

Fourth Quarter 2008 Knowledge College

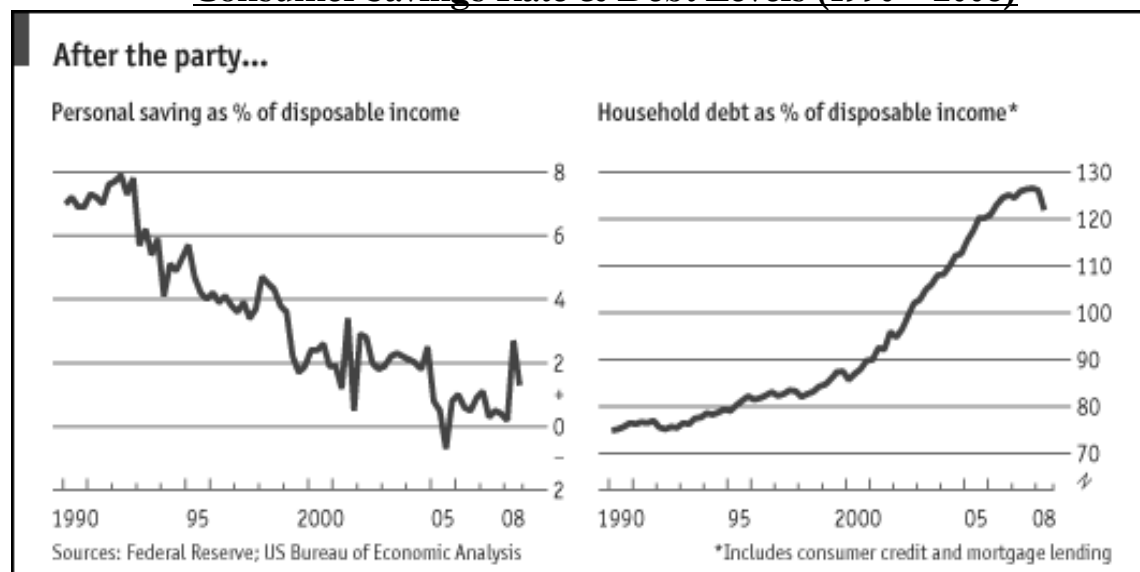
All Hand on Deck at The Fed and Treasury

2008's financial turmoil led to unprecedented government intervention into the capital markets. With a crumbling housing market, shattered confidence, a banking system on life support, a deep credit freeze, and an accelerating recession, politicians and policy makers are determined to buttress the most severe financial crisis since the 1930s.

How Did We Get Here?

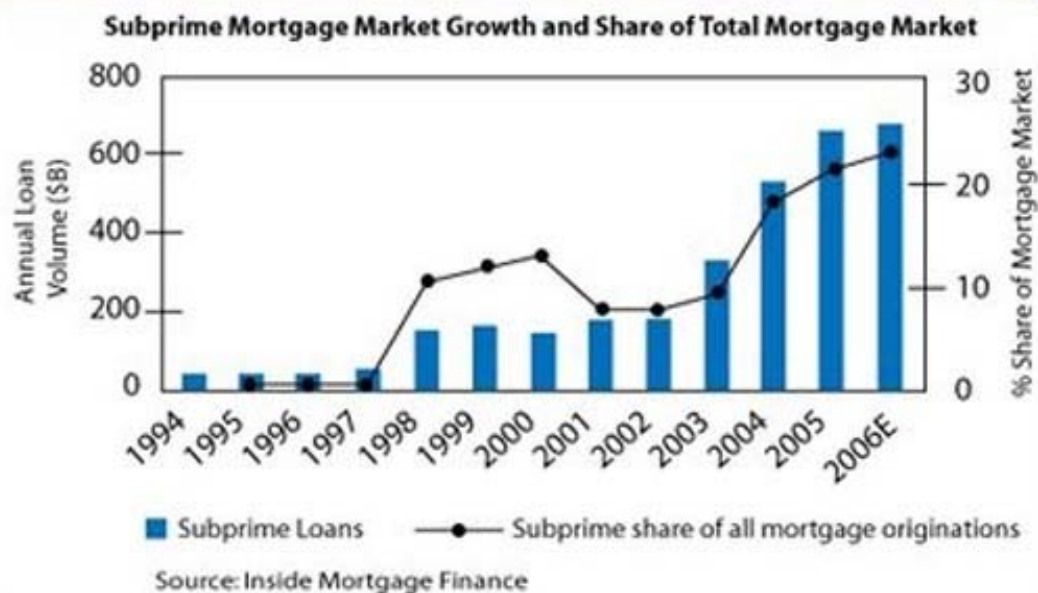
- ✓ **Consumer Savings & Debt:** Torrid spending by the American consumer finally hit a tipping point in 2008. From 1950 to 1985, the American consumer saved 9% of their average disposable income and average household debt as a percentage of disposable income was 77%. By 2008, the savings rate had declined to (virtually) zero with household debt peaking at 127% of disposable income. With nowhere to go but up, an era of a declining consumer savings rate came to an abrupt end in 2008.

