# Credit's Cheap, But It Ain't Easy

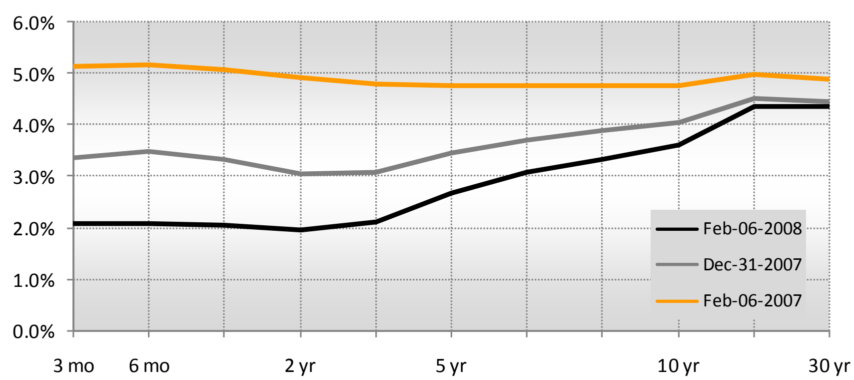
The near-simultaneous blows of the housing market collapse, the subprime borrowing meltdown, a severe tightening of credit standards, and huge mortgage-related write downs at the world's largest banks have led to a very pessimistic stock market. The consumer, which was already dealing with falling housing prices and reduced access to home equity credit lines, is now suffering a negative wealth effect from the declining stock market. On top of all this, a massive $7 billion loss caused by fraudulent trading activity at France's Société Générale only heightened investors' fears that there is an unlimited supply of shoes to drop. There has been nowhere to hide as European, Asian and U.S. equity markets have simultaneously melted down. A time like this really drives home the importance of Miracle Mile's "worst case scenario" analysis and the importance of diversification into non-correlated assets.

*What's the Issue?*

With so many worries on the minds of investors, it has become difficult to sort out what really matters. We believe that it can be summed up in a single word: credit. Above and beyond the myriad of other issues, we believe that the severity of this downturn, and the timing of a sustained recovery from it, hinges on investors' confidence that they will be able to access credit.

The U.S. has become a nation built on debt and leverage. Our government sets a poor example of fiscal prudence with ballooning deficits and unbridled spending. Credit cards and home equity lines have provided on-demand liquidity to consumers. Low interest rates, low inflation and **easy credit** have kept the party going well into the night. Now the next morning has arrived, and the hangover is brutal.

**US Treasury Yield Curves**

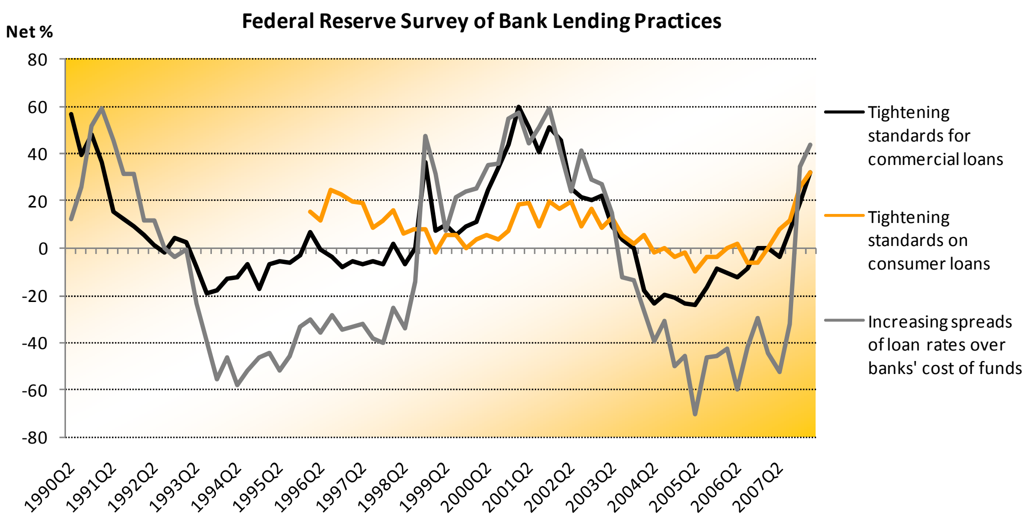



Source: U.S. Treasury Department

*Rates are Low, Credit ~~Is~~ (Should Be) Cheap*

Twelve months ago, interest rates were low by historical standards, and the yield curve was almost flat with yields hovering around 5% across the maturity spectrum (gold line, above). Since that time, the Federal Reserve has lowered the fed funds target rate by 225 basis points, driving yields down further from these already-low levels (black line, above). **Cheap credit** is not the real problem; instead, it is the lack of access to credit that is roiling the markets today.

