CORNERSTONE
INVESTMENT SERVICES, LLC

Cornerstone Commentary

01/19/2008

Key Points

- Low interest rates stimulate borrowing
- High Interest Rates stimulate lending

As Seen in

Forbes

Cornerstone Investment Services has been chosen by Goldline Research as one of the **Ten Most Dependable Wealth Managers of the NorthEast**

Risk Costs

John Riley, Chief Strategist

To stimulate growth, much lower interest rates is the last part of the stimulus plan that the collective wisdom of the team running the economy into the ground is proposing.

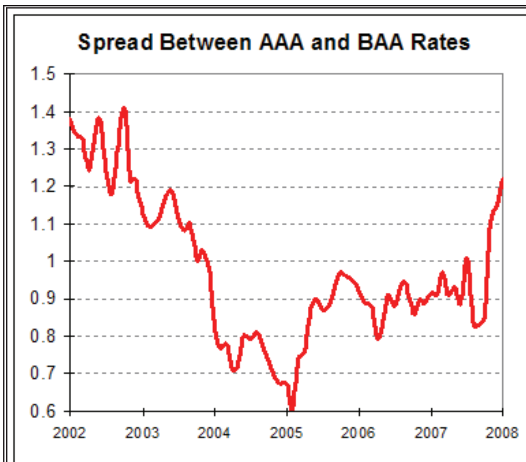
This will be known in the future as "Bernanke's Folly". Too bad, because its Greenspan's doctrine, but he was smart enough to get out before the waste product collided with a wind machine.

Understanding Debt

Any time you buy a bond, invest in a CD or deposit money in a bank, you are making a loan. You are loaning to your money with a promise to get that money back at a certain time in the future. The borrower pays you an interest rate for the privilege of using your money. The rate of interest you as the lender collects is commensurate with the risks of the borrower being able to pay you back.

Putting money in a bank is low risk, so you get very little interest. Putting money into Junk bonds is riskier, so the interest rate you are paid is higher, compensating the lender (you) for the extra risk.

Any time you borrow money, you borrow from an investor that has loaned his money. You as the borrower are determined to have a certain amount of risk and the lender demands a certain amount of interest to offset that risk.



Source: Fed Reserve, Format: CIS

Spreads bottomed in early 2005. Since then a re-pricing of risk has accelerated until the 4th quarter of 2007 when the spread jumped about 40 basis points.

Homeowners with great credit get the lowest interest rate mortgages, homeowners with lousy credit have to pay higher rates on their mortgage.

But for a while, the rates that lower quality borrowers had to pay kept getting lower and lower, closing in on the rate top quality borrowers paid. The chart below shows the spread between AAA rated debt and BAA rated. As risks rise, and lenders re-price risk, the spread between the two ratings rises. Since early 2005, the rate has climbed over 1/2%.

The past couple of years has seen a re-pricing of risk in the bond markets, especially the mortgage markets. During the heyday of the real estate peak, anybody with a pulse got a mortgage. We all saw the TV commercials for that one mortgage company that used to say they had banks competing for your business. You as the borrower could sit back and choose the lowest rate.

Lenders were falling all over each other to get their money lent into the hot real estate market. And to compete, they ignored some of the basic rules. The most basic is to get paid for the risks they took. This is where sub-prime mortgages come from.

People that should never have qualified for a library card were getting $500,000 mortgages. (We are not going to go into the "predatory practices" some lenders are accused of. People are responsible for their own actions. I do not believe that homeowners bought houses 2 and 3 times what they could afford didn't know it. This does not include fraudulent lenders that lied to the borrowers. They should have their corporate officers in jail.)

Why It Won't Work

So now we fast forward to the lower interest rates planned to stimulate the economy. According to the Monatarist's World Economic view, (See Money Money…) lower interest rates stimulate lending and this new money in the economy propels the economy forward.

Almost right. Lower interest rates do not stimulate lending. Higher interest rates stimulate lending. Lower interest rates stimulate borrowing, sometimes.

It is simple, if you have $100 to lend to your friends, who are you going to give it to, Friend A offering you 5% interest or Friend B offering 10% interest? You will give it to the guy offering the most interest, all other things being equal. (These aren't really good friends for all of you thinking I wouldn't charge a friend interest!)

But what if they are not equal? What if Friend B still owes you a bunch of money he can't pay off? What if Friend B had a hard time paying you off the last time you loaned him money? What if Friend B just lost his job? Friend A is a much better risk, even

though you will get less interest.

So at what price would you lend to Friend B? Is there an interest rate that would get you to look past the risks? Is it higher or lower? Of course it is higher.

Lenders in the US economy have to ask themselves the same questions. Is it worth the risk? At what interest rate am I being properly compensated for the risks I am taking when lending money to this homeowner or that small business? The idea that that lower interest rates will stimulate lending in this part of the cycle ignores the lender's position.

Real Life Example
We don't have to look far to see the failure of the Monatary World View. Japan has been in a deflationary funk for almost 20 years. Since its market peaked in 1989, Japan has slipped into a deflationary economy that is held back by a mountain of debt.

Interest rates in Japan have hit 0.00%, (zero) and yet their economy still can't get up off the mat. Why? Because while rates were low, lenders increased their requirements to qualify for a loan.

The same thing is going on in this country right now. Lenders are increasing their qualifications for borrowers and people that qualified for a loan a year ago, may not today.

Conclusion
Regardless of the direction of interest rates, if lenders don't want to lend, the economy goes nowhere. Since we should be concentrating on reducing our debt burden anyway, this isn't a bad thing.

The economic decline that comes along with that will be painful to many lenders, homeowners, the stock market and unprepared investors. They will be finding out the true cost of the risks they took.

Investment Implications
Having hedge positions on the US Equity markets, bond markets and the Dollar are important. Hedges should benefit from declines in these areas. As risk is re-priced, the values of these markets should decline significantly.

At Cornerstone, market hedges are the first thing added to a new client's portfolio. We don't just anticipate the declines, we are prepared to profit from them.

Key Points

- The direction of rates won't matter if lenders won't lend
- Hedge the US markets, bond markets and US Dollar

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