

Greed, Gullibility and Overleverage...

This entire issue will deal with the current economic crisis. I will handle pages one and four. The first page will deal with the root causes of today's crisis and page 4 will address the investment implications and the stock market now. Julie will handle page 2, the size and shape of the current economic problem, and Anne will discuss current and future government actions and how we might get things back on a more even keel.

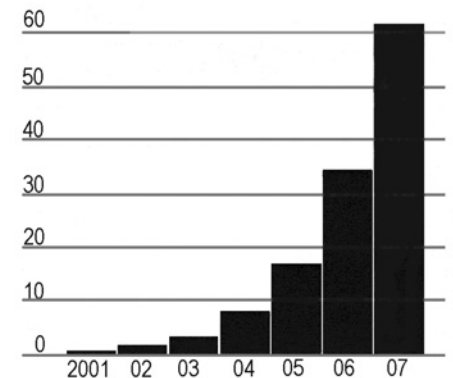
This crisis is all about debt, some of it good but a lot more of it bad. As a society we have been living beyond our means, gullible about how much debt we could assume. We have been greedy for high returns without regard to the quality of underlying assets

and Wall Street investment firms have overleveraged, stretching \$1 of capital to \$30 of assets. Everything is so clear now. We understand life backwards but live life forwards as it were! But that's the way it is.

The chart at the bottom shows that consumer debt, be it mortgage, credit card, personal loans, etc. has been building dramatically since about 1980. The chart in the upper right shows the growth of one type of derivative, the credit default swap (CDS). The total value of CDS today is four times the size of the entire U.S. economy! CDS start from a logical economic objective - I loan you money but am worried about your ability to pay me back, so I turn to a third party to insure that if you don't pay me, they will. The problem is in the modeling that determines the probability of you defaulting on that loan. Nassim Taleb's book *The Black Swan* is getting a lot of press today. Outlier events or 'black swans' seem to happen a lot more often than mathematicians tell us they should. This is what has gotten us in trouble. We just don't understand that you can't model

Swaps shop

CDS Contracts
(notional amount outstanding \$'000bn)



Sources: ISDA; Credit Suisse, Financial Times

human behavior that precisely.

So now we are in a period of debt liquidation and balance sheet rebuilding. Americans will learn to save again and Wall Street balance sheets will shrink but it will take time and most assuredly more pain. The U.S. economy will grow at a lesser rate over the next five years than we would have otherwise. But we will get through this. We hope this primer helps.

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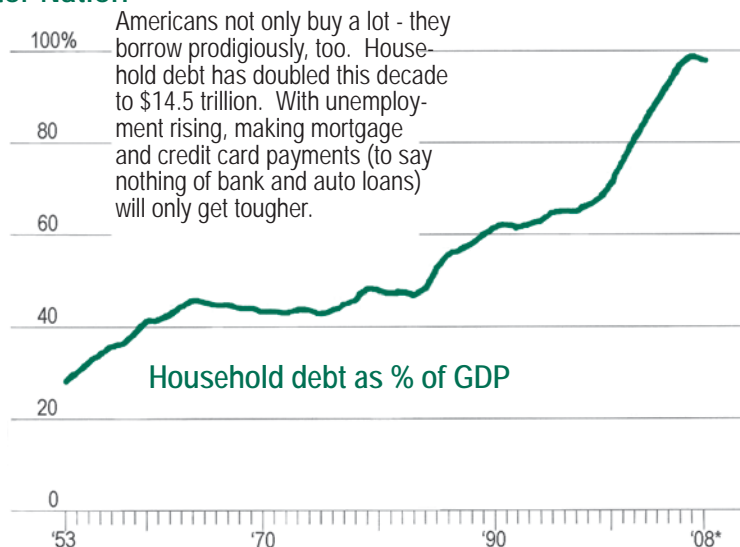


Julie Won, Eric Hanson, Anne Doremus

Hanson Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.

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Debtor Nation



Source: Federal Reserve; Forbes

*Second quarter 2008.

Here Be Dragons...

There's plenty of blame to go around for the mess we're in. We can point fingers at the White House and Congress pushing for greater home ownership, or at regulators letting the home-lending industry run wild. We can blame predatory lenders for behaving fraudulently, Wall Street for creating products it didn't understand, and rating agencies for not properly assessing credit risk. We can even blame the Fed for keeping rates too low. But the fact is we all benefited. Homeowners got mortgages that allowed them to live in bigger houses than they should have. Mortgage brokers and lenders earned fees on huge loan volumes. Bankers benefited from repackaging and slicing up those mortgages to meet ever-growing investor appetite for CDOs or collateralized debt obligations. And investors got higher yields on securities with outlandishly high credit ratings. Risk got spread around but accountability for it never clearly rested anywhere.

