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Sometimes, procrastination pays off. I spent two days last week crafting an email on why the Fed should hold off cutting rates as long as possible, unless the upcoming employment report was so bad that Bernanke's hands would be forced. I never did finish that email and then Friday's curiously disastrous report came, so it's Sunday night and I am starting all over again.

When the stock market was under serious fire in March, July and August, I sent regular emails throughout the weeks to keep you informed on the happenings and let you know what I thought would happen next and why. Of course, some people emailed me that I was communicating too much. Point taken!

Over the past few weeks, I didn't send many emails since I spelled out my thoughts about a trading low being established and not much risk until after Labor Day. Of course, other people emailed me to find out if I was still alive since they did not receive many of my babbling emails! I guess sometimes... you just can't win!

I did manage to travel with my extended family to Cape Cod for a bit at the end of August. That was great! Lots of adult relatives, only my kids = many babysitters! And with the markets being relatively quiet, I was able to curtail work to the first few and last hours each day.

Let's spend some time talking about Ben Bernanke's conundrum with the credit market, economy and stock market. To begin with, you'd have to be living under a
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rock not to know about the sub prime mortgage problem. Sub prime is just a fancy name for the riskiest mortgages, kinda like saying High Yield bonds instead of Junk bonds.

We first learned of this potential problem when HSBC warned more than six months ago. The long forgotten March hiccup was half China related and the other half sub prime. At that point, sub prime became front and center with investors and the media, although it was widely accepted, by dumb money, to be contained to only the riskiest of loans.

Fast forward to June and we saw the entire sub prime mortgage market essentially disappear. The next step up, Alt A, has become a thing of the past and now even prime mortgages are becoming more difficult to secure. Jumbo loans, which usually cost .25% more, are now .75% to 1% more and even tougher to fund.

Yes folks, when the masses in government and on Wall Street assured us that sub prime would be contained and we shouldn't worry, that was the time to worry and batten down the hatches! It's become downright nasty and the worst is not behind us.

The problem here is multi-fold. First, all these mortgage companies and banks drank Wall Street's Kool Aid and packaged these loans into securities, selling them to investors creating a trillion dollar plus market. Professionals leveraged these traditionally conservative investments and now are watching their values get cut 10, 20, 50, even 75%! Add leverage on to that and you have the makings of a complete and utter disaster.

Next, hundreds of billions of dollars in adjustable rate mortgages that were taken out with rates of 2-3% are now in the process of being reset into fixed rate mortgages at 7-9%. Imagine your single largest monthly expense was $1000 for years. Then, all of a sudden, it became $2000-$3000 and you were barely making ends meet at $1000. As Astro, the cartoon dog on the Jetsons would say, "Rut Rot"!

Let's add in an already slowing U.S. economy with inflation not yet under wraps. Shake it all up and throw in hundreds of billions in unpriced leveraged buyout deals (LBOs) from private equity shops and you've got one giant, systemic problem!

Not only has sub prime spread into the prime mortgage market, but an entire industry has evaporated with hundreds of thousand of real jobs. Wall Street's latest and greatest derivatives with monikers like CDO, CLO, and CPDO are causing havoc on the financial system that will result in firms shuttering whole departments, another 100,000 jobs lost.

The recession is here. By the time it is finally confirmed by the government or Wall Street, it's likely either over or about to end. It's not great in the real world now, but unfortunately, it's about to get worse.

CRASH! Bye bye private equity... Hello risk repricing

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So now we know that the mortgage market has imploded and all the jobs and Wall Street securities with that. Giant problem number 1. If that was the only issue, the government could set up a bailout like they did in the early 1990s when Resolution Trust was created to save the savings and loan industry and that would be it.

But similar to that period, there are other things festering beneath the surface that have longer-term effects. Right now, the credit market is undergoing a massive, macro repricing of risk. For the past few years, deals have been done with more and more lenient covenants. That means that the rules have been severely skewed towards the issuer and not the investor.

At one point not too long ago, the average junk bond was only paying 2.50% over the 10 year, guaranteed Treasury Note. As a frame of reference, in October 2002 with Enron, Worldcom and Tyco, the average junk bond paid 11.00% over the 10 year. Even if we return to somewhere in the middle, that's almost 7%, and we're currently at 3.75%.

As risk continues to be repriced, think about all of those private equity firms that announced LBOs in 2007. With junk bonds being so cheap and institutional investors' appetites at an all time high, these deals were as easy as Tiger Woods sinking a four foot putt to win another golf tournament. Of course, being a rabid Mickelson fan, I will wrongly argue that he wasn't there today to compete and he was hurt most of the year anyway with that wrist injury!

