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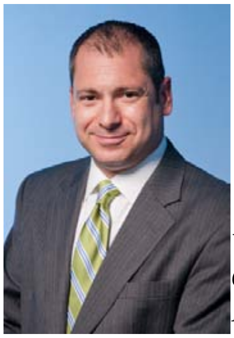

Written by Mitchell O. Goldberg, September 19, 2008.
ClientFirst Strategy, Inc.
For immediate release.

The Game Changer

This is the simple sum of this week in the markets…

And the only one you need!

The news from the Treasury regarding the formation of a new Resolution Trust Corporation is THE game changer for this haywire market! From now on I'll refer to it as RTC2 until the Treasury and Congress comes up with an official name.

1. Here's the NIGHTMARE scenario that the FED was worried about and tried desperately to stop. Investors need to understand this in order to realize the significance of RTC2.

The Fed was petrified of counter party risk. If an investment bank leverages its balance sheet, let's say, 100 to 1, and if the assets on the bank's balance sheet go down just a little, the bank will have to write down the value of the decline in the asset price. This is similar to a margin call for retail investors. If the investment bank does not have the cash on hand IMMEDIATELY for the write down, it will face an IMMEDIATE liquidity problem. You see, when you are highly leveraged, you have no room for error.

An example of leverage, for the uninitiated, would be if an investment bank put up 700 Million Dollars on its balance sheet to buy 70 Billion Dollars worth of Mortgage Backed Securities, a drop of only 700 Mil, or 1%, would create a write down and wipe out the original capital (700 Mil) that was put up for the 70 Bil of mortgage backed securities. Investment banks do this because this way is infinitely more profitable than just working off the original 700 Mil base. Get it? It's great when it works. When it stopped working, it infected the entire world.

Now, let's say that the investment bank in this example gets hit with a big write down and it doesn't have the cash immediately (because it underestimated the volatility of the leveraged securities on its balance sheet). The banks that leveraged their own balance sheets to help the investment bank leverage up are the ones who now are on the hook for the write down. Do you see how the "write down fever" just spread to a bunch more banks? Now these new banks in question have to go to yet other banks that leveraged their own balance sheets in order to help leverage the original banks that leveraged up the investment bank! Again, the "write down fever" spread to a bunch more banks. This domino effect is what the Fed so desperately needed to stop – a death spiral taking down the global financial system. Due to global financial connectivity; Central Bankers globally were under intensifying pressure – and scared. Alas, this is the nightmare situation. The Fed hoped to stop it with the engineered JP Morgan takeover of Bear Stearns last March. Eventually, this "write off fever" led to the failure of Lehman and this is why Bank of America had to rescue Merrill Lynch. This is why AIG, with 1 Trillion Dollars of tangled global leveraged connectivity on its balance sheet, was too big to fail.

And once these banks sell out of these securities, the price is driven even lower; creating another fresh round of more write downs. Required "mark to market" accounting principles for financial services companies were constantly barraging a growing list of problematic balance sheets. Sorry for the long winded technical analysis! But you must know the dangers we were faced with in order to fully understand RTC2.

2. Here's how RTC2 removes the nightmare situation:

~It removes the junk form the bank balance sheets. The banks can now stop hoarding their cash for future write downs and actually start lending again!

~This will unfreeze the credit markets. Consumers will once again be able to get loans.

~This will clean up the gigantic glut of unsold homes, automobiles, and appliances.

~Housing and bank related jobs can come back.

~It will help reduce the number of upcoming bank failures.

~It will remove the tremendous selling pressure from mortgage backed securities and commercial paper.

~It will insure money market accounts.

~It will negate to a large degree the yet to be reported horrible 3rd quarter earnings season.

Had this news come out last week, Lehman, Merrill, Fannie Mae, Freddie Mac, AIG and others may have survived in their previous form. Since these firms helped propagate this mess, it is only fitting that the order of events worked out this way. Some of these names will go into the dust bin of formerly venerable names like Drexel Burnham Lambert – the ’89-’91 bankruptcy of that period.

Yes, a game changer indeed. I’m not declaring an end to rough days on Wall Street or Main Street, but we are at a point when we can once again have confidence that long term investors can be rewarded instead of constantly getting another kick in the pants.

3. Conclusion:

I’ve made references in my previous articles to the ’89-’91 time frame and how the current financial environment is, in my opinion, so similar. Today’s RTC2 news will most likely take at least a few months to sort out, but its coming and for now, that’s good enough to help.

I’ll copy and paste from previous articles that I’ve written this past July and August to bring new readers up to speed:

“However, I am one who believes that as the U.S. economy has undergone such deep structural changes since the last comparable period of **1989-1991**, the definition of a recession needs to be adapted to today’s global economy. Back then and like today, the economy underwent a severe banking crisis, horrific red ink from the domestic auto sector, a flat lined home building sector, rising unemployment, and a hard to get credit environment (amongst other negatives).

Folks, as a student of economics for over two decades, I want to assure you it is rarely just one factor. The fact is; a slower rate of growth both here and abroad should do most of the heavy lifting in bringing down inflation **expectations**.” (Since then, oil and other commodities have dropped substantially)
-Written July 9, 2008.

“Eventual recovery in housing? It’ll be here! When? The way I see it, it may take about another year for the U.S. banking sector to shore up its balance sheet. That’s why people are so perplexed as to why the banks aren’t lending money despite very low interest rates. The banks need to help themselves before they can be in a position to help borrowers. So, I’m looking at mid 2009 for the banks to start lending again. Expect more turbulence in that sector while you wait.

For the first time home buyer, the cost of purchasing became out of reach for too many. Do you think no one will ever buy a house again?! Once activity picks up a little, it becomes a self fulfilling prophecy. Houses are off the books of the banks, housing inventory drops, housing related jobs once again need to be filled, and durable goods orders (think washing machines, refrigerators, and furniture) rise.

Investors profited handsomely between the end of 1991, the end of another banking crisis, to the end of 2007.

What happens to cheap stocks, being fundamentally sound of course? They go back up. Often, they go on to make new highs – again and again.”
-Written August 19, 2008.

Combine RTC2 with aggressive cost cutting on the part of businesses, low current inflation, low interest rates, and cheap asset prices, we have the ingredients for an environment that is very favorable for equity price stability and rising a rising stock market. The comparisons to the '89-'91 period just keep making more sense. The near collapse of the banking system, credit market, and real estate market of that era is what cleared the way for the strong stock market returns of the '90's.

Since history is a repeating mechanism, I'm sure RTC3 will be a doosey!

Thanks for reading this. Please forward this to anyone you know who may find it interesting (or amusing). Please reply me if you'd like to comment.

Congratulations to clients of ClientFirst Strategy, Inc.! No one panic sold one single solitary share of stock or anything! You held in there with calmness and confidence. It's a good thing we were prepared for turbulent markets going into this mess July '07. It's a good thing we sold natural resource investments months ago and reinvested into CD's and bonds.

Interested in becoming a client? Call me. Let's talk about it.

(Disclosure: This is solely MY opinion. Of course, you are welcome to share your opinions with me too. If you act on any of this without speaking to me first and you lose money, don't blame me. I may be wrong. I reserve the right to change my mind about any of this whenever I want and without warning. We're NOT totally out of the woods yet! Have a great freaking day! ☺)