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NIGHTMARE ON WALL STREET

Quarterly Newsletter
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The fear and trepidation of the financial markets came to realization in the month of September. The broad market fell 8.9% in the month, with the average U.S. equity mutual fund down 10.5%. This brings the market down 25.6% from it October 9, 2007 high through September 30, 2008. Credit markets seized up. Bank failures continued. Auto sales plummeted. Unemployment rose.

The secretary of the Treasury, Hank Paulson, and the chairman of the Federal Reserve, Ben Bernanke told the President and Congress of the dark peril that faced the U.S. if a massive aid package was not adopted. The epiphany for Paulson came as he watched his trading screens flat line across global credit markets. The London Interbank Offering rate soared as banks hoarded cash and declined to loan even to one another. Commercial paper activity, the life blood of industry, dried up and rates soared. America stood on the brink.

Paulson and Bernanke brought a massive recovery package to congress which included granting extraordinary powers to the Secretary of the Treasury.

Alan Greenspan, in an interview on CNBC with Maria Bartiromo, volunteered himself to serve on a group as yet unnamed, presumably as Chair, to be given extraordinary powers over the economy. It is not known if anyone accepted his offer.

Congress was asked to pass the sweeping legislation just weeks before an election. Presidential candidates were asked to take a position. The measure was dubbed a bail out of Wall Street. All of this was nearly too much for the democratic process. John McCain suspended his campaign and flew to Washington to take charge. Congressional leaders of both parties labored to find enough votes to pass the legislation that Bernanke and Paulson had proposed.

The leaders of the House apparently believing that they had the votes for passage brought the measure to the floor on Monday, September 29. Whether or not they had the votes is unclear. Before the vote, the House Speaker, Nancy Pelosi gave a speech with seemed to presage failure; apparently it also made many Republicans angry. Liberal Democrats and

Conservative Republicans joined to vote against the bill in sufficient numbers to defeat it. As a result, the Dow Jones Average suffered its worst point loss ever. (October 1987, Alan Greenspan's debut as Fed Chairman, still keeps the record as the largest percentage drop since the Great Depression). Over a Trillion and a half dollars in wealth, savings and retirement plans disappeared in a single day.

A run on Washington Mutual, perhaps started by TV talking heads, lead to the largest Bank failure in U.S. history. Banks in Europe failed. Ireland was forced to guarantee all deposits in Irish banks, putting the pressure on other European governments to follow suit.

The Republicans used the financial crisis to hand the election to Barack Obama. John McCain looked ineffective and uncertain in his meetings over the package. The House Republicans made ideology, not the economy their lodestar at a time when action was needed. No doubt they managed to make their business constituency angry too.

It is unlikely that the recovery package by itself will save the economy and the markets seemed to recognize that fact. Indeed global markets swooned, The Dow suffered a melt down and European banks teetered on the edge.

FDIC insurance for deposits in qualified institutions was increased to $250,000.00 from $100,000.00.

The SEC which has repeatedly demonstrated its' incompetence, indicated it might revert back to the uptick rule which the commission abolished last summer after no policy discussion or reason for doing so. (I criticized this change in this column when the rule was abolished.) McCain says he will fire Chairman Cox. Obama should join McCain. A house cleaning at the SEC is in order. It was the SEC of course that allowed investment banks to take on unprecedented leverage which contributed to their demise, and along with the Federal Reserve allowed a $60 trillion unregulated market in credit securities related to housing loans to proliferate.

Additionally the "mark to market" rule, may be jettisoned, thus making Wachovia an interesting target for Wells Fargo after the FDIC had brokered a takeover by Citigroup. The "mark to market" rule, although well intentioned, has caused enormous accounting losses for financial institutions which has damaged their balance sheets and capital.

If the SEC had not allowed investment banks to take on enormous leverage, if the mark to market rule had not been in effect, if FDIC insurance had been higher, we probably would not have seen the demise of Bear Stearns, Fannie Mae, Freddie Mac, Lehman, or Washington Mutual and the jobs and savings loss that went with them. What a different world we would be living in if policy makers had been ahead of the problem instead of behind it. Look no further than Wachovia for proof.

Looking ahead, the markets will stabilize after a lot more work by the U.S. Treasury and Federal Reserve. Central bankers around the world joined in a global interest rate cut. Look for more cuts to come. There will be more pressure on the Euro, and a strengthening dollar. Some even question the continued viability of the Euro as the European governments go their distinctive ways.

Some predictions: Barrack Obama will be our next President. Congress will be overwhelming Democrat. In his first six months in office President Obama will see remarkable legislation come to him from Congress as congress retaliates for eight years of George Bush. A tax increase will be among the bills. Some of the bills will even be hard for the new President to swallow but he will sign them. Prime Minister Putin may challenge new President Obama somewhere in the world, likely in the states of the former Soviet Union, one of the Stans, Georgia, Ukraine or Belarus. Next year will be a rocky year, not just for the economy.

This past quarter we saw financial stocks continue their swoon then rise as government support rose. We had little exposure to that sector. Sectors that have been among our favorites, food, commodities, energy and materials all fell as the dollar strengthened. Exposure to defensive sectors such as consumer staples and health care helped us, but with the drop of the overall market we were not spared. We brought money home from international markets, and changed our investing strategy because of the strengthening dollar and softening global economy. We ended the quarter with considerable cash in order to be defensive. We expect a recession and will invest as prudently as we are able.

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William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" For investment information contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com

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