in the American Recovery and Reinvestment Act an increase in the guarantee of SBA loans from as low as 75% to as high as 90%.

· Reducing Fees for SBA 7(a) and 504 Lending and Provide Funds for Both Oversight and Speedier and Less Burdensome Processing of Loan Applications.

The EMU versus the Global Recession

The European Economic and Monetary Union (EMU) and its common currency, the euro, and single central bank, the European Central Bank (ECB), were created with the primary objective of achieving economic stability in Europe. January 1, 2009 marked the 10th anniversary of the introduction of the euro. Broadly speaking, a high degree of macroeconomic stability has been achieved, with a welcome end to exchange-rate turbulence.

However, this anniversary year happens to coincide with the most severe test of the EMU and the euro to date, due to the deep recession that is rocking Europe and the global economy. The declines in industrial production in the eurozone in the 4th quarter of 2008 were extremely severe. This week ECB President Trichet said available data point to “very negative quarter-to-quarter real GDP growth in the last quarter of

2008.” Questions are being raised as to whether the Union can survive this test. We believe the EMU will muddle through this difficult period, but important weaknesses in its architecture have been revealed and need to be addressed.

It was hoped that the EMU would lead to a convergence of economic performance among the separate member economies, a development which would greatly strengthen the efficacy of a single monetary policy. The progress towards convergence has been limited in important respects, and serious divergences have become apparent in recent months. The elimination of restrictions on financial flows within the EMU and the mandatory use of a common currency, the euro, resulted in a high degree of integration of the euro area money market (the short-term interbank market), essentially from 1999. Short-term lending rates varied little within the EMU until the period of credit market turbulence and greatly increased volatility began in mid-2007. Over the past year and a half there have been greater concerns about national differences in credit risk and increased preference for national counterparties.

Convergence in the European securities markets has been far more limited due to differences in market standards and practices, liquidity, and the availability of developed derivative markets. Another factor which has increased in importance due to the current economic strains is perceived country differences in credit risk – sovereign risk in the case of government securities.

The ECB calculates “harmonized long-term interest rates” to assess the progress towards market convergence. As recently as December 2007, while spreads over the benchmark German 10-year bond rate had started to widen, they were only 14 basis points for France and 33 basis points for Italy. By December of 2008, these spreads had widened sharply to 49 basis points for France and 142 basis points for Italy. Very large spreads developed for other EMU members, including Spain (81 basis points), Ireland (152 basis points), and Greece (203 basis points). This serious divergence reflects significant differences among the EMU member economies with respect to their competitiveness and perceived ability to recover from the recession while maintaining price stability and avoiding an erosion of confidence in their solvency.

Budget deficits have worsened due to the recession, with economies in which housing growth has been particularly strong being hit the hardest (Spain, Ireland). Also, increasing government guarantees to loans, capital injections, and purchases of toxic assets have been a factor. Ireland is notable in this respect; guarantees offered to Irish banks amount to 221% of GDP. In addition, the current account positions of some members (Greece, Spain, Portugal, and Ireland) have deteriorated sharply. They do not have the option of depreciating their currencies or cutting short-term interest rates.

Underlining these differing situations, Standard & Poors has downgraded the sovereign debt of Spain, Greece, and Portugal in recent weeks and Moody’s has issued a warning that it may downgrade Ireland.

The ECB is quite limited in its ability to assist individual member countries whose economies are suffering the most from the recession. It has to apply the same monetary policy across the EMU. It is not permitted to buy sovereign bonds in the primary markets (a restriction designed to protect the independence of the ECB from the kind of political pressures to which European national central banks were subject prior to 1999). The ECB could buy debt in the secondary market, but this would require agreement across the EMU as to what debt to buy, how much, on what terms, etc. There is no provision permitting the EU to support a country should it default.

On the other hand, countries for which spreads and hence borrowing costs have widened substantially are unlikely to be driven to leave the Euro area and reintroduce and devalue a national currency. The costs for doing so would be high and their already high sovereign spreads would very likely widen significantly more. The country would find itself under even greater pressure to undertake needed economic reforms.

Aside from these problems, the ECB, with its mandatory single policy objective of price stability, maintained a restrictive monetary policy for too long last year. It continues to be somewhat behind the curve in responding to the global recession, apparently reluctant to lower interest rates as aggressively as the US Federal Reserve and the Bank of England.

National governments within the EMU have announced substantial fiscal stimulus programs and in various ways have stepped in to shore up their financial institutions and unfreeze credit markets. However, economic recovery will be hampered by continuing rigidities in labor and other markets. Economic hardships create strong headwinds for needed economic reforms, as was demonstrated by the massive national protests in France in recent days against economic reforms and layoffs in that country.

The eurozone economies as a group are expected to decline by 2% this year, following an estimated 1% advance in 2008 (this latter number may well be revised downward). The projected decline this year is similar to that expected for the US, but the time path will be different, with recovery in the US becoming apparent in the second half of this year, leading to a near potential growth rate of 2.5 – 3% in 2010. Recovery in the Eurozone will likely be slower for the reasons cited above, with 2010 growth around 1.5%.

