All recessions are not created equal

In February, I spoke with Alan Blinder, former vice-chair of the Federal Reserve. Much of the discussion revolved around the question of whether we are in a technical recession or just a growth recession. Wisely, he pointed out that the important question is not the type of recession, but when will it bottom out?

It's a great question. It's important to look beyond academic distinctions of "technical versus growth" recessions. We tend to compare the current recession with the last recession, which is not helpful in this case. Recessions that are credit-based, like this one, are different from those that are inventory-based or trauma-induced, like 9/11.

The last credit-based recession hit the U.S. approximately 1989-1991. This type of recession tends to be longer than the normal recession, which is only 10 months. The S&P has been down five straight months so far.

Congress changed the tax code in 1986 to eliminate most tax advantages for investing in commercial real estate. That reduced the value of investing in real estate and real estate values dropped dramatically. The resulting recession was long and painful.

Commercial real estate is usually financed by bank loans. With the value of the collateral dropping, the bank loans were often greater than the collateral. Banks pressured borrowers to come up with more collateral, with little success.

This set the stage for what became known as the "Savings & Loan Crisis," which was the last recession that started with real estate and quickly became a severe banking problem. Over a thousand banks in this country disappeared. While nationwide, the crisis was largely concentrated in Texas.

During this time I was appointed by the late governor Ann Richards to the member group consisting of the state treasurer, state controller, state banking commissioner, and myself. It was an interesting vantage point to study that recession and offers a perspective today. There are obvious similarities with today's credit crisis and some worrisome differences as well.

Deju vu . . . all over again

One difference is that the earlier recession started with commercial real estate, while this one started with residential real estate, which raises its political profile. While banks owned the mortgages on commercial real estate, the owners of today's residential home mortgages are the many, faceless (and largely clueless) owners of bonds, collateralized with the home mortgages. Unfortunately, the value of that collateral is falling. But, there is no way for the struggling homeowner to sit down with bondholders and work out a deal. They can only deal with their servicing agent, who receives their monthly payments.

Treasury Secretary Hank Paulson and Fed Chairman Ben Bernanke have asked servicing agents to be as cooperative and accommodating as possible. Already, the trial lawyers are lining up to represent the bondholders in suing the servicing agents for being too cooperative and accommodating. I am not optimistic this private-sector approach will help.

The worst in my lifetime

At this point, the credit markets are unusually frozen or illiquid. In fact, it is the worst in my lifetime. Even the historically safe market of auction rate securities, or "floaters," is illiquid. It may be a triple-A investment, but sometimes you still cannot sell it. The longer this frozen state continues, the worse it's going to be.

a party who could deal with the issue, i.e., the federal government, because it regulated the banks and also provided FDIC insurance. It was forced to solve the problem at an estimated cost to taxpayers of $340 billion. But, who can clean up the mess this time?

I am fond of saying "there is no problem the government cannot make worse," but this may be an exception. If there is a way for the private sector to deal with this recession, I don't see it, unless we are willing to risk depression for the long term. The longer it takes to fix, the worse it's going to be.

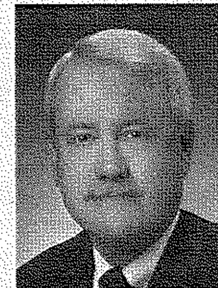
The Fed only controls monetary policy. Fiscal policy is controlled by Congress and the president. Without both policies, there is no "one-two" punch to end this recession. The "stimulus package" is a helpful fiscal response but it is too little, too late. Secretary Paulson has come out with several good ideas to prevent the next credit crisis, but it does nothing to help now. He proposed better regulation of mortgage brokers. We will need a more aggressive fiscal response, and the longer we wait, the worse it will be.

1st quarter was ugly

The Wall Street Journal described the first quarter as simply "ugly," the worse in over five years. The Dow was down 7.6 percent. The S&P was down almost 10 percent, while the Nasdaq was down 14 percent. That was ugly.

It may be small consolation, but the rest of the world was uglier. Outside the U.S. and Canada, markets were down 15 percent. India was down 20 percent, and goliath China was down 32 percent. One benefit of the extremely weak dollar is that most U.S. investors only experienced an average 9 percent loss investing abroad – but still ugly enough.

More important than the financial sadly. During the first quarter, 232,000 people lost their jobs. Unemployment has gone from 4.8 percent to 5.1 percent and going higher. Mark Zandi of Moody's predicts it will reach 6.1 percent. Foreclosures continue at an all-time high. With consumers making up 70 percent of GDP, the short-term still looks pretty ugly to me.



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How we're managing it

Back in the financial markets, it is cherry-picking time. The cash level in our portfolios is at all-time highs, and exposure to the financial sector is at an all-time low. We have begun to cherry-pick both financials and consumer discretionary stocks, both of which were the worst performers of last year. We're also buying municipal bonds. With the problems of illiquidity in the municipal bond markets, those bonds are much more attractive than they have been in many years, especially when compared to corporate bonds.

So where is the bottom?

The chief investment officer of BlackRock, Bob Doll, suggested recently that a bottom was very close, if not already here. It is easier to believe the bottom is near than to believe that growth will resume. We continue to believe it is not a time to panic but a time to cherry-pick.

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