It didn't all happen overnight. *The chart to the right* shows that mortgage debt has been rising and home equity decreasing for the last two decades or so (and the chart on the bottom of page 1 shows the same thing). This has been a long time coming, and

that means the clean-up and deleveraging will take some time too.

First we've got to get through the emotional fear that's gripping us. The media has been full of words like "downward spiral" and "vicious feedback loop" -- referring to falling asset prices forcing us to deleverage, which in turn leads to further asset drops and so on. MIT finance professor Andrew Lo noted last week that as bad as the news has been, we were much more frightened by the news we hadn't gotten -- and "human imagination is nothing if not limitless in its ability to create disastrous scenarios." And in retrospect, letting Lehman Brothers go bankrupt really did seem to drain confidence from the markets. It's always easy to see missteps when reviewing the tapes, but it seems pretty clear that the Treasury and Fed didn't see how large the fallout would be for Lehman debtholders and counterparties -- and the market at large.

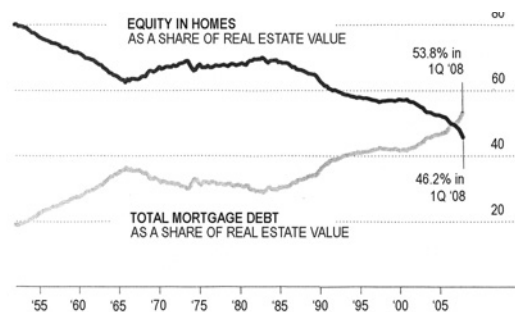
Plenty is being done that should help to clear the emotional aspects of the crisis (see page 3). But let's get back to the economics. No matter how we look at it, cleaning up bank balance sheets will

mean a reduction in credit, and that spills over to the rest of the economy. Harvard historian Niall Ferguson recently noted that U.S. banks have so far admitted to writedowns of \$324 billion but that the final total will be much higher. In the meantime, banks have raised \$235 billion in new capital. The gap between what's already been written down and what's been raised implies that banks will need about a trillion dollars to maintain the ratio between assets and capital. These numbers may turn out to be quite different in reality, but the implication is that there is no avoiding a massive reduction in credit. This will affect businesses of all kinds. It will affect companies' abilities to maintain inventory. It will affect employment, and it will affect consumers' ability to spend.

The chart to the left shows that individuals are preparing for a dim employment market and reduced spending. Things like the ailing car market are not likely to turn around quickly. The good news is that we will be able to get to better balance sheets and economic health eventually, and that we should be able to avoid a 1930s-style scenario. The reality is that we should be prepared for an extended period of subpar growth.

A nation of half-home owners

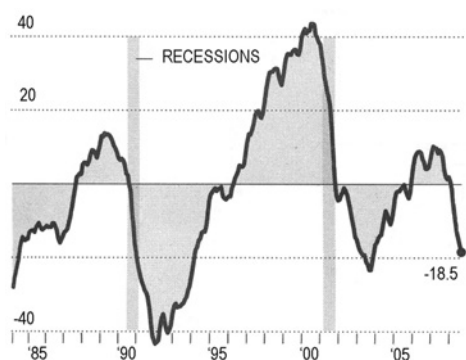
The portion of their homes that Americans own free and clear has declined for decades. A major downturn began in the late 1980s with the explosion of home equity loans. In 2007, equity dipped below 50 percent as real estate values plummeted.



Source: The Federal Reserve; *International Herald Tribune*

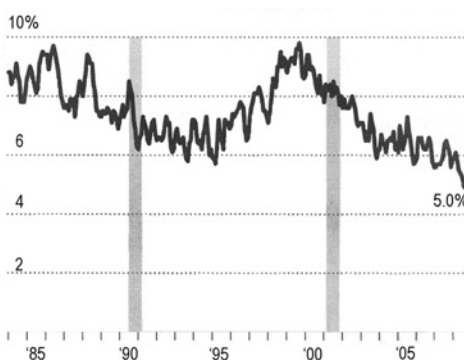
The job market looks bad...