Back to risk, just think about how costly it's going to be for any company needing to issue junk bonds as the premium over treasuries continues to grow. That goes right to their bottom line and will certainly affect earnings for many, many quarters to come.

On the LBO side, with hundreds of billions in yet to be priced deals, there will be more than a few deals that just don't get done. Banks are balking. Institutional investors are walking away and the private equity bust is going to be massive!

That also hurts the stock market, the mid and small caps the most, as a "bid" has been under these groups for several years as this is where most of the LBOs have been. It seemed like every time the mid cap group saw a decline, another buyout was announced from a private equity firm. It's safe to opine that those days are long gone!

Bye bye Fortress! Bye bye Blackstone! Bye bye KKR! Your partners are about to receive huge tax increases and your idiot proof deals are now a thing of the past. I do give them a tremendous amount of credit for recognizing how silly the industry became and going public to begin their cash out phase.
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Finally, the credit market itself has essentially grinded to a halt for the past few months. Spreads are so wide, you could drive the state of Texas through them. Bids on bonds, if you can even find one, are anything but firm.

In fact, friends in the industry have told me that most attempts to move sizable positions result in bond dealers backing off immediately from their bids. This is why Ben Bernanke cut the discount rate and not the fed funds rate. He was and is trying to stave off a complete credit crunch, the likes of which we have not seen since 1990.

Sure, interest rates remain low. Sure, mortgage rates are still very reasonable. But good luck finding an institution to loan you the money! The group most sensitive to this is the small cap stocks. After a 7 year outperformance streak, I fully expect a longer period of underperformance, like we've seen since the end of June.

Big Ben to the Rescue?

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If you're with me right now, the answer to most of the above mentioned maladies is simple. The fed should cut and cut and cut interest rates. It will help the mortgage market. Banks will earn more and shore up their balance sheets before eventually loosening lending restrictions. The credit market will breathe a sigh of relief and begin to return to normalcy. While it may not fix the ills immediately, it will do the trick over time.

Here are the problems. First of all, the U.S. dollar has been in decline this whole decade. Low interest rates and a high budget deficit have put our currency on the brink of total collapse. Cutting rates is VERY inflationary and would mean grave consequences for our economy.

Inflation is not contained right now with energy prices close to all time highs and food costs soaring. The price of wheat, thanks to various droughts and huge emerging market demand has DOUBLED in the past year! The Fed would actually need to raise rates to bring inflation under wraps.

Lastly, lowering interest rates with the Dow at 13,000 and most indexes within striking distance of new highs would set off yet another Fed induced paper asset bubble. History shows the Fed usually moves multiple times, not just once.

I have been very critical of Alan Greenspan during his reign as Czar of the Fed, having sucked liquidity out of the stock market when he took control just before the 1987 crash. He bailed out the Wall Street investment banks and Long Term Capital in 1998 and fed fuel to that fire by wrongly adding a flood of liquidity in 1999 to prevent a banking collapse in the greatest joke of all time, Y2K.

To make matters worse, after the stock market was in complete and utter collapse
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and the economy was in recession in 2000, King Alan held off cutting rates because of the Presidential election. By the time the Fed did a surprise between meeting cut in January 2001, it was too little, too late. After initial euphoria wore off in a week, it took almost two YEARS for the bear market to end.

By creatively cutting the discount rate and not the fed funds rate last month, Ben Bernanke already has my respect. It's clear he does not want to continue Greenspan's ill timed ways, but does want the financial markets to sort out their problems unless economic growth is at stake.

I can almost picture Big Ben asking his committee why they should bail out investors who took on more risk than they should have. It's not the Fed's job!

Last Friday's employment report was almost too drastic to believe. Bad news has become good news since it almost certainly means a rate cut. But Friday's number was so bad that investors now think Goldilocks is dead, recession is here, and one rate cut is probably meaningless. Sounds a bit manic/depressive if you ask me!

On September 18, Ben and his troops are going to meet and discuss one of the most difficult situations this era. A 1/4 point cut is almost guaranteed, but the consequences could be grave. Only a nice stock market debacle into that meeting would relieve some of their angst.

Interesting times we live in...

This is already a very long update and I haven't even discussed the stock market and my outlook. I promise to send another email during the week.

After knocking the cover off of the ball in July, we had another good month in August. I am really proud of how well our models have performed, having made significant money from the March bottom to the July high and preserving those gains and even adding during the 10% correction.

I know I am preaching to the choir, but it's still great. If for some reason, we don't manage a piece of your portfolio, I truly don't know what you are waiting for. I used to say to stop accepting mediocrity, and that was during the bull run!

I have no idea what to say now when most investors have seen such carnage. Call me immediately if you fit in to this unfortunate group!

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