

Hurricane on Wall Street

The Current Environment

It is time to take a deep breath and reflect on how the world changed this past week. Make no mistake about it, these are very uncertain—indeed scary—times for the financial services industry, for investors, and for the entire global economy. There is no amount of hyperbole that can adequately describe what is happening here. During the past week the world's stock markets have morphed into a daily, if not hourly, "Global Shock Market." And it is not over by a longshot.

The struggle has been going on for many weeks now. Daily volatility seems to be about the only constant characterizing the market's recent behavior. Indices open high and swoon, or open low and never recover, or open low and race for the sky at close. All players, from the largest institutions to the smallest individual investor, are reeling, trying to find a comfort level amidst all the confusion.

Over the last five trading days alone roughly \$5 trillion in value across the markets disappeared in the first three trading days of the week only to miraculously reappear at the end of trading Friday after a record two-day surge. Incredibly, this \$10 trillion swing represents more than a quarter of the world's entire stock market value. The markets have been trading on rumors, buyouts, bankruptcies and bailouts—it is pure emotion and it is not healthy.

A Sense of Perspective

For those of us who have been in this business since the early 1970s, there is, at one level, a certain déjà vu to it all. Experience and historical analysis provide objective perspective and understanding. We appreciate how market cycles work over time—the inevitable excesses and contractions, the booms and the busts, the impact of specific events like savings and loan crisis of the 1980s and 1990s, the market crash in October, 1987 and the aftermath of 9/11. And we can generally take comfort in the rationale of these market cycles, these defining events and how investment risk must be considered and managed over time, with a longer view.

But this time, at a gut level, it feels different. In fact, it feels very different than the past. It feels surreal, out-of-body, eerie, and unnatural, as if the twin forces of uncertainty and change have joined in a cruel diabolical plot to overwhelm the economic landscape. Essentially, there is no reference point to what is happening today. It is truly uncharted territory.

The Mother of All Storms

Wall Street and Main Street have taken a direct hit by the economic equivalent of a Category 5 hurricane. Landfall officially occurred on Sunday, September 14th and the storm's epicenter was the bankruptcy of the storied Lehman Brothers, quickly followed by the fire sale of iconic Merrill Lynch to Bank of America and the federal bailout of AIG (American International Group), this country's largest insurance company.

It is the sheer scope and dimension of the storm surge that is so absolutely astounding. By Wednesday, over \$2 trillion of value on the US markets and an estimated \$3 trillion across international markets vaporized as global markets plummeted. These actions followed the earlier government takeovers of Freddie Mac and Fannie Mae, the two mortgage banking behemoths. Rumors are circulating that Washington Mutual (WAMU), the nation's largest thrift, will be the next to go down. And there is late word that the two largest independent investment banking firms, Morgan Stanley and Goldman Sachs, will change their charters to become commercial banks in order to avoid a similar fate. Unbelievably, in a week's time, Wall Street as we have known it is dead.

To be certain, there were early warning signs that a serious storm could be out there, lurking ominously. The storm's outer bands of rain and wind—initially evident with last year's volatility caused by the subprime mess, growing concerns about market liquidity and institutional solvency, and the takeover of Bear Stearns last March—all signaled potential trouble. However, it was the speed and fury of last week's confluence of cataclysmic events that caught everyone off guard.

Regulatory Impotence

The financial levees designed to regulate the industry and protect the investing public—the Federal Reserve, the Securities and Exchange Commission, and the Treasury—were quickly breached. It speaks volumes that even government regulators were not fully aware of the gathering storm.

Long hobbled by balkanized oversight and growing gaps in disclosure rules, the regulators have been increasingly marginalized in recent years. Additionally, complex new derivative products, such as collateralized debt obligations, have spread virus-like through the entire global system with virtually no oversight or risk control apparatus in place as a safety check.

The developments of last week merely magnify how badly outdated our regulatory infrastructure has become and how inadequate the tools are to effectively deal with large, complex and rapidly evolving problems that are increasingly global in nature. Our regulatory framework is seriously flawed and its strategy resembles a cross-your-fingers exercise. The old ways of protecting

our financial system no longer work. Wall Street, and arguably our entire financial system, is broken, and it is broken badly.

Repair Costs

The economic costs to fix the damage will be staggering: to innocent taxpayers for open-ended government bailouts (current estimates approaching \$1 trillion may be the proverbial “tip of the iceberg”—the fact is no one really knows) on top of increasing federal deficits; to an already fragile financial system whose existence depends upon stability, confidence and the efficiency of the capital markets; to vendors and creditors dealing with firms threatened by bankruptcy or insolvency; to a slowing economy that relies on predictable supply and demand relationships, etc.

And how do we measure the costs in a human dimension? Tens of thousands of job losses, family dislocations, ruined careers, personal portfolios wiped out, heavy losses to individual retirement plans, etc. Measured any way, the financial *and* psychological costs of recent events are extremely significant, and for many, they are life-altering.

Lessons Learned

If we have learned anything over the last week, it is that the damage was not just confined to Wall Street or to Main Street, USA. In fact, the storm’s impact extends worldwide. Emerging from the debris is a new place called Global Main Street, Planet Earth. The problem is that there are no maps or street signs to tell us where we are, there are no rules of the road to guide us and, quite frankly, our destination is yet unknown.

Perhaps most telling was the unprecedented action that central banks took last week by flooding the world’s financial markets with hundreds of billions of dollars as part of a coordinated strategy to bolster liquidity. The recognition was that it is more important than ever to view the financial markets as part of an integrated global system, not simply a collection of unrelated parts.

Parting Thoughts

We are witnessing history in the making. Times of crisis provide the opportunity for fundamental change and this is truly a defining moment. The structural changes we need to undergo will forever alter the financial landscape as we know it. What is happening now will be referenced in text books and financial journals for decades to come.

As we endure a period and a process best described as “creative destruction,” there will undoubtedly be major challenges ahead. Borrowing from a popular political slogan, it is “Change We Need!” but the devil is clearly in the details and we are in uncharted territory. The stakes are very high and failure is not an option. Hopefully our elected representatives will get it right.