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by James Swanson, CFA

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Navigating through the credit crisis

I want to share my thoughts on this "day after." I wish I could explain to the average voter or congressional lawmaker in Washington what this all means. It is difficult to do. But in my view, the proposed bailout is meant to forestall greater economic woes for the average American and is not intended to transfer wealth to titans on Wall Street.

The essence of the problem as we see it

What we have seen is a breakdown in the credit delivery system. Try to think of this breakdown in terms of an oil pipeline. When the pipeline gets damaged, oil does not get delivered. That is what is happening to credit. In other words credit is not getting to the companies that need it to fund increases in their inventories, finance shipments, or buy new computers. Of course, fear is one of the reasons behind the breakdown. And that fear is coming from banks that will not even lend to each other because they do not know how many bad mortgages are on each other's balance sheets.

The gauges we watch, and that we think are more important to watch than the stock market now, are those that measure the net cost of money — which is now negative — in the banking system. These gauges are indicators such as the London Interbank Rate, or LIBOR, the overnight index swaps rate, and repo rates. These are the gauges we look at and that have been flashing red for several weeks. They are telling us that the credit pipeline has been broken and this breakdown has real knock-on effects in the economy.

I also want to touch on the difference between liquidity and solvency. Banks need liquidity to continue day-to-day operations. Right now they are burdened with mortgages. If banks can get those bad mortgages off their books and replace them with more-liquid and better-quality assets, they can begin to get back to business. Solvency has to do with balance sheet issues. Once the liquidity issues can be solved, the door can be opened for banks to bring in new capital to fill the gaping hole left by the mortgages gone bad.

When banks get new capital, the banking system experiences a multiplier effect. We are hoping this is what a bailout will produce.

The immediate implications

- Fourth-quarter economic growth is likely to be negative. We have not seen a contraction for some time because we have had an amazingly resilient economy.
- Because of the events of the past weeks, I expect growth will be negative in the first quarter of 2009.
- At MFS® we now believe the U.S. Federal Reserve Board may cut rates another 50 basis points by the end of the year.

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Are there any positives in this?

Yes. The U.S. economy has been amazingly resilient; it has held up over the past 13 months of crises. We have experienced the collapse of housing prices, the credit market lockdown, the oil crisis, and various ballooning deficits. And through it all, the economy has expanded and may show positive growth through the end of the third quarter. However, I do not think it is possible to maintain the positive growth trajectory in the current environment.

The path out

The return of affordability: Eventually, I believe we will see the return of affordability. Companies are cheap. In some areas of the country housing prices have fallen to what we refer to as the dirt, timber, and cement levels. In some markets, prices are approaching levels that we would say are near the bottom. Conventional mortgage rates have begun to come down, thereby making housing more affordable for the average American.

Are there values out there? It is a dangerous time in the market. I know that. Historically, cheap does not mean that things cannot get cheaper. But the following asset classes, from a historical measurement point of view in terms of spreads or valuations, are cheap. Those are municipal bonds, short-term high-grade corporate bonds, bank notes, high-yield debt, and parts of the stock market — most notably financial and consumer discretionary stocks.

The press and how to interpret the headlines: On Monday the press told us that the stock market suffered its biggest drop in history. In fact, while it may have fallen the most in terms of actual points, in percentage terms, which is a more accurate measurement, the drop was really the 18th largest. I would have thought the situation could have been far worse, but there is resilience out there. We are going to return to a world where people buy assets based on fundamental values, for example, on the basis of sustainable cash flows. Once again investors are going to be looking for companies that pay sustainable dividends or that have real products to sell and that do not have a lot of debt.

Do not forget, that while the economic outlook does indeed look grim, there are signs of hope out there.

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