The Global Liquidity Crash of 2008

There can be no doubt now that we are in the midst of experiencing a once in a lifetime liquidity crisis. The world's governments are announcing a major new strategy every day, yet none of it is working to stabilize the world's markets. Because the reduction of debt is happening so quickly we are in the midst of a daisy chain of financial implosion.

What is happening?

Within a short period of time we have had a $700 billion bail out, a program put in place to secure money markets funds, and a global coordinated central bank rate cuts. Governments around the world are taking over and investing in huge banks. It seems that every day a major new initiative is announced by the world's central banks, but as we all know, none of it appears to be working. **Without a functioning debt market there is a rush to monetize assets wherever possible.**

The world's economy relies on money flowing freely across the financial system. The veins and arteries of our financial system are the banks and financial institutions that circulate our money through the multitude of transactions occurring every second of every day all over the globe. The world needs the free flow of trillions of dollars every day throughout the system.

With major banks failing every day and not trusting each other's credit worthiness, we have clogged arteries throughout our system. **This means that companies, states and individuals cannot rely on debt to fund their every day obligations, but they still need money to operate, and so they have to sell assets (including stocks) to raise cash.** All of the actions from the central banks so far have been focused on pumping more liquidity into the system to make up for the clogging, but as these arteries become more clogged then these actions become less effective.

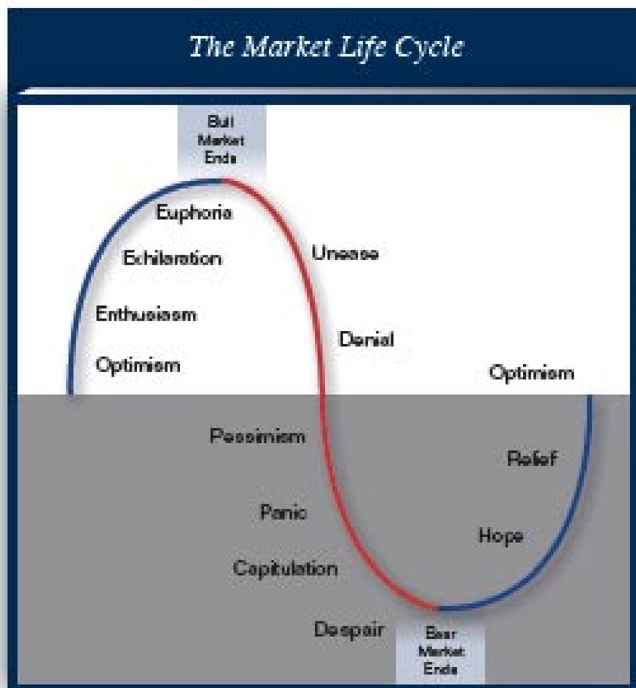
The best gauge of the level of clogging in the system is the rate that banks charge to lend each other money. That rate is called the LIBOR rate or the London Interbank Offered Rate. The 3-month LIBOR rate has historically been slightly above the Treasury Bill Rate. The T-Bill rate is only 1% right now; however the LIBOR rate is 4.8%. This is an unprecedented spread. Until the world's governments drive the LIBOR rate back down we will have two major issues overwhelming the world's financial markets:

1. **The need for liquidity forcing people and firms to raise cash wherever possible**. Since loans are harder to come by, and the confidence in banks is crumbling, there is a rush to cash. To get the cash for their operating needs people are selling wherever there is liquidity, from the stock market to commodity markets. This creates a vicious cycle as those watching the global asset declines sell because of their fear.
2. **The impact that the rapid reduction of debt will have to stifle global economies**. Since no one can assess how severe this liquidity crisis will be, nor how long this clogging will last, nor how much of a lending reduction will occur, it is impossible to determine the impact on global growth, and by extension, what earnings will be going forward for all companies world wide.

This combination of events makes valuations irrelevant.

<u>When will this crisis come to an end??</u>

It's hard to believe the Dow Jones Industrials and the S&P 500 hit new highs a year ago. Since then, the markets have fallen over 40% in value and global markets have collapsed even further, making this one of the worst bear markets in history. If the world's governments can develop a plan to guarantee the exchange of funds across all participating institutions, it will drive down the LIBOR rate. The global liquidity crunch would come to a halt and then investors would have to evaluate what the impact that this crisis, and the future reduction of global debt, will have on earnings going forward. For the meantime **it's highly likely that the liquidity crisis will have dropped the prices of stocks and commodities below what their intrinsic value really is.**



SOURCE: MS. LIZ ANN SONDERS, CHIEF INVESTMENT STRATEGIST OF CHARLES SCHWAB

The market cycle chart to the left is a very helpful way to think about the markets. When panic and despair kick in (and who can doubt that we are in that process today), we are in the final stages of capitulation. Unfortunately this is a messy process because the liquidity crisis is still hanging over us, and every day without resolution means more selling of assets, regardless of prices. But when this is resolved we could be near a climatic bottom that could allow for a recovery in the world's stock markets. The recovery will no doubt be very choppy because it will be hard to ascertain the ripple effects of this mess.

What should you be doing?

Remember **the market is a current measurement of everyone's future expectations**. That means that the market decline already reflects the pessimistic outlook everyone has for the future. So the question for all investors is not where the *economy* will be in six months, but what our *expectations* will be six months from now. No doubt the economy will be in worse shape six months from now, that's what the stack markets are telling us, but what will our *expectations* be at that time? It is highly probable that our outlook will be far more optimistic than it is today and the market could reflect that by being at higher levels.

To make it through any decline, the secret is to stay within your comfort zone so that you remain invested in all environments. Some folks might want to make a short term shift to reduce their risk while the chaos unfolds, even though there is a high possibility that the market will have a massive snap back rally, which might well be short lived before a sustained rally occurs. **Unfortunately, after a decline of this magnitude, recoveries and bottoms are noisy. However, when the liquidity situation is resolved we could see a very impressive and abrupt recovery**. Therefore, please work closely with your adviser to assure that you can navigate this very treacherous environment. Our teams around the country have a range of alternatives to help you in these challenging times.

It is of little solace to focus on opportunity when fear is so rampant, but it is also true that only then is opportunity really available to everyone. There will be unique opportunities for all of us in these unusual times. The average recovery after a bear market is a gain of 168.5% and lasts over five years. This has been no average drop and so, while there are no guarantees in stock investing, a stronger recovery is very likely.

If you have not yet completed one of our Financial Control Scorecards® with your adviser, we urge you to do so. This will allow you to know how this decline might affect your personal situation and ensure that you stay invested in a way that keeps you comfortable. Rest assured that we are all overseeing your portfolio throughout these challenging times.

Thank you for your continued trust and confidence,

Joe Duran, CEO & the United Capital Investment Committee

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