

INVESTMENT UPDATE

The talented English singer/songwriter Richard Thompson is known for his dour and heart-rending tunes, so much so that he once had a fan-sourced bootleg recording entitled *Gloom and Doom from the Tomb*.

That album would make good listening for anyone involved in today's bond market.

Not since the bad old days of 2002, when bondholders were howling about the asymmetry of corporate bond risk (Heads: I lose everything, Tails: I get my money back!) has sentiment been so downbeat as it is right now in the bond market.

This is especially gut-wrenching since we had thought that the worst was over in August, when investors first saw the writing on the wall for the subprime market, and calculated the breadth of the problem and the impact on their own individual balance sheets. For investors like Agincourt, the math was pretty simple: We had no subprime exposure, and no real credit risk in the mortgage/structured product markets. We shed no tears for either the borrowers or the ultimate holders of these bottom-of-the-barrel home loans; the borrowers were extended credit they couldn't really afford, and the buyers of these loans were looking for fat yields in a market built on a foundation of quicksand. Neither party did their homework, neither properly accounted for the risk they were taking on, and both were due for an ugly day of reckoning.

The Fed apparently agreed, and in August lowered the discount rate so that the credit-worthy segments of the capital markets could continue to get the funds they needed to run their businesses. They followed up in September and October, lowering the Fed funds rate (and the discount rate) by a total of 75 basis points (0.75%), sending a message to the markets that the Fed would keep the economy moving during this period by taking back some of the monetary stringency they had put in place in the run-up of short-term rates since the end of the last recession. They offered nothing to directly assist either party to the subprime meltdown (although lower short-term rates would help ease the initial

impact of expiring teaser rates).

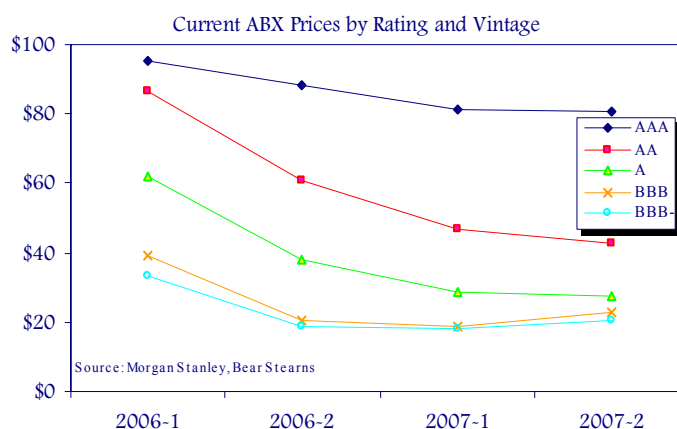
This seemed to calm things down, at least for a while. High-grade corporate bonds, which had been sold off in a semi-indiscriminant fashion throughout the summer, made a comeback, outperforming Treasuries in September and October as credit spreads narrowed. A more-or-less orderly liquidation of some of the subprime paper (and its derivative instruments) from weaker to stronger hands began. Sentiment seemed to be on the mend.

Then just as quickly, sentiment turned south again. First, rumors of big subprime and collateralized debt obligation (CDO) writedowns surrounded Merrill Lynch, culminating in an \$8.4 billion charge-off and the dismissal of CEO Stanley O'Neal. Next came Citigroup and a nearly identical scenario—a \$10 billion writeoff and the firing of their chief executive. Bank of America, Wachovia, and Barclays all took multi-billion dollar charges. Unconfirmed reports of more hidden losses in the MBS and derivatives markets put investors in a frenzy, and NY State Attorney General Cuomo poured fuel on the

fire by accusing Fannie Mae and Freddie Mac of colluding with mortgage lender Washington Mutual by artificially inflating home appraisals (without explaining the mystifying motive of why the Agencies would want to make their guaranteed loans less credit worthy).

All told, investors were presented a real mess, and could hardly be faulted for wondering just when the bleeding, which had appeared to have been staunched, would finally be stopped. And therein lies the main force driving this market: Uncertainty.

As we've said before, it's not just the size of the problem that affects the markets; investors can handle the truth if they have the data they need to analyze the situation. In the present case, the size of the subprime market is fairly well-known. We can make some educated guesses about how many of these loans will default, and we can price securities accordingly. But what is, quite literally, freaking investors out, are the unknowns, which currently fall into two main



categories: First, where are all the bad loans and bonds held (and how strong are those holders), and secondly, what are the remedies for dealing with these loans and can they help keep the broader economy from slipping into recession?