At Cumberland we are continuing to under-weight the eurozone as a region in our International and Global Multi-Asset Class portfolios. We are monitoring the individual eurozone countries closely, for some are likely to do better than others in the coming months. We also expect the US dollar to strengthen further in 2009, in particular, versus the euro.

It Isn’t That Hard

The FDIC on January 27 proposed a change in the restrictions on interest rates that institutions that are “less than well capitalized” may pay on deposits to prevent moral hazard behavior by zombie institutions. The notice of the proposed change goes on to note that “(T)he proposed rule applies only to the small minority of banks that are less than well capitalized. As of third quarter 2008, there were 154 banks that reported being less than well capitalized, out of more than 8,300 banks nationwide.”

Something isn’t right here. If there are only a handful of institutions that are inadequately capitalized, then why are we talking about buying bad assets from banks, or establishing a “bad” bank to house those assets and potentially commit another several hundred billion (maybe as high as two trillion) dollars of taxpayer money to support banks? This disconnect has plagued the handling of the financial crisis in financial institutions from the outset and continues to be a problem that has to stop.

It isn’t that hard to put the system on a sound footing, and it has been done before by others. The Scandinavian countries experienced a financial crisis that resulted in nationalization of most of the banks; and the episode, its successes and failures, have been aptly described in a book by Thorvald Moe, Jon Solheim, and Bent Vale, entitled The Norwegian Banking Crisis, published by the Norges Bank in 2004. The parallels between their crisis and ours and the problems with how it was handled are sobering, and it appears that we have learned nothing from their experience.

What needs to be done can be summed up quite succinctly in three simple steps. Some might object that these proposals may be too costly, but it seems we have already crossed that bridge and now it is time to get some bang for our spending.

Step 1. Losses Must Be Identified.

Loss identification should be the job of management. After all, they granted the loans and/or purchased the assets and are closest to the source. If management won't or can't do it, then it is the responsibility of the regulators as part of their supervisory activities. Unfortunately, management hasn't done its job and neither have the supervisors.

Step 2. Losses must be written off against common equity.

Carrying unrecognized losses creates uncertainty about institutional solvency and is at the heart of the breakdown of the interbank market and the decline in bank stock values. Furthermore, avoidance of loss recognition by relying upon government guarantees only creates moral hazard incentives and behaviors and encourages increased risk taking. Again, it is the responsibility of management and bank supervisors to see that not only are losses identified, but also written off. So far all we have seen is serial loss identification and recognition, with no end in sight. No wonder institutions are having trouble funding themselves.

Step 3. Insolvent institutions must be closed, reorganized, recapitalized, and reprivatized.

Policy makers and regulators have been paralyzed by the fear of so-called systemic risk and by concerns that some institutions are "too –big –to fail." Note that I didn't suggest that institutions should be liquidated. What the Nordic countries did was to inject government capital into their major institutions, but only after losses had been identified and taken by shareholders. Management was replaced and a plan was put in place to reprivatize the institutions. Those institutions left standing were soundly capitalized for which there was no uncertainty about their financial condition. Only after losses have been recognized will the public and financial markets be assured that the existing institutions are healthy, regardless of whether they are privately owned or temporarily government owned. Confidence can be restored only by such actions. Unfortunately, this is not the path we have taken, and it now looks like we are bent on throwing good money after bad, under current proposals.

A Bad Bank as Proposed Is a Bad Idea

Current proposals to establish a “bad bank” that would buy, hold, and liquidate bad assets, perhaps in combination with additional guarantees of losses on retained assets, are likely to be expensive and not solve the fundamental problems. As it stands, the bad bank idea is nothing but reconstitution of the original idea in the TARP, with all its associated problems. The sticking point before was how to price the assets that are acquired, which boils down to loss sharing between the taxpayers and the institution’s debt and equity holders. Pay the current market value (or some very low price), and equity has to be written down, which risks forcing the institution into insolvency. Pay too much, and the taxpayer gets the loss. Then there is the problem of monitoring the asset maintenance and/or liquidation process, especially if some of the assets remain on bank balance sheets subject to loss guarantees. Granting loss guarantees is equivalent to letting people with no equity stake in their homes to continue to live there free. We know what that does to incentives to maintain the property.

One proposal being floated by the administration is to have the “bad bank” buy only assets that have written down. But someone isn’t thinking. If the assets have already been written down, then they are no longer bad assets, unless they haven't been written down enough. This would leave the selling bank with only the remaining questionable assets in which all the risks reside. This will do nothing to assuage market uncertainty about the viability or soundness of the institution, and hence will not restore the smooth functioning of the interbank market or lower risk spreads. Coupling the purchase of bad assets with a government guarantee would only create uncertainty about the quality of remaining assets on the books and the ability of the institution to go it on its own without continued government support. This is a band-aid covering up the wound. Guarantees also have the added problem that they imply there is no exit policy in place for removal of government support.

A "bad bank" only makes sense to hold assets after reorganization and recapitalization has already taken place. Existing shareholders would be wiped out, and questionable assets would be taken over and managed by the FDIC or some other entity, where true costs to the taxpayer can be scored and their performance monitored and assessed. Dividing a bank into a "good" bank and "bad" bank also avoids the accounting nuances that have served as a deterrent to loss recognition. Management and shareholders are then left with the sole responsibility for running the good bank, and presumably, taxpayers would be granted warrants and/or equity to participate in the upside as recovery occurs. It just isn't that hard!