Consumer Savings Rate & Debt Levels (1990 – 2008)



- ✓ **Home Finance Innovation:** Mortgage innovation, aided by securitization, lax regulatory oversight, real estate speculators, creative mortgage structures (i.e., interest only ARMs, negative amortization, etc.), and a political climate promoting an “ownership society” all conspired to promote an irresponsible binge in home mortgage debt that drove unsustainable real estate values. As housing prices boomed, they required ongoing (ultimately unsustainable) easing of credit to sustain the Ponzi process. Over the last ten years, the use of subprime and Alt-A loans grew from approximately 3% to over 20% of the overall mortgage market. The deterioration of credit standards was particularly strong between 2004 and 2006.

Primed for Disaster



Two Bear Stearns Hedge Funds Collapse

- ✓ On July 31, 2007, two Bear Stearns hedge funds that bet heavily on subprime mortgages collapsed and filed for Chapter 15 bankruptcy. These collapses were an early preview of what was to come in 2008.

Bear Stearns Bailout

- ✓ On March 14, 2008, the Federal Reserve along with JP Morgan Chase intervened with a \$29 billion bailout which prevented an imminent bankruptcy filing. Bear Stearns was later acquired by JP Morgan Chase on March 17, 2008, with the assistance of the Fed.

Fannie Mae & Freddie Mac Bailout



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On September 7, 2008, the U.S. Treasury placed mortgage giants, Fannie Mae and Freddie Mac into conservatorship. This was done to protect the financial soundness of the two companies, limit systemic risks, and to sustain affordable mortgage credit.

Lehman Brothers Files Bankruptcy

- ✓ On September 15, 2008, after unsuccessfully trying to find a buyer, Lehman Brothers filed for Chapter 11 bankruptcy protection. The day before, Merrill Lynch agreed to sell itself to Bank of America for \$50 billion.

AIG Intervention

- ✓ On September 16, 2008, the U.S. Government seized control of AIG and put into effect a plan that would allocate over \$100 billion to capital investments, bridge loans, and mortgage-backed and commercial paper purchases to bail out the world's largest insurance company.

Money Market Guarantees

- ✓ On September 19, 2008, after a major "run" on money market funds stoked by the Lehman bankruptcy, the U.S. Treasury announced a voluntary insurance plan to insure up to \$3.5 trillion in money markets.
- ✓ Later, on October 7, 2008, The Federal Reserve Board announced the creation of the Commercial Paper Funding Facility, extending its efforts to provide liquidity to corporations struggling to get loans from banks.

Troubled Asset Relief Program (TARP)

- ✓ On October 3, 2008, Congress approved the Emergency Economic Stabilization Act of 2008 to fund the Treasury Department with up to \$700 billion to buy mortgage-backed securities and other troubled assets on bank balance sheets. The Treasury Department immediately received \$250 billion to begin the program with an added \$100 billion available if the President deemed it necessary. An additional \$350 billion would be provided if the President and Congress approved the funding.
- ✓ On October 14, 2008, Henry Paulson declared revisions to the TARP program and stated that the first \$250 billion would be used to buy equity stakes in banks. This new capital was designed to boost bank lending. However, there is little evidence that lending increased as banks continue to hoard cash.
- ✓ This bill also increased the Federal Deposit Insurance Corporation limits from \$100,000 per account to \$250,000 until December 31, 2009.

Liquidity Guarantee Program

- ✓ On November 21, 2008, the FDIC agreed to guarantee newly issued bank bonds with maturities greater than three months. This was another effort to provide much needed liquidity to the credit markets and financing for banks.

