

INVESTMENT UPDATE

The mortgage crisis has come full circle. After originating in thousands of local mortgage loan offices on the Main Streets of America, low quality loans blew up and took out Wall Street, and in so doing, crippled the financial system. The subsequent rationing of credit has put the US on the verge of the most severe recession in at least three decades. And now the effects have spread overseas, with the potential of launching a global economic depression. This is getting serious.

How we got here is well documented: A housing market wildly inflated by easy credit extended to borrowers who couldn't afford the payments (even under the terms of wondrous new "affordability products"), all made possible by another miracle of The New Financial Age—the structured mortgage securities market. While structured mortgage bonds have been around since the mid-1980s, what made these different was the poor quality of the underlying loans, built on inflated real estate values. The ratings agencies, working under the all-too-obviously faulty assumption that home prices couldn't go down, assigned "AAA" ratings to these packaged nightmares. On top of this sat the overly levered and overly optimistic titans of Wall Street (and their neighbors in London, Frankfurt and Greenwich, Connecticut).

The first pillar to fall was the one built on the shakiest ground, the class of bonds backed by adjustable-rate subprime loans. Putting lipstick on these pigs fooled enough yield-greedy, poorly capitalized banks, brokerages and hedge funds to ensure a few quarters of spectacular returns before the bottom dropped out. If only it had stopped with subprime loans, much of the current meltdown could have been avoided. Instead, losses only exposed the soft white underbelly of these institutions: They did not have the capital to withstand the hundreds of billions in writedowns in subprime and still continue on in a "business as usual" manner. What ensued next, beginning with Bear Stearns in March of this year and culminating in the mushroom cloud that marked the collapse of Lehman in September, could best be described as an old-fashioned run on the bank.

And that's when things get really messy. When the public cannot trust the institutions that custody their funds, they move their money to higher, safer ground. Lenders, knowing how poorly capitalized they are, refuse to lend to each other. Healthy industrial companies see their credit lines dry up and their cost of raising new capital skyrockets as investors shed risk. The negative feedback loop circles back on itself, eventually eroding consumer's confidence in their own prospects; they pull back on retail purchases, and

aggregate demand for goods and services slump. The final and most destructive step comes next, as companies see sales projections fall and are forced to lay off workers.

What's making this downturn worse than the average recession is that it has been brought about not by a stifling spike in inflation or an overleveraged industrial sector that has run its cyclical course, but due to a lack of confidence in the global financial and capital markets. In this way, it is reminiscent of the Big Bogey of recessions, the Great Depression. Determined not to repeat the policy mistakes that exacerbated the stock market collapse of 1929 (one of Fed Chairman Ben Bernanke's pet topics), US policy-makers slashed short term rates and began putting in place, as early as last December, an alphabet soup of fiscal stimulus programs including the PDCF, the TSLF, the TAF, and of course, the TARP. Of all of these, the TARP (troubled asset relief program) has been the biggest, and so far, perhaps the biggest disappointment. To some, even its name has become a sort of mocking joke, especially after Treasury Secretary Paulson announced on November 12th that none of the \$700 billion allocated to this program would actually be used to buy up troubled assets.

TARP money has already been pledged or placed with a number of banks (mostly big, but some small) in exchange for preferred stock and warrants on common stock. Because the money is earmarked for banks, there is a mad scramble for finance companies (including American Express and CIT) to convert themselves to banks. But it's not stopping there; insurance companies, municipalities, and even the US automakers are clamoring for TARP money. Desperate times call for desperate calls to your elected representative; Washington has been in an expansive mood lately, but it's an open question as to how much more aid money will be forthcoming. Our considered opinion is that lending Federal money to otherwise profitable lending institutions who have no other sources of funds but who can pay back those loans, with interest, within a reasonable period of time, is not a bad use of taxpayers' money. It's not so clear whether it's sound to lend money to, say, General Motors, a company that's been declining for the past 25 years, a company with a relatively high-cost work force (at least compared to their foreign rivals) and a management that grew complacent selling large, inefficient (but high-margin) SUVs.

Why the emphasis on the banks? Haven't they been as poorly run as the auto manufacturers? Why are we bailing out Citibank and not Circuit City?

The reason we must keep the banks solvent is that, without a



healthy lending and monetary system, we do not have a functioning economy. One of the first things that the former Soviet states learned after the fall of the Iron Curtain was that they needed to establish a banking system before they could hope to convert to capitalism. At its most primal, capitalism insists that weak companies fail and stronger competitors succeed to ensure the success of the entire system. But the US Government decided, rightly in our opinion, that letting the banking system slowly bleed to death would have dragged our economy into a true depression. We now know that simply letting Lehman's creditors twist in the wind proved to be disastrous—the S&P 500 dropped nearly 30% in

the month following Lehman's bankruptcy, as shell-shocked investors, seeking safety, bid up the prices of Treasury Bills to yield less than 10 basis points (0.10%). Conditions deteriorated so quickly that within two weeks after Lehman's failure, Congress was already debating the terms of TARP. If they had found a way to protect Lehman's creditors, the Government wouldn't have had to dig so deeply into their toolbox. Now, imagine three or five or ten more Lehman failures, and we begin to get a feel for the magnitude of how bad things could be.

And that's the critical point we're struggling to make: As difficult as conditions are in the credit markets—and make no mistake, they're abysmal—they would be much worse today without the aid that's already been put in place. The expansion of the Fed's operations alone is staggering. As the top chart shows, after hovering around the \$1 trillion mark for years, the Fed's various new liquidity programs have more than doubled the size of their balance sheet, to nearly \$2.5 trillion. The expansion also includes a massive buildup of bank reserves (included here in the "Other" category), as banks are choosing to park their excess reserve balances at the Fed (where they now earn interest) rather than lend them out. Unfortunately, the Fed can only encourage lending; they cannot force banks to lend. Judg-

ing by the recent improvements in the short-term money markets, the best we can say about the markets right now is, to use a medical analogy, while the hemorrhaging has stopped, the patient remains in intensive care.

Yes, the credit markets remain unhealthy (see the bottom chart, indicating the current record levels for average prices and yield spreads on investment grade corporates), and now that they have dragged down the overall economy, policy-makers' jobs are far tougher. Calls have already gone out for the President-Elect, still two months away from taking the oath of office, to reveal what his plans are. The heads of the G-20 countries just wrapped up an

important (but, so far, largely symbolic) meeting in Washington. There is certainly more aid coming, most likely in the form of infrastructure spending, both here and around the globe, as central banks are running out of options with respect to monetary stimulus. Government programs will be focused on keeping folks employed, as the US labor market is now deteriorating at a rapid pace, with unemployment at its highest level since 1994 and on a path to test the highs of the early 80s.

And, of course, there is pressure to do more to directly assist US home owners, especially "prime" borrowers who bought at the top of the market and now, with zero or negative equity in their homes, have a strong incentive to simply walk away from their mortgages. In many cases, it's in the servicer's best interest to renegotiate terms of these loans in order to keep the borrowers current, but if the loans have been securitized and re-sold as bonds, the servicer may not have the legal right to negotiate on behalf of the bond holders. It's a complicated situation in need of a solution, and with TARP funds not being used to buy up impaired assets, a dark cloud remains over the structured mortgage markets.

Meanwhile, there is massive new Treasury bond issuance coming, and deflationary pressures growing. Please pass the antacids.