Maiden Lane Losses

As we contemplate the prospects for more government support for financial institutions, it is useful to reflect on what lessons we can now glean from the performance of the portfolio the Federal Reserve acquired in assisting the acquisition of Bear Stearns by JPMorgan Chase through its sponsored LLC, Maiden Lane. At the hearings following the rescue before the Senate Banking Committee in April of 2008, Chairman Bernanke suggested that not only was the support of Bear Stearns's acquisition by JPMorgan Chase necessary to avoid a potential crippling disruption to financial markets, but the Fed might even make money on the deal.

Now, one might ask, what were the Fed's alternatives? Might it have struck a better deal? How much of the performance was the unforeseen consequence of the further decline in markets following the Lehman Brothers failure?

We can't really answer most of these questions, because of the lack of transparency going into the deal, how Bear was initially valued, how over-collateralized the transaction was, or how much was actually known about Bear's true condition. All we know about the portfolio is contained in Appendix II of then-NY Fed president Timothy Geithner's prepared remarks before the Senate Banking Committee on April 3, 2008. On the surface, it appeared to be of reasonable quality:

"The portfolio supporting the credit extensions consists largely of mortgage related assets. In particular, it includes cash assets as well as related hedges.

The cash assets consist of investment grade securities (i.e. securities rated BBB- or higher by at least one of the three principal credit rating agencies and no lower than that by the others) and residential or commercial mortgage loans classified as "performing". All of the assets are current as to principal and interest (as of March 14, 2008). All securities are domiciled and issued in the U.S. and denominated in U.S. dollars.

The portfolio consists of collateralized mortgage obligations

(CMOs), the majority of which are obligations of government-sponsored entities (GSEs), such as the Federal Home Loan Mortgage Corporation ("Freddie Mac"), as well as asset-backed securities, adjustable-rate mortgages, commercial mortgage-backed securities, non-GSE CMOs, collateralized bond obligations, and various other loan obligations."

The question we can address is, how has Maiden Lane done so far? The Fed reports on the net portfolio holdings and accrued interest and expenses for Maiden Lane each week in its H.4.1. release, "Factors Affecting Reserve Balances." The Fed discloses the net portfolio value based on quarterly revaluations of the assets in the portfolio, estimated as if they were sold on the valuation date in an orderly market, presumably done by the asset manager, BlackRock Financial Management. We don't know the specifics, though, of how the estimates were compiled. There have been three portfolio revaluations since the initial portfolio was set up, and these were as of June 30, 2008; September 30, 2008; and December 30, 2008.

So far the results aren't good, and there is no prospect for a profit on the assets. In fact, the portfolio has lost over 10% of its value, and losses are mounting. The attached chart details the reported performance of the portfolio from its inception. Included in the calculations are not only the value of the portfolio but also the accrued interest owed to both the Federal Reserve Bank of New York and JPMorgan Chase. Not included are the fees paid to the asset management company.

As part of the terms of the assistance provided, JPMorgan agreed to absorb the first $1 billion of losses. The chart shows that JPMorgan was in the hole for almost all of the $1 billion from the outset. The loss appeared to begin to shrink, based on the June 30 asset valuations. But the shocker occurred in October when the portfolio was revalued using September 30 valuations. Not only did JPMorgan lose all of the funds it had committed, but suddenly the taxpayer appeared to also be thrown into a substantial loss position of nearly $2.5 billion. Again, over the ensuing months, the loss situation seemed to moderate; but then the portfolio was finally revalued in the most recent H.4.1 release, and losses skyrocketed again. At present, losses now exceed $4.5 billion and the taxpayers' share is now $3.5 billion.

The declines in the net portfolio value probably reflect not only the deteriorating condition of the housing market, since most of the assets are housing related, but also reflects the likely optimistic valuation of the portfolio at the outset. The chart also suggests that most of the monthly reports on the performance of Maiden Lane are worthless, since changes in the market value of the portfolio are key to assessing where the entire transaction stands and what the taxpayer losses are.

Three conclusions suggest themselves from this analysis, that have implications for the kinds of transparency Congress should demand from policy makers in future bailout situations. First, without more detailed disclosure of the initial assets that were included in the deal, it was hard to even guess what the likely risks would be to the taxpayer under alternative economic scenarios. Second, meaningful reporting transparency requires more frequent valuation of the portfolio than quarterly, when markets are volatile and disrupted. Third, it clearly was the case that the transaction was not structured with adequate over-collateralization to protect the taxpayer from losses, given the downside economic risks that were perceived for housing-related assets at the time and that were also reflected in the Federal Reserve's own forecasts for the economy as a whole.

Managing Inflation Expectations and Motivating Economic Growth by Joseph R. Mason

The term “liquidity trap” originated with John Maynard Keynes in 1936 with the publication of his seminal work: “The General Theory of Employment, Interest, and Money.” Essentially a liquidity trap occurs when expansive monetary policy fails to stimulate the economy. Keynes wrote about when bond interest rates were so low that fear of an impending rise in rates motivated people to avoid holding bonds. In our modern times “liquidity trap” is used to describe the situation where the nominal interest rate is near zero. Implied is that monetary policy becomes impotent. Also, implied is that fiscal policy is needed in great quantity to derive stimulus because of the ineffectiveness of monetary policy. Joe Mason has honed skills in this area and has given us permission to offer our readers his recent commentary about the present US liquidity trap.

