

INVESTMENT UPDATE

It's the Holiday Season, and that means giving. And receiving. Tradition holds, however, that only the good children get gifts, and those that are naughty get a lump of coal and a bag of sticks.

Evidently, nobody told the US Government.

While no one likes to play Ebenezer Scrooge, from our vantage point down here in the bond market bunker, we have to wonder just what's been spiked in the Government eggnog. The Federal Reserve hatches up a plan to inject liquidity into the international capital markets—not bad, we say. They lower the Fed funds rate by 25 basis points (0.25%)—another baby step, but you're moving in the right direction, we think. Congressional committees cobble together a group of laws designed to protect borrowers and punish predatory lending—that horse has left the barn, but go ahead and close the door anyway, we say. But leave it to the US Treasury to come through with the humdinger, the Santa Claus is Coming to Town moment, a program designed to help “up to 1.2 million subprime ARM borrowers”—the Hope Now Alliance plan.

How could anyone be opposed to a program that helps impaired borrowers by preventing the interest rates on their homes from rising, and thus allowing these struggling homeowners to stay in their houses?

Before we take this on, point by point, we should back up a couple of steps and review just a bit.

We're all familiar with the recent history of the US housing market, how steadily rising home prices emboldened both borrowers and lenders to enter into loan agreements on increasingly easy terms. How, once all the credit-worthy buyers had been satisfied, new loans were created to make it feasible, if only for an initial period, for those with shaky finances to buy a house. And finally, how yield-hungry investors failed to roll their sleeves up and carefully examine the underlying quality of these loans, many of which were repackaged into structured mortgage-backed securities of dubious quality.

The conventional prescription for the resolution of such ill-advised risk-taking is unpleasant: financial loss. Throughout the history of civilization, those who speculate have taken their occasional beating. It is what maintains discipline and order—without the periodic and painful downside, there is no reason to restrain one's animal spirits. Entering into a financial transaction with an uncertain payoff

should only be entered into with one's eyes wide open, fully cognizant of the possibility of a negative return on your investment.

Enter the politicians. The Treasury wants to show that they're doing something “to help financially responsible but struggling homeowners,” in the words of Secretary Paulson. Despite the seeming benevolence of this sound-bite, overstretched borrowers are not the only, or even the most essential beneficiaries of the Treasury's plan. Yet this program will extend, for five years, the initial teaser rates for certain qualifying subprime borrowers, and to help other qualifying mortgage holders “fast-track” financing into an expanded FHA program. The folks in the first group must be sufficiently un-creditworthy that they do not qualify for any public or private financing options; they must have an adjustable-rate loan that was originated between January of 2005 and July of 2007 with a first reset falling between January of 2008 and July of 2010; live in the house as the primary resident; be no more than 60 days delinquent; and have a FICO score of less than 660 (subprime is typically defined as a FICO score below 620).

These lucky, chosen few will be rewarded—all other struggling, subprime borrowers unable to get refinancing will, presumably, have to play by the old rules and fend for themselves. This plan, for all its good intentions of helping homeowners, does less than that. Less because it selects an arbitrary group of people who, it could be argued, should have known what they were getting into when they signed up for their loan. Less because it does not directly help the victims of predatory lending. Less because (alternatively) it does nothing for folks with good credit scores, and may even encourage otherwise responsible borrowers to miss payments so that they, too, can qualify for relief.

In fact, some might argue that this plan was designed more to bail out the lenders and servicers than the borrowers. Lenders won't get stuck now with as many foreclosures, and have the Government's help in renegotiating tens of thousands of individual adjustable rate mortgages. Servicers, who simply earn a fee from the homeowners' monthly mortgage payments before forwarding these cash flows to the ultimate holders of the loans (or securities created out of the loans), will see no interruption of their revenue under this plan.

Of course, the biggest loser in this plan is the integrity of the credit markets, which are already struggling to come to grips with a deep sense of mistrust towards institutions who underwrote these loans, as well as those who securitized them and



those who passed judgment on their credit quality. Those of us who deal with the credit markets on a daily basis want to see normal market forces at work, not financial intervention by politicians looking for a boost in opinion polls. The Government's goal in all this should be to make sure that lending practices are fair and fully disclosed, and that consumers have all the tools available to them to make sound decisions. We shouldn't be bailing out borrowers and lenders for their mistakes in judgment by re-writing financial contracts.

