



**GERALD L. RAY**  
& ASSOCIATES, LTD.  
Investment Advisors

# THE RAY REPORT

October 24, 2008

## The Blame Game

A worldwide financial crisis that some compare to the Great Depression of the 1930's. A stock market fall that compares to the crash of 1987 and the bear market of 1971-2. Bank failures. Housing glut. A consumer in retreat.

Just one year ago, the S&P500 was at an all-time high and the consumer was ebullient. How did we get here? How did this market fall so far so fast?

The policies that fueled this recent decline were born years ago. Alan Greenspan responded to the attacks of September 11 aggressively and appropriately by lowering rates. However, the reaction to September 11 was emotionally, not economically driven. As a result, the 1% discount rate made credit simply too easy. Easy money was coupled by the desire of both the Clinton and Bush administrations to encourage home ownership. Freddie Mac and Fannie Mae, the quasigovernmental lending agencies, were given broader powers to lend and methods of financing surfaced that required little or no money down that were accepted by banks. Under the new game of home lending, mortgage brokers who had no financial interest other than writing the loans would provide financing to virtually any borrower. The broker after having collected his commission/fees would immediately sell the loan to a bank who would likely repackage the loan to Fannie, Freddie or a large bank with the implicit approval of the rating agencies or bond insurers who assigned or provided a AAA rating to much of these instruments even

though the initial mortgage broker did little or no due diligence, because he lacked an economic interest. This worked in good times, but as value of properties fell, the lack of oversight was disastrous.

It is clear the system was setup to fail, but how did it get so bad? The first signs of trouble go back over a year to last spring when it was clear to many that the economy was slowing. Bernanke, who was new, seemed to resist lowering rates aggressively. He was reluctant I suspect to avoid looking soft on inflation so early in his tenure. Clearly Fed response was slow and inappropriate.

Government response also was slow as lack of oversight of Fannie and Freddie was criminal despite warnings by the Bush administration and others.

Rating agencies clearly share in the blame game as they continued to rubber stamp AAA ratings to questionable paper. They also failed to let us know just how on the hook banks were to this toxic mess. When they did decide to act, such as when they lowered AIG's rating while they were

### Market Performance For The September 2008 Quarterly Period

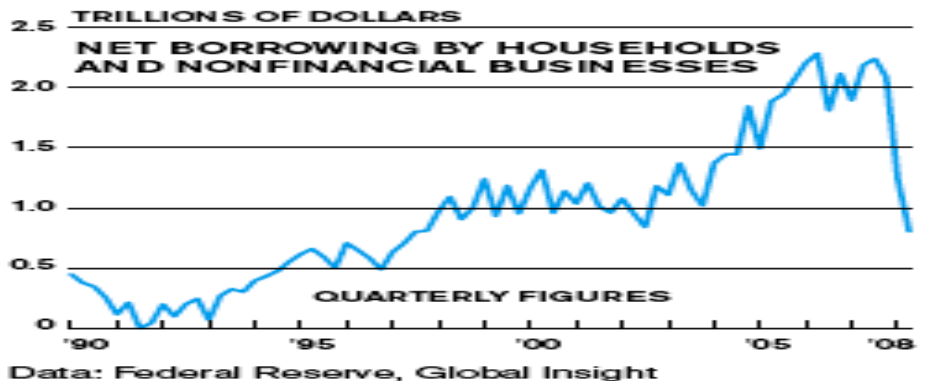
<i>Dow Jones Industrials</i>	-3.68%
<i>Standard &amp; Poor's 500</i>	-8.49%
<i>Russell 1000 Growth</i>	-12.83%

in government discussions, it was irresponsible and cost AIG shareholder's and the government billions of dollars. The current rating agencies having demonstrated their incompetence need to be eliminated and new entities formed.

Hank Paulson, who as Treasury secretary, inherited much of this mess, failed to recognize that Bear Stearns was only the first to suffer from this contagion. He instead tried to portray them as a renegade firm and thus failed to insist that other firm's take appropriate steps to de-lever earlier. He also allowed Lehman to fail after saying smaller Bear Stearns could not. Much of the stock market's September/October mess goes back to Lehman's failure.

Chris Cox, the SEC head, has been invisible. His insistence to allow naked short selling, promote lack of (continued on page 2)

## PLUNGING CREDIT IS STARVING GROWTH



Courtesy of BusinessWeek.com

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 disclosure for hedge funds and his firm stance of mark to market even when there is no market has lead to serial writedowns by banks that were exploited by hedge funds helping to cause Wachovia's demise and the near death of Morgan Stanley. All of this can be laid directly at his door.

Clearly, the way business was done will change. Congress will use it as an opportunity to extend regulation despite its many failures to oversee Fannie and Freddie. Banks will become less levered and will initially struggle for growth and lenders will at least initially show some discipline in lending. The stock market will remain volatile as we assess the effect on earnings of the inevitable recession that will occur as a result of deleverage. Yet, there will be a time where opportunities in this world will present themselves and we hope to be ready.

Sincerely,



Joseph H. Ray, President

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