

MORAL HAZARD BE DAMNED

December 6, 2007

It has often been said that the difference between a recession and a depression is confidence. As we wrote in our April 3, 2007, piece, *Rolling Bubbles*:

The current debate on Wall Street centers on whether this sub-prime problem will spread or be contained. Frankly, at Cadinha & Co., we feel this debate is inherently moot. The sub-prime borrower is simply the weakest link in the mortgage chain...and it has broken. The facts show that most mortgages have been securitized and these securities (with a value well into the trillions of dollars) can be found in most bank, insurance company and finance company portfolios. It is simply impossible to know where these securities lie and furthermore to differentiate between the good and the bad. Major Wall Street firms are responsible for much of the securitization along with the trillions of dollars of derivatives that are divined to augment institutional portfolios. Obviously, the risk in the finance sector of the market has increased tremendously. Accordingly, we have exited this sector with sales of bank, insurance and Wall Street brokerage investments.

We now find ourselves in December, and frankly, after eight months the picture has not changed. What has changed is that more individuals are beginning to understand the magnitude of the problem associated with financial “deleveraging”.

Clearly, Ben Bernanke and the Federal Reserve Board “threw in the towel” with massive cash infusions and interest rate cuts in August and September. They obviously understand the problem and will probably continue to cut rates and provide liquidity to a banking sector that is scrambling to maintain capital adequacy ratios.

A recent convert to this view is Treasury Secretary Paulson, who just weeks ago railed against “bailing out speculators”. He now is advocating a plan to do just that, proposing to freeze mortgage payments for those who can’t afford the payments on mortgages that reset to a higher monthly payment. If this isn’t a bail-out, what is? Furthermore, it isn’t yet clear who will pay for this. In effect, we now have the Administration joining with the Federal Reserve in a two-pronged effort to shore up confidence in the entire financial system. The moral issue has apparently been put aside, suggesting that the problem is quite severe and that moral hazard is an acceptable risk.

Perhaps the most significant aspect of Paulson’s plan is that our banks may be relieved from the required “marking to the market” or re-pricing of mortgage backed securities until next year. Paulson’s proposal appears to be a stalling tactic to avoid the ugliness that would prevail if these issues are re-priced at year end.

We believe that there is yet another significant new force joining in to help the United States avoid a serious financial and economic calamity. The simple fact that Dubai has invested billions to help beleaguered Bear Stearns and Citicorp, coupled with Saudi Arabia’s announcement that they have increased oil production to 9mm bbls/day and are prepared to go even higher, suggests that the moderate Arab states are doing what they can to help economically. Spiking oil tanker rates over the last few days confirms that this extra oil is headed toward

western refineries. And lastly, yesterday, Saudi Arabia declared that they were not interested in changing from pricing their oil in U.S. dollars. In Iraq, thousands of Sunni volunteers have joined with Shiite forces in a burgeoning police force aimed at defeating Al Qaeda. Perhaps there is a new found concern among moderate Arabs that a U.S. defeat in Iraq coinciding with a severe recession will assure the political fact that Americans may not be seen in that part of the world for decades. That would mean that they will be forced to deal with Iran and Syria by themselves.

So there you have it; the Federal Reserve, the Administration, and the moderate oil producing states all working in unison to avoid a serious financial and economic correction. Expect lower oil and lower gasoline prices, as we head into next year.

This is indeed an interesting dynamic, but we still are in a wait and see mode until there is more clear evidence that confidence is returning to the marketplace. Until then, we plan to keep our portfolios hedged and quite liquid. Good quality common stocks, Treasuries, and cash will continue to be our prescription for the immediate future.

Wishing you and yours a very happy holiday season.

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