TCM INSIGHTS

2008—THE REAL STORY

A decade after the Financial Crisis, misunderstandings remain regarding the reasons for the lengthy bull market that has followed. Many investors blame Wall Street for the panic of 2008, while anointing Quantitative Easing (QE) and TARP as the saviors of the global financial system. This narrative has been told for so long that many believe underlying issues were inadequately addressed, and the "artificial" bull market is overdue to end. This thinking is what leads to normal corrections (such as the one experienced late last year) generating abnormal levels of fear.

Even more frustrating is that the true heroes and villains have been publicly exposed, but many no longer care. Peter Wallison's book "Hidden in Plain Sight" reveals it was Fannie Mae and Freddie Mac who pushed the subprime loan space. Congress and HUD mandated that Fannie and Freddie buy more subprime paper, and by 2007 - along with the federal government - owned 76% of it. Wall Street is not without blame, but government had assumed an unhealthy and dangerous role in the economy.

> Unfortunately, because so many analysts have accepted the government's version of the story as truth, younger generations believe that government is better than the free market at generating growth. Such thinking supports poll numbers that suggest a growing number who back socialism. During the crisis, George W. Bush said that the U.S. had to "violate free market principles in order to save the free market." Nothing could be further from the truth. Either free markets work, or they don't. President Bush, like so many others, succumbed to the popular, but false, narrative. They have yet to find a way to explain their positions. As a result, socialist ideologies are gaining power and influence.

Such a narrative ignores the role of mark-to-market accounting in the crisis. This accounting method allowed banks to used bids in the marketplace to value assets, rather than relying on more stable variables such as cash flow and underlying asset values. The result was a broken loan market and assets that continued to pay on time selling at bargain prices.

Hypothetically, if a bank owned a pool of 1,000 mortgages and 300 of them defaulted (which given the collapse in underwriting standards by Fannie and Freddie wasn't unreasonable to expect), it would still pay 70 cents on the dollar. Because of frozen markets however, bids entered a state of freefall where some of these pools traded for 10 to 20 cents on the dollar. Mark-to-market accounting rules forced banks to accept the bids, include it on income statements, and subtract the loss from capital. What resulted was a vicious cycle that ended with the demise of several banking giants.

The Federal Reserve responded by implementing Quantitative Easing in September 2008, which injected $700 billion of TARP money into the system, thus providing significant liquidity. The S&P 500 continued to decline however, and eventually fell another 40% after TARP was implemented (bank stocks declined a staggering 73%). This free fall occurred because the problem was related to capital, not liquidity.

In March 2009, the Financial Services Committee held a hearing to target mark-to-market accounting rules. The rule wasn't reversed until a month later, but it signaled to financial markets that a major source of the problem was finally being addressed by policy makers. This process ignited the current bull market, which has produced a 300% increase in market values, a stronger banking system, and an overall "normal" recovery. Meanwhile new technology and alternative energy sources lifted productivity and profits, and stocks responded. It was not QE and TARP that saved the financial system, but instead capitalism.

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