Joe Mason wrote:

A Rising Tide Lifts All Boats (that can Float)

Economists are still vexed by liquidity traps. The reason is that it is easy to see frictions in resolving bad assets, but difficult to see a way out. Right now, banks can’t afford to write off their full exposures to bad assets without additional capital, but banks also can’t afford to keep the assets on the balance sheet without even more capital because, without explicit recognition they are unable to credibly commit their exposure to the bad assets. Hence, banks don’t lend and economic growth stagnates.

The problem, however, is not just the banks but also what can be called the “unwitting” investors in the bad assets. In the Great Depression, regular bank depositors turned into unwitting long-term creditors overnight when banks failed without deposit insurance. Today, myriad banks and funds are prohibiting withdrawals (even against contractual terms) or paying out only “in-kind” in order to stem debilitating losses in a manner similar to the Great Depression. Even bank shareholders who thought they had blue-chip investments are finding out they held junk.

To wake up one day and find you had intended to invest in blue-chips but had really invested in junk is systemically problematic when you can’t withdraw your funds. When redemptions or sales are impossible because the market is flooded with junk, investors are stuck with maturities and risk grades they did not desire and are unable to reallocate their portfolios to their preferred characteristics, particularly investments issued by value-producing firms.

Government funds to take the assets off investors’ hands don’t help, either, only replacing the personal tax with an equivalent public fiscal burden. No matter how we distribute the loss, the aggregate amount of loss to the economy remains the same: the resulting liquidity trap substantially drags down economic growth.

The trap, however, is endemic in the “wait until tomorrow” approach that is so attractive in crises. Values slid from historic highs to today’s levels. The central bank has stepped in with accommodative measures, bringing rates to historic lows. Economic growth is right around the corner. So investors wait… and wait… and wait. But growth never comes. Why?

The answer proposed in my own research[1] is that the cost of waiting has been reduced by the central bank to almost zero. Without a traditional market cost of waiting, investors’ money remains tied up in bad assets. With zero interest rates and no economic growth, deflationary expectations arise and begin to be priced into financial contracts. The liquidity trap does not respond to traditional interest rate cuts because investors' behavior is working for them. Hence, exit from the liquidity trap requires changing investors' incentives.

The goal should be to put bad assets to investors willing and able to make use of them, particularly deep pockets investors (with a lot of long-term cash) that know how to extract value out of the assets. The sentiment is similar to that espoused by Ben Bernanke in his famous "Non-monetary Effects…" paper: Bernanke (1983, p. 272) surmised that as "…a matter of theory, the duration of the credit effects … depends on the amount of time it takes to (1) establish new or revive old channels of credit flow after a major disruption and (2) rehabilitate insolvent debtors." In practice, Bernanke seems to be attempting to "establish new channels," but the only attempt at "rehabilitation" seems to be mortgage modification. In my opinion, "establishing new and reviving old credit channels," will follow "rehabilitation" if "rehabilitation" is carried out completely and targeted at the right group of debtors.

So how do we get the assets from the current "unwitting" investors to the vulture investors who know how to remediate credit and rehabilitate borrowers? The government could buy the assets and subsidize the reallocation but that is bound to be horribly inefficient. Furthermore, if investors thought they could get a better price later – from the government or the market –they still face the zero cost of waiting.

Perhaps it is better to raise the cost of waiting by reflating interest rates. That means credibly committing to an inflationary bias in order to get investments out of the hands of "unwitting" investors and into the hands of vulture specialists that have the means and capability of managing bad assets. With the cash received, previously "unwitting" investors can reallocate their portfolios to value-producing firms rather than facing the potential for further valuedestruction in their present portfolios. When value-destroying firms lock up markets, they drag the economy down with them. When value-producing firms raise funds, they exert a powerful force for economic growth.[2]

The new administration has a unique opportunity support value-producing firms by promoting reflation now. Timothy Geithner, having spent considerable time inside the Federal Reserve System and having worked directly with Bernanke already, may have the ability to creatively pursue coordinated Treasury and Federal Reserve actions not seen since the Fed-Treasury Accord of 1951, which affirmed the Fed's staunch independence from Treasury.[3] While I would not normally suggest the breakdown of central bank independence and the strategy carries with it risks of whether the Fed can effectively de-politicize itself on the other side of the crisis, the strategy allows the Fed to maintain short-term rates at their current low levels while the Treasury swaps out or repurchases TIPs and assembles its financing for the higher inflation to follow. By generating inflationary expectations in such a manner, the Fed avoids further embedding the zero-rate liquidity trap problem in longer-term markets through the proposed purchase of longer maturity paper and can stop overextending their balance sheet to fund troubled asset liquidity programs that, themselves, threaten not just the central bank's independence, but continued viability.