Percentage of Americans who say jobs are plentiful less those who say jobs are hard to get.



...and so does the car market

Percentage of Americans who plan to buy a car within six months.



Source: Conference Board consumer confidence survey; *The New York Times*

“In Strange Territory, Almost Any Map Will Do...” *The Economist*

Financial authorities in the U.S. have traveled a long road since mid-March when they arranged a hasty marriage between failing investment bank Bear Stearns and JP Morgan. This effort was the Fed’s first rescue of a broker since the Great Depression.

Over the next six months, the U.S. government spent billions trying to rescue a variety of ailing financial institutions. Mortgage giants Freddie Mac and Fannie Mae and insurance company AIG, all deemed too big to fail, received direct government support while Merrill Lynch was forced into the arms of Bank of America. Washington Mutual, the nation’s largest mortgage lender, and leading investment bank Lehman Brothers, were allowed to go bankrupt. As September wore on, it became clear that these government efforts were no more effective than sticking one’s finger in a dike. The core problem, swiftly deteriorating confidence in global financial institutions and markets, required a more systemic and coordinated response.

Unfortunately, Treasury Secretary Henry Paulson’s \$700 billion “bail-out” did not exactly fit that bill. The plan, which focused on removing troubled mortgage assets from financial firms’ books, suffered from at least two problems. First, market participants and economists alike questioned how best to implement the program. Who’s assets do you buy and at what price? Second, purchasing these bad assets rewarded the bankers who packaged them and investors who held them but did little to get banks lending and credit flowing again.

To say that U.S. regulators have taken an aggressive approach since the bail-out’s passage is an understatement. Over the last several weeks, the Federal Reserve, FDIC and Treasury combined have insured money market accounts, raised FDIC insurance limits, backed overnight bank loans and cut interest rates. And

just last week, the government stepped in to guarantee most new bank debt, expand insurance on short-term business borrowing and take direct stakes in banks.

Whether any of this will work or not is unclear but we remain optimistic. True, in hindsight, it would have been nice if Treasury Secretary Paulson came up with a more comprehensive approach more quickly. But to his credit, his remedies have been flexible and pragmatic. And fortunately, we are not in entirely new territory here. Efforts to address past financial crises, such as Sweden’s

The price of safety

Country	Start of crisis	Gross fiscal cost, % of GDP
United States	1988	3.7
Finland	1991	12.8
Sweden	1991	3.6
Mexico	1994	19.3
Japan	1997	24.0
South Korea	1997	31.2
United States	2007	5.8 *

*Includes \$700bn to the Troubled Asset Relief Programme, \$85bn to AIG, \$29bn to Bear Stearns. Excludes capital investment in GSEs. Source: *The Economist*

1991 banking crisis and Mexico’s 1994 peso collapse all offer valuable lessons that we can, and are, drawing on.

So what are the long-term implications of these measures? No matter how you calculate it, the bail-out is going to cost American taxpayers a lot – at least \$1.6 trillion by some current estimates (see charts). Add on the most recent moves to recapitalize banks and any economic stimulus package passed next year and the number could well exceed that. Unfortunately, coming up with an accurate number at this point is difficult. If the banks do well, the federal government could end up making money on its equity stakes but it may also end up losing. In any event, the financial burden will not be easy to handle in the face of looming budgetary pressures from Medicare, Medicaid and Social Security programs.

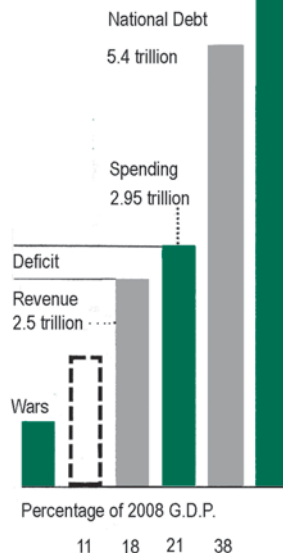
Thanks to the recent financial crisis, we can also expect a complete rewriting of our nation’s financial regulations. This will not be an easy task. As we are now all too painfully aware, the global financial system has become incredibly complex. New regulations will have to address the root causes of the recent problems and include mechanisms for coordinated global oversight. But I think we are up to the task. The current regulatory system was the result of massive changes made after the Great Depression. These regulations, while grossly inadequate now, helped avoid serious downturns for most of the last seventy-five years.

