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How Will We Know When The Credit Crisis Is Over?

When searching for the bottom of a bear market in stocks, experts often seek signs of "capitulation." That's the moment when almost everyone throws in the towel, selling in a panic. The notion is that all the bad news—about the economy, earnings, everything—is out there, and things could only improve. Now, as global markets suffer a seemingly endless credit crunch, it makes sense to look for the same kind of crucial juncture.

To find the end, consider the beginning. In 2003, the world economy had cash to burn. The U.S. federal funds rate, for lending among banks, had bottomed out at 1%, and interest rates around the globe had also dropped to near-record lows. As the economy began to pick up, all that cheap money was put to work in the form of business financing, consumer loans, and home mortgages—lots and lots of mortgages. Growing demand for real estate pushed up prices, and holding loans on fast-appreciating assets seemed safe and profitable. So investment banks began packaging mortgages into opaque securities that promised a steady stream of investment income.

It was those mortgage-backed investments, largely built around adjustable-rate loans to "subprime" borrowers, that ultimately spelled disaster. When rates on those loans jumped higher, homeowners began to default, and foreclosures flooded real estate markets with unsold homes. House prices declined, and the sinking value of mortgage-backed debt led to billions of dollars of losses at investment banks. To meet capital requirements, those institutions sold assets and invited investments by deep-pocketed outsiders. But each quarter brought more dismal news.

Last March, the U.S. Federal Reserve provided a $30 billion credit line for JPMorgan Chase to help it take over Bear Stearns, one of the nation's largest investment banks, which had been crippled by bad mortgage debt. The sale was accompanied by an announcement that the Fed would make funds available to other cash-strapped investment banks to help prevent additional failures.

Still, the drumbeat of multibillion-dollar losses continued. Investment banks, required to "mark to market" the worth of their portfolios, kept reducing the estimated value of their mortgage-backed debt. In July, Merrill Lynch sold collateralized debt obligations with a face value of $30.6 billion for just $6.7 billion, a move that guaranteed other banks, too, would take more huge write-downs.

As fall approached, the credit crisis intensified. One week into September, the government announced it was putting the two U.S.-sponsored mortgage behemoths, Fannie Mae and Freddie Mac, into federal receivership, while Lehman Brothers, another pillar of Wall Street, desperately sought to sell itself. But now no one wanted to throw good money after bad. Lehman had to file for bankruptcy, and Bank of America rescued Merrill Lynch, which had also been on the brink of failure. Just one day later, the federal government put together an $85 billion loan package to prop up American International Group, a giant insurance company that had insured mortgage-backed investments for virtually all of the banks now on the ropes. If AIG, too, had gone down, it would likely have triggered a chain reaction of additional failures. The same week, the last two major American investment banks, Goldman Sachs and Morgan Stanley, announced that they were reorganizing as bank holding companies, a move that invites much closer regulation but could help them survive.

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November 2008

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Market Watch

	11/28/2008	YTD
DJIA	8,829	-33.44%
S&P 500	896	-38.98%
NASDAQ	1,535	-42.13%

Best 5 Days in 75 Years

Wall Street finally found something to cheer about as the holiday season kicks off, offering hope that the battered stock market has turned a corner.

Since November 20th, the Dow has gained more than 17% and the S&P has gained 19%, their best five-day performance since 1933.

The market got big boosts over the past week from President-elect Barack Obama naming his economic team, the government propping up Citigroup, and the Federal Reserve deciding to buy massive amounts of mortgage-backed securities. These efforts reassured the market that broad efforts are still being made to fight the financial crisis that intensified in September with the bankruptcy of Lehman Brothers Holdings Inc.

Confidence seems to be returning and many experts believe that much of the dire economic outlook is already priced into the market.