In summary dealing effectively with liquidity traps vexes even the best economists. Agencies like Treasury do not maintain significant staffs of economists devoted to understanding and dealing with today's crisis, but they do possess policy tools that can be used to fight the crisis. The Federal Reserve, on the other hand, possesses vast economic knowledge and creative thought about the crisis, but its tools for dealing with financial exigencies such as this are limited. Coordination between Treasury and the Federal Reserve can therefore augment the Federal Reserve's very limited toolbox for affecting inflation expectations. We need to incentivize the shift of bad assets from general investors to specialists by increasing inflation expectations. Treasury policies like a TIPs buyback or swap could be a powerful means of shaping expectations in the near term, incentivizing Bernanke’s resuscitation of “…channels of credit flow after a major disruption and …rehabilitat[ion of] insolvent debtors.”

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[1] *“A Real Options Approach to Bankruptcy Costs: Evidence from Failed Commercial Banks during the 1990s.” Journal of Business, July 2005 (79:3), pp. 1523-53. “Bank Asset Liquidation and the Propagation of the Great Depression,” (with Ali Anari and James Kolari). Journal of Money, Credit, and Banking, August 2005 (37:4), pp. 753-773.*

[2] *Indeed, Japan’s economic growth only began to take off when it pursued a reflation program, albeit nearly a decade after their crisis began.*

[3] *Prior to that time, the Fed agreed with Treasury that the primary emphasis, for funding WWI, the Great Depression programs, and WWII, was to keep Treasury borrowing rates low.*

Pondering Madoff as you Choose Auditors by

Friehling & Horowitz was the accounting firm that supposedly performed the audits of Bernie Madoff's alleged Ponzi apparatus. The report of due diligence done by an investigator from Aksia helped steer that company clear of doing business with Madoff. Their recommendation was based, in part, on the findings about the Madoff's auditor. As part of our research we asked a longtime friend, Jack Blumenthal, about the standards of audits and if adherence to those standards would have kept someone from using Madoff. Jack was kind enough to write this contribution which we offer to our readers.

Jack Blumenthal wrote:

As we now know, Madoff is a firm that was audited by a three person C.P.A. firm which performed no other audits than Madoff's. Would a competent auditor have uncovered the fraud? An audit of financial statements does not guarantee that fraud will be uncovered, but using a competent audit firm increases the probability of uncovering fraud if it does exist.

First the Structural Issues.

Independent Peer Reviews:

44 of the 50 states have regulations which require that in order to perform audits a C.P.A. firm must have a peer review of its audit practice by an independent C.P.A. firm. Unfortunately, New York State, at the time, did not require this.

Peer reviews of audit practices have been administered under the auspices of the American Institute of CPA's for more than twenty years. A peer review consists of outside auditors from other firms, approved by the AICPA, paid for by the subject firm, inspecting the quality control over audit processes, procedures and a sample of actual engagement files together with evaluating the governance of the firm. The resulting peer review formal report is a public document which can be obtained from the AICPA or from the reviewed audit firm. Peer reviews are conducted every three years and although mandatory in 44 states, it is done voluntarily by firms in the six states that do not currently require them.

Public Company Accounting Oversight Board (PCAOB) Inspections:

As an outgrowth of Enron, the SEC established the PCAOB to oversee the quality of audit firms which audit public companies. As part of this process, the PCAOB conducts quality audits of C.P.A. firms which audit publicly held companies. Although considered, the PCAOB does not currently require PCAOB inspection of C.P.A. firms which audit brokerage or other regulated financial firms, unless they are publically owned.

These inspections are conducted by former audit partners or managers who work full time for and are paid by the PCAOB. These inspections, while they focus on audits of publically held clients, also cover the quality control and governance of these firms, including independent, professional staff training and performance procedures, adherence imposed by the PCAOB, as well as an audit of a sample of audit engagements.

Like peer review reports, the reports on each PCAOB inspections are also public information.

How Do These Inspections Impact a C.P.A. Firm’s Professional Behavior?

Given the competitive business pressures on C.P.A. firms, no firm which is thus regulated can afford to have an adverse opinion and stay in the audit business or continue to provide audits to publically held companies. Firms which have unqualified inspections, communicate this to their clients, prospective clients, and users of their audit opinion. The results also impact recruiting and retention of quality professionals who view this as an important factor in developing their professional careers.

With respect to our firm, the importance of having clean peer reviewed PCAOB reports incents us to establish, enhance, and adhere to every aspect of our quality control, governance and engagement conduct. It encourages every principal to dot every "i" and cross every "t", knowing that every engagement and all processes are subject to an independent set of eyes scrutinizing and reporting on everything we do.

So What to Do?

Before investing in a private and unregistered investment entity, ask whether the vehicle is audited and whether the auditor is a PCAOB audit firm. Any security that is registered with the Securities and Exchange Commission (SEC) is likely to meet this test. Had you followed this procedure, you would not have placed any money with Madoff. To obtain the PCAOB report on a CPA firm go to
www.pcaobus.org, click on inspections, and click on the firm name.

About the author:

Jack Blumenthal is a Principal at Causey Demgen & Moore Inc., a PCAOB member firm. Mr. Blumenthal leads the firm's financial services industry practice which serves clients throughout the U.S. He can be reached at jblumen@cdmcpa.com or at (303) 672-9890.

