



## An Analogy – Past & Present

In January 2008, we wrote in PERSPECTIVE:

### *An Analogy*

*We all understand the importance of the heart to the human body. All the extremities of the body suffer when there's trouble with the heart. Whether it's a denial of proper blood supply to a finger, or an eye, the human body as a system starts to shut down. And the body doesn't fully recover its health until the heart regains its health.*

*The "heart" of any country's financial system is its national banks. All the extremities of the financial system start to suffer when there's trouble at the national bank level. Whether it's at the securities exchange trading level, or at the small business financing level, everyone suffers. All parts of the system become suspect when we are not able to fully understand all the underlining problems the banks are facing. Until the banks "regain their health", the natural thing is for all parts of the financial system to slow down. Pessimism takes over and everyone goes on alert.*

*Today, the US financial system is unsure of what tomorrow will bring. Unfortunately, until all the bank related issues are known, you can probably plan on slow growth. We'll stay out of a recession, but until we're absolutely sure all issues are uncovered, such as the size of the unredeemed credit default swap issue, and the home market begins to stabilize, the economy will most likely keep "going sideways". Portfolio returns will be low.*

*For us in the portfolio advisory business, it's time to "check and double check" all what/if scenarios on the securities we hold.*

Well, we didn't get the "you can probably plan on slow growth" and "we'll stay out of recession" right. But over the last year, we've found ourselves returning to this analogy frequently.

As your Advisor, we have checked and double checked all our portfolio risk measurements and what/ if scenarios time and time again. Where we have found vulnerability, we have acted.

So, if you will allow us, based upon the above, how would we write the subsequent chapter of this analogy? What happened to the national banks...as represented by "the heart" in our analogy? What follows is An Analogy II, the next chapter as we see it: The fall and deleveraging of Wall Street, along with the unraveling of the world Fixed Income markets.

### *An Analogy II*

In the early spring of 2008, "the heart" continued to suffer and was eventually diagnosed with a form of congenital heart failure. The seriousness of the situation took on a whole new perspective as spring rolled into summer. On March 16th, the Fed, with a federal guarantee, facilitated the sale of Bear Sterns to J P Morgan. But, the heart's problems did not subside. Mortgage woes grew and the US Fed responded by using traditional responses to economic problems: lowering interest rates and infusing more money into the credit markets. >

# Perspective *(continued)*



On September 8th, the US Treasury Department put Fannie Mae and Freddie Mac into conservatorship. On Sunday, September 15th, Bank of America struck an all stock deal to buy Merrill Lynch. Within days the Fed, acting to avert another possible world wide financial crisis involving Credit Default Swaps, seized control of AIG, one of the world's largest insurers.

On the early morning of September 16th, the heart in our analogy had a major stroke...Lehman Brothers filed for bankruptcy. All the body's blood supply, the contracts and interbank lending that normally flow through and between Lehman and its counter parties, stopped. The body shut down! Every national bank looked over their shoulder and said, "Am I next?" All the normal flows of money between banks in the US, Europe and Japan stopped! "CODE BLUE-CODE BLUE" was sounded and the national banks were rushed into the Operating Room. The call went out for more blood! Mounting fears shook world markets as banking giants rushed to raise capital. Finally, somewhat stabilized, the body was released to the Recovery Room.

The finest doctors and nurses on a hospital staff are found in a Recovery Room...for at any time the patient's heart monitor may go "flat line" pronouncing that the heart has stopped beating. These doctors and nurses are trained to jump in and do everything possible to get the heart beating again.

It's our opinion as we write this at the end of January 2009, our National Banks are for the most part still in the Recovery Room. Some are in better shape than others. Washington Mutual was sold to JP Morgan Chase and Wachovia was purchased by Wells Fargo. There are positive signs that intercompany lending between banks is starting to flow but, bad mortgages and the Credit Default Swap (CDS) issues are still inhibiting real stabilization and progress. It's as if there's an infection, a virus if you will, in the body (bad mortgages in banks and CDS bets) that still needs to be localized and extracted from the body before it can return to health. Possibly the original TARP program modified to work like the Resolution Trust did during the S&L Crisis will work

We're often asked, "How soon will the economy recover?" Our polite and honest answer is "we don't know." If time permits, we reiterate this analogy to help explain ourselves. It seems to help put the situation into perspective, because everyone knows the impact of a stroke to the body. It takes an undefined amount of time to recover. You can't say how long it will take. For sure, it won't happen until the banks start lending again.

Not since the Great Depression have we had such turmoil within our banking system and fixed income markets. For us in the portfolio advisory business, it's time to "check and double check" all what/if scenarios on the securities held in our client portfolios. It's also time for patience, perspective and persistent vigilance.

Albert Heeg Investment Management

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