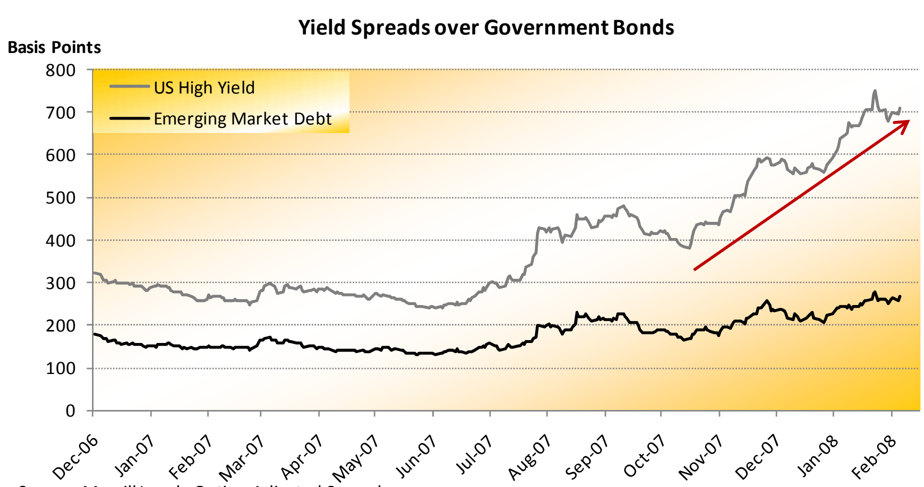
Despite the low interest rates, lending has dried up and the willingness to take on risk has diminished. Every quarter the Federal Reserve surveys a selection of banks to gauge their willingness to lend, and the latest results are not encouraging.




In the most recent survey, we saw that the net percentage of banks tightening their lending standards shot up for both consumer and commercial loans. Spreads of loan rates above the banks' cost of funds also rose dramatically, as the risk premium demanded to lend increased. Given the historically-low level of interest rates, we believe this risk premium is driven by fear and overly-negative sentiment, not a truly broad-based credit crisis.

*Where Do We Go from Here?*

Despite the bear market rally in late January, we do not believe that conditions are in place for a sustained recovery. Headlines regarding credit rating downgrades and shaky bond insurers continue to send waves of fear into the equity markets almost daily. Before a real recovery in equities can take hold, investors will need to regain confidence that most of the bad news is priced into the market. We cannot predict exactly when a recovery will happen, but we believe that a narrowing of credit spreads will be one of the first signs that risk aversion has subsided.



Source: Merrill Lynch, Option Adjusted Spread

For now, the price of risk is at a premium in most markets. Since the middle of 2007, the spread of U.S. high yield bonds over Treasurys has gone from 250 basis points to more than 700 basis points. That's a 4.5% yield increase in a matter of six months. One area of divergence from this trend is emerging market debt. Emerging debt spreads have only marginally increased, perhaps signaling a more constructive long-term scenario for companies in this region.

Another catalyst for an equity rally simply could be a lack of other options. With the Fed lowering rates, 3-month CDs are yielding right around 3%, not even enough to keep up with inflation at current levels. Treasurys are expensive due to extensive safe-haven buying, with the 10-year yield down to about 3.6%, and the two-year yielding less than 2%. In a global economy, capital is highly mobile and will seek out the best risk-reward tradeoff. Eventually investors will see past the negative headlines and realize that to earn a return which can keep up with inflation they will need to return to equities. When this happens, we believe that they will return first to the emerging markets, which have taken a more severe beating than the U.S. yet should maintain a healthy rate of economic growth driven by domestic demand.

*Is the Negativity Overdone?*

In the U.S., current market valuations make sense only if the most dire economic predictions are true. On the contrary, we believe that inflation will be the major concern a year from now as a result of the massive stimulus currently being injected into the economy. The federal funds target rate has been lowered by 2.25% in the last several months, and the federal government is finalizing a stimulus package to refund money back to the American consumer. Since monetary and fiscal stimulus act with a significant lag, the liquidity pumping into the economy today will be greasing the wheels 6 to 12 months from now. As long as we see an improvement in access to credit, we believe that the spring of 2008 could mark the bottom in equities.

February 7, 2008

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