We thank Jack Blumenthal for his guest contribution to our website. We note that Cumberland Advisors follows the advice outlined here. Our own auditor handles public companies and falls under these rules. And we only use listed securities for our clients and thus have the publicly owned standard applying to them.

2008 Muni Madness: The Movie

“Education is what’s left after everything learned at school has been forgotten.” – Albert Einstein

It was that type of year in tax-free municipal bonds, as most of the assumptions that investors and portfolio managers have made for years were thrown up in the air. We are completing a year which has seen high-grade municipal bonds yielding 200% of US Treasury yields, two episodes of massive municipal bond hedge fund blowups, most municipal bond insurers’ ratings downgraded, insurers ceasing to be a force in the market, a total collapse of Wall Street Liquidity supporting the market and, recently, massive supply. All of this amidst the stock market meltdown and various federal bailouts. We will review these forces at work in a market that Cumberland Advisors still feels represents a terrific opportunity in tax-free bonds.

Wall Street liquidity

We first noticed the drop in Wall Street liquidity in relation to the municipal bond market in the fall of 2007, as concerns about balance sheets and subprime exposure began. This was the first instance of tax-free bond yields rising above longer US Treasury yields. Clearly this liquidity situation became dramatically worse with Bear Stearns being taken over by JPMorgan, Merrill Lynch being absorbed by Bank of America, Lehman Brothers declaring bankruptcy, UBS closing their public finance department, and Wachovia awaiting absorption by Wells Fargo. Smaller dealers have not been immune to this drop in liquidity, either. The result has been, with few exceptions, a market which has had to rely on the bid from retail investors – which can often be very strong but which is overwhelmed in the face of hedge fund liquidations or huge supply. Some of this drop-off in street liquidity is being replaced by some nontraditional sources: pension funds, state and local governments, foreign buyers, and charitable foundations. None of these groups benefit from the tax-exempt nature of municipal bonds. But the absolute cheapness of the market is attracting these buyers on a long-term total-return basis – especially when the credit quality of municipals is compared to that of corporate securities.

Insurers

	BOND INSURANCE RATINGS					
	as of January 17, 2008			as of January 5, 2009		
	Moody’s	S&P	Fitch	Moody’s	S&P	Fitch
AMBAC	Aaa	AAA	AAA	Baa1	A	AAA
Assured Guaranty	Aaa	AAA	AAA	Aa2	AAA	NR
CIFG	Aaa	AAA	AAA	B3	B	NR
FGIC	Aaa	AAA	AAA	Caa1	CCC	NR
FSA	Aaa	AAA	AAA	Aa3	AAA	AAA
MBIA	Aaa	AA	AAA	Baa1	AAA	NR
XLCA	Aaa	AAA	AAA	Caa1	B	NR
Radian	Aa3	AA	A+	A3	BBB+	NR
ACA	NR	CCC	NR	NR	NR	NR
Berkshire Hathaway				Aaa	AAA	NR

The chart above shows the ratings of the various insurers at the end of 2007 and where they are now. The drop is dramatic and reflects two main themes: (1) The rating agencies’ request that insurers raise more capital in the face of the drop-off in the market value of mortgage-backed securities that they insured and (2) the rating agencies’ opinion of a bleak outlook for municipal bond insurance in general.

The drop in market value of the mortgage-backed securities that the insurers backed has been dramatic, reflecting the liquidity of this class and, to a lesser degree, the outright default rate to date of these securities. Many of the insurers did in fact raise capital, but not to the satisfaction of the rating agencies. The downgrades of the insurers have also triggered covenants in certain swap agreements, requiring the insurers to post more collateral. This has exacerbated an already troubled situation. As for the downgrading related to prospects for the industry (cited often as a reason for recent downgrades), we feel this is in part a self-fulfilling prophecy on the part of the rating agencies. This year has also seen Berkshire Hathaway and the Macquarie Group of Australia announce the new entry into the municipal market of a new insurer of AAA-rated bonds. Thus these groups clearly see an opportunity (caused in no small part by the rating agencies' downgrades of other insurers). In any case, insurance coverage by all insurers with the exception of Berkshire, and to a lesser extent the combined Assured/FSA, has been rendered moot by the market. Insurance is still in force, of course, but the bond market treats bonds with insurance on all but the aforementioned as if they had none and are instead pricing bonds off the underlying ratings. This process has been exacerbated since MBIA and AMBAC were downgraded by Moody's to BAA1 early in November.

This has really created a municipal bond universe of haves and have nots. Bonds with denigrated insurers and weaker underlying ratings have seen their market values lowered and have not participated in what has been a rally in municipals in January. Bonds insured by Assured Guaranty, FSA, or Berkshire Hathaway have participated in this rally, but clearly high-grade bonds with AA or higher ratings on their own have performed the best. We are now witnessing the market phenomenon of seeing issues with no insurance out-trade the VERY SAME bond issues which have insurance – though downgraded. Thus the market is treating the existence of one of the denigrated insurers as a net NEGATIVE impact on the pricing of bonds. This is an unusual development indeed, and we feel it represents some value.