As to the first question, it seems that the holders are pretty big players—large banks both here and abroad (including central banks), securities dealers, levered/hedge funds, and, to a much smaller extent, mutual funds and money managers. The fact that there are such massive pools of these instruments held by relatively few large players clearly hurts their liquidity, and makes an orderly and quiet disposition of these assets nearly impossible. Adding to the un-marketability of these bonds is the fact that the very dealers who might ordinarily position them for a trade are the same banks and dealers who are having to take writedowns on the lower quality, equity-like tranches of these deals that they underwrote. With billions of realized and unrealized losses, they are not interested in adding to their positions (poetic justice for Wall Street, having cooked these bonds up the first place).

As the chart on the front page makes clear, it's not just the lower-quality classes ("tranches," in industry parlance) that are being marked down. The graph shows, for subprime CDOs originated earlier this year (the "2007-01" vintage), even the tranches rated "AA" are trading at only 50 cents on the dollar. The prices on "BBB" rated bonds (which are still investment grade) have fallen a staggering 80 percent from par value (\$100), where they traded only a few months ago. The chart also shows that the most recent loan vintages have had the poorest performance, based on their perceived greater chance of default.

While we're on the subject, we might as well throw the ratings agencies under the bus, too. What the heck were they thinking? Did they believe that the US housing market was immune to a downturn? Why did they use models that were based on the risk-minimizing benefits of diversification in the junk bond market? By doing so, they made the epistemological leap of faith that a large pool of different subprime mortgages would show similar diversification benefits. Here's a newsflash, Moodys and S&P: homeowners are not corporations. An adjustable-rate subprime mortgage made in Iowa to a person who should be renting their residence will default under similar mortgage rate reset and home price declines as a loan made in Arizona or Massachusetts. There is no credit diversification for these loans like there might be with different companies operating in various industries with disparate customer bases. When rates turn up for highly-levered, low income borrowers and the collateral goes down, they will all send in their keys at the same time. Game over.

So, we can surmise that the writeoffs/liquidation/redistribution of these loans and the derivative securities backed by these loans will continue for the next few months, and will be a painful and unprofitable exercise for the holders. What remedies are likely to be taken to ease the process?

As we mentioned above, we shouldn't expect to see much help from the Federal Reserve, beyond what indirect benefits arise from a lowering of short-term rates. Likewise, for all the hand-wringing on Capitol Hill, we don't foresee any emergency legislation coming out of Congress; borrowers with poor credit history, rightly or wrongly, don't generate much sympathy, and there are no powerful lobbies to represent the interests of these low-income folks. On the other hand, Treasury Secretary Paulsen has been instrumental in encouraging the three largest US Banks to form an emergency fund for specialized investment vehicles (SIVs are the institutions that provide short-term funding for mortgage originators). This so-called "super SIV" was agreed to in principle by Citigroup, JPMorgan Chase, and Bank of America on November 11. The fund is due to be in place by year-end, and will be able to provide up to \$80 billion in funding.

We are getting anecdotal reports that the mortgage lenders themselves are beginning to offer renegotiated terms to impaired borrowers of certain mortgages. These adjustments are likely to be much more effective in keeping borrowers from walking away from their loans than any government-sponsored program, as they can be custom-tailored to the individual borrower. Lenders, even if they no longer hold the loans, have a vested interest in keeping the borrowers "in the game," as they retain the servicing fees associated with the loans as long as monthly payments are made.

Ultimately, this entire discussion gets down to the question of whether the problems in the US housing market are large enough and deep enough to send the US into an economic recession. While the risks appear higher today than they did even a month ago, we continue to believe that the underlying strength in the economy is sufficient to withstand a period of dislocation and illiquidity in this sector. Clearly, certain borrowers are impaired; there is no question that lending standards have been tightened; we are seeing increased delinquencies even among prime borrowers in the adjustable rate mortgage market, as they also face higher rate resets as their teaser rates roll off.

As a result, personal consumption is expected to rise at a slower rate than the 5%-6% we've become accustomed to over the past few years. Job growth will slow and savings rates will rise as consumers realize that they can no longer depend on their homes to provide an income buffer. But—and this is important—a strong industrial sector is helping to offset the slowdown in consumer spending (which represents some 70% of US GDP). Propped up by the weak US dollar, foreigners have stepped up their buying of US manufactured goods. In fact, we saw an almost one-for-one offset in third quarter GDP between residential investment (down 1.1%) and net exports (up 0.9%). We'll address the currency markets in a future *Investment Update*; the short version is that our weak dollar policy is helping to propel the economy, and this policy is not going away any time soon.

