

Deconstructing the Credit Bubble (Part 2)

Last quarter, we examined the origins of the housing bubble and the resulting credit crisis. At the time, we pointed to the widening of the Treasury - Euro Dollar (TED) Spread¹ as evidence of increased credit risk. Our main concern was that banks would stop lending, both to each other and to their clients, as a result of increased uncertainty surrounding subprime related losses at major money center banks. The resulting “credit crunch” would subside only after all losses were made public and properly accounted for on bank balance sheets.

However, this line of reasoning missed one crucial, if subtle point – the TED Spread widened as a result of Treasury rates decreasing at a faster rate than LIBOR, not as a result of any sudden spike in the LIBOR rate. In fact, as you can see in Exhibit 1 (below), the LIBOR rate has stayed fairly stable (moving less than 10%) throughout the past six

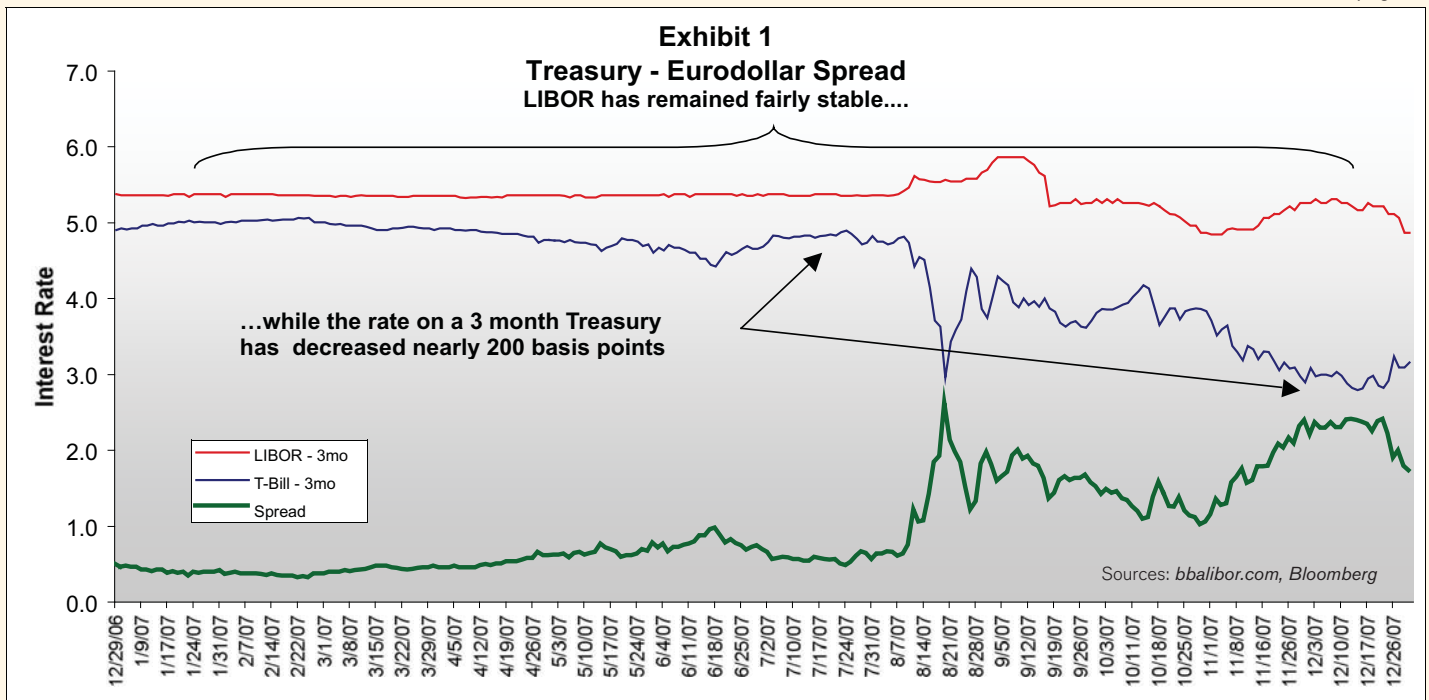
months - a period characterized by extreme volatility. This means the cost of borrowing for companies (using 3 month LIBOR as a proxy) remained relatively unchanged throughout much of the period, in spite of increased uncertainty in the credit markets. By contrast, the Treasury (3 month) and Fed Funds (overnight) rates declined sharply, driven primarily by aggressive Fed cuts. It was the sharp decrease in the effective Fed Funds rate, in particular, that helped facilitate an increase in interbank lending (Exhibit 2, next page). This is noteworthy, since it runs counter to a popularly held belief in the mainstream media that the current credit crisis is driven (or at least exacerbated) by the unwillingness of banks to lend to one another.

According to data from the Federal Reserve’s Statistical Release, not only are banks willing to lend to one another, they are also willing to lend to their clients, as evidenced by the increase in commercial

and real estate loans for both small and large, domestically chartered banks in the U.S.² This contrarian viewpoint, while supported by Fed data, does not conform to the prevailing conventional wisdom on Wall Street. Namely, that the uncertainty regarding the full extent of subprime related losses would lead to a credit crunch as banks would prefer to hoard cash to firm up their own balance sheets rather than lend to a counterparty with subprime exposure. In fact, the data tells us that money continues to flow through the system (i.e., banks are lending to each other and to their clients), and that recent Fed actions have indeed had an effect on keeping the banking system liquid and the financial system functioning – at least in retrospect.