Overall Muni Cheapness

Source: Bloomberg

We have published the above graph a number of times this year. It shows the difference in yields between the thirty-year US Treasury bond and the Bond Buyer 40, a long-maturity index of mostly AA and higher-rated tax-free bonds. Normally, the yield on tax-free bonds has been below that of Treasuries, for the main reason of Federal tax exemption of income. This year has seen a dramatic about-face: blowups of municipal bond hedge funds in February, and then later in October, were precipitated by municipal insurer downgrades in February and the Lehman Brothers bankruptcy in October. We thought the point of absurdity had been reached in mid-October, in the midst of hedge fund selling, when the yield gap between the thirty-year US Treasury and the Bond Buyer 40 reached 250 basis points. That was eclipsed in December with the gap climbing to over 350 basis points. The further gapping between these two markets was due to a drop in long Treasury yields caused by what we think is outright buying of US Treasuries by the Federal Reserve in an effort to lower long-term interest rates and hence mortgage rates. At the same time, long tax-free rates headed higher through a combination of events. High-yield bond funds saw a lot of redemptions and were selling many A-rated and BBB bonds, pushing yields on those instruments much higher and dragging better-quality bond yields higher as well. Since then there has been a dramatic about-face in the municipal market, with a vigorous price rally and drop in muni yields similar to that in October. This has been due to a number of factors: a market realization that yields had become distended, renewed institutional buying as year-end rollover of coupons and maturing bonds combined with flows into municipal bond funds to form a wedge of demand, and the overall collapse of short-term interest rates, forcing investors in to longer-dated paper. In addition, there was recognition that the new administration will a have a stimulus program that includes state and local governments, thus lowering some of the default concerns which had been present last December in the muni market. Bottom line: munis, though less cheap than in December, are still a bargain, with plenty of room for price appreciation.

Looking Ahead in 2009

Source: Bloomberg

Supply has picked up recently as issuers who had the flexibility and avoided coming to market in mid to late December are lining up now that yields are less distended. Bulges of supply should be looked upon as opportunities. Overall supply is clearly at a higher sustained level than two years ago – and issuers are seeking access to the capital markets now that rates have dropped.

Creditworthiness will continue to be important. General-obligation and essential-service revenue bonds will continue to garner most of the interest, and we expect it will take a while for the high-yield municipal bond market to recover. That is more of a story for 2010.

Higher-coupon bonds (5.5% or higher) that were issued in 2008 at various times are excellent candidates to be prerefunded by their issuers when overall interest rates in tax-exempt bonds move down. Bonds that get prerefunded to call dates in 2017-19 will have terrific upsides in price appreciation, both from the steepness of the yield curve as bonds move to being priced to their call dates, as well as the inexorable pick-up in credit quality from the defeasance in US Treasuries. Thus, "cushion bonds" are excellent municipal investments, especially as the relative values of municipals and Treasuries move back to a more normal environment.

State and local Governments will benefit from the House stimulus package. This includes direct aid, infrastructure programs, aid for schools, unemployment insurance payments, and an increase in Medicaid matching grants. There is no question that state and local governments will be under pressure in 2009. However, as Cumberland Advisors has stated before, we DO NOT believe that we are having a repeat of the 1930s depression: both monetary and fiscal stimulus are much higher and at faster response levels than in the ’30s.

Bottom line: the turmoil of 2008 has created the opportunity of 2009.

Today’s Fed Statement

Excerpt from today’s Fed statement:

“The focus of the Committee’s policy is to support the functioning of financial markets and stimulate the economy through open market operations and other measures that are likely to keep the size of the Federal Reserve’s balance sheet at a high level. The Federal Reserve continues to purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand the quantity of such purchases and the duration of the purchase program as conditions warrant. The Committee also is prepared to purchase longer-term Treasury securities if evolving circumstances indicate that such transactions would be particularly effective in improving conditions in private credit markets.”

Translation of key words follows.

“Open market operations” means the Fed will print money (expand the liability side of our balance sheet) and buy these securities through the primary dealers. We will do so for our own System Open Market Account (SOMA). We are prepared to hold them. This is the traditional form of monetary policy and has usually been focused on short-term treasuries.

The "size" of the Fed's balance sheet has tripled in a matter of weeks (see www.cumber.com). The Fed has been targeting the asset side with its special facilities. The liability side of the balance sheet is the electronic equivalent of the printing of money to buy the assets.

"Purchase large quantities of agency debt and mortgage-backed securities" means, the Fed will go into the mortgage finance market and do whatever it takes to drive the mortgage interest rate lower. The Fed is in partners with the Treasury and Fannie and Freddie in trying to implement a 4.5% conforming mortgage interest rate. The Fed has unlimited power to direct newly created money to this sector. We believe they will succeed.

"Purchase longer-term Treasury securities" means the Fed is broadcasting that it is willing to buy and hold longer-term Treasury notes and bonds. This means the Fed is targeting two points on the yield curve. They are targeting the short-term rate (Fed Funds) and a longer-term rate (Treasury notes). Once it is established that the Fed is targeting two points on the yield curve, one can quickly determine all the other points on the yield curve.

