# ❖ Horizon Asset Management, Inc. ❖

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## Interim Market Commentary

*TALF and Its Historical Context*

*&*

*Differences between the Great Depression & the Current Panic*

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### *TALF and Its Historical Context*

*This was recorded on February 9, 2009. On February 10, 2009, the Federal Reserve Board announced that it is prepared to expand TALF substantially to as much as $1 trillion. It also could broaden the eligible collateral to include newly issued AAA-rated commercial mortgage-backed securities, private-label residential mortgage-backed securities and other asset-backed securities. The U.S. Treasury will support the expansion with additional funds from TARP. The comments below do not reflect the February 10th announcement.*

It seems odd to talk about selling stocks short after the market has gone down 50%. Obviously, in such an environment we're reluctant to sell stock short, since the not inconsiderable problems of many companies are heavily reflected in the prices of their securities. Nevertheless, there are some interesting subjects to discuss. The focus of this section will be on two topics. The first is the Term Asset-Backed Securities Loan Facility program sponsored by the New York Federal Reserve, familiarly known as TALF. The terms for TALF were announced on Friday, February 6, 2009.[1] The second topic discusses the uniqueness of TALF in a historical context.

It's interesting that the TALF program has not attracted much scrutiny by the press, though I think it should have. TALF is a $200 billion facility that offers three year loans on a non-recourse basis to eligible borrowers for the purpose of buying securities of so-called eligible asset-backed bonds. Those securities will be used as collateral for the non-recourse loans granted by the New York Fed to the buyers.

On Friday, the New York Fed published its table of how much it would lend based on the market value of each instrument. There are some restrictions on these loans. The first restriction is that the asset-backed securities themselves must have the highest possible rating from two or more nationally registered rating agencies which, in many cases, may not be possible to obtain. All bonds that are eligible for the program must be issued subsequent to January 1, 2009, and be composed of loans that were originated subsequent to October 1, 2007. By law, any principal payment or remittance from the asset-backed securities themselves must be used to reduce the Fed loan in proportion to the original loan value.

The United States Treasury Department will jumpstart the program. Under the Troubled Assets Relief Program (TARP), the U.S. Treasury will buy the first $20 billion of asset-backed securities issued under TALF. The facility itself will cease making loans on December 31, 2009, unless the Board of Governors of the Federal Reserve extends the program beyond that date.

[1] This was recorded on February 9, 2009, prior to announcement of the program expansion.

**Table 1: TALF Haircuts**
Preliminary collateral haircuts are as follows:

| | | ABS Expected Life (years) | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sector | Subsector | 0-1 | 2-Jan | 3-Feb | 4-Mar | 5-Apr | 6-May | 7-Jun |
| Auto | Prime retail lease | 10% | 11% | 12% | 13% | 14% | | |
| Auto | Prime retail loan | 6% | 7% | 8% | 9% | 10% | | |
| Auto | Subprime retail loan | 9% | 10% | 11% | 12% | 13% | | |
| Auto | Floorplan | 12% | 13% | 14% | 15% | 16% | | |
| Auto | RV/motorcycle | 7% | 8% | 9% | 10% | 11% | | |
| Bank Card | Prime | 5% | 5% | 6% | 7% | 8% | | |
| Bank Card | Subprime | 6% | 7% | 8% | 9% | 10% | | |
| Retail Card | Prime | 6% | 7% | 8% | 9% | 10% | | |
| Retail Card | Subprime | 7% | 8% | 9% | 10% | 11% | | |
| Student Loan | Private | 8% | 9% | 10% | 11% | 12% | 13% | 14% |
| Student Loan | Gov't guaranteed | 5% | 5% | 5% | 6% | 7% | 8% | 9% |
| Small Business | SBA loans | 5% | 5% | 5% | 5% | 6% | 7% | 8% |

Source: www.newyorkfed.org/markets/talf_terms.html

In Table 1 is listed a series of so-called haircuts, or discounts, that the New York Fed will apply to the market values of the instruments in question for the purpose of making loans. For example, on a prime bank credit card asset-backed security with an expected life of one to two years, the so-called haircut is 5%. That means that the Fed will lend the borrower 95% of the market value of that asset-backed security. It's important to note that it's almost certain to be a newly issued asset-backed security (ABS). The discount, or haircut, on auto loans for a life of one to two years is 7%. Looking at the table, the weighted average discount, based on borrower preference, can be as low as 5%, or as high as 14%.

To place this program in context, 2004 was in the bubble period, or the pre-bubble period, depending on how one views history. According to Thompson Financial, ABS issuance in 2004 was $857 billion; therefore, a fully extended program would absorb ABS issuance greater than that of a good bubble year. That amount assumes that the only capital attracted to the ABS market would be via the TALF program. It is conceivable, though perhaps not likely, that other capital would be attracted to the ABS market, and that loans would be obtained from different sources. It's impossible to say; however, whether or not that's a likely scenario. This program is a huge seminal event and, in my opinion, should be treated as such.

### *Differences between the Great Depression & the Current Panic*

The TALF program is important in its own right and merits scrutiny not only for its intended effect on the credit markets, but also because it is absolutely without historical precedent. Many allude to similarities between the current environment and that of the Great Depression, but I think it is a great misreading of history to consider the two periods to be even remotely analogous. To that effect, what follows is a list of 12 obvious differences between them, though the list could easily have extended to 24 or 36 features.

1. Currently we have the Social Security System, but it did not exist during the Great Depression; it hadn't yet been created. That system is a not insubstantial buffer against economic problems.

