HAWK Talon

HAWK 100

Monthly News from Hawk100 — Issue 18, June 2010

Meanwhile, Stocks Fell

At right, you can follow why Hawk100 scores a zero for the Dodd-Frank financial regulatory reform bill. Regardless, during June, that score outperformed nearly every market segment.

Small US stocks led the decline by losing 7.1% during the month according to the S&P SmallCap 600 Index. Among small issues, value stocks underperformed growth by 2.5% for the month. Large US stocks also fell by 5.2% during the month as measured by the S&P 500. Like small stocks, large cap value lagged growth by 1.0% in June. US financial services dropped 8.0% on the pending Dodd-Frank.

The MSCI EAFE international bellwether dropped just 1.0% as Euro-area fears had already washed through most stock markets and currency exchanges. Indonesia led all countries, up 6.1% while Poland trailed at –7.5% according to MSCI.

Fixed income securities eked out gains. Municipal bonds were basically flat. Long-term treasuries did climb 5.5% on a continued flight to quality. The 10-year bond yield stands at 2.93%, its lowest since April 2009.

Latest economic statistics consistently reflect a month-to month downturn. Whether this leads to a double-dip recession is something we have long foretold.

Your wealth.
Your life.
Aligned.

6600 Perimeter Dr.
Suite 200
Dublin, Ohio 43016

614.791.HAWK

www.hawk100.com

Frankly, Dodd-Frank is a Zero.

In the midst of the September 2008 financial market storm, I briefly described the road that led to the financial crisis in writing for a former firm. I encouraged then that Congress recognize those failures in crafting "TARP." Now, Congress is serving a stale financial reform package courtesy of Rep. Barney Frank and Senator Chris Dodd. Let's revisit my 2008 road to destruction and ascertain whether subsequent intervention or Dodd-Frank abrogated any of those points.

The Road to Destruction — Then CFA Institute CEO, Jeffrey Diermeier, CFA blamed a "combination of exuberance, carelessness, and undoubtedly some malfeasance." *Dodd-Frank seeks to control human elements of greed through tighter regulation of the banking system. Score 1 point for Dodd-Frank.*

Loans for All — The Community Reinvestment Act of 1977 and its subsequent amendments encouraged financial institutions (backed exuberantly by Fannie and Freddie) to provide credit to low and moderate income borrowers. For decades, increased homeownership among Americans with modest means eventually stretched beyond equilibrium. *Dodd-Frank doesn't touch CRA and misses vitally needed Fannie and Freddie fixes. Minus 1/2 point.*

Loose Federal Reserve — Since Paul Volcker famously arrested stagflation from the helm of the Federal Reserve Board, American monetary policy has tended toward lax accommodation. Low cost of funds enabled creditors to ease lending standards and increase their balance sheet leverage. *Fed policy remains in a record-setting expansion phase. Though Dodd-Frank contains a provision named Volcker, it fails to hold the Fed accountable for monetary policy excess. Instead, it grants further power and control to the Fed and Treasury.*

Bankruptcy Law — Federal bankruptcy law revisions made it more difficult for consumers to seek protection. Then relying on more powerful position in bankruptcy proceedings, lenders lowered loan application hurdles. *Bankruptcy is a mess, especially since Chrysler, and foreclosures continue to be a source of imbalance.*

Fair Value Accounting — Traditionally, companies report balances for assets and liabilities at historical cost. These highly reliable balances lacked relevance in dynamic economic conditions, especially with longer-term assets and liabilities. Of late, financial reporting standards increasingly promoted fair value accounting practices whereby assets and liabilities were marked to estimates of fair market values. The intention herein was to provide more relevant financial reporting information, but fair value estimates were based on unreliable judgment. Fair values spiraled down with each corresponding write-down. *Financial reporting remains in transit toward IFRS, principles-based accounting, which is expected to improve reporting relevance. Frankly, this is beyond Dodd-Frank.*

Credit Card Culture — Irresponsibly excessive borrowing by American consumers, companies, and governments had fueled the fire. Warnings went unheeded for years, and spending behavior was routinely rationalized as indicative of American strength. It may now be its great weakness. *Leverage has only moved to the Treasury's books, and Obama appears poised to continue fiscal irrationality. Dodd-Frank does seek to reign certain practices in lending and consumer credit, but risks constraining business capital. Sarah Wallace of First Federal Savings in Newark, Ohio states this well in a recent Wall Street Journal. Give Dodd-Frank a 1/2 point.*

Moral Hazard — The relationship between risk and reward must be preserved for markets to function properly, fairly, and freely. Congress must carefully consider regulatory costs. Again Diermeier said, government must not "routinely … bail out risky behaviors … There must be consequences to the risk-takers." *Moral hazard remains. Congress thinks Lehman's failure caused the crisis, the more studious recognize the Lehman shock was possible only because the Fed rescued Bear Stearns (as it did LTCM in 1998). Dodd-Frank does nothing to end "too big to fail" and potentially institutionalizes this notion with more risk concentrated in fewer bank institutions. The risk-reward relationship is lost on Dodd-Frank, and they lose a point because of it.*

By Richard Clemens, CFA, President