The takeaway from this analysis comes with one significant caveat – there is a lag between the time loans are presented to loan committees and the

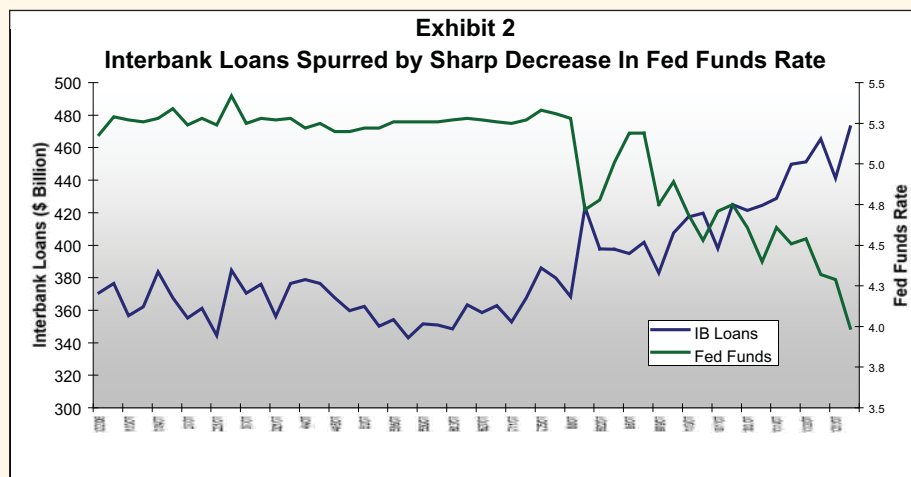
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¹ Note that the TED Spread is the difference between the rates on the US Treasury (3 month) and the Eurodollar (3 month LIBOR) and is indicative of perceived credit risk. As shown above, the TED Spread spiked from an average of 50 bps to 250 bps in late August and in December.

² According to bank balance sheet data for large, domestically chartered banks and small, domestically chartered banks in the U.S. (not seasonally adjusted) found in the Federal Reserve Statistical Release (www.federalreserve.gov/releases/h8/data.htm#fn6).

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Date gathered from bank balance sheet data for all commercial domestically chartered banks in the U.S. (not seasonally adjusted). Source: Federal Reserve Statistical Release

time they show up on bank balance sheets, which means that although loan amounts appear to be increasing (at least through the end of the year), it may not be entirely reflective of the availability of credit today.

This does not mean we have seen the last of the subprime related write downs, nor does it mean the markets will be immune from further multiple contractions if the constant drip of bad news continues unabated. In fact, banks are likely to take additional losses as their CDO/SIV structures are unwound and the last significant "vintage" of subprime ARM loans reset in 2008. While painful, the process will help clear up some of the uncertainty by

placing a more accurate range around the likely number of foreclosures, and therefore losses, to be incurred. Over the past year, banks have written off close to \$90 billion (see Exhibit 3), and while the estimates of final losses range from \$100 - \$800 billion, the more commonly accepted number is somewhere in the \$250-\$300 billion range. This means there may be more to come, at least over the near term.

As for our managed portfolios, we remain underweight in financials, as the probability of further write downs/negative news is high and will likely remain so for the next six months. That said, there is so much negativity priced into these stocks that any moderation in bad news or unexpected

good news (losses lower than anticipated) could potentially provide some upside surprises, especially among those stocks with no subprime exposure. Our study of Fed data reveals that the banking sector is much better capitalized and functional than is commonly accepted, and could therefore provide some interesting opportunities (on a selective basis) once the subprime fears and write downs subside and investors begin taking a closer look at the sector fundamentals. ■

Exhibit 3
Bank Write Downs
As of 12/31/07

Institution	Write Down (\$B)
Citigroup	14.5-17.5
UBS AG	13.7
Morgan Stanley	10.3
Merrill Lynch	8.4
Credit Agricole	4.8
Freddie Mac	3.6
HSBC	3.4
Bank of America	3.3
Deutsche Bank	3.1
Barclays Capital	2.7
RBS	2.6
Washington Mutual	2.4
Lehman Brothers	2.1
Bear Stearns	1.9
Credit Suisse	1.9
JP Morgan Chase	1.6
Goldman Sachs	1.5
Wells Fargo	1.4
LBBW	1.1
Wachovia	1.1
Swiss Re	1.1

Source: Reuters, Wall Street Journal

Economic & Market Outlook

We regularly review the thesis that it is in our clients' best interest to be invested in the public equity markets. We do this for our high net worth clients that task us to be stewards of their capital and use it as the starting point in determining our investment strategy. The volatility during the last six months has caused us to frequently revisit this thesis and given the current market uncertainty, we decided to use our outlook section to share this process.

We know that long-term equity market returns are tied to company earnings and that those in turn are tied to economic growth. We therefore start our investment process by deciding if the economy will drive favorable or unfavorable market returns given current data and potential risks. (Figure 1, next page.)

The following points summarize the most important factors that have contributed to

recent economic growth and need to remain intact for that growth to continue:

1. Globalization of world markets,
2. Productivity and efficiency of labor markets,
3. Accommodative central banks,
4. Healthy corporate balance sheets, and
5. Low inflation.

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