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Quarterly Investment Outlook

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The Treasury Refuels the Credit Markets to Steer Through Recession

We had planned to address and comment on the upcoming election in this issue, but in the last 90 days we've seen conditions arise in the capital markets that we believe could one day be viewed as the most serious threat to the Financial System since the Great Depression. The effects of the housing downturn have exceeded expectations, turning a credit crunch into a credit crisis that has spread virally through the securities markets to the rest of the world. The stock markets have been churning on speculation whether financial companies will be able to replace what may be $1 trillion in capital that has been vaporized by the downturn of the housing market. At the epicenter of the maelstrom are the Government Sponsored Entities, Fannie Mae and Freddie Mac whose balance sheets suffer from an overabundance of "pseudo-AAA- rated" paper used as collateral for the issuance of their debt instruments. The recovery of the economy and its markets is dependent on how successful they and other major banks are in rebuilding their capital structures and restoring the flow of credit to the economy. That could take time and require help from the Treasury and the taxpayers.

The US Financial System: Running Low on Fuel

Those who thought a still-expanding global economy would help us avert recession underestimated the extent to which problems in our capital markets would spread worldwide. To date, we have seen more than $500 billion in capital stripped from the balance sheets of banks and brokers by the decline in home prices. It's estimated the tally could reach into the trillions worldwide by the time housing stabilizes. That missing capital is the fuel that drives the growth engine of the US economy and right now, the fuel gauge is reading close to empty. As we said in our March Outlook, the US tipped over into recession sometime in Q1 of this year. **Recession, as defined by the National Bureau of Economic Research, is a significant *decline* in GDP accompanied by downturns in employment, wages, and industrial production.** The downturn in housing and subsequent impairment of the capital markets has created those conditions here and triggered a very tangible slowdown abroad. **The first, critical step toward recovery is seeing financial institutions recapitalize in order to restore the flow of credit and liquidity to our economy.** The devil is in the details. The specifics as to how they accomplish this will have longer term ramifications for the economy and its markets.

So, where can they go to raise needed capital? They can sell equity to existing shareholders and new investors or borrow capital in the credit markets. However, the condition of many banks' portfolios makes them unattractive to investors in both those markets. Selling assets to raise capital is a less palatable alternative. Doing so can impair future growth prospects and buyers are demanding deep discounts from book value. The remaining alternative is to borrow from the Fed or be taken over by the Treasury or FDIC. That's what happened to Fannie Mae and Freddie Mac this past weekend when the Treasury forced them into conservatorship. Despite a nice rally in the market the day following the announcement, we viewed it an indication that the systemic problems in the capital markets are more serious than many thought. This takeover was necessary to preserve the underpinnings of the residential mortgage market and a dramatic first step toward stabilizing the housing market. In effect, the Treasury has officially declared them "too big and important to fail". It will be interesting to see how the market greets the collapse of lesser entities.

In this case, Treasury Secretary Paulson was faced with making the better of two bad choices: Do nothing and risk a meltdown in the capital markets; or step in and spend public money to execute a crisis management plan as a bridge to a stable housing market in the future. Few can argue the critical importance of Fannie Mae and Freddie Mac but many are fearful this action has created a moral hazard that invites the assumption of undue risk by other financial institutions. Paulson has done much to allay those fears in structuring the deal. **This is not a bailout of the shareholders but rather an assumption of the liabilities on the balance sheet that will allow the entity to continue operations.** In essence, the common and preferred shareholders have been thrown under the bus and any future gains accruing to the GSEs will benefit the bondholders and taxpayers. Whether the GSEs should continue in their role as a public/private partnership is in question but for now they are critical to the process of building toward recovery.

A Market in Search of Recovery

The road through recession to economic recovery is a long and winding one and the GSE event was an important first turn in the right direction. **Unlike the prior recessions of the last thirty years, the consumer is squarely in the crosshairs of this one.** Consumers emerged relatively unscathed in the recession that followed the Tech Bubble Bust and 9/11. The Housing Bubble is another story. Its effects are widespread, extending from homeowners to lenders, to builders and suppliers. Rising unemployment, lower wages, and weakening retail sales indicate that the consumer will most certainly feel the pain this time around. Our analysis draws us to conclude that this downturn is likely to be more like the *atypical* recession we witnessed in the 1970s where both business *and* consumers reduced spending in response to high oil prices and inflation. Those factors are once again in play today but to a lesser extent and pale in comparison to the damage done by the downturn in housing and the collapse of the credit markets.

For many investors, this will be the first consumer-based recession they've experienced. With housing at the root of the problem one could argue that its effects might be more onerous and pervasive than recent recessions. **Given that, we're wondering how investor expectations will bear on the market's efficiency and have concerns that this stock market has yet to fully price in the effects of this downturn.** As a result, we have positioned our clients more defensively than at any time in our history. We're keenly focused on a number of key variables affecting consumption and credit flow as indicators of a change in sentiment and trend in the stock market. Recently, we've seen the speculative bubble in oil prices deflate on weaker demand due to both the recession here at home and the resulting slowdown abroad. This should offer some real relief to consumers and take inflation worries off the table. Secondly, the GSE takeover has to be viewed in a positive light. Restoring credit in the mortgage markets is critical to the re-pricing of homes to levels that will begin to shrink inventories.

The belief that some major financial companies will be unable to recapitalize hangs heavy over the market. We think it's likely that several major names will fall by the wayside before the end of the year and expect some interesting market openings on Mondays as these announcements are generally made over the weekend. It's always darkest before dawn. However, the stock market is a forward thinking, discounting machine and we must continuously gauge where we are in that process. When the market bottoms, we want to be over-weighted in financials, consumer/retail, tech and small cap, relative to the S&P. We are currently combing the ranks of those and other issues, looking for opportunities that will move us toward that position.

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