This last item is very important. It says that the Fed will do what it needs to do to keep any inflation expectation from creeping into the pricing of longer-term Treasury notes and bonds. The Fed is now transparent about this policy and wants to remove any market-driven guesswork. We can expect Treasury bill rates in the US to remain between zero and something above zero, but under 1%, in the shorter-term sector for a while. We define "a while" as most, if not all, of 2009, and maybe into 2010. We can also now expect the longer-term Treasury notes (10-year for reference) to trade at yields somewhere between 2% on the low side and 3% on the high side, with 2.5% a good estimate of the average. The Fed is trying to tell the market that this rate, too, will be maintained for a while.

Now that the Fed is defining the range of the yield curve, financial agents can quickly determine where they want to take risk and how to price it. Cumberland's strategy is to place bond positions in the longer end of the term structure and to focus on spread product. We are buying longer-term tax-free municipal bonds and taxable bonds of investment-grade quality. We believe that these spreads will narrow to treasuries over time, as the Fed continues to hold this policy in place.

The Fed is inviting investors to take risk. They are encouraging agents to move their money from the zero interest rate on cash to something else. At Cumberland we are doing just that for our clients.

Why Secretary Geithner's China Comments Matter

Treasury Secretary Geithner's comments at his confirmation hearing and subsequent responses to written questions from Senators have provoked surprise and consternation here, in China, and around the world. His comments went far beyond his own personal views when he stated that the Obama administration believes that the Chinese government has engaged in currency manipulation. Why would the administration deliberately pick that moment to intentionally slight the Chinese government? It is clear that this slight was not, like forgetting to pay taxes, an “innocent mistake.”

What has gotten somewhat lost in the turmoil over these remarks is that this was not a “slip” by an inexperienced person. Regardless of what one thinks about the economic credentials that Secretary Geithner brings to the job, he does have credentials when it comes to international relations, and especially China and the Far East. He served as Undersecretary of the Treasury for International Affairs and was director of the Policy Development and Review Department at the International Monetary Fund. In terms of degrees, his bachelor’s degree is in government and Asian studies, and his master’s degree is from Johns Hopkins School of Advanced International Studies, in international economics and East Asian studies. In addition, he has studied both Japanese and Chinese and has lived in East Africa, India, Thailand, China, and Japan.

This is not the background of someone who would fail to understand the import of his remarks. He, above all, should have realized that the carefully worded statement would send a strong message. This means that either he actually believes that the slight was worth the potential costs, or else he may have warned against how the response would be received, but was ignored. Either way, we should be concerned.

Consultation versus Confrontation with China

The first move by the Obama economic team in the delicate area of international economic and financial relations is a serious misstep, in our view. The counterparts in China to Treasury

Secretary designee Tim Geithner and the head of the National Economic Council, Larry Summers, were confronted at the end of last week with the following statement (repeated twice) in a written submission by Geithner to the US Senate Finance Committee:

“President Obama – backed by the conclusions of a broad range of economists – believes that China is manipulating its currency. President Obama has pledged as President to use aggressively all the diplomatic avenues open to him to seek change in China’s currency practices.”

This statement takes an issue central to the US – Chinese commercial and financial relations, which have been handled with considerable finesse by former Treasury Secretary Paulson – and moves it from thoughtful consultations to “aggressive diplomacy”, in other words, confrontation.

The Chinese are familiar, from the Clinton era, with the blunt, undiplomatic style of Larry Summers but probably still were surprised to receive this shot across their bow in the opening days of the Obama Presidency. While this may play well among the more protectionist-leaning politicians in the US, it risks seriously undermining our relations with a major trading and investment partner at a critical time for our economy. It is ironic, as well as disturbing, that an administration that has the stated intention to move the US from a confrontational approach to more effective diplomacy in the foreign policy arena should veer off in the opposite direction in international economic relations.

There is no debating the fact that China has a managed exchange rate. China’s fears about moving all the way to a freely floating currency are not without some merit. The Chinese financial and regulatory system still is not up to advanced-economy standards. The consultations between China and the US on this issue have focused, rather, on the (managed) speed of appreciation of the Chinese currency, with the US urging faster appreciation in view of the apparent undervaluation of the Yuan. These consultations have been part of the “US-China Strategic Economic Dialogue,” recognized on both sides of the Pacific as a successful framework for US-China discussions. We hope the Obama team will continue this dialogue. There is little evidence in history of belligerency and confrontation yielding positive results. Rather, in this case, they risk affecting the willingness of China to continue to accumulate US securities, essential for the financing of our huge and growing debt, while stoking dangerous protectionist sentiments in the US. Following the example of the Smoot-Hawley Act of 1930 would be the surest way to turn the current serious recession into a depression.

Finally, we would note that a stronger Chinese currency would not necessarily mean a dramatic improvement in the US- China balance of trade. Many Chinese firms are likely to have considerable scope to absorb the impact of a stronger currency. They weathered an overnight 30% revaluation during the Asian crisis and emerged in good shape. Moreover, their costs of imported raw materials would be lowered by currency revaluation. Industries where margins are tight in China are being phased out, in any event, and are moving to lower-cost countries such as Viet Nam.

While the Obama team should continue the currency consultations and encourage the Chinese to move in a direction that would be in the long-term interests of China as well as the global economy, the Strategic Economic Dialogue should give at least equal emphasis to encouraging efforts to promote domestic consumption and to pressing for further opening of Chinese markets. These efforts should be backed up by effective use of the World Trade Organization to hold the Chinese to their WTO commitments..