The Big Picture

Here are comparisons with the gross domestic product of the United States in 2008, which was \$14.2 trillion.....

Combined potential total of the government rescues (purchases, guarantees, grants and loans) detailed at far right: \$1.6 trillion.

Eight years of estimated appropriations for the wars in Iraq and Afghanistan and the war on terror, from 2001 to 2008: \$790 billion.



Source: *The New York Times*

Every Time a Trade is Made, Someone is Wrong...

But who is it this time? The buyers or the sellers. It is important in these very uncertain times to fall back on things we know. One thing we know is that financial panics are temporary. Stephen Roach, the head of Morgan Stanley Asia, pointed out in an op-ed piece in the *International Herald Tribune* recently that panics either end in exhaustion or are overwhelmed by heavy government policies. Right now governments worldwide are bringing out the heavy artillery.

Another thing we know is that stocks are getting progressively cheaper. At the peak of the high tech boom in 2000 the Standard & Poor's 500 sold at a record 30x earnings. Today the PE is somewhere between 10 and 13 depending on how you do the math. We are not at the all time low of 8x earnings which some markets bottom at, but we are a lot closer to the low valuation than we were a year or two ago.

The final thing we know is that stocks prices longer term are driven by only two things - corporate earnings and interest rates. Over a ten year or longer period, stocks will go up if corporate earnings go up and if interest rates stay at moderate levels. *The chart at the bottom* shows that earnings and dividends in the 1990s increased 8.4% a year and with price to earnings ratios expanding, the total return came to 18.4% a year. Over the past ten years including the violent correction of high tech stocks, earnings still averaged 6.8% per year. PEs contracted however, and this pushed the total return down to 3.7% per year.

It may be a leap of faith but I still think earnings and dividends will continue to increase after the economy bottoms. Maybe not 8% to 10% a year but 6% is certainly reasonable and if PEs stay stable or increase back to the long term average, total return to stock investors will be attractive.

Since World War II there have

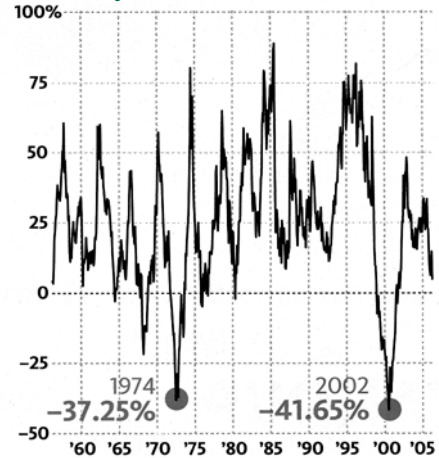
been 12 Bear Markets and 12 Bull Markets. The average Bear Market lasted 14 months and involved a decline of 22.4% in the Standard & Poor's index. Bull Markets lasted much longer, 45 months on average and involved a much greater rate of return, 124%. History augurs for a long term rebound in stock prices when the cycle turns. Just consider, at today's low prices about one third of Standard & Poor's Compustat universe (9,194 companies) sell at under 8x earnings. In addition, over 800 companies sell for less than the cash on their books. In effect you get the entire rest of the company for free.

In most markets if you are a rational buyer you are facing equally rational sellers on the other side. It is very difficult to get an edge in normal markets. In today's environment, rational buyers are looking across the table at only one kind of seller - very irrational panicked traders. Forget valuations; forget what companies will be worth 1 or 5 years down the

KNOW HOW LOW STOCKS CAN GO

Every few decades, the S&P 500 loses more than 35% in a two-year stretch. It's easier to hang on if you expect such bumps.

Previous two-year return



Source: Ibbotson Associates; Money

line. Just get me out. These moments of opportunity happen only very infrequently.

This doesn't mean throwing caution to the wind and buying with every dollar. It does mean however that if you have a longer term perspective, 10 years or more, then the values in this market are probably very unique.

BLUE-CHIP BLUES

Based on profits and dividends, the S&P 500 is doing nearly as well as in the '90s. But while rising price/earnings ratios padded returns then, falling P/E's have recently cut gains.

1998 to 2008			
6.8%	MINUS	3.1%	= 3.7%
Earnings And Dividends		Losses From Drop in P/E	Annual Total Returns
1988 to 1998			
8.4%	PLUS	10.0%	= 18.4%
Earnings And Dividends		Gain From Rise in P/E	Annual Total Returns

Source: Morningstar; Money