GSE Mortgage-Backed Securities Purchases

- ✓ On November 25, 2008, the Federal Reserve announced it would purchase up to \$500 billion of direct obligations and mortgage-backed securities of government-sponsored enterprises Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Term Asset-Backed Securities Loan Facility

- ✓ On November 25, 2008, the Federal Reserve announced it would purchase up to \$200 billion of certain AAA asset-backed securities, thus creating the Term Asset-Backed Securities Loan Facility. This resource is intended to help market participants meet the credit needs of consumers by supporting the issuance of debt collateralized by student loans, credit card loans, and auto loans.

Fed Funds Rate

- ✓ From June, 2006 to October, 2008, the Fed Funds rate (the targeted overnight lending rate charged by one financial institution to another) had been lowered from 5.25% to 1.00%. The most recent cut on December 16, 2008 dropped this rate essentially to zero (0.00 - 0.25%).

The Big Three

- ✓ On December 19, 2008, despite the Senate's initial rejection, President George W. Bush authorized \$17 billion as a bridge loan to Chrysler and General Motors that would be made available from TARP funds. Any additional funding would be at the discretion of President-elect Barack Obama and the new administration.

The Fed's Balance Sheet

- ✓ In the fourth quarter of 2008 alone, the Federal Reserve, through open market operations, expanded its balance sheet approximately 2.5 times from \$933 billion to \$2.3 trillion. There was the \$600 billion money market guarantee, the \$1.4 trillion program to buy commercial paper, the \$200 billion asset-backed securities purchasing program, the \$500 billion mortgage-backed securities purchasing program and the \$100 billion program to buy Fannie and Freddie debt.

Balance Sheet of the Federal Reserve		
(Based on end-of-week values, in \$Billions). Source: Federal Reserve Release H.4.1.		
	12/05/07	12/17/08
Securities	779.7	493.8
Repos	46.5	80.0
Loans	2.1	1039.9
Other	92.0	733.0
Factors supplying reserve funds (Assets)	920.4	2346.7
Currency in circulation	819.3	877.7
Reverse Repos	36.7	71.9
Treasury accounts	5.1	484.6
Service and reserve balances	16.0	801.8
Other	43.4	110.7
Factors absorbing reserve funds (Liabilities)	920.4	2346.7
Off balance sheet		
Securities Lent to dealers	4.5	186.5

Looking Forward



“There is no doubt that the cost of this plan will be considerable. It will certainly add to the budget deficit in the short-term. But equally certain are the consequences of doing too little or nothing at all, for that will lead to an even greater deficit of jobs, incomes, and confidence in our economy.”

- President-elect Barack Obama, January 8, 2009.

- ✓ President-elect Barack Obama’s estimated \$775 billion stimulus plan (the American Recovery and Reinvestment Act) focuses mainly on job creation and consumer spending through infrastructure and tax relief.
- ✓ Infrastructure: The new administration plans to create jobs that can not be outsourced by directing funding to highways, bridges, energy conservation, etc.
- ✓ Taxes: Roughly 40% (\$310 billion) of the stimulus plan focuses on tax cuts and potential rebates for U.S. citizens. Businesses will also be allowed to write-off expenditures, and will have incentive to hire and retain employees.
- ✓ There will also be funding provided for education in the form of grants and student loans, as well as funding to provide healthcare to the uninsured and to update medical records and facilities.

A Historical Perspective

- ✓ World War II expenditures were estimated at \$341 billion (in 1940's dollars) which represented approximately 47% of total GDP on an averaged annualized basis spanning December 1941 – August 1945 (or approximately 3.7 years).
Note: Annual GDP (in Billions) between 1942–1945 was \$161.9 (1942), \$198.6 (1943), \$219.8 (1944), and \$223.1(1945).

- ✓ \$2.7 trillion in 2008 rescue spending represents approximately 20% of 2007's GDP (\$13.8 trillion).
Note: \$2.7 trillion includes new Federal Reserve open market activities and new U.S. Treasury investments & expenditures (including 2008 tax rebates).

- ✓ In order to match World War II's spending rate (as a percent of GDP), we would need to spend approximately \$6.5 trillion per year over the next 3 years on stimulus and/or rescues.