While their actions are misguided, we understand the Government's avowed interest in the consumer. With at least 70% of the US economy driven by consumer spending, recession risks are looming, and policy-makers of all stripes are starting to panic, especially on the dawn of a major election year.

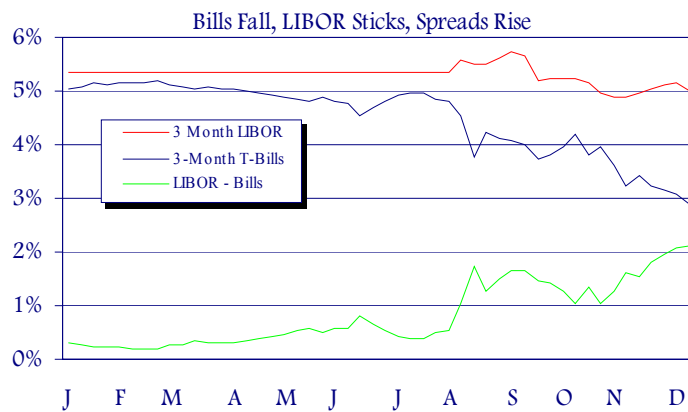
The easiest way to protect the consumer and thus, stimulate spending, is to simply lower rates—but it's not so easy these days. Banks used to control the cost of borrowing, but as we've seen very clearly this year, banks have increasingly securitized loans and sold them into the capital markets over the past decade or so. Even though the Fed has lowered the overnight funds rate three times in the last five months (for a total of 1%) the market's reaction has been lukewarm at best. Neither banks nor borrowers (nor Wall Street, for that matter) care much about the Fed funds rate; they care about LIBOR.

LIBOR (the London interbank offering rate) is the rate at which banks lend to each other. It is, in effect, a bank's cost of liquid, short-term (less than one year) funds. If one bank needs cash, it can borrow in the LIBOR markets from another bank that is flush with cash. LIBOR is also (and this is important!) the index interest rate that 98% of subprime adjustable rate mortgages reset from. As the adjustable rate teaser rates roll off, they are typically reset at 3-month LIBOR plus some "spread" (it is this spread that makes lending profitable). The spread varies, depending on how aggressive the lender was, or how well the borrower shopped around.

As a result, the most direct way to ease the burden of resetting mortgage rates is to lower LIBOR. Borrowers' monthly mortgage payments rise to a lesser extent, and banks and other LIBOR-funded financial intermediaries can still earn their spread and make a profit. And here we get to the hard kernel of the matter: LIBOR has remained stubbornly elevated, as there is currently a very high degree of mistrust among bankers regarding the quality of assets they are lend-

ing against. As the chart on this page shows, while three-month Treasury Bill rates have fallen by more than 2% since August, three-month LIBOR has barely budged, down by less than 0.50% over the same period.

And this is where the Government (specifically, the Fed) may be able to do some real good. Last week the Fed announced a plan, in concert with the European Central Bank, along with the central banks of England, Canada and Switzerland, designed specifically to provide cheap funds into the banking sector in the hopes of encouraging inter-bank lending and bringing down LIBOR. This so-called Term Auction Facility will allow banks to swap securities for cash for short periods of time at favorable interest rates. By participating in these auctions, banks can use the cash to shore up their balance sheets over the next few months, easing pressure on dollar-based short-term rates. It is, essentially, a more formal, international version of the Fed's discount window operations (which were expanded, with only modest success, in August).



It's still too soon to tell if this new plan will help bring down LIBOR, but the initial reactions are somewhat encouraging; three-month LIBOR has fallen by 15 basis points in less than a week. Still, these secured loans depend on the credit quality of the underlying assets, and as they are secured by, in the Fed's words, a "wide variety of collateral," the Fed will be bearing some de-

gree of risk that participants in the capital markets are reluctant to bear.

In other words, this plan's ultimate success, and the normal functioning of the global credit markets, is still dependent on a long-term improvement in investor sentiment. In the short term, the global capital markets are likely to remain unsettled, as participants work to fully reprice risk and assess the damage to their financial statements. While we believe that we're well advanced in that process, market psychology is still quite negative. And that's something no government program can easily fix.

As always, we wish our clients and all our business associates a happy holiday season, and a prosperous and healthy New Year.

