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What To Do in a Recession - Part I
Smoke and Mirrors

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“The banks exposed themselves too much; they took on too much risk .... It's their fault. There's no need to blame anyone else.” Warren Buffett in an interview with a Madrid newspaper, El Pais, speaking on the sub-prime crisis published May 25, 2008

“I believe that we are already in a recession…It will be deeper and longer than what many think.” Warren Buffett quoted by a German newspaper May 25, 2008, when asked whether the US is in a recession.

If you are reading this article, I probably do not need to give you the bonafides of Warren Buffett, other than to say he is one of the wealthiest men in the world and most of his wealth is derived from investments made over 50-plus years. Unlike many men of his stature, Mr. Buffett exudes folksy Midwestern charm and has an impeccable reputation for being ethical and remarkably honest. But I respectfully disagree with his conclusion as to the responsibility for the sub-prime crisis.

Mr. Buffett is chairman and chief executive officer of Berkshire Hathaway. Berkshire owns or has a majority interest in 80-plus companies from Coca Cola to Johnson and Johnson. Ominously, Berkshire owns close to 20% of Moody’s Corp. which calls into question the above statement. Moody’s, along with Standard & Poors and Fitch, assigns ratings to investments, governments and companies. The assignment of the ratings (AAA through D) is relied upon by investors to determine the risk involved in transactions. The ratings are central to the securitizations of mortgages; otherwise investors (pension, hedge and mutual funds, insurance companies, trusts, etc.) would not have the confidence or inclination to invest in mortgage-backed securities without performing their due diligence on the underlying assets. The rating agencies' classification of tranches, (see Recession: Federal Reserve Issuing Welfare Checks at Discount Window for explanation of tranches) allow issuers such as Goldman Sachs, Citi Group, Bear Stearns, UBS, Deutsche Bank, Merrill Lynch, JP Morgan Chase amongst others, to structure their securities for sale to investors.

In the summer of 2007, after the collapse of two of Bear Stearns hedge funds and a wave of defaults on sub-prime loans within mortgage-backed securities and collateralized debt obligations, rating agencies came under scrutiny by investors and some states - over the investment grade ratings on what essentially turned out to be junk. The rating agencies' response, particularly Moody's, was to refer their complainants to the companies' disclaimers:

S&P - "Any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision."

Moody's - "Moody's has no obligation to perform, and does not perform, due diligence."

When critics of the agencies discovered the issuers-investment houses-were paying the rating agencies fees for their ratings and consultancy, an avalanche of lawsuits followed. Attorneys general, institutional investors and astute observers did not agree with Mr. Buffett. The bubble could not have been inflated without the rating agencies' seal of approval. As a final note to this part of the column, when Federal Reserve Chairman Bernanke went before Congress to explain the Bear Stearns deal, the chairman assured the Senate Banking Committee the American taxpayer was not on the hook for the $29 billion in guarantees to JP Morgan because Bear Stearns had pledged $30 billion in AAA securities.

A structural shift is occurring within our economy due to several trends in the markets over the past two decades and a half. Now the entire US economy is being threatened, which brings me to the other comment made by Mr. Buffett, while in Europe, regarding recession. I suspect you are wondering why one should believe this statement by Mr. Buffett and not the other. Mr. Buffett's comment regarding the banks' culpability was self-serving. It is in his interest the public believes responsibility for the sub-prime crisis stops at the doorsteps of banks and not any higher up. On the other hand, the comment about the economy in a recession was objective, in my opinion. I cannot discern any beneficent motive for making such a statement.

Because this is not a cyclical phase in the economy, consumers will need to make some adjustments in their personal lives. This is not to alarm you but the job loss in this economy is going to get worst and the downward spiral will continue. I assume your first reaction is disbelief. Perhaps you will believe Mr. Buffett who stated the recession will be deep. Being one of the trendsetters in the marketplace, he would know. He is in Europe looking for value - something the United States has very little of after the corporate takeovers, leveraged buyouts and unregulated derivatives market peaked. As the markets unwind, so should individuals. Future installments will provide information on de-leveraging for consumers.

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