2. There was no unemployment insurance.

3. The size of the government sector was radically different. In the current environment, the United States government employs over 22 million people out of a workforce of perhaps 150 million. The government employs roughly 15% of all the employed persons in the country. There was nothing remotely comparable to that in the Great Depression.

4. The size of so-called stable sectors of the economy differs from those of the Great Depression. The government was just referred to in number 3, and there is also healthcare, which exceeds 12% of GDP. That sector is not much affected by economic cycles, which makes it relatively stable. There was no parallel to that kind of stability in the Great Depression; it's very difficult to find a stable sector for that time. Even the food sector, which today is regarded as fairly stable, was anything but that during the Great Depression, because people dramatically changed their food consumption preferences.

5. The policy of the Federal Reserve regarding monetary expansion in the current environment has been, if anything, massive. By contrast, in the Great Depression the Federal Reserve actually permitted, and some would argue even encouraged, the money supply to shrink. That in itself is a salient difference.

6. The willingness of Congress to enact spending programs is greater now than it was in the 1930's. There was nothing comparable to the current spending proposals at any time during the Great Depression, even during the Roosevelt Administration.

7. Another very important difference between the Depression era and the current one is that in 1932 there was a massive tax increase. The top bracket increased from 25% to 63%. There were other increases as well: user fees, various tariffs and certain fees to states increased with a view to gaining revenue. The rise in taxes and fees was regarded as necessary to balance the budget. That situation is completely different from the current environment.

8. The mortgage market was completely different. The idea of a self-amortizing loan for real estate didn't exist. A so-called prime real estate loan in the world before the Great Depression generally required a 50% down payment. It's hard to imagine, but that's what was required. There was a lively market for second mortgages, because so few people had the wherewithal necessary to make a 50% down payment. Second mortgages carried interest rates anywhere from 8% and 25%. That was the then equivalent of the now sub-prime market. Lending was far, far more restrictive.

9. Another difference, which is much more subtle, but very profound, is the reality of many two-wage-earner families. In the Great Depression, there weren't very many two-wage-earner families; there were mostly one-wage-earner families. Unemployment insurance and other factors aside, if the breadwinner lost employment, the family was left destitute. The prevalence of two-wage-earner families in the current era is a major difference.

10. In item number 6, I alluded to the willingness of Congress to enact legislation aimed at correcting the economic problems in each era. In July 1932, for example, after seven or eight months of debate, Congress passed the Federal Home Loan Bank Act. Even the passage of that Act required a variety of procedural maneuvers to secure approval when the opposition was off guard. It's no accident that the legislation was passed in the summer but, even so, the opponents managed to change the legislation to require that the Federal Home Loan bank could only accept a mortgage loan that had a loan-to-value ratio of 50% or more, which defeated the whole purpose of its enactment.

11. There's a significant difference in the type of legislation enacted to combat The Great Depression and the legislation currently proposed. The National Industrial Recovery Act was the first major piece of legislation enacted during the Great Depression era. It was designed to deal with overproduction, as the problem was then described by noteworthy economists. It was believed that one factor causing the Great Depression was having too many factories, stores and developed real estate. If there were too many goods and services available for purchase, the proposed remedial measure was to reduce the available supply of them as a way of restoring the pre-depression equilibrium.

Under that Act, The National Recovery Administration was authorized to place restrictions on business such as limiting the number of hours of operation. The idea was that limiting the hours of operation of various retail establishments would ensure the survival of more retailers. Of course, when retailers are open for fewer hours, they naturally require fewer employees, not more.

12. Another provision was called the Agricultural Adjustment Act. It was aimed at reversing what was then believed to be excess production of agricultural commodities. Under the Agricultural Adjustment Act, farmers were paid for not growing crops. In the course of three years, the amount of planted acreage was reduced by about 25%. Of course, such a significant reduction of planted acreage meant a reduction in the necessary labor force, farm machinery and other accoutrements of agriculture.

    The Agricultural Adjustment Act was ruled unconstitutional by the United States Supreme Court in the case of the United States versus Butler in 1935, but that didn't stop the government from continuing its policies. The Agricultural Adjustment Act was reenacted in the form of the Soil Conservation and Domestic Allotment Act. Instead of giving the government authority to reduce acreage as a cure for overproduction believed to be a cause of the Great Depression, it gave the government the de facto power to reduce planted acreage in the interest of conserving the soil. Thus, it presented the Act as ecologically friendly. Obviously, as noted above, reduction of planted acreage will diminish, not increase, GDP.

    One of the unintended consequences of the Agricultural Adjustment Act was that a large farmer could evict tenant farmers and sharecroppers as a way of reducing production. The farmer would, of course, forego the rent paid by the sharecropper or tenant farmer, but would instead receive a much larger Federal subsidy. As large farmers responded to that incentive a great number of small farmers and laborers were driven off the land, leading to a great migration into cities of people in search of jobs in industrial areas. The consequences of the Agricultural Adjustment Act took several decades to reach culmination, and the consequences are still visible today. Obviously, it was a factor that increased unemployment, although the intent was the opposite. It's likely that when the events of the current era are examined in the cold light of retrospective history, many of the proposals being considered right now will be seen as damaging rather than helpful.

These comments present an encapsulated view of history and, as such, a great distortion. Nevertheless, it should serve to illustrate how radically different the current environment is from that of the Great Depression. I don't mean to understate what the current problems might be, since it's possible that they are even more severe than those of the Great Depression. Severity aside, however, the problems of the two eras are very different, and the government